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US Subpart F Legislative Proposals: A Comparative Perspective

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This article reviews recent US proposals to amend the US Controlled Foreign Corporation (CFC) rules, also known as Subpart F. It places the US debate in a comparative perspective by describing how the US proposals fit in with developments in other countries that have CFC rules.

1. Introduction: tax deferral and CFC legislation

Under the international tax regime[3], residents may be taxed on their worldwide income (the so called global jurisdiction model, adopted, for example, by U.S. or Italy) or only on the income sourced within the residence country (the so called source - or territorial - jurisdiction model, adopted, for example, by France). On the contrary, non-residents may only be taxed on the income sourced within the (non-residence) country or may be exempted.

Countries cannot tax foreigners on their worldwide income for both practical and theoretical reasons: on one side, foreigners cannot be audited on worldwide income (but only on source income), so that taxes cannot be collected; on the

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[3] The international tax regime is defined in REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME, (CAMBRIDGE UNIVERSITY PRESS: CAMBRIDGE, 2007). See also, for a comparative analysis, REUVEN S. AVI-YONAH, N. SARTORI, O. MARIAN, GLOBAL PERSPECTIVES ON INCOME TAXATION LAW, (OXFORD UNIVERSITY PRESS, 2011) at 149.

other side, there is a customary international law rule (related to jurisdiction to tax) preventing countries from taxing foreigners on worldwide income.

Therefore, resident taxpayers from global jurisdictions could generally avoid tax on foreign source income if the income is earned through a controlled foreign subsidiary, which is not a resident of their home jurisdiction. In this case, the tax can be deferred until the income is distributed as a dividend or the domestic taxpayer sells the foreign shares of the corporation[4]. This postponement of taxation is generally known as tax deferral and is a consequence of the fact that a foreign corporation is not taxable on foreign income. The consequence of tax deferral is a reduction of the domestic effective tax rate (due to the time value of money).

CFC legislation puts some limits on tax deferral[5]. Yet, the OECD has clarified that "CFC rules have been developed for a variety of purposes in the light of the overall international tax policies of member countries. In some cases, the policy focus is on tax avoidance transaction and in others represents a broader limitation on the deferral of tax on income realized thorough foreign subsidiaries"[6].

Therefore, many reasons have induced OECD countries to adopt CFC legislations (the need to fight tax havens, the need to preserve certain financial centers, the need to give a response to EU or OECD harmful tax competition projects, *etcetera*), but the need to prevent tax deferral remains the most important one (at

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[4] For an analysis of the concept of deferral, as the basic goal of CFC legislations, see REUVEN S. AVI-YONAH – DIANE M. RING - YARIV BRAUNER, U.S. INTERNATIONAL TAXATION. CASES AND MATERIALS, (FOUNDATION PRESS: 2005), at 226. See also BRIAN J. ARNOLD, THE TAXATION OF CONTROLLED FOREIGN CORPORATIONS: AN INTERNATIONAL COMPARISON, (CANADIAN TAX FOUNDATION: TORONTO, 1986), at 83.

[5] MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION, (FOUNDATION PRESS: NEW YORK, 2003), at 217, clarifies that "*because of the ease with which U.S. corporations can establish foreign subsidiaries and choose their country of residence, opportunities for deferral must be limited in order to preserve the U.S. tax base*".

[6] See OECD, HARMFUL TAX COMPETITION. AN EMERGING GLOBAL ISSUE (PARIS, 1998), paragraph 98.

least in the U.S.). According to CFC legislation, domestic shareholders are taxed on certain foreign income of controlled foreign corporations.

2. Historical analysis of CFC legislation: an example of convergence

The United States was the first to put some limits on tax deferral, by enacting first the “Accumulated Earnings Tax” (adopted in 1921), and then the "Foreign personal holding company rule” (adopted in 1937). Under the “Accumulated Earnings Tax”, earnings that are unreasonably accumulated inside a corporation are taxed at the top individual rate rather than at the corporate rate[7].
Although this regime was not originally implemented as an anti-deferral regime, it can also apply to the situation in which foreign-source income is accumulated inside a foreign corporation. It is worth noting that the burden of proof is on the U.S. tax authorities (I.R.S.) and for this reason there are very few cases where it applied (i.e. the I.R.S. was never able to show unreasonable accumulation of earnings).
Consequently, in 1937, U.S. also adopted the "Foreign personal holding company rule” (FPHC), stating that the income of foreign personal companies is deemed to be distributed to U.S. shareholders by way of dividends. According to this regime, when a foreign corporation is controlled by 5 or fewer individuals and it earns more than 60% of its earnings as passive income, then the individuals are taxed on a deemed dividend, regardless of the actual distribution. This legislation was not enough to stop the tax deferral phenomenon, because it applied only to individuals.

[7] To fully understand the rationale of this legislation it should be noted that in the U.S. the marginal individual tax rate has always been much higher than the marginal corporate tax rate. In the 20's the marginal individual tax rate was about 70%, while the marginal corporate tax rate about 10%. It reached its peak in 1944 when it was 94% (when for corporations the marginal tax rate was 40). Today, the marginal tax rates are both equal to 35%.

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Given the failure of these two previous rules in limiting tax deferral, the U.S., in 1962, under the Kennedy administration, was the first country to adopt CFC legislation[8], called Subpart F, which is still the most important U.S. anti-deferral regime. This was true back in 1962 and continues to be true today, even if, as will be explained, most CFC legislation (including the one adopted by the U.S.) need to be updated, given the big economic changes of the last decades.

However, the U.S. was aware of the customary international tax law rules mentioned above, according to which foreigners cannot be taxed on worldwide income. For this reason, the U.S. CFC legislation has been structured in a way that the U.S. does not tax foreign corporations directly, but, under certain conditions, it taxes domestic shareholders on certain foreign income realized by a controlled foreign corporation, that is deemed to be distributed to them by the way of dividends (deemed dividend approach). In other words, the U.S. taxes domestic shareholders on imaginary (deemed) dividends of controlled foreign corporations. This is what still happens in most of the CFC legislations adopted around the world.

The basic characteristics of U.S. CFC legislation are the following:

- it requires over 50% control to designate a foreign corporation as a "controlled foreign corporation" (CFC). In order to be counted, each shareholder must have at least a 10% share in the foreign corporation;
- it follows a transactional approach according to which the rules apply to foreign companies wherever they are located (so the CFC rules also apply to foreign companies that are not located in tax havens);
- the income earned by the CFC is treated as deemed dividend only if it can be classified as tainted income, which is passive income (that is, primarily, with certain exceptions, dividends, interest, and royalties), base company income (that is income arising from transactions between companies within the same group)

[8] Also known as "Subpart F" (Sections 951 to 960 of the I.R.C.) of part N, which is the international section of the Internal Revenue Code.

and 956 income (generally, loans of the subsidiary companies to the shareholders).

Because of the effects of globalization and the free movement of capital, many countries faced the same problem of tax deferral. The U.S. approach to taxing controlled foreign companies, as a way to limit tax deferral, was widely followed by many jurisdictions, including pure territorial jurisdictions: Germany (1972), Canada (1975), Japan (1978), France (1980), United Kingdom (1984), New Zealand (1988), Australia (1990), Sweden (1990), Norway (1992), Denmark (1995), Finland (1995), Indonesia (1995), Portugal (1995), Spain (1995), Hungary (1997), Mexico (1997), South Africa (1997), South Korea (1997), Argentina (1999), Brazil (2000), Italy (2000), Estonia (2000), Israel (2003), Turkey (2006), and China (2008).

In certain cases, CFC legislations have been also used as a way to fight tax havens and to force them to exchange information. This is particularly true in those countries following the jurisdictional approach, according to which a foreign corporation is considered a CFC for tax purposes to the extent it is resident (or located) in a tax haven. This is true, for example, for Japan, France, U.K., New Zealand, Sweden, Finland, Portugal, Italy, and Estonia.

The spread of CFC legislations in several countries (using a comparative terminology, the transplant or the circulation of the CFC model) concentrated mainly in the 90s and continued in the 2000s[9].

The international aspect of income taxation is an area where it is possible to find the highest convergence between national systems, because this is where tax systems interact directly with each other[10]. CFC legislation is not an exception.

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[9] For a comparative analysis see also B. ARNOLD, THE TAXATION OF CONTROLLED FOREIGN CORPORATIONS: AN INTERNATIONAL COMPARISON, (CTF ACEF: Toronto, 1986) and OCSE, CONTROLLED FOREIGN COMPANY LEGISLATION. STUDIES IN TAXATION OF FOREIGN SOURCE INCOME, (OCSE: Parigi, 1996).

[10] REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME (CAMBRIDGE UNIVERSITY PRESS 2007). The practical implication is that an international tax regime exists: countries are not free

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Globalization and the free movement of capital have contributed to the spread of the common international problem of tax deferral, so that many countries were induced to adopt CFC rules as anti-deferral regimes. The international need to fight tax havens also induced some countries to adopt this kind of legislation[11].

Overall, the CFC rules present a remarkable instance of convergence and even direct transplantation. Part of the pressure to converge stems from the fear that tax competition would lead to the establishment of parent corporations in other jurisdictions to avoid the CFC rules (this happened in the United States when public corporations set up new nominal parents in Bermuda, which led to the enactment of Code § 7874 to block such "inversion" transactions[12] and also in the UK where several companies moved to Ireland). However, despite tax competition, countries have not abandoned their CFC rules, which serve an important function in protecting the domestic tax base against shifting income overseas.

Despite the significant degree of convergence in CFC legislations, on a more detailed level, significant differences persist even for countries that have adopted CFC rules (and most countries do not have them yet).

As a result of the wide evolution of the CFC rules, the distinction between global and territorial jurisdictions has lost much of its importance.

On one hand, territorial jurisdictions seek to tax passive income earned by their residents from foreign sources through the operation of the CFC rules, and many have endorsed worldwide taxation of individuals. On the other hand, global jurisdictions tend to allow deferral for active income earned by their residents

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to adopt any international tax rules they please but rather operate in the context of the regime, which changes in the same ways that international law changes over time.

[11] See OECD, HARMFUL TAX COMPETITION. AN EMERGING GLOBAL ISSUE (PARIS, 1998).

[12] See R. Avi-Yonah, *For Haven's Sake: Reflection on Inversion Transactions*, 95 TAX NOTES 1793, 2002; R. Avi-Yonah, *Law Professor Testimony on Corporate Inversions*, 2002 TNT 201–20, 2002; N. Sartori, *Tax Dynamics of (U.S.) Corporate Expatriations*, in 10 GLOBAL JURIST (2010), Iss. 3 (Topics), Article 3

through CFCs, and the recent trend has been to go even further and exempt dividends distributed by CFCs to their parents. This was always the rule in territorial jurisdictions (the so-called “participation exemption”), but it has been adopted by global jurisdictions such as the United Kingdom and Japan and is being considered in the U.S.

From a comparative perspective, four major structural variables serve to distinguish between CFC regimes: the level of ownership of a foreign corporation required to designate it as a CFC, whether the foreign tax system is relevant to the operation of the CFC rules, the type of income or activities of the CFC subject to the rule and the approach adopted in taxing the CFC.

3. The level of ownership of a foreign corporation required to designate it a CFC

CFC legislations apply when domestic shareholders have a “substantial influence” on the foreign corporation.

However, each country has a different concept of “substantial influence”. In most cases, “substantial influence” is defined as control, because of the assumption that only controlling shareholders can really influence the foreign company distribution policy.

Generally speaking, most countries have one or two tests that must be met in order to qualify a foreign entity as a CFC: a single ownership test (each domestic shareholder must hold more than a certain percentage or interest of the foreign corporation), and a global domestic ownership test (domestic shareholders, altogether considered, must hold more than a certain percentage or interest of the foreign corporation). In this latter case, some countries consider every domestic shareholder in order to quantify the global domestic ownership percentage; others require a minimum ownership requirement test (i.e. each domestic shareholder must hold more than a certain percentage in order to be counted in the global percentage).

The tests can be structured in a formal or in a substantial way.

As it will be exemplified, formal tests are very simple (so that compliance and administrative costs stay low), but easy to manipulate. The more formal are the tests and the higher the percentages of ownership, the easier it is for domestic shareholders to escape the application of CFC rules. For this reason, the OECD suggested the adoption of "*detailed indirect and constructive ownership tests*"[13].

In order to avoid manipulation, some countries (as, for example, Australia, Italy, Israel, and New Zealand) have more substantial tests (like *de facto* control tests) that make it harder for domestic shareholders to avoid CFC legislations (at the cost of higher compliance and administrative costs).

A subsidiary issue is the time of the year the ownership tests should be met: most countries check the status of the foreign company at the end of the year (this solution is very simple, but easy to manipulate); in other countries a foreign company may be considered a CFC at any time in the year (this solution is harder to manipulate, but quite complex to implement).

The **U.S.** rule is very formal on this regard. In fact, a foreign corporation is a CFC if the U.S. shareholders[14] hold, by vote or value, over 50 percent of the foreign corporation[15]. In order to be counted, each domestic shareholder must individually own, by vote, at least 10 percent (minimum ownership requirement). In other

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[13] OECD, CONTROLLED FOREIGN COMPANY LEGISLATION. STUDIES OF TAXATION OF FOREIGN SOURCE INCOME, (PARIS, 1996). See, also, B.J. ARNOLD, THE TAXATION OF CONTROLLED FOREIGN CORPORATIONS: AN INTERNATIONAL COMPARISON, (CANADIAN TAX FOUNDATION 1986), who pointed out that "*Constractive ownership rules are necessary to prevent the avoidance of the control test through the ownership of shares of related or non-arm's-lenght parties*" (at 415).

[14] Section 957(c) refers to § 7701(a)(30) for the definition of the U.S. person, and that section, in turn, defines U.S. person as including: (A) a citizen or resident of the U.S., (B) a domestic partnership, (C) a domestic corporation, etc.

[15] I.R.C. § 957(a) states that a CFC is "*any foreign corporation if more than 50% of (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation, is owned […] by United States shareholders on any day during the taxable year of such foreign corporation.*".

words, the U.S. CFC legislation, in order to be applicable, requires a global ownership test together with a minimum ownership requirement test.

Being very formal, the U.S. rule are very simple, but easy to be manipulated by U.S. shareholders[16]. For example, if eleven U.S. shareholders own as a group 100 percent of the stock of a foreign corporation, but each of them owns about 9 percent, CFC legislation is not applicable. Likewise, if two U.S. shareholders own 50 percent each of a foreign corporation, CFC legislation is again not applicable.

It is worth noting that attribution rules might apply if U.S. individual shareholders are part of the same family or if U.S. entity shareholders are part of the same group.

France used to require a single ownership test, according to which CFC rules were applicable to French persons owning 10 percent or more of the shares of the foreign corporation. This rule was radically changed due to competitive pressure in 2006[17].

Since 2006, France adopts a hybrid solution: a foreign entity[18] is a CFC if it is owned, directly or indirectly, for more than 50 percent by a single French person[19]; a foreign entity is also a CFC, if it is owned for 5 percent or more by a French company if the domestic shareholders[20] (globally considered), directly or indirectly, hold over 50 percent of the capital, voting rights or financial rights of

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[16] See REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME (CAMBRIDGE UNIVERSITY PRESS 2007), at 132 – 133.

[17] Law December 31st 2004, n. 1484, applicable since January 1st, 2006. This law amended Art. 209B of the French General Tax Code (*Code Gènèral des impôts, CGI)*. The amendments were also driven by the need to make CFC legislation compatible with tax treaties and EC law.

[18] Under French CFC rules, also foreign permanent establishments are captured by the rule. This is a consequence of the territoriality principle adopted in French.

[19] See B. Gouthière, *Overview of the French CFC Legislation*, European Taxation, 2008, vol. 48, n. 2, at 50.

[20] Art. 209 B (CFC legislation) of the CGI only applies to French companies. However, art. 123-bis was introduced in 1999 with regards to individual French shareholders, providing a similar legislation.

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the foreign corporation. This latter rule is different from the U.S. one: in fact, under U.S. rules minor shareholders (below 10%) are not counted for determining the global ownership percentage[21], while under French rules minor shareholders are counted, even though the CFC rules are applicable only to shareholders owning 5 percent or more of the CFC in France (and owning 10 percent or more in the U.S.).

Therefore, even after the 2006 law changes, the French CFC rules remain stricter than the U.S. ones.

Under **Canadian** law, a foreign company is a CFC if more than 50 percent of capital or voting shares are held, directly or indirectly, by 5 or fewer Canadian residents or a related group[22].

Australia and **New Zealand** have similar rules.

Differently, other countries adopt just one of the tests (either the general domestic control test, like Germany, or the single control test, like Italy), instead of both, making the CFC rules more difficult to be avoided. The percentage threshold is generally considered 50 percent (which means control).

Here are some examples.

Italy has only an individual control test[23]. Only the interest of the single (individual or corporate) shareholder counts. The global ownership percentage held by all Italian shareholders does not count. "Control" is defined by articles 167 and 168 of T.u.i.r.[24] with reference to art. 2359 of the Civil Code: a foreign entity is CFC if (*i*) a domestic person holds, directly or indirectly, the majority of the votes at the shareholders' meeting; (*ii*) a domestic person holds, directly or

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[21] See, also, Staff of the Joint Committee on Taxation, *Techical Explanation of the Tax Simplification Act of 1993*, in FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 226, (M. J. Graetz ed. 2003).

[22] There i salso a 1% minimum ownership requirement.

[23] For an analysis of the Italian CFC legislation see C. GARBARINO, MANUALE DI TASSAZIONE INTERNATIONALE, (KLUWER: MILANO, 2008) at 1631.

[24] Presidential Law Decree n. 917/1986.

indirectly, sufficient votes to exert a decisive influence in the shareholders' meeting; or (*iii*) the entity is under the relevant influence of a domestic person due to a special contractual relationship. Moreover, the CFC legislation is applicable to each Italian shareholder who holds 20 percent or more of the CFC stock.

Under the **Spanish** CFC regime[25] (also known as "international fiscal transparency" regime) a foreign company is a CFC if a Spanish person (directly or together with any associates) owns 50 percent or more of the capital, equity, results or voting rights.

The individual ownership control test is also adopted by **Lithuania** (50 percent)[26], **Mexico** (*de facto* control of the distribution policy), **Turkey** (50 percent), China (50 percent) and **Denmark** (50 percent).

The individual ownership test is applied with lower percentages by **Sweden** (25 percent), **Hungary** (10 percent), **Portugal** (25 percent or, under certain conditions, 10 percent[27]), and **South Korea** (20 percent).

On the contrary, **Germany**[28] has only a global domestic control test: a foreign company is a CFC if (current or former) German shareholders hold (directly or indirectly) more than 50 percent. Only if the CFC's shares are listed in a

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[25] IBFD Tax Research Platform, Corporate Taxation: Spain. See also P. Amat – P. Monasterio, *Spain: Controlled Foreign Corporation Legislation*, BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, 1995, vol. 49, n. 6, at 289.

[26] A foreign company is defined as a CFC if a domestic person:

- directly or indirectly holds more than 50% of shares or rights (options) to dividends; or

- together with related parties, holds more than 50% of shares or rights (options) to dividends, and the controlling company does not hold less than 10%.

See J Beratonis, *National Report Lithuania*, in CFC LEGISLATION: DOMESTIC PROVISIONS, TAX TREATEIS AND EC LAW, (M. Lang ed. 2004).

[27] The 10 percent threshold is applicable if more than 50 percent of the foreign corporation capital is owned (directly or indirectly) by Portuguese residents.

[28] See H. Mueller, *General features of German CFC Rules*, conference paper (International Tax and Competitiveness, Washington D.C., 2011).

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recognized trading market, each shareholder, in order to be subject to the CFC rules, must hold 1 percent or more of the foreign corporation stock.

Similar rules apply in **Norway**[29] (where a foreign corporation is a CFC if it is owned or controlled, directly or indirectly, for at least 50% by resident taxpayers), in **Indonesia**, in **Israel** (where there is also a *de facto* control test, according to which a foreign entity is CFC if a resident has the right to change the CFC substantial managerial decisions), and in **Finland** (a foreign corporation is a CFC if it is controlled[30] by Finnish residents and if the domestic shareholder holds, directly or indirectly, at least 25% of the capital or the yield of the assets of the entity)[31].

Similarly, **Japanese** CFC rules define a foreign company as a CFC (or *tokutei-gaikoku-kogaisha-to* – SFS) when residents of Japan (individuals or entities) together with related foreigners hold, directly or indirectly, the majority of outstanding voting shares of the foreign corporation. Each shareholder is counted (i.e. there is no minimum ownership requirement) for control purposes. For simplicity reasons, income of the CFC is deemed to be distributed only to Japanese shareholders holding 10 percent or more of the voting shares (but this is not a minimum ownership requirement test)[32].

A similar rule applies in **South Africa** and **Brasil**.

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[29] See S. Sollund, *Norway – Taxation of Norwegian-controlled Companies Residente in Low tax Countries*, EUROPEAN TAXATION, 1992, vol. 32, n. 10, at 364.

[30] The control test is met if one or more residents jointly own, directly or indirectly, at least 50% of the capital, the voting power, or the yield of the assets, of the foreign entity.

[31] See M. HELMINEN, FINISH INTERNTIONAL TAXATION, (Helsinki: 2002).

[32] See T. Fujitani – Y. Nishikori, *Japanese CFC Rules*, conferente paper, (International Tax and Competitiveness, Washington D.C., 2011).

Under **U.K.** law, a foreign company is CFC if U.K. shareholders have an interest of more than 50% in that company[33]. The legislation applies if the U.K. shareholder has an interest of at least 25% in the foreign company.

Finally, **Argentina** CFC is the only one applicable to all domestic shareholders regardless of the participation threshold. The Argentinian rules are thus the strictest on this regard.

4. The relevance of the foreign tax system to the operation of the CFC rules.

Regarding the relevance of the foreign tax system, CFC legislations can be based on two different approaches: global or jurisdictional approach.

Some countries (for example, **United States**, **Canada**, **Indonesia**, **New Zealand**, **Israel**, and **South Africa**) apply their CFC rules to all CFCs wherever they are resident (or located) and regardless of the foreign tax rates. This first approach is defined as global approach. In its pure version, domestic shareholders are taxed only certain types of income (so called "tainted income"). This is why this approach is also known as transactional approach.

Other countries (for example, **Japan**, **Italy**, **United Kingdom**, **Germany**, **France**, **Australia**, **Denmark**, **Portugal**, **Spain**, **Sweden**, **Hungary**, **Argentina**, **Turkey**, and **China**) apply CFC rules only to foreign companies resident in low-tax jurisdictions. This second approach is defined as jurisdictional (or entity) approach, because it focuses on the foreign tax jurisdictions. In its pure version, all types of income realized by CFCs are taxable. However, as we will see, many countries adopting the jurisdictional approach also focus on the types of income earned by the CFC.

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[33] There is a deem control where there are two persons who control the company together, provided that the UK resident controls at least 40% of the company and the other controls at least 40% but not more than 55%.

Brazil adopts a hybrid solution that is worth mentioning separately: Brazilian CFC rules tax shareholders in all CFCs (wherever located) on all of the CFC's income without regard to either type of income or the foreign tax regime. This policy has recently been under challenge by the Supreme Court, which finally declared it constitutional[34].

The definitions of "low tax jurisdictions" and "tainted income" are the two major points of comparison of CFC rules.

In this paragraph, we will deal with the definition of "low tax jurisdictions", while the next paragraph will be dedicated to the definition of "tainted income".

Under the jurisdictional approach, there are many ways to define a low-tax jurisdiction. The basic guideline is that the territorial requirement has to be structured in a both substantial and simple way, in order to prevent the avoidance of the CFC rules[35] or an unjustified complexity. The correct trade-off between substantiality and simplicity is thus fundamental in defining the territorial requirement of CFCs.

For example, the **French** rule, until 2004 used to be very substantial, but not simple. Foreign entities were qualified CFCs if the local taxes paid were substantially less significant in amount than the taxes in France. For simplicity

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[34] The decision was taken on August 26th, 2011.

[35] Let's consider two examples taken from B. ARNOLD, THE TAXATION OF CONTROLLED FOREIGN CORPORATIONS: AN INTERNATIONAL COMPARISON, (CTF ACEF: TORONTO, 1986):- "*Under the French, German, and Japanese lists, the United Kingdom is not designated as a tax haven country; and, under the U.K. tax system, a company incorporated in the United Kingdom is not subject to tax as a U.K. resident company if its central management and control are located elsewhere. Therefore, a U.K. non resident company that is resident in a tax haven may be used to avoid the anti-tax-haven measures of France, Germany, and Japan. This result can be prevented if the U.K. nonresident company is considered to be resident where its place of management is located or if, in the case of the French and German lists, the presumption established by the lists that the United Kingdom is not a tax haven is rebutted by the tax authorities*" (at 435);- "*Under the French tax system, business income earned by a French corporation through a foreign permanent establishment is exempt from French corporation tax. Therefore, if a controlled foreign corporation established in France carries on business through a branch operation in a tax haven, and France is not a designated jurisdiction under the anti-tax-haven measures of a country, those measures will not apply to the French corporation even though it is used as cloak for tax haven operation*" (at 435-436).

reasons, the law was changed as a result of the Finance Law for 2005[36], by providing that a foreign entity is a CFC if the foreign taxes it has to pay on its income or profits are less than 50 percent of the tax it would have had to pay under French rules. The new rule is more formal and simpler[37] than the previous one.

Let's see some ways to define low tax jurisdictions.

Some countries use a foreign tax rate that is a specified percentage of the domestic rate. The comparison can be based on the nominal tax rate, the effective tax rate and or simply the effective tax burden.

A nominal tax rate is very easy to adopt (so that administrative and compliance costs would be very low), but not accurate in identifying low tax areas[38]. **Portugal**, for example, includes a list of countries in a "black list" but also defines the term "low-tax jurisdiction" as any country in which the nominal corporate tax rate is equal or less than 60% of the applicable general Portugese rates.

An effective tax rate is a much more accurate way to identify low tax jurisdictions, but it is not easy to agree on the way it is determined. In **South Korea**, for example, a low-tax jurisdiction is a foreign country with an average effective tax rate of 15% or less on taxable income for the past 3 years.

In **Norway**, a "low-tax country" is a foreign country with a general income tax rate on corporate profits which is less than two thirds of the Norwegian rate (that would be applicable if the company were resident in Norway).

Under **Hungarian** law, a foreign entity is a CFC if it has a local effective corporate income tax (or equivalent) burden which is less than 10 percent.

In **Finland**, a foreign entity is a CFC if its local effective tax corporate tax rate is lower than 15.6 percent.

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[36] The Finance Law for 2005 rewrote Art. 209B and 238A of the CGI.

[37] Regulations provide guidelines on how to make the comparison.

[38] This is because nominal tax rates do not always reflect the effective amount of taxes levied.

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A comparison of the actual local taxes paid by the CFC with the taxes the CFC would have had paid under domestic law (or with a certain percentage of net income) is the most accurate method, although compliance costs might be quite high (considering that CFCs have to determine their tax burden under two different jurisdictions).

As seen, this is the rule in **France** today. This is also the rule in **U.K.**, where a foreign company is a CFC if the effective taxation of the foreign company in the local jurisdiction is at least 25% lower than what it would have been had the company been subject to U.K. corporate tax.

In **Spain**, in order to qualify as CFCs foreign entities must be located in countries where the local corporate income tax paid in connection with the "tainted" income is less than 75 percent of what it would have been paid under Spanish corporate income tax rules.

Under **German** law, as in France, there is no list of tax havens for CFC purposes: a foreign company is a CFC if the effective local tax burden (on passive income determined under German law) is less than 25 percent.

Similarly, **Japanese** law qualifies a foreign entity as a CFC if its effective corporate tax rate is 20 percent or less.

The percentage is 14.5 in **Sweden**.

Under **Turkish** law, if the tax burden on the foreign entity's commercial balance sheet profits is less than 10%, then it is a CFC.

Other countries identify low tax jurisdictions in a list (legislative or administrative list), either of countries subject to the CFC rules (black list – adopted, for example, by **Mexico** and **Norway**) or of countries exempt from the rules (white list – adopted, for example, by **Australia**, **New Zealand**, **Italy**[39], **Lithuania** and **Sweden**).

The list can be the only method adopted or can be added to one of the other methods above mentioned (like in Sweden).

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[39] Currently, Italy adopts a black list, but after the recent law changes, Italy should soon adopt a white list.

Apparently, the global approach is much stricter than the jurisdictional approach because it does not identify target territories. It would seem that multinationals based in countries where a global approach has been adopted (like the U.S.) could claim that they have difficulties in competing with those multinationals based in countries where a jurisdictional approach has been adopted (like Italy). This argument is partially wrong.

In fact, the legislative details and mechanisms make the global and jurisdictional approaches very similar to each other. By analyzing the tax details and mechanisms of CFC rules, the result is that both global and jurisdictional approaches grant deferral with regards to high tax income (which is typically active income because it is less mobile) while they avoid deferral with regards to low tax income (which is typically passive income, because it is very movable[40]).

First, CFC legislations based on the transactional approach generally kick out of the rule high tax countries. For example, under Subpart F (U.S. CFC legislation), if the tax rate of the country where the CFC is located is 90 percent or more of the U.S. corporate tax rate, the CFC legislation is not applicable[41]. Also in South Africa, there is a "high-tax exemption": CFC rules are not applicable if foreign taxes payable by the CFC is equal to at least 75 percent of the amount the CFC would have paid, were it resident in South Africa.

Second, foreign tax credit is applicable to CFC income: the tax credit is equal to the taxes the CFC has to pay to local government[42]. Even if the foreign tax credit has the main goal of avoiding international double taxation, it also makes the transactional approach very similar to the jurisdictional one: the CFC income is (partially) taxable in the hands of domestic shareholders only if the foreign

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[40] On the difference between active and passive income in international taxation see R.S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEXAS L. REV. 1301 (1996).

[41] Note that the current U.S. tax rate is 35 percent: this means that any foreign rate over 31.5 percent qualifies for the high-tax exemption.

[42] Under the transactional approach, only taxes paid on tainted income are creditable.

jurisdiction has a lower effective tax rate than the domestic one (as it happens under the jurisdictional approach).

In conclusion, this distinction between global and jurisdictional approach is somehow superficial: the tax mechanisms are different but the results are quite similar. A sort of convergence between the two different approaches is thus observable in practice.

It could be argued that the global approach has higher administrative and compliance costs because of the need to regulate and apply the tax credit mechanisms. This is not true, because the foreign tax credit (or other equivalent mechanism in order to avoid international double taxation) is adopted and regulated by legislations based on the jurisdictional approach as well.

5. The type of income or activities of the CFC subject to the rule

Regarding the types of income and activities subject to the CFC rule, some countries adopt a tainted income approach (also known as transactional approach), others the total income approach (also know as jurisdictional or entity approach).

Under the first approach (adopted, first, by the United States, in 1962), only the tainted income of the CFC is taxable to its shareholders.

Under the second approach (adopted, first, by Japan in 1978[43]), either all or none of the foreign entity income is taxable. If the foreign entity is located in a low tax jurisdiction (this is why this approach is defined as jurisdictional or entity approach), its income is fully taxable in the hands of domestic shareholders. If the

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[43] T. Fujitani – Y. Nishikori, *Japanese CFC Rules*, conference paper, (International Tax and Competitiveness, Washington D.C., 2011), at 1, observe that "*The reason why Japan did not follow the "tainted income" approach, adopted by U.S. Subpart F, was that the tax authority expected administrative difficulties in implementing such approach. The authority also thought that the income/transaction-based approach would be too burdensome for Japanese taxpayers. In addition, the jurisdictional approach was believed to be consistent with the tax policy of combating the tax-oriented use of tax havens for activities that have no business connection with that jurisdiction*".

foreign entity is not located in a low tax jurisdiction, CFC rules are not applicable (i.e. foreign entity income is not taxable).

Under the transactional approach, the big issue is the definition of CFC income (i.e. tainted income).

The most important category of tainted income, common to most countries (namely, U.S., Argentina, Australia, Canada, Denmark, Germany, Israel, New Zealand) is passive income (dividends, interest, royalties, grants and capital gains). This is because passive income is very mobile and thus it is generally subject to lower tax rates, making tax deferral very attractive.

Some exemptions are applicable. For example, in the U.S., under Subpart F, neither rents and royalties derived from active business[44], nor dividends, interests and royalties derived from another CFC are considered tainted income. Moreover, there is a general exception for banking, finance and insurance businesses[45].

The other important category of passive income is base company income, which is active income with no real connection to the jurisdiction in which the CFC is located. Technically, this is defined as income from sale and services rendered between affiliated parties (located in different countries) when there is no significant modification of the product by the base company (U.S. definition). In the U.S., this is one of the most controversial provision of Subpart F, since U.S. multinationals believe that this specific rule make them less able to compete with other multinationals. For this reason, U.S. taxpayers try to avoid this provision, by qualifying base company income in partnership income (which is quite easy after "check the box" regulations).

The German approach in qualifying tainted income is quite different. Tainted income is defined as net income (determined under German rules) of the CFC that is subject to an effective tax burden of less than 25 percent, unless the income is

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[44] This is the case, for example, of the high-tech business income.

[45] This exception was enacted in 1996.

"good income" and the business is qualified as "good activity"[46]. Passive income and base company income are thus defined by exclusion.

While the first versions of CFC legislations used to adopt pure versions of the two above-mentioned approaches, nowadays hybrid solutions are more common.

Germany is an example, since it adopts a jurisdictional approach in defining low tax jurisdictions but also a transactional approach in qualifying tainted income.

Also the Italian CFC Legislation, historically based on jurisdictional approach, recently adopted (with the Decree No. 78 of 2009 converted into Law No 102 of 2009 - the CD. Decree anti-crisis) some elements of the "transactional approach" and it introduced the concept of passive income and base company income[47]. The amendment enlarged the territorial scope of the CFC rules, stating that, in addition to white-listed countries (now, still black listed), the CFC rules also apply if the effective tax rate of taxation of the CFC is 50 percent or lower of taxed it would have had to pay under Italian law and if more than 50 percent of the CFC profits are passive income or base company income (defined as income from infra-group services). The change was driven by the consideration that passive income can be subject to low tax also if it is realized in high tax jurisdictions.

In Norway, the passive nature of income is relevant only if the CFC is resident in a treaty country.

In Spain, the CFC rules apply only with regards to passive income, which is defined as income from immovable property or rights (not used in business activities), from financial assets, from loans between related entities, and capital gains from the disposal of immovable property or assets.

Under U.K. law all CFC income is computed other than capital gains.

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[46] Good activities, with many exceptions, are the following: agriculture and forestry; manufacturing, processing, treating or assembling tangible property, generating energy, exploiting natural resources; operating a banking or insurance business in a businesslike manner; trading; rendering services; letting and leasing. See H. Mueller, *General features of German CFC Rules*, conference paper (International Tax and Competitiveness, Washington D.C., 2011).

[47] See S. Garufi, Amendments to the Italian Controlled Foreign Company Rules: A Witch-Hunt?, 49 European Taxation 10, (2009).

Some countries are still applying strictly their CFC rules to all types of income of the CFC (see, for example, Brazil, New Zealand or Sweden).
Moreover, it should be considered that CFC legislations based on jurisdictional approach provide an exception for local active businesses (for example, this is the rule in Italy, Germany and United Kingdom). This means that if the local business is real, CFC rules do not apply even if the business is located in a low tax jurisdiction.
In conclusion, also by analyzing the difference between the jurisdictional and transactional approaches in terms of types of CFC income, the distinction seems superficial: as already seen, it is observable a sort of convergence between the two different approaches: both jurisdictional and transactional approach end up for focusing on low tax jurisdiction and movable income.

6. The approach adopted in taxing the CFC

Finally, countries vary in the way the CFC income is taxable.
The United States uses a deemed dividend approach, but most countries simply tax domestic shareholders (treating the CFC as a pass-through entity).
Countries generally did not directly tax domestic shareholders on the CFC income because that might violate treaty obligations on taxing a foreign corporation that does not have a permanent establishment in the taxing country.
The piercing the veil approach is much simpler than the deemed dividend approach (especially when there is a chain of CFCs and the deemed dividends have to jump up the chain). Considering that customary international tax law has changed in the last decades, so that taxing the shareholders on CFC income is permissible, the U.S. may consider changing its approach.

7. Current U.S. Proposals

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As noted above, in recent years most OECD countries that have traditionally been global taxing jurisdictions, such as the U.K. and Japan, have adopted territoriality, i.e., they do not tax dividends received from CFCs. The same reform is under active consideration in the U.S., and the President's National Commission on Fiscal Responsibility and Reform has recommended adopting a territorial approach.[48] On the other hand, Senators Wyden (D-OR) and Coats (R-IN) have introduced a tax reform proposal that would repeal deferral altogether.[49]

One of the major concerns if the U.S. adopts territoriality would be that allowing dividends to be repatriated tax free would increase the incentive to shift profits to CFCs through transfer pricing and other techniques. The Obama Administration has introduced several proposals to limit the scope of such income shifting. The Administration's Fiscal 2012 budget would expand Subpart F to impose current U.S. tax on "excess income" associated with the transfer of intangible assets to low-taxed affiliates offshore.[50] While the details are unclear, the proposal would impose current tax on "excess income" from the transfer of intangibles to CFCs if the income is subject to an undefined low foreign tax rate.

Another Administration proposal that would have an impact of deferral and that could be enacted in conjunction with adopting territoriality is imposing limitations on the current deductibility of interest expense related to deferred income. The proposal would defer the deduction of interest expense that is properly allocated and apportioned to a taxpayer's foreign source income that is not currently subject to U.S. tax. If territoriality is adopted this rule could be applied to repatriated exempt dividends as well.[51] Finally, the Administration has proposed limiting

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[48] National Commission on Fiscal Responsibility and Reform, *The Moment of Truth* (Dec. 2010), at 33.

[49] S. 727, The Bipartisan Tax Fairness and Simplification Act of 2011.

[50] U.S. Department of the Treasury, General Explanation of the Administration's Fiscal Year 2012 Revenue Proposals (Feb. 2011)(the "Greenbook"), at 32.

[51] Greenbook, at 40-41.

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deemed paid foreign tax credits based on the amount of consolidated earnings and profits of CFCs that is repatriated.[52] The effect of these proposals is intended to induce repatriations by allowing more deductions and credits to income that has been repatriated.

At the time of writing it is far from clear whether any of these proposals can be enacted. The Ways and Means Committee is reportedly about to introduce territoriality without any of these limitations, but it seems unlikely that major tax reform can pass before the November 2012 elections.

8. Conclusion

The U.S. Subpart F was the first CFC legislation to be enacted. It was followed by many other countries adopting CFC rules, including many developing countries (most recently China). In general, as more countries become capital exporters, they tend to adopt CFC rules as a way to protect their domestic tax base.

The effect of CFC rules and the concurrent adoption of territoriality by most OECD countries is to diminish the importance of the distinction between global and territorial jurisdictions. Both tend to currently tax passive income under their CFC rules, while exempting active or business income. This is a remarkable example of tax convergence.

At the same time, the details of CFC legislation vary tremendously from country to country. This article has attempted to provide an overview of structural features of CFC legislation and how the U.S. rules fit in within this structural framework. Subpart F is clearly a work in progress and in some ways is showing its age (e.g., the deemed dividend rule and the relative lack of reference to the effective foreign tax rate). Reforms are currently being considered but it is clear that this debate will continue in the future.

[52] Greenbook, at 42.

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