Dear Mr. Pross,

**BEPS Discussion Draft: Action 3: Strengthening CFC rules**

PricewaterhouseCoopers LLP (PwC) welcomes the opportunity to comment on the OECD’s *Public Discussion Draft on Action 3: Strengthening CFC rules*.

In light of the complexity of the subject matter and the diversity of existing approaches adopted by territories, we recognize the difficulty of the task being addressed in Action 3, and accordingly, we commend the Working Party (the WP) for its efforts to date in reaching agreement over many of the best practice recommendations. We set out in this document our concerns over some areas and our responses to your specific questions. In the body of this letter we set out our overview comments, providing more detail and specific responses to your questions in the Appendix.

We appreciate your consideration of our comments on the Discussion Draft and we would be pleased to assist the OECD further in its efforts under Action 3.

The response in the pages that follow reflects the views of the PwC network of firms.

**Overview comments on the Discussion Draft**

Prior to considering detailed comments, we would like to set out our key concerns in relation to the Discussion Draft. These relate, firstly, to clarifying the overall aim of the Action and the Discussion Draft, and secondly, the huge potential for increased complexity, administrative burden and unrelieved double taxation which could arise under badly implemented CFC rules and the inadequately thought-through interactions with the other BEPS Actions.

In relation to the overall aims of the Action and Discussion Draft, the 2013 Action Plan called for “recommendations regarding the design of CFC rules”. We are concerned whether the Discussion Draft is seeking to go too far and in particular have concerns over both the scope of the CFC rules outlined in the document and the suggestion that a “secondary rule” be introduced. We set out our views on the proposed scope of CFC rules below, but here we would like to express our concern that the WP is seeking to go beyond the remit of Action 3 in proposing the use of such a secondary rule.
This rule seems to be a potential extension to source country taxation rights and hence seems to be beyond what Action 3 was tasked with considering.

In terms of the scope of the CFC rules which are considered in the Discussion Draft, some of these appear to be far too broad to achieve consistency amongst nations (in particular the potential for CFC rules to challenge ‘foreign-to-foreign’ shifting). Given many territories adopt a territorial tax system, frequently supplemented by anti-abuse rules, such an approach is likely to be anathema to them and hence trying to make them mandatory is likely to be politically impossible. We could then be in the situation of many territories with strict CFC rules and others with none and even more competition between nations (especially between OECD and non-OECD nations). We would strongly recommend that the WP aim to recommend a realistic, focused set of provisions to prevent the *artificial diversion of profits from parent territories* which may actually be adopted by the majority of territories.

Another concern we have is in relation to the interactions with the other Actions. Some of the more far-reaching proposals set out in the document appear to be trying to resolve problems which may not effectively be dealt with by other BEPS Actions. We are concerned that this overlap of remit and unresolved interactions will lead to an unworkable international tax system. This can either be resolved through detailed investigation of the complex interactions or, more reasonably given the time scale, through accepting that each Action does not have to independently solve BEPS.

If territories were to implement some of the proposals in the Discussion Draft, it would be inevitable that we would have a much greater incidence of unrelieved double taxation suffered by taxpayers who are not undertaking BEPS activities. We already have examples of double taxation with existing CFC rules and whilst we note that the WP does intend to include recommendations to deal with the interaction between CFC rules, even if these interactions are properly legislated for in each member territory, which cannot be guaranteed, there could also be a significant amount of double taxation arising as a result of interactions between the CFC rules, the CFC rules of non-member territories and the output from other Actions. Whilst some businesses may be able to restructure their operations to remove this economic double taxation, many could find this infeasible and could end up with medium to long term structural double taxation.

In our view, only by proposing balanced, reasonable CFC rules will the OECD be able to achieve any level of coherence between countries – removing both the incentive for competitive behaviour between countries and, we hope, reducing the risk of unrelieved double taxation. We consider that there are some very good examples of CFC rules which effectively deal with BEPS concerns, whilst at the same time not putting the parent territories at a significant competitive disadvantage compared to other territories (see, for example, our discussion of the UK below). We feel that these should be the key aims of recommended CFC rules.

In relation to most of the ‘building blocks’ which are set out in the Discussion Draft, we are in broad agreement with the WP. The main area where we have concerns from a policy perspective is that of identifying the appropriate income to be apportioned to the parent territory set out in Chapter 5. We consider that the recommendations which the WP ultimately make in relation to defining CFC income will fundamentally determine the success or otherwise of Action 3. We strongly agree with the position set out in Para 83 that full inclusion and excessively broad partial inclusion systems go beyond what is necessary to prevent BEPS and furthermore, may ultimately impact negatively on international trade and growth. Leaving to one side the position for EU/EEA Member States, which we cover in more detail below and in the Appendix, it is our firm belief that CFC rules should not seek
to tax activities in territories where there are genuine economic activities. To go further than this in our opinion would permit protectionist behaviour supposedly in the name of challenging BEPS.

HMRC in the UK (and accordingly our UK firm) have had the recent experience of the modernisation of CFC rules. These new rules have, at their core, this principle. Genuine activity should be respected and the CFC rules should target artificial shifting of profits from the UK. This is mainly achieved through the use of a Gateway which is based on the principle of attributing profits to the Significant People Functions (SPFs) who manage assets and risks and, if those SPFs are outside the UK, does not seek to charge tax under the CFC rules. The role of the CFC rules is thereby focused on preventing artificial avoidance strategies – in particular those which split ownership of income-producing assets and risks from the functions who manage them – whilst permitting businesses to actually structure themselves in the most economic manner. We believe that such an approach, when combined with effective transfer pricing rules, is more than sufficient to challenge BEPS behaviours. To go further in the OECD’s recommendations could inadvertently permit or even encourage states to enact rules which dissuade international trade.

In relation to EU/EEA states, we are in agreement that this does give rise to particular restrictions on the potential application of CFC rules and we fully agree with the analysis in paragraphs 11 to 13. In paragraph 14, however, we feel that two of the bullet points may give a slightly misleading impression as to the current state of EU jurisprudence. Accordingly, in the Appendix we set out some analysis which the WP may find helpful.

We hope that the comments we make above and in the Appendix are helpful to the WP and we remain available to provide any assistance that the OECD may require.

Yours sincerely,

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Appendix – General comments and responses to questions for consultation

Chapter 2: Definition of a CFC

Our main comment in relation to this chapter is that we do not see the rationale, from a BEPS policy perspective, for modified hybrid mismatch rule to be on the broader basis in para 37. If a payment is not base eroding then by definition what we are considering does not exhibit BEPS characteristics and accordingly should not, in our opinion, form part of a BEPS recommendation.

1. Would any particular practical issues arise from treating transparent entities as separate entities in the cases listed above? If so, what are they and how could they be dealt with?

Firstly, we have a specific comment regarding one of the forms of entity discussed in the paper which may cause problems in practice - that of trusts. The issue here can arise with certain forms of trust, such as English law discretionary trusts, where establishing precisely who ‘owns’ the interest in the entity cannot be defined prior to a decision being made by the trustees. This gives rise to difficulties in working out to whom profits should be apportioned prior to the funds actually being distributed. The UK domestic and CFC laws have been developed to accommodate such trust issues by focusing more on ensuring that, when any income is derived from trusts, this is correctly taxed.

More generally, broadly defining a CFC to include transparent entities would potentially be over inclusive, so it would be important that other elements of the CFC rules operate to limit double taxation situations (e.g. where the income is taxed to the transparent entity’s owner(s)) and limit taxation to the types of income that are problematic under BEPS (i.e. not active business income). Exceptions will need to be defined to avoid over-inclusion/double taxation where the disparate treatment of an entity between the parent and entity jurisdictions does not give rise to BEPS concerns.

Furthermore, determining the classification of an entity for tax purposes, in most countries, is driven by the legal classification of the entity which can vary according to the terms of establishment of the entity. As a result, an entity could be classified differently by multiple jurisdictions (e.g., entity, owner and ultimate parent) due to differences in how each country’s law classifies the entity. As such, it may be necessary to determine how the entity is taxed in each of these jurisdictions to determine whether BEPS is occurring. For example, intermediary jurisdictions may tax the income of the CFC or its owners. This complexity should also be considered.

The extension to non-corporate entities could have some unintended consequences in the financial services sectors. A number of insurers operate through such entities in overseas jurisdictions for entirely commercial reasons, in particular in the life insurance and savings market.

2. Should the recommendations consider any other issues related to determining which entities could be considered CFCs?

If the parent entity jurisdiction’s rules are to govern the determination and computation of CFC income, as suggested, then the parent jurisdiction rules should apply for purposes of determining which entity is a CFC. The proposed rules would give rise to circumstances where a transparent entity would be treated as a separate entity even when the parent
jurisdiction’s rules disregard the entity. As noted above, this rule would be overly-inclusive and add complexity to the analysis as it would require analysis of the treatment of the entity in multiple jurisdictions.

3. **Are there any practical problems with either the narrow or the broad version of the modified hybrid mismatch rule mentioned above?**

Firstly, we struggle to see how either approach is consistent with a territorial system of taxation which exists in many territories. If the broad approach were adopted, then as noted above there would appear to be a completely unjustifiable (within a BEPS context) risk of double taxation. We consider that any justifiable BEPS output should take into account valid reasons for the exemption of the income (e.g. participation exemption, approved patent regimes) and should be limited in the types of income that are considered problematic under BEPS (i.e. not active business income). More fundamentally, we do wonder if a hybrid mismatch rule is required in the context of the CFC rules in light of the output of Action 2.

In relation to practical issues, assuming CFC rules are self-assessment (rather than applying by direction), with modern groups of companies with multiple tiers this could be a lot of work in practice. Both the narrow and broad options require that each parent company in a chain assesses how their subsidiary entities or arrangement between subsidiary entities would be classified (in both payee and payer jurisdiction). It then requires the parent company to determine if in their territory they had classified the entities and arrangements in the same way whether it would have been included in CFC income. Understanding how entities and payments are treated in each and every payee/payer and then taking this classification and transposing it to the parent location may be a huge exercise even where the position is clear cut.

It is also not clear what is meant by "classified the entities or arrangements in the same way". For example, if this is a country which taxes income on (say) a receipts basis do you need to bear this in mind when performing "in the same way" the analysis? It becomes even more difficult where entity classification or arrangement classification is not clear cut and the analysis is not relevant to the treatment in B or C. Entity classification often requires detailed legal and technical analysis and even then often requires confirmation from the relevant tax authority (e.g. UK entity classification of foreign entities). There are also situations where some concepts under local law do not exist elsewhere e.g. France has opaque, transparent but also ‘translucent’ entities. In the UK, we have just opaque and transparent.

As above, the broad option would seem to be wholly at odds with tackling tax avoidance in that it catches situations where there is no base erosion or profit shifting and prima facie could result in a CFC charge where there is no tax benefit from the arrangements between B and C.

There is also potentially a lot of work for taxpayers when dealing with differences between domestic tax systems e.g. credit vs branch exemption etc.

**Chapter 3: Threshold requirements**

As a practical matter, for groups operating in many territories, we agree with the WP that entity-based threshold requirements are a vital part of a practical yet focused CFC regime.
We set out our more detailed thoughts on a low-tax threshold below, but would like to discuss further the appropriateness of a de minimis exemption with suitable anti-abuse protection. In our experience, such an exemption can greatly simplify compliance with CFC rules whilst not exposing territories to a significantly increased risk of BEPS.

4. **What practical problems, if any, arise when applying a low tax threshold based on an effective tax rate calculation?**

Whilst we agree with the WP that a low tax threshold exemption based on an effective tax rate calculation is appropriate for a recommended CFC regime, we should highlight how such an exemption is utilised in practice and hence the limitation of solely relying on a low tax entity exemption. Our experience is that taxpayers do not by default rely on lower level of tax exemptions even for entities located in higher tax jurisdictions. The key reason for this is the complexity that derives from the need to recompute taxable profits of every entity under the rules of the parent territory. Complexities which have to be dealt with include fiscal unities, losses (including classifying different types of loss) and timing differences. Instead of being one of the first exemptions considered by groups, it typically becomes an exemption considered for the residue of entities not exempt under another method.

In addition, the recommendation will have to conclude on how the denominator is calculated (currently considering either the parent jurisdiction’s rules or an amount computed under an international standard, with adjustments made to reflect tax base reductions that cause the CFC’s tax on the income to be low). As acknowledged in the report, not all differences between the parent and entity’s tax base computations would give rise to BEPS concerns. Therefore, strictly applying the tax principles of the parent jurisdiction in determining the income base for the ETR calculation could cause the ETR to appear low when the driver for that lower effective rate is not a tax advantage that should give rise to BEPS concerns (e.g. participation exemptions, patent box, exclusions/tax holidays based on people activities). The lack of specificity in the report on this topic and other aspects of the calculation leave room for a great deal of discretion for the adopting countries to determine how the rule should apply which, in addition to the complexity of the calculation, could lead to inconsistent results for taxpayers.

Another potential issue to be aware of with a lower level of tax threshold is that it can exacerbate competition between holding company locations – by offering a lower rate than other territories, even if based on the same percentage (i.e. 75% of a lower headline tax rate extends the competitive advantage into the CFC arena).

5. **How could these problems be addressed or mitigated?**

Whilst including a lower level of taxation exemption should certainly be recommended, a more practical form of entity exemption is a white list approach. Whilst we appreciate the need for additional criteria to ensure that such a methodology is not abused, in our experience, such an approach is much more heavily relied upon by taxpayers to eliminate from consideration low risk entities than a low tax entity exemption based on an effective tax rate. We would also note that such a list should also have a carveout for genuine economic arrangements so that it does not fall foul of EU/EEA concerns for relevant territories. We would strongly support such a proposal aimed at making the rules more effective and focused in practice.
6. **Does the discussion above correctly address the situation of permanent establishments that are subject to a different tax rate than CFCs?**

Subject to our earlier comments on the consistent application of parent territory rules, we consider that a PE which is treated as exempt from tax in the CFC jurisdiction should be considered as a separate entity for CFC purposes and hence a low level of tax test should be applied separately to the ‘head quarters’ in the CFC territory and the exempt PE.

**Chapter 4: Definition of control**

In light of the often complex ownership structures which exist in the real world, we agree with the general approach here of ensuring that a variety of tests are recommended. In particular we agree with both a legal test and an economic test. Reliance on too narrow or mechanical a set of rules may encourage behaviours aimed at circumventing the desired objectives of the CFC rules.

What we do, however, have concern over are the circumstances in which the draft recommendations give apparent approval to lowering the control threshold below 50%. Whilst we agree that it may be appropriate to aggregate ownership of related parties and also when parties are found to be acting in concert, we do not see a BEPS-related policy reason for a blanket aggregation of the ownership of unrelated parties who are not acting in concert, but who just happen to be resident in the same territory. This would put such taxpayers, who individually have no control over the actions of a CFC, at a competitive disadvantage compared with CFCs held by shareholders in different territories. Whilst we accept the draft paper notes that such tests may be to achieve “broader policy goals”, as this is a discussion of a set of CFC rules to challenge BEPS, we feel including mention of them in the recommendation is inappropriate.

7. **What practical problems, if any, arise when applying a control test?**

In the context of related parties then there should not be any significant problems applying a control test. In addition, if parties are genuinely acting in concert such that they are affecting control of a CFC, again it should be reasonably straightforward for taxpayers to self-assess their control in relevant circumstances. We would suggest that the onus should be on tax authorities to prove that parties are acting together.

We do see joint venture situations where partners are not willing to share full details of their ownership structure with JV partners and this can be a problem in identifying control.

8. **Are there particular practical problems that arise when applying a control test that considers interests held by unrelated or non-resident parties? If so, what are they, and how can they be dealt with?**

In the context of non-resident but related parties, we do not consider that there should be significant difficulties in establishing control.
In the case of unrelated parties who happen to be resident in the same territory, then for listed groups, the respective ownership of significant shareholders is frequently in the public domain. What can complicate matters, however, is identifying who exactly is the actual owner of shares from such public records (e.g. due to nominee arrangements) and then establishing where they are resident. For privately held groups, however, the information requirements can be even more burdensome and in some cases identifying precisely who else owns shares and their residence status may not be possible (e.g. if other investors refuse to share the information required to make an assessment of control).

Local legal requirements may make this measure difficult for taxpayers to comply with, eg, stifftungs, where beneficiaries may not have legal rights to understand the ownership structure.

**Chapter 5: Definition of CFC Income**

In addition to the comments made in the main body of the letter, we have the following additional comments in relation to Chapter 5.

- We recognise and appreciate the objective of the WP in seeking to identify mechanical rules where possible. We also note, however, that in the context of an international tax system where groups are becoming more skilled in undertaking functional analyses for transfer pricing purposes, proportional substance-based rules relying on transfer pricing principles may not entail excessive incremental burdens on businesses – provided they apply consistent transfer pricing principles. To have one set of functional analysis rules for transfer pricing and another for CFCs would be a huge burden for businesses and tax authorities alike. Accordingly, we would strongly recommend that the WP consider substance-based rules which leverage from existing transfer pricing functional analysis methodologies.

- We have significant concerns over the potential for an ‘excess profits’ approach to become a recommendation unless it is significantly restricted in its scope. On its own we feel it is too blunt an instrument and when combined with necessary additional substance exclusion(s) would lose the benefits of relative simplicity. Whilst we have a strong preference for the categorical approach for these reasons, a suitably restricted excess profits approach might be used as an additional exclusion to ensure that the categorical approach was in line with EU/EEA obligations where relevant – i.e. profits relating to genuine activities in the territory in question would still benefit from an exemption.

- In terms of IP income and sales income, other BEPS Actions would seem to be addressing these concerns (e.g. intangibles, CBCR, PE threshold) and it is not clear why these will not effectively tackle cases of avoidance. Therefore tackling these actions under CFC as well would seem to be an added complication. If it is thought that these other Actions will not successfully address all circumstances perhaps the CFC rules could be targeted more narrowly to avoid significant analysis being undertaken where there is no avoidance or where other rules already catch the avoidance?

- Whilst we appreciate the desire of the WP to ensure that passive, thickly capitalised financing income should be within scope, again, it is important to ensure that where a different BEPS Action (e.g. interest deductibility, hybrid
mismatch, etc) mean that the income is not deductible, this is taken into account for CFC purposes so there is no double taxation.

- Whilst we accept that the development of the digital economy has blurred the lines between certain forms of income, we do think that a form-based approach targeting types of highly mobile income streams is the most practical solution to ensuring any rules are focused on BEPS activity and do not become overly burdensome to business and tax authorities.

- We strongly believe that substance-based exclusions are not only important in the context of EU/EEA Member States, but are important in developing rules for all states interested in preventing BEPS whilst embracing international development.

- We agree with the WP’s proposal to recommend a transactional approach and not an entity-by-entity approach.

Financial Services specific comments:

There are concerning comments about the link between people activities and active business. In Financial Services business, value is a function of both people and capital, and to link the definition of active business to simply that of people (common to most of the substance analysis tests in Para. 89) does not reflect commercial reality.

We have concerns that captive reinsurance activities are again highlighted as de facto passive profit shifting activities. There are many good commercial reasons as to why an insurance group may wish to reinsure third party policies into a single location, and many good commercial and regulatory reasons as to why that group reinsurer should be located in an offshore financial centre like Bermuda, for instance regulatory capital benefits and less constrained investment rules. It is simply not true, as is suggested in Paras 102 and 103, that where a captive re/insurer does not have external business that it is engaged in profit shifting. We note that in 9 of the last 16 years, the tendency has been to shift losses from the insurer to the reinsurer, not to shift profits.

We also note that captive insurance in a non-insurance context is considered to give rise to passive income. There are often significant benefits to insuring risks in multi-national groups to a captive insurance company, including geographical diversification, better access to external insurance and a greater control over the retained risk. If you accept the premise that the risks would be externally insured anyway, there can be significant non-tax benefits to the group from pooling risks and reinsuring a portion of that risk portfolio externally. These benefits are not brought out in the paper.

There is a general concern that insurance of risks outside of the jurisdiction of residence is seen as profit shifting and to be discouraged through the use of CFC rules. In highly regulated markets, there may be significant commercial benefits to insurers being resident outside of the territory of their target markets. This may be true even in multi-jurisdictional areas with a common regulatory framework. It would be regrettable if free choice of regulatory jurisdiction were to lead to disparity in tax rates depending on where the corporate group holding company was incorporated, creating an imbalance in competition between inbound and outbound groups.

There are concerns as to how the word 'over-capitalised' might be interpreted and applied. There are a number of different potential measures of capitalisation, including regulatory, rating agency and the decisions of the managers of the business and how
prudently they want to run their business. Inconsistent interpretation and application could lead to excessive taxation through multiple layers.

There are concerns as to how the excess profits test could work in the context of insurance, which by its very nature is cyclical. Therefore, whilst over a longer period of time there is an expectation of a particular rate of return, from year to year there can be very significant swings in profitability, with some years producing significant losses whilst other years produce significant profits. The 'excess profits' proposal does not adequately consider the impact of the cyclical nature.

There are currently regulatory pressures in the financial services sector to be operating through local territory companies rather than branches. This gives the local regulator a greater level of security over the assets of that company. However, with this pressure is an additional pressure to strongly capitalise the company so as to maximise the substance of that security. Unless there is consensus over what constitutes 'over-capitalisation' there is a risk that regulated companies are going to be unfairly judged as being over-capitalised when actually it is merely responding to the desires of the local regulator.

Additionally it is not generally possible for any regulated entity to operate with the minimum regulatory capital requirement, as a cushion is needed to ensure minimum capital is maintained even after unexpected external events. This would need to be factored into any definition of over capitalisation.

In much the same way as insurers use risk centralisation and diversification vehicles, banks and other financial services sector groups employ similar strategies with their higher risk products, such as derivatives. This is often encouraged by the local regulators. This allows the bank to better manage its net risk position, and determine the level of net risk that they are prepared to accept. It would be inappropriate for this sort of vehicle to be the subject of a CFC charge unless it was significantly overcapitalised.

**EU/EEA specific comments:**

As noted in the covering letter, in relation to EU/EEA states, we are in agreement that EU/EEA law does give rise to particular restrictions on the potential application of CFC rules and we fully agree with the analysis in paragraphs 11 to 13. In paragraph 14, however, we feel that two of the bullet points may give the misleading impression as to the current state of EU jurisprudence. We presume that the OECD does not want to encourage EU/EEA Member States to implement CFC rules which ultimately are unenforceable and accordingly set out our views on these matters below.

- In the second bullet point of Paragraph 14, it is stated that applying CFC rules equally to domestic and cross border situations would mean that they cannot be inconsistent with the freedom of establishment. This is not the case. In a number of tax and non-tax cases at the CJEU it has been found that, although a law is not discriminatory between Member States, it can still constitute an unjustifiable restriction on the freedom of establishment (see, for example, Deutsche Shell GmbH v Finanzamt für Großunternehmen in Hamburg [C-293/06] and Caixabank France [C-442/02]). Even in the absence of this technical position, however, from a practical perspective, applying 'CFC' rules
in a domestic context would greatly increase the admin burden borne by businesses.

- In relation to the third bullet point, covering the concept of “partly wholly artificial”, whilst we feel this paragraph is closer to being accurate, we again consider it to be incomplete. Paragraph 81 of the decision in the Thin Cap Group Litigation case (C-524/04) indeed refers to "whether the transaction represents, in whole or in part, a purely artificial arrangement". However, paragraphs 92 and 133 of that decision in contrast use the phrase "the existence of a purely artificial arrangement". Paragraph 81 is a reference to the excess over arm’s length being a distribution or otherwise disallowed and therefore applying this in the context of a CFC should mean that no CFC apportionment should be made where profits represent the arm’s length remuneration of Significant People Functions of the CFC outside the parent jurisdiction.

9. **What are the practical problems with any of the three substance analyses set out above? How could these practical problems be dealt with?**

The main practical problems with both a substantial contribution test and a viable independent entity test are that they are both quite subjective and will potentially require significant analysis. Again, we would recommend ensuring consistency between any functional analysis required for CFC purposes and that which will be required for transfer pricing purposes to minimise complexity and burden.

If the objective is to have a more mechanical test looking at whether the CFC has sufficient employees and establishment, then this can superficially appear to be less burdensome. The main issue with the employees and establishment analysis (EEA) is, however, that determining whether activities are substantial is an inherently factual inquiry and varies by industry and company. See further discussion below regarding the “substantial contribution” rules. While the goal of the EEA test is administrative simplicity, it has the strong potential to produce the wrong results (i.e., negatively impact companies that are earning a justifiable profit) and is inconsistent with existing transfer pricing and value creation principles.

Whichever methodology to identify appropriate substance is recommended, we consider that it would be preferable to have a full exemption once a requisite threshold is reached in any recommended test. To retain proportionality, however, and to ensure EU/EEA compliance, then if the threshold test is not satisfied there should be some way to exempt the value attributable to the activities/employees in the CFC territory.

10. **Do you have experience with applying substance analyses in existing CFC rules? If so, how can these be made more mechanical while still accurately attributing income?**

As noted above, the UK have adopted several substance-based tests in their recently introduced CFC rules. Whilst the introduction of significant people functions (“SPF”) based exclusions certainly required a significant change in approach for UK groups, this should be seen in the context of a much broader education of taxpayers in terms of
transfer pricing methodologies. As SPFs are becoming a key part of transfer pricing methodology, this consistency with the CFC rules has encouraged groups to analyse their global operations on one basis, thereby making it more straightforward and cost-efficient to comply.

The US Subpart F rules contain an exception for activities that constitute a “substantial contribution” to manufacturing. Due to the factual nature of the determination and to account for differences that inherently exist in how companies conduct their operations, the US substantial contribution rules operate as guidelines which are intentionally flexible and not mechanical. To attempt to apply a mechanical rule that would not account for differences in companies’ business operations, value drivers, risk profile, industry standards, etc., would lead to a distortion of income in many cases and is not conducive to accurate income attribution.

11. How can CFC rules accurately attribute income that raises concerns about BEPS (i) in a business that is licensed under an appropriate regulatory body and is market-facing in a particular jurisdiction, (ii) in a reinsurance business carried on by a CFC of a multinational insurance group or (iii) in a “captive” insurance business of a CFC that is not part of an insurance group? Are there practical problems with current rules that distinguish between these two situations? If so, what are they and how can they be dealt with?

We consider that the UK approach is generally an acceptable one, where the question is whether the ultimate source of the risk is third party or connected party. Therefore, the reinsurance of third party business is acceptable in principle, whereas captive insurance (of UK risks) in a general corporate context is not (although please note our concerns regarding captive insurance above). There is then a secondary test whereby profits can still be caught where the capital level maintained by the insurer is excessive compared to that which might be expected in a comparable company writing insurance with third parties, or where the offshore insurance company is reliant on people working in the UK for that company. There has been significant progress with HMRC in understanding what is meant by overcapitalisation, and a variety of methodologies have been accepted, including the expectations of ratings agencies, intended short-to-medium term use for the capital (and therefore anticipated capital requirements), capitalisation relative to other companies within the group and management’s own capital management policies (i.e. insurers with very prudent capital retention policies could maintain higher levels of capital in overseas insurance companies without being overcapitalised).

12. Are there practical problems with applying the same rule to sales and services income and IP income?

Treating all sales and services income as passive income we believe would be over-inclusive as many entities earn such income without it being connected to IP, which is the concern the rule intends to address. This approach would put the burden on the taxpayer to rebut a presumption that all sales and services income is passive CFC income, which, as a practical matter, would encompass many entities in the structures of MNCs that are conducting activities that should not give rise to BEPS concerns. Such a rule would accordingly be onerous to taxpayers.
13. **Are there existing CFC rules that accurately attribute any or all of these categories of income while also reducing administrative and compliance burdens?**

Here are some examples:

UK – under the UK’s CFC rules, the effective use of threshold exemptions significantly reduces the overall administrative burden by effectively excluding many low risk entities. The more detailed ‘Gateway’ approach, which identifies different forms of income stream in higher risk entities and tests each separately is then applied. The Gateway splits income streams into: general trading (which would inter alia cover sales and service and IP income streams), finance (trading and non-trading), captive insurance and solo consolidation. The substance/SPF tests are then applied to these categories of income in proportion to their respective risks. In practice we are finding that this combination of rules is not causing a disproportionate level of compliance burden whilst at the same time effectively focusing on the higher risk areas.

US – the US rules apply an attribution approach that identifies categories of income by CFC accurately, but in conjunction with quite detailed reporting requirements, the compliance burden is high. Therefore, carve outs to CFC income, as discussed above, such as white lists and de minimis exceptions, would be helpful in reducing compliance/administrative burdens.

14. **Does the discussion above consider all categories of income that should be attributed under CFC rules?**

We feel that the categories set out are sufficient to target BEPS activities. In particular, we consider that property-based income streams such as rental income should remain outside of the scope of CFC rules due to the inherent low risk of BEPS behaviours in relation to real estate.

In relation to dividends, the paper correctly outline that different countries have different rules regarding the taxation of dividends and indeed most do now provide an exemption. It is not clear why a dividend paid out of passive income should be taxed again at the level of the receiving CFC (given that it will presumably have generally been taxed at the level of the subsidiary). Tracking good and bad income through multiple tiers of holding companies can be burdensome. Perhaps tracking could be restricted to higher risk avoidance cases.

15. **Is it clear how the two approaches above would work? If not, what further detail is required to clarify the approach?**

The categorical approach seems clear enough in general, although recommendations on the specific definitions of income to be included in each category and which categories should be treated as CFC income would be helpful to ensure consistency. The excess profits approach on the other hand inherently involves complexity and uncertainty in establishing a standard for a “normal” return, as this would vary by company and industry.

16. **What practical problems arise with applying the categorical approach and the excess profits approach?**
While the categorical approach allows for more precision in identifying income streams that pose a BEPS concern, and thus limits the risk of over-inclusion, it requires taxpayers and countries to distinguish between types of income, which can pose challenges particularly when IP is involved. However, such classification and the determination of the income in a related party context should be consistent with and supported by transfer pricing analysis which would assist and align with income categorization.

Although mechanical and, therefore, theoretically simpler, the Excess Profits Approach is quite arbitrary and also puts the burden on the taxpayer to prove that the assets are used in the active conduct of a trade. Furthermore, as described in the report, the nature of the excess return calculation seems to presume that the price paid by the CFC for the acquisition of the IP did not account for the “supernormal” returns that accrue to the IP. These aspects of the Excess Profits Approach, along with the shift away from focusing on the active nature of the activity as an exception to treatment of the income as CFC income, are distinct disadvantages of this approach.

17. **How could the practical problems be addressed or mitigated?**

See points above.

18. **Which approach is most likely to accurately attribute income that gives rise to BEPS concerns? Is one approach likely to be more effective than the other in terms of dealing with IP income?**

We consider that a categorical approach with suitable substance tests would be most appropriate in challenging BEPS behaviours. The Excess Profits Approach has a high likelihood of being over-inclusive. For the same reason, it would clearly capture more IP income. However, whether IP income in general should be treated as CFC income simply because it is taxed at a favourable rate is debatable and/or because it has a higher than “normal” return under the terms in the report, is debatable. The Discussion Draft seems to take the view that all IP income is inherently problematic if it is located in a low tax jurisdiction. However, there are certainly instances where favourable treatment of IP income should not be viewed as problematic — e.g., patent box regimes, self-developed intangibles. Therefore, a more tailored, categorical approach would be better because it is narrower in its application.

19. **Could the excess profits approach be applied to income other than IP income and what would be the practical implications of this?**

If the Excess Profits Approach were applied to other types of income as with IP the results can be arbitrary. As such, exceptions would need to be added to the rule to avoid potential double taxation and ensure the rule applies to the type of income intended to be addressed (i.e. those with specific BEPS concerns). Additionally, the “normal” return calculation would need to be tailored to address what would be considered appropriate returns for other types of income that would be covered by the expanded Excess Profits Approach rule.
20. **What other approaches could be considered for determining excess profits or excess returns?**

None noted.

21. **What difficulties or practical problems arise in applying an entity approach or a transactional approach?**

An entity approach could lead to over-inclusion. The entity approach can also lead to swamping or tainting.

A transactional approach may result in more administrative effort by companies but benefits from being proportionate. Furthermore, given that these transactions which are the focus of the CFC rules are related party cross-border transactions, reconciliation of the information reported by entities in different jurisdictions may be required to accurately analyse and report the transactional information.

A joint approach with an entity based approach (with safe harbour limits for levels of high risk income), coupled with a transactional approach where safe harbour levels are breached would allow taxpayers the best of both worlds – namely simplicity where an entity does not have significant high risk income, and proportionality where the safe harbour limits are breached.

22. **What concerns arise from the two approaches in terms of administrative burdens and compliance costs?**

We recommend a combination approach to balance the aim of challenging BEPS without introducing undue burden on businesses. For lower risk entities, an entity approach with threshold exclusions is most appropriate as a way of eliminating these from further consideration. For higher risk entities, then the increased cost of complying with transactional rules – in terms of more detailed financial analysis and complexity of rules – is, in our opinion, not excessive and is justified by the need to challenge BEPS.

23. **How could these concerns and/or practical problems be dealt with while still ensuring that the CFC rules achieve an accurate result and attribute income that raises BEPS concerns?**

As for question 22 and as noted previously, more alignment with and combining of reporting in conjunction with transfer pricing reporting could minimise the overall burden by eliminating any duplicative information gathering and reporting.

**Chapter 6: Rules for computing income**

We are in broad agreement with the draft recommendations in this Chapter. In relation to the use of losses in a CFC territory, we agree that following parent territory loss offset rules would seem reasonable, but do not see any policy reason why losses within a CFC should not be capable of being used against profits in other entities in the CFC territory, and also respect losses used in the context of fiscal unities.
24. **Do the rules on computing the income of a CFC present any difficulties in practice? If so, what are these and how could they be dealt with?**

The use of parent territory rules of computation will in practice be very familiar to the persons within a group responsible for computing any CFC income. Accordingly there should be little additional burden in relation to understanding the rules. From a policy perspective, however, applying the law of the parent jurisdiction presumes that the primary concern is erosion of the parent jurisdiction’s tax base. As noted above, such an approach may not account for differences in the computation in the CFC’s and parent’s tax bases that do not give rise to BEPS concerns. Exceptions to limit double taxation in these situations would need to be implemented in conjunction with this rule.

A practical difficulty may arise where multiple entities are in a CFC territory and where that territory allows for fiscal consolidation or group relief of losses. Here if the parent territory rules do not, a CFC charge could arise by virtue of having more than one entity in a territory when there is no overall profit. This would seem to give unfair results where the existence of more than one entity in the CFC territory does not have a tax avoidance motive.

The other practical difficulty we see in existing CFC regimes which adopt this approach is in obtaining information. Whilst high level accounting information is typically straightforward to obtain, the complexity arises when trying to adjust the CFC local GAAP profits into parent territory taxable profits. This usually occurs because the local accounting systems have not been configured to allow easy identification of adjusting items and also because non-accounting based items (e.g. values of assets for tax depreciation rules) may require detailed analysis to determine values. The former issue can be dealt with by appropriate accounting system configuration (which could be justified if regular CFC apportionments of the same income are required). The latter item requires the parent territory CFC rules to include sensible valuation methods to establish tax values in the first year of apportionment – accepting that it is unreasonable to expect a taxpayer to recreate the entire history of ownership of assets for a purpose that was never anticipated.

25. **Does this chapter accurately reflect the issues that could arise with losses or are there any other situations that need to be considered?**

No additional situations noted. We do have concerns over the potential recommendation of a rule to prevent loss offset against "bad" income within a CFC territory. This would seem to be unfair/ disproportionate if such relief would have been available if the income was earned in the parent territory. The mitigation proposed (carry forward/ carry back) would only help if the losses were indeed utilised and certainly would not alter significant potential timing disadvantages with tax being paid in year 1 and mitigation for a loss of the same year not being available for potentially many years to come (or indeed potentially ever).

**Chapter 7: Rules for attributing income**

We are again in broad agreement with the recommendation of the WP in this Chapter. Our only proviso is to reiterate the point made above in relation to Chapter 4; we see no BEPS policy reason why unrelated parties who are not acting in concert should satisfy the
control definition and accordingly do not consider it appropriate for income to be attributed to shareholders in such circumstances.

26. What difficulties, if any, arise under existing CFC provisions for attributing income?

Under US Subpart F rules, income is attributed to shareholders based on their relative ownership percentages in the CFC stock. Because the US employs a foreign tax credit system to alleviate double taxation, the attribution of income based on stock ownership and treatment of that income as a deemed dividend to the shareholder allows the shareholder the opportunity to mitigate double taxation with the foreign tax credits associated with the dividend. If a transactional approach to CFC rules were taken, rather than an entity approach as is currently the case in the US Subpart F rules, consideration would need to be given as to how the CFC income would be attributed to the parent and how it should be treated (i.e., deemed dividend or earned by the parent) to ensure double taxation can be mitigated.

27. Does the description of a top-up tax set out all the advantages and disadvantages of such an approach?

The description appears to fairly capture the advantages and disadvantages of a top-up tax.

Chapter 8: Rules to prevent or eliminate double taxation

28. Are there any other double taxation issues that arise in the context of CFC rules that are not dealt with here?

The proposed recommendations do not seem to consider the CFC rules of countries who do not adopt the proposals of paragraphs 154-155 where such entities exist in the ownership chain. This gives the possibility of double taxation.

29. What administrative or practical difficulties arise currently in respect of double tax relief rules and how could these be mitigated or dealt with?

Generally speaking, we find that the parent territories’ double tax relief rules, applied with suitable contextual changes, are not unduly burdensome in this context. The complexity and administrative work related to the computational and information tracking aspects of the US foreign tax credit computation, however, seem to generally outweigh the exemption system used by many countries. If the proposed CFC recommendations are enacted in a way that, as noted above, results in the same CFC income being subjected to tax by more than one jurisdiction, then the complexities of a foreign tax credit computation could be exacerbated. An exemption approach for taxes imposed under other countries’ CFC rules may be a simpler approach.