CHALLENGES ON THE APPLICATION OF CFC RULES

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Abstract: *Nowadays a large number of businesses are operating around the world in more than one country, being exposed to various tax jurisdictions. In order to avoid companies to take advantage of this cross-country diversity in taxation and therefore to reduce their taxes, countries have created various anti-tax prevention rules, one being the commonly named Controlled Foreign Corporation (CFC) rules. Mainly, these measures target the ability of multinational companies to transfer their income to low-taxed jurisdictions. While on the whole these rules pursue a universal template around the world, on the other hand they vary by jurisdiction. We argue that a review of the similarities and divergences is important as international organizations are considering expanding the CFC rules to better address threats of multinational tax avoidance in the 21st century.*

Keywords: CFC rules, ATAD, tax system

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Introduction

"A properly designed tax system can strike a balance between helping the poor and, at the same time, giving people the incentive to work"
Eric Maskin

In October 2015, the OECD issued the 15 final reports of its BEPS Action Plan in order for the governments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created. Action 3 "Designing Effective Controlled Foreign Company Rules" sets out some guidance based on best practices to strengthen the rules for the taxation of Controlled Foreign Companies (CFCs).

On 12 July 2016 the EU Anti - Tax Avoidance Directive (2016/1164) (ATAD) was formally adopted. It is intended to provide EU countries a minimum level of protection against aggressive tax planning.

ATAD was implemented in Romania through Government Emergency Ordinance no. 79/10 November 2017 (Ordinance 79), which is effective from 1 January 2018. Starting 1 January 2019 all EU countries should apply ATAD. Ordinance 79 implements four out of five anti-tax avoidance measures including CFC rule.

Definition of a CFC

In order to establish whether CFC rules apply, an entity must first consider two questions: (1) whether a foreign entity is of the type that would be considered a CFC and (2) whether the parent company has sufficient control over the foreign entity for it to be a CFC.

Controlled Foreign Companies are generally non-resident companies directly or indirectly controlled by a resident company that are established in a no - or low-tax jurisdiction. Non-resident companies could be either entities or permanent establishments.

According to the Romanian Fiscal Code, a foreign company is controlled and applies CFC rules if the following two conditions are cumulatively met:

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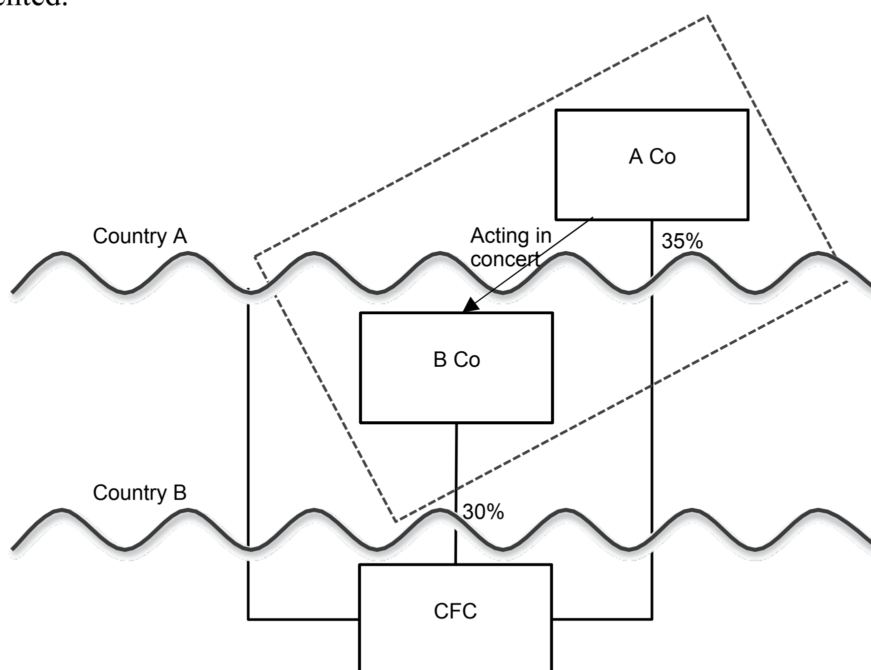
- the taxpayer (resident parent company), ***alone*** or ***together with its associated undertakings***, controls the foreign entity, i.e. a) holds a ***direct*** or ***indirect participation*** of more than 50% of the voting rights or b) owns directly or indirectly more than 50% of capital or c) is entitled to receive more than 50% of the profits of that entity (participation condition), and
- the actual corporate tax paid on its profits by the CFC entity is lower than the difference between the corporate tax computed according to the Romanian rules and the actual corporate tax paid on its profits by the CFC entity i.e. corporate tax paid by the foreign entity is lower than 50% than the corporate tax that would have been paid according to Romanian rules (taxation condition).

The above definition is a mix between legal control (holding of share capital) which it is easy for both tax administrations and taxpayers to apply and economic control (rights to the profits). The definition is straightforward when there is a single shareholder, but when minority shareholders/associated parties are acting together ("act in concert") to exert influence, cases could be more complex. Their interests should be aggregated to determine whether the CFC entity is subject to CFC rules.

Example: Control interest held by associated parties acting in concert

A, B and C are all associated entities. A owns 35% and B owns 30% of a CFC entity, A owns more than 25% of B. If they act independently no CFC would arise as they need to own more than 50%. However, if they act in concert, they will control the CFC entity and CFC rules could apply. Romanian CFC rules do not contain "act in concert" provisions and thus CFC rules could be circumvented.



Source: Paragraph 39, Figure 2.2 from Action 3 – 2015 Final Report

Without CFC rules companies are able to shift their profits to dependent companies in low tax countries, reducing the taxable profits in the resident country (i.e. Romania). With CFC rules in place, companies can still shift their profits but those profits will be taxable in the resident country.

Definition of CFC income

After determining that a foreign company should be considered a CFC, it has to be determined whether or not the income earned by a CFC is of the type that raises concerns and should be attributed to shareholders or controlling parties.

CFC rules apply only to certain types of income. Romania has chosen to categorize income according to its legal classification, including as CFC income specific types of income (interests & income from financial assets, royalties and intellectual property income, dividends, gains from disposal of shares, finance lease income, income from banking, insurance and other financial activities, income from invoicing associated enterprises as regards goods and services where there is no or little economic value added). These sources of income are generally called passive income.
Romanian legislation does not make a clear distinction when categorizing income into "passive" or "active" income. "Active" income should be connected with real economic activity in the foreign subsidiary. For example, with regard to dividends, the concern should be that they could be used to shift purely "passive" income (i.e. income that does not arise from any underlying activity) into a CFC.

Generally, the dividends paid out from active income should not raise concerns. Secondly, applying Parent Subsidiary Directive, dividends should be exempt from tax providing that the parent owns at least 10% of the share capital of the controlling entity for an uninterrupted period of at least one year ending on the date of payment of the dividend. Also, if the CFC is in the active trade or business of dealing in securities, then dividends paid to that CFC should not raise concerns if they are linked to the CFC's trade or business. However, as we can see below, dividends could be exempted from being qualified as CFC income if they are received from an entity established in an EU/EEA country and carries on a substantive economy activity.

Another concern underlying the treatment of royalties and other income from IP is that, since IP assets are highly mobile, the income from these assets can easily be diverted from the location where the value of the assets was created. IP income (including income from digital goods and services) raises several challenges for CFC rules:

- IP income is particularly easy to manipulate because it can be exploited and distributed in many different forms, all of which may have different formalistic classifications under the CFC rules of different countries. For instance, income from IP could be embedded in income from sales and therefore treated as active sales income and could escape CFC inclusion if substance is demonstrated.
- IP assets are often hard to value because there are often no exact comparables, and the cost base of these assets may be an inaccurate measure of the income they can generate.
- Income that is directly earned from the underlying IP asset is often difficult to separate from the income that is earned from associated services or products.

Therefore, it is important to do a substance analyses and always ask the question whether the CFC entity has the ability to earn the income itself.

The question to be answered is how to demonstrate in practice the substance of the transactions to the Romanian tax authorities.

CFC Exemptions

According to the above mentioned definition of the CFC, if the participation condition and taxation condition (corporate tax paid by the foreign entity is lower than 50% of the corporate tax that would have been paid according to Romanian rules) is not fulfilled CFC rules are not applicable.
Using statutory tax rate may reduce administrative complexity and compliance costs. The recommendation under BEPS Action 3, of the Directive 1164/2016 and that implemented into the Romanian Fiscal Code is to use the effective tax rates, creating thus a more accurate comparison.
Example (if effective tax rate would be used): A CFC in Country C generates 100,000 of income in one year. Romania would apply CFC rules if the effective tax rate applied to the CFC was below a fixed rate of 8% taking into account the tax base as computed under Romania's rules. Country C allows an exemption of 55% when computing the taxable income to promote investments.

Calculation of actual tax paid in Country C:	
Income in Country C	100,000
Deduction (55%)	55,000
Taxable income	45,000
Corporate tax due (16%)	7,200
Actual tax paid	7,200
Income in Country C	100,000
Effective tax rate calculation:	
7200/100 000	7%

CFC rules will also not apply (the income will not be included under CFC income) where the controlled entity is established in an EU/EEA country and carries on a substantive economy activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances (substance test).

According to the latest provisions to the Fiscal Code, it appears that, indirectly, Romania has not opted for an exclusion from the application of CFC rules for CFCs located in countries outside the EEA, even these CFCs meet the substance requirement test. According to 2018 version of the Fiscal Code, if the CFC's were located outside the EEA and would have met the substance requirement test, it would had been excluded from the application of CFC rules.

Romanian Fiscal Code provides for another exemption from the application of CFC rules, when the CFC income of an entity consists for one third or less out of the total income of the CFC entity. That is why it is very important to categorize income into "passive" CFC income or "active" income in order to determine whether CFC rules are applicable.

CFC regime implemented in Romania must respect the fundamental freedoms of European Law. In Cadbury Schweppes and subsequent cases, the ECJ has stated that CFC rules that are justified for purposes of prevention of tax avoidance must "*specifically target wholly artificial arrangements which do not reflect economic reality and whose only purpose would be to obtain a tax advantage*".

BEPS Action 3 Final Report suggests that EU Member States should consider "*including a substance analysis that would only subject taxpayers to CFC rules if the CFCs did not engage in genuine economic activities*". The effect is that CFC rules should not target income from substantive economic activities.

Calculation of CFC income

Once CFC rules have determined that income is attributable, they must then consider how much income to attribute.

The income to be included in the tax base of the Romanian controlling entity shall be calculated in accordance with the Romanian Fiscal Code rules, where the controlling entity is resident, in proportion to ownership of the Romanian taxpayer in the CFC entity.

Regarding losses, ATAD provides that losses of the CFC (either entity or PE) will not be included in the tax base. However they may be carried forward, as provided for by national law. Romanian Fiscal Code only provides for the tax treatment of the losses of a CFC as a PE and does not provides details about the treatment of the tax losses of a CFC as an entity.

Generally, the recommended approach should be that CFC losses should only be offset against CFC profits since allowing CFC losses to be offset against the profits of parent companies or CFCs in other jurisdictions could encourage manipulation of losses in the CFC jurisdiction.

Romania should also introduce a rule for CFC entities so that CFC losses should only be offset against CFC profits.

Attribution of CFC income

Once the amount of CFC income has been calculated, the next step is determining how to attribute that income to the appropriate shareholders in the CFC.

Income attribution can be broken down into five steps: (i) determining which taxpayers should have income attributed to them; (ii) determining how much income should be attributed; (iii) determining when the income should be included in the returns of the taxpayers; (iv) determining how the income should be treated; and (v) determining what tax rate should apply to the income.
Romanian Fiscal Code provides that attributed income is included in the taxpayer's taxable income in proportion to the taxpayer's participation in the entity. The income should be included in the tax period of the taxpayer in which the tax year of the controlled entity/permanent establishment ends.

The law does not provide what happens when the proportion of ownership changes during the year. It could be the case when ownership is 60% at the beginning of the tax year and 50% at the tax year end or vice versa. In such a case what is the proportion used to allocate the income to the taxpayer?

Elimination of double taxation

Double taxation may arise when applying CFC rules which tax the income of a company's foreign subsidiary in the jurisdiction of the parent company (i.e. in our case Romania).

One of the fundamental question raised by CFC rules is how to ensure that they do not lead to double taxation.

There are at least three situations where double taxation may arise: (i) situations where the attributed CFC income is also subject to foreign corporate taxes; (ii) situations where CFC rules in more than one jurisdiction apply to the same CFC income; and (iii) situations where a CFC actually distributes dividends out of income that has already been attributed to its resident shareholders under the CFC rules or a resident shareholder disposes of the shares in the CFC.

ATAD and national rules provide certain rules in order to avoid double taxation:

- Profits distributed by a CFC to a taxpayer residing in Romania, which (1) are taxable at the level of the taxpayer and (2) have already been taxed as CFC income, can be deducted from the tax base of the taxpayer, when calculating the amount of tax due on the distributed profits.
- Proceeds from the disposal of participation in the CFC entity or of the business carried out by the PE which have been taxed as CFC income can be deducted from the tax base of the taxpayer, when calculating the amount of tax due on those proceeds.

The taxpayer shall allow a deduction of the tax paid by the entity or permanent establishment from the corporate tax due by the taxpayer according to national regulation.
ATAD and Romanian rules do not include provisions preventing multiple taxation resulting from, e.g. indirect participations.

Example: CFC taxation from indirect participation

Assuming that A is resident in Romania and holds 100% of B, a resident in EU holding 51% of C subsidiary a CFC. In case both Romania and EU country apply the same CFC rules, 51% of the CFC income will be taxed (1) in Romania at the level of A and (2) again in the other EU country at the level of B.

In such case there should be a rule hierarchy to determine which country's CFC rules will apply first.

If Country C has a tax rate of 10%, Country B has a tax rate of 20%, and Country A has a tax rate of 30%, then both Country B and Country A will want to collect their full amount of tax, potentially only giving a credit for Country C's tax. If the income of C Sub is 100, this would mean that Country A would want to collect 20 (i.e., 30 minus 10) and Country B would want to collect 10 (i.e., 20 minus 10). The rule hierarchy, where Country B's rules apply prior to Country A's rules,

would require that Country A provide a tax credit for taxes paid to both Country C and Country B. This would mean that Country C would collect 10, Country B would collect 10 (i.e., 20 minus 10), and Country A would also collect 10 (i.e., 30 minus 20).

If, in contrast, Country C has a tax rate of 10% and Country A has a tax rate of 30%, but Country B has a tax rate of 40%, then Country A should no longer collect any taxes if it granted a tax credit for taxes paid to Country B.

The recommended rule hierarchy is therefore for Country A to apply its CFC rules only after Country B has applied its CFC rules (or to provide a credit for CFC taxes paid to Country B, which may be simpler).

Another situation when CFC could lead to double taxation is when resident taxpayers of a CFC dispose of shares and the taxpayer holding the shares has previously been taxed on undistributed income of the CFC. Romanian CFC fiscal rules include provisions for the avoidance of double taxation i.e. when the taxpayer disposes of its holding into a controlled entity and part of the *proceeds* from the disposal were previously included in the taxable base of the taxpayer, that amount shall be deducted in the tax period in which the amount of tax due for these proceeds is calculated.

According to paragraph 134 of BEPS Action 3 "*Countries may choose not to tax subsequent gains realized by a taxpayer in respect of the shares of a CFC disposed of to the extent that the same amounts have previously been taxed under CFC rules operating in the taxpayer's jurisdiction*".

Exemple: Sell shares of a CFC

In 2019 a Romanian company A buys 100% of a CFC for 100 million. In 2019 CFC records an undistributed income (taxable profit) of 10 million. Let's suppose A is taxed on 10 million under Romanian CFC rules (we assumed no participation exemption is available).

In 2020 A sells CFC for 110 million which includes the capital gain of 10 million already taxed in 2019. Since A has already been taxed on undistributed income of 10 million under CFC rules, the capital gain of 10 million as a result of disposal of shares in CFC should be deductible in 2020 for tax purposes.

The questions arising here are: (1) How to defend the tax deduction of undistributed profits (10 million in the example above) in front of the tax authorities (e.g. what supporting documentation to prepare)?

(2) If CFC is a listed company, how one can argue that the market price at which Company A sells CFC includes the previously taxed profit, which should be available as a deduction?

Reporting

A tax system is efficient only if the tax authorities have the instruments to verify the reporting provided by taxpayers. If the tax authorities are not able to audit the tax statements, fraudulent behavior may give an unfair advantage to some taxpayers.

Tax authorities can practically audit only the documentation available in their own jurisdiction and the facts existing in this jurisdiction.

However, if a Romanian company declares income earned by its CFC located in the British Virgin Islands, in practice the Romanian tax authorities will not be able to verify it or even if they could, it would be prohibitively expensive for them to do so. If a company does not declare the CFC's income (which should be declared), then the tax authorities (in any jurisdiction) in most cases will not even be aware of any tax obligation to be audited.

How can the tax authorities verify if the parent has computed the taxable income of the CFC properly? How can they check if all the income has been reported or if the tax-deductible costs are not overestimated?

We expect Romanian tax authorities will issue more detailed guidelines to address this matter.

Conclusion

CFC rules are measures to counter profit shifting. Under CFC rules, the parent company has to declare income obtained by the CFC if certain criteria are met.

CFC rules are not designed to raise tax on the income of the CFC, they are designed to protect revenue by ensuring that profits are taxed where economic activities generating the profits are performed.

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