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COMPARATIVE TAX LAW FOR THE INTERNATIONAL PRACTITIONER

Current taxation by Host Country of income earned by Controlled Foreign Corporations

FACTS

HCo, a limited liability business entity formed under the law of Host Country ("HC"), is engaged in business worldwide through other business entities. HCo wholly owns Sub1, incorporated in Third Country, which in turn wholly owns Sub2, incorporated in Foreign Country ("FC"). Sub2 is engaged in business in FC. HCo, Sub1 and Sub2 are treated as corporations for HC, Third Country, and FC income tax purposes.

QUESTIONS

1. Does HC have a CFC regime for taxing to HCo all or part of the income realised by Sub2 ? If yes:
a. Briefly describe the history and objectives of the regime.
b. What is the definition of a CFC for purposes of the regime? What are the definitions of "corporation", "foreign", and "controlled"? Could the CFC regime apply if Sub1 were wholly owned by an individual (resident of HC)? What if Sub1 were wholly owned by a trust or partnership?
c. What types of income of Sub2 are subject to current taxation? Are there any "safe harbour" rules pursuant to which income is exempt from current inclusion? Is it significant whether HCo had a "tax avoidance purpose" in setting up Sub2?
d. Is current taxation of Sub2's income also triggered in certain other circumstances, e.g., if Sub2 has participated in a boycott, made bribes, or made "investments in HC property"?
e. What rules are used to determine income for the purposes of the CFC regime, e.g., FC financial accounting rules, IFRS, FC income tax rules, HC income tax rules etc.?
f. How would HCo's pro-rata share of income subject to current taxation be determined if, 70 percent of the stock value of Sub1 was in common stock held by HCo and the remaining 30 percent was in preferred stock held by an unrelated party?
g. How is HCo taxed on the income subject to current taxation, e.g., is the value of the income deemed to be paid directly to HCo or is it deemed to flow up through Sub1? Are credits given for foreign income taxes incurred by Sub2 to FC with respect to the income being currently taxed to HCo? How is the amount of such credits determined? What if Third Country has its own CFC regime and income of Sub2 is currently taxed to Sub1?
h. What adjustments are made to ensure that the value of currently taxed income of Sub2 is not taxed again by HC when it is considered distributed or the stock of Sub2 is sold? What if part of HCo's indirect interest in Sub2 were held through a corporation that did not constitute a CFC for HC income tax purposes?
i. What is the impact on HC's CFC regime of any of its treaties e.g., income tax treaties or the EU "Constitution"? How has HC's domestic tax law been impacted by the ECJ's Cadbury Schweppes decision?
2. Are there any other regimes in HC's income tax law under which income realised by an entity that is not subject to taxation by HC might be taxed to direct or indirect owners of the entity that are residents of HC? If yes:
a. Briefly summarise the rules of such regime(s)
b. What is the impact on such regime(s) of any treaties that HC has entered into?

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THE FORUM

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QUESTIONS

1. Does HC have a so-called "controlled foreign corporation" ("CFC") regime for currently taxing to HCo all or some part of the income realised by Sub2 (even though the value of that income is not yet considered distributed to HCo)?

If yes:

a. Briefly describe the history and objectives of the regime.
b. What is the definition of a CFC for purposes of the regime? In particular, what are the definitions of "corporation", "foreign", and controlled"? Could the CFC regime apply if Sub1 were instead wholly owned by an individual who is a resident of HC? What if Sub1 were wholly owned by a trust or partnership?
c. What types of income of Sub2 are subject to current taxation? Are there any "safe harbour" rules pursuant to which income is exempt from current inclusion? Is it significant whether HCo had a "tax avoidance purpose" in setting up Sub2?
d. Is current taxation of all or some part of Sub2's income also triggered in certain other circumstances, e.g., if Sub2 has participated in a boycott, made bribes, or made "investments in HC property"?
e. What rules are, or may be, used to determine income for purposes of the CFC regime, e.g., FC financial accounting rules, HC financial accounting rules, IFRS, FC income tax rules, HC income tax rules, or HC "earnings & profits" rules?
f. How would HCo's pro rata share of income subject to current taxation be determined if, instead of the facts assumed, 70 percent of the stock value of Sub1 was in common stock held by HCo and the remaining 30 percent was in preferred stock held by an unrelated party?
g. How exactly is HCo taxed on the income subject to current taxation, e.g., is the value of the income deemed to be paid directly to HCo ("hopscotched") or is it deemed to flow up through Sub1? Are credits given for foreign income taxes incurred by Sub2 to FC with respect to the income being currently taxed to HCo? If yes, how is the amount of such credits determined? What if Third Country has its own CFC regime and income of Sub2 is currently taxed to Sub1?
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j. What is the impact, if any, on HC's CFC regime of any treaties that HC has entered into, e.g., income tax treaties or the European Union "Constitution"? If HC is a member of the EU, how has HC's domestic tax law (including case law and administrative guidance) been impacted by the ECJ's Cadbury Schweppes decision?

2. Are there any other regimes in HC's income tax law under which income realised by an entity that is not itself subject to taxation by HC might be currently taxed to direct or indirect owners of the entity that are residents of HC? If yes:

a. Briefly summarise the rules of such regime(s).
b. What is the impact, if any, on such regime(s) of any treaties that HC has entered into?

Host Country ARGENTINA

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I. Tax treatment of foreign entities and Argentina's CFC regime

Argentina has a *sui generis* version of a controlled foreign companies (CFC) regime that does not require any element of control for the regime to apply.[1]

The CFC rules are to be found in section 133 a) and b) of the Income Tax Law (ITL), and sections 165 (VI) 1 to 5 of the Income Tax Regulations (the "Regulations"), and were enacted in 2000 following the latest recommendations of the OECD, as a measure targeting harmful tax competition. Argentina's CFC regime, therefore, applies only with respect to stock companies organised in tax havens or low tax jurisdictions.

It is helpful to an understanding of the CFC regime to set out the classification and tax treatment of foreign corporations and entities under the current text of the ITL, which is as follows:

- *Entities treated as corporations for Argentine tax purposes*: this includes foreign stock companies. The income of such entities is taxed in the hands of their Argentine shareholders when distributed to them in the form of dividends.
- *Entities treated as partnerships for Argentine tax purposes*: all other foreign entities are subject to the rule in section 150 of the ITL which, by reference to section 50 of the same law, provides that the non-Argentine-source income of such entities is considered fully distributed to their Argentine members or partners. Argentine-source income of these entities is not deemed distributed because normally it will be subject to tax in Argentina by means of withholding taxes when it is paid to them.
- *Foreign trusts and investment funds*: income of foreign trusts and foreign investment funds is taxed when distributed to Argentine residents.

The CFC regime represents a departure from the treatment described above in 1. Thus, income derived by a foreign stock company is taxable in Argentina when it is distributed to Argentine residents, except when the foreign stock company is incorporated or located in a low or zero-tax jurisdiction, in which case passive income derived by the corporation may be taxed in the hands of its Argentine shareholders without the benefit of tax deferral.

Other foreign entities do not enjoy any deferral benefit, so that Argentine members or partners of such entities are subject to current taxation with respect to the non-Argentine-source income earned by such entities, irrespective of whether they are incorporated or domiciled in jurisdictions classified as tax havens or in jurisdictions not so classified.

Income earned by a foreign trust, foreign investment fund or equivalent vehicle is taxed in the hands of its Argentine beneficiaries at the time of its distribution, and in principle, the CFC regime does not apply to such an entity not even to a foreign investment fund that is organised as a stock company, a legal form used for investment funds in many jurisdictions.

The enactment of the CFC regime was part of a series of legislative measures adopted to counter harmful tax competition, which included a number of measures of the type recommended by the OECD and others designed to discourage the use of companies located in tax havens. The first category of measures comprises the rules on the taxation of foreign-source income, the transfer pricing regime and the CFC regime. The second category includes a special presumption for payments made by and money transfers from companies situated in tax havens, a special presumption that a transaction with a tax haven company does not conform to arm's length standards, and a special presumption of the prices at which certain commodities are exported.

A. Definition of a CFC

The CFC regime applies only to foreign stock companies, but the ITL contains no definition or test to determine whether a particular foreign entity qualifies as a stock company. In this respect, it is not clear if this determination is to be made under the law of the foreign jurisdiction in which the entity is incorporated or domiciled or under Argentine law, but it is likely that the Argentine tax authorities will make the

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characterisation by comparing the essential features of the foreign entity with those of an Argentine corporation (*sociedad anónima*).

It should be noted that if an entity is not classified as a stock company, then it will be treated for Argentine income tax purposes as a partnership, and all its income will be taxed in the hands of its Argentine resident partners on a current basis. This raises the question of the practical relevance of making the proper characterisation in the case of a tax haven entity, as the result seems to be the same in both cases: if a tax haven entity is classified as a stock company, its passive income will be subject to tax in the hands of its Argentine shareholders on a current basis; if it is not a stock company, all its income will be taxable in the hands of its Argentine partners without the benefit of deferral and given the nature and functions usually assigned to tax haven entities, it is highly likely that all such an entity's income will anyway be passive rather than active.

However, there are some differences in the tax treatment of CFCs and partnerships that make such characterisation still relevant. The main difference, as already noted, is that the CFC regime applies only to passive income, while partnership treatment applies to all types of income, including profits derived from an active trade or business. A second difference is that the CFC regime does not apply in a taxable year in which the active income of the CFC amounts to at least 50 percent of its total income attributable to that year (see I.C., below), while partnership treatment is not subject to this exclusion. On the other hand, the CFC regime limits the foreign-source losses that may be deducted from passive income (see I.G., below), a limitation that does not apply in the case of partnership treatment.

Under the Argentine Business Entities Law, a stock company is a legal entity with its own legal personality and an existence separate from that of its shareholders. The typical and distinctive feature of a stock company is precisely the issuance of shares of stock with several essential functions, the main one being that the shares represent ownership in the entity, and confer economic and political rights, including the right to receive distributions of profits, and distributions in the case of the redemption of shares or total or partial liquidation, and also confer voting rights and the right to attend shareholders' meetings with the right to speak and vote[2].

The limitation of liability is another fundamental characteristic of a stock company: shareholders are only liable for payment to the corporation of the subscription price of their shares, and have no liability to the creditors of the corporation.

The administration and management of a corporation is in the hands of a Board of Directors, elected by a shareholders meeting. Shareholders cannot engage in the administration or management of a corporation and, of course, have no power or authority to bind the company, unless they are elected to the Board.

The fundamental decisions of the corporation are made by shareholders' meetings. This body has the authority to appoint and remove the members of the Board of Directors, to approve the financial statements of the corporation, and to approve the payment of dividends, new issuances and redemptions of shares, mergers, spin-offs, etc.

Section 133 a) of the ITL provides that the CFC regime applies to stock companies organised or situated in low or zero tax jurisdictions. The term "organised" refers to the place of creation or incorporation of the entity. This provision is coherent with the rule on the residence of corporations in section 119 d) of the ITL, which provides that entities incorporated in Argentina are residents of Argentina.

No clarification is provided regarding the meaning to be given to the term "situated" but, in the opinion of the authors, it refers to the place of "residence" of the corporation as determined on the basis of factors other than the place of incorporation, such as the place of management and administration of the entity. Thus, if the terms "organised" and "situated" in section 133 a) of the ITL are read together, income earned by a stock company will be subject to the CFC regime not only if the company was incorporated in a low or zero tax jurisdiction, but also if it was organised elsewhere but its place of residence is such a jurisdiction.

As noted above, the Argentine CFC regime does not require any element of control for it to apply, nor even a minimum participation in the foreign entity. The regime, therefore, applies to any Argentine resident owning shares in a CFC, without regard to the percentage of the capital of the CFC he owns. Thus, there is no requirement that a CFC be controlled by residents of Argentina, so the regime may apply even where Argentine residents own only a minority interest in the foreign corporation concerned.

The regime applies to all shareholders that are residents of Argentine, including corporations, individuals, partnerships and trusts (*fideicomisos*) created under Argentine Law 24,441.

The regime encompasses not only direct participation in a CFC, but also participations held by a CFC in other entities organised or situated in low or zero tax jurisdictions.

B. Income subject to the CFC regime

The regime applies only to passive income derived by a CFC or by another entity also incorporated or situated in a low or zero tax jurisdictions in which the CFC owns a participation.

Under section 133 a) of the ITL, the CFC regime applies to interest, dividends, royalties, rents and other passive income as determined by the Regulations. In turn, section 165 (VI) 2 of the Regulations deems passive income to be income derived from the leasing of real estate, loans, the disposition of shares or equity interests, deposits in financial institutions, public bonds, investment funds, and derivative instruments that do not have a hedging purpose.

By way of exception, the Regulations exclude from passive income, income from the leasing of real estate, where the CFC is engaged in the leasing and administration of property as an active business. Interest derived from the performance of an active banking business is also excluded from characterisation as passive income.

The prevailing opinion is that the CFC regime applies to foreign-source passive income, but not to passive income from Argentine sources. Such income is normally subject to taxation in Argentina by means of withholding at source, but Argentine-source passive income that is exempt from Argentine tax (for example, interest on Argentine sovereign debt) is also excluded from the CFC regime.

C. Circumstances in which passive income is subject to current taxation

The CFC regime applies when the passive income of a CFC amounts to more than 50 percent of its total income in any given taxable year.

In this context, section 165 (VI) 1 of the Regulations limits the scope of the CFC regime to those cases in which the passive income of a CFC for the fiscal year concerned is more than 50 percent of its total income for that year. Specifically, the Regulations state that the imputation provided for in section 133 a) of the ITL will not apply if the CFC derives, during the fiscal year, at least 50 percent of its income from the performance of industrial, commercial or agricultural activities, mining, forestry, or services, including banking and insurance services, and in general from activities that do not produce passive income.

To determine whether the active income of a CFC amounts to at least 50 percent of its total income, the Regulations provide that a comparison must be made between the total taxable income of the pertinent taxable year and the taxable income derived from the activities that produce active income derived in the same taxable year. For these purposes, profits that are exempt or not subject to tax in the jurisdiction of residence of the CFC must be added to the total taxable income. If the jurisdiction concerned does not impose a tax on income on the CFC, then the comparison must be made by reference to the profits determined by applying accounting principles accepted in that jurisdiction, as shown in financial and economic statements certified by duly authorized professionals.

D. Attribution to the taxable year of the Argentine resident

Where the CFC regime applies with respect to a particular CFC for any given taxable year, the ITL provides that the passive income of the CFC must be attributed to the taxable year of the Argentine resident during which the fiscal year of the CFC ends.

E. Determination of pro-rata share of income subject to taxation

The *pro rata* share of each shareholder in the CFC income must be calculated in proportion to that shareholder's participation in the income of the CFC.

If the CFC has issued different classes of shares carrying different rights, the *pro rata* share must be determined on the basis of the rights of each class of shares to the profits of the entity.

F. Determination of passive income of CFC to be attributed to Argentine resident shareholders

Passive income to be attributed to Argentine resident shareholders is the passive income derived by the CFC during the taxable year determined in accordance with the accrual rules in the ITL.[3]

These rules are to be found in section 18 of the ITL and, in connection with profits that are characterised as passive income. They provide as follows:

- **Dividends:** accrue when the paying entity puts the dividends at the disposal of the beneficiary;
- **Interest on bonds:** same rule as for dividends;
- **Royalties:** general accrual rules;
- **Other interest:** by reference to the periods for payment of the interest;
- **Rent:** by reference to the rental periods;
- **Sale of shares or equity interests:** to the taxable year when the property in the shares is transferred to the buyer;
- **Derivatives:** general accrual rules; and
- **Other passive income:** general accrual rules.

G. Losses from foreign sources

The Regulations do not allow the set-off of losses incurred by a CFC against the passive income to be attributed to Argentine resident shareholders, with the exception of losses incurred by a CFC in connection with the sale or disposition of shares, equity interests and quotas in private investment funds, which may be deducted from profits derived by the CFC from transactions of the same kind.[4]

This rule applies only to losses incurred by a CFC, but does not limit or restrict the set-off of other losses from foreign or Argentine sources of the Argentine resident shareholders against the passive income of a CFC that is attributed to them under the CFC regime.

H. Foreign tax credits

The ITL allows a credit for "similar taxes" paid in the country (ies) of source of foreign income derived by an Argentine resident. This credit is deductible only from the Argentine tax attributable to the foreign-source income, which is calculated as the amount by which the Argentine income tax liability is increased as a result of the inclusion in the taxable income of the Argentine resident of the income from foreign sources. As a consequence of this mechanism, the foreign tax credit cannot exceed such increase.

Creditable foreign taxes include not only taxes that a foreign country imposes on income paid to Argentine residents by means of withholding at source, but also taxes imposed on the income of a foreign corporation with Argentine resident shareholders (underlying tax).

The ITL does not provide for any "per country" or "per activity" foreign tax credit limitations, which in practice allows Argentine residents deriving foreign-source income that is subject to foreign country taxes at rates higher than that applying in Argentina, to set off part of those taxes against the Argentine tax on their CFC Income.

The Regulations allow Argentine resident shareholders of a foreign stock company to take a foreign tax credit for the "similar taxes" paid by the company, either directly or indirectly by other foreign companies in which the first foreign stock company owns an interest. The tax that the foreign country in which the stock company is located imposes on the distribution of dividends to the Argentine shareholders is also allowed as a credit.

In the case of direct participation, the Regulations require an Argentine resident shareholder to hold a minimum interest of 25 percent in the capital of a foreign stock company for the shareholder to be entitled to a credit for the "similar taxes" paid by the foreign company. With respect to "indirect participation," the Regulations require the Argentine shareholder to an indirect interest of more than 15 percent in the capital of the entity via the shareholder's participation in the first-tier foreign entity. However, no indirect tax credit is allowed if the second-tier foreign entity is located in a low or zero tax jurisdiction. No credit is allowed for taxes paid by third and lower-tier foreign entities.

Similar taxes paid by first and second-tier foreign companies are creditable in proportion to the participation of the Argentine resident in such companies.

I. Dividends

The attribution of passive income of a CFC to its Argentine shareholders needs to be complemented by a provision designed to avoid double taxation when the CFC makes a subsequent distribution of dividends out of income that has already been subject to Argentine tax in the shareholders' hands under the CFC regime.

In this respect, section 133 a) of the ITL provides that the Regulations are to prescribe rules for the exclusion from the tax base of the amount of dividends paid out of income previously attributed to Argentine shareholders.

The relevant rules are to be found in section 165 (VI) 4 of the Regulations and prescribe that dividends paid out of passive income of a CFC that was attributable to its Argentine resident shareholders in previous taxable years will not be treated as taxable income of such shareholders.

Section 165 (VI) 4 of the Regulations also provides for the order in which dividends are to be applied to the income of the CFC: dividends must be applied first to the excess of the accumulated earnings of the CFC over the passive income declared by the Argentine resident shareholders.

In contrast, the current rules do not provide a mechanism for avoiding double taxation when an Argentine resident sells stock of a CFC. Thus, if there is undistributed income at the level of the CFC that was previously included by its Argentine shareholders as taxable income under the CFC regime, neither the ITL nor the Regulations provide any relief from the double taxation that potentially arises in that situation.

J. Low or zero tax jurisdictions

Low or zero tax jurisdictions are the 87 jurisdictions listed in section 21.7 of the Regulations, which applies for all purposes of the ITL and the Regulations, including the CFC regime.[5] All the "jurisdictions" listed in section 21. 7 are territorial jurisdictions, with the exception of two special tax regimes: the Uruguayan SAFI regime and the Luxembourg Holding Company regime.

The Regulations provide that those jurisdictions that have entered into an international agreement with Argentina for the exchange of information for tax purposes and that, under their international legislation, cannot deny the disclosure of information on the grounds of bank or other types of secrecy are to be removed from the section 21.7 list.

Section 165 (VI) 2 of the Regulations provides that the CFC regime also applies to corporations created in jurisdictions not included in the section 21.7 list but that enjoy special tax treatment. However, there is no further clarification as to what is to be understood by the term "special tax treatment," or whether it is necessary, in order for the CFC regime to be applied with respect to a company enjoying special tax treatment, that the special tax regime concerned be included in the section 21.7 list,[6] as are the Uruguayan SAFI and Luxembourg Holding Company regimes.

K. Application of Argentine CFC regime to present case

Whether the CFC regime applies or not depends on the country in which Sub1 and Sub2 are incorporated or situated. The four possible situations envisaged in the Forum fact pattern and the tax consequences applicable to each of them under the CFC regime are analysed in I.K.1. to 4. below.

1. Case 1: Both Sub1 and Sub2 are in jurisdictions not qualifying as "low or zero tax jurisdictions"

The Argentine CFC regime does not apply where both Sub1 and Sub2 are incorporated or situated in jurisdictions that do not qualify as "low or zero tax jurisdictions." Thus, in these circumstances, none of the income of Sub1 or Sub2 will be taxed in Argentina on a current basis.

The characterisation of the income of Sub1 or Sub2 is irrelevant. Actually, the income of Sub1, which will mostly consist of dividends received from Sub2 will be characterised as passive income under the CFC regime, but it will not be taxed in the hands of HCo until it is distributed by Sub1 to HCo as a dividend.

Thus, Sub1 and Sub2 can accumulate income without the giving rise to taxation in the hands of Sub1's Argentine shareholders. Also, specifically at the level of Sub1, such accumulated income may be invested in other subsidiaries of Sub1 without triggering Argentine taxation.

The general rules for the deduction of foreign tax credits and the set-off of losses from foreign sources apply in these circumstances. When HCo receives a distribution of dividends from Sub1, the relevant rules will allow it to deduct from its Argentine tax liability, by way of a foreign tax credit, the similar taxes paid by Sub1 and Sub2, and also the withholding taxes that Sub2 may have to withhold from dividends it pays to Sub1, as well as any withholding tax withheld on the dividends distributed by Sub1 to HCo.

2. Case 2: Only Sub1 is in a "low or zero tax jurisdiction"

Because Sub2 is not in a "low or zero tax jurisdiction," its income is not attributable to the Argentine shareholders of Sub1, whether such income derives from an active trade or business or is passive.

On the other hand, when Sub2 makes a distribution of dividends or pays to Sub1 any other type of passive income, HCo will be subject to tax on such income in Argentina if, in the year of distribution, the passive income of Sub1 exceeds 50 percent of its total profits.

In this case, the general foreign tax credit rules will apply to HCo, so that it will be able to deduct from its Argentine tax liability the "similar taxes" paid by both Sub1 and Sub2, and also the withholding taxes that the jurisdictions in which Sub1 and Sub2 are located impose on the distribution of dividends.

3. Case 3: Only Sub2 is in a "low or zero tax jurisdiction"

Because Sub1 is not in a "low or zero tax jurisdiction", the CFC regime will not apply to its income. Thus, Sub1 may receive dividends and other passive income from Sub2 without triggering Argentine tax on its Argentine shareholders.

"Similar taxes" paid by Sub1 will be creditable against HCo's Argentine tax liability. However, no indirect credit will be allowed to HCo for taxes paid by Sub2 because Sub2 is located in a "low or zero tax jurisdiction" (see I.H., above).

4. Case 4: Both Sub1 and Sub2 are in "low or zero tax jurisdictions"

The CFC regime will apply to both Sub1 and Sub2 and passive income derived by either of them will be taxed in the hands of HCo if it exceeds 50 percent of the total income of Sub1 or Sub2 as the case may be. Also, even if Sub2's income derives from an active trade or business, it will be subject to tax in Argentina when it is distributed to Sub1 as a dividend, because it will be characterised as passive income in the hands of Sub1, and therefore as taxable under the CFC regime.

No (indirect) tax credit will be allowed to HCo for taxes paid by Sub2, but there is no such limitation on the availability of a credit with respect to the "similar taxes" paid by Sub1 or the withholding tax imposed by the jurisdiction in which Sub1 is located, if any.

L. Impact of tax treaties on the CFC regime

Some of the jurisdictions listed in section 21.7 of the Regulations are part of the territory to which tax treaties signed between Argentina and certain foreign countries apply.[7]

The treaties concerned follow the OECD Model Convention, which, according to the Commentary thereto, does not limit the right of a Contracting State to tax its own residents under the CFC provisions of its internal laws.[8]

II. Other rules that may give rise to current taxation

As noted in I., above, all foreign entities that do not qualify as foreign stock companies are treated for Argentine tax purposes as partnerships. This treatment extends to entities that normally are treated like corporations for tax purposes in their countries of creation, such as limited liability partnerships, *sociedades de responsabilidad limitada*, and similar entities.

Under section 149 of the ITL, the Argentine members or partners of a foreign entity that is not a stock company must recognise as taxable income their *pro rata* share in the profits of the entity, even if those profits are not distributed to them.

The profits to be attributed to the Argentine residents must be determined following the rules applying for purposes of "similar taxes" in the country of residence of the entity. If that country does not impose a "similar tax", the attribution must be made on the basis of the profits shown in the financial statements of the entity.

The general tax credit rules apply in these circumstances, allowing the Argentine members or partners to deduct from their Argentine tax liability the similar taxes paid by the foreign entity by way of a foreign tax credit.

Of the 17 tax treaties signed by Argentina that are in force, 14 follow the OECD Model Convention, and allow Argentina to tax the profits that Argentine residents derive from sources within the other Contracting States, while obliging Argentina to grant a credit for the similar taxes paid in those States.

The treaty with Brazil (which again does not follow the OECD Model Convention) provides that dividends may be taxed by the country of residence of the company that pays the dividends. When dividends are distributed by a Brazilian company to an Argentine resident, the treaty provides that Argentina may not tax them. This provision has been interpreted as preventing the application of section 149 of the ITL to Brazilian entities in order to avoid contravening the purpose of the treaty provision regarding the avoidance of double taxation, which is to prevent the taxation by Argentina of profits that may be taxed by Brazil.

Under Argentina's tax treaties with Chile and Bolivia (which do not follow the OECD Model Convention), income derived from an equity participation in a business entity can be taxed only by the country of residence of the entity, which prevents the taxation by Argentina of profits derived by entities resident in Bolivia or Chile, thus preventing the application of section 149 of the ITL in such cases.

NOTES

[1] ITL, secs. 133 a) and b) provide as follows: "Income and expenses subject to this Title will be attributed according to the provisions of section 18 that may be applicable, with the adjustments set forth below: a) The net taxable income or loss of permanent establishments defined in section 128 will be attributed to the fiscal year of their owners resident in the country [i.e., Argentina] mentioned in sub-sections d) and e) of section 119, in which the corresponding fiscal year of the permanent establishments ends, or if the owner is a resident individual or undivided estate, to the fiscal year in which such fact occurs. The same attribution shall apply to the shareholders resident in the country [i.e., Argentina] with respect to the net taxable income of stock companies created or situated in low or zero tax jurisdictions deriving from interest, dividends, royalties, rents or other similar passive income to be defined by regulations. The regulations shall establish the manner in which dividends paid out of income attributed in prior fiscal or taxable years to residents who are shareholders of such companies, will be excluded from the tax base. b) Income attributable to the permanent establishments and to the stock companies indicated in the preceding sub-section must be attributed according to the provisions of section 18, fourth paragraph of its sub-section a) of its second paragraph and its fourth paragraph.

[2] Issuance of non-voting preferred stock is allowed, but all corporations must issue common stock with voting rights.

[3] ITL, sec. 133 b).

[4] Regulations, sec. 165 (VI) 5.

[5] The list includes the following jurisdictions:1. ANGUILA (Territorio no autónomo del Reino Unido); 2. ANTIGUA Y BARBUDA (Estado independiente); 3. ANTILLAS HOLANDESAS (Territorio de Países Bajos); 4. ARUBA (Territorio de Países Bajos); 5. ASCENCION; 6. COMUNIDAD DE LAS BAHAMAS (Estado independiente); 7. BARBADOS (Estado independiente); 8. BELICE (Estado independiente); 9. BERMUDAS (Territorio no autónomo del Reino Unido); 10. BRUNEI DARUSSALAM (Estado independiente); 11. CAMPIONE D'ITALIA; 12. COLONIA DE GIBRALTAR; 13. EL COMMONWEALTH DE DOMINICA (Estado Asociado); 14. EMIRATOS ARABES UNIDOS (Estado independiente); 15. ESTADO DE BAHREIN (Estado independiente); 16. ESTADO ASOCIADO DE GRANADA (Estado independiente); 17. ESTADO LIBRE ASOCIADO DE PUERTO RICO (Estado asociado a los EEUU); 18. ESTADO DE KUWAIT (Estado independiente); 19. ESTADO DE QATAR (Estado independiente); 20. FEDERACION DE SAN CRISTOBAL (Islas Saint Kitts and Nevis: Independientes); 21. Régimen Aplicable a las Sociedades Holding (Ley del 31 de julio de 1929) del Gran Ducado de Luxemburgo. *(*Punto sustituido por art. 1° del Decreto N°115/ 2003 B.O. 23/1/2003*);* 22. GROENLANDIA; 23. GUAM (Territorio no autónomo de los EEUU); 24. HONK KONG (Territorio de China); 25. ISLAS AZORES; 26. ISLAS DEL CANAL (Guernsey, Jersey, Alderney, Isla de Great Stark, Herm, Little Sark, Brechou, Jethou Lihou); 27. ISLAS CAIMAN (Territorio no autónomo del Reino Unido); 28. ISLA CHRISTMAS; 29. ISLA DE COCOS O KEELING; 30. ISLAS DE COOK (Territorio autónomo asociado a Nueva Zelanda); 31. ISLA DE MAN (Territorio del Reino Unido); 32. ISLA DE NORFOLK; 33. ISLAS TURKAS E ISLAS CAICOS (Territorio no autónomo del Reino Unido); 34. ISLAS PACIFICO; 35. ISLAS SALOMON; 36. ISLA DE SAN PEDRO Y MIGUELON; 37. ISLA QESHM; 38. ISLAS VIRGENES BRITANICAS (Territorio no autónomo del Reino Unido); 39. ISLAS VIRGENES DE ESTADOS UNIDOS DE AMERICA; 40. KIRIBATI; 41. LABUAN; 42. MACAO; 43. MADEIRA (Territorio de Portugal); 44. MONTSERRAT (Territorio no autónomo del Reino Unido); 45. NIUE; 46. PATAU; 47. PITCAIRN; 48. POLINESIA FRANCESA (Territorio de Ultramar de Francia); 49. PRINCIPADO DEL VALLE DE ANDORRA; 50. PRINCIPADO DE LIECHTENSTEIN (Estado independiente); 51. PRINCIPADO DE MONACO; 52. REGIMEN APLICABLE A LAS SOCIEDADES ANONIMAS FINANCIERAS (regidas por la ley 11.073 del 24 de junio de 1948 de la República Oriental del Uruguay); 53. REINO DE TONGA (Estado independiente); 54. REINO HACHEMITA DE JORDANIA; 55. REINO DE SWAZILANDIA (Estado independiente); 56. REPUBLICA DE ALBANIA; 57. REPUBLICA DE ANGOLA; 58. REPUBLICA DE CABO VERDE (Estado independiente);

59. REPUBLICA DE CHIPRE (Estado independiente); 60. REPUBLICA DE DJIBUTI (Estado independiente); 61. REPUBLICA COOPERATIVA DE GUYANA (Estado independiente); 62. REPUBLICA DE PANAMA (Estado independiente); 63. REPUBLICA DE TRINIDAD Y TOBAGO; 64. REPUBLICA DE LIBERIA (Estado independiente); 65. REPUBLICA DE SEYCHELLES (Estado independiente); 66. REPUBLICA DE MAURICIO; 67. REPUBLICA TUNECINA; 68. REPUBLICA DE MALDIVAS (Estado independiente); 69. REPUBLICA DE LAS ISLAS MARSHALL (Estado independiente); 70. REPUBLICA DE NAURU (Estado independiente); 71. REPUBLICA DEMOCRATICA SOCIALISTA DE SRI LANKA (Estado independiente); 72. REPUBLICA DE VANUATU; 73. REPUBLICA DEL YEMEN; 74. REPUBLICA DE MALTA (Estado independiente); 75. SANTA ELENA; 76. SANTA LUCIA; 77. SAN VICENTE Y LAS GRANADINAS (Estado independiente); 78. SAMOA AMERICANA (Territorio no autónomo de los EEUU); 79. SAMOA OCCIDENTAL; 80. SERENISIMA REPUBLICA DE SAN MARINO (Estado independiente); 81. SULTANATO DE OMAN; 82. ARCHIPIELAGO DE SVBALBARD; 83. TUVALU; 84. TRISTAN DA CUNHA; 85. TRIESTE (Italia); 86. TOKELAU; 87. ZONA LIBRE DE OSTRAVA (ciudad de la antigua Checoeslovaquia)

[6] The prevailing opinion is that the list in Regulations, sec. 21.7 is not an open list, implying that a special tax regime must first be included in the list by the Argentine authorities for the CFC regime to be applied with respect to it.

[7] This is the case with Campione D'Italia and Trieste (Argentina-Italy tax treaty), Polinesia Francesa and San Pedro y Miguelón (Argentina-France tax treaty) and Isla Christmas, Isla Cocos o Keeling and Isla de Norfolk (Argentina-Australia tax treaty). .

[8] Para. 13 of the Commentary on OECD Model Convention, Art. 7 states: "13. The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also para. 23 of the Commentary on Art. 1 and paras. 37 to 39 of the Commentary on Art. 10).

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Host Country BELGIUM

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I. Absence of a CFC regime in Belgium

Belgium does not have a controlled foreign corporation (CFC) regime pursuant to which HCo, as a Belgian corporation (hereafter "BelCo") might be subject to current taxation on all or part of the undistributed profit realised by Sub2 in Foreign Country (FC).

The Belgian Income Tax Code of 1992 (BITC), does however, contain several specific anti-avoidance rules that prevent Belgian taxpayers from shifting taxable profits to low-tax jurisdictions. Some provisions allow the Belgian tax administration (hereinafter the "tax administration") to add back[1] the profit transferred by a Belgian taxpayer to an affiliated company or to a foreign taxpayer located in a tax haven or benefiting from a preferential tax regime. Other provisions disallow the deduction of certain expenses incurred in relation to beneficiaries located in low-tax jurisdictions.[2]

These provisions do not allow the tax administration to tax the recurring, undistributed profits of a foreign controlled subsidiary of a Belgian taxpayer.[3] It is beyond the scope of this paper to provide a detailed analysis of the specific provisions concerned. However, the BITC does contain a provision that can, if certain requirements are met, produce the same effect as CFC rules, i.e., a provision that allows the tax administration to tax the recurring, undistributed profits of a foreign controlled subsidiary of a Belgian taxpayer.

II. Article 344, § 2 of the Belgian Income Tax Code of 1992

A. The history and objectives of Article 344, § 2 of the Belgian Income Tax Code of 1992

In 1954, the legislator first enacted a provision[4] that formed the basis for Article 344, § 2 of the BITC and allowed the tax administration to disregard the "sale, transfer or contribution" of certain assets to a foreign "holding company" that was located in a low-tax jurisdiction.[5] The term "holding company" was not defined in the statute.[6] The assets targeted were only certain portfolio assets, such as bonds, shareholdings and debt claims. The application of the provision could be avoided if the taxpayer successfully demonstrated that he had received consideration for the assets transferred that continued to produce normal taxable income in Belgium.

The *ratio legis* of this provision was to counter the practice whereby a natural person would transfer his portfolio assets to a foreign holding company in a low-tax jurisdiction with the sole purpose of avoiding Belgian taxes on the investment income.[7]

Article 80 of the Law of June 25, 1973 made substantial changes to the scope of Article 344, § 2 of the BITC. Apart from the transfer of portfolio assets, the transfer of certain industrial assets, such as patents, trademarks and manufacturing processes, was now also targeted by the provision. In addition, Article 344, § 2 was extended to encompass the transfer of assets to any foreign person (whether an individual or a corporation) located in a low-tax jurisdiction. Finally, the amendment both extended and restricted the ability of taxpayers to escape the application of Article 344, § 2.

This ability was extended by including a second exception that allows the taxpayer also to demonstrate that a transfer is justified by legitimate financial or economic needs. The ability was restricted by requiring the taxpayer to demonstrate that he has received consideration for the transfer that continues to produce normal taxable income in Belgium that is subject to a normal tax burden, as compared to the tax that would have been levied had the transaction not taken place. Consequently, it no longer suffices to demonstrate that the value received as consideration for the assets transferred continues to produce normal taxable income. The taxable income so produced must also be subject to a normal tax burden in Belgium (i.e., a tax burden that is comparable to the tax burden that would have been borne if the asset transfer had not taken place).[8]

Finally, in 1992, the scope of application of Article 344, § 2 of the BITC was further extended,[9] when the list of tainted assets was completed by adding cash.[10]

The addition of cash was targeted at a tax avoidance scheme in which a Belgian taxpayer sells certain income-producing assets to a third party against a cash payment and subsequently contributes the cash to the paid-up capital of a foreign company based in a low-tax jurisdiction that operates as a personal holding company of the transferor (in some cases, the income-producing assets are then bought back by the holding company from the third party).[11] In addition, the list of tainted beneficiaries (i.e., foreign holding companies and persons located in low-tax jurisdictions) was deleted and replaced by the concept of a non-Belgian tax resident who "according to the laws of the country where he is established, is not subject to income tax or is, with respect to the income derived from the assets and rights transferred, subject to a tax treatment there that is considerably more favourable than that to which similar income is subject to tax in Belgium." According to the tax administration, the latter amendment did not change the scope of application of the provision *ratione personae*.[12]

The characteristics of Article 344, § 2 of the BITC are compared with the characteristics of CFC rules in II.B. below.

B. Article 344, § 2 of the Belgian Income Tax Code of 1992 not a CFC rule

Article 344, § 2 of the BITC and CFC rules have a common purpose, i.e., to prevent the accumulation of profits by a resident taxpayer in a low-tax jurisdiction and to impede the benefit of tax deferral. Assuming, as is the case in the Forum fact pattern, that BelCo indirectly controls Sub2 in FC, Article 344, § 2 produces a similar result to a CFC regime. Nonetheless, for reasons that will be explained below, Article 344, § 2 cannot be regarded as CFC legislation.

As indicated above, Article 344 § , 2 of the BITC provides a basis for the tax administration to disregard the transfer of certain assets to a taxpayer that is located in a low-tax jurisdiction.[13] It thus introduces a legal fiction[14] under which the assets, although transferred pursuant to private law, are deemed to remain in the estate of the Belgian transferor. Pursuant to this fiction, the tax administration attributes the income from the assets to the Belgian taxpayer and taxes him accordingly on the income that the assets continue to generate in the hands of the transferee.

The basic tax mechanism is, therefore, akin to that of CFC rules: income earned by a taxpayer located in a low-tax jurisdiction is attributed to another taxpayer based in another (high-tax) jurisdiction. Since only transfers to low-tax jurisdictions fall within the scope of Article 344, § 2 of the BITC, the article exhibits some similarity to a CFC regime that takes a designated jurisdiction approach under which all the undistributed income earned by a CFC based in a low-tax jurisdiction is attributed to its controlling shareholder.[15]

In contrast, Article 344, § 2 of the BITC, while it has some similarity to a CFC regime that takes an approach under which only "tainted income" (generally passive income) of the CFC is attributed to the controlling shareholder, differs from a regime that takes such an approach in that the provision only targets the income produced by the *transferred* tainted assets. It requires the tax administration to keep track of the assets transferred. A CFC regime based on a global approach generally does not require the tracking of the assets transferred to the CFC.[16]

Article 344, § 2 of the BITC does not tax BelCo on the basis of the receipt of a deemed dividend nor does it introduce a tax transparency rule[17] under which all the income generated by Sub2 in FC is assumed to flow directly to BelCo. Article 344, § 2 merely attributes to the Belgian taxpayer the income produced by the transferred assets. Moreover, Article 344, § 2 applies regardless of whether the Belgian taxpayer exercises any control over the transferee and there is no affiliation requirement.

A final difference between a CFC regime and Article 344, § 2 of the BITC is that the latter provides no measures to mitigate the adverse effects of economic (i.e., when the income is attributed) and juridical double taxation (i.e., when the income is effectively distributed) resulting from the application of the provision.

C. Assets and transactions covered by Article 344, § 2 of the Belgian Income Tax Code of 1992

Under Article 344, § 2 of the BITC,[18] the "sale, transfer or contribution" of certain specified assets, particularly "shares, bonds, debt claims or other securities, patents, manufacturing processes, trademarks or any similar rights, or cash" to a non-Belgian tax resident (company or individual) established in a low-tax country does not have to be respected by the tax administration unless the taxpayer demonstrates that:

- The transfer meets legitimate needs of an economic or financial nature (first exception); or
- The consideration received for the transaction produces income that is subject in Belgium to a tax burden that is normal in comparison with the burden that would have been borne if the operation had not taken place (second exception).

Article 344, § 2 of the BITC targets only transfers of specific assets to tainted beneficiaries. A tainted beneficiary is a nonresident taxpayer "who, according to the laws of the country where he is established, is not subject to income tax *or* is, with respect to the income derived from the assets and rights transferred, subject to tax treatment there that is considerably more favourable than that to which similar income is subject to tax in Belgium" (emphasis added).

The words ". . .who, according to the laws of the country where he is established, is not subject to income tax. . ." refer to "tax havens," in which there is no, or only a very small level of, taxation.[19] The wording is similar to that used in the context of Article 203 of the BITC (requirements for benefitting from the participation exemption regime) and should be under-

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stood to mean that, to avoid the application of Article 344, § 2 of the BITC, the transferee should be subject in his country of residence to a tax that is analogous to Belgian corporate income tax and the nominal and effective tax rate should be at least 15 percent.[20] According to this interpretation, any transfer of assets to a transferee resident in a country in which that transferee is not subject to such a tax, i.e., a low-tax jurisdiction, would be covered by Article 344, § 2.

It has been suggested that even if the assets are transferred to a transferee resident in a low-tax jurisdiction (i.e., where no, or very little, income tax is imposed), Article 344, § 2 of the BITC can only be applied if it is established that the level of taxation on the income produced by the assets transferred in the hands of the transferee is considerably more favourable than the Belgian tax treatment that would be applicable to similar income if the assets had never been transferred.[21] Consequently Article 344, § 2 ought not to apply where an interest-bearing bond is transferred by a Belgian taxpayer to a non-Belgian tax resident located in a low-tax jurisdiction, but the income produced by the asset is subject there to an effective tax rate that equals the Belgian tax burden that would have been borne had the transfer of the asset not taken place.

Under Article 344, § 2 of the BITC, the assets transferred are deemed to remain in the estate of the Belgian transferor. The income is attributed to the Belgian taxpayer at the point in time when it is earned.[22] The income attributed to the Belgian taxpayer retains its source and character under Belgian law and also, presumably, Belgian accounting principles would be used to determine the Belgian taxable income.[23]

The list of tainted assets in Article 344, § 2 of the BITC is exhaustive[24] only the assets listed there are affected by the provision. Moreover, only direct transfers are covered by the provision.[25] In the case at hand, Belgium could only tax BelCo on the undistributed income produced by the tainted assets located in Sub2, if those assets were directly transferred by BelCo to Sub2.

Assuming that Sub1 in Third Country is subject to a normal tax burden on the assets transferred as compared to the Belgian tax burden, a transfer of assets from BelCo to Sub1 would not be targeted by Article 344, § 2 of the BITC. The subsequent transfer of the assets by Sub1 in Third Country to Sub2 in FC should be respected by the tax administration (provided the transfer was not a sham transaction).[26]

If Sub1 in Third Country is not subject to a normal tax burden on the assets transferred as compared to the Belgian tax burden, a transfer of assets from BelCo to the former is clearly covered by Article 344, § 2 of the BITC. The question becomes complicated when one tries to determine whether the subsequent transfer of the assets by Sub1 in Third Country to Sub2 in FC should be respected by the tax administration, and thus whether BelCo remains taxable on the income produced by the assets subsequently transferred.

Pursuant to one interpretation, BelCo should remain taxable on the income produced by the assets transferred for the total life of the assets (for example, an interest-bearing bond with a life of 10 years, generating 5 percent interest, should remain taxable in the hands of BelCo for the entire life of the asset, i.e., 10 years, regardless of whether the asset is subsequently transferred to a tainted or a non-tainted beneficiary).[27] In contrast, another opinion holds that the income produced by the assets transferred remains taxable in the hands of BelCo, as long as the assets are owned by a tainted beneficiary.[28] According to the latter view, Article 344, § 2 ceases to apply if the assets are transferred from a tainted beneficiary to a non-tainted beneficiary.

Another question that arises is whether Article 344, § 2 of the BITC can continue to operate when the asset transferred is reinvested by the tainted beneficiary (for example, an interest-bearing bond is sold to a third party located in a country with a normal tax regime and the proceeds are used by the tainted beneficiary to grant a intra-group loan carrying a fixed interest percentage). Some scholars seem to be of the opinion that the Belgian taxpayer remains taxable on the income produced by the reinvested asset.[29] There are no administrative guidelines on how to apply Article 344, § 2 to this situation. Nor are the authors aware of any case law that might clarify the matter. It, therefore, remains to be seen how the provision would be applied by the Belgian Courts to such a situation.

D. Exclusions from application of Article 344, § 2 of the Belgian Income Tax Code of 1992

As discussed in II.C. above, Article 344, § 2 of the BITC introduces a legal fiction that certain transfers of assets do not have to be respected by the tax administration. The tax administration bears the burden of proving that all the conditions for the application of Article 344, § 2 are satisfied (for example, with respect to the beneficiary being a tainted beneficiary and the nature of the income).[30] It is then up to the taxpayer to prove that the conditions for avoiding the application of Article 344, § 2 are satisfied.

The taxpayer can avoid the application of Article 344, § 2 of the BITC by demonstrating that the transfer concerned was justified by legitimate needs of an economic and financial nature (at the point in time when the assets are transferred), which encompasses all justifications of a financial or economic nature other than those aimed at alleviating the taxpayer's income tax burden.[31]

A taxpayer who is unable to prove that a transfer was justified by legitimate needs of an economic and financial nature can still avoid the impact of Article 344, § 2 of the BITC if he is able to demonstrate that the consideration received for the transaction produces income that is subject in Belgium to a tax burden that is comparable to the tax burden that he would have borne had the transaction not taken place. The taxpayer must first demonstrate that he received an arm's length consideration for the asset transferred.[32] In addition, the taxpayer must demonstrate (not that the amount of taxable income is comparable, but) that the consideration received bears a tax burden in Belgium that is comparable to the tax burden that would have been levied on the income produced by the asset if the transfer had not taken place. This burden of proof must be met on an annual basis.[33] Thus, a taxpayer who contributed certain assets to the paid-up capital of a tainted beneficiary can only meet the burden of proof if the tainted beneficiary distributes sufficient dividends.[34]

III. Article 344, § 2 of the Belgian Income Tax Code of 1992 and tax treaties

No administrative guidelines are available that indicate how Article 344, § 2 of the BITC should operate in a tax treaty context. Belgium's general position is that a tax treaty cannot prevent the application of domestic anti-abuse legislation, even when the treaty does not contain an explicit provision to that effect.[35]

As discussed in II.B, above, Article 344, § 2 of the BITC has some elements in common with a CFC regime. In particular, the tax mechanism of the provision is similar to a CFC regime that uses a transactional method, because the provision only targets specified tainted income. Thus, in order to determine whether Article 344, § 2 is consistent with Belgium's tax treaties, it might be useful to look at Belgium's position in relation to CFC legislation.

It should be noted that the Belgian Government has made a strong observation on the 2003 OECD Commentary. Belgium considers that the application of CFC legislation is contrary to the provisions of paragraph 1 of Article 7 and paragraph 5 of Article 10 of the OECD Model Tax Convention, especially where a Contracting State taxes one of its residents on income derived by a foreign entity by way of a fiction.[36] In accordance with the principle of good governance, it might be expected that Belgium would not apply Article 344, § 2 of the BITC to transactions involving residents of States with which Belgium has concluded tax treaties.

The Belgian Courts have already confirmed that provisions adopting fictions (such as Article 344, § 2 of the BITC) that permit Belgium to claim back the right to tax on certain items of income, where Belgium has initially agreed to grant the right to tax to the other Contracting State, cannot be upheld.[37] How the Belgian Courts will interpret Article 344, § 2 in relation to Belgium's tax treaties remains an open question.[38]

Finally, it should be observed that the Belgian Government is of the opinion that Article 344, § 2 of the BITC is not contrary to Article 9 of the OECD Model Convention because it provides for a rebuttable presumption and does not significantly amend the rules on the determination of the amount of taxable income.[39] This however, is debatable, and will depend on a factual analysis of each case.

IV. Possible effect of EC case law on the application of Article 344, § 2 of the Belgian Income Tax Code of 1992

Article 344, § 2 of the BITC can, if certain requirements are met, produce the same results as CFC legislation. Like a CFC regime, Article 344, § 2 aims to prevent the accumulation of profits by a resident taxpayer in a low-tax jurisdiction and impedes the benefit of tax-deferral.

The compatibility of CFC legislation with the freedoms conferred by the Treaty on the Functioning of the European Union (TFEU) has already been addressed by the European Court of Justice (ECJ) in *Cadbury Schweppes*.[40] In its judgment in that case, the ECJ held that CFC legislation is compatible with the principles of the TFEU, provided certain strict requirements are met.

First, the ECJ observed that the CFC legislation at issue was capable of restricting the freedom of establishment because it deterred taxpayers resident in one EU Member State from setting up in another Member State second establishments subject in that State to a lower level of taxation.[41] The ECJ went on to state that such a restriction can only be justified by overriding reasons of public interest and must not go beyond what is necessary to attain that interest.[42] The ECJ concluded that the CFC legislation at issue was apt to prevent wholly artificial arrangements but that the measure did go beyond what was necessary insofar as the measure also applied to situations in which, "despite the existence of tax motives, the incorporation of a CFC reflects economic reality."[43]

As discussed above, a Belgian taxpayer is targeted by Article 344, § 2 of the BITC whenever one of the assets listed in the Article is transferred to a non-Belgian tax resident located in a low-tax jurisdiction. The scope of application of Article 344, § 2 is, therefore, broader than that of CFC rules. First, there is no requirement that the transferor have any control over the transferee. Second, there are no genuine safe-harbour rules that allow the application of Article 344, § 2 to be avoided. Third, Article 344, § 2 provides for a rebuttable presumption that a transfer of assets that meets the objective criteria for its application is *prima facie* motivated by tax avoidance. And finally, Article 344, § 2 provides no measures to mitigate the adverse effects of economic (i.e., when the income is generated) and juridical double taxation (i.e., when the income is distributed by the transferee subsidiary)

It is, therefore, possible that Article 344, § 2 of the BITC obstructs both the freedom of establishment provided for by Article 49 of the TFEU[44] and the principle of the free movement of capital as provided for by Article 63 of the TFEU.[45]

In the case at hand, BelCo has an indirect 100 percent shareholding in Sub2. According to settled case law of the ECJ, "a national of a Member State who has a holding in the capital of a company established in another Member State which gives him definitive influence over the company's decisions and allows him to determine its activities, is exercising his *right of establishment*" (emphasis added).[46] Moreover, it is likely that there will be links between the companies involved at management level. As that circumstance was recently taken into account by the ECJ in concluding that a particular situation fell within the scope of the freedom of establishment,[47] it can be safely stated that a situation such as that envisaged in the case at hand is within the scope of the freedom of establishment.

Article 344, § 2 of the BITC is likely to obstruct the freedom of establishment insofar as it only targets a transfer of assets to a non-Belgian tax resident. Consequently, an intra-EU transfer is put at a disadvantage as compared to a purely Belgian domestic transfer.[48] As Article 344, § 2 was enacted to counter international profit shifting schemes, it seems likely that the Belgian government would justify this restriction as preventing abusive transfers, and on the grounds of the need to preserve the tax base. However, according to the ECJ, such a provision can only be justified if it exclusively targets wholly artificial arrangements and does not go beyond what is necessary to achieve the prevention of such arrangements.

Finally, the Belgian tax administration is of the opinion that Article 344, § 2 is problematic in relation to the EC Arbitration Convention insofar as the rule is applied to transactions between associated enterprises and leads to an adjustment of the profits of the Belgian transferor that does not respect the arm's length principle.[49]

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NOTES

[1] For example BITC, Art. 26 allows the tax administration to add back to the profit of a resident transferor the "abnormal and gratuitous" advantage granted to the transferee unless the advantage so granted is taken into account in determining the taxable base of the latter. An advantage granted is deemed to have an abnormal or gratuitous character if it is established that the transferor did not receive (proper) consideration or that the consideration received is contrary to normal business practice. To counter the risk of economic double taxation, the administration, in principle, does not apply the provision where both the transferor and the transferee are located in Belgium.

[2] BITC, Art. 54 allows the tax administration to disallow the deduction of certain payments made to beneficiaries located in low-tax jurisdictions. Art. 54 introduces a presumption that such payments relate to sham transactions and/or do not meet the arm's length requirement. The taxpayer can avoid the application of Article 54 by demonstrating that the payments are made with respect to genuine and good faith operations. Recently introduced BITC, Art. 198, 10° disallows the deduction of payments made by a nonresident that is subject to Belgian income tax (e.g., a branch) to a beneficiary located in a country that does not meet the requirements of the Organisation for Economic Cooperation and Economic Development (OECD) as regards the exchange of information, or to a beneficiary located in a low-tax jurisdiction (i.e., a jurisdiction in which the general income tax rate is lower than 10 percent a presumptive list of such low-tax jurisdictions is included in Art. 74/4 *quater* of Royal Decree 92 implementing the BITC). The deduction is disallowed if the nonresident, Belgian taxpayer, failed to declare the relevant payment in his tax return (which is an obligation under BITC, Art. 307, § 1) or, if the qualifying payment is declared, it cannot be regarded as being made in the framework of genuine and good faith transactions entered into with persons other than artificial structures.

[3] BITC, Art. 26, for example, allows the tax administration only to add back to the profits of a Belgian transferor an "abnormal and gratuitous advantage" granted and does not permit it to tax the recurring, undistributed profits of a foreign controlled subsidiary of a Belgian taxpayer.

[4] Coordinated Laws on the taxation of income, Art. 41, § 2 (introduced by Law of Feb. 23, 1954, Art. 2).

[5] C. Docclo, "National Report (Belgium) - Limits on the use of low-tax regimes by multinational businesses: current measures and emerging trends," in IFA (ed.), *Cah. Dr. Fisc. Int.*, Volume LXXXViB, Den Haag, Kluwer Law International, 2001, pp. 399-419 at p. 402; P. Lion, "Artikel 344, § 2 van het W.I.B. 1992: "een papieren tijger", *A.F.T.*, 1995, pp. 317-344 at p. 318.

[6] See C. Docclo, fn. 6, above, at p. 402.

[7] See P. Lion, fn. 6, above, at p. 318.

[8] See P. Lion, fn. 6, above, at p. 318.

[9] Law of 28 June 1992; See J. Malherbe, *Droit Fiscal International*, Brussel, Larcier, 1994, pp. 1 – 910, at p. 606.

[10] This inclusion does not cover the granting of loans (whether or not for consideration) because this does not fall within the scope of the transactions covered by BITC, Art. 344, § 2 (i.e., it cannot be regarded as a sale, transfer or contribution); see to that effect J. Kirkpatrick and D. Garabedian, *Le régime fiscal des sociétés en Belgique*, Brussels, Bruylant, 2003, pp. 1- 604, at p. 492. In contrast, the Belgian Minister of Finance is of the opinion that loan transactions do fall within the scope of BITC, Art. 344, § 2 (see Parl. Question of May 6, 1993, *Bull. C.*, 1993, p. 3156).

[11] L. De Broe, *International Tax Planning and Prevention of Abuse*, Amsterdam, IBFD Publications, 2008, pp. 123 -143, at p. 131.

[12] J. Malherbe and Ph. Malherbe, *"Les prix de transfert. Approche moniste ou dualiste?" — Ann. Dr. Louvain*, 2001, pp. 117 – 235, at p. 185; see P. Lion, fn. 6, above, at p. 319.

[13] J. Malherbe and P. Faes, 953-2nd T.M., *Business Operations in Belgium*, p. A-170.

[14] See J. Malherbe and P. Faes, fn. 14, above, at p. A-186. According to the administrative guidelines (Com.IB 344/1) on BITC, Art, 344, § 2, the provision introduces a rebuttable presumption of a sham transaction. This is very likely based on the wording of the statute according to which the tainted transfer is "not binding on the tax administration." This expression is often used in Belgian tax law to show that a sham transaction cannot produce legal effects towards third parties. Based on the fact that a taxpayer can avoid the application of Art, 344, § 2 by proving that the transaction is justified by legitimate financial or economic needs, the Belgian lower Courts and the Belgian Supreme Court (*Hof van Cassatie/Cour de Cassation*) are of the opinion that Art, 344, § 2 merely introduces a fiction according to which the assets transferred are

deemed to remain in the estate of the transferor. Consequently, the income that is produced by the tainted assets is deemed to remain taxable in the hands of the transferring Belgian taxpayer. See L. De Broe, fn.12, above, at pp. 128 – 129.

[15] See L. De Broe, fn.12, above, at p. 127.

[16] See L. De Broe, fn.12, above, at p. 127.

[17] This however is debatable; see J. Malherbe and Ph. Malherbe, fn.13, above, at p. 184.

[18] BITC, Art. 344, § 2 provides that : "The sale, transfer or contribution of shares, bonds, debt claims or other securities, patents, manufacturing processes, trademarks or any similar rights, or cash to a taxpayer mentioned in Article 227 who, according to the laws of the country where he is established, is not subject to income tax or is, with respect to the income derived from the assets and rights transferred, subject to tax treatment there that is considerably more favourable than that to which similar income is subject to tax in Belgium, is not binding on the income tax authorities, unless the taxpayer proves that the operation is justified by legitimate needs of a financial or economic nature or that the consideration received for the operation produces income that is subject in Belgium to a tax burden that is normal in comparison with the burden that would have been borne if the operation had not taken place."

[19] See J. Malherbe, fn.10, above, at p. 592; see fn. 3, above.

[20] See J. Kirkpatrick and D. Garabedian, fn. 11, above, at pp. 151 and 444.

[21] See L. De Broe, fn. 12, above, at p. 132.

[22] See L. De Broe, fn. 12, above, at p. 132.

[23] This question is relevant because, in Belgium, taxable income is in principle determined by reference to Belgian accounting principles; see J. Malherbe, M. De Wolf and C. Schotte, *Droit Fiscal l'Impôt des Sociétés*, Bruxelles, Larcier, 2007, pp. 1 – 453, at pp. 40 – 41.

[24] See J. Malherbe, fn. 10, above, at p. 606.

[25] J. Malherbe and F.X. Jeanmart, "Utilisation des filiales et des succursales étrangères à des fins de moindre impostition" in *Le droit fiscale international belge et l'évitement de l'impôt*, Ed. Jeune Barreau Bruxelles, 1996, p. 59; J. Malherbe and Ph. Malherbe, fn. 13, above, at p. 185.

[26] J. Malherbe and F.X. Jeanmart, fn. 26, above, at p. 56.

[27] See J.P. Lagae and P. Mathieu, "Prix de transfert entre sociétés belges et sociétés étrangères" in *Le droit fiscal belge et l'évitment de l'impôt*, Ed. Jeune Barreau de Bruxelles, 1996, pp. 77 – 132, at p.109.

[28] See L. De Broe, fn. 12, above, at p. 135.

[29] See P. Lion, fn. 6 above, at p. 333 with reference to A. Haelterman, "De Belastingvrije Luxemburgse Holdings versus Belgische fiscale anti-holdingsbepalingen" in *Is er nog leven na de Luxemburgse Holding?*, Biblio-dossier, Fiscaliteit 27, 9. This view implies that the transferor would have given the assets transferred the same destination as the transferee. Such an interpretation is doubtful. J. Kirkpatrick and D. Garabedian, fn.11, above, at p. 492.

[30] The tax administration is not, however, required to prove the existence of fraud or an intention to reduce the tax base. The statute itself presumes that the taxpayer intended to avoid tax by transferring the asset(s) abroad.

[31] See L. De Broe, fn. 12, above, at p. 140, which argues that the use of the word "legitimate" seems to indicate that the statute requires a reasonableness test. Thus, the needs put forward by the taxpayer can be rejected if it is clear that a reasonable person who was guided by those needs would not have opted to enter into the scheme set up by the taxpayer. However, if it is established that the scheme meets the legitimacy requirement, BITC, Art. 344, § 2 cannot be applied.

[32] A conflict may therefore arise between BITC, Art. 26 (see fn. 2, above) and BITC, Art. 344, § 2. The tax administration cannot apply both provisions simultaneously, because, under Art. 26, the tax administration accepts that the transfer has effectively taken place (although adding back to the profits of the transferor the "abnormal and gratuitous" advantage granted to the transferee), while Art. 344, § 2, on the other hand, is based on the fiction that the transfer has not taken place.

[33] See P. Lion, fn. 6, above, at p. 331.

[34] See J. Kirkpatrick and D. Garabedian, fn.11, above, at p. 491; J. Malherbe and F.X. Jeanmart, fn. 26, above, at p. 62. If, prior to the transfer, the asset produced taxable income in Belgium of 5, the dividend distributed would have to be at least 5. However, in the unlikely situation that the dividend were to qualify for the participation exemption regime, so that 95 percent of the dividend was exempt in Belgium, the transferee would have to distribute at least 100 (so that after the exemption of 95 percent of the dividend, there would remain a taxable income of 5) to meet the requirements of BITC, Art. 344, § 2.

[35] See official Commentary on the Belgium's tax treaties 28/17 and 9/3 and 5.

[36] See Belgium's Observations on the 2003 OECD Commentary on OECD Model Convention, Arts. 7 and 10.

[37] Supreme Court, Dec.5, 2003, *F.J.F.*, 2004/64.

[38] AS BITC, Art. 344, § 2 was introduced in 1954, and all Belgium's tax treaties were signed after 1954, an argument could be made that Art. 344, § 2 is compatible with Belgium's tax treaties. Conversely, it could be argued that Belgium has expressly renounced the right to apply Art. 344, § 2, because it did not include in its treaties safeguarding clauses to that effect.

[39] See Com. DTT 9/5.

[40] ECJ, Sept. 12, 2006, Case C-196/04 Cadbury Schweppes.

[41] See C-196/04, § 46.

[42] See C-196/04, § 47.

[43] See C-196/04, § 65.

[44] Treaty establishing the European Community (ECT), old Art. 43.

[45] ECT, old Art. 56; this principle can also be applied in relation to third countries. However, there is an explicit safeguarding clause in TFEU, Art. 64 with regard to restrictive measures that existed on Dec. 31, 1993: such provisions are not affected by TFEU, Art. 63. BITC, Art. 344, § 2 was first introduced in 1954 and the last modifications to it were made in 1992 it is, therefore submitted that Art. 344, § 2 can be applied without limitation in relation to third countries.

[46] ECJ, April 13, 2000, Case C-251/98 *Baars*, § 22.

[47] ECJ, Jan. 21, 2010, Case C-311/08 SGI, § 35. To the authors' knowledge, this was the first case in which the ECJ referred to "links between companies at a management level" in concluding that the freedom of establishment was at stake.

[48] See J. Malherbe and Ph. Malherbe, fn.13, above, at p. 187.

[49] Circular Letter of June 28, 1999, AFZ 98-0003, p 12 – 13 ; See L. De Broe, fn.12, above, at p. 995.

Host Country
BRAZIL

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I. Brazilian regime for taxing foreign-source income of Brazilian companies

A. History and objectives

Until 1995, Brazil did not charge income tax (or any similar tax) on profits derived abroad by Brazilian companies.

However, with the enactment of Law n. 9,249/1995, the Brazilian tax system changed significantly. This law instituted a system of worldwide income taxation requiring Brazilian companies to pay income tax on income derived abroad. The system applied not only to income derived abroad by Brazilian companies directly or through branches, but also encompassed the income of foreign companies controlled by or affiliated with Brazilian companies. Tax on the income of a controlled or affiliated foreign company became due when such company issued its balance sheet at each year end, regardless of whether there was any actual distribution of profits to the controlling/affiliated Brazilian company.

Law n. 9,249/1995, which was vigorously challenged by tax scholars, was justified by the legislators as being a necessary instrument for tackling schemes that achieved the postponement of tax payments through the use of foreign structures.

The first aspect of Law n. 9,249/1995 that provoked opposition was that the rules it introduced disregarded the requirement that there should be an income tax triggering event, i.e., the income becoming economically or legally available to the taxpayer. In addition, the rules created a number of practical difficulties. For instance, how could the Brazilian taxpayer set off the foreign income tax payable on the foreign income against its Brazilian income tax liability with respect to that income if the latter liability became due before the former? Or, to take another example, if the foreign country levied withholding tax on the distribution of dividends, how could the Brazilian company credit such foreign withholding tax against its Brazilian tax liability, where the latter liability became due before such distribution was made?

In response to all the questions raised, Normative Ruling (NR) n. 38/1996 was issued. Although the expressed goal of NR n. 38/1996 was to regulate Law n. 9,249/1995, in reality, it materially changed the rules on the taxation of foreign profits. In fact, under NR n. 38/1996, income tax became due when the profits of a foreign company were paid or credited to a Brazilian company (rather than, as previously, on the issuance of the foreign company's balance sheet at year end).

In 1997, subject to some changes, the regime set forth in NR n. 38/1996 was given legal status, with the enactment of Law n. 9,532/1997. The new law was proposed by the Minister of Treasury, who justified it based on the need to conform the taxation of foreign profits to the income tax triggering event.

In 2001, Supplementary Law n. 104/2001 amended the National Tax Code in order to allow mere ordinary laws to establish the conditions under which and the point in time at which foreign-source income was to be considered "available" for purposes of Brazilian income tax.

In the same year, Provisional Measure (MP) n. 2,158-34/2001 was enacted, having the same force and consequences as a law. MP n. 2,158-34/2001 established the rules for the taxation of the profits of controlled and affiliated foreign entities that are currently in force, which are as follows:

Article 74

In order to assess that tax basis for the income tax and the social contribution on profits, in accordance with Article 25 of Law n. 9,249, of December 26, 1995, and Article 21 of this provisional measure, the profits derived by controlled and affiliate foreign companies will be deemed available to the Brazilian controlling or affiliated company at the date of the balance sheet in which such profits were determined, as governed by further regulations.

Sole paragraph

Profits derived by controlled or affiliate foreign companies up to December 31, 2001 will be deemed available on December 31, 2002, unless a triggering event provided by the legislation currently in force has occurred before that date.

Since controlled foreign company (CFC) rules are usually designed to tackle tax avoidance schemes by taxing, *inter alia*, the profits of tax haven entities and profits arising from passive investment, it is commonly agreed among Brazilian tax scholars that, rather than proper CFC rules, Brazil has very broad rules for the taxation of foreign profits, since the rules apply to any foreign-source income regardless of its nature or origin.

As might be expected, MP n. 2,158-35/2001 attracted much criticism, as well as raising many doubts with a single provision, and one that provided very little detail, the legislators had attempted to regulate a matter as complex as the taxation of foreign profits.

Even though, in 2011, MP n. 2,158-35/2001 will have been in existence for ten years, it is still uncertain whether it created a rule for the taxation of:

- Profits derived by foreign companies;
- Deemed distributions of profits by foreign companies; or, even
- Increases in the net equity of Brazilian companies resulting from their participation in foreign companies.

Which of these alternatives is correct is extremely significant in a number of contexts, particularly so in the context of profits derived from controlled companies and affiliates resident in countries that have entered into tax treaties with Brazil.[1] For example, if Article 74 of MP n. 2,158-35/2001 is a rule for taxing profits derived by foreign companies, Article 7 of Brazil's tax treaty (which, subject to minor deviations, follows the wording of Article 7 of the OECD Model Convention) would prevent Brazil from imposing such taxation on profits derived by companies resident in treaty partner countries. On the other hand, if Article 74 is a rule for the taxation of deemed distributions of profits, only a treaty under which Brazil has waived its right to tax dividends received from companies resident in the other Contracting State would prevent Brazil from applying Article 74. (So far, Brazil has concluded only five such treaties those with Argentina, Austria, Ecuador, India and Spain). Finally, if Article 74 is a rule for taxing increases in the net equity of Brazilian companies resulting from their participation in foreign companies, none of Brazil's tax treaties would prevent Article 74 from applying, since this would be considered a matter of domestic taxation and tax treaties are designed to avoid juridical, not economic, double taxation.

In the most recent cases on the matter, the Brazilian Administrative Tax Courts have held that Article 74 of MP n. 2,158-35/2001 is a rule for taxing profits derived by foreign companies.[2] In older decisions, however, other conclusions were reached.[3]

It is worth noting that Article 74 of MP n. 2,158-35/2001 has been challenged before the Brazilian Supreme Federal Court.[4] To date, six Justices have ruled on the case: three voted for its unconstitutionality, two for its constitutionality, and one for its unconstitutionality only with regard to affiliates. Four Justices have yet to vote (although the Full Bench is composed of 11 Justices, one will not vote because he was the Federal Public Attorney when the measure was enacted).

B. Relevant definitions

As discussed in I.A., above, Brazil's regime for taxing foreign profits is not a CFC regime *per se*, as it applies to any foreign income regardless of its nature or origin. There is thus no legal definition of a CFC for purposes of the regime.

As regards other relevant terms, Brazilian tax law adopts a very broad concept of "corporation" or "company." In principle, any form of legal entity would fall within the scope of this concept for purposes of the Brazilian rules on the taxation of foreign profits even foreign partnerships, which are generally deemed not to be legal entities, are treated as legal entities for these purposes under Brazilian law.

A "foreign" company is any legal entity incorporated under the laws of another country.

Finally, a legal entity is deemed to be "controlled" by a Brazilian company when the Brazilian company has the power, directly or indirectly, to:

- Prevail with respect to decisions concerning the legal entity; and
- Elect the majority of the legal entity's management team.

Brazil's so-called "CFC rules" do not apply to individuals.

Brazilian law does not provide for the formation of "trusts" and partnerships," even though it recognises their existence in other countries and the legal effects in Brazil derived from the relationship of Brazilian individuals and legal entities with such structures. Given this approach, one interesting question that might arise in this context is whether the so-called "CFC rules" would apply to profits derived by foreign companies that are controlled by or affiliates of Brazilian condominiums or consortia, which, under Brazilian law are not legal entities, but in some situations are treated as such for tax purposes. The authors are not aware of any legal precedents on this subject, but understand that the tax authorities may try to apply a "look-through" approach in these situations, i.e., they would attempt to apply the so-called "CFC rules" to the members of a condominium or consortium that are legal entities, but not to members who are individuals.

C. Types of income subject to current taxation, "safe harbour" rules and significance of a "tax avoidance purpose"

Brazil's so-called "CFC rules" apply to any type of income and there is no applicable "safe harbour" provision.

Since the rules are not anti-avoidance rules, as CFC rules normally are in other countries, it would usually be irrelevant from the perspective of the tax authorities whether or not the creation of Sub2 had a tax avoidance purpose. Nonetheless, when a Brazilian controlling or affiliate company fails to demonstrate the business purpose or economic substance of its controlled or affiliate foreign company, the tax authorities tend (even though there is no legal basis for such an approach) to disregard the existence of the foreign company and consider the profits directly earned by the Brazilian company.

Furthermore, since a number of multinational groups with headquarters in Brazil interpose foreign holding companies in treaty partner countries in order to avoid the application of the "CFC rules," in recent years the tax authorities have resorted to such concepts as "treaty shopping" and "conduit companies" when issuing tax assessments (again without any legal basis for doing so).

Another very controversial issue is the scope of the Brazilian "CFC rules." In *Eagle 2*,[5] the Brazilian Administrative Tax Court analysed a structure in which a Brazilian company (Eagle) controlled a Spanish company (Julua) that, in turn, controlled two companies one in Uruguay (Monthiers) and one in Argentina (CCBA). The Court ruled that the Brazil-Spain tax treaty prevented Brazil only from taxing the profits derived in Spain, and not the profits derived by the two indirectly controlled companies. Since Brazil has no tax treaty with Uruguay, the Court reached the conclusion that Brazil was entitled to tax the profits of Monthiers. (As CCBA was in a loss position, the Court did not address the question, but, if CCBA had profits, it seems likely that the Court would have concluded that the Brazil-Argentina tax treaty prevented Brazil from taxing such profits).

The Court's decision in *Eagle 2* is highly questionable since it disregards the fact that profits of an indirectly controlled company can only represent an increase in wealth for the Brazilian company through the medium of the directly controlled company. For example, if the indirectly controlled company has profits of 100 but the directly controlled company has losses of 200, the consolidated result abroad would be a loss of 100. Taxing the 100 derived by the indirectly controlled company would, therefore, be unfair and would not correctly reflect the results of the group outside Brazil.

In view of the above, if the line of reasoning used in *Eagle 2* prevails, this will have an enormous tax impact for most Brazilian groups with international structures.

D. Other circumstances triggering current taxation

As discussed in I.A., above, Article 74 of MP n. 2,158-35/2001 requires the profits of a controlled or affiliated foreign company to be taxed in the hands of its Brazilian controlling or affiliate company as of the date of issuance of the balance sheet on which such profits are reflected (unless a provision of an applicable tax treaty provides otherwise). Thus, in principle any of the other tax triggering events that are commonly found in the CFC rules of other countries (bribes, boycotts, etc.) would occur after the triggering event laid down in the Brazilian legislation.

However, also as discussed in I.A., above, before the enactment of MP n. 2,158-35/2001, the taxation of foreign profits was governed by Law n. 9,532/1997, under which profits from a controlled or affiliated company were taxed in Brazil on their being paid or credited to the Brazilian controlling or affiliated company.

Under Law n. 9,532/1997, such profits were considered to have been *credited* on their registration as an obligation in favour of the Brazilian beneficiary in the accounts of the foreign company, and to have been *paid*:

- On their transfer to a bank account of the Brazilian beneficiary, whether in Brazil or abroad;
- On their transfer to a representative of the Brazilian beneficiary; or
- On the use of the proceeds for the benefit of the Brazilian beneficiary, including by way of an increase in the capital of a controlled or affiliated foreign company of the Brazilian company.

Moreover, under Law n. 9,532/1997, profits were deemed to have been distributed if a profitable controlled or affiliated foreign company lent money to its Brazilian controlling or affiliate company or paid in advance for goods and services acquired from the latter.

Since MP n. 2,158-35/2001 did not expressly repeal Law n. 9,532/1997, it is uncertain whether the hypotheses set forth in Law n. 9,532/1997 are still in force. The tax authorities are of the opinion that the two pieces of legislation co-exist, even though each imposes a very different regime for the taxation of foreign profits. Another area of uncertainty is what would happen should Article 74 of MP n. 2,158-35/2001 be declared unconstitutional by the Supreme Federal Court. Would Law n. 9,532/1997 continue to apply or would the legislators have to enact a new provision to govern the taxation of foreign profits (since Law n. 9,532/1997 would have been implicitly repealed by MP n. 2,158-35/2001)?

There is no clear prevailing position on this issue, even among scholars and practitioners who specialise in such matters.

E. Rules for determining income

In Brazil, the starting point for determining the income tax basis is the accounting profit. The tax law sets forth some items (for example, goodwill and accelerated depreciation) that are to be excluded from and some items (for example, non-deductible expenses and provisions) that are to be added to the accounting profit to arrive at the taxable profit.

As regards foreign companies, Brazilian law allows the profits of a controlled or affiliated foreign company to be determined in accordance with the accounting rules of its country of residence (if that country does not have accounting rules, the Brazilian rules will apply). However, some recent tax assessments have attempted to apply Brazilian rules to determine the taxable profits of foreign companies, on the grounds that the rules of the country concerned deviate excessively from those applicable in Brazil (for example, because they allow the deductibility of a provision that is not accepted in Brazil). Use of this method is clearly in contravention of the law and is being strongly criticised by taxpayers and their representatives.

F. Determination of HCo's pro-rata share of income

HCo would be liable to tax on the foreign profits concerned in proportion to its participation in the stock value of Sub1, regardless of the percentage or nature of such participation. Thus, in the example given, HCo would have to add 70 percent of the profits derived by Sub1 to its income tax basis. If the situation were reversed, i.e., if HCo were to hold the remaining 30 percent in preferred stock, it would have to add 30 percent of the profits derived by Sub1 to its income tax basis.

G. Rules for current taxation of foreign income

In the example given, the profits of Sub2 are deemed to flow up to HCo through Sub1 (indeed this is one of the strongest arguments for defending the position that the Brazilian regime constitutes a rule for the taxation of foreign profits rather than a rule for the taxation of deemed dividend distributions). Thus, assuming that Sub2 had a profit before taxes due to FC of 100, this would be the amount added to HCo's income tax basis in Brazil.

Brazilian law provides for an ordinary credit method with regard to taxes paid abroad, provided the source country also allows Brazilian taxes to be credited against taxes due in the reverse situation (i.e., where Brazil is the source country). Thus, taxes paid in FC and in Third Country can be credit against the tax due in Brazil. A per country limitation applies.

Brazilian taxpayers are frequently confronted with a complex situation when the Brazilian tax is due before payment of the foreign tax. Even the tax authorities do not know precisely how to resolve this situation, which can lead to double taxation.

H. Adjustments to avoid double taxation

Profits already added to the income tax basis in Brazil in accordance with Article 74 of MP n. 2,158-35/2001 are excluded from the taxable profits of the Brazilian recipient company when they are actually distributed, in order to avoid the double taxation of the same profits. If Sub1 is situated in a treaty partner county and, for this reason, Article 74 did not apply to tax the profits of Sub2, these profits will be subject to taxation in Brazil on distribution to HCo, unless Sub1 is resident in a country that has a treaty with Brazil that exempts dividends distributed by a company resident in that country from Brazilian income tax.

I. Impact of Brazil's tax treaties

For the impact of Brazil's tax treaties on the so-called "CFC rules," see the comments at I.A., above.

Even though Brazil is not a member of the EU, cases such as *Cadbury, Schweppes*, *Schneider* and *Vodafone* are regarded as providing important guidance with respect to international tax planning by both taxpayers and the tax authorities, especially as the taxation of foreign profits is a rather recent phenomenon in Brazil and case law and legal doctrine on the subject are still scarce.

II. Other regimes imposing current taxation

There are no other regimes in Brazil's income tax law under which income realised by an entity that is not itself subject to taxation by Brazil might be currently taxed to direct or indirect owners of the entity that are residents of Brazil.

NOTES

[1] Currently Brazil has tax treaties in force with the following countries: Argentina, Austria, Belgium, Canada, Chile, China (PRC), the Czech Republic, Denmark, Ecuador, Finland, France, Hungary, India, Israel, Italy, Japan, Korea (ROK), Luxembourg, Mexico, the Netherlands, Norway, Peru, the Philippines, Portugal, the Slovak Republic, South Africa, Spain, Sweden and the Ukraine. Treaties with Russia, Venezuela and Trinidad and Tobago, though signed, are not yet in force or effect.

[2] Decision n. 101-95.802, of Dec.19, 2006 (*Eagle*) and Decision n. 101-97.070, of Dec. 17, 2008 (*Eagle 2*).

[3] For example, Decision n. 108-08.765, of March 23, 2006 (*Refratec*) held that MP n. 2,158-35/2001, Art. 74 is a rule for taxing deemed distributions of dividends.

[4] Unconstitutionality Action n. 2,588.

[5] See fn. 2, above.

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Host Country CANADA

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I. The Canadian foreign affiliate system

The Canadian foreign affiliate system provides the rules that govern the taxation of Canadian taxpayers on income earned by their foreign affiliates. In the example provided, it is expected that the income earned by Sub2 would be considered to be active business income from a business carried on by it in its home foreign jurisdiction and that it would be considered to be tax resident in that jurisdiction. The Canadian foreign affiliate rules would not seek to tax that active business income until it was repatriated to Canada or otherwise realised by the Canadian taxpayer, HCo (hereinafter "Canco"). If, however, Sub2 was also to earn foreign accrual property income (FAPI), as defined in the Canadian Federal Income Tax Act[1] to be essentially passive or inactive/non-qualifying business income, as Sub2 is a controlled foreign affiliate (CFA) of Canco, that income would be taxed on an accrual basis to Canco in Canco's taxation year in which the taxation year of Sub2 ends.

Canco, as a taxable Canadian corporation, is subject to Canadian mainstream combined federal and provincial corporate income tax[2] on its worldwide taxable income (computed by deducting from its gross income the deductions to which it is entitled under the ITA). Canada, in designing its foreign affiliate system, opted for a hybrid regime that has blended features of an exemption and of a credit system and combines both deferral and accrual-based taxation, depending on the character of the income earned by a foreign affiliate and a CFA of a Canadian corporate taxpayer. The deferral system relies on concepts of exempt surplus, taxable surplus and pre-acquisition surplus in order to tax active business earnings of a foreign affiliate.

Exempt surplus of a foreign affiliate of a Canadian corporation includes earnings of a foreign affiliate resident in, and from the carrying on of an active business in, a designated treaty country (a country with which Canada has concluded a double tax agreement ("tax treaty") or a country with which Canada has concluded a Tax Information Exchange Agreement (TIEA), the non-taxable portion (50 percent) of capital gains and the taxable portion of certain capital gains from excluded property other than shares of other foreign affiliates and partnership interests, deemed payments, including inter-affiliate payments and amounts that are deductible by another affiliate from its active business income, and certain currency hedging items and dividends received by the foreign affiliate from the exempt surplus of another affiliate.[3]

Active business for this purpose means any business carried on by a foreign affiliate other than an investment business, a non-active business or a non-qualifying business.

Taxable surplus of a foreign affiliate of a Canadian corporation includes earnings from an active business of a foreign affiliate resident in, and from the carrying on of an active business in, a non-tax treaty/non-TIEA country (net of taxes) that are not non-qualifying business income, the taxable portion of certain capital gains, FAPI and dividends received by the affiliate from another affiliate from the latter's taxable surplus. Pre-acquisition surplus includes amounts not allocated to exempt or taxable surplus.

Distributions received by Canco from Sub1 of amounts dividended to it by Sub2 from Sub2 exempt surplus, or otherwise from the exempt surplus of Sub1, will not be subject to Canadian corporate income tax to Canco due to a dividend received deduction equal to 100 percent of the amount of such distributions to which Canco will be entitled.[4] No credit is given by Canada to Canco for underlying foreign tax paid by either Sub1 or Sub2 in respect of such amounts. Taxable surplus distributions received by Canco from Sub1 from amounts it earns or from amounts it receives from Sub2, will be included in its income but are also subject to a dividend received deduction for amounts previously included in Canco's income as FAPI, for underlying foreign tax and withholding taxes withheld, which is intended to provide a credit to Canco for foreign taxes paid by Sub2 and Sub1 on earnings forming part of such taxable surplus, but only up to the amount of Canadian corporate tax otherwise payable by Canco. Distributions from pre-acquisition surplus reduce the adjusted cost base of the shares held by Canco in Sub1. If the adjusted cost base goes into a negative position, the result will be a capital gain to Canco. In this way, the Canadian government has ensured that Canadian companies operating abroad are globally competitive.

The Canadian accrual system applies only to FAPI, including passive income and certain capital gains, and to non-active business income and other non-qualifying business income of a CFA of a Canadian taxpayer. A participating percentage mechanism measures the economic entitlement of the Canadian taxpayer to the income. FAPI is taxed to a Canadian taxpayer on a current basis as it is earned by the CFA, subject to a deduction for grossed up foreign accrual tax.

A. The history and objectives of the foreign affiliate system

As early as 1919, the basic principles of Canadian international taxation were in evidence. Residents were taxed on worldwide income, subject to certain deductions and exemptions, as well as a credit (limited to Canadian tax otherwise payable) for foreign income taxes. Generally, however, all amounts were lumped into "income" without distinction. During the following decades, refinements were introduced to accommodate Canada's first tax treaties with the United Kingdom and the United States. The scope of the exemption system had, by 1949, been made broad enough to render unnecessary the indirect credit mechanism, which was repealed. It was only in 1971, after more than a decade of study[5], that the Canadian government, concerned at the diversion of income both from Canadian and foreign sources to tax havens, introduced proposals that became effective on January 1976 and that form the basis for the Canadian system of taxing on an accrual basis, FAPI from CFAs. Notwithstanding technical amendments introduced since 1974, the current system remains in principle that introduced in 1976 and is the product of a continued balancing by the Canadian government of its tax policy objectives in the international area.

B. The definition of a "controlled foreign affiliate"

The definitions of "foreign affiliate" and "controlled foreign affiliate" are central to Canada's taxation of a Canadian taxpayer in respect of ownership interests in foreign corporations.

A "foreign affiliate" is defined to mean a corporation not resident in Canada, where the Canadian taxpayer's equity percentage in the non-resident corporation is not less than 1 percent, and the total of the equity percentages of the taxpayer and of persons related to the taxpayer in the non-resident corporation is not less than 10 percent.

The concept of "corporation" is crucial to the application of the foreign affiliate rules. The statutory definition of the term, which "includes an incorporated company," is not particularly useful. However, both the Canada Revenue Agency (CRA) administrative guidelines and Anglo-Canadian jurisprudence would suggest that for a foreign entity to be considered in Canadian law to be a corporation, the entity must be composed of one or more members who, by legal fiction operating pursuant to statutory authority, are constituted (or incorporated) into a separate legal personality with a specific or more general purpose and with capacity to exercise rights and incur obligations in respect of its assets. Transferability of interests in the entity and limited liability do not seem to be requisites.[6]

Equity percentage and direct equity percentage[7] are intended to determine the Canadian taxpayer's effective equity interest in a particular foreign corporation. The equity percentage of a taxpayer in a particular foreign corporation is the aggregate of the taxpayer's direct equity percentage in a corporation multiplied by that corporation's equity percentage in another corporation and so on. Direct equity percentage is computed on a class by class basis as the taxpayer's highest percentage ownership in any class of shares. The total direct equity percentage of a taxpayer in a particular foreign corporation may exceed 100 percent.[8]

A "controlled foreign affiliate"[9] is currently defined to mean a foreign affiliate of the taxpayer controlled by:

- The taxpayer;
- The taxpayer and not more than four other persons resident in Canada;
- Not more than four persons resident in Canada, other than the taxpayer;
- A person or persons with whom the taxpayer does not deal at arm's length; or
- The taxpayer and a person or persons with whom the taxpayer does not deal at arm's length.

Traditionally, the test for control for purposes of this definition was understood to be *de jure* control, such as would exist where the taxpayer or the taxpayer and other persons had the right by virtue of their shareholdings to elect a majority of the board of directors of a corporation. Residence in Canada was construed to be the nexus required to form a group.

However, the decision of the Federal Court of Appeal in *Silicon Graphics Limited v. The Queen*[10] has given rise to some uncertainty as to whether there must be more of a connection than common residence in Canada for a group of persons to be considered to control a foreign corporation. In response to this judgment, the definition of "controlled foreign affiliate" has been modified by proposed amendments.

By virtue of these proposed amendments, a "controlled foreign affiliate" is defined to mean a foreign affiliate of the taxpayer that:

- Is controlled by the taxpayer; or
- Would be controlled by the taxpayer if the taxpayer owned all of the shares of the foreign affiliate owned by:
  - (a) The taxpayer;
  - (b) Each person that does not deal at arm's length with the taxpayer;
  - (c) Each of not more than four persons (other than those referred to in (a) and (b)) who are resident in Canada; and
  - (d) Each person that does not deal at arm's length with a person resident in Canada described in (c).[11]

In the example provided, Canco owns 100 percent of the shares of Sub1 and Sub1 holds 100 percent of the shares of Sub2. Both Sub1 and Sub2 are treated as corporations for Canadian tax purposes. Sub2 would, therefore, be a foreign affiliate and a CFA of Canco. As the rules [12] apply to all Canadian taxpayers, if Canco was an individual for Canadian tax purposes who was a resident of Canada, Sub2 would still be a CFA. If Sub1, and indirectly Sub2, were wholly-owned by a partnership or a trust, these entities would also be required to include FAPI of the CFAs in computing their income.

C. Types of income subject to current taxation and exceptions

Basically, the accrual regime under the Canadian foreign affiliate system was put in place to prevent what the Canadian government considered to be inappropriate erosion of the Canadian tax base by forcing current taxation on income that is passive or otherwise considered to be highly mobile. For this purpose, income of a foreign corporation is divided into three separate and distinct types: passive income interest, dividends, rents, royalties and other property income; active business income; and income from a business other than an active business. Income from property and income from a business other than an active business is FAPI.

Income from property includes various amounts derived from a property that are not, based on a facts and circumstances analysis, earned in an active business or otherwise statutorily deemed to be income from an active business, and includes income from an investment business or an adventure or concern in the nature of trade.

The inclusion of earnings from an investment business in FAPI was a reaction to findings by the Canadian courts that a minimal level of activity in a corporation could produce active business income and a concern that earnings from highly mobile businesses would escape the Canadian tax net. Exceptions were included to ensure that genuine foreign businesses would not be caught.

An investment business of a foreign affiliate is a business the principal purpose of which is to derive:

- Income from property (interest, dividends, royalties, rents or any similar returns or substitutes);
- Income from insurance or reinsurance of risks;
- Income from factoring of trade accounts receivable; and
- Profits from the disposition of investment property[13]

A safe harbour rule is provided to carve out certain businesses from the definition. To meet the requirements of the carve out, the business must be carried on principally with arm's length parties. It must also be carried on as:

- A regulated financial business;
- A real estate development business;
- The lending or licensing of property; or
- The insurance or reinsurance of risks.
- Finally, more than five employees must be employed full time in the active conduct of the business.[14]

The second component of FAPI is income from a business other than an active business.[15] Income from four types of activity is caught:

- The sale of property;
- The insurance or reinsurance of risks;
- Activities carried out to earn income from indebtedness and lease obligations; and
- The provision of services.

These provisions are directed at trapping Canadian-source income that would otherwise escape the Canadian tax net. They are broadly drafted but contain a number of exceptions or safe harbour provisions.

The first category of inactive business income comprises income of a foreign affiliate from the sale of goods (or the performance of services as agent in relation to such sale) where the goods were manufactured or otherwise grown, extracted or produced in Canada by the taxpayer or a non-arm's length person in the course of a Canadian business. An exception applies to allow a Canadian exporter of Canadian goods to use a foreign affiliate as a retail distributor to non-resident persons. A foreign affiliate may also sell goods manufactured or processed in its home jurisdiction where its principal business is carried on. A *de minimis* rule excludes the earnings of the foreign affiliate if 90 percent of its gross revenue for the year is derived from the sale of property to arm's length persons, whether directly or indirectly.

The second category of inactive business income derives from activities carried on by a foreign affiliate that insure Canadian risks. Again, a *de minimis* rule will provide an exception if more than 90 percent of the gross premium revenue (net of reinsurance ceded) for a taxation year is from the insurance or reinsurance of non-Canadian risks of arm's length persons.

The inclusion of the third category of inactive business income is directed at base erosion through the use of foreign affiliates by Canadian taxpayers in a financing and leasing business to acquire obligations from Canadian residents. Again a *de minimis* rule applies if more than 90 percent of the gross revenues derive directly or indirectly from obligations of non-resident arm's length persons. A number of other exceptions may also apply, depending on whether the foreign affiliate is regulated or whether the income is excluded. Special rules also apply where income arises from obligations of a partnership, the income or loss from which would affect the Canadian taxpayer's (or a non-arm's length party's) Canadian income computation.

The final deemed inactive business rule applies where a CFA provides services. Under the current provision, income will be from an inactive business and therefore FAPI if, generally, an amount is paid or payable for services and is deductible in Canada in computing income from a business by a person of whom the affiliate is a CFA or by a related person.[16] The rule also applies where the services the affiliate has undertaken are to be performed by an individual resident in Canada of whom the affiliate is a CFA or who is related to such a person. There are currently proposals to expand this provision to apply to income from services of all foreign affiliates, to deductions in computing FAPI of CFAs as well as Canadian income, and to services performed by a broader group of related Canadian individuals.

There is currently no provision in the Canadian foreign affiliate regime that would allow Canco to escape taxation on current FAPI of Sub2 or Sub1 by establishing that it had no tax avoidance purpose in setting up the subsidiaries.[17]

D. Other circumstances in which there is current taxation of income of a controlled foreign affiliate

For taxation years that begin after 2008, the terms non-qualifying country and non-qualifying business are relevant in determining whether income earned by a foreign affiliate constitutes FAPI. A non-qualifying business is defined to be a business carried on through a permanent establishment (PE) in a non-qualifying country. A non-qualifying country is a country that has not entered into a tax treaty with Canada and that has not, within five years of being invited to do so, entered into a TIEA with Canada.

E. Rules used to determine income

FAPI is computed separately for each taxation year of each CFA of a Canadian taxpayer. FAPI cannot be a negative amount. A net FAPI loss will not be attributed to a Canadian taxpayer and is not available to offset a Canadian taxpayer's income from other sources in a taxation year. A net FAPI loss of a foreign affiliate can be carried back three years and forward seven years and used to offset FAPI income of the affiliate in those years.

Amounts included in FAPI are computed in Canadian dollars applying, generally, the rules in Part I of the ITA as if the foreign affiliate were resident in Canada.[18] Foreign exchange issues due to the fact that the foreign affiliate's currency of operation will rarely be Canadian dollars are, in certain circumstances, deemed to be nil.[19] Pre-existing gains or losses on property owned when a foreign corporation becomes a foreign affiliate are also eliminated.[20]

F. Rules for determining pro-rata shares

A Canadian resident taxpayer who directly owns shares in a CFA must determine, for each share, the share's participating percentage in a directly owned CFA and in each lower tier CFA. That percentage of each CFA's FAPI is included in the taxpayer's income, as income from that share, subject to a *de minimis* exception if the CFA's FAPI for its taxation year is CAD 5,000 or less.[21] A share's "participating percentage" is determined at the CFA's taxation year-end and is intended to reflect the amount of FAPI the Canadian taxpayer would have received in respect of the share had all such income been distributed at the end of the year.

Where the CFA that earns the FAPI and each upper tier corporation through which the taxpayer owns shares in that CFA has only one class of issued shares, each share's participating percentage in that CFA is the taxpayer's equity percentage determined as if the taxpayer owned only that one share.[22] For example, if Sub1's only issued shares are 50 common shares (all owned by Canco) and Sub1 owns 100 percent of the common shares in Sub2 (being Sub2's only issued shares), the participating percentage of each share Canco owns in Sub1 is 2 percent, and in respect of each such share Canco is attributed 2 percent of Sub1's and Sub2's FAPI. In respect of all its shares in Sub1, Canco includes 100 percent of Sub1's and Sub2's FAPI in its income.

Where the CFA that earns the FAPI or any upper tier corporation has more than one class of issued shares, a share's participating percentage is determined by "distribution entitlement" rules in Regulation 5904. Pursuant to those rules, one determines the Canadian taxpayer's percentage interest in the total distributions the CFA made to its shareholders during the year and the distributions it might reasonably be expected to make immediately after year-end if it then distributed the consolidated current year earnings of the CFA and lower tier CFAs. For example, if Canco owns all the common stock of Sub1 (being 100 shares), an unrelated party owns all the preferred shares (entitled to current year dividends[23] of CAD 30,000) and Sub1's consolidated earnings for the year are CAD 100,000, each share Canco owns in Sub1 has a 0.7 percent participating percentage. Canco would include, in respect of each Sub1 share, 0.7 percent of Sub2's FAPI. If Sub2's FAPI were CAD 50,000, Canco would include CAD 35,000 in total.

G. Mode of taxation to Canco

Canco includes the participating percentage of each CFA's FAPI in income on an accrual basis, as the FAPI is earned. The income inclusions are treated for purposes of the ITA as income from the shares that Canco owns in Sub1. The amounts are neither deemed paid directly to Canco by lower tier CFAs nor deemed to flow up through Sub1.

Where Canco has included an amount of FAPI in income, Canco is entitled, under sub-section 91(4), to deduct in computing its income, for the inclusion year or the five subsequent taxation years, a grossed-up amount of "foreign accrual tax" (FAT) applicable to that FAPI.

FAT is defined[24] as the portion of any income or profits tax paid by a CFA that is reasonably attributable to the amount of the CFA's FAPI included in Canco's income and the portion of such tax paid by an upper tier CFA in respect of a dividend it received from the FAPI of a lower tier CFA.[25] FAT also includes amounts prescribed by Regulation 5907(1.3), which applies when a CFA and one or more other corporations resident in the same country determine liability for taxes on a consolidated or combined basis or where the CFA's residence country tax law permits the CFA to deduct losses of another corporation resident in that country. In such circumstances, amounts the CFA pays to other group members in respect of foreign taxes paid by them or the use of their losses can be treated as FAT. However, the definition of FAT does not include tax paid by Sub1 if its residence country had a FAPI regime pursuant to which income of Sub2 (resident in another country) was currently taxed to Sub1.

Canco is permitted to deduct the amount of FAT grossed-up by a "relevant tax factor." The relevant tax factor is a reciprocal of the Canadian federal corporate tax rate and is 3.7736 for 2011 and 4 for 2012 and subsequent years. The grossed-up FAT deduction ensures that, where the foreign tax rate is less than the Canadian tax rate, the total Canadian and foreign tax is the same as it would have been had Canco earned the FAPI directly, and that no net FAPI arises where the foreign tax rate equals or exceeds the Canadian tax rate.

Proposed amendments to the ITA, generally applicable to taxation years ending after March 4, 2010, contain FAT denial rules that operate in circumstances where, by virtue of hybrid instruments, such as repo transactions, foreign tax law considers the Canadian taxpayer or certain connected persons to own less than all the shares of a CFA that are considered to be owned under the ITA.[26] These amendments were introduced in response to "foreign tax credit generator" strategies, which the Canadian government viewed as creating deductions and credits for foreign taxes the burden of which is not, in fact, borne by the Canadian taxpayer.

H. Adjustments to preclude double taxation on actual distribution or on sale of stock

The ITA contains a number of mechanisms to prevent double taxation when currently taxed FAPI is subsequently distributed or when stock in a CFA is later sold. These mechanisms are implemented through rules (explained below) pertaining to "surplus" accounts and stock basis adjustments.

For purposes of determining the tax consequences of foreign affiliate distributions, a Canadian corporation maintains "surplus" accounts in respect of each foreign affiliate. The foreign affiliate's FAPI, less income or profits tax paid by the affiliate in respect of the FAPI, is added to its "taxable surplus" account, and an "underlying foreign tax" account tracks income or profits taxes the affiliate has paid on its FAPI.[27] When a lower tier foreign affiliate pays dividends sourced from its taxable surplus to an upper tier foreign affiliate, the recipient's taxable surplus and underlying foreign tax accounts are increased, respectively, by the amount of such dividends and a proportionate share of the payor's underlying foreign tax, and corresponding reductions are made to the payor's accounts.

Under the FAPI rules, a Canadian taxpayer adds to the basis of the shares it owns in a first tier CFA the amount of FAPI imputed to those shares.[28] The Canadian taxpayer reduces the basis of such shares by amounts it deducts in respect of FAT.[29] Accordingly, the basis of the Canadian taxpayer's shares is increased by the net amount of FAPI included in its income.

Where a Canadian resident corporation receives a dividend from a foreign affiliate, the amount of the dividend is included in its income pursuant to section 90 of the ITA. Where the dividend is paid from the foreign affiliate's taxable surplus account, the corporation may be entitled to deductions in computing its income and taxable income. These deductions prevent double taxation of FAPI previously included in income and provide relief for income or profits tax the affiliate has paid on its FAPI. In particular, when a Canadian corporation receives a taxable surplus dividend from its foreign affiliate, paragraph 113(1)(b) permits it to deduct, in computing its taxable income, the foreign tax prescribed by Regulation 5900(1)(d) to be applicable to the dividend multiplied by its relevant tax factor. In computing income, it can deduct, pursuant to sub-section 91(5), the lesser of: (1) the dividend minus the deduction from taxable income; and (2) the net increase for FAPI (less FAT deductions) in the basis of the CFA's stock. For example, if Sub2 earns CAD 100 of FAPI on which it pays CAD 10 of FAT and Canco includes CAD 60 in its income (being CAD 100 FAPI less CAD 40 deducted in respect of FAT), upon Canco receiving a CAD 90 taxable surplus dividend, it deducts CAD 40 in computing taxable income and CAD 50 in computing income, resulting in no additional tax on the dividend.[30]

When a Canadian corporation disposes of shares of a foreign affiliate, it can elect under sub-section 93(1) to treat all or part of the disposition proceeds as a dividend and not as disposition proceeds. Amounts so treated as exempt surplus or taxable surplus dividends reduce the capital gain the Canadian corporation would otherwise realise. The amount of the dividend is included in the corporation's income and rules prescribed in Regulations 5900 to 5902 determine the portions of the dividend treated as an exempt surplus and a taxable surplus dividend. To the extent a dividend is an exempt surplus dividend, that amount is deductible in computing the corporation's taxable income and is not subject to Canadian income tax. To the extent a dividend is treated as a taxable surplus dividend, the Canadian corporation will be entitled to deductions in computing taxable income (in respect of underlying foreign tax paid by the affiliate) and deductions in computing income (to the extent of the net FAPI previously included in its income).

Sub1's basis in its stock of Sub2 is not increased by amounts in respect of Sub2's FAPI. Sub2's FAPI, less income or profits tax Sub2 has paid thereon, is recorded in Sub2's "taxable surplus" account and such tax is recorded in Sub2's underlying foreign tax account. If Sub1 sells the stock of Sub2, Canco may elect (or be deemed to elect) that a portion of Sub1's sale proceeds be deemed a dividend received by Sub1 from Sub2. For FAPI computation purposes, the amount of this dividend reduces Sub1's capital gain on the sale of Sub2 (and hence the amount of FAPI that Canco may realise in respect of the capital gain). The deemed dividend also increases Sub1's applicable surplus accounts in respect of Canco. Accordingly, previously taxed FAPI of Sub2 and underlying foreign tax applicable to the FAPI are added to Sub1's taxable surplus and underlying foreign tax accounts in respect of Canco. On receiving dividends from Sub1, Canco would be entitled to the deductions (explained above) in computing income and taxable income.

If part of Canco's indirect interest in Sub2 were held through a non-resident corporation that was not a CFA of Canco, the percentage of Sub2's FAPI included in Canco's income would reflect only the participating percentage in respect of Canco's shares in Sub1. The remaining portion of Sub2's FAPI would not be included in Canco's income on a current basis or added to Canco's basis in the stock of Sub1 or the non-resident corporation.

I. Impact of treaties to which Canada is a party

The "Miscellaneous Rules" Articles in virtually all treaties to which Canada is a party include provisions retaining Canada's right to apply the FAPI regime. Many are similar to Article 27(3) of the Canada-United Kingdom treaty, which provides that the treaty "shall not be construed as restricting the right of Canada to tax a resident of Canada on that resident's share of any income or capital of a partnership, trust or controlled foreign affiliate, in which that resident has an interest."[31] Certain other generally older treaties contain provisions similar to those of Article XXX in the Canada-Barbados treaty, which stipulate that nothing in the treaty "shall be construed so as to prevent Canada from imposing its tax on amounts included in the income of a resident of Canada according to section 91 of the Canadian Income Tax Act." The Canada-United States treaty follows the US practice of including a "saving clause," which provides that ". . . this Convention shall not affect the taxation by a Contracting State of its residents. . .".

II. Other regimes in addition to the FAPI regime

There are other regimes in Canadian income tax law under which income realised by an entity that is not itself subject to taxation by Canada may be currently taxed to Canadian resident owners of the entity.

A. Other inclusion rules in brief

Under Canadian tax law, a partnership is a disregarded entity. Canadian resident members of a partnership (including one formed under foreign law and operating outside Canada) are currently taxed on their shares of the partnership's income.[32] Section 6.2 of the Income Tax Conventions Interpretation Act (Canada) specifically preserves Canada's right to so tax its residents, notwithstanding that the partnership may be a resident or enterprise of a country with which Canada has a tax treaty.

A non-resident "commercial" trust[33] to which Canadian residents have made contributions may be treated, for purposes of the FAPI rules, as a CFA of a Canadian resident beneficiary who holds 10 percent or more (by fair market value) of the beneficial interests in the trust. The beneficiary must include in income its proportionate share of the trust's undistributed FAPI and may claim deductions in respect of applicable FAT.[34]

Non-resident trusts to which Canadian residents have transferred property but that are not treated as CFAs of Canadian resident beneficiaries may themselves be deemed resident in Canada,[35] or interests therein held by Canadian residents may be subject to offshore investment fund property (OIFP) rules contained in section 94.1. Trusts deemed resident in Canada are directly liable for Canadian income tax on their worldwide income, subject to certain exclusions. Canadian investors subject to the OIFP rules are imputed, and must include in income, annually, a prescribed rate of return on their investment, as reduced by income (other than capital gains) actually received from the fund in the same year.

B. Impact of treaties to which Canada is party

As with respect to the FAPI regime, the position of the Canadian Department of Finance is that tax treaties to which Canada is a party do not preclude Canada's ability to tax residents of Canada with respect to income earned in foreign entities. An amendment is proposed to the Income Tax Conventions Interpretation Act (Canada)[36] to ensure that foreign trusts that the ITA deems to be resident in Canada will be so resident in applying Canada's tax treaties. Accordingly, the treaties will not relieve such trusts from liability for Canadian tax.

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NOTES

[1] R.S.C. 1985, c. 1(5th Supplement), as amended (hereinafter "ITA"). Unless otherwise stated, statutory references in this article are to the ITA and references to a "Regulation" or "Reg" are references to the Regulations to the ITA.

[2] Effective 2012, the combined corporate income tax rate is expected to be 25 percent

[3] Para. 95(2)(a) is a broad deeming provision that includes in active business income payments from other foreign affiliates that they are able to deduct from their active business income and also includes incidental and ancillary income of a foreign affiliate in active business income.

[4] Para. 113(1)(a).

[5] The Report of Royal Commission on Taxation (Ottawa: Queen's Priater and Controller of Stationery, 1967) made a series of recommendations with regard to Canada's international tax position. However, the main features of Canada's modern foreign affiliate regime are more closely linked with the White Paper on Tax Reform issued by the Department of Finance in 1969 (the "White Paper").

[6] Interpretation Bulletin IT-343R, "Meaning of the Term Corporation", Sept. 26, 1977; *Hague v. Cancer Relief & Research Institute*, [1939] 4 D.L.R. 191 (Man. K.B); B*achman v. R.*, 2001 S.C.C. 10 (S.C.C.); *Spire Freezers Ltd. v. R.*, 98 D.T.C. 1287 (T.C.C.) aff'd 99 D.T.C. 5297 (F.C.A.).

[7] Subsec. 95(4).

[8] Shares of a nonresident corporation owned by a partnership are deemed for purposes of certain of the rules affecting Canadian corporate residents to be owned by the partners of the partnership *pro rata* to their interests in the partnership (subsec. 93.1(1)).

[9] Subsec. 95(1).

[10] 2002 D.T.C. 7112 (F.C.A.).

[11] The proposed amendment assumes the taxpayer will have access to information concerning the shareholdings of other shareholders and their related parties. Proposed paras. 95(2)(u) to (x) provide look through rules that apply to holdings through holding companies, partnerships and trusts.

[12] See sec. 91.

[13] Investment property is defined in subsec. 95(1) to include an expansive list of properties including shares, debt, currency and options.

[14] Special rules in para. 95(2)(l) deal with income from trading or dealing in indebtedness. Income from certain arm's length indebtedness is carved out of income from property by the provision. Where the Canadian taxpayer (or its parent or subsidiary) is a regulated financial business resident in Canada and the foreign affiliate is also regulated in its jurisdiction, income of the foreign affiliate will not be income from property.

[15] Income from property may, in certain circumstances, be recharacterised as active business income (para. 95(2)(a)); income from an inactive business cannot be recharacterised.

[16] Para. 95(2)(b).

[17] There are, however, tax avoidance rules that may apply on set up or reorganisation of foreign affiliates that will permit the Canadian revenue authorities to disregard certain transactions in characterizing income.

[18] Paras. 95(2)(f) and (f)(1).

[19] Paras. 95(2)(g) and (i).

[20] Paras. 95(2)(f). There are a number of other adjustments to and exclusions from FAPI, notably for most dispositions of excluded property, which must also be taken into account.

[21] "Participating percentage" is defined in subsec. 95(1) and the CAD5,000 exception is contained in para. (a) of that definition.

[22] Subpara. (b)(i) of the definition of "participating percentage" in subsec. 95(1).

[23] Ordering rules are contained in Regulation 5904(3)(d) to address circumstances where a class of issued shares is entitled to cumulative dividends. Distributions on such shares are ascribed to taxation years based on the sufficiency of profits in those years to satisfy such dividends, so that arrears of cumulative dividends paid in a particular year are considered distributions made in a prior year, and not in the current year, to the extent they are referable to the prior year's profits.

[24] The definition of "foreign accrual tax" is in sub-sec. 95(1).

[25] The ITA does not contain detailed rules for allocating foreign tax as between FAPI and other income.

[26] The FAT denial rules are contained in proposed subsecs. 91(4.1) to (4.5). Corresponding amendments in respect of a foreign affiliate's "underlying foreign tax" are made in Regulation 5907.

[27] The definitions of "taxable surplus" and "underlying foreign tax" are contained in Regulation 5907(1).

[28] The basis additions are provided for in paras. 53(1)(d) and 92(1)(a).

[29] The basis deductions are provided for in paras. 53(2)(b) and 92(1)(b).

[30] The amount deducted pursuant to subsection 91(5) reduces the basis in the stock of the first tier CFA.

[31] Similar provisions are contained in, among others, the Canada-France, -Germany, - Luxembourg and -Netherlands tax treaties.

[32] For this purpose, subsec. 96(1) requires that partnership income be calculated as if the partnership were a separate person resident in Canada.

[33] Under current subsec. 94(1), a trust is "commercial" if the amount of its income or capital distributions are not subject to a discretionary power. Proposed amendments released on Aug. 27, 2010 will add additional conditions that must be satisfied in order that a trust to be considered "commercial." These are contained in para. (h) of the definition of "exempt foreign trust" in proposed subsec. 94(1).

[34] Income computation rules in respect of trusts deemed to be CFAs are contained in current sec. 94, and will be replaced by similar rules in proposed sec. 94.2, generally applicable to taxation years that end after March 4, 2010.

[35] Rules whereby foreign trusts are deemed resident in Canada are contained in subsec. 94(1). Substantial modifications to those rules are contained in draft amendments released on Aug. 27, 2010.

[36] Being new sec. 4.3 of that Act.

Host Country PEOPLE'S REPUBLIC OF CHINA

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I. The CFC regime of the People's Republic of China

The People's Republic of China (PRC) does indeed have a regime comparable to the US Controlled Foreign Corporation (CFC) regime for currently taxing HCo, a PRC limited liability business entity or enterprise (hereinafter "ChinaCo"), on all or part of the income realised by Sub2 even if that income is not yet distributed to ChinaCo. However, on the basis of the facts provided here, current tax would not be triggered under the PRC CFC regime because there is a safe harbour for income derived through active business operations. Sub2 is engaged in a trade or business, which would be viewed as active business operations and therefore fall within the safe harbour, as described in greater detail below.

The income tax regimes applicable to enterprises and individuals are governed by separate bodies of legislation in China. Therefore, China's current CFC regime, which is established under the Enterprise Income Tax Law (the "EIT Law") is somewhat different from the CFC regimes of other countries it is broader in some aspects, while narrower in others.

A. History and objectives of the PRC CFC regime

China developed its own CFC regime through learning from other countries, in particular the United States. It seems that, in early 2000, the term "CFC" was already cited in certain published notices issued by the State Administration of Taxation (SAT) in an attempt to combat tax avoidance.

The CFC regime was formally codified under the new EIT Law, with effect from January 1, 2008. Chapter 6 of the EIT Law, entitled "Special Tax Adjustments," sets forth the basis for China's various anti-avoidance rules, such as transfer pricing rules, rules relating to cost sharing, advance pricing arrangements, thin capitalisation, and the general anti-avoidance rule (GAAR), as well as the CFC rules. The basic Special Tax Adjustment rules under the EIT Law were elaborated by the State Council's Implementation Regulations of the EIT Law (the "EIT Regulations") and the SAT's Implementation Measures for Special Tax Adjustments (the "Measures").

There are no corresponding CFC rules under China's individual income tax law. Accordingly, at least for the present, the CFC rules are applicable only to enterprise shareholders, and do not apply to individuals even if they are also shareholders of a CFC.

The main objective of the current CFC rules is to defeat unreasonable tax deferral arrangements adopted by PRC resident enterprises with respect to their offshore operations. According to Article 45 of the EIT Law, when a CFC reduces or makes no distribution of its profits without a reasonable business purpose, the CFC's profits attributable to its PRC resident enterprise shareholder(s) must be included in the current income of such resident enterprise(s).

B. Definition of a CFC

Strictly speaking, under China's regime, a CFC should be called a "Controlled Foreign *Enterprise*," rather than a "Controlled Foreign *Corporation*," because, in China, the enterprises covered by the EIT Law encompass more than corporations, as defined under the PRC Company Law. Under the EIT Law, all companies, social groups, and other revenue-generating organisations are regarded as "enterprises." The only excluded entities are individuals, and partnerships organised under the PRC Partnership Law. Thus, a foreign trust and a foreign partnership, which are commonly viewed as fiscally transparent entities, are caught by the definition of "enterprise" under the EIT Law and taxed in China as EIT taxpayers. Thus while, for convenience sake, this paper refers to the CFC rules or regimes in China, CFCs under these rules include a broader range of entities than comparable legislation in many other jurisdictions.

The EIT Law does not directly provide a definition of a CFC, but under Article 45 of the EIT Law, a foreign enterprise must meet the following two conditions to be a CFC:

- It must be controlled by PRC resident shareholders; *and*
- It must be established in a foreign jurisdiction where its effective income tax rate is obviously lower than the PRC standard EIT rate.

The measures do provide a definition of a CFC, which, in addition to the above two conditions, incorporates a third condition to the effect that the foreign enterprise must have made a reduced or no distribution of profits without a reasonable business purpose. Logically, reducing or making no profit distributions should not be a condition for the existence of a CFC, but rather should be a condition for triggering the current taxation of the CFC's income to its PRC resident shareholder.

1. PRC resident shareholder

Because the current CFC rules are established under the EIT Law, the rules function only to impose current taxation on resident enterprise shareholders. However, for purposes of determining the CFC status of a foreign enterprise, its PRC individual shareholders are still counted.

Thus, PRC resident shareholders will comprise of either:

- Resident enterprises, or
- Resident enterprises plus resident individuals.

However, if a foreign enterprise only has PRC individual shareholders, the foreign enterprise will not be deemed a CFC under the current CFC rules.

2. Foreign enterprise

A foreign enterprise is an enterprise established pursuant to the laws of a foreign jurisdiction, which includes Hong Kong, Macau and Taiwan for this purpose. Usually, a CFC is a foreign enterprise. More accurately, a CFC is a nonresident enterprise, since certain foreign incorporated enterprises may be regarded as resident enterprises if they maintain their effective management in China. Such foreign-incorporated resident enterprises are excluded from the scope of CFCs, as confirmed in *Guo Shui Fa* [2009] No. 82.

3. Control

A foreign enterprise will be considered "controlled" by PRC resident shareholders if:

- In any day in the tax year, a single PRC resident shareholder directly or indirectly holds more than 10 percent of the foreign enterprise's voting shares, and all PRC resident shareholders jointly hold more than 50 percent of the total shares of the foreign enterprise; *or*
- The enterprise's PRC resident shareholders do not meet the above criteria, but the PRC resident shareholders maintain effective control over the foreign enterprise in terms of shareholdings, funding, operations, purchases and sales, etc.

In the case of an indirect shareholding, to determine the controlling shareholding ratio of a PRC resident shareholder, the shareholding ratios in all intermediary subsidiaries are multiplied to arrive at that shareholder's shareholding ratio. If the shareholding ratio of an intermediary subsidiary in its lower tier subsidiary is more than 50 percent, the shareholding ratio of that subsidiary in its lower tier subsidiaries is deemed to be 100 percent.

4. Effective income tax rate

The standard PRC EIT rate is 25 percent. An effective income tax rate "obviously lower" than the PRC standard EIT rate means an effective income tax rate in the subject CFC jurisdiction of less than 50 percent of the standard EIT rate, i.e. a rate lower than 12.5 percent. To simplify the determination of the effective income tax rates of non-CFC jurisdictions, the SAT has issued a white list of foreign jurisdictions under *Guo Shui Han* [2009] No. 37. A foreign enterprise incorporated in one of the white list jurisdictions will not trigger current taxation to its PRC resident enterprise shareholders. The current white list includes the following 12 countries: Australia, Canada, France, Germany, India, Italy, Japan, New Zealand, Norway, South Africa, United Kingdom and United States. The list may be amended by the SAT from time to time. However, inclusion in the white list is not a requirement for precluding the application of the CFC rules, so long as the taxpayer can prove that a particular jurisdiction indeed has an effective income tax rate higher than 12.5 percent.

5. Application in case at hand

ChinaCo is a PRC resident enterprise and owns 100 percent of the shares of Sub1, which in turns owns 100 percent of Sub2. It is assumed that neither Sub1's nor Sub2's home jurisdiction is a white list jurisdiction and that both have an effective income rate of less than 12.5 percent.

First, Sub1 is a CFC of ChinaCo since Sub1 is 100 percent owned and controlled by a PRC resident enterprise, ChinaCo, and is located in a low tax jurisdiction. However, if Sub1 were wholly owned by a PRC resident individual, as noted in I.B.1., above, Sub1 would not be regarded a CFC because it would have no PRC resident enterprise shareholder.

Alternatively, if Sub1 were wholly owned by a partnership established under the PRC Partnership Law, the partnership would not be regarded as an enterprise under the EIT Law and hence could not constitute a PRC resident enterprise shareholder. Thus, Sub1 would not be a CFC of the partnership. However, if one or more partners of the partnership were enterprises and themselves qualified as PRC resident shareholders, Sub1 could be regarded as a CFC of such enterprise partners.

If, on the other hand, Sub1 were wholly owned by a trust in China, it is not clear whether Sub1 would be regarded as a CFC of the trust. China does not have the same trust concept as common law jurisdictions and the tax status of a trust is not clearly set out under the current tax rules. In practice, this makes the adoption of trust arrangements a rare phenomenon. It remains to be seen whether a trust will be taxed in China as an enterprise or a transparent entity, like a partnership. In practice, it is currently likely that a trust will be taxed as forming part of the operations of the trustee, as the trustee is the nominal and legal owner of the trust assets.

Second, Sub2 is also a CFC of ChinaCo, as determined under the indirect shareholding rules. Multiplying the shareholding ratios of ChinaCo in Sub1 and Sub1 in Sub2 shows that ChinaCo indirectly owns 100 percent of Sub2.

C. Types of income subject to current taxation and exemptions

In general, the PRC CFC rules do not make a distinction between the various types of income of a CFC for purposes of the current taxation of the CFC's PRC resident enterprise shareholders. However, the Measures do provide certain safe harbour rules that exempt a CFC's PRC resident enterprise shareholders from current taxation if the CFC fulfils one of the following conditions:

It is established in one of the non-low tax jurisdictions designated by the SAT (i.e., the white list jurisdictions);

- It primarily derives its income from active business activities; or
- It has an annual profit of less than RMB 5 million (approximately USD760, 000).

The Measures provide no further explanation of what is meant by "active business activities" and "primarily derives its income." Reference to prior rules for determining manufacturing enterprise status indicates that it is possible that a CFC may have to derive at least 50 percent of its income from manufacturing or the provision of services in order to qualify for the active business activities safe harbour.

Because both Sub1 and Su 2 are CFCs, both have to meet the safe harbour rules in order to avoid the current taxation of their income to ChinaCo. For example, if Sub2 qualifies under the active business safe harbour, but Sub1 does not qualify under any of the safe harbour rules, Sub1's CFC status may still trigger current taxation to ChinaCo if Sub1 defers profit distribution without a reasonable business purpose.

On a literal interpretation, the application of the CFC rules does not require a finding that the PRC resident shareholders have a tax avoidance purpose in setting up or operating the CFC. Rather, the standard adopted under the CFC rules is that the deferral of profit distribution is not supported by a reasonable business purpose. Presumably, such lack of a reasonable business purpose is determined on an ongoing basis. For example, even if a CFC was established with a reasonable business purpose (i.e., without a tax avoidance purpose), it may still later be found to lack a reasonable business purpose for deferring the distribution of profits. However, if ChinaCo did indeed establish Sub2 with a tax avoidance purpose, it is more likely to be determined that Sub2's deferral of profit distribution lacks a reasonable business purpose.

D. Current taxation in other circumstances

The PRC CFC rules do not provide for income attribution in the case of other particular circumstances, such as where Sub2 has participated in a boycott, given bribes, or made "investments in HC Property." Thus, unless such other particular circumstances cause Sub2 to fall within the situations that would trigger the application of the CFC rule as discussed above, they should not otherwise lead to any current tax liability for ChinaCo.

E. Rules to determine income

The PRC CFC rules are silent on the subject of which country's tax or accounting rules should be applied to determine the income for purposes of the CFC regime. According to the CFC rules, the income currently included in the income of a PRC resident enterprise shareholder is the proportionate amount of the deferred profits of the CFC attributable to such PRC shareholder, i.e., the CFC's profits that would actually have been distributed to the PRC shareholder in normal circumstances.

Pursuant to the Measures, the following formula should be used to calculate the income currently included by the PRC resident enterprise shareholder:

PRC resident enterprise shareholder's current income = Deemed dividend distribution amount x Actual days of shareholding ÷ number of days in CFC's tax year) x Shareholding ratio

The above formula adopts a CFC's tax year, rather than the tax year of the PRC resident enterprise shareholder. Also, as a foreign enterprise, a CFC generally would calculate its distributable profits following its home jurisdiction's accounting rules. Thus, it would appear that the deemed dividend distribution amount to the PRC shareholder (here, ChinaCo), is calculated by following the accounting rules of the CFC's home jurisdiction (for example, in the case of Sub2, the accounting rules of FC).

F. Rules to calculate pro-rata share of income

As indicated in the formula for calculating the current income of the PRC resident enterprise shareholder (see I.E., above), the number of days during the tax year on which the shareholding is held and the shareholding ratio would be relevant, i.e., only the PRC resident enterprise shareholder's *pro rata* share of the CFC's profits would be currently taxable to such shareholder.

For these shareholding purposes, the PRC CFC rules make no distinction between whether the shares held by the PRC resident enterprise shareholders are common stock or preferred stock. However, preferred stock normally has priority over common stock as regards the payment of a certain level of dividends. The priority enjoyed by the preferred stock will determine how much distributable profit of the CFC will be attributable to the PRC resident enterprise shareholders for current inclusion, if they only hold common stock. From this perspective, the above general formula would need to be modified to reflect the rights of different classes of shareholders to the payment of dividends.

G. Mode of taxation to ChinaCo

The PRC CFC rules appear to have adopted a "hopscotch" rule. Under Article 45 of the EIT Law, Sub2's proportionate profits attributable to its PRC resident enterprise shareholder (i.e., to ChinaCo, an indirect shareholder of Sub2) must be included in the current income of ChinaCo, as if the deemed dividend distribution income were paid directly by Sub2 to ChinaCo.

According to the foreign tax credit (FTC) rules under the PRC EIT Law, if a PRC resident enterprise receives income that arises outside China, the resident enterprise is entitled to claim a credit, within the applicable FTC limitation, for foreign income taxes actually paid on such foreign-source income. Article 24 of the EIT Law specifically allows for an indirect FTC for foreign income taxes that should have been borne by the PRC resident enterprise with regard to the dividend income received from certain directly or indirectly controlled foreign subsidiaries. The SAT and the Ministry of Finance issued rules *Cai Shui* [2009] No. 125 and Public Announcement [2010] No. 1 detailing how to calculate the FTC. The indirect FTC is limited to dividends received from 20 percent controlled subsidiaries, down to third tier subsidiaries.

Thus, when ChinaCo has to pay current tax on the deemed dividend distribution amount of Sub2's profits under the CFC rules, in theory, ChinaCo should be entitled to claim an indirect credit for the foreign income taxes paid by Sub2 in FC.

However, the current FTC rules appear to address only the scenario in which a dividend is actually distributed from the lowest tier (i.e., the third tier) up to the top tier, tier by tier along the chain of ownership for example, from Sub3 (if any) to Sub2, from Sub2 to Sub1 and finally from Sub1 to ChinaCo. Thus, it is not clear how the indirect FTC is to be calculated in a scenario in which a dividend distribution is deemed to be made directly from Sub2 to ChinaCo under the CFC rules. This will have to be clarified by the PRC tax authorities.

For reference purposes only, the general formula for calculating the indirect FTC at each tier in the case where a dividend is actually distributed is as follows:

Taxes paid by the enterprise but deemed borne by the upper tier enterprise = (Foreign income tax actually paid by the enterprise on operating profit and investment income + foreign income tax indirectly borne by the enterprise) x Dividend distributed from the enterprise to the upper tier enterprise ÷ Profits of the enterprise after tax payment

While this appears more akin to the scenario in which a dividend is actually distributed, the FTC rules are still silent on how to calculate the indirect FTC available to ChinaCo where Third Country has its own CFC regime so that income of Sub2 is currently taxed to Sub1,

H. Adjustments to preclude double taxation on actual distributions or on sale of stock

According to the measures, the value of a deemed dividend that has been currently taxed to a PRC resident enterprise shareholder is to be excluded from the PRC shareholder's current income when the CFC subsequently actually distributes dividends to the PRC shareholder. This ensures that there will be no double taxation to the PRC shareholder on the previously taxed value. This would also apply if part of ChinaCo's indirect interest in Sub2 were held through a corporation that did not constitute a CFC.

The current CFC rules are silent on the question of how the sale of a CFC is to be dealt with. The authors believe that where a deemed dividend has been taxed to a PRC resident enterprise shareholder, when the PRC shareholder sells its interest in the CFC, any gain attributable to the value of the previously taxed deemed dividend should, in theory, be excluded from taxation. Certain technical gaps remain however, with regard to how this is to be achieved where a CFC is held indirectly. For example, if Sub2 is sold, the direct selling shareholder is Sub1, and gains are realised by Sub1, rather than ChinaCo, which has paid taxes on the deemed dividend distribution. The PRC tax authorities can be expected to issue additional guidance in this respect.

I. Impact of tax treaties to which the PRC is a party

China introduced its CFC regime with effect from 2008. As China has concluded only a few treaties since 2008, it is not possible to ascertain whether China's treaties will have any significant impact on the CFC rules. However, since the CFC regime is designed to be part of the PRC anti-tax avoidance rules under the Special Tax Adjustment chapter of the EIT Law, in certain tax treaties, or amendments or protocols thereto, entered into after 2005, China has managed explicitly to incorporate a clause providing that nothing in the relevant treaty is to prejudice the right of either party to apply its domestic laws and measures concerning the prevention of tax avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to the treaty. This would establish an explicit legal basis for China to enforce its domestic anti-tax avoidance rules, including the CFC rules, in the context of its tax treaties. An example of such enforcement would be a denial of treaty benefits to a taxpayer from a treaty country on anti-tax avoidance grounds.

II. Other regimes in addition to the CFC regime

Currently China's EIT Law does not provide for any other regimes under which income realised by an entity that is not itself subject to taxation by China might be currently taxed to direct or indirect owners of the entity that are residents of the PRC.

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Host Country
DENMARK

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I. CFC taxation in Denmark

A. Introduction, history and objectives

Danish controlled foreign corporation (CFC) taxation takes the form of the mandatory joint taxation of a Danish company ("DanishCo") holding a qualifying interest (see I.C.1., below) in a foreign or Danish entity ("SubCo"). In this context, "mandatory joint taxation" means that SubCo's net taxable income, if positive, will be included in the taxable income of DanishCo.

The CFC regime was introduced in 1995 as a measure designed to target tax havens. Originally it was a condition for the application of the regime that the entity in which the qualifying interest was held was resident in a foreign state (FC) and that taxation in FC was significantly lower than Danish taxation. As a consequence of the European Court of Justice (ECJ) judgment in *Cadbury Schweppes*,[1] the CFC regime was amended significantly in 2007, among other things, to bring Danish SubCos within the scope of the regime in order to comply with EC law (although this had no practical consequences, since Danish SubCos were already subject to mandatory Danish tax consolidation).

At the same time, the scope of the regime was narrowed by:

- Raising the percentage threshold for what constitutes a controlling interest of DanishCo in SubCo from 25 percent to 50 percent;
- Increasing the proportion of the aggregate income of SubCo that must consist of CFC income for the regime to apply from to ½; and
- Adding a requirement regarding the composition of SubCo's assets.

B. Entities within the scope of the regime

1. DanishCo

The CFC regime applies to a Danish company incorporated under the Danish Companies Act and a Danish foundation. The Danish company or foundation must be fully liable to Danish corporate income taxation under section 1 of the Corporate Income Tax Act. The regime also applies to the Danish permanent establishment (PE) of a foreign company.[2] Finally, the regime applies to a foundation or an association subject to full tax liability under section 1 of the Foundation Tax Act.

An individual and the estate of a deceased individual may also be subject to CFC taxation if the individual or the estate is subject to full Danish income taxation (i.e., the individual is or was a Danish resident).

2. SubCo

A foreign entity that does not meet the Danish criteria for being considered a separate legal entity (i.e., that the entity is carrying on business, the entity has a fixed share capital and the liability of its shareholders is limited to the capital subscribed for) cannot be considered a CFC but will be considered a tax-transparent entity and any income generated by the entity will, therefore, be subject to Danish taxation (see II., below).

C. General conditions

In general, CFC taxation applies if the following three conditions are met:[3]

DanishCo controls SubCo, which generally means that DanishCo holds more than 50 percent of the voting rights in SubCo (the "CFC Control Test");

The CFC Income of SubCo exceeds 50 percent of the aggregate taxable income of SubCo (the "CFC Income Test"); and

The financial assets of SubCo constitute more than 10 percent of the total assets of SubCo (the "Financial Assets Test").

If all three conditions are met, *the aggregate taxable income* of SubCo will be included in the taxable income of DanishCo. In determining the taxable income of SubCo, Danish law is applied, meaning that only income that is taxable and expenses that are deductible under Danish law will be taken into account in determining the amount to be included in DanishCo's taxable income.

If SubCo is not wholly owned by DanishCo, DanishCo will only have to include the proportionate part of SubCo's income that corresponds to DanishCo's ownership share in SubCo.

As will be evident from the above, the regime does not include any "safe harbour" rules and there is no subjective test as to the reasons for the incorporation of SubCo. (i.e., tax avoidance, etc.).

The CFC regime as it applies to an individual holding a controlling interest in a CFC is to some extent the same as the regime applicable to a Danish corporation holding such an interest. There is, however, no Financial Assets Test īnstead a "Comparable Taxation Test" is applied, under which the income tax in FC on the aggregated income of SubCo must not be less that ¾ of the income tax that would have been payable to Denmark had SubCo been a Danish entity subject to Danish corporate income tax at the rate of 25 percent.

1. The CFC Control Test

In determining whether DanishCo's ownership of SubCo meets the CFC Control Test, direct, indirect and constructive ownership rules apply. Thus, voting rights held by certain related companies of DanishCo are included in the calculating DanishCo's percentage ownership for purposes of the CFC Control Test and it is immaterial whether these related companies are, themselves, also considered CFCs. Voting rights held by individual shareholders of DanishCo and their relatives, or by a foundation or trust established by related parties of DanishCo are also included. Further, voting rights held by companies with whom DanishCo has entered into an agreement concerning the exercise of control or that are held by a transparent entity in which DanishCo participates are included.

The definition of "control" was amended on March 1, 2010 for purposes of ensuring compliance in substance with the corresponding definition set out in the International Accounting Standards (IAS). The definition was amended in the Danish Financial Statements Act, the Companies Act and the Corporate Income Tax Act and has resulted in some changes from former practice.

"Control" is now considered to exist where a company, foundation, association, trust, etc. is the parent of one or more subsidiaries.[4] A company may only have one direct parent. If more than one company meets one or more of the criteria for being a parent company, only the company exercising the actual controlling interest over the subsidiary's financial and operational decisions will be considered the parent company.

A "controlling interest" is the right to control the subsidiary's financial and operational decisions. A controlling interest exists where the parent, directly or indirectly, owns more than half of the voting rights in the subsidiary, unless it is clearly demonstrated that such ownership does not constitute a controlling interest.

In a binding advance ruling of March 2010, the Danish National Tax Board (a body that, *inter alia*, issues private letter rulings) expressed the view that the existence of a shareholders' agreement that requires consensus with respect to all shareholder decisions will demonstrate that none of the shareholders has a controlling interest even if one shareholder holds more than half of the share capital. According to former practice, the shareholder holding more than half of the share capital would have been subject to CFC taxation, even where there was a shareholders' agreement of this kind.

A parent company that does not own more than half of the voting rights in the subsidiary will still meet the criteria for having a controlling interest, if the parent has:

- The right to dispose of more than half of the voting rights by virtue of an agreement concluded with other investors;
- The right to control the financial and operational affairs of the subsidiary pursuant to an article of association or an agreement;
- The right to appoint or remove the majority of the members of the supreme management body, where that body has a controlling interest in the subsidiary; or
- The right to dispose of the actual majority of the votes at the general meeting or in any similar body, giving it the actual controlling interest in the subsidiary.

The existence and impact of potential voting rights, including subscription rights and call options relating to shares that may immediately be exercised or converted, must be taken into consideration when assessing whether a company has a controlling interest. In calculating the voting rights in a subsidiary, any voting rights attaching to shares held by the subsidiary or by its subsidiaries are disregarded.

As a consequence of the amendments, in the future, more emphasis will be given to *de facto* controlling interest in a company than to the formal holding of the share capital/voting rights.

Under Danish corporate law, there is no concept of "common stock" and "preferred stock." However, a company's articles of association may provide that the company can have more than one class of shares, in which case the articles of association must state the difference between the share classes, the size of each share class and any restrictions on pre-emptive rights in the case of the issue of new shares or increases in share capital.

Equal rights must attach to all of a company's shares of the same class. As a general rule, all shares must carry voting rights; however, it can be provided in a company's articles of association that certain shares carry no voting rights.[5] A company's articles of association may also provide that certain shares carry increased voting powers.[6]

The share capital of many Danish companies (especially listed companies) is divided into different classes of shares, ordinarily A shares and B shares, the A shares typically carrying ten times as many votes per share as the B shares (there are no limits on the scale of the differentiation).

In addition, the articles of association may provide that:

- A shareholder can only exercise a limited number of votes (or the votes relating to a specific limited percentage of the entire capital) irrespective of the actual number of shares held by the shareholder;[7] and
- A shareholder who has acquired shares by transfer is not entitled to exercise voting rights with respect to the shares in question at general meetings, until the new shareholder has been registered in the shareholders' register or the shareholder has given notice of his acquisition of the shares to the company and substantiated his acquisition.[8]

2. The CFC Income Test

CFC income items are explicitly defined and include the following:

1. Net interest income;
2. Net gains on receivables and debts and financial instruments;
3. Certain commissions;
4. Net capital gains on the transfer of shares (see below);
5. Dividends (see below);
6. Payments with respect to intellectual property (IP) rights and capital gains arising from the disposal of such rights;
7. Deductions for tax purposes that relate to the income items at (1) through (6);
8. Leasing income deriving from financial leasing, including losses and gains on such assets; and
9. Income from insurance, banking and other financial activities.

Net capital gains realised on the transfer of shares only constitute CFC income to the extent they would be taxable under Danish law if realised by a Danish company. This means that capital gains realised by a Danish company on shareholdings of at least 10 percent in a company resident in the European Union (EU)/European Economic Area (EEA) or a country that has concluded a tax treaty with Denmark, or of more than 50 percent in any other company do not constitute CFC income.

Dividends only constitute CFC income to the extent they would be taxable under Danish law if received by a Danish company. Thus, dividends that would have been tax exempt under the Danish dividend participation exemption if received by a Danish company do not constitute CFC income.

Dividends are exempt under the dividend participation exemption if the shareholder:

- Holds a minimum participation of 10 percent in the distributing company and Denmark has concluded a tax treaty with the country of residence of the distributing company that either exempts the dividends from Danish taxation or reduces the Danish taxation of the dividends, or the distributing company is resident in an EU Member State; or
- The shareholder controls the distributing company (generally by holding more than 50 percent of the voting rights in that company).

The determination of whether the CFC Income Test is met is made on a yearly basis, taking into account only the income of that particular year. Thus, carry forward losses are not included in the computation of the CFC income ratio. The territorial principle applies in determining the income of SubCo. Thus, income from foreign PEs and foreign real property of SubCo is not included in the calculation of SubCo's CFC income ratio. Rather, an independent assessment is made for each foreign PE.

If SubCo controls one or more subsidiaries ("Local SubCo") located in the same jurisdiction as SubCo, the test is performed on a consolidated basis. This means that the CFC income of a Local SubCo is included in the computation of SubCo's CFC income ratio. Any CFC income received by SubCo from a Local SubCo is eliminated when computing SubCo's CFC income ratio. If SubCo controls only a part of a Local SubCo, only a proportional part of the Local SubCo's income corresponding to SubCo's share of ownership in SubCo is attributed to SubCo.

Generally, both the total aggregate income of SubCo and its CFC income are determined by applying Danish income tax rules. There are, however, some exceptions to this general rule where specific CFC rules apply and, in some instances, the income tax rules of FC will also be taken into consideration. The Danish tax rules are also applied in determining the extent of the income to be excluded under the territorial principle (i.e., in determining which part of SubCo's income can be deemed to be realised by a PE of SubCo in a third country and, therefore, not to be included in SubCo's CFC income).

3. The Financial Assets Test

For purposes of determining whether the Financial Assets Test is met, financial assets are assets the proceeds from which are considered CFC income. The computation is made based on the financial value of the assets (except in the case of IP, when it is based on market value). Assets the proceeds from which are not subject to Danish taxation do not constitute financial assets (but are included in the computation of the total (gross) assets).

Proceeds from shareholdings of:

- 10 percent or more in companies resident in the EU/EEA and tax treaty countries; or
- More than 50 percent in companies resident in any other jurisdictions are not taxable under Danish law and are therefore included in total assets as non-financial assets.

Consolidation rules also apply under the Financial Assets Test. Thus, if SubCo controls one or more Local SubCos located in the same jurisdiction as SubCo, the financial assets of the Local SubCo(s) are included in computing whether SubCo meets the Financial Assets Test. If SubCo holds only a part of a Local SubCo, only a proportional part of the Local SubCo's income corresponding to SubCo's share of ownership in the Local SubCo is attributed to SubCo.

As the Financial Assets Test computation is based on the average portfolio of financial assets for the income year in question, the contribution of non-financial assets at year-end will not significantly affect its results.

Generally, both the total value of SubCo's assets and the value of its financial assets are determined by applying Danish income tax rules. There are, however, some exceptions to this general rule where specific CFC rules apply and, in some instances, the income tax rules of FC will also be taken into consideration.

D. Taxation of DanishCo

For Danish tax purposes, the aggregate taxable income of SubCo is not deemed to flow up to DanishCo (or, for that matter, to flow through any entities interposed between SubCo and DanishCo). Instead, DanishCo is considered to have derived the income directly. Credits are accordingly given to DanishCo for (FC) taxes incurred by SubCo. However, the taxes eligible for credit are (like the income items) determined under a territorial principle. Thus, if SubCo is taxed in FC on income generated in a third country, such tax is not eligible for credit in Denmark.

If DanishCo's ownership share of SubCo is reduced (for example, by a sale of the shares in SubCo), DanishCo is considered to have disposed of the assets and liabilities owned by SubCo in proportion to the reduction of DanishCo's ownership share in SubCo. Any tax that would have been levied on SubCo by FC on account of an actual sale of its assets/liabilities may be credited against the Danish income tax due on the reduction of its ownership share in SubCo.

If SubCo distributes dividends to DanishCo, such dividends are exempt from Danish tax in SubCo's hands if SubCo is within the scope of the CFC regime.

If the aggregate Danish and FC income tax on SubCo's income exceeds the amount of Danish tax that would have been payable had SubCo been a Danish entity, such excess tax can be reimbursed to DanishCo.

Under Danish law, if the income is also taxed by another country in the hands of another company resident outside Denmark (i.e., in the hands of an intermediary company (not being a CFC) interposed between DanishCo and SubCo), no credit is given for the tax imposed by that country.

E. Exemption

The income of SubCo may be exempt from Danish CFC taxation if SubCo is an insurance company, mortgage bank or ordinary bank. The exemption is granted on SubCo applying for permission to the Danish tax authorities. SubCo must demonstrate that a number of requirements are met to ensure that it is actually conducting ordinary insurance, mortgage banking or banking activities in its country of incorporation.

Danish individuals may also be exempt from CFC taxation upon application. The requirements for exemption are that the SubCo concerned is incorporated in an EU or EEA Member State and also that the Danish taxpayer can demonstrate that the SubCo carries on genuine economic activities in its state of incorporation (i.e., the exemption accords with the principle established by the ECJ in *Cadbury Schweppes* that a CFC regime should not apply if it can be shown that the controlled foreign entity concerned is actually established in the overseas jurisdiction and carries on genuine economic activities there).

II. Other regimes

A. Tax transparent entities

Generally, a foreign entity that does not meet the Danish criteria for being considered a separate legal entity is regarded as transparent for Danish tax purposes so that income derived by such an entity in which a DanishCo participates is taxed as if the income was derived by the DanishCo itself. However, if the income is derived from real property situated in the foreign country in which the entity is established or if the income can be regarded as derived by a PE of the DanishCo in that foreign country, Denmark only has the right to tax such income if the source state has relinquished its right to tax such income under a tax treaty or other international agreement.

B. Carried interest regime for private equity/venture funds

Fund managers (individuals) may be subject to a carried interest regime under which carried interest is treated as ordinary income for tax purposes and is subject to ordinary tax (at rates of up to 56.5 percent) instead of, as previously, being treated as share income (and taxed at rates of up to 45 percent).

The carried interest regime applies to investments where the following three conditions are met:

- The fund manager is liable to tax in Denmark;
- The fund manager invests in an equity fund; and
- The fund manager holds a privileged position in the fund in relation to the distribution of profits.

An "equity fund" is defined as an investment vehicle that acquires one or more companies for purposes of participating in the management and operation thereof. A fund manager "holds a privileged position" if he/she receives a disproportionally higher yield on his/her investment compared with the other investors in the fund. Even if the agreed rate of return on the equity investment is exactly the same for all the investors, a fund manager may still hold a privileged position if one or more of the other investors has invested a relatively large amount in the form of loans to the investment vehicle.

Only yield that exceeds the yield that the other investors are entitled to, proportionately, will be treated as carried interest. Yield up to this threshold will be taxed as share income.

The regime is divided into two sub-regimes: one for direct investments and one for indirect investments. The conditions listed above generally apply to both regimes. Indirect investments are, however, subject to look-through treatment and thus, to taxation at fund manager level. The effective tax rate for carried interest with respect to indirect investments is slightly higher (56.5 percent) than the tax rate for direct investments (56 percent).

NOTES

1 C-196/04.
2 See Income Tax Act, sec. 2(1)(a).
3 Corporate Income Tax Act, sec. 32.
4 Corporate Income Tax Act, sec. 31C.
5 Companies Act, sec.46 (1).
6 Companies Act sec.46 (1).
7 Companies Act, sec. 107(2)(4): by implication.
8 Companies Act, sec. 49.

Host Country
FRANCE

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I. The CFC regime of France

A. History and objectives of the French CFC regime

Controlled foreign corporation (CFC) rules were introduced into the French legislation by the 1980 Finance Law in the form of Article 209B of the French Tax Code (FTC). The rules allow the French Tax Administration (FTA), in certain circumstances, to impose French tax on the results of a French corporation's foreign subsidiary or branch that is subject to a privileged tax regime abroad.

Although, historically, inspired by the US rules, the French CFC regime relies on different technical assumptions because of the French territoriality rules. France has a territorial tax system under which corporate tax is payable by corporations only on business executed in France. The income of its foreign branches is in principle ignored in determining a corporation's French taxable basis. In addition, the double taxation of dividends from foreign subsidiaries is eliminated by the exemption of the dividends (only a lump sum 5 percent of the dividends, which is deemed to correspond to shareholder costs, is taxed) rather than a tax credit (the former tax credit, the *avoir fiscal* has been repealed).

Thus, a French corporation ("FrenchCo") that has branches and subsidiaries abroad is in principle not taxed on its foreign profits. This is in contrast to the tax systems of countries like the United States, which tax worldwide profits, use tax credits to avoid the double taxation of dividends received from foreign subsidiaries, and have CFC rules that allow the taxation of foreign income that should, in principle, anyway become taxable at some stage i.e., when (and if) it is distributed to be accelerated.

The French CFC rules allow for the taxation of foreign profits derived by branches and subsidiaries established or incorporated in low tax countries. However, Article 209B of the FTC provides safe harbour rules that can significantly narrow the extent of the situations in which Article 209B applies. As a result of the restrictive stance taken by the FTA, the scope of the safe harbour rules, which are discussed in more detail I.C., below, is open to debate and indeed is currently the subject of litigation.

After its implementation in 1980, Article 209B of the FTC was first amended to extend its scope to encompass foreign branches, which were not covered by the regime as initially introduced. After that amendment, no significant changes were made until those introduced by the Law of December 30, 2004, which substantially amended the CFC provisions in response to certain French and European court decisions.

The first 2004 amendment consisted of a change to the characterisation of the income taxed in the hands of a FrenchCo consequent on the French *Schneider* case,[1] so as to allow for the taxation of CFC income in a treaty context. In its initial version, Article 209B of the FTC provided that a FrenchCo was to be taxed on the "profits" derived by its CFC. The French High Court ruled that such taxation was not consistent with the provision in tax treaties under which business profits are taxable in the State in which they are derived. The law was changed to provide that, in the case of a subsidiary, taxation proceeds on the basis that there is a deemed distribution by the CFC to the FrenchCo. The consequences of this change and the potential impact of treaties on the application of the French CFC rules are discussed in more detail in I.G., below.

The second substantial amendment concerned the safe harbour rules and was a consequence of the European Court of Justice's (ECJ's) important decision in *Cadbury Schweppes*.[2] In *Cadbury Schweppes*, the ECJ held that the UK CFC regime (which was comparable to the regime provided for in Article 209B of the FTC) constituted an obstacle to the freedom of establishment, which was not permissible except where it could be justified by a compelling reason, i.e., where it was necessary "to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory."

The more detailed discussion of the current incarnation of the safe harbour rules (in I.C., below) will show that there remain major doubts as to how these rules should be interpreted, which in turn can have substantial implications for the scope of Article 209B of the FTC.

B. Definition of a CFC

A FrenchCo will be subject to taxation under Article 209B of the FTC if it holds, directly or indirectly, more than 50 percent of the shares, voting rights or financial rights in a legal entity incorporated outside France in a country where it is subject to a privileged tax regime as defined in Article 238 of FTC. Article 209B also applies to foreign branches established in such countries.

A foreign tax system is considered to be a privileged tax regime if, under that regime, the amount of tax borne by the local entity on its income is less than half the tax that would have been payable in France on the same income computed under French tax rules. As the comparison is made by applying the French corporate tax rate (33.33 percent) and the additional contribution (3.3 percent of corporate tax due in excess of EUR 763,000), the threshold would be around half of 34.4 percent of the income computed under French rules.

As regards the minimum holding in the CFC, the 50 percent threshold can be tested by reference to voting rights or financial rights (the financial rights and voting rights are tested separately, they are not aggregated). The percentage of shares, financial rights or voting rights held indirectly through a chain of shareholdings is obtained by multiplying the successive holding percentages. Rights held by related parties with which FrenchCo has a common interest (whether of a personal, financial or economic nature) may also be taken into consideration in computing whether the 50 percent holding threshold is reached.

The 50 percent threshold can be reduced to 5 percent when the holdings have been artificially fragmented. Specifically, the 5 percent threshold applies when more than 50 percent of the shares in the CFC are held either by other corporations established in France or by related parties of the FrenchCo.

C. Types of income subject to the CFC regime the Safe harbour rules

Technically, Article 209B of the FTC allows any kind of income derived by a foreign branch or CFC to be taxed. However, Article 209B II and B III provide safe harbour rules that prevent the CFC provisions from applying when the branch or CFC carries on a genuine activity (i.e., to "active income") or is not used to avoid tax.

As noted in I.A., above, the safe harbour rules were amended by the Law of December 30, 2004 (which took effect from 2006) so as to reflect the principles laid down by the ECJ in *Cadbury Schweppes*.

Before describing these rules (and the new wording is rather complex unnecessarily so despite the fact that the 2004 Law was supposed to clarify the situation), it is worth commenting on their purpose.

As noted above, Article 209B of the FTC represents an obvious exception to French territoriality principles and its purpose, as indicated in the relevant parliamentary discussions, seems clearly to be to combat tax avoidance. This purpose is also consistent with the ECJ's delineation of the scope of CFC rules, which limits the application of such rules to tax avoidance situations.

The purpose of the safe harbour rules should therefore be to define those situations in which there is no French tax avoidance so as to limit the scope of application of Article 209B of the FTC to those situations in which there is such avoidance. Historically, however, the FTA has taken a restrictive position with regard to the interpretation of the safe harbour rules that can result in Article 209B being applied in situations in which no tax is avoided in France. This is, for example, the case where a subsidiary (CFC) is created and held by another foreign subsidiary (Foreign SubCo) of FrenchCo for local tax reasons. If there is no tax effect in France for FrenchCo, the safe harbour rules should allow FrenchCo to escape the application of Article 209B, even if the CFC has only passive income. Another example is provided by the "Trojan horse" situation, in which a French group gains control of a foreign group that has stakes in CFCs. Article 209B should probably never apply in such circumstances, but this is not currently the position of the FTA.

The extensive application of Article 209B of the FTC in situations in which no tax is avoided in France is clearly unacceptable in an EU context, as is evident from the position of the ECJ, which has stated that:[3]

> "In order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to *escaping the tax normally due on the profits generated by activities carried out on national territory*."

The FTA's position is probably also not compatible, in a non-EU context, with the intention of the French parliament in implementing Article 209B of the FTC and the safe harbour rules. There is outstanding litigation on this matter that should clarify both the purpose of Article 209B and the scope of the safe harbour rules, i.e., whether Article 209B should apply mechanically even when no tax avoidance is achieved or whether its application should be limited strictly to cases in which there is avoidance of French tax. *Cadbury Schweppes* clearly confirmed that only the second interpretation is sustainable in an EU context, and there are very strong arguments for suggesting that the same approach should prevail in a non-EU context and even with respect to a CFC located in a state with which France has no tax treaty.

The provisions applicable since 2006 provide different safe harbour definitions in: 1) an EU context; 2) a non-EU context; and 3) in addition, specific rules were recently enacted to cover situations involving investments in "non-cooperative States".

1. EU context

As regards branches and CFCs established in the EU, Article 209B II of the FTC exempts from the application of the CFC regime situations that do not constitute artificial arrangements designed to circumvent the French tax legislation. The definition of such artificial arrangements directly refers to the *Cadbury Schweppes* decision and is very close to the definition of "abuse of law." This safe harbour clause implicitly covers situations in which the branch or CFC carries on a genuine activity, with staff and premises in the other EU Member State. Except in situations in which a genuine activity exists, the difficulty for FrenchCo is that it bears the burden of a proof that is defined negatively: i.e., it must prove that it *did not* create an artificial arrangement to avoid French tax. In its comments on the clause, the FTA has indicated that such proof may be adduced by any means. In fact, the FTA seems to look mainly to the existence of a genuine activity and business, while an analysis of the rule indicates that it ought also to be possible to rely on other factors, including the minimisation of taxes other than French taxes (which is present, for example, in the "Trojan horse" situation described above).

2. Non-EU context

As regards the safe harbour rules applicable to a non-EU branch or CFC, Article 209B III refers to situations in which the branch or CFC carries on a genuine activity. The new wording removes the requirement contained in Article 209B before the 2004 amendments that the activity be carried on "in the local market," which created unnecessary disputes over what a "local market" was.

The second paragraph of Article 209B III provides specific rules that apply to certain tainted income derived by a non-EU branch or CFC and require the FrenchCo to prove that the establishment of the foreign entity concerned mainly had "an effect other than to allow the location of profits in a state or territory where it is subject to a privileged regime of taxation." This additional evidence is required when more than 20 percent of the CFC income derives from the management of financial or intangible assets by the branch or CFC, for its own account, or for the account of a related party belonging to the same group, or when more than 50 percent of the CFC income is derived from the same management income increased by income for the supply of services to related parties belonging to the same group.

In both these two cases, the FrenchCo must provide evidence of the absence of tax objectives. This requirement is in fact quite close to the requirements applying in the case of EU branches and CFCs, except that the law in this context does not expressly refer to avoiding French tax. There is consequently potential for debate as to whether the existence of a non-French tax optimisation purpose would satisfy the safe harbour rule requirements thus allowing the application of Article 209B of the FTC to be avoided, but there are strong arguments suggesting that this should be the case.

3. Investments in "non-cooperative States"

In 2010, the safe harbour rules were amended as regards their application with respect to branches and CFCs located in "non-cooperative States," as defined in the law. However, the list of non-cooperative States published by the FTA is, so far, very short.[4] It is technically possible that the list could be extended to encompass even countries that have signed tax treaties with France but that do not effectively exchange tax information with France. Moreover, the difference in the scope of the application of the safe harbour rules to these countries is in practice immaterial when compared to the scope of their application to other countries: the FrenchCo must establish the reality of the activity carried on by the CFC and, in the case of tainted group activities, the FrenchCo must also prove that the setting up of the structure mainly had "an effect other than to allow the location of profits in a state or territory where it is subject to a privileged regime of taxation." The rule requires that the company must provide all the information required to support this proof, which is in fact the same requirement as applies in situations other than those involving non-cooperative States.

In short, despite the quite complex wording of Articles 209B II and B III of the FTC, the position of branches and CFCs in the EU is not that different from that of branches and CFCs outside the EU, or even of branches and CFCs in non-cooperative States: in all instances, the FrenchCo must prove that no tax has been artificially avoided in France. In practice however, the FTA is probably going to be more demanding as to the level of proof for a branch/CFC in a non-cooperative State than for an EU branch/CFC. In all situations, it is strongly recommended that French-

Cos maintain comprehensive documentation of their CFCs' activities (including transfer pricing policies) to provide to the FTA.

D. Rules used to determine CFC income

The profits of a foreign branch or CFC are deemed to be derived by the FrenchCo on the first day of the year of FrenchCo opening after the close of the year of the CFC. (For example, if the CFC's year closes on September 30, N and FrenchCo's on December 31, N, the CFC income of the year to September 30, N is taxable as income of FrenchCo on January 1, N+1 and taxed as N+1 income.) The income is computed according to French tax rules and French GAAP.

Dividends received by a CFC are exempt from tax in the same way as other dividends received by FrenchCos (i.e., 95 percent exemption if the CFC owns more than 5 percent of the capital of the distributing corporation). Dividends received from corporations in non-cooperative States do not benefit from the 95 percent exemption. This exclusion was introduced in 2009, the previous version of the law providing an exemption for dividends received from corporations resident in countries with tax treaties providing for an exchange of tax information with France. While the concept of "non-cooperative States" is technically wider than the concept used in the prior exclusion, as noted in I.C., above, the number of jurisdictions designated as non-cooperative States is in practice, so far, very limited.

Long-term capital gains on the sale of investment stock held by a CFC are also 95 percent exempt.

Losses incurred by a CFC or foreign branch cannot be offset against the FrenchCo's profits or the profits of another CFC, but can be carried forward to offset the income of that branch or CFC in subsequent years. Losses incurred by the FrenchCo can, by contrast, be set off against the profits of its CFC or branch (which was not possible before 2006).

E. Rules for determining pro-rata shares

Obviously, where a FrenchCo has a foreign branch or owns directly all of the shares of a CFC, its *pro rata* share in the income of the branch or CFC will be 100 percent, and it can be taxed on all of that foreign income, except when the safe harbour rules apply to the income.

The situation is slightly more complicated when the FrenchCo meets the 50 percent participation threshold that triggers the application of Article 209B of the FTC, but part of the 50 percent is held indirectly:

Firstly, while voting rights are taken into account in computing whether the 50 percent threshold is reached, they are ignored in computing the proportion of the CFC income to be included in the taxable income of the FrenchCo, as are shares held by related parties with which the French corporation has a common interest but that are not owned directly or indirectly by the FrenchCo.

Secondly,[5] to avoid double taxation, financial rights held indirectly in the CFC by another, intermediary, French entity that is already subject to tax in France under Article 209B on the CFC income are ignored. Hence, where there is a chain of holdings, the entity liable to tax under Article 209B is the entity that is at the tier closest to the CFC.

F. Adjustments to prevent double taxation on actual distributions or the sale of stock

The tax paid locally by a branch or CFC can be credited against the tax payable by the FrenchCo on the CFC income, provided such local tax can be "assimilated to" French corporation tax. This requires certain conditions to be met, i.e., that: the local tax is computed as a percentage of income; the tax is not deductible from income; and payment of the tax is final and "without counterparty" (meaning, for example, that there can be no entitlement to a refund). In the case of an indirect subsidiary, the tax paid locally can be credited in proportion to the financial rights held, directly or indirectly, in that subsidiary by the FrenchCo subject to Article 209B of the FTC.

Withholding tax imposed on dividends, interest or royalties received by a branch or CFC and paid in a country with which France has signed a tax treaty can also be credited in accordance with the terms of the treaty concerned (although taxes paid in non-cooperative States cannot be credited).

Dividends received by a FrenchCo from a CFC are exempt from corporate tax even the 5 percent portion that normally remains taxable under the French participation exemption. Withholding tax imposed on the distribution of such dividends can be offset against the French tax payable on the CFC income.

The law does not provide a specific rule for dealing with double taxation resulting from CFC taxation in France and in another country with similar CFC rules. The FTA has indicated that such situations need to be examined and resolved in light of the tax treaty between France and the other country (if any). In such situations, however, it is likely to be possible to argue for the application of the safe harbour rules on the grounds that the CFC was created for non-French tax reasons (see I.C., above).

No adjustment is made to any gain on the sale of the shares of a CFC, but such a gain can benefit from the participation exemption for long-term gains. Only shares in CFCs located in non-cooperative States are excluded from the exemption (and, in such circumstances, there is clearly a risk of double taxation when the CFC rules apply).

G. Impact of France's tax treaties

In contrast to the position in some countries (for example, the United States), the French Constitution provides that a treaty automatically takes precedence over domestic law, even law that is enacted after the signing of the treaty.

As noted in I.A., above, the French Supreme Court ruled in *Schneider*[6] that, unless it is expressly authorised by the applicable tax treaty, the taxation of the profits of a foreign branch or CFC is not consistent with the provision in treaties under which business profits are taxed in the state in which they are derived.

This case law continues to apply with respect to foreign branches, so that the taxation of the income of such branches under Article 209B of the FTC depends on whether the applicable tax treaty expressly allows Article 209B to apply, either by referring to it or by providing for a method of elimination of double taxation by way of a tax credit rather than an exemption method. New treaties signed by France generally allow for such taxation, but not all France's treaties have been adapted to that effect.

As regards subsidiaries, the law has been amended so that a FrenchCo is not technically taxed on the profits derived by its CFC, but on a distribution deemed to be made by the CFC. The purpose of the change was to provide for a CFC's income to be taxed as "other income" (when the applicable treaty so allows) or as dividend income (which, depending on the definition of dividend income in the applicable treaty, can create an issue when no income is effectively distributed). The new wording of the law has not yet been tested before the High Court.

II. Other regimes in addition to the CFC regime

Under Article 238 *bis* O I of the FTC, a FrenchCo that transfers assets outside France, whether directly or indirectly, to a person, an organisation, a trust or a comparable institution, with a view to managing in its own interest or assuming for its own account an existing or future commitment or liability, is taxable on the income resulting from the management of such assets. The provisions of Article 238 *bis* O I may apply concurrently with those of Article 209B. Article 238 *bis* OI applies, in priority, to income defined in that Article, with the remaining portion of the CFC income being taxable under Article 209B, so that the same profits are not taxed twice. Article 238 *bis* OI is, however, seldom invoked by the FTA.

Apart from this provision, it is also worth mentioning;

Article 238A of the FTC, which provides that interest, royalties and fees for services payable to an entity located in a tax haven are allowed as deductible expenses only if the debtor supplies proof that the expenses correspond to actual operations and that they are priced at arm's length.

Article 123 *bis* of the FTC, which provides a rule equivalent to section 209B that applies to individuals owning more than 10 percent of an entity located in a tax haven.

NOTES

[1] CE ass. 28 juin 2002 n° 232276, *ministre c/ Sté Schneider Electric*. RJF 10/2002n 1080.

[2] CJCE 12 sept. 2006 aff 196/04 RJF 2006 n 1644.

[3] ECJ 12 sept 2006, 196/04 para. 55

[4] The 2010 list published by the Administration on Feb. 12, 2010 (OJ 17 p. 2923) identifies the following non-cooperative jurisdictions: Anguilla; Belize; Brunei; Costa Rica; Dominica; Grenada; Guatemala; the Cook Islands; the Marshall Islands; Liberia; Montserrat; Nauru; Niue; Panama; Saint Kitts and Nevis; the Philippines; Saint Lucia; and Saint Vincent and the Grenadines.

[5] FTC, Art. 102 T of annex II.

[6] CE ass. 28 juin 2002 n° 232276, *ministre c/ Sté Schneider Electric*. RJF 10/2002n 1080.

Host Country
GERMANY

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I. The CFC regime of Germany

The German controlled foreign company (CFC) rules are contained in the Foreign Relations Tax Act of 1972 (*Auszensteuergesetz* – AStG). Originally modelled on Subpart F of the US Internal Revenue Code (IRC), as a result of numerous subsequent amendments, the German rules have taken on their own characteristic qualities and complications. They occupy the largest part of the 22 §§ of the AStG (specifically §§ 7-14 and 17-20) and are intellectually extremely demanding.

A. The history and objectives of the German CFC regime

The German CFC legislation was introduced in 1972 and has the objective of combating a specific device of international tax evasion, i.e., the transfer of certain sources of income to tax haven base corporations. The device consists in setting up a foreign corporate veil to avoid German taxation the objective of the CFC legislation is to pierce that veil. Of course, a foreign corporation may be taxable in Germany, but only with respect to its domestic income[1] the purpose of §§ 7-14 AStG is to subject to German taxation certain income of a foreign corporation that would otherwise not be so taxable.

Before the enactment of the German CFC legislation, the German tax administration would attempt to treat the establishment of a foreign base company and the transfer of income sources to that company as tax evasion under Germany's general anti-abuse rule.[2] However, that rule is difficult to apply, and where the administration has assumed abusive tax evasion, the tribunals have most often found that the device concerned is legal tax avoidance. As in many other instances, the reaction of the legislator has been to enact a special anti-evasion rule. The relationship between the general anti-abuse rule and the CFC regime is discussed in some detail in II., below.

B. The definition of a CFC

The German technical term for a foreign base company is not "controlled foreign company," but "intermediary company" or "interposed company" (*Zwischengesellschaft*). An intermediary company can only be a foreign entity that:

- Qualifies as a corporation under German standards;
- Is controlled by German resident taxpayers;
- Has neither its seat nor its management in Germany; and
- Would not itself be tax exempt if it were a domestic corporation.[3]

A corporation that meets the above criteria qualifies as an intermediary company insofar as it derives passive income that is subject to a low foreign tax.[4]

A foreign corporation is "controlled by German resident taxpayers" if resident taxpayers, directly or indirectly, hold the majority more than 50 percent of the shares or voting rights in the foreign corporation.[5] Such taxpayers may hold the majority individually or collectively. If they hold the majority collectively, it is not necessary that they should be aware of each other or that they should be aware that they hold shares in a corporation controlled by German taxpayers. Resident taxpayers are individuals who have their residence or ordinary abode in Germany[6] and entities subject to corporation tax that have their seat or management in Germany.[7]

If shares or voting rights in a foreign corporation are held by a partnership, the shares or rights are attributed to the partners in the partnership.[8] There are no trusts in Germany, but any entity that is subject to corporation tax, such as a foundation, may qualify as the shareholder of a foreign base corporation.

A foreign base corporation is also an intermediary company if, even though it is not controlled by domestic taxpayers, it derives capital investment income (*Zwischeneinkünfte mit Kapitalanlagecharakter*). Insofar as a foreign base corporation derives such income and such income amounts to more than 10 percent of total income, it is sufficient for resident taxpayers to hold a share of at least 1 percent to make it an intermediary company, and if the income it derives is exclusively or almost exclusively such income, any share is sufficient.[9]

The historical background to this extension of the intermediary base company legislation to uncontrolled companies is as follows. In the 1980s, Ireland enacted special legislation with respect to capital investment companies to be established in its International Finance and Service Centre. This legislation, which was explicitly approved of by the Commission of the EC, is known in Germany as the "Dublin Docks" legislation and provides for a corporation tax rate of 10 percent on the capital investment income of such companies. In the following years, many powerful taxpayers, including virtually all the big German corporations, acquired shares in Irish investment corporations and transferred large amounts of money to those corporations, which consequently derived billions of marks in capital investment income. For a number of reasons, the German CFC legislation then in force was of no assistance in piercing the corporate veil represented by the Irish corporations, the main reason being that the Germany-Ireland tax treaty was an obstacle to the application of the intermediary base company legislation.[10] As Ireland would not consent to the amendment of the treaty in order to insert an activity clause, special German legislation targeted at the Dublin Docks regime was enacted in 1992 and 1993. In the years before the introduction of this special legislation, the German tax administration unsuccessfully attempted to apply the general anti-abuse rule to such arrangements and lost probably billions of marks in tax revenue (see II., below).

If a foreign corporation qualifies as an intermediary corporation within the meaning of § 7(1) AStG, its qualifying income is deemed to be distributed to its German shareholders in proportion to their shares.[11] This fictitious distribution takes place in the year after the intermediary income is derived.[12]

In the Forum case, the intermediary income of Sub1 derived in year 1 would be allocated to HCo in year 2. Qualifying income derived by Sub2 is attributed to Sub1 in the year in which it is derived and allocated to HCo (in year 2) together with any qualifying income otherwise derived by Sub1.[13]

The foreign corporation must be subject to low taxation. Taxation is low if the tax burden is less than 25 percent of the relevant income.[14] It has been suggested that, as the German corporation tax rate is 15 percent, a tax burden of less that 25 percent should not be considered low. However, the total tax burden on domestic corporations is normally more than 25 percent of income, because the municipal trade tax, which is normally more than 12 percent of income, must be added to the 15 percent corporation tax.

C. Types of income subject to current taxation

Only passive income of a foreign corporation qualifies as CFC income or intermediary income. Income is passive income if it is not active income within the meaning of § 8(1) AStG. In other words, the Act does not define passive income, but does define active income. If income is not active, it qualifies as intermediate CFC income. The list of what constitutes active income comprises ten items and two print pages. It is characterised by complicated definitions, and exceptions and counter-exceptions. To give but one example: income from letting and leasing is active income, unless it relates to real estate, but even income from the letting of real estate is active income, if the domestic taxpayer proves that the income from that letting of real estate would be tax-exempt under a tax treaty, if it were realised by the domestic shareholder himself.[15] (Under all of Germany's treaties as under Article 6(1) of the OECD Model Convention the other Contracting State may tax income from real estate situated in that State. Under most of its treaties, Germany exempts that income from German tax compare Article 23 A of the OECD Model Convention. Exceptionally for example under its treaties with Spain and Switzerland, Germany does not grant a tax exemption in such circumstances, but a tax credit. Thus, for example, a German taxpayer would not be able to prove that the income of his Swiss CFC from real estate situated in Switzerland would be tax exempt if he derived it himself. Consequently, such income would not be active income.) It should be noted that dividends are always active income.[16] Originally dividends were typically passive income, but when the general tax exemption for dividends received by corporations was introduced,[17] the legislator had to designate dividends active income for purposes of the base company regime. Currently, interest and royalties are typically passive income, but may, exceptionally, be active income.[18]

The CFC legislation does not apply with respect to a foreign corporation located in a Member State of the European Union, if the foreign corporation carries on a real business in a business establishment.[19] This exception is the consequence of the European Court of Justice's (ECJ's) *Cadbury-Schweppes* decision.[20] According to the *Cadbury-Schweppes* decision, a CFC regime is incompatible with the EC principle of freedom of establishment, unless it combats an artificial device of tax evasion. The German legislator apparently assumed that a foreign corporation does not serve the purpose of tax evasion if it carries on a real business. Strangely, the exception does not apply to the extended intermediary base company regime, even though *Cadbury-Schweppes* was a "Dublin Docks" case.[21]

The German base company regime does not apply if the conditions for the application of the *de minimis* rule in § 9 AStG are fulfilled. Thus, § 7(1) AStG does not apply if the gross income on which the qualifying intermediary income is based does not exceed 10 percent of the total gross income of the foreign corporation concerned, provided the qualifying income of the foreign corporation or the domestic taxpayer does not exceed EUR 80,000.

D. Other circumstances in which there is current taxation of the income of a CFC

There are no such other circumstances. The participation of Sub1 or Sub2 in a boycott or bribe would probably give rise not to taxable income but to a nondeductible expense, because, as explained in I.E., below, income of a CFC must be determined under German rules and, according to § 4 (5) No.10 EStG (*Einkommensteuergesetz* Income Tax Act), bribes are not deductible. If Sub1 or Sub2 were to receive bribes, the corresponding income would, undoubtedly, not be active income.

Investment by a foreign corporation in German property would normally give rise to domestic income in the hands of the foreign corporation, which would anyway be taxable under the general rules. There is one instance, however, in which the legislator has perceived there to be a potential fiscal risk. Domestic taxpayers might be tempted to have a CFC that they control invest in a domestic REIT-AG (a German real estate investment trust) in order to benefit from the fact that a domestic REIT-AG is not taxable on its income. If that income is distributed to the REIT-AG's foreign shareholders, a 15 percent final withholding tax is imposed.[22] To avoid this consequence, the legislator introduced §§ 7(8), 14(2) AStG, under which the REIT-AG's domestic income may be attributed to the foreign base corporation and allocated to its domestic shareholders.[23]

E. Rules used to determine income

Qualifying foreign income must be determined in accordance with German rules.[24] In Germany, accounting for income and corporation tax purposes is based on commercial accounting rules, as modified (in many respects) for tax purposes. Domestic taxpayers controlling a CFC must file balance sheets and profit and loss accounts of the CFC drawn up in accordance with German accounting rules. At the request of the Finance Office, they must also submit the balance sheets and profit and loss accounts drawn up and certified in accordance with the relevant foreign tax accounting rules.[25]

The Finance Office must produce particular assessments of the amounts of income of Sub2 to be attributed to Sub1 and of the amounts of income of Sub1 to be allocated to the domestic taxpayers.[26]

F. Rules for determining pro-rata shares

As noted in I.B., above, in determining the relevant shares of resident taxpayers in a CFC, both direct and indirect holdings are taken into account. The majority requirement in § 7(1) AStG will, for example, be met if German taxpayer A holds 35 percent of the shares of the foreign base company and German taxpayer B holds 60 percent of the shares in another foreign corporation that, in turn, holds 30 percent of the shares in the foreign base company. In these circumstances, A and B together hold 53 percent of the shares and, therefore, the majority in the foreign base company.

The majority requirement in § 7(1) AStG is also met if resident taxpayers, together with taxpayers that are nonresident but are subject to extended limited tax liability within the meaning of § 2 AStG, hold more than 50 percent of the shares or voting rights of a foreign corporation.[27]

If the foreign corporation has no defined stock or equity capital, the profit shares are taken into account in determining the relevant shares.[28]

G. Mode of taxation to HCo

A German shareholder of a foreign base company is subject to taxation on the income amount allocated to it in proportion to its shares in the base company. If the German shareholder is a business enterprise, as is the case with HCo, the CFC income to be allocated to it is classified as business income, which is subject not only to income or corporation tax, as appropriate, but also to trade tax. Otherwise, the income to be allocated to the German shareholder qualifies as income from investment.[29] CFC losses are not taken into account.[30] As noted in I.B., above, in the Forum case, the passive income of Sub2 will be attributed to Sub1 and then allocated to Sub1's German shareholders in proportion to their shares in Sub1. In the case of HCo, the allocation amount is the entire qualifying income of Sub1, which includes the entire qualifying income of Sub2. There is no hopscotch rule with respect to second- or lower-tier corporations.

Foreign taxes may either be deducted from the allocation amount[31] or, on request, credited against German tax.[32] Foreign taxes may be taken into account only if and when they are paid and if they are paid (in the Forum case) on Sub1's and Sub2's passive income. These rules raise two problems. First, foreign taxes will normally be paid after the year in which the foreign base company income is allocated to the German shareholders. Thus, they are deductible or creditable only with respect to the allocation amount in that subsequent year. Second, if Sub1 and Sub2 derive both passive and active income, the foreign taxes must be apportioned between the active and the passive income, and only the taxes apportioned to the passive income will be deductible or creditable. The foreign taxes may be credited only against German income or corporation tax, not against the municipal trade tax, although the foreign taxes are included in the allocation amount and, consequently, in the taxable income for trade tax purposes. If HCo chooses to have Sub1's foreign taxes credited against its German corporation tax, the taxable allocation amount must be grossed up by those foreign taxes.

If Sub1 distributes its income to HCo and if Third Country levies a withholding tax on that distribution, that withholding tax can also be credited against HCo's German corporation tax on HCo's allocation amount.

H. Adjustments to preclude additional taxation on actual distributions or on sale of stock

If Sub2 distributes its income to Sub1, the dividend is active income and will not qualify for allocation to HCo. If Sub1 distributes its income, which was previously allocated to HCo, the dividend will be tax-exempt.[33] If HCo sells its shares in Sub1, any capital gain arising on the sale will be tax-exempt.[34]

I. Impact of treaties to which Germany is a party

The CFC regime is not affected by Germany's tax treaties. This is explicitly provided for,[35] even though the tax treaties would not affect CFC taxation under general principles: the purpose of tax treaties is the avoidance of double taxation, but the CFC regime does not give rise to double taxation, because HCo is taxed only once on the CFC income. Formerly the Act explicitly prescribed the "analogous application" of Germany's tax treaties to the CFC regime,[36] but the relevant provision was repealed in 2003.

An applicable German tax treaty would, however, have an impact, if the CFC function were exercised not by a foreign corporation, but by a foreign permanent establishment (PE). In such circumstances, the AStG provides for a genuine treaty override.[37] If passive income is derived by a foreign PE (located in the treaty partner country) of a German resident taxpayer and that income would qualify as CFC income if it were derived by a foreign base corporation, and if the relevant treaty provides for the tax exemption of the income of the PE, the tax exemption is replaced by a foreign tax credit. This "switch over" clause was challenged before the ECJ, but the ECJ found it not to be incompatible with European law.[38] The Federal Finance Court, however, held (in the same case) that the "switch over" clause was inconsistent with the freedom of establishment guaranteed by the EC Convention.[39]

II. Other regimes in addition to the CFC regime

The CFC regime applies only if Sub1 is really a *foreign* subsidiary of HCo. In the Forum case, for Sub1 to be foreign, both Sub1's seat and Sub1's management must be in Third Country. Consequently, the tax administration will first examine whether in reality the management is not in Germany. Often, foreign base companies are managed from within Germany. If Sub1's place of management is within Germany (for example, in HCo's offices), Sub1 will be resident in Germany and, therefore a domestic taxpayer, subject to German corporation tax on its worldwide income.

Nor will the CFC regime apply if Sub1 is a sham, i.e. if it does not exist in reality.[40]

The relationship between the CFC regime and the general anti-abuse rule in § 42 AO (*Abgabenordnung* Tax Code) is not entirely clear. In theory, § 42 AO prevails over §§ 7 ff. AStG. If there are no economic or other relevant reasons for the interposition of the foreign base corporation (here Sub1), the conditions for the assumption of an abuse may be fulfilled. The legal consequence is that the abusive facts are replaced by fictitious appropriate facts, under which HCo itself would derive Sub1's income. In practice, if the conditions for its application are fulfilled, the CFC regime applies and generally prevails over the general anti-abuse rule.

Before the extension of the CFC rules to uncontrolled foreign capital investment corporations, the German tax administration attempted in a number of cases to treat the establishment of Dublin Docks corporations in the International Finance and Service Centre as an abusive device under § 42 AO. The administration's arguments were based mainly on the fact that the management of the Irish capital investment corporations was exercised by separate management corporations. The administration, however, lost these cases before the Federal Finance Court (*Bundesfinanzhof* BFH), the BFH finding that there were good reasons for the transfer of the investment function to a foreign corporation and for the outsourcing of the management function to a management corporation.[41]

NOTES

[1] §§ 2, 8(1) KStG (*Körperschaftsteuergesetz* Corporation Tax Act); 49(1), EStG (*Einkommensteuergesetz* Income Tax Act).

[2] § 42 AO (*Abgabenordnung* Tax Code).

[3] § 7(1) AStG (*Auszensteuergesetz* Foreign Relations Tax Act of 1972).

[4] § 8(1) AStG.

[5] § 7(2) AStG.

[6] § 1(1) EStG.

[7] § 1 KStG.

[8] § 7(3) AStG.

[9] § 7(6) AStG; in addition the capital investment income must amount to more that €80,000.

[10] For more details, see *Kramer* in Lippross, Basiskommentar Steuerrecht, Köln loose-leaf-commentary, § 7 AStG note 41.

[11] § 10(1) AStG.

[12] § 10(2) AStG.

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[13] § 14 AStG; for more details, see *Kramer*, German CFC Legislation's Tax Haven Trapdoor, TNI 2005 (Vol.39) page 619.
[14] § 8(3) AStG.
[15] § 8 (1) No.6 b) AStG.
[16] § 8(1) No.8) AStG. This is also generally true for capital gains from the sale of shares in corporations, § 8(1) No.9 AStG.
[17] § 8b(1) KStG.
[18] § 8(1) No.6 a) and 7 AStG.
[19] § 8(2) AStG.
[20] ECJ, decision of Sept.12, 2006, C-196/04, EuGHE 2006.I-7995 = IStR 2006, 670.
[21] For more details, see *Kramer*, in Lippross *loc.cit.* § 9 AStG note 32.
[22] §§ 43, 43a EStG, § 32(1) KStG.
[23] For more details and criticism of the German provisions, cf. *Kramer*, German CFC Legislation Regarding Real Estate Investment Trusts, TNI 2009 (Vol.55) page 469.
[24] § 10(3) AStG.
[25] § 17(1) AStG.
[26] § 18 AStG.
[27] See *Kramer* in Lippross, *loc.cit.* § 7 AStG Note 22.
[28] § 7(5) AStG.
[29] § 10(2) AStG.
[30] § 10(1) last sentence AStG.
[31] § 10(1) AStG.
[32] § 12 AStG.
[33] § 3 No. 41a) EStG.
[34] § 3 No.41 b) EStG.
[35] § 20(1) AStG.
[36] Former § 10(5) AStG.
[37] § 20(2) AStG.
[38] ECJ, decision of Dec.6, 2007, C 298/05 (*Columbus Container Services*), IStR 2008, 63.
[39] BFH, decision of Oct. 21, 2009, I R 114/08, IStR 2010, 149.
[40] § 41(2) AO.
[41] BFH, decision of Jan.19, 2000, I R 94/97, BStBl.II 2001, 222; decision of Feb.25, 2004, I R 42/02, BStBl.II 2005, 14.

Host Country
INDIA

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I. The CFC regime of India

The Indian income tax law, as it currently stands, contains no provisions constituting a controlled foreign company (CFC) regime. However, the Direct Taxes Code (DTC), which is likely to become effective from April 1, 2012, incorporates provisions relating to the taxation of CFCs. In August 2010, the DTC was presented in the form of a Bill before the members of the Parliament of India for discussion and enactment. Until such time as the DTC is enacted by the Parliament, it will not have the force of law. This paper examines the forthcoming CFC regime as envisaged in the DTC, which is still due to be enacted. Thus, the views expressed in this paper are based on the Bill as presented to Parliament and released for public comments and would be subject to modification in accordance with the DTC as finally enacted. This paper may, therefore, be regarded as an analysis of the proposed regulations.

A. History and objectives of the regime

As noted above, the CFC regime has not come into force in India, but is expected to do so with the enactment of the DTC Bill. Under the current Income-tax law, as well as under the DTC, an Indian company (hereinafter, "ICo") is taxable on its worldwide income. However, under the existing regime, ICo is liable to tax only on income that accrues or arises to or is received by it in India. The DTC aims to widen the tax net by including the income of a prescribed foreign subsidiary (hereinafter, "FSub") in the income of ICo if certain conditions are satisfied. The income of FSub attributed to ICo would be considered taxable as "income from residuary sources," which can be explained by reference to the fact that dividend income is also considered income from residuary sources.

What would constitute a CFC, the persons that could be said to have control over a CFC and the attribution of the income of a CFC to a resident of India are discussed in I.B. to G., below.

B. Definition of a CFC

The Twentieth Schedule of the DTC defines a "Controlled Foreign Company" ("CFC") as a foreign company that satisfies all the conditions laid down in the Schedule.[1] The DTC defines a "foreign company" as a company that is not a domestic company, i.e., a company that is not a resident of India.[2] Because a CFC is defined to mean a foreign company (that satisfies the requisite conditions), it is necessary to look at what the word "company" means in the context of the term "foreign company" under the proposed DTC.

A "company" is defined as:[3]

- An Indian company incorporated under the laws of India;
- Any body corporate incorporated by or under the laws of a country outside India; or
- Any person who is or was assessed as a company under the repealed Indian Income Tax Act, 1922 or the current legislation, Income-tax Act, 1961.

The definition of a company given above is extremely broad, not being restricted only to corporations but extending to any entity that may qualify as a "body corporate." As the term "body corporate" is not defined in the DTC, following the canons of statutory interpretation, reference may be made to a statute that is in *pari materia* with the definition in question or has been judicially explained under the relevant statutes or related statutes. Statutes are considered to be in *pari material*, i.e., to pertain to the same subject-matter, when they relate to the same person or things, or to the same class of persons or thing, or have the same purpose or object.[4]

Section 2(7) of the Companies Act, 1956, which defines a "body corporate," may be said to be in *pari materia* with Clause 314(54) of the DTC, since both deal with the same object of defining a company.

The definition of a "body corporate" under the Companies Act is an inclusive definition, and includes a company incorporated outside India but does not include:

- A corporation sole;[5]

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- A co-operative society registered under any law relating to co-operative societies; or
- Any other body corporate not falling within the definition of "company," as provided in the Companies Act that the Indian Government may notify.

The terms "body corporate" and "corporation" are understood to have the same definition under the Companies Act. Justice Marshall, in *Trustees of Dartmouth College v. Woodword*,[6] observed that:

> "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law it possesses only those properties which the charter of its creation confers upon it either expressly or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality and if the expression may be allowed, individuality; properties by which a perpetual succession of many persons are considered as the same, and may act as a single individual."

Further, the High Court of Madras has made it clear that the term "body corporate" is wider than the term "company." The Court observed that an incorporated company is a body corporate but many bodies corporate are not incorporated companies.[7] Moreover, the Department of Company Affairs has indicated that generally speaking, it "would consider that any corporate body, i.e., a body which has been or is incorporated under some statute and which has a perpetual succession, a common seal and is a legal entity apart from the members constituting it, will come within the definition of the term 'body corporate'."[8]

It follows from the above discussion that a "body corporate" here refers to an entity that has been incorporated under the company laws of a foreign country. The essential features of a body corporate can be summarised as being that it:

- Is a juristic person;
- Is incorporated under a statute;
- Has a perpetual existence; and
- Has a common seal.

Thus, it can be said that any entity that, under the laws of a foreign jurisdiction, meets the above criteria could be considered a "body corporate" incorporated by or under the laws of a country outside India and could be classified as a "foreign company" for purposes of the CFC provisions under the DTC.

For a foreign company to be a CFC, it must fulfil all the following conditions:

1. It must be a tax resident of "a territory with a lower rate of taxation;"
2. It must not be listed on any stock exchange recognised by the law of the territory in which it is tax resident;
3. It must be controlled, individually or collectively, by persons resident in India;
4. It must not be engaged in active trade or business; and
5. Its "specified income"[9] must not be more than Rs 2.5 million (approximately USD 50,000).

Condition 1 requires two criteria to be satisfied that the company is a tax resident of a territory and that such territory has a lower rate of taxation. These criteria are explained below.

A company is considered to be a "resident" of a territory if, in any accounting period, it is liable to tax in that territory by reason of its place of incorporation or place of management,[10] i.e., is regarded as resident by a territory that uses the residence basis of taxation.

If more than one territory is identifiable as the place where a company is so liable to tax, the company will be deemed to be a resident of that territory in which its place of effective management (PoEM) is situated.[11] Under the DTC, the "place of effective management" of a company is stated to be the place where the board of directors of the company or its executive directors make their decisions or the place where the executive directors or officers of the company make commercial and strategic decisions that are routinely approved by board of directors.[12] If the company's PoEM is situated in two or more territories, the company will be deemed to be a resident of the territory in which, at the end of the relevant accounting period, the greater amount of its assets are situated.[13] If still no single territory is identifiable from the application of the above criteria, the company will be deemed to be a resident of either the place of incorporation or the PoEM where, at the end of the accounting period, the greater amount of its assets are situated.[14]

It is also provided that if the relevant territory does not tax on the basis of incorporation or PoEM, or a company is not liable to tax in a territory by reason of its incorporation or PoEM, the company will be deemed to be resident in a territory with a lower rate of taxation.[15] In this context, it seems that this rule may cover a company that is located in a territory that taxes its residents on a territorial basis or any basis other than a residence basis.

A foreign company will be considered a resident of a "territory with a lower rate of taxation" if the amount of tax paid by the company on its profits under the laws of that territory is, in an accounting period, less than 50 percent of the tax payable by the company on its profits as computed under the DTC.[16] The provision refers to "tax paid," which may be understood to mean tax actually paid[17] by FSub on its profits in its territory of residence. Such tax paid by FSub is to be compared with the tax that would be payable by the company on the same profits if it were an Indian company. If the tax actually paid by FSub on its profits in its territory of residence, after taking into account all underlying tax credits, is less than 50 percent of the tax payable, as computed under the DTC, on those profits, FSub will qualify as resident in a territory with a lower rate of taxation, thereby satisfying this condition for being a CFC. This provision is similar to those provided under the legislation of other jurisdictions such as South Africa and the

United Kingdom where the lower rate of taxation threshold is higher, being set at 75 percent.

As regards the control requirement, one or more persons resident in India would be considered to have "control" over a company if such persons, individually or collectively:[18]

- Possess or are entitled to acquire, directly or indirectly, shares carrying at least 50 percent of the voting power or capital of the company;
- Are entitled to secure that at least 50 percent of the income or assets of the company will be applied, directly or indirectly, for their benefit;
- Exercise a dominant influence over the company as result of a special contractual relationship; or
- Directly or indirectly control sufficient votes to exert a decisive influence at a shareholders' meeting of the company.

It will be observed that the legal status of the Indian resident is not relevant, i.e., even an individual, a partnership or a trust that is a tax resident of India may be liable to include CFC income in its total income. The CFC rules are not limited in their application to Indian companies alone.

According to Black's Law Dictionary, the word "possess" means to have in one's actual control, to have possession of. Further, the word "possession" refers to the right under which one may exercise control over something to the exclusion of all others and, according to the *Corpus Juris Secundum*, "possess" means to have actual control, care and management of, and not a passing control. Also, it has been pointed out that "possess" has been held to be equivalent to or synonymous with "control," "hold," "occupy" and "own." Hence, it could be argued that the word "possess" could be regarded as referring to, as well as the legal owner having possession, a person having possession without being the legal owner.

The meaning of the phrase "entitled to acquire" can be deciphered from entries in the legal dictionaries. Black's Law Dictionary defines the word "entitle" to mean to grant a legal right to or qualify for, and the word "acquire" to mean to gain possession or control of, to get or obtain. According to the *Corpus Juris Secundum*, the word "entitle" connotes the granting of a privilege or right to be exercised at the option of the party for whose benefit the word is used, and upon which no limitation can be arbitrarily imposed. In other words, it gives the person named the right to demand or receive, and in particular connections, imports the transfer of legal title. Also, it has been indicated that the word "entitled" signifies a claim of right the right to demand or receive. When it is used to express the idea of ownership, it may signify complete ownership already vested or merely a claim or right thereto. Further, the *Corpus Juris Secundum* explains that the word "acquire" implies substantial ownership, something more than temporary possession. In its primary sense, the word has been defined as meaning to attain or to become owner of.

The phrases "entitled to acquire" and "entitled to secure" could apply to two situations one in which a person is currently entitled to acquire or secure an asset at a future date, and one in which a person will, at a future date, be entitled to acquire or secure an asset. Hence, it may be argued that though the phrase "entitled to acquire" may have a wide connotation, it could refer to substantial ownership or becoming the owner of, in other words the relevant right being vested as a "right *in rem*" as opposed to a "right *in personam*." However, in the absence of any clarification on the intention of the provision, it may not be possible at this stage to confine the term to a specific meaning.

Further to the above, the condition requiring that persons resident in India "possess or are entitled to acquire directly or indirectly shares carrying at least 50 percent of the voting power or capital of the company" could refer to Indian residents actually holding 50 percent of the shares or capital of FSub or to such persons having a right to own 50 percent of the voting shares or capital by way of an option. Such actual holding or having a right to own need not be direct, but may also be attributable by way of a holding company structure; for example, even though there may be 12 subsidiaries between the Indian resident and the foreign company under scrutiny, as long as the chain of 50 percent ownership of the intermediate subsidiaries is not broken, the Indian resident would be considered to have 50 percent control over the thirteenth subsidiary (i.e., the company under scrutiny) for purposes of the Twentieth Schedule of the DTC. This means that, in the fact pattern envisaged here, the holding of a subsidiary of ICo in FSub, a second-tier subsidiary, would be attributable to ICo.

Accordingly, any foreign subsidiary, whether directly or indirectly held, will be subject to the CFC regime provided the subsidiary concerned falls within the definition of a CFC under the Twentieth Schedule of the DTC and the income of any such subsidiary as satisfies the relevant test will be attributable to its Indian parent entity.

With respect to the condition requiring that "such persons, individually or collectively, exercise dominant influence over the company as a result of a special contractual relationship," it may be stated that the term "dominant" could mean exercising the most influence or control. Further, the word "influence" means the power to affect persons or events, especially power based on prestige, etc. The *Corpus Juris Secundum* characterises the word "dominate" as a strong word meaning to master, to rule, to control. The word "influence" has been held to be synonymous with the word "control."

Based on the above, it is possible to take the view that if, based on a contractual relationship, residents of India (whether individually or collectively) have the requisite powers to influence or control persons or

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events of the foreign company, the control test may be said to have been passed.

With respect to the condition requiring that "such persons, individually or collectively, have, directly or indirectly, sufficient votes to exert a decisive influence in a shareholders' meeting of the company," it may be stated that the word "decisive" could mean determining or having the power to determine an outcome. Hence, it is possible to take the view that if, in a shareholders' meeting, residents of India (whether individually or collectively) have the power to determine the outcome of any event or decision of the foreign company, the control test may be said to have been passed.

Under the Twentieth Schedule of the DTC, a foreign company will be deemed to be "engaged in active trade or business," if it actively participates in industrial, commercial or financial undertakings through employees or other personnel in the economic life of the territory of which it is resident for tax purposes *and* its income from the following sources does not exceed 50 percent of its total income:[19]

- Dividends.
- Interest.
- Income from house property.
- Capital gains.
- Annuity payments.
- Royalties.
- Income from the sale or licensing of intangible rights with respect to industrial, literary or artistic property.
- Income from the sale of goods or the supply of services, including financial services, to:
  - Persons that directly or indirectly control the company, or persons that control such persons;
  - Persons that are controlled by the company; or
  - Any associated enterprises.[20]
- Income from the management of, holding of, or investment in, securities, shareholdings, receivables or other financial assets.
- Any other income falling under the head "Income from residuary sources."

Thus, if the foreign company is actively involved in any industrial, commercial or financial undertaking in the territory of its residence or, in aggregate, less than 50 percent of its income is from the sources listed above, the company will be considered to be involved in active trade and business and, therefore, will not qualify as a CFC. It seems that both conditions must be complied with and, where even one of them is not complied with, the foreign company would not be considered to be involved in an active trade or business.

The words "actively participates in industrial, commercial or financial undertakings through employees or other personnel in the economic life of the territory" have not been explained. It remains to be seen whether they would encompass profits arising from both "capital" and the exploitation of "labour."

In determining whether the 50 percent of income threshold is reached, income from transactions with related parties would be taken into account (see above at 8.) It remains to be seen whether activities that are entirely intra-group activities and that add no value to the group (for example, intra-group lending) or profits arising from capital or assets (for example, intellectual property) placed or retained in the CFC, can be regarded as contributing to the "economic life of the territory." On the other hand, the participation of the CFC in an industrial, commercial or financial undertaking through employees in a territory, even where related to the activities of associated concerns (for example, manufacturing) could be considered to constitute participation in the economic life of the territory.

It is also necessary to examine whether the payment of taxes by the CFC in its territory of residence, which could be said to be used for the economy of the territory, would be considered to constitute participating in the economic life of the territory.

The remittance of dividends by FSub to ICo creates a safe harbour that exempts FSub's income from current inclusion.[21] The sum so repatriated will not be included in CFC income. It should be noted that the exclusion is only available with respect to any amount received by the Indian parent from its foreign subsidiary in the form of a dividend. "Dividend" has a wide meaning under the DTC and includes:[22]

- Any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company;
- Any distribution by a company to its shareholders of debentures, debenture-stock, or deposit certificates in any form, whether with or without interest, and any distribution to its shareholders of its preference shares by way of bonus, to the extent the company has accumulated profits, whether capitalised or not;
- Any distribution made to its shareholders (other than shareholders not entitled in the event of liquidation to participate in the surplus assets) on the liquidation of a company, to the extent the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not;
- Any distribution made to its shareholders (other than shareholders not entitled in the event of liquidation to participate in the surplus assets) by a company on the reduction of its capital, to the extent the company has accumulated profits, whether capitalised or not; and
- Any payment made by a closely-held company, to the extent of its accumulated profits, if such payment is made:
  - By way of advance or loan to a shareholder that is the beneficial owner of equity shares carrying not less than 10 percent of the voting power;
  - By way of advance or loan to any HUF, firm, association of persons, body of individuals, or company (in this clause referred to as "the said

concern"), in which such a shareholder is a member or a partner or a shareholder, and in which the shareholder has a substantial interest; or

- To any person on behalf, or for the individual benefit, of such a shareholder.

It can, therefore, be argued that any distribution made by FSub to ICo in any manner, as discussed above, could be treated as a dividend and therefore deducted from the total income attributable to ICo as CFC income.

However, it may also be noted that there are no rules on whether income arising from the sale or transfer of control, etc. of the CFC in a subsequent year would be considered income of the Indian resident or would be considered exempt to the extent of the dividend subsequently received, as in the case of the CFC income discussed above.

C. Determining the CFC income

The net profit of the CFC may be calculated in accordance with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), Generally Accepted Accounting Principles (GAAP), International Accounting Standards (IAS) or accounting standards notified under the Indian Companies Act, 1956. However, only that part of the income of FSub that is attributable to ICo is to be included in the total income of ICo. The DTC provides the following formula for computing the income of a CFC attributable to its Indian parent:

Specified Income[23] x Higher of percentage of value of capital or voting shares held by the Indian parent x (Number of days FSub has been a CFC ÷ number of days in an accounting year)

On this basis, it seems that the entire income of the CFC, including active income would be attributable to the Indian resident and not only the part comprising passive income.

Further, it is unclear whether, where the shares of a CFC are held by two or more Indian residents, one of which has control over the CFC, the income of the CFC would also be attributable to the other resident(s), i.e., the resident(s) who does not/do not have control over the CFC.

D. Rules for determining pro-rata shares

Where an Indian parent holds 100 percent of the voting stock of a CFC (as is the case in the fact pattern at hand), the entire income of the CFC will be attributable to the Indian parent, in accordance with the formula set out at I.C., above.

E. Mode of taxation of second tier CFC

An Indian entity will be taxed on the income of its second tier CFC, as if the CFC had repatriated the income directly to the Indian entity. This principle flows from the fact that the provisions of the Twentieth Schedule of the DTC state that even if an Indian tax resident holds an interest in a foreign company indirectly (provided all the other conditions for the CFC regime are satisfied), the income of that foreign company will be included in the income of the Indian tax resident. The income attributable to the Indian tax resident is, of course, limited in proportion to the prorated interest that it has in the foreign company (see further at I.D., above).

F. Treatment of actual distribution

If in a subsequent year a foreign subsidiary distributes dividends to its Indian parent out of income of a previous year (and that income is attributed to the parent under the CFC regime), those dividends will be excluded from the income of the Indian parent in computing its tax liability for that subsequent year.[24] However, any withholding tax paid by the CFC can be claimed as a credit by the Indian parent.

In the event of the actual distribution of dividends by a CFC, the situation may arise that the profits out of which the dividends are distributed have been included as CFC income in a previous year. Withholding tax (if any) will be charged in the territory of residence of the CFC in the year of actual distribution, not in the year in which the income is included as CFC income. The foreign tax credit (FTC) provisions are ambiguous as to the timing of the credit for the withholding tax, i.e., as to whether the credit for the withholding tax paid by a CFC on actual distribution is to be allowed in the year of distribution or in the preceding year in which the CFC income is taxable in the hands of the CFC's Indian parent. Since the withholding tax deducted in the foreign jurisdiction cannot be considered to have been paid at the time of the inclusion of the CFC income in the taxable income of the Indian parent, it is on actual distribution that the provisions for claiming FTC will apply. These provisions state that an assessee (i.e., a taxpayer) under the DTC will be given credit with respect to any income that has been taxed in a foreign country.[25] Thus, although the income would have been included in a previous year, the deduction may only be claimed in the year of actual distribution.

G. Impact of tax treaties to which India is a signatory

The DTC expressly provides that the CFC provisions are to override the provisions of tax treaties entered into by India.[26] The relevant provision states that:

> "(9) Notwithstanding anything in sub-section (8), the provisions of this Code relating to—

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(a) General Anti-Avoidance Rule under section 123;

(b) Levy of Branch Profit Tax under section 111; or

(c) Control Foreign Company Rules referred to in the Twentieth Schedule, shall apply to the assessee referred to in sub-section (8), whether or not such provisions are beneficial to him."

When the provisions of a tax treaty entered into by India are applicable to a taxpayer, sub-section (8) of Clause 291 of the DTC limits the application of the DTC only to the extent that such limitation is beneficial to the taxpayer.

II. Other regimes in addition to the CFC regime

Under the current income tax regime, which is governed by the Income-tax Act, 1961 (the "Income-tax Act"), any income that arises to a non-resident as a result of the alienation of intellectual property or an asset of a Indian tax resident is taxable in the hands of the Indian resident.[27] The Supreme Court of India has held that if a resident has the power to enjoy the income accruing or arising out of an asset transferred to a non-resident, the resident will be deemed to have received the income and therefore be liable to be assessed under the Income-tax Act.[28]

A. Rules for including the income of a non-resident in the total income of an Indian resident

The essential factor in establishing that income accrued to a non-resident from assets over which a resident has rights is subject to tax in the hands of the resident is that the income accrues to the non-resident on account of the transfer of the assets.

The income may arise out of the transfer of the assets itself or in conjunction with associated operations. An "associated operation" is interpreted to mean an operation of any kind effected by any person in relation to any of the assets transferred, or any assets representing, whether directly or indirectly, any of the assets transferred, or the income arising from any such assets, or any assets representing, whether directly or indirectly, the accumulation of income arising from any such assets.

Under section 93 of the Income-tax Act, a person is deemed to have the power to enjoy the income of a nonresident if the income is in fact enjoyed by the resident at some point in time and is used for the benefit of the resident. Further, if the receipt or accrual of the income leads to an increase in the value of any assets held by the resident or for the resident's benefit, the income will be taxable in the resident's hands. The provision also provides that if the resident receives or is entitled to receive, at any time, any benefit provided or to be provided out of that income or out of moneys that are or will be available for the purpose by reason of the effect, or successive effects, of the associated operations on that income and assets that represent that income, the income shall be deemed to be enjoyed by the resident. In the event the resident has the ability to beneficially enjoy the income, the resident will be deemed to have the power to enjoy the income accruing from the asset. Finally, if the resident is able to control the application of the income, the resident will qualify as a person that has the power to enjoy the income from the asset.

In determining whether a resident has the power to enjoy income, the substantial result and effect of the transfer of the assets and any associated operations, and all benefits that may, at any time, accrue to the resident as a result of the transfer and any associated operations are to be taken into account, irrespective of the nature or form of those benefits.

B. Impact of India's tax treaties on these rules

The Income-tax Act provides that for purposes of granting tax relief for the avoidance of double taxation, the provisions of an applicable tax treaty are to apply if they are more beneficial than the provisions of the Income-tax Act. However, the revenue authorities may take the position that treaty benefits are not available, unless it is proven beyond doubt that the arrangement concerned was not entered into for tax avoidance purposes.

C. Other circumstances in which there is current taxation of income of a CFC

There are no other rules, in either the DTC or the current income tax regime, apart from the CFC regime described in I., above, under which a CFC's income is subject to current taxation in the hands of an Indian entity. However, IFRS and GAAP rules will also need to be examined in this context.

The views expressed above are those of the authors, and Deloitte India and its affiliates do not take any responsibility for the contents thereof.

NOTES

[1] DTC, Twentieth Schedule, para. 5.

[2] DTC, Clause 314(104).

[3] DTC, Clause 314(54).

[4] See fn. 2, above.

[5] Under English law, a corporation sole is a legal entity consisting of a single incorporated office occupied by a single person.

[6] 17 US (4 Wheat.) 518, 636 (1819)

[7] *Madras Central Urban Bank v. Corporation of Madras*, (1932) 2 Com Cases 328.

[8] Circular: No. 8(26)/2(7)/63-PR, dated March 13, 1963 issued by the Department of Company Affairs.

[9] DTC, Twentieth Schedule, para. 5 gives the formula for the calculation of "specified income." Specified income = (A + B – C – D) X E/F where:

A - net profit as per profit and loss account for the accounting period, prepared in accordance with the International Financial Reporting Standards issued by the International Accounting Standards Board, Generally Accepted Accounting Principles, International Accounting Standards or accounting standards notified under the Indian Companies Act, 1956;

B = provisions against profit made for meeting liabilities;

C = interim dividend paid out of profits of the accounting period;

D = any loss not been previously taken into account;

E - number of days during which the company is a CFC during its accounting period; and

F = number of days in the accounting period.

[10] DTC, Twentieth Schedule, para. 5 (c) (i).

[11] DTC, Twentieth Schedule, para. 5 (c) (ii) (A).

[12] DTC, Clause 314 (192)

[13] DTC, Twentieth Schedule, para. 5 (c) (ii) (B).

[14] DTC, Twentieth Schedule, para. 5 (c) (ii) (C).

[15] DTC, Twentieth Schedule, para. 5 (c) (iii).

[16] DTC, Twentieth Schedule, para. 5 (d).

[17] DTC, Clause 314 (178) defines "paid" as follows:

"(a) In relation to "Income from business" or "Income from residuary sources", to mean incurred or actually paid, according to the method of accounting on the basis of which the income under those heads are computed; and

(b) In all other cases, mean actually paid."

[18] DTC, Twentieth Schedule, para. 5 (b).

[19] Clause 5 (e) of Twentieth Schedule to DTC

[20] "Associated enterprise" (AE) is defined in DTC, Clause 124 (5). An AE is an enterprise that is associated with another enterprise by virtue of certain relationships prescribed by the DTC. For these purposes, an enterprise is not restricted to a body corporate and includes non-incorporated entities. The ambit of such relationships is very wide and has been left open-ended by providing that the government may prescribe any other relationship between enterprises to establish that they are AEs. The relationships envisaged in the DTC include situations in which one enterprise holds at least 26 percent of the voting power in another enterprise or any person, directly or indirectly, holds at least 26 percent of the voting power in both enterprises. Two enterprises will also be deemed to be AEs if loans advanced by one enterprise to the other enterprise constitute at least 50 percent of the book value of the total assets of the other enterprise or if one enterprise guarantees at least 10 percent of the total borrowings of the other enterprise. Further, if more than 50 percent of the governing board of one enterprise or one or more executive directors/ member of the governing board of that enterprise is appointed by the other enterprise or more than 50 percent of the directors of the governing board, or one or more of the executive directors/members of the governing board of each of the two enterprises, is appointed by the same person, such enterprises will qualify as AEs. Where one enterprise is wholly dependent on the use of intellectual property, or any other business or commercial rights of the other enterprise for carrying out its business, that enterprise will be an AE of the other enterprise. Further, two enterprises will be deemed to be AEs if 90 percent or more of the raw materials and consumables required by one enterprise to carry on its business is supplied by the other enterprise, or by persons nominated by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise or, as the case may be, the products of one enterprise are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise. The provision of any services, directly or indirectly, by one enterprise to another enterprise or to persons specified by the other enterprise, where the amount payable and the other conditions relating thereto are influenced by such other enterprise, will result in the enterprises being AEs. If a Hindu undivided family (HUF) or an individual controls two enterprises or one of them is controlled by a member of the HUF or the individual's relatives, the enterprises will be AEs. In the case of an unincorporated body, if an enterprise holds at least a 10 percent interest in such unincorporated body, the enterprise and the unincorporated body will be deemed to be AEs.

[21] DTC, Clause 59(1)(c).

[22] DTC, Clause 314(81).

[23] See fn. 9, above

[24] See fn. 21, above.

[25] Clause 207 of the DTC

[26] Clause 291(9) of the DTC

[27] Section 93 of Income Tax Act, 1961

[28] *M.CT.M. Chidambaram Chettiar v. CIT* [1966] 60 ITR 28 (SC).

Host Country
IRELAND

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I. Absence of a CFC Regime in Ireland

Ireland does not have controlled foreign corporation (CFC) legislation. The general focus of the Irish tax system is on attracting and retaining foreign direct investment; for example the rate of corporation tax on Irish trading income is a low 12.5 percent and Irish transfer pricing rules have only been introduced with effect from January 1, 2011.

In addition, the number of Irish domestic groups with major foreign subsidiaries is limited and accordingly, there is limited concern about Irish domestic companies operating through foreign subsidiaries and deferring the repatriation of foreign profits to Ireland. Provisions exist in Irish tax law to impute foreign income to Irish resident individuals in certain circumstances, but they do not apply to companies.

In addition, capital gains of certain non-Irish tax resident closely held companies may be attributed to participators that, if companies are tax resident in Ireland and if individuals are both tax resident and domiciled in Ireland.

The absence of Irish CFC legislation makes Ireland a relatively attractive location for headquarter companies compared with countries that have CFC legislation and, undoubtedly, was a factor in the recent migration to Ireland of a number of headquarter companies, in particular from the United Kingdom, a country with CFC legislation.

There are no indications of Ireland proposing to introduce CFC rules, and the focus of Ireland's tax system, at least in the medium term, will continue to be on attracting and retaining foreign direct investment, as evidenced by the repeated assertions by both the Irish Government and opposition parties of the importance of the retention of the 12.5 percent corporation tax rate.

II. Other regimes

Income tax anti-avoidance provisions exist to prevent individuals creating foreign structures to accrue income outside of Irish taxation.

Where an individual is deemed by the provisions to have power to enjoy the income of a foreign person as a result of a transfer of assets made by the individual, the individual is subject to tax on an arising basis on the income of the foreign person. As the actual income is deemed to be the individual's income, any treaty benefits referable to that income will be available.

Where the income of the foreign person is not taxed under the transferor provisions mentioned above, tax is charged by attribution when a benefit is received by a person who did not make the transfer of assets. This is done by attributing to the benefit so much of the current and prior income of the foreign person as has not been previously attributed, and if necessary, by continuing to attribute future income until the entire value of the benefit has been matched by attributions. In these circumstances, it is not clear whether the amount of historic income attributed is the actual income carrying any relevant treaty benefits, or is deemed to be a separate item of attribution merely quantified by reference to historic income.

Similar capital gains tax anti-avoidance provisions apply that attribute capital gains. Gains of a foreign closely held company are attributed on an arising basis to participators who are tax resident in Ireland, and in the case of individuals, who are domiciled in Ireland as well. Relevant treaty benefits will apply.

Gains can also be attributed on an arising basis to the settlor of a foreign trust who is tax resident and domiciled in Ireland. Again, relevant treaty benefits will apply.

Where the settlor attribution of trust gains does not apply, capital payments made to beneficiaries who are tax resident and domiciled in Ireland will be attributed with current and historic gains and if not fully matched by them, with future gains until so fully matched. As with the parallel income tax provision, it is not clear whether attribution with historic gains carries relevant treaty benefits or whether the attribution is deemed to be a separate item of gain merely quantified by reference to the historic gains.

Host Country ITALY

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I. The Italian CFC legislation

A. History and objectives of the regime

Controlled Foreign Company (CFC) rules were first introduced into the Italian tax legislation by Article 1 of Law 342/2000[1] and the related implementing decrees, with effect from the year 2002. The measure was inspired by the 1998 OECD Report on "Harmful Tax Competition: An Emerging Global Issue,"[2] which was echoed in the Explanatory Reports[3]to the draft laws preceding the eventual adoption of Law 342/2000.

At that time, there were only two provisions in the Italian Income Tax Code (ITC) that specifically addressed relationships with low tax jurisdictions. One, introduced in 1992, established special conditions for the deduction of costs arising from transactions with related enterprises located in low tax jurisdictions;[4] the other provided for the full taxation of dividends distributed by companies resident in such jurisdictions.[5]

The new CFC regime originally applied only to participations granting control over the foreign entity concerned and only to entities resident or established in states or territories having "privileged tax regimes."[6] In subsequent years, the scope of application of the CFC regime has been significantly enlarged.

The first extension was the result of Legislative Decree 344/2003, which introduced, with effect from January 1, 2004, Article 168 of the ITC, under which the CFC rules also apply to entities (located in countries or territories with "privileged tax regimes") in which an Italian resident holds a participation in profits of at least 20 percent (reduced to 10 percent if the foreign entity is publicly listed).[7]

The second extension was implemented through Article 13 of Law Decree, July 1, 2009, No. 78, which made the provisions of Article 167 of the ITC applicable also to controlled entities resident in countries and territories other than those having privileged tax regimes, subject to conditions relating to the effective taxation of the relevant foreign entity and its dominant activity.[8]

Finally, it is worth mentioning a legislative change that has not yet entered into effect and that may, in the future, further enlarge the scope of application of the CFC rules. The Finance Law for 2008[9] envisages the replacement of the current "black list" approach with a "white list" system that, *de facto*, will downgrade to the rank of countries and territories considered to have privileged tax regimes all those countries that have not signed tax treaties with Italy. The actual implementation of this reform is subject to the actual adoption of the new "white list" for CFC purposes and to a subsequent five-year transitional period.

B. The definition of a CFC

1. Scope of application of the Italian CFC rules introduction

The current CFC regime, resulting from the amendments applicable since 2004 and 2010, has a rather wide scope of application and is structured in different sections, depending on the share ownership of the Italian shareholder(s) and the location of the foreign entity concerned. Table A below represents the overall picture.

In view of the statutory differences in the conditions for application and the related exemptions, the two different sets of rules applicable to "black list" and "non-black list" participations are discussed separately in I.B.2.-5., below.

2. Scope of application of the "Black List" CFC rules

Article 167, Paragraph 1 of the ITC provides that the CFC legislation is to apply to the holding of a controlling participation in an enterprise, a company or any other entity that is a resident of, or that is located in, a state or territory having a privileged tax regime.[10] The CFC regime also applies to participations in non-resident persons with regard to items of income accruing from permanent establishments (PEs) situated in states or territories that are included in the "black list."

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In this context, the exact meaning of the terms "enterprise," "company" and "any other entity" has been the subject of ongoing debate.

Based on the contributions of the most authoritative doctrine, it can be concluded that the concept of an "enterprise," for the most part, largely coincides with that of a "company" and "any other entity." In particular, it would appear to be extremely difficult to conceive of anything that could be labeled an "enterprise" that would not also qualify either as a "company" or as "any other entity." Indeed, in this context, the only conceivable concrete example of an "enterprise" that would likely not coincide with the concept of a "company" or of "any other entity" is that of a sole proprietorship situated in a "black-listed" state or territory over which an Italian resident exerts, by any means, some degree of dominant influence.[11]

The concept of a "company" encompasses any possible body corporate, while the concept of "any other entity" has a residual nature, aimed to encompass any possible legal person that cannot be qualified as a body corporate.

As to the location requirement, while it is generally agreed that "resident," as used in Article 167, Paragraph 1 of the ITC, is intended to mean "tax resident," it is not entirely clear whether such tax residence should be determined based on Italian, foreign or tax treaty criteria.

In line with the approach taken when Italy implemented the EC Parent-Subsidiary Directive,[12] it has been suggested[13] that the concept of "tax residence" should be that provided for in Italian domestic law, as integrated with the relevant tax treaty provisions in cases of double tax residence.

In any case, any doubts arising from the application of the residence test should be resolved in light of the much broader concept of "localisation" also set forth in Article 167, Paragraph 1 of the ITC. In particular, the Report of the 6th Finance Committee of the Senate made it clear that "localisation" refers to any factual situation based on which income earned by a "controlled foreign company" benefits from a preferential tax regime regardless of the territorial link with the jurisdiction concerned, so that the link may consist not only of tax residence but also of factors such as domicile or the mere incorporation of the entity under the laws of the relevant state or territory. The notion of "localisation" is also designed to include in the subjective scope of application of the CFC regime cases in which the "controlled foreign company" concerned is not situated in a "black-listed" state or territory but nonetheless operates a PE in such a state or territory.

Based on Article 1, Paragraph 3 of Ministerial Decree No. 429 of November 21, 2001, the relevant concept of "control" is that enshrined in Article 2359 of the Italian Civil Code. The definition provided in Article 2359 is very broad and includes:

- Control exerted through the holding of participations;
- Factual control, i.e., a situation in which a shareholder does not have a majority stake in an entity but has a dominant influence over the entity, for instance, because the shareholders' body is very fragmented; and
- Contractual control, i.e. a situation in which a shareholder has a dominant influence over the entity as a result of specific contractual ties.

Based on Article 2359, Paragraph 3 of the Italian Civil Code, the above forms of control can be exerted directly or indirectly. In this respect, Article 167, Paragraph 1 of the ITC indicates that control can also be exerted through persons acting in a fiduciary capacity or by interposition.

Nor is it relevant whether the indirect links in a chain of control are represented by resident or nonresident persons. What matters in relation to the applicability of the CFC legislation is that the control test should be met at each link in the control chain.

Whether a trust can constitute an intermediate link in the chain of control is the subject of dispute, although a trust generally cannot constitute such a link where it is a "blind trust," meaning a trust where all the management decisions are exclusively the prerogative of the trustees.[14]

The CFC regime applies to all Italian resident taxpayers, including natural persons and entities of any kind. It is not necessary that the taxpayer should be carrying on a business activity.

In a case in which there is no control relationship, but there is a participating interest, Article 168 of the

TABLE A

Relationship	States or territories with privileged tax regimes ("black list" CFCs)	Other states or territories ("non-black list" CFCs)
Direct or indirect control (as defined in Civil Code, Art. 2359)	Applicable to locally resident entities and local permanent establishments of nonresident entities	Applicable only if: ▪ " More than half of revenue derives from financial activities, intangibles, intra-group services; and ▪ " Effective income tax is lower than half of comparable Italian taxation
Direct or indirect participation in profits no lower than 20 percent (10 percent if the foreign entity is publicly listed)	Applicable to locally resident entities, but not applicable to local permanent establishments of non-resident entities	Not applicable

ITC will apply. However, as this provision largely refers to Article 167 of the ITC with a few exceptions (for example, with respect to PEs), the same rules would come into play.

3. Scope of application of the CFC "non-black list" rules

Paragraph 8-*bis* of Law Decree 78/2009 extends the CFC rules to all controlled entities resident in countries or territories other than those having privileged tax regimes, if two conditions are fulfilled.

The first condition relates to the activity carried on by the controlled entity. Such activity must consist of the management of financial assets and intellectual property, or the provision of services (including financial services) within the group of which the controlled entity is a member.

The second condition is fulfilled when the effective level of taxation on the foreign entity is "less than half" of the taxation that would be imposed if the entity were resident in Italy. The wording of the rule (which seems to be patterned on the "comparable tax approach") indicates that the comparison is to be made systematically, on a year-by-year basis.[15]

4. Exemptions from the CFC "black list" rules

The first exemption (the "business test") originally provided that the CFC rules did not apply (subject to a ruling procedure) if the controlled entity performed an actual industrial or commercial activity, as its main activity, in the state or territory in which it was established. Law Decree No 78/2009 replaces the reference to the country of establishment with a reference to the "market" of that country, which is designed to ensure that the exemption is granted only if there is a further connection with the country of establishment (for example, in terms of the clients or suppliers of the entity, or other factors), beyond its being the place of business of the controlled entity.[16]

The second exemption (the "subject to tax" test) applies (subject to a ruling procedure), if the holding of shares in the foreign entity does not have the consequence that its income is only taxable in a country or territory having a privileged tax regime.[17]

5. Exemptions from the CFC "non-black list" rules

The recent reform implemented by Law Decree 78/2009 introduced a new, specific exemption applicable only to "non-black list" CFCs. Subject to the same procedural rules as are provided for the other exemptions, the taxpayer may demonstrate that the foreign establishment "is not an artificial arrangement intended to escape taxation." The formula is clearly drawn from the case law of the European Court of Justice (ECJ)[18] and aims to prevent possible conflict with the principles of the Treaty of Rome.

According to the ECJ, no artificial arrangement will exist where there is an "actual establishment intended to carry on genuine economic activities" that "physically exists in terms of premises, staff and equipment." Circular Letter 51/E tends to follow the guidelines laid down by the ECJ, and also makes explicit and wide reference to the Council Resolution of June 8, 2010 on the coordination of CFC and thin capitalisation rules in the European Union.[19]

C. Types of income subject to current taxation

Once it is ascertained that the Italian CFC regime applies (i.e., all the conditions are fulfilled and no exemption is applicable), the entire income of the foreign entity concerned is attributed to its Italian resident shareholders, on the basis of their respective shares in the entity profits. It is worth emphasising that the exemptions do not look to whether there is a "tax avoidance purpose" underlying the setting up of the foreign entity even though a "tax avoidance purpose" is somehow part of the rationale which that led to the adoption of the CFC rules, the exemptions are granted on a factual basis and not on the basis of the purpose of any individual taxpayer.

In conclusion, it may be argued that the Italian CFC regime remains "jurisdictional" even after the amendments introduced by Law Decree 78/2009,[20] which, though they make the nature of the activities performed by the foreign entity one of the conditions for the application of the regime, do not then limit the consequences of the application of the regime to income arising from those activities (i.e., the activities that bring the entity within the regime).

D. Other circumstances in which there is current taxation of the income of a CFC

Other than those described above, there are no circumstances in which current taxation of all or part of a CFC's (here Sub2's) income is triggered (for example, if Sub2 participates in a boycott, makes bribes, or makes investments in Italian-situs property). The usual rules would, nonetheless, apply to Italian-source income.

E. Rules for the determination of income

The consequence of the application of the CFC rules is taxation, in the hands of the Italian shareholder(s), of the income of the foreign entity concerned, regardless of whether the income is actually distributed. The taxable income is determined differently, depending on whether the Italian shareholder(s) has/have a control relationship with, or merely a participating interest in, the foreign entity.

Where there is a control relationship (Article 167 of the ITC), income is determined by applying the Italian business income tax rules to adjust the profit reflected in the foreign entity's profit and loss account as drafted in accordance with local rules (i.e., local GAAP or IFRS, as the case may be).

In case of a participating interest (Article 168 of the ITC), the income taxable in the hands of the Italian shareholder is equal to the greater of:

- The (before-tax) profit reflected in the financial statements drawn up by the foreign entity in accordance with local rules (with no adjustments); or
- An amount determined presumptively on the basis of statutory rates of return applied to the book value of certain assets.

F. Imputation of income

Income of the foreign entity is attributed to its Italian resident shareholders in proportion to their respective (direct or indirect) participation in the profits of the entity.

G. Taxation of income and foreign tax credit

Income attributed to an Italian resident shareholder is subject to a substitute tax (with the consequence that it cannot be offset with losses from a different source) at a rate equal to the higher of 27 percent or the average tax rate of the shareholder for that year.

Gross tax so determined is reduced by a foreign tax credit for:

- Underlying taxes levied on the CFC income; and
- Withholding taxes levied at the time of the distribution of dividends by the CFC.

H. CFC regime and double taxation

The double taxation of CFC income is prevented by specific provisions, under which:

- Dividends distributed by a CFC are not taxed in the hands of the Italian (direct or indirect) recipient to the extent of the income previously taxed on accrual; and[21]
- The recognised tax basis of shareholdings in a CFC is increased by an amount equal to income taxed on accrual and reduced by an amount equal to dividend distributions.[22]

However, it is not clear whether this rule would also apply with respect to indirect shareholdings (unlike the relief with respect to dividends, which is explicitly provided both for direct and indirect shareholders).

According to the traditional interpretation of the Italian Revenue Agency, which has been the subject of some criticism, double taxation may nonetheless occur if a dividend distributed by a CFC flows through other CFCs, whose income (including the dividends) is subject to tax on accrual in the hands of their Italian shareholders.[23] More recently, in Circular Letter No. 51/E of 2010, the tax authorities seem rather to be focusing on the existence of a reasonable overall tax rate and the systematic distribution of the income to Italy.

I. Impact of tax treaties and EC law

1. Tax treaties

Italy's most recent tax treaties contain a specific paragraph making it clear that the Non-discrimination Article is not to be construed as preventing the application of Italy's domestic anti-avoidance rules, including the CFC legislation.[24] The Italian Revenue Agency has traditionally[25] taken the position that the Italian CFC legislation is not in conflict with tax treaty provisions, so that the application of CFC rules was intended to be allowed even where the applicable treaty did not contain any safeguard rule.[26]

Until recently, there was no case law with regard to the interaction between Italy's tax treaties and its CFC legislation. However, in late 2009, a Provincial Tax Court (i.e., the lowest of the three levels of judgement to be found in the Italian tax judicial system) was asked to decide[27] on the compatibility of Article 167 of the ITC with certain provisions of the Italy-Cyprus tax treaty[28] (hereinafter, the "Treaty"). The Court came to the conclusion that, under Article 7(1) of the Treaty, the power to tax the profits of a non-resident enterprise can be granted only where the enterprise has a PE in the taxing State, with the result that the Italian CFC legislation should not apply in the circumstances concerned.

It is doubtful whether this case constitutes meaningful precedent or simply represents an isolated decision. The latter possibility cannot be dismissed, in light of the fact that the official OECD position on the matter[29] openly supports the view that CFC rules and tax treaty provisions are compatible. On an international level, the only precedent that goes in the direction taken by the Provincial Tax Court of Bergamo is to be found in the well-known French case, *Schneider.*[30] The courts of other countries[31] have consistently found that CFC rules and treaty provisions are not incompatible.

2. EC law

Although some references may be found in earlier Italian literature, it was not until the *Cadbury Schweppes* decision, delivered by the ECJ on September 12, 2006, that the possibility of a conflict between the CFC legislation of an EU Member State and EC law became evident.

According to the ECJ, a CFC regime may constitute a restriction on the freedom of establishment of companies, since it creates a difference in treatment between domestic and foreign subsidiaries, which may deter the acquisition or maintenance of a subsidiary in another EU Member State. According to the *Cadbury Schweppes* decision, however, a CFC regime may be justified if it has the specific purpose of preventing the creation of wholly artificial arrangements aimed at circumventing national tax rules.

At the time of the *Cadbury Schweppes* decision, the Italian CFC legislation was applicable almost exclusively to non-EU subsidiaries.[32] And, indeed, the exemptions provided by the law (especially the "business test") seemed to indicate that the regime was not in breach of the guidelines arising from the ECJ judgment.

As to the current regime resulting from the amendments made by Law Decree 78/2009,[33] it has already been noted that the wording of the new legislation and the related instruction (Circular Letter 51/E of 2010) are largely inspired by a desire to comply with EU criteria. As the new rules have only recently been enacted and the Italian Revenue Agency has wide discretionary powers, it may be argued that whether the rules are actually consistent with the *Cadbury Schweppes* doctrine will depend on administrative practice, and in particular on how concrete will be the opportunity afforded to resident taxpayers to produce evidence that their CFCs are actually established and that their CFCs' activities are genuine.

II. Other regimes in addition to the CFC regime

The only other circumstance in which income of a foreign subsidiary is subject to Italian taxation on accrual is under the elective group taxation regime, which is applicable on a worldwide basis.[34] This regime provides for the determination of a single tax base that includes, proportionally to the shares held, the income of all non-resident subsidiaries in a group. The regime is not generally considered to interfere with Italy's tax treaties.

NOTES

[1] Law No. 342 of Nov. 21, 2000, Art. 1, Para. 1, Letter b) introduced into the ITC new Art. 127-*bis*, which was later renumbered Art. 167.

[2] See, in particular, Para. 97 thereof.

[3] Explanatory Report to Law Draft No. 4185 of 1999 and Explanatory Report to Law Draft No. 4136 of 1999.

[4] Reference is made to now repealed ITC, Art. 76, Para. 7-*bis*, whose provisions, also enlarged over the years, are now enshrined in ITC, Art. 110, Para. 10.

[5] Otherwise, ITC, Art. 96 provided, at that time, for the exemption of 60% of dividends distributed by companies in which an Italian corporate shareholder owned a participating interest.

[6] On the initial adoption of the Italian CFC legislation, see A. Russo, D. Busetto, *Italy :proposal for the introduction of CFC legislation*, in *Tax Planning International Review*, Vol. 26 (1999), No. 12, p. 8 ff.; A. Russo, D. Busetto, *Final controlled foreign companies legislation enacted*, in *European Taxation*, Vol. 41 (2001), No. 1, p. 32; F. Nanetti, *Italy's controlled foreign companies legislation*, in *Bulletin for International Fiscal Documentation*, Vol. 54 (2000), No. 6, p. 281 ff; P. Valente, M. Magenta, *Italy : new CFC legislation*, in *Intertax*, Vol. 29 (2001), No. 2, p. 52; P. Tognolo, *New Italian CFC rule : main issues and comments*, in *Tax Planning International Review*, Vol. 29 (2002), No. 1, p. 19; M. Gazzo, *Italy's CFC legislation implemented and participation exemption extended*, in *Bulletin for International Fiscal Documentation*, Vol. 56 (2002), No. 2, p. 77 s.; P. Troiano, *Italian controlled foreign company legislation: publication of the 'black list'*, in *Intertax*, Vol. 30 (2002), No. 3, p. 109.

[7] The new provision was complemented by Ministerial Decree No. 268 of Aug. 7, 2006, according to which the new provisions had effect from the tax period in progress as of the related date of publication (Oct. 20, 2006).

[8] S. Garufi, *Amendments to the Italian controlled foreign company rules: a witch-hunt?*, in *European Taxation*, Vol. 49 (2009), No. 10, p. 504; P. Scarioni, S. Muni, *The new Italian CFC rules: EU holding companies challenge the 'artificial arrangement' assessment*, in *Intertax*, Vol. 38 (2010), No. 10, p. 527.

[9] Law No. 244 of Dec. 24, 2007 introduced ITC, new Art. 168-*bis*.

[10] As briefly noted above, ITC, Art. 168-*bis* provides for the adoption of a Ministerial Decree containing a "white list" of all states and territories that impose taxation comparable to that of Italy and that are compliant with an effective standard of information exchange. In the meantime, the CFC regime is applied to states and territories included in the "black list" contained in the Ministerial Decree of Nov. 21, 2001.

[11] In this sense, see Assonime Circular Letter No. 65 of Dec. 18, 2000, p. 11 and G. Maisto, *Il regime di imputazione dei redditi delle imprese estere partecipate (cd.* Controlled Foreign Companies*)*, *Riv. dir. trib*., 2000, IV, p. 50.

[12] See the Report on the Draft of Legislative Decree No. 136 of March 6, 1993.

[13] See M. Piazza, *Guida alla fiscalità internazionale*, IX Ed., Milan, 2004, p. 1264.

[14] For a review on the matter see P. Troiano, *L'uso del "trust" e la nuova disposizione antielusiva di cui all'art. 127*-bis*, D.P.R. 22 dicembre 1986, n. 917, Boll. Trib.*, 2001, p. 1054.

[15] Some of the criteria for making the comparison were outlined by the Italian Revenue Agency in Circular Letter No. 51/E, dated Oct. 6, 2010. For example, it was made clear that the Regional Tax on Productive Activities (IRAP) should not be taken into account and that, in order to identify the foreign tax to be compared, reference should be made to Italy's tax treaties. Conversely the approach taken by the Italian Revenue Agency, under which taxes levied in states other than those in which the subsidiaries are located are not to be taken into account, is questionable.

[16] According to Circular Letter No. 51/E of Oct. 6, 2010, the reference to "market" is usually intended to refer to the market of destination or supply, but other elements may be also taken into account. Also, the market of the state or territory concerned may be deemed to include the neighboring region.

[17] This typically happens when income of a PE situated in a "black list" Country is subject to worldwide taxation in the country of residence of the general enterprise. According to Circular Letter 51/E (see fns. 15 and 16, above), the exemption is granted, in more general terms, when the CFC income is subject to a global effective tax rate that appears reasonable compared to the level of taxation applicable in Italy.

[18] *Cadbury Schweppes and Cadbury Schweppes Overseas*, Sept. 12, 2006, Case C-196/04.

[19] Published in OJEU, C156 of June 16, 2010.

[20] For a comparative perspective on the possible regulatory approaches in this context, see OECD, *Controlled Foreign Company Legislation*, Paris, 1996, pp. 31 *et seq*.; B.J. Arnold and P. Dibout, *Limits on the use of low-tax regimes by multinational businesses: current measures and emerging trends. General Report*, in *Cahiers de Droit Fiscal International*, Vol. LXXXVIb, Deventer, 2001, p. 44.

[21] ITC, Art. 167, Para. 7.

[22] Ministerial Decree No. 429 of Nov. 21, 2001, Art. 3, Para. 5.

[23] This position was taken in Resolution No. 235/E of Aug. 23, 2007

[24] See in this respect, the Italy- Armenia, -Jordan, -Slovenia, -Uganda and –Ukraine tax treaties.

[25] For an overview on the "evolution" of the Italian position on CFC rules and tax treaties see P. Bracco, *Italy – Branch Report,* in AA.VV., *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, *Cahiers de Droit Fiscal International, Vol. 95 a*, Amsterdam, 2010, p. 439

[26] See Circular Letter No. 207 of Nov. 16, 2000, Para. 1.1.1.

[27] Decision No. 170 of the Provincial Tax Court of Bergamo, Nov. 20, 2009. For a commentary on this decision, see N. A. Ballancin, *Osservazioni a margine di una sentenza di merito in tema di incompatibilità della disciplina CFC con le Convenzioni internazionali contro le doppie imposizioni. Ulteriori riflessioni sul rapporto tra la novellata normativa CFC ed il diritto comunitario (nota a Commissione tributaria provinciale di Bergamo, sez. I, n. 170/2009)*, in *Riv. dir. trib.*, 2010, II, p. 161 and P. De' Capitani Di Vimercate, *La CTP di Bergamo dichiara l'incompatibilità del regime CFC con le disposizioni delle convenzioni per evitare le doppie imposizioni*, in *Strumenti finanziari e fiscalità*, 1/2010, p. 85.

[28] In particular, Italy-Cyprus tax treaty, Art. 5(6) and Art. 7(1).

[29] See, in this respect, Para. 26 of OECD Commentary to OECD Model Convention, Art. 1, according to which "States that adopt controlled foreign companies provisions or the anti-abuse rules referred to above in their domestic tax laws seek to maintain the equity and neutrality of these laws in an international environment characterised by very different tax burdens, but such measures should be used only for this purpose. As a general rule, these measures should not be applied where the relevant income has been subjected to taxation that is comparable to that in the Country of residence of the taxpayer."

[30] Conseil d'Etat, Decision No. 232276 of June 28, 2002.

[31] E.g., Finland (Korkeis Hallinto – Oikheus, Decision No. 596 of March 20, 2002), Sweden (Supreme Administrative Tribunal, Decision No. 2655-05 of April 3, 2008), Japan (Supreme Court, Decision No. 2008 of Oct. 29, 2009) and the United Kingdom (*Bricom Holdings v. IRC*, [1997] STC 1179, [1997] 70 TC 272).

[32] Exceptions concern Luxembourg ("1929" Holding Companies) and until recently Cyprus and Malta. The Ministerial Decree of July 27, 2010, published in Official Journal No. 180 of Aug. 4, 2010, which entered into force on Aug. 5, 2010, excluded from the "black list" relevant for the application of the CFC legislation contained in the Ministerial Decree of Nov. 21 2001, Cyprus, Malta and Korea (ROK). Previously, all Cypriot entities were included in the "black list," while Maltese and Korean entities were included only with regard to certain privileged tax regimes. As a matter of fact, the Ministerial Decree contains no provision governing its effective date; it is, however, generally believed (see Circular No. 22 of Nov. 29, 2010, of the Association of the Chartered Accountants of Milan) that the "amended" black list will be applicable with regard to the whole of the 2010 Fiscal Year.

[33] It is interesting to note that while, in most EU Member States, the *Cadbury Schweppes* decision has raised doubts as to the compatibility of local CFC legislation with EC law, in Italy the decision is somehow at the root of the extension of the CFC regime to EU subsidiaries. See, e.g., G.T. Meussen, *Cadbury Schweppes: The ECJ Significantly Limits the Application of CFC Rules in the Member States*, in *European Taxation* n. 1/2007, p. 13; J. Schoenfeld, *The Cadbury Schweppes Case: Are the Days of the United Kingdom's CFC Legislation Numbered?*, in *European Taxation* n. 10/2004, p. 441; T. Roenfeldt, Ed. E. Werlauff, *CFC Rules Go up in Smoke - with Retroactive Effect*, in *Intertax* n. 1/2007, p. 45; A. Rainer, E O. Thoemmes, Are German CFC Rules Compatible with EU Freedoms?, in *Intertax* n. 11/2005, p. 554.

[34] ITC, Arts. 130 to 142.

Host Country The Netherlands

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I. Absence of "typical" CFC rules in the Netherlands

The term "controlled foreign corporation (CFC) rules" generally applies to the apportionment of passive income of a controlled foreign company to its parent company and the taxation of the income in the country of residence of the parent company, without reference to the distribution of a dividend by the controlled company or the realisation of a capital gain upon a disposal of its shares.

The Netherlands has no such "typical" CFC rules, perhaps because the Dutch domestic market is relatively small and benefits from an open economy that encourages investment abroad. There is, however, a provision in the Dutch participation exemption rules that can be considered to have CFC rule characteristics. This provision is discussed in II. below.

II. Rules with the characteristics of CFC rules

A Dutch corporate taxpayer (hereinafter "DutchCo") is subject to corporate income tax on its worldwide income. Dutch taxable income is calculated in accordance with the principles of "sound business practice," as developed in Dutch case law. In many cases, sound business practice allows for the deferral of tax on income, i.e., the taxation of unrealised profits can be deferred until the moment such profits are realised. One circumstance in which this general deferral rule applies is where a Dutch corporate taxpayer owns shares in a foreign entity, such as Sub1, that qualifies as a company for Dutch tax purposes. The Dutch participation exemption rules contain one exception to the general deferral rule: a participating interest of 25 percent or more in a company whose low-taxed, non-business related investments comprise 90 percent or more of its direct and indirect assets, which does not qualify for the participation exemption, is subject to annual revaluation to market value.

The Dutch entity qualification and participation exemption rules are described, respectively, in II.A. and B., below. The annual revaluation rule for non-qualifying participating interests, which may be considered to have the characteristics of CFC rules, is summarised in II.C. below. Finally, the possible impact of this rule on the structure envisaged in the Forum fact pattern is discussed in II.D. below.

A. Qualification of foreign entities

The Netherlands makes its own analysis of the qualification of a foreign entity for Dutch tax purposes, based on criteria developed in case law and policy issued by the Ministry of Finance.[1] The tax treatment of the foreign entity in its country of residence is not relevant. The Dutch tax authorities will consider the corporate law of the foreign country and the incorporation documents and/or by-laws of the foreign entity in deciding whether the entity is similar to a corporation or a partnership. Corporations are non-transparent for Dutch tax purposes, while partnerships are generally deemed to be transparent.[2]

In qualifying a foreign entity, the most important questions to be answered are:

- Can the entity own the legal title to the assets employed in the course of its business;
- To what extent can the participants in the entity be held liable for the entity's debts;
- Does the entity have a capital divided into shares; and
- Are the participations/shares in the entity freely transferable?

In principle, a foreign entity is to be considered a company if, under the relevant foreign corporate law:

- It can own assets and be a legal counterparty in transactions;
- All its participants/shareholders have limited liability; and
- Its equity is divided into shares or participations that confer on their holders proportionate entitlement to the entity's profits (and distributions on liquidation) and proportionate decision-making powers.

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B. Dutch participation exemption rules

Under the Dutch participation exemption rules, which are contained in section 13 of the 1969 Dutch Corporate Income Tax Act (CITA), dividend income received from, and capital gains realied on the disposal of, qualifying participating interests in companies are exempt from corporate income tax. Capital losses on qualifying participating interests, not being liquidation losses, are non-deductible.

A participating interest qualifies for the participation exemption if it represents 5 percent or more of the nominal paid-up share capital of a company with a capital divided into shares, provided it is not held as a passive investment (the "intention test"[3]). Although the intention test is subjective, participating interests should generally pass this test if there is a link between the businesses of the parent company (or the parent company's group) and the subsidiary, and/or the parent company is actually involved in the day-to-day operations of the subsidiary through representation on its board of directors.

A participating interest in a company of 5 percent or more that is held as a passive investment may still qualify for the participation exemption if it passes either the "taxation test" or the "asset test," both of which are objective tests. The taxation test prescribes that the company in which the participating interest is held must be subject to a profit tax that, according to Dutch standards, results in a realistic levy. A standard tax rate of 10 percent or more and the absence of substantial differences between the foreign tax base and the Dutch tax base generally would result in a realistic levy.

The asset test stipulates that any low-taxed, non-business related investments of the company in which the participating interest is held should generally comprise less than 50 percent of its total assets. For purposes of this test, the assets of lower-tier subsidiaries (Sub2) need to be allocated to the first-tier subsidiary (Sub1). Generally, real estate assets are considered to be business related for purposes of the asset test. Non-business related investments are considered low-taxed if the income derived from such investments is not subject to a profit tax resulting in a levy that is considered realistic by Dutch standards.

C. Annual revaluation for non-qualifying participating interests: section 13a of the Corporate Income Tax Act

In principle, only realised income is recognised under the participation exemption rules. This applies with respect both to participating interests that qualify for the participation exemption and to interests that do not qualify but are less than 25 percent interests. By way of exception to this general deferral of unrealised income rule, under section 13a of the CITA, non-qualifying participating interests (whether Dutch or foreign) of 25 percent or more in companies whose low-taxed, non-business related investments comprise 90 percent or more of their direct and indirect assets are to be valued at market value on an annual basis. Unrealised capital gains resulting from this revaluation are taxable and, conversely, unrealised valuation losses are tax-deductible.

The revaluation results in an adjustment of the book value of the participating interest for tax purposes, which forms the basis for calculating taxable income in the event of the disposal of the interest. An actual distribution of income will be considered part of the taxable profit of the Dutch corporate shareholder, but will also have a negative impact on the market value of the participating interest at year-end. Thus, under this system, income from the participating interest should be subject to Dutch tax only once.

Pursuant to section 13a of the CITA in conjunction with section 23c of the CITA, income from a non-qualifying participating interest, including valuation gains, must in principle be grossed up before being included in the taxable profit of the taxpayer. This gross-up rule does not apply to participating interests in tax-exempt companies. The difference between the grossed-up amount and the actual net income is deemed to be underlying tax, which qualifies for a credit against the Dutch tax liability. In the case of EU participating interests, the actual foreign tax on a profit distribution may be taken into account in the gross-up formula and when applying the credit. For non-EU participating interests a deemed gross-up factor of 100/95 and a maximum credit for 5 percent of the grossed-up gain apply.

1. Background to section 13a of the Corporate Income Tax Act

The obligatory annual revaluation of a non-qualifying participating interest of 25 percent or more is provided for in section 13a of the CITA. That section was introduced on January 1, 2007 and can be regarded as a combination and continuation of previous revaluation rules that were introduced in 1991: section 28 of the CITA contained a provision on the basis of which a shareholding of 25 percent or more in a qualifying Dutch fiscal investment institution was to be valued at market value;[4] and section 28b prescribed a similar valuation for participating interests of 25 percent or more in foreign investment institutions whose passive investments comprised 90 percent or more of their assets.

The purpose of the former revaluation rules and current section 13a of the CITA is to discourage investors from storing profits from passive investments in low-taxed investment companies. The object and purpose of these rules are comparable to the object and purpose of CFC rules in general.

2. Bilateral aspects

According to the Dutch Deputy Minister of Finance, the application of the revaluation rule contained in section 13a of the CITA is not in violation of the tax treaties concluded by the Netherlands.

According to the Dutch Supreme Court, the Netherlands is, in principle, allowed to tax notional income and unrealised capital gains under its tax treaties. An exception applies with respect to a fiction in Dutch tax law that erodes the taxation rights of the other treaty State.[5] In most of the tax treaties to which the Netherlands is a party, the Netherlands is awarded the right to tax a capital gain on a disposal by a Dutch resident of shares in a company located in the other State.[6] Based on the above, this right to impose tax covers both realised and unrealised gains.

3. EU aspects

The revaluation rule in section 13a of the CITA applies to non-qualifying resident and nonresident participating interests. This means that, formally, no distinction is made between Dutch and foreign participating interests. It is nevertheless argued in the literature that section 13a of the CITA *does* result in a material distinction, as in practice it will be primarily foreign participating interests that fall within the scope of the provision. If such a distinction between Dutch and foreign participating interests obstructs Dutch residents that wish to incorporate or invest in foreign companies in the EU/European Economic Area (EEA), it may represent a violation of EC law especially where it concerns foreign companies with real economic activity.[7]

The Dutch Ministry of Finance takes the position that the revaluation rule in section 13a of the CITA is "EU-proof."

D. Case at hand

DutchCo is engaged in a trade or business and wholly owns Sub1, which in turn wholly owns Sub2, a company also engaged in a trade or business. If there is a clear link between the trades or businesses of DutchCo and Sub2 and DutchCo is actually involved in the operations of Sub2, the participation exemption should apply with respect to DutchCo's participating interest in Sub1 on the basis that DutchCo passes the intention test. As a fallback position, DutchCo's participation should pass the asset test assuming that Sub1 is a pure intermediate holding company and holds no other (passive) investments. Under the participation exemption, all income and gains realised by DutchCo in connection with its participating interest in Sub1 will be tax-exempt.

In the unlikely event that the participating interest held by DutchCo in Sub1 fails both the intention test and the asset test and Sub1 is to be considered a low-taxed entity according to Dutch standards, meaning that it also fails the taxation test, the participation exemption will not apply and, consequently, all income and gains realised by DutchCo in connection with its participating interest in Sub1 will be taxable. In such circumstances, if more than 90 percent of Sub1's assets (including the assets of Sub2) consist of low-taxed, non-business related investments, DutchCo will be obliged to revalue its participating interest in Sub1 to market value at year-end, which will result in a step-up in the taxable basis of the participating interest. A revaluation gain, like all income, will be grossed up before being included in the taxable profit of DutchCo and it will be granted a credit for 5 percent of the grossed-up gain.

If Sub1 or Sub2 is resident in the EU/EEA, DutchCo could claim that the revaluation rule in section 13a of the CITA is in violation of EC law. It is uncertain whether such a claim would hold up in Court.

NOTES

[1] Policy published by the Ministry of Finance is binding on the tax authorities but not on the taxpayer.

[2] In principle, a limited partnership is non-transparent for Dutch tax purposes, unless the transferability of participations in the partnership is subject to unanimous consent.

[3] According to Dutch case law, a participating interest is held as a passive investment if it is held with the intention of acquiring the returns that could be expected from normal asset management.

[4] Dutch fiscal investment institutions with passive investments may benefit from a 0 percent tax rate, subject to strict conditions.

[5] Dutch Supreme Court, Sept. 5, 2003 (No. 37.651); Dutch Supreme Court, Nov. 26, 2010 (No. 09/03219).

[6] Exceptions may apply where the foreign company owns real estate in the other State.

[7] In *Cadbury Schweppes* (C-196/04), the ECJ made it clear that CFC rules may be allowed to combat situations of abuse such situations should be considered to exist only in the case of purely artificial structures, without real economic activities in the foreign country.

Host Country
SPAIN

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I. The CFC regime of Spain

A. History and objectives of the Spanish CFC regime

Controlled foreign corporation (CFC) legislation has been in force in Spain since 1995[1] and is currently applicable to both Spanish individual and Spanish corporate shareholders.[2] The regime is entitled "International Fiscal Transparency" ("*Transparencia Fiscal Internacional*") and was enacted with the aim of preventing the accumulation of passive income in low tax jurisdictions by Spanish residents intending to defer or avoid payment of Spanish income taxes, and the carving out of Spanish taxable income by way of charges for services from companies subject to favourable tax regimes.

Although the provisions have been amended on a few occasions over the last 15 years, the amendments have been of only minor significance, despite the substantial changes undergone by the Spanish income tax system and the international environment generally in the same period.

Under the Spanish CFC rules, certain kinds of income (hereinafter, "tainted income") derived by non-Spanish entities controlled by a group of Spanish related shareholders will be attributed to the controlling Spanish shareholders as it is derived, and taxed in their hands, even if the income is not distributed to them, if certain conditions are fulfilled.

B. Definition of CFC and conditions for the attribution of tainted income

The CFC regime applies to "foreign entities." Neither the Spanish CITL nor the Spanish IITL contains a definition of foreign entity, although the CITL[3] includes under the term "entity" all kinds of commercial corporations, investment and pension funds, and most public institutions. On the other hand, the Law[4] provides for a look-through regime that applies to associations and entities that either do not have a legal personality independent of that of their partners or do not have a commercial purpose (*sociedades civiles*). Income derived by such look-through entities is always attributed to their partners, which, in practice, achieves a result not so different from that achieved by the CFC regime. There are no provisions designed to characterise foreign associations as either entities or look-through vehicles, but there is a significant amount of case law leading to the conclusion that most partnerships and limited partnerships will be characterised as look-through vehicles. As the CFC provisions only apply to entities, a Spanish taxpayer that is a partner in a foreign partnership is likely to be taxed on its share of the partnership income, irrespective of whether the CFC regime applies. If Sub 2 qualifies as a foreign-look through partnership, its income will be attributed to Sub 1 for purposes of determining whether the CFC regime is applicable to Sub 1. The CFC regime is not applicable to permanent establishments (PEs), whose income or losses are directly attributed to their head offices. Finally, trusts are likely to be disregarded as there is no trust law in Spain.

The application of the Spanish CFC rules to a foreign entity directly or indirectly owned by HCo (hereinafter "SpanishCo") depends on all three of the following factors being present:

- **Control:** 50 percent or more of the foreign entity's capital, equity, profits or voting rights must be controlled, on the closing date of its accounting year, by SpanishCo, solely or jointly with related individuals or entities. Article 16 of the CITL provides a broad definition of related party which (in relation to a company) includes not only other group companies, but also direct or indirect shareholders owning more than 5 percent of its capital (1 percent if the company is quoted), board members, companies under common control or persons related by family links to shareholders or directors of the company or of group companies. In the case of joint control by a group, whether the control requirement is met is determined by aggregating the participation directly held by each of the individuals or resident entities forming part of the controlling group, plus, where non-resident entities belong to the controlling group, the indirect participation percentage held through those non-resident entities by the resident entities or resident individuals belonging to the group (which will be obtained by multiplying the percentage held by the Spanish residents in the first tier foreign entities by the percentage owned by such entities in the CFC, performing a similar calculation as many times as is required by the number of lower tier subsidiaries in the CFC ownership chain).

- **Tainted income:** the CFC regime only applies with respect to certain types of income, i.e., tainted income. As will be seen in I.C., below, the law distinguishes four different types of tainted income, each of which is to be computed separately to determine whether it should be attributed to the Spanish shareholders.
- **Low taxation of the foreign entity:** the effective tax paid abroad on any of the four kinds of tainted income must be less than 75 percent of the tax that would have been payable on the income under the Spanish CITL. The position of the Spanish Tax Authorities is that the comparison to be made is with the rate of tax that would have been paid by the CFC if it were a Spanish resident and not with the effective rate that would have been paid by SpanishCo had it derived the income directly, which cancels the effect of any tax benefit to which SpanishCo may be entitled. As the general Spanish CIT rate is 30 percent, in practice, tainted income that has been subject to an effective tax rate of less than 22.5 percent is potentially subject to the CFC regime.

Initially, the CFC regime was not applicable to entities resident in a European Union (EU) Member State. From 2008, provided all the conditions for applying it are satisfied, the CFC regime is also applicable to an EU subsidiary, if the Spanish taxpayer is unable to prove that the incorporation of the subsidiary was based on valid economic reasons and that the subsidiary carries on business activities.

Tainted income derived by a CFC is also attributed to individual shareholders belonging to the controlling group, unless the CFC is resident in an EU Member State that is not considered a tax haven jurisdiction for Spanish tax purposes.[5]

Even if the three factors listed above are present, income of the CFC does not have to be reported in either of the following cases:

- When the income is derived by "qualified subsidiaries," that is, where the CFC holds, directly or indirectly, more than 5 percent of the subsidiaries, provided the CFC manages its participation through an adequate organisation of material and human resources and at least 85 percent of the income of the subsidiaries derives from business activities; or
- When the tainted income derived is less than 15 percent of the CFC's total net income or less than 4 percent of its total annual turnover.

C. Types of income subject to current taxation and exceptions

The law distinguishes the following categories of "tainted income:"

1. Income from immovable property or rights thereon, unless the property is used in a business activity or leased to a non-resident entity that forms part of the same group as the CFC under commercial law.[6]
2. Dividends and other profit distributions derived from participation in the equity of other companies, as well as interest income. The following types of income, however, are not considered dividends or interest:
   - Income from financial assets held to meet legal requirements imposed by the special type of business activity;
   - Income from financial assets that represent debt claims related to a contractual relationship entered into in the course of business activities;
   - Income from financial assets held in the course of a business activity such as brokerage on an official stock market;
   - Income from financial assets held by financial and insurance entities in the course of their business activities; and
   - Interest received from a non-resident entity that forms part of the same group under commercial law, provided the paying entity derives at least 85 percent of its income from active business activities.
3. Capital gains from the disposal of immovable property or rights thereon or from the disposal of financial assets.
4. Income from credit, financial and insurance facilities or services (other than export-linked services) supplied directly or indirectly to resident individual or corporate related parties if these related parties are entitled to deduct the amount paid from their Spanish taxable income (i.e., financial interest, insurance premiums and service fees).

Dividends and gains derived from equity participations (categories 2. and 3.) will not be tainted if the company in which the participation is held is a "qualified subsidiary," i.e. an entity:

- In which the CFC holds, directly or indirectly, an interest of at least 5 percent;
- In whose management the CFC is directly involved; and
- At least 85 percent of the total income of which arises from "active" business activities.

The law provides three safe harbour rules applicable to:

- **Income in categories 1, 2 and 3:** tainted income belonging to these three categories will be exempted from attribution if the aggregate amount of such income is less than 15 percent of the total net income of the CFC or less than 4 percent of its total turnover. If the CFC forms part of a group of companies as defined for commercial purposes, all these amounts total tainted income, net income and turnover may reflect the consolidated figures of all nonresident companies belonging to the group.

- **Income in category 4 (Spanish services income):** such tainted income will be exempted from attribution if more than 50 percent of the income from credit, financial and insurance facilities or services of the CFC is connected with transactions with non-related parties.
- **The sum of all tainted income:** no attribution of tainted income will be required if the CFC realises a loss in the accounting period, nor can the total amount of tainted income to be attributed in any taxable period exceed the CFC's total net income.

Only positive tainted income obtained by the CFC will be attributed to SpanishCo. In all cases, income must be attributed respecting the percentage participation of SpanishCo in the CFC. This percentage participation must be determined in relation to SpanishCo's participation in the benefits of the CFC. If this criterion cannot be used, SpanishCo's participation in the capital, own funds or voting rights of CFC will be taken into account. For purposes of calculating the income to be attributed to SpanishCo, each category of income must be computed separately.

Finally, the fact that SpanishCo had a "tax avoidance purpose" in setting up Sub2 will only be significant for purposes of the application of the CFC regime in the event that Sub2 is an entity tax resident in an EU Member State. In this case, the CFC regime will not apply if the Spanish taxpayer can prove that the incorporation of the company was based on valid economic reasons and that the company carries on business activities.

If Sub2 is resident in a tax haven, a stricter regime applies as, in these circumstances, there is a rebuttable presumption that:

- The corporate tax actually paid on any kind of income by the CFC is less than 22.5 percent;
- All income accruing to the CFC is "tainted income;" and
- The annual minimum income derived by the CFC is equal to 15 percent of the acquisition cost of the underlying participating interest.

These presumptions, however, do not apply if the CFC consolidates its accounts with those of a Spanish resident entity.

D. Other circumstances in which there is current taxation of income of a CFC

Spanish law does not provide for any anti-boycott, anti-bribery or similar regime.

E. Rules used to determine Income

In accordance with the Spanish legislation, the rules contained in the CITL are to be used to determine taxable income from Sub2, following the criteria and principles established in the CITL and other provisions relating to Spanish corporate taxation. The taxable income of Spanish companies is determined based on the Spanish Accounting Principles which in general follow International Financial Reporting Standards (IFRS), subject to some exceptions.

A resident company (here SpanishCo) can choose to include the attributed income in its taxable base either:

- In the same tax year as that in which the CFC closed its relevant accounting period (for this purpose, the accounting period is not allowed to exceed 12 months); or
- In the tax year in which the annual accounts of the CFC are approved, provided that such approval is given within six months after the close of the accounting period.

The Spanish tax authorities must be explicitly informed of the resident company's choice in the first tax return in which the reporting of income from CFCs is required. The chosen method must be used for a minimum period of three years.

Any results in foreign currency must be converted into Spanish currency at the official exchange rate on the date of the CFC's year-end accounting date.

F. Rules for determining SpanishCo's pro-rata share of attributable tainted income

The CFC income must be attributed based on the percentage participation of SpanishCo in Sub2. The percentage participation must be determined in relation to the participation held by SpanishCo in the CFC's profits. If it is not possible to determine the right to participate in profits (which may happen in the case of foundations and trusts), the attribution will be made pro rata to SpanishCo's participation in the capital, own funds or voting rights of the CFC.

Should SpanishCo hold 100 percent of the common stock of Sub1, which entitles it to receive 70 percent of the company's profits, while the remaining 30 percent is received by unrelated holders of preferred stock, it will be necessary to determine what part of the annual profits would be received by SpanishCo if actually distributed; if it is not possible to make this calculation, 70 percent of the CFC's tainted income would be attributed to SpanishCo.

G. Mode of taxation to SpanishCo

On a general basis, SpanishCo is taxed on Sub2's tainted income as if Sub2 had made a distribution directly to SpanishCo.

SpanishCo will be entitled to credit any foreign corporate or withholding tax corresponding to the attributed taxable income except for taxes paid in listed tax havens (see I.H., below).

The Spanish CFC rules would still apply at the level of SpanishCo should Third Country have its own CFC regime, the income of Sub2 being currently taxed to

Sub1 under that regime. However, this fact would have an impact on the tax credits available to SpanishCo (as explained in I.H., below).

H. Adjustments to preclude double taxation on actual distributions or on sale of stock

To avoid double taxation, dividends or other profit distributions made to SpanishCo by the CFC that have previously been attributed to SpanishCo are not included in SpanishCo's taxable income. This treatment also applies to any advance payment of dividends.

A credit is granted for the tax effectively paid abroad on dividends or other profit distributions, either under the domestic law of the foreign country in which the CFC is resident or under an applicable tax treaty. This credit is granted only when the CFC has actually made a profit distribution to SpanishCo and the tax has been withheld abroad. This implies that SpanishCo can credit foreign withholding taxes relating to income that has been attributed to it in previous tax periods.

A credit is also granted for the underlying tax effectively paid abroad by Sub2 on the "tainted income" attributed to SpanishCo. The tax credit for the underlying tax on the attributed income out of which the profit distributions are made includes the tax actually paid by Sub2's (any tier) subsidiaries, subject to the condition that the CFC has had a minimum holding of 5 percent in such subsidiaries.

The tax credits are only available when the taxes paid abroad have been previously included in taxable income. No credit is available with respect to foreign taxes paid in any of the countries listed as tax havens.

A capital gain or loss realised by SpanishCo when disposing of its interest in a CFC is determined as the difference between the sale price and the cost of the participation. For this purpose, the cost of the participation is equal to the historic cost price paid for the participating interest plus any amount attributed to SpanishCo under the CFC regime minus dividends actually distributed out of attributed income.

I. Impact of tax treaties to which Spain is a party or of CFC being tax resident in an EU Member State

Under the Spanish Constitution, Spain's tax treaties prevail over its domestic tax rules.

Spanish law does not make any explicit reference to the possibility of applying the CFC rules when the CFC is resident in a country that has signed a tax treaty with Spain. Nevertheless, under Article 107.13 of the CITL, the Spanish CFC rules will be applied taking into account the terms of an applicable Spanish tax treaty.

Only a few of Spain's most recent tax treaties explicitly allow Spain to apply its domestic CFC rules. Most commentators consider that, in the absence of explicit authorisation, the CFC regime will not be applicable to CFCs that are residents of the other Contracting State under an applicable Spanish tax treaty. However, following OECD doctrine, the Spanish Tax Authorities[7] have ruled that the CFC rules do not contravene the terms of Spain's tax treaties, on the grounds that only resident taxpayers are affected by these provisions, and, in consequence, the CFC rules cannot be impacted by Spain's tax treaties, which may not affect the application of the tax law in a domestic context.

Paragraph 1.13 of the Commentary on Article 7(1) of the 2008 OECD Model Tax Convention states the following:

> (. . .) The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these resident's participation in that enterprise (. . .).

In principle, the Spanish CFC rules are also applicable in situations in which the CFC is a tax resident of another EU Member State. In this context, the ECJ decision in *Cadbury Schweppes*, from which the following is an extract, needs to be taken into account:

> (. . .) Articles 43 EC and 48 EC must be interpreted as precluding the inclusion in the tax base of a resident company established in a Member State of profits made by a controlled foreign company in another Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Accordingly, such a tax measure must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that controlled company is actually established in the host Member State and carries on genuine economic activities there (. . .).

In this respect, a distinction must be made between:

- **The CFC rules in force as from 2004:** these were not applicable when the CFC was tax resident in another EU Member State, unless it was resident in a tax haven jurisdiction. The European Commission considered these Spanish CFC rules to be contrary to the EC Treaty and sent a formal request to Spain in 2008 (taking into account *Cadbury Schweppes*), which stated that:

> (. . .) The Commission considers that the Spanish legislation is contrary to Community law: It goes beyond what is necessary, since it is applicable not only to wholly artificial arrangements but also to parent companies controlling subsidiaries carrying out genuine economic activities in those Member States or territories (. . .).

- **The CFC rules in force as from 2004:** these were not applicable when the CFC was tax resident in another EU Member State, unless it was resident in a tax haven jurisdiction. The European Commission considered these Spanish CFC rules to be contrary to the EC Treaty and sent a formal request to Spain in 2008 (taking into account *Cadbury Schweppes*), which stated that:

(. . .) The Commission considers that the Spanish legislation is contrary to Community law: It goes beyond what is necessary, since it is applicable not only to wholly artificial arrangements but also to parent companies controlling subsidiaries carrying out genuine economic activities in those Member States or territories (. . .).

- **The CFC rules in force as from 2008:** as a result of the European Commission's request, the Spanish CFC rules are no longer applicable to any entity resident in another EU Member State (irrespective of whether the EU Member State is considered a tax haven for Spanish tax purposes) to the extent the Spanish taxpayer can prove that the incorporation of the entity was based on economic reasons and that the entity carries on business activities.

Given the above, whether the current CFC rules are compatible with the EC Treaty, taking into *Cadbury Schweppes*, is not a clear cut issue.

II. Other regimes in addition to the CFC regime

A. Spanish look-through entities regime

As noted in I.B., above, the Spanish look-through entities regime regulates the treatment of Spanish entities with no separate legal identity, such as civil law partnerships with or without legal personality, and estates, among others. Under this tax regime, income is taxed at the level of the investors. In this respect, a foreign entity is considered to be a look-through entity for Spanish tax purposes, if it has a "similar or analogous nature to the Spanish ones" (taking into account, among other things, the lack of a separate legal identity).

B. Collective investment undertakings incorporated in countries classified as tax havens for Spanish tax purposes

The following special rules are applicable to a collective investment undertaking incorporated in a country classified as a tax haven for Spanish tax purposes:

- The annual taxable base of an entity or individual resident for tax purposes in Spain with a participation in the collective investment undertaking will include the positive difference between the liquidation value of the participation on the last day of the fiscal year and its acquisition value, which amount will increase the tax basis of the investment.
- The amount of the difference referred to in the first bullet is presumed to be at least 15 percent of the acquisition value, unless it is proven to be otherwise.
- Income distributed by the collective investment undertaking will not be included in the taxable base of the taxpayer, but will reduce the acquisition value of the participation. No credit to avoid double taxation is available with respect to this income.

C. Impact on these rules of tax treaties to which Spain is a party

Such impact would have to be analysed on a case-by-case basis. The Spain-US tax treaty, for example, is deemed to apply to any "other body of persons," which term is understood to include, among other bodies, partnerships, which as a general rule, are considered look-through entities for Spanish tax purposes.

NOTES

[1] Law 42/94, Dec. 30, 1994.

[2] Currently governed by Art. 91 of Law 35/06, Nov. 28 2006, approving the Spanish Individual Income Tax (IITL, this tax being abbreviated "IIT") and Art. 107 of Legislative Royal Decree 4/04, March 5, 2004, approving the consolidated version of the Spanish Corporate Income Tax (CITL, this tax being abbreviated "CIT").

[3] CITL, Art. 7

[4] CITL, Art. 6, and IITL, Arts. 8.3 and 86 to 90.

[5] Royal Decree 1,080/91, July 5, 1991 contains a list of tax haven jurisdictions, including EU jurisdictions such as Gibraltar, the Channel Islands, the Isle of Man and Cyprus. A listed jurisdiction will not be considered a tax haven if it has signed a tax treaty or a qualifying exchange of information agreement with Spain, as have Luxembourg (holding companies) and Malta.

[6] According to Commercial Code, Art. 42, a parent company and a subsidiary will form a group for accounting purposes where:

- The parent company owns the majority of the voting rights in the subsidiary;
- The parent company is entitled to appoint or dismiss the majority of the directors of a subsidiary;
- The parent company can control, by virtue of agreements with other participators, the majority of the voting rights in the subsidiary; or
- The majority of the directors of the subsidiary at the time when the consolidated accounts are reported and during the preceding two years were appointed by the parent company using its own voting power.

[7] Ruling issued on Nov. 10, 1995.

Host Country SWITZERLAND

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I. Overview of CFC rules and absence of CFC regime in Switzerland

Corporate profits can be taxed twice first when a corporation pays taxes on its profits and again when the corporation pays a dividend to its shareholders. Tax systems usually provide for deferral, in the sense that, for as long as no dividend is paid, no taxes are imposed at the level of a corporation's shareholders.

Under the US tax system, for example, the earnings of a foreign corporation in which US shareholders hold an interest generally are not taxed in the United States until the foreign corporation repatriates its earnings to those shareholders through the distribution of dividends. This is known as "deferral" (i.e., US taxation is deferred until repatriation). Subpart F of the Internal Revenue Code is an anti-deferral regime, which applies only with respect to controlled foreign corporations (CFCs), in the sense that it imposes tax at the level of the US shareholders, even where no dividends have been distributed by the CFC. For these purposes, a CFC is generally defined as any foreign corporation in which US persons own more than 50 percent of the corporation's stock (measured by either vote or value).

Apart from the United States, a number of countries (not including Switzerland) have CFC regimes, including France, Germany (*Hinzurechnungsbesteuerung* pursuant to the *Aussensteuergesetz*), Italy and the United Kingdom. Of these, the Italian system is particularly harsh because its CFC regime is supported by rules that deny the deductibility of costs incurred with respect to entities resident in a number of listed countries, among them Switzerland. Thus, for example, if an Italian multinational receives IT services provided by a Swiss subsidiary, the Italian fiscal authorities may deny the deductibility of the service fees paid by the Italian company to the Swiss service provider.

While the United States and the OECD essentially endorse CFC regimes, the European Court of Justice (ECJ) fiercely opposes them. On September 12, 2006, the ECJ handed down its judgment in *Cadbury Schweppes* to the effect that the UK CFC rules constitute a restriction of the freedom of establishment and may only be applied in the case of "wholly artificial arrangements."[1] The ECJ held that, merely by choosing to set up subsidiaries in Ireland in order to benefit from Ireland's favourable tax regime, Cadbury Schweppes was not abusing the freedom of establishment and was therefore free to rely on it. The ECJ further held that the UK CFC rules constitute a restriction of the freedom of establishment because they represent an obstacle to a UK parent company setting up a subsidiary in another EU Member State with a more beneficial tax regime than that of the United Kingdom. The preceding opinion rendered by Advocate General Léger on May 2, 1996 contains the following statement: "In the light of those considerations and in the absence of community harmonisation it must be accepted that there is competition between the tax regimes of the various Member States. That competition, which is reflected in particular by great disparity between the Member States in the rates of taxation of company profits, may have a significant impact on the choice of location made by companies for their activities in the European Union."[2]

As Switzerland has comparatively low corporate income tax rates, it has not implemented a CFC regime. On the other hand, in a recent survey, it was indicated that Switzerland suffers from the discriminatory effects of the CFC regimes imposed by its major trading partners. The survey indicated that the US sub-part F system is felt to be something that US-controlled Swiss subsidiaries "can live with," but found that the discriminatory effects of the Italian CFC regime are seen as a serious obstacle to Italian direct investment in Switzerland.[3]

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II. Relevant court cases

Although there are no CFC rules in Switzerland, there are a number of court decisions finding the earnings of foreign corporations to be subject to corporate income tax in Switzerland.

In this context, the Swiss Federal Supreme Court has found there to be tax liability in Switzerland based on three different legal positions:

- In the *Panama* case, the Supreme Court upheld the right to tax in Switzerland based on a mandate;
- On December 4, 2003 the Supreme Court stated that income realised by a foreign parent company is taxable in Switzerland when its place of effective management is located in Switzerland; and
- In its judgment of January 30, 2006, the Supreme Court considered a foreign subsidiary that committed tax fraud to be tax-transparent and consolidated its income with that of its Swiss affiliate.

A. Mandate case

On May 9, 1995, the Federal Supreme Court rendered its judgment in the *Panama* case to the effect that the income earned by an offshore subsidiary located in Panama was taxable in Switzerland based on a mandate.[4] The Supreme Court took the fundamental requirements of the Swiss mandate law for granted. In the case at hand, the offshore corporation had purchased a block of shares in a third company. The Swiss parent company had rendered this purchase possible by granting a loan to the offshore company. Furthermore, the offshore subsidiary operated for the account, in the interest and with the financial support of the Swiss parent company. According to Article 400, paragraph 1 of the Swiss Code of Obligations, the profit (and loss) resulting from the agreement had to be reallocated to the client, i.e., to the Swiss parent company. This led the Supreme Court to the conclusion that the profit generated by the offshore subsidiary in Panama had to be reallocated to the Swiss holding company and, thus, that Swiss corporate income tax was due on the income earned by the foreign subsidiary.

B. Place of effective management case

The Swiss Supreme Court decided on December 4, 2003 that the income realised by a foreign parent company was subject to Swiss corporate income tax when the place of effective management of the company was located in Switzerland.[5] In a previous case, the Court defined the "place of the effective management" of an entity as being located where the entity has its economic and effective centre of existence.[6] Any management activities that go beyond ordinary administration work may indicate the performance of effective management.

In the case at hand, an employee of a Swiss subsidiary was responsible for certain management activities of the Swiss subsidiary's foreign parent corporation, i.e., for carrying out banking transactions, and monitoring the risks and consequences of a number of transactions. In order to be able to fulfill these duties, the employee held the sole power of signature for the foreign corporation. The Supreme Court came to the conclusion that the activities performed by the employee created a place of effective management in Switzerland. Thus, the income of the foreign parent corporation was taxable in Switzerland on a worldwide basis.

C. Tax fraud case

In its judgment of January 30, 2006, the Swiss Supreme Court decided that the presence of tax fraud meant that an offshore corporation in Panama had to be regarded as tax-transparent.[7] In the case of a transparent entity, the income of the entity concerned is added to the income of its affiliated company (the "look-through approach" or "*Durchgriff*").

Under Swiss tax law, tax fraud is present (in relation to the setting up of a foreign subsidiary) if all the following requirements are met:

- The establishment of the foreign subsidiary is an unusual or inadequate transaction that lacks economic substance;
- The subsidiary was established to achieve significant tax savings; and
- Significant tax savings could indeed be achieved with this unusual structure if the tax authorities were willing to accept it.

The Supreme Court assumed tax fraud to be present in the case at hand, in particular because no clear separation existed between the assets of the Swiss corporation and the foreign offshore entity. Thus, the court considered a look-through approach to be appropriate and consolidated the income of the foreign offshore entity with that of the Swiss affiliated corporation.

In contrast to the other possibilities for taxing foreign income in Switzerland referred to above, in the case of tax fraud, the corporation concerned is considered non-existent. However, the deemed non-existence of a subsidiary as a result of tax fraud is, in Switzerland, only applicable in especially unusual cases and, therefore, is only used *ultima ratio*.

It is also worth noting that the Swiss tax authorities may also levy corporate income tax on a foreign corporation when its staff working in Switzerland qualify as a Swiss permanent establishment (PE) of the foreign corporation,[8] which qualification requires there to be sufficient substance in Switzerland. However, in these circumstances, the foreign corporation will be subject to Swiss corporate income tax only on its income generated in Switzerland and not on a worldwide basis.

To summarise, over the last two decades, the Swiss Supreme Court has laid down rules of jurisdiction that are similar to CFC rules. The common effect of CFC rules and the Swiss jurisdictional rules is the taxation of income realised by foreign companies and the elimination of the deferral of corporate income tax on income earned by foreign subsidiaries despite the fact that no dividend has been distributed by such foreign subsidiaries.

III. Impact of Switzerland's tax treaties

A tax treaty is generally a bilateral treaty between two Contracting States designed to reduce or avoid double taxation of the same income. A tax treaty determines the taxing right of a Contracting State as well as the method for avoidance of the double taxation. The Contracting States agree by way of bilateral negotiations to give up or to limit their taxing rights despite the fact that the income concerned may be taxable under their domestic law. (The US considers Subpart F to be domestic law.) The question that needs to be asked, therefore, is whether such unilateral measures can be applied even there is an applicable tax treaty in force or whether they contradict the treaty.

The views of the OECD on this subject are interesting. The OECD recognises that CFC rules target only abusive behaviour on the part of a parent company and not income that has been subject in the country of residence of the subsidiary to taxation comparable to that in the country of residence of the taxpayer (i.e., the parent). The OECD Model Tax Convention states that, if CFC legislation is structured in a particular way, it should not be considered contrary to treaty provisions. Nevertheless, CFC rules may be considered to override a particular treaty article, i.e., the Business Profits Article. Under the Business Profits Article, the right to tax industrial and commercial income of an enterprise of a Contracting State is given exclusively to that State, i.e., the State in which the enterprise is established (unless, of course the enterprise has a PE in the other State). Thus, if the other State applies its CFC rules and taxes the industrial and commercial income, this means that it is disregarding the terms of the treaty under which it has previously given up its taxing rights.

Treaties concluded between Switzerland and other countries become directly applicable at the Swiss federal level as soon as they enter into force. No procedure is required for the multinational law to become part of the national law (the "*Monistisches System*"). With respect to the relationship between federal law and multinational treaties, the latest position of the Swiss authorities and Swiss doctrine is that multinational treaties take precedence over federal law.

One may, therefore, conclude that Switzerland will not apply any rules developed in its court cases that contradict an applicable treaty. Switzerland greatly appreciates arriving at a *quid pro quo* in the course of its negotiations prior to the signing of a tax treaty with another country. As, in particular, Switzerland has agreed to include exchange of information clauses in its treaties in accordance with the OECD Model Tax Convention, it might be entitled to expect in exchange a concession regarding the application of CFC rules. Switzerland should be treated at once no better and no worse than other EU Member States.

NOTES

[1] C-196/04, ECJ, Sept. 12, 1996 in the matter of *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd. vs. Commissioners of Inland Revenue*.

[2] C-196/04, Opinion of Advocate General Léger, Note 55.

[3] Altenburger/Avagliano, Archiv für Schweizerisches Abgaberecht, vol. 79, 545 *et seq*.

[4] BGE 9.5.1995; StE 1995 B 72.11 Nr. 3.

[5] BGE 2A.321/2003. Even though Federal Income Tax Act (FITA), art. 50 provides that the income of an entity may be taxed in Switzerland if its place of effective management is located in Switzerland, the Swiss Supreme Court did not comment on the impact of this article in an international context until the 2003 decision.

[6] BGE 54 I 308.

[7] BGE 2A.145/2005.

[8] FITA, art. 51 I lit. b.

Host Country
UNITED KINGDOM

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I. The CFC regime of the United Kingdom

The United Kingdom has had a CFC regime since 1984 under which HCo, as a UK resident company,[1] could be liable to current taxation on an amount calculated by reference to the profits of Sub2. The UK CFC regime is found in Part XVII, Chapter IV (sections 747 -756) of the Income and Corporation Taxes Act 1988 (ICTA) and regulations made thereunder.[2]

Without the UK CFC regime, HCo would be liable to UK corporation tax on its worldwide profits, i.e., income and chargeable gains, subject to any relevant relief afforded to it under the UK rules dealing with double tax relief. However it would not be liable to tax on the profits of subsidiaries resident outside the United Kingdom and, following the introduction of wide-ranging dividend exemption (discussed below) from July 1, 2009, would only be liable to tax on dividends from such subsidiaries in cases where dividend exemption was unavailable.

A. History and objectives of the regime

The UK CFC regime was introduced in 1984 primarily to cause income of a company, controlled from the United Kingdom but tax resident in a tax haven, to be taxable on the UK company that controlled it. The consultative documents[3] indicated that the regulation was intended to bring into charge the profits of "captive" insurance companies, "dividend trap" companies, "money box" companies and some patent holding companies. It was not intended to handicap non-UK resident companies carrying on genuine trading activities overseas (and overseas holding companies of such trading companies) and so exceptions are available for companies carrying on "exempt activities."[4] A company also used to be able to sidestep the legislation if it followed an acceptable distribution policy (ADP) and, in broad terms, distributed 90 percent of its profits to the United Kingdom, thus enabling the other 10 percent only to be liable to the tax, if any, to which the CFC itself was subject until any subsequent distribution to the United Kingdom.

Over time, the legislation became more complex to counteract arrangements whereby, for instance, "passive" income that would have been apportionable from a company that only carried on investment activities would instead be accumulated in a trading company and so benefit from exemption. Also, changes in 2000 to the way in which overseas dividends were taxed were intended to reduce the scope for mixing "high tax" profits (which when paid to the United Kingdom would carry tax credits that would largely or entirely eliminate the UK tax otherwise payable on the receipt of dividends) with "low tax" profits earned by CFCs.

From July 1, 2009, the role of the CFC legislation changed again as, from that date, most dividends from overseas (and UK resident) companies became exempt in the hands of UK resident companies[5] and so the CFC regime is intended to be a deterrent to the artificial diversion of profits from the United Kingdom.

B. The definition of a CFC

A CFC is a company which is resident outside the United Kingdom, is controlled by persons (not necessarily corporations) resident in the United Kingdom and is subject to a lower level of taxation in the territory in which it is resident.[6] In addition, a non-resident company can also be a CFC if two persons together control it and, broadly, a UK resident person has at least a 40 percent interest and another person (which may be either resident or non-resident) has at least a 40 percent interest and no greater than a 55 percent interest in that non-resident company.[7]

A company is defined[8] as including any body corporate but does not include a partnership.[9] A company's residence is determined for CFC purposes by reference to whether it is liable to tax in a territory by reference to domicile, residence or place of management.[10] Control has regard to whether one or more persons can, alone or together, secure that the affairs of the company are conducted in accordance with its or their wishes,[11] taking account of interests that can be attributable to it or them and the test of control has been widened to include persons that would be entitled to receive the majority of the income, sale proceeds or assets on a winding up.

The CFC regime could not apply if Sub1 were instead wholly owned by an individual who is resident in the United Kingdom: while the individual would have control of Sub1 and hence of Sub2, an apportionment cannot be made to an individual.[12] Apportionment under the CFC regime could, however, apply to Sub1 (although incorporated under the law of a Third Country) if it was UK resident for tax purposes by virtue of its central management and control being in the United Kingdom so that Sub2 was a directly owned CFC insofar as Sub1 was concerned.

If Sub1 were wholly owned by a trust or partnership then, in principle, the CFC regime could not apply. However, as an anti-avoidance measure, if assets were settled by a UK group into a trust, with members of the group being beneficiaries, and where the income produced was not otherwise taxable under the CFC rules the settler or beneficiary could still be treated as being entitled to the income of the trust.[13]

C. Types of income subject to current taxation and exceptions

Currently[14] if a company meets the requirements for being a CFC, all of its income,[15] computed as if it were resident in the United Kingdom for tax purposes,[16] is apportionable to companies that have the requisite interest in the company.[17] There is, currently, no exception for particular types of income earned by a CFC. However, UK legislation provides for certain companies that would otherwise be CFCs to be outside the regime and, hence, an amount calculated by reference to their income is not subject to current taxation in the United Kingdom. These exceptions are:

- Where the company is carrying on exempt activities;[18]
- Where the profits of the CFC do not exceed GBP 50,000 for the accounting period;[19]
- Where the profits of the CFC do not exceed GBP 50,000 for the accounting period;[19]
- Where the CFC meets the requirements of the Excluded Countries Regulations; and[20]
- Where the "motive test" is satisfied.[21]

Accordingly, apart from the exceptions summarised above, there is no "safe harbour" rule pursuant to which income is exempt from current inclusion.

In addition, a reduction in the amount of profits that can be apportionable to the United Kingdom can be made where a CFC has a business establishment in a European Economic Area (EEA) territory[22] by reference to the level of profits that could be said to be generated in that business establishment by reference to "qualifying work" performed in that establishment.[23]

D. Other circumstances in which there is current taxation as the income of a CFC

Currently, the UK CFC regime is a mechanical test and, hence, the motive for setting up Sub2 is irrelevant except insofar as the operation of the motive test is concerned. One of the requirements of the motive test is that "it was not the main purpose or one of the main purposes [of one or more transactions] to achieve [a] reduction [in UK tax"].[24] However, in the light of the decisions in *Cadbury Schweppes* and *Vodafone 2*, even if the establishment of Sub2 (if resident in an EEA territory) was for tax avoidance purposes, the UK CFC legislation should not apply if there is sufficient substance in the EEA territory.[25]

Whether Sub2 has participated in a boycott or made bribes will not affect the operation of the CFC regime. If Sub2 made "investments in HC property" this could prevent it relying on the exempt activities exemption for a trading company if, as a result, its main business became investment business[26] or, as a result of deriving income from outside Sub2's country of residence, it ceased to meet the requirements of the Excluded Countries Regulations.

E. Rules used to determine income

Currently[27] profits of a CFC are calculated as if the company were UK tax resident and certain assumptions are made as to whether it would have claimed capital allowances (a form of tax relief by reference to the proportion of the cost of capital equipment, rather than depreciation taken from the company's accounts) and other reliefs.[28]

F. Rules for determining pro-rata shares

Where a UK company, such as HCo, wholly owns, directly or indirectly, all the shares of a CFC, it's *pro rata* share is 100 percent. In principle, determining the *pro rata* shares could be more difficult when there are several UK companies to which the profits of a CFC can be apportioned and they hold different classes of shares that carry different economic rights, for example, ordinary and preference shares, although the persons who have interests in a CFC are not limited to shareholders.[29] Sections 752-752C of ICTA set out complex attribution provisions but, essentially, they do not apportion income to a UK resident company which has an indirect interest in a CFC if that interest is traced via another UK company which has an interest in the CFC in essence treating the "water's edge" UK resident company as if it alone has the interest. Where relevant interests in a CFC are not held solely by virtue of ordinary shares (so that the proportion of profits attributable to UK companies is not just *pro rata* and, in consequence, section 752(3) does not apply), the apportionment of profits must be on a just and reasonable basis.[30]

Where all of the ordinary shares in Sub1 were held by HCo and all of the preference shares in Sub1 were held by an unrelated party, the suggested apportionment[31] to HCo would be of the entire apportionable profits reduced by the dividend paid out on the preference shares.

G. Mode of taxation to HCo

Assuming that Sub2 satisfies the definition of a CFC and its income is not exempt from the CFC rules (for example, because it carries on exempt activities or the motive test is satisfied), HCo will be taxed by reference to the amount of chargeable profits attributed to it, with a reduction for the creditable taxes[32] attributable to HCo's share of chargeable profits, i.e., the income subject to the CFC rules is "hopscotched" to HCo.[33] The fact that HCo is taxed by reference to the profits that would have been chargeable to UK tax had Sub2 been resident and is given credit for the foreign tax that is attributable to any income brought into account in determining these profits means that tax imposed on other companies resident outside the UK by reference to profits treated as accruing to Sub2 is ignored.

So if Third Country has its own CFC regime and income of Sub2 is currently taxed to Sub1, no relief would be available to HCo under the UK CFC regime by reference to any tax imposed at the Sub1 level by reference to Sub2's profits.[34]

H. Adjustments to preclude double taxation on actual distributions or on the sale of stock

As a general rule, dividends and other distributions received by a UK resident company, whether from another resident company or a non-resident company, are exempt from UK tax.[35] Therefore, in most cases, there is no need to give credit against current tax for income already taken into account under the CFC regime when a dividend is subsequently received. However, there are two circumstances transitional[36] and elective[37] where relief from current taxation on dividends is needed where profits have previously been the subject of apportionment. In such circumstances, tax payable on apportioned profits is treated as an overseas tax so that, in computing UK corporation tax on the dividends received, the UK tax already paid is creditable.[38]

Where a UK company has been assessed on chargeable profits of a CFC and it disposes of the shares in the CFC (or another company through a holding in which the UK company was treated as having an interest in the CFC) it may claim a deduction in computing the gain.[39]

The relief provided for by paragraph 3 is reduced[40] if, as a result of the subsequent payment of a dividend, there is a fall in the value of the shares that are the subject of the disposal and/or credit for all or part of the tax (on the chargeable profits attributable to the claimant) has been treated as creditable overseas tax under paragraph 4 of Schedule 26.

As the UK CFC legislation enables an interest in a CFC to be traced through any number of persons who have direct or indirect interests in the CFC,[41] ordinarily[42] it would not matter if HCo's indirect interest in Sub2 was traced through a company that was not a CFC ("the non-CFC"), as the relief in paragraph 3 applies to sales of indirect holdings.[43]

I. Impact of treaties on UK CFC regime

The United Kingdom's position as regards bilateral tax treaties is that they have no impact on the UK CFC regime.[44] This was considered in *Bricom*[45] when profits of a Netherlands resident company, which consisted mainly of interest income in respect of which the Netherlands-UK tax treaty conferred taxing rights on the Netherlands company, were apportioned to a UK company. The Court of Appeal held that since the CFC legislation operated by taxing the UK company on an amount calculated by reference to the profits of the Netherlands company, this did not conflict with the treaty[46].

As regards the application of the *Cadbury Schweppes*[47] decision, the UK CFC legislation was amended in 2007 to enable a company which would otherwise be required to self-assess an amount under the CFC legislation to apply to HMRC to reduce[48] the amount of chargeable profits chargeable. In broad terms the applicant company claims how much of the profits of the overseas company can be said to represent the value of work done[49] by individuals employed[50] in EEA countries. There are doubts as to whether the approach adopted by the legislation fully gives effect to Cadbury Schweppes.[51]

II. Other regimes in addition to the CFC regime

There are other regimes in UK tax law under which income realised by an entity which is itself not liable to UK taxation might be currently taxed to direct or indirect owners of the entity that are UK residents.

The income of entities subject to special rules or reliefs under UK tax legislation will be governed by such rules.

The income of a trust is either currently taxed on the trust itself or in certain circumstances on the beneficiaries. If the income is taxed on the trust, then the beneficiaries may be permitted to take into account (or in appropriate circumstances reclaim) the tax paid by the trust when taxed income is, or is treated as, distributed to them.

The income of a partnership, or any other entity which is considered to be "transparent" for UK tax purposes,[52] is taxable on an arising basis on individuals or companies who have partnership or other membership interests in the partnership or other entity. It should be noted that a determination or election under local tax law (for example, the US "check the box election") to disregard the legal personality of an entity has no effect for UK tax purposes.

Apart from the offshore funds legislation, which applies to individual taxpayers as well as corporate taxpayers and is summarised in II.A., below) the United Kingdom has no other regime which treats the income of a non-resident entity as taxable on a UK corporate entity on an arising basis.

If certain requirements are met, anti-avoidance legislation[53] can treat profits of an overseas resident entity[54] as taxable on an individual who is ordinarily resident in the United Kingdom.

A. Offshore funds legislation

The offshore funds legislation can treat income of a reporting offshore fund as received by direct or indirect holders of interests in the fund, whether or not the income is distributed to them. The offshore funds legislation[55] is, in general, intended to prevent UK taxpayers from seeking to roll up income in no-tax or low tax entities resident for tax purposes outside the United Kingdom and claiming that, when the interests are sold or redeemed, profits are liable only to taxes on chargeable gains. Very broadly, the distinction is between a reporting fund, profits of which are attributed on an arising basis to UK residents (whether or not distributed to persons with the interest in the fund), where disposals should be liable to taxes on chargeable gains, and non-reporting funds, gains on the disposal of which are treated as income in the year of disposal.

B. Impact on such regimes of UK tax treaties

As income of a reporting fund may be distributed, then, to the extent the income is distributed, the normal double tax relief rules will ordinarily apply (and where income is not distributed to the holder but is taxable in the United Kingdom, ordinarily there will be no overseas taxable event requiring relief for overseas tax to be considered). For holders of interests in non-reporting funds, only where distributions are made to them will it be relevant to consider the UK double tax relief rules.

NOTES

[1] A company incorporated under the laws of England & Wales, Scotland or Northern Ireland is automatically treated as resident in the United Kingdom for tax purposes. A UK resident company ("migrant company") whose place of effective management is another territory which has entered into a tax treaty with the United Kingdom which contains a "tie-breaker clause" may, for most corporate tax purposes, cease to be UK resident. However, in determining whether the UK CFC regime could apportion income to the migrant company, the effect of the "tie-breaker clause" on its residence is ignored: see ICTA, s. 747(1B). Although a company that was treaty non-resident in the United Kingdom prior to April 1, 2002 is generally not affected by this rule, in certain circumstances, it can become subject to this rule, e.g., if it obtains control of a UK subsidiary.

[2] Non-binding guidance on how Her Majesty's Revenue & Customs (HMRC) would interpret the legislation is contained in the International Manual (paras. 201000-217050), abbreviated to INTM.

[3] In particular, "Taxation of International Business," 1982.

[4] ICTA, s. 748(1)(b) and Sch. 25, part 2.

[5] FA 2009 Sch. 14 and now Corporation Tax Act 2009 (CTA 2009), Part 9A.

[6] ICTA, s. 747(1).

Certain tax regimes of overseas territories enable a company to choose a tax rate such that it just fails to satisfy the lower level of taxation test. Where such a regime has been prescribed in regulations, a company resident in such a territory is deemed to be subject to a lower level of taxation: ICTA, s. 750A.

[7] ICTA, ss. 747(1A) and 755D (3)-(4). In broad terms this enables a jointly owned non-resident company where two persons have control to be a CFC insofar as the UK "controller" is concerned.

[8] Corporation Taxes Act 2010, s. 1121.

[9] This will mean that where there is doubt as to whether an overseas entity is a company, regard will need to be had to its attributes under local corporate law. See the discussion in II. and fn. 60, below.

[10] ICTA, s. 749. This section provides how to determine residence where a company could be resident in more than one territory: see ICTA, s. 749(2)-(7).

The rules for determining residence of a company may sometimes have the effect that a company is not resident in any overseas territory. In such circumstances it is conclusively presumed to be subject to a lower level of taxation: ICTA, s. 749(5). For the purposes of the exempt activities test see I.C. a company that is not resident (e.g., because the overseas tax regime imposes tax by reference to sources of income) may be treated as resident in the jurisdiction in which its business affairs are effectively managed: ICTA, Sch. 25, para. 5(2).

[11] ICTA, s.755D (1).

[12] ICTA, s. 747(1)(b) refers merely to "Persons resident in the UK" but sub-section (4) limits apportionment to UK resident companies.

[13] See ICTA, s. 747(6)(aa).

If a CFC has an interest in a partnership or a trust (although HMRC believed that the appropriate share of the partnership income or trust income should on general principles have been treated as received by the CFC) this is now deemed to be part of the CFC's income: ICTA, Sch. 25, paras. 6(5C)-(5E).

[14] HMRC are consulting on: (1) draft legislation intended to be contained in the Finance Act 2011 that would exempt companies with particular characteristics and proportions of income from the UK CFC regime; and (2) more wide ranging reforms intended to be contained in the Finance Act 2012: see "Corporate Tax Reform: delivering a more competitive system" (CTRD), Nov. 2010.

[15] Gains are excluded: ICTA, s. 747(6)(b).

[16] ICTA, s. 747(6) and Sch. 24.

[17] Broadly, either alone or together with connected persons a 25% + interest: ICTA, s. 747(5).

[18] Essentially either companies which constitute holding companies of companies which carry on trading activities, or companies which themselves carry on trading activities, where in either case the activities generally do not have too significant a connection with the United Kingdom.

[19] Or a proportionately lower amount if the accounting period of the CFC is less than 12 months.

ICTA, s. 748(1)(d). In the CTRD, for certain companies it is proposed that this *de minimis* threshold will increase to £200,000.

[20] ICTA, s. 748(1)(e). INTM 203020 indicates that the purpose of the Regulations is to exempt companies which, because of the territory in which they are resident and the nature of their income, can be assumed not to be involved in avoidance.

The Controlled Foreign Companies (Excluded Countries) Regulations; SI 1998/3081.

[21] ICTA, s. 748(3).

The motive test has been considered, as regards its application to companies resident in another Member State of the European Union, in *Cadbury Schweppes plc -v- IRC* [2006] STC 1908 and *Vodafone 2 -v- HMRC* [2009] STC

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1480. In *Vodafone 2*, the UK Court of Appeal concluded that, notwithstanding the wording of ICTA, s. 748(3), the CFC legislation as a whole could be interpreted in a way which conformed with EU jurisprudence governing the extent to which anti-avoidance legislation of Member States could be enforceable if it had an impact on the freedom of a company in an EU Member State to establish a subsidiary in another EU Member State even if the motive was tax avoidance.

HMRC practice is to allow a period of grace where an overseas company first becomes subject to the CFC regime, e.g., as a result of a takeover by a UK company or a group of companies of a foreign group of companies if certain conditions are satisfied, where originally the overseas companies were not set up to avoid UK tax: INTM 208310. In the CTRD it is proposed that this period be extended.

[22] ICTA, s. 756(1A).

[23] See ICTA, s. 751A, which was introduced in response to the ECJ decision in *Cadbury Schweppes*.

[24] ICTA, s. 748(3)(a).

[25] In *Cadbury Schweppes*, the requirement was that there should be "objective factors which are ascertainable by third parties. . . that the CFC is actually established in the host member state and carries on genuine economic activities there."

[26] See ICTA, Sch. 25, para. 6(2)(a)(i).

[27] The interim proposals for CFC reform (see fn. 17, above) propose that, in determining whether a company's profits are subject to a lower level of taxation, profits will be based on total profits (excluding capital gains or losses) calculated in accordance with GAAP: see CTRD, p.79, para. A29.

[28] See ICTA, Sch. 24, paras. 1(i), 4, and 10.

[29] For instance option holders: see ICTA, s. 749B(1).

[30] ICTA, s. 752(4).

[31] See INTM 210120, Example 1.

[32] ICTA, s. 751(6) describes what constitutes creditable tax.

[33] ICTA, s. 747(3) sets out how the apportionment is performed and ICTA, s. 747(4)(a) imposes the charge to corporation tax.

[34] Unless that tax could be said to have been imposed in earning the income of Sub2, the subject of the CFC apportionment.

Relief is potentially available in calculating UK corporation tax on profits of Sub1 that are apportioned to HCo and that include profits (probably dividends paid out of such profits) from Sub2 that are also the subject of an apportionment on HCo. In effect, the tax paid on the Sub2 profits apportioned to Sub1 is treated as creditable tax in computing the corporation tax on the Sub1 profits apportioned to H Co: INTM 209220.

[35] Technically all dividends, etc. are taxable unless they satisfy the conditions for one of the exemptions (CTA 2009, s. 931B, in relation to small companies, and CTA 2009, ss. 931E-931I) and are not as a result of one of the exceptions from exemption (CTA 2009, ss. 931J-931Q, but only in respect of "large companies") brought back into charge. In practice it is expected most dividends will be exempt.

[36] Prior to July 1, 2009, the profits of a CFC which satisfied the ADP requirements, i.e., in very broad terms, paid out dividends at least equal to 90% of its net chargeable profits within 18 months of the end of the relevant accounting period, were not subject to apportionment. With the introduction of a dividend exemption (see fn. 43, above), the ADP exception is only relevant to accounting periods ending on or before, or to that part of an accounting period (which actually continues after July 1, 2009) as is treated as ending on June 30, 2009.

[37] In certain circumstances, principally where tax treaties with other countries require dividends to be subject to tax in another jurisdiction (in this case the United Kingdom), a UK resident company may elect for dividends capable of being exempt under CTA 2009, Part 9A o be taxable: CTA 2009, s. 931R.

[38] ICTA, Sch. 26, para. 4. This is discussed in INTM 211130-211220.

[39] ICTA, Sch. 26, para. 3(1).

[40] ICTA, Sch. 26, paras. 3(4) and (5).

[41] ICTA, s. 752B.

[42] It could be important to HCo if the non-CFC were treated as having an interest in the CFC which, as a result, could not be attributed to HCo (ICTA, s. 752A(3)), so that HCo's interest was below the 25% attribution threshold. In such circumstances, HCo would not seek relief on a sale of the shares in the non-CFC for HCo would not have been the subject of an apportionment.

[43] ICTA, s. 752A(3).

[44] See INTM 167460.

[45] *Bricom Holdings Ltd -v- IRC* [1997] STC 1179.

[46] The chargeable profits . . . . ."are a purely notional sum. . . they are merely the product of a mathematical calculation. . . .." and hence the interest received by the Netherlands company was not as such included in the amount on which the UK parent was assessed.

[47] *Cadbury Schweppes Plc -v- HMRC* [2006] STC 1908.

[48] In theory, this could involve a reduction to nil: ICTA, s. 751A(2).

[49] ICTA, s. 751A(4), (7).

[50] Or directed by the CFC to perform duties on its behalf, e.g., a group employee seconded to the CFC or a person provided by an employment agency: ICTA, s. 751A(9) ICTA and INTM 210570.

[51] A distinction is drawn between economic activities resulting from the holding of assets by the CFC and work actually carried out in the CFC by employees: INTM 210530.

[52] In broad terms, this is determined by features of local (non-tax) law, such as whether the entity has legal personality, whether profits belong to members as they arise or their entitlement is subject to a prior determination by the management of the entity: see for example *Memec plc -v- IRC* [1998] STC 754 and the list of factors to which HMRC have regard contained in INTM 180010, which is subject to appeal.

[53] Income Tax Act 2007 (ITA), s. 720.

[54] Although, to the extent income has been the subject of an apportionment under the CFC legislation, it cannot also be taxable under ITA, s. 720: see ITA, s. 726.

[55] This is contained in Taxation (International and Other Provisions) Act (TIOPA), Part 8 and regulations, principally the Offshore Funds (Tax) Regulations 2009: SI 2009/3001.

Host Country
UNITED STATES

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I. The CFC regime of the United States

The United States does have a controlled foreign corporation (CFC) regime pursuant to which HCo, as a US corporation (hereinafter "USCo"), might be subject to current taxation on all or part of the income realised by Sub2 (even though the value of that income is not yet considered distributed to USCo). The US CFC regime is found in §§ 951-965 of the US Internal Revenue Code of 1986, as amended ("the Code").[1]

USCo, as a US corporation, is subject to US corporate income tax on its worldwide taxable income (determined by subtracting from its worldwide gross income the deductions to which it is entitled). Theoretically, US income tax law could have required mandatory consolidation of USCo with all of its US and foreign subsidiaries and then taxed that consolidated "person" either on a worldwide basis or, in order to promote the global competitiveness of US companies, on a territorial basis, using perhaps worldwide formulary apportionment.[2] Congress in its wisdom, however, decided to set up a system in which:

- There is no mandatory consolidation;
- US corporations are taxed on a worldwide basis; and
- Foreign corporations are taxed on a territorial basis.[3]

Generally speaking, under this system, a US corporation is not currently taxed on income being realised by its foreign subsidiaries (assuming they are corporations for US income tax purposes). Rather, such income is generally taxed to the US parent corporation only when it is considered distributed to the US parent in the form of a dividend (or as gain on the sale of stock[4]). This principle is known as "deferral" and refers to the deferral of US income tax on income being earned by foreign subsidiaries. This system allows the US Congress to tax US corporations on their worldwide income (which is politically popular, at least among certain members of Congress) and yet allows foreign income earned through foreign subsidiaries to be currently exempt (which helps US companies to be globally competitive[5]).

The basic exception to this principle of deferral is the US CFC regime.[6]

A. The history and objectives of the US CFC regime

Until 1962, generally the only exception to the principle of deferral was a regime for foreign personal holding companies, which applied to foreign corporations that were held by five or fewer individuals.[7] As part of a series of tax reform proposals presented in 1961, President John F. Kennedy recommended that deferral be ended with respect to all income derived by foreign subsidiaries controlled by US persons, except operating income derived in less developed countries.[8] Moreover, even with respect to such operating income derived in less developed countries, deferral would have been ended for "tax haven" income. Congress did not go as far as the President recommended because it feared a proposal of that scope would harm US exports and place US-owned firms operating abroad at a competitive disadvantage vis-à-vis foreign-owned firms that were not subject to worldwide taxation by their home countries.[9] Instead, Congress focused on the perceived abuses involving income derived from "passive" foreign financial investments and from activities in foreign tax haven countries to which high profits were ascribed through related-party pricing.[10] Congress responded to these perceived abuses by enacting the US CFC regime as part of the Revenue Act of 1962.[11]

The original objectives of the CFC regime, which generally continue to this day, were to subject two main types of income to current taxation: (1) income from assets or activities that can be "easily moved" to low-tax jurisdictions;[12] and (2) income from certain transactions between related persons.

B. The definition of a CFC

As its name suggests, a CFC is a "corporation" that is "foreign" and "controlled."

In order to understand the concept of a "corporation," it is first helpful to understand the role of the concept of an "entity" in the US tax system. For purposes of determining tax units under the Code, i.e.,

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units potentially subject to taxation or potentially subject to reporting (referred to in the Code as "persons"), two main concepts are involved individuals and entities. There are, in turn, four main types of entities business entities, trusts (including, for this purpose, estates),[13] non-profit organisations (qualifying for tax-exempt status), and entities subject to special rules under the Code (such as regulated investment companies (RICs) and real estate investment trusts (REITs)).

A "corporation" is a business entity (as defined under § 7701(a)(3) and Regs. § 301.7701-2(a)) that is treated as a corporation: (1) under the "*per se*" rules;[14] (2) under the default rules;[15] or (3) under an election to be treated as a corporation.[16] A business entity recognised as a corporation for US tax purposes may also include a wholly-owned business entity that is treated as "disregarded" within the meaning of Regs. § 301.7701-2(a).

A corporation is "foreign" if it is created or organised in, or under the law of, a foreign country, a US possession or territory, or any subdivision thereof.[17]

The most complicated component in the definition of a CFC is the definition of the term "controlled." The key question here is whether a foreign corporation is "controlled" by "United States shareholders." For this purpose, a "United States shareholder" with respect to a foreign corporation is a US person (generally as defined in § 7701(a)(30)[18]) who owns 10 percent or more of the total combined voting power of all classes of voting stock of the foreign corporation.[19] Ownership includes direct, indirect, and constructive ownership. Under the rules for indirect ownership, stock owned, directly or indirectly, by a foreign corporation, foreign partnership, or foreign trust is treated as being owned proportionately by its shareholders, partners, or beneficiaries.[20] Under the rules for constructive ownership, special indirect ownership rules apply to ownership through a US corporation, US partnership, or US trust, and special attribution rules apply whereunder stock owned by one individual can be attributed to a member of the individual's family and stock owned by a shareholder, partner, or beneficiary can be attributed to the corporation, partnership, or trust.[21]

Generally, a foreign corporation is "controlled" by United States shareholders, and thus considered a CFC, if more than 50 percent of the total combined voting power of all classes of its voting stock or more than 50 percent of the total value of all of its stock is owned by United States shareholders.[22] Ownership for this purpose has the same meaning as it has for purposes of the definition of a "United States shareholder" it includes direct, indirect, and constructive ownership.[23] Thus, a foreign corporation might be a 17th-tier foreign subsidiary of a US parent corporation and yet it would still be a CFC. (However, deemed-paid foreign tax credits with respect to current inclusions would not be allowed in that case because the corporation is below the sixth tier.[24])

It should be noted that there are special rules for foreign corporations deriving insurance income. If more than 75 percent of a foreign corporation's insurance income constitutes income of a type subject to current inclusion,[25] then, for purposes of applying the current inclusion rules relating to insurance income, the foreign corporation is considered a CFC if more than 25 percent of the vote or value of its stock is owned by United States shareholders.[26] In addition, for purposes of applying the current inclusion rules with respect to "related person insurance income" (as defined in § 953(c)(2)), a foreign corporation is considered a CFC if US persons (as defined in § 957(c)) own directly or indirectly (within the meaning of § 958(a)(2)) 25 percent or more of the vote or value of the stock of the corporation and any US person (as so defined) who so owns any stock in the corporation is considered a United States shareholder with respect to the corporation.[27]

As noted above, for purposes of the CFC provisions, a "United States shareholder" is generally a US person who owns 10 percent or more of the total combined voting power of all classes of voting stock of a foreign corporation. For this purpose, a "US person" is a:

- US citizen or US resident;
- US corporation;
- US partnership; or
- US trust.[28]

Thus, if Sub1 were instead wholly owned by an individual who is a resident of the United States, Sub2 would still be a CFC. If Sub1 were wholly owned by a trust, then one would first have to determine if it was a foreign trust or a US trust. If it was a foreign trust, then one would look at its beneficiaries to determine if Sub2 was a CFC.[29] If it was a US trust, then that US trust would be a US person and thus Sub2 would be a CFC.

If Sub1 were instead wholly owned by a partnership, then one would first have to determine if it was a foreign partnership or a US partnership. If it was a foreign partnership, then one would look at its partners to determine if Sub2 was a CFC.[30] If it was a US partnership, then that US partnership would be a US person and Sub2 would be a CFC.[31]

C. Types of income subject to current taxation and exceptions

Two main types of income are subject to current taxation under the US CFC regime:

- Income from assets or activities that can be easily moved to low-tax jurisdictions; and
- Income from certain transactions between related persons.

This income is referred to as "Subpart F income," after the portion of the Code in which the CFC rules are found, i.e., Title 26 (Internal Revenue Code), Subtitle A (Income Taxes), Chapter 1 (Normal Taxes and Surtaxes), Subchapter N (Tax Based on Income from Sources Within or Without the United States), Part III (Income from Sources Without the United States), Subpart F (Controlled Foreign Corporations).[32]

The first main type of income (income from assets or activities that can be easily moved to low-tax jurisdictions) consists of:

- Insurance income as defined in § 953(a); and
- Foreign personal holding company income (FPHCI) as defined in § 954(c).

The latter is often referred to as "passive" income, even though it can be derived in the active conduct of a trade or business. Exceptions are provided for corporations engaged in an active insurance or banking business, but these exceptions expire (unless extended) for taxable years beginning after December 31, 2011.[33]

FPHCI consists of the following categories of income:

1. Dividends, interest, royalties, rents, and annuities (other than royalties and rents derived in the active conduct of a trade or business from unrelated parties).[34]
2. The excess of gains over losses from the sale or exchange of property (other than inventory property) that: (a) gives rise to income described in 1. above (other than property that gives rise to income not treated as FPHCI because of the exceptions for active insurance or banking businesses); (b) is an interest in a trust, partnership, or REMIC; or (c) does not give rise to any income.[35]
3. The excess of gains over losses from certain transactions in commodities (including futures, forward, and similar transactions).[36]
4. The excess of foreign currency gains over foreign currency losses (as defined in § 988(b)) attributable to "section 988 transactions" (other than transactions directly related to the business needs of the CFC).[37]
5. Income equivalent to interest, including income from commitment fees (or similar amounts) for loans actually made.[38]
6. Net income from certain notional principal contracts.[39]
7. Payments in lieu of dividends that are made pursuant to an agreement to which § 1058 applies (relating to transfers of securities under certain agreements).[40]
8. Certain income from personal service contracts.[41]

Certain exceptions and special rules for FPHCI are provided in § 954(c)(2)-(6).[42]

The second main type of income (income from certain transactions between related persons) was apparently included as Subpart F income as a backstop to § 482 (relating to arm's-length pricing for transactions between related persons). Thus, in cases where Congress felt taxpayers were playing fast and loose with the rules for related-party pricing, Congress simply provided that the income allocated to a CFC as a result of such rules is currently taxed to the CFC's United States shareholders.[43] This second main type of income consists of:

- Foreign base company sales income;[44]
- Foreign base company services income;[45] and
- Foreign base company oil-related income.[46]

(These three categories plus FPHCI constitute "foreign base company income."[47]) The first two categories explicitly involve transactions with related parties; the third category implicitly does (at least generally speaking) since, in order to have foreign base company oil-related income, a CFC must be a member of a group that includes a large oil producer.[48]

If the total gross Subpart F income[49] of a CFC meets a *de minimis* rule, i.e., the total is less than the lesser of 5 percent of the CFC's gross income or USD 1,000,000, then the CFC is not considered to have any Subpart F income for the year.[50] Moreover, if the total gross Subpart F income is more than 70 percent of the CFC's gross income, then all of the CFC's gross income for the year is considered gross Subpart F income.[51] In addition, an "item" of Subpart F income (other than oil-related income) will not be treated as Subpart F income if the controlling United States shareholders (as defined in Regs. § 1.964-1(c)(5)(i)) establish that the item was subject to an effective rate of foreign income tax greater than 90 percent of the maximum rate specified in § 11 (currently 35 percent).[52] Once the amount of gross Subpart F income has been determined, deductions are taken into account in determining the current inclusion.[53] A final limitation on Subpart F income is the earnings and profits (e&p) limitation, pursuant to which the Subpart F income of a CFC for a particular year cannot exceed the e&p of the CFC for that year.[54]

There is currently no provision in the US CFC regime under which USCo could escape current taxation by establishing that it did not have a tax avoidance purpose in setting up Sub2.[55]

D. Other circumstances in which there is current taxation of the income of a CFC

Under certain other provisions of the US CFC regime, income of a CFC can be currently taxed to United States shareholders regardless of what type of income it is. Under these other provisions, there are current inclusions of the income of a CFC generally equal to:

- The income of the CFC (excluding income otherwise subject to current inclusion) multiplied by the international boycott factor as determined under § 999 (relating primarily to economic boycotts of Israel);[56]
- The total of the amounts of illegal bribes, kickbacks, and other payments (within the meaning of § 162(c)) paid by the CFC directly or indirectly to an official, employee, or agent of a government;[57]
- The income derived by the CFC from a foreign country to which § 901(j) applies (relating to foreign countries with which the United States does not have diplomatic relations or that the US Secretary of State has designated as foreign countries that repeatedly provide support for acts of international terrorism;[58] and
- The amount of investment in United States property as determined under § 956.[59]

The first three amounts are also included in the term "Subpart F income" and thus also subject to the e&p limitation, discussed earlier.[60] With respect to investment in United States property, an e&p limitation is built into the definition of the amount of investment in United States property that a CFC is considered to have.[61]

E. Rules used to determine income

Generally speaking, the US rules for determining taxable income are used to determine Subpart F income.[62] However, the US rules for determining e&p are also relevant because of the e&p limitation for Subpart F income, discussed earlier.[63] In addition, as also discussed earlier, the US rules for determining e&p are also relevant for purposes of determining the amount of investment in United States property.[64] The US rules for determining the e&p of a CFC are generally the same as those for determining the e&p of a US corporation.[65]

F. Rules for determining pro-rata shares

Obviously, where a United States shareholder, such as USCo, wholly owns, directly or indirectly, all of the shares of a CFC, its *pro rata* share is 100 percent. However, determining *pro rata* shares can become somewhat murky when there are several United States shareholders and they hold different classes of stock that possess different distribution rights, for example, common stock and preferred stock.

Under prior regulations, a United States shareholder's *pro rata* share of current inclusion income was determined by first assuming there was a distribution by the CFC at the end of the current year of all of its current-year e&p (the hypothetical year-end distribution) and then calculating how much of that distribution would be allocated to the United States shareholder's interest in the CFC.

The United States shareholder's *pro rata* share of current inclusion income would then be equal to the ratio of:

- The amount of e&p allocated to the United States shareholder's ownership interest in the hypothetical year-end distribution; to
- The total e&p of the CFC for the current year.

However, because of concerns that this hypothetical year-end distribution approach was overly mechanical and subject to abuse,[66] new regulations were issued in 2005.[67]

Under the new regulations, one still does the analysis using the approach of the hypothetical year-end distribution.[68] However, the *pro rata* share obtained thereby is now subject to a number of exceptions. There is an exception where the allocation of the CFC's e&p between two or more classes of stock depends on the exercise of board discretion.[69] In addition, "any limitation that has the effect of limiting the allocation or distribution of earnings and profits" by a CFC to a United States shareholder will not be taken into account, other than a currency or other type of restriction imposed under the laws of a foreign country as provided in § 964(b) (relating to "blocked foreign income") and other than the requirement that preferred stock be satisfied prior to the making of distributions to another class of stock.[70]

With respect to the treatment of dividend arrearages on preferred stock, the new regulations still provide that current-year e&p is considered attributable to an arrearage only to the extent that the arrearage exceeds the e&p from prior taxable years beginning after December 31, 1962. However, the new regulations now also provide that only e&p arising after the issuance of the preferred stock can be allocated to the arrearage.[71]

G. Mode of taxation to USCo

Generally speaking, USCo is taxed on Sub2's Subpart F income as if Sub2 had made a distribution directly to USCo (the "hopscotch rule") and USCo is entitled to a "deemed-paid foreign tax credit" under § 960 with respect to the inclusion.[72] The fact that USCo is taxed as if Sub2 had made a distribution directly to USCo is particularly relevant with respect to the computation of the deemed-paid foreign tax credit since it means that only the foreign income taxes of Sub2 are taken into account in determining the amount of that credit. Thus, there is no "dilution" of the credit (or increase) as a result of the effective foreign tax rate of Sub1. The deemed-paid credit is determined on the basis of a multi-year pooling of e&p and separately with respect to the foreign tax credit category (generally, general limitation income or passive income) to which the current inclusion relates.[73]

With respect to a current inclusion under § 956 (attributable to investment in United States property) (which, as discussed earlier, is not within the definition of "Subpart F income"), the hopscotch rule applies but subject to a new limitation, enacted on August 10, 2010.[74] Under this new limitation, the amount of the deemed-paid credit under the hopscotch rule cannot exceed the amount of deemed-paid credit the United States shareholder would have had if the amount of the current inclusion had been distributed "up the chain" to the United States shareholder (but ignoring any foreign taxes that would have been paid on the distribution).[75] Thus, in the factual scenario under consideration, if USCo has a current inclusion with respect to Sub2 as a result of Sub2's investment in United States property, USCo's deemed-paid credit with respect to that current inclusion is limited to the amount of deemed-paid credit USCo would have had if the amount of the current inclusion had been distributed up to USCo through Sub1. If Sub1 has a lower effective foreign tax rate than does Sub2, "dilution" of the deemed-paid foreign tax credit might have occurred and, if such is the case, USCo's deemed-paid credit with respect to the current inclusion is limited to the diluted amount. It should be noted that the new limitation is just that a limitation. If USCo would have had a greater deemed-paid credit had value in the amount of the current inclusion gone up the chain, that is ignored and USCo is limited to the amount of deemed-paid credit that it has under the hopscotch rule.

If Third Country has its own CFC regime and income of Sub2 is currently taxed to Sub1, any additional taxes paid by Sub1 as a result of that CFC regime would be ignored under the hopscotch rule but would be taken into account for purposes of the limitation on the hopscotch rule that applies with respect to current inclusions attributable to investment in United States property.

H. Adjustments to preclude double taxation on actual distributions or on sale of stock

Since income of a CFC may be currently taxed to United States shareholders before any actual distributions are made to such shareholders, there must be a mechanism to ensure that those shareholders are not taxed again when they receive distributions that are considered to represent the value on which they were previously taxed. Moreover, if the stock of a CFC is sold before currently taxed income is considered to have been distributed from the CFC, there needs to be some adjustment to take that into account so that the selling shareholder is not taxed again on that value.

Under the US CFC regime, in the case of stock in a CFC that is held directly by a United States shareholder, the first adjustment to be made is an adjustment to the basis in the stock of the CFC to provide relief in case the stock in the CFC is sold before currently taxed income is considered to have been distributed from the CFC. Thus, the basis in the stock of the CFC attributable to a United States shareholder is increased for amounts currently included in the income of the United States shareholder.[76] If the stock in the CFC is owned indirectly through other CFCs, the bases of the stock in the other CFCs are also adjusted upwards.[77] Thus, in the factual scenario under consideration, if USCo has a current inclusion with respect to Sub2, Sub1's basis in its stock in Sub2 is adjusted upwards by the amount of the inclusion and USCo's basis in its stock in Sub1 is adjusted upwards by the same amount.

Having adjusted basis, it is also necessary to make an adjustment in case actual distributions are made by a CFC after there have been current inclusions with respect to the income of the CFC. One possible approach could have been to treat the amount of the current inclusion as having been distributed at the time of the current inclusion and then having been immediately contributed back to the CFC as a contribution to capital (thus producing the increase in the basis in the CFC stock discussed above). However, this would have meant that actual distributions, which, under general rules, are considered as coming first out of e&p,[78] would have been subject to tax since e&p that had been subject to a current inclusion would have been converted to capital. Thus, a United States shareholder would not have received a benefit from having been taxed on a current inclusion until all e&p had been distributed and a distribution was considered to come out of capital.

In order to give United States shareholders a more upfront benefit from being taxed on current inclusions, the US CFC regime has the notion of "previously taxed income" (PTI). Thus, if there is a current inclusion with respect to the e&p of a CFC, an upwards adjustment to basis in the stock is made but the e&p of the CFC is not reduced. Instead, a portion of the CFC's e&p equal to the amount of the current inclusion is converted to PTI. PTI is still e&p and any actual distributions are considered made first out of PTI. Moreover, because the PTI is, as its name indicates, "previously taxed," a distribution out of PTI is not taxed.[79] Distributions of PTI are also excluded from the gross income of intervening CFCs.[80] Thus, a United States shareholder receives a more immediate benefit from having been taxed on current inclusions. When there is a distribution of PTI by a CFC, there is also a downward adjustment to the United States shareholder's (direct or indirect) basis in the CFC.[81]

If part of USCo's indirect interest in Sub2 were held through a foreign corporation that did not constitute a CFC for US income tax purposes, then, under § 961(c), USCo's stock basis in that non-CFC would still be adjusted upwards as a result of any current inclusions USCo has with respect to Sub2. However, the non-CFC's stock basis in Sub2 would not also be adjusted upwards because the non-CFC is not a CFC.[82] The character of a distribution as a distribution of PTI should flow up the chain even if a non-CFC is part of the chain.[83]

I. Impact of treaties to which the United States is a party

The only type of treaty to which the United States is a party that might impact the application of its CFC regime is an income tax treaty. However, all US income tax treaties contain a "saving clause," pursuant to which the United States (with certain exceptions not relevant here) retains the right to tax its residents (US persons) as if the treaty had not come into effect. The saving clause in the 2006 US Model Income Tax Treaty (the "US Model Treaty") provides in part as follows: "[T]his Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens."[84] Since United States shareholders (not CFCs) are taxed under the US CFC regime and United States shareholders are US persons (who are residents of the United States for purposes of an income tax treaty), it is the position of the US Department of the Treasury that, under the saving clause, the United States retains the right to apply its CFC regime.[85]

II. Other regimes in addition to the CFC regime

There are other regimes in US income tax law under which income realised by an entity that is not itself subject to taxation by the United States might be currently taxed to direct or indirect owners of the entity that are residents of the United States (or, in the words of the Code, "US persons"). As indicated earlier, there are four main types of entities under the Code: business entities, trusts, non-profit organisations (qualifying for tax-exempt status), and entities subject to special rules under the Code.

The income of entities subject to special rules under the Code is subject to such special rules and is generally not subject to any additional regime.

The income of non-profit organisations is subject to the special rules for tax-exempt organisations and is generally not subject to any additional regime.[86]

The income of trusts is currently taxed to the trust itself or to the beneficiaries. If taxed to the trust itself, beneficiaries may be permitted to take into account, when the taxed income is considered distributed to them, the tax paid by the trust.[87]

There are three types of business entities: corporations, partnerships, and disregarded entities. The income of a disregarded entity is currently taxed to its owner. The income of a partnership is currently taxed to its partners. The income of a corporation is currently taxed to the corporation (if subject to US taxing jurisdiction), except it may be taxed to its direct or indirect owners under the CFC regime or under the passive foreign investment company (PFIC) regime. The CFC regime was discussed above; the PFIC regime is discussed below.

A. The rules of the PFIC regime in brief

The PFIC regime was enacted in order to curtail the benefit of deferral (of US income tax) being realised by US persons investing in PFICs. Generally speaking, a foreign corporation is a PFIC if:

- 75 percent or more of its gross income consists of "passive income" (generally FPHCI); or
- 50 percent or more of its assets consists of passive assets.[88]

The default rule of the PFIC regime is that an interest charge applies to the US tax due when certain PFIC distributions are received or PFIC stock is sold.[89] However, two optional approaches are available. Under the mark-to-market approach, a PFIC owner is taxed each year on the appreciation in value of his/her/its interest in the PFIC.[90] Alternatively, a PFIC owner may elect to treat the PFIC as a Qualified Electing Fund, in which case the PFIC owner is taxed annually on his/her/its *pro rata* share of the income of the PFIC.[91]

Under a co-ordination rule, a foreign corporation cannot be a PFIC with respect to a US person if the foreign corporation is a CFC and the US person is a United States shareholder with respect to the CFC.[92]

B. Impact of treaties to which the United States is a party

As with respect to the CFC regime, the position of the US Department of the Treasury is that no treaty to which the United States is a party impacts the application of the PFIC regime.

NOTES

[1] Unless the context indicates otherwise, all "§ " references are to the Code and all "Regs. § " references are to the regulations issued thereunder (and set forth in 26 CFR).

[2] If USCo were a subsidiary of a foreign parent corporation, arguably the mandatory consolidation should include that foreign parent and all of its subsidiaries. In that case, presumably the United States would apply a territorial approach in taxing the consolidated person.

[3] Another alternative to mandatory consolidation is the taxation of all corporations, including US corporations, on a territorial basis. The concept of taxing all corporations, including US corporations, on a territorial basis is gaining momentum in Congress and was included as a recommendation by the Co-Chairmen of the President's bipartisan National Commission on Fiscal Responsibility and Reform in their proposal released on December 1, 2010. *See* Rothman, "Fiscal Commission Seeks Major Overhaul of Tax Code, Elimination of Expenditures," *BNA Daily Tax Report* (12/2/10).

[4] See § 1248.

[5] For example, if a US parent corporation has a foreign subsidiary operating in a low-tax country like Singapore, deferral helps the US group to compete with foreign groups that also have operations in Singapore but are not subject to home country tax on the income earned in Singapore because their home countries utilise territorial systems.

[6] It should be noted that even if a territorial system were adopted for all corporations, some type of regime would still be necessary to deal with situations in which assets or activities can be easily shifted to low-tax jurisdictions.

[7] Former §§ 551-557. This regime was repealed by the American Jobs Creation Act of 2004. P.L. 108-357, § 413, effective for taxable years of foreign corporations beginning after Dec. 31, 2004, and for taxable years of US shareholders with or within which such corporate years end.

[8] "Message from the President of the United States Relative to Our Federal Tax System," dated April 20, 1961, *reprinted as* H.R. Doc. No. 140, 87th Cong., 1st Sess. 6-7 (1961).

[9] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 57-8 (1962).

[10] S. Rep. No. 1881, 87th Cong., 2d Sess. 78-9 (1962).

[11] P.L. 87-834, § 12, effective for taxable years of foreign corporations beginning after Dec. 31, 1962, and for taxable years of "United States shareholders" with, or within which, such corporate years end.

[12] For this purpose, "moving an asset" can include loaning money to a foreign person rather than a US person.

[13] Whether an entity constitutes a business entity or a trust is not always an easy determination. See Regs. §§ 301.7701-2(a) and -4.

[14] Regs. § 301.7701-2(b)(8).

[15] Regs. § 301.7701-3(b).

[16] Regs. § 301.7701-3(c).

[17] § 7701(a)(4) and (a)(5), and Regs. § 301.7701-5.

[18] § 957(c).

[19] § 951(b).

[20] § 958(a)(2).

[21] §§ 958(b) and 318(a).

[22] § 957(a).

[23] *Id.*

[24] See §§ 960 and 902.

[25] It is assumed here that the reference in § 957(b) to § 953(a)(1) is intended to take into account the exception

in § 953(a)(2). Otherwise, a foreign corporation with any amount of insurance income would likely meet the 75% test.

[26] § 957(b).

[27] § 953(c)(1).

[28] § 7701(a)(30).

[29] § 958(a)(2).

[30] *Id.*

[31] However, the Internal Revenue Service (IRS) issued Notice 2010-41, 2010-22 I.R.B. 715, on May 14, 2010, indicating that the US Department of the Treasury and the IRS intend to issue regulations that will implement a type of Rube Goldberg logical contraption, under which, in certain situations, a US partnership will be treated as a foreign partnership for purposes of determining the United States shareholders that are subject to current inclusions of income. It would have been much simpler to simply provide that income of a CFC that is included in the income of a US partnership is in turn included in the income (on a proportionate basis) of its direct or indirect US partners.

[32] The Code definition of "Subpart F income" (§ 952(a)) actually includes three additional amounts, relating primarily to participating in an international boycott, paying bribes, or deriving income in foreign countries that support international terrorism. These amounts, which are discussed below in I.D., are not types of income derived by a CFC but are amounts by which deferral is ended by virtue of the CFC having engaged in certain activities.

[33] §§ 953(e), 954(h), and 954(i). The exceptions were most recently extended by § 750 of P.L. 111-312 (Tax Relief, Unemployment Insurance Reauthorisation, and Job Creation Act of 2010), enacted on Dec. 17, 2010.

[34] § 954(c)(1)(A) and (2)(A). Under a special rule in § 964(e), gain realised by a CFC on the sale of stock in a foreign corporation is treated as a dividend to the extent it would have been so treated under § 1248 had the CFC been a US person.

[35] § 954(c)(1)(B).

[36] § 954(c)(1)(C).

[37] § 954(c)(1)(D).

[38] § 954(c)(1)(E).

[39] § 954(c)(1)(F).

[40] § 954(c)(1)(G).

[41] § 954(c)(1)(H).

[42] Section 954(c)(3) provides the "same-country" exception under which, under certain circumstances, dividends and interest received from a related foreign corporation organised in the same foreign country as the receiving CFC, and rents and royalties from a related corporation for the use of property in the country in which the receiving CFC is organised, are excepted from treatment as FPHCI.

Section 954(c)(6) provides a "look-through" rule for dividends, interest, rents, and royalties received from a related CFC. Under the rule, the income does not constitute FPHCI to the extent he related deductions of the related CFC are allocable to income that is neither Subpart F income nor income effectively connected with a US trade or business. Pursuant to § 751 of P.L. 111-312 (Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010), enacted on Dec. 17, 2010, this rule does not apply to taxable years beginning after Dec. 31, 2011.

[43] In his budget proposals released on Feb. 1, 2010, President Obama proposed including in the Subpart F income of a CFC "excess returns" from the use of intangible property that was transferred to the CFC from a US person. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, Feb. 2010, p. 43.

[44] § 954(d).

[45] § 954(e).

[46] § 954(g).

[47] § 954(a).

[48] § 954(g)(2).

[49] Excluding, however, the three additional amounts included in the term "Subpart F income" that are discussed below in I.D.

[50] § 954(b)(3)(A).

[51] § 954(b)(3)(B).

[52] § 954(b)(4); Regs. § 1.954-1(d).

[53] § 954(b)(5).

[54] § 952(c)(1)(A). Under certain circumstances, a CFC's prior year deficits in e&p with respect to a "qualified activity" may also operate to limit the CFC's Subpart F income with respect to that activity. § 954(c)(1)(B). In addition, under certain circumstances, a "qualified chain member's" deficit in e&p with respect to a qualified activity may also operate to limit a CFC's Subpart F income with respect to that activity. § 954(c)(1)(C).

[55] Prior to amendment by § 1221(d) of P.L. 99-514 (The Tax Reform Act of 1986), enacted on Oct. 22, 1986, § 954(b)(4) allowed an item of income realized by a CFC to be excluded from foreign base company income if it could be demonstrated that the CFC was not used for a tax avoidance or tax reduction purpose with respect to that item. However, the Tax Reform Act of 1986 replaced this subjective no-tax-avoidance test with the objective high-tax exception. See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 970-971: ". . . Congress believed that if movable types of income have been moved to a jurisdiction where they in fact bear a low rate of tax when compared to the US rate, then it is appropriate to impose current US tax on such income without any inquiry into the subjective motivations of the taxpayer. Thus, taxpayers should be permitted to except income from current taxation under subpart F only by showing that such income is subject to foreign tax at a rate substantially equal to the US rate."

[56] § 952(a)(3).

[57] § 952(a)(4).

[58] § 952(a)(5).

[59] The term "United States property" is defined in § 956(c). Section 956 was intended to deal with what were viewed as, in substance, distributions by a CFC to United States shareholders, but the section can have the bizarre effect of punishing United States shareholders if a CFC decides to invest in the United States.

[60] § 952(c).

[61] § 956(a).

[62] Regs. § 1.952-2. Special rules are provided for determining insurance income. § 953(b) and Regs. § 1.952-2(a)(2) and (b)(2).

[63] § 952(c).

[64] § 956(a).

[65] §§ 952(c)(3) and 964(a). Rules for determining the e&p of a US corporation are found in § 312.

[66] See Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations*, JCS-3-03, Vol. I, at 242–60 (describing how the "Project Apache" transaction "exploited a highly mechanical earnings and profits allocation rule in Treas. Reg. sec. 1.951-1(e)(2)").

[67] Regs. § 1.951-1(e).

[68] Regs. § 1.951-1(e)(3)(i).

[69] Regs. § 1.951-1(e)(3)(ii).

[70] Regs. § 1.951-1(e)(5)(ii), (iii).

[71] Regs. § 1.951-1(e)(3)(iv).

[72] §§ 960 and 902. Deemed-paid foreign tax credits are not available with respect to CFCs below the sixth tier. § 902(b). It should be noted that the current inclusion rules apply for a particular taxable year of a CFC only if the CFC was a CFC for an uninterrupted period of at least 30 days during that taxable year. § 951(a)(1). Moreover, the United States shareholders of the CFC that must take into account current inclusions with respect to the CFC are those that owned stock, directly or indirectly (within the meaning of § 958(a)), in the CFC on the last day of the year on which the foreign corporation was a CFC.

[73] § 904.

[74] § 214 of P.L. 111-226 (a nameless law commonly referred to as the "Education Jobs and Medicaid Assistance Act of 2010").

[75] § 960(c).

[76] § 961(a).

[77] § 961(c).

[78] § 316(a).

[79] § 959 (a).

[80] § 959(b).

[81] § 961(b) and (c).

[82] § 961(c).

[83] § 959(a).

[84] Art. 1(4), US Model Treaty.

[85] See US Department of the Treasury, *United States Model TechnicalExplanation Accompanying the United States Model Income Tax Convention of November 15, 2006*, Art. 1(4).

[86] *See* §§ 501-530.

[87] *See* §§ 641-685.

[88] § 1297(a).

[89] § 1291.

[90] § 1296.

[91] § 1293.

[92] § 1297(d).

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Thierry Pons is an expert in finance tax, including the provision of tax advice for French and cross-border banking, capital markets and derivatives transactions. Thierry covers all tax issues, including litigation, in the banking, finance and capital market industries, concerning both corporate and indirect taxes. He has wide experience in advising corporate clients on international tax issues.

GERMANY

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Dr. Jörg-Dietrich Kramer studied law in Freiburg (Breisgau), Aix-en-Provence, Gottingen, and Cambridge (Massachusetts). He passed his two legal state examinations in 1963 and 1969 in Lower Saxony and took his LL.M. degree (Harvard) in 1965 and his Dr.Jur. degree (Göttingen) in 1967. Dr. Kramer was an attorney in Stuttgart in 1970 and 1971. From 1972 to 1977 he was with the Berlin tax administration. Since 1977 he has been on the staff of the Federal Academy of Finance, of which he has been the Vice-President since 1986. In 2003 he retired from that post, but he continues to lecture at the Academy. He was also a lecturer in tax law at the University of Giessen from 1984 to 1991. Dr. Kramer is the commentator of the Foreign Relations Tax Act (Außensteuergesetz) in Lippross, BasiskommentarSteuerrecht, and of the German tax treaties with France, Morocco and Tunisia in Debatin/Wassermeyer, DBA. He maintains a small private practice as a legal counsel.

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Before joining private practice as a lawyer and tax adviser in 1993, Dr Rosemarie Portner, LL.M., worked as a civil servant for several State and Federal tax authorities, including in the Tax Counsel International's office of the Federal Ministry of Finance. Her areas of practice are employee benefits and pensions with a focus on cross-border transactions, and international taxation (at the time she worked as a civil servant she was member of the German delegation which negotiated the German/US Treaty of 1989).

INDIA

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Kanwal Gupta is Director in the Mumbai office of Deloitte Haskins & Sells. He is a member of the Institute of Chartered Accountants of India. He has experience on cross-border tax issues and investment structuring including mergers and acquisitions. He is engaged in Tax Knowledge Management and Litigation practice of the firm and advises clients on various tax and regulatory matters.

Shruti Sinha works with Deloitte Haskins & Sells in Mumbai in the International tax team. She is an Indian qualified lawyer and has completed an LL.M. in International Taxation at New York University School of Law in May 2008. Prior to working with Deloitte, she has gained experience in the tax team of a leading law firm in Singapore.

IRELAND

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Peter Maher is a partner with A&L Goodbody and heads up the firm's tax department. He qualified as an Irish solicitor in 1990 and became a partner with the firm in 1998. He specialises in the area of inward investment, cross border structuring and capital markets transactions. Peter is recommended as a leading adviser by a number of publications and directories including Who's Who of International Tax Lawyers 2008, PLC Which Lawyer? 2008 and 2009, Chambers Europe 2008 and 2009, Who's Who Legal 2008, Chambers Global 2008 and 2009, The Legal 500 2008 and 2009, Tax Directors Handbook 2008, and World Tax 2007 and 2008. He is a former Co-chair of the Taxes Committee of the International Bar Association and of the Irish Chapter of the International Fiscal Association. Peter is also a former representative of the Law Society of Ireland on the Tax Administration Liaison Committee, a consultative body of the Revenue Authorities and the various professional bodies.

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He practises in all areas of Irish taxation law but with particular emphasis on corporate investment in Ireland, mergers & acquisitions and structured finance transactions. Philip tutors and lectures in tax and business law at the Law School of the Law Society of Ireland, and as a consultant to the Law School, he has drafted the VAT tutorial materials and examination questions used by the Law School. He is a frequent speaker on Irish tax issues. He has spoken to Irish solicitors at seminars organised by the Dublin Solicitors Bar Association and as part of the Law Society of Ireland Continuing Practice Education programme. His interests cover a wide variety of tax law topics and he has been a speaker at Private Equity conferences in San Francisco and Boston, at an Intellectual Property conference in Dublin, a European cross border tax seminar in Frankfurt, in addition to presenting at A&L Goodbody talks to the asset finance and banking groups of City of London law firms and the European tax group of a major Benelux law firm. As a member of the Dublin Solicitors Bar Association, he is also an active member of the Association Internationale des Jeunes Avocats (AIJA).

ITALY

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Law Society of England and Wales. Liesl is Honorary Secretary of the British Branch of the International Fiscal Association. She also sits on the International Taxes Committee of the Law Society of England and Wales.

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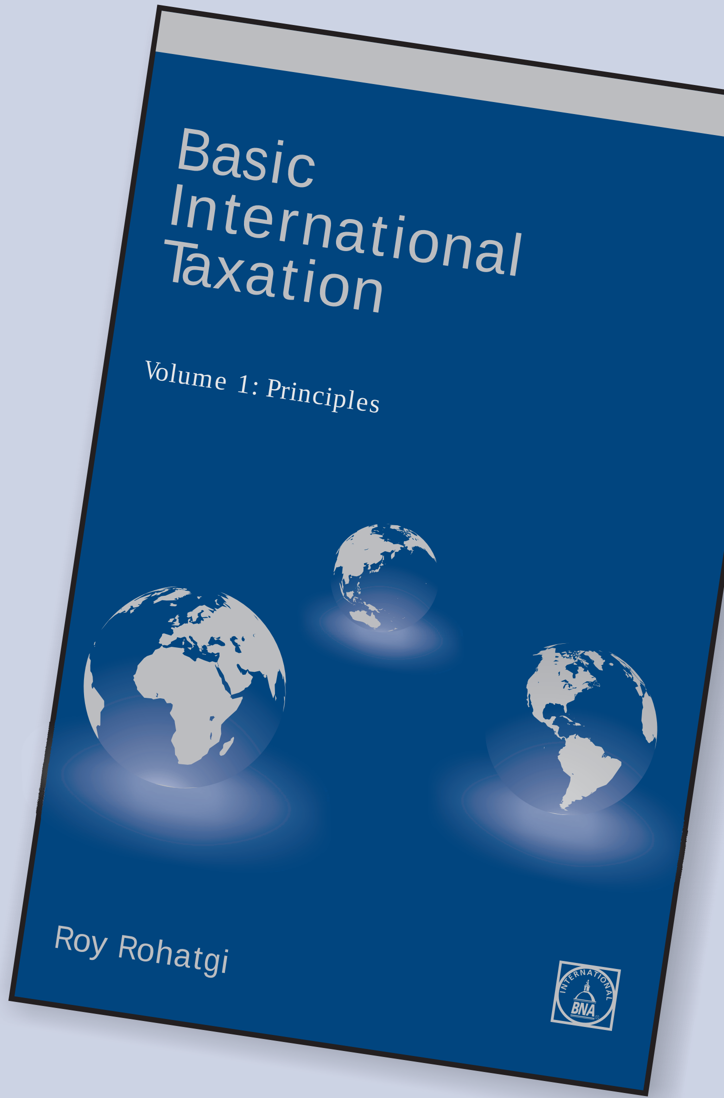
Basic International Taxation: Principles

Professor Roy Rohatgi



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