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BEPS Action 3 Missing in Action: CFC Rules or Global Formulary Apportionment?

The author provides observations and clarifications on the most notable public policy issues—from an international tax perspective—arising from the Organization for Economic Cooperation and Development’s public discussion draft under BEPS Action 3, which covers strengthening rules on controlled foreign corporations.



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The Organization for Economic Cooperation and Development’s discussion draft on strengthening the rules for controlled foreign companies, released April 3, highlights numerous policy considerations and discusses the building blocks—as they are referred to by the OECD—for designing and imple-

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menting effective CFC rules.¹

‘Less than Single Taxation’

The OECD suggests in paragraph 8 of the draft that countries with CFC rules are put at a competitive disadvantage relative to jurisdictions without CFC rules. But this is only a rhetorical starting point to a more profound malaise that has accompanied the OECD member countries for more than 30 years. The draft seems to imply that countries with a “tax mix” that is different from that of industrialized countries should be admonished for their unwillingness to increase the burden on their taxpayers.

This general assertion in the CFC draft of “striking a balance between taxing foreign income and maintaining competitiveness” is aligned with the notion of “less than single taxation” that can be found in the OECD’s

¹ The draft, issued under Action 3 of the OECD’s Action Plan on Base Erosion and Profit Shifting (BEPS), is available at 23 *Transfer Pricing Report* 1586, 4/16/15.

BEPS action plan.² Historically, this somewhat derogatory idea is based on the interests of the industrialized countries. It asserts that taxation other than that imposed at high effective rates is less than single taxation. This notion has been conveyed in one form or another in multiple OECD reports released through the years.³

For example, the 1998 OECD report on harmful tax competition criticized the preferential tax regimes for their inclination to attract “economic activities which can be most easily shifted in response to tax differentials, generally financial and other service activities.”⁴ Behind this criticism was the notion that a low effective corporate tax rate is, by definition, harmful to countries that perpetuate high effective corporate tax rates such as the industrialized countries.

Previously, the 1986 report on base companies condemned the use of entities “predominantly situated in low tax countries” and “used for the purposes of sheltering income there and thus reducing taxes in the home country”—that is, an industrialized country—“of the taxpayer.”⁵ This time, it was the corresponding notion that a taxpayer may arrange its affairs to legally minimize its tax burden that was challenged, in spite of the case law on the subject globally.

The CFC draft is rife with the notion that there may not be sufficient CFC taxation under existing rules, a fact that leads to BEPS. Specifically, Chapter 3 of the draft raises the concept of a “low effective tax rate” that would act as a threshold to apply effective CFC rules. This is not a de minimis threshold, contrary to the OECD’s contention in the CFC draft. This bottom-line-driven approach goes against every jurisprudential and legal trend that has recognized the right of a taxpayer to legally minimize its tax burden.

Paragraph 42 of the CFC draft suggests that the scope of the CFC rules be limited to exclude companies that are “likely to pose little risk of base erosion and profit shifting.” In itself, this methodological approach is a concern. The recent public discussion draft issued under BEPS Action 11, on improving the analysis of BEPS,⁶ demonstrates that it is impossible to differentiate commercially based activities from tax-based activities with any sort of accuracy or objectivity.

To use the concepts outlined in the Action 3 draft to lay the foundation for an international set of CFC rules is ludicrous. Doing so would create an incredible number of disputes and a considerable level of uncertainty. Although tax is a social phenomenon and politically driven to some extent, tax law and international tax principles should not rest on the partisan consider-

ations and interests of the industrialized countries at the expense of the developing countries and the business community. The “low-(effective) tax threshold” proposed in Chapter 3 of the CFC draft is another iteration of the “less than single taxation” concept that should be condemned for its partiality toward industrialized countries.

Global CFC Rules— Or Formulary Apportionment 2.0?

To resolve this “less than single taxation” issue, the CFC draft indicates in paragraph 10 that “countries working collectively and adopting similar rules could reduce the competitiveness concerns.” Playing devil’s advocate, how is that cooperation expected to successfully unfold? Obviously, constant tax bases, identical tax mixes and equal tax rates across every country are out of the question. This then leaves the prospect of a new international system in which each state, for the common international taxation good, would willingly participate in designing, implementing and obeying similar CFC rules.

But the OECD member countries already have argued at great length that some types of internationally based tax systems, such as global formulary apportionment, are not feasible. Among the specific concerns that have been raised by OECD member countries are protection against double taxation, ensuring (once again) single taxation from industrialized countries and achieving consensus on the formula to be used. Moreover, according to the OECD, implementing any formula-driven international tax system would require “a level of international cooperation that is unrealistic to expect in the field of international taxation” and likely would entail “intolerable compliance costs and data requirements” for the taxpayers.⁷ The OECD candidly explains that each country “would have a strong incentive to devise formulae or formula weights that would maximise that country’s own revenue.”⁸ How is this different from the actual design of CFC rules focused on the interests of industrialized countries?

This latest complaint of the OECD on the compliance costs related to the feasibility of global formulary apportionment also is found in the CFC draft as the third policy consideration. The striking similarity between the alleged shortcomings of global formulary apportionment and the purported limitations of CFC rules is remarkable. The CFC draft explains in paragraph 15 that “although one of the benefits of CFC rules can be their relatively mechanical application, CFC rules that are entirely mechanical may not be as effective as rules that allow more flexibility.” This sounds like a criticism of global formulary apportionment.

Discussion of Control

The discussion in Chapter 4 of the CFC draft, on the definition of control, also is troubling. Paragraph 67 says that “legal control is a relatively mechanical test that is easy for both tax administrations and taxpayers to apply”—a statement that is misleading at best. Any

² OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, p. 10 (OECD version). The action plan is available at 22 *Transfer Pricing Report* 379, 7/25/13. For the OECD version, see <http://www.oecd.org/ctp/BEPSActionPlan.pdf>.

³ See (in reverse chronological order) OECD, *Harmful Tax Competition—An Emerging Global Issue*, 4/9/98; OECD, *Double Taxation Conventions and the Use of Base Companies*, OECD Council, 11/27/86; OECD, *Double Taxation Conventions and the Use of Conduit Companies*, OECD Council, 11/27/86; and OECD, *Thin Capitalisation*, OECD Council, 11/26/86.

⁴ See OECD, *Harmful Tax Competition—An Emerging Global Issue*, 4/9/98, para. 58.

⁵ OECD, *Double Taxation Conventions and the Use of Base Companies*, OECD Council, 11/27/86, para. 1.

⁶ “BEPS Action 11: Improving the Analysis of BEPS,” 4/16/15, available at [http://op.bna.com/ITDTR.nsf/id/mmos-9w2lyb/\\$File/BEPSAction11.pdf](http://op.bna.com/ITDTR.nsf/id/mmos-9w2lyb/$File/BEPSAction11.pdf).

⁷ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, paras. 1.24 and 1.27.

⁸ See note above, para. 1.23.

CFC practitioner will attest that legal control is far from a black-and-white issue in international taxation, and that existing domestic CFC regimes around the world are becoming ever more complex.

The CFC draft also highlights the possible use of economic control and de facto control to apply the CFC rules. Any transfer pricing practitioner will recognize that these two tests are driven mostly by the functional analysis of the multinational group—another process that is not as black and white as the draft would have one believe. A fourth possible test relates to control based on consolidation, an accounting procedure.

In spite of these similarities to global formulary apportionment, paragraph 68 concludes that legal and economic control tests are “reasonably mechanical and so should limit the administrative and compliance burden involved.” On the one hand, the author certainly would object to the alleged administrative and compliance “lightness” of these tests—based on professional experience as well as the OECD’s views on the feasibility of global formulary apportionment. On the other hand, the notion that any type of functional analysis is mechanical is completely unsubstantiated. These declarations cannot be supported by past OECD positions or the reality of international taxation in the 21st century. It is indeed curious to find these in a document that aims to supplement the existing rules and principles of the international tax regime.

Sales and Services, Royalties

The discussion in Chapter 5 of the CFC draft on the definition of income also is surprising. Paragraph 84 suggests that sales and services income and royalties and other intellectual property income may be included in the computation of CFC income. Paragraph 85 of the draft indicates that CFC rules would apply “within each category” on income that “raises BEPS issues.” However, as in the aforementioned public discussion draft on BEPS Action 11,⁹ the noticeable problem with that one-size-fits-all approach is the practical impossibility of differentiating between commercial purpose and tax purpose in any given transaction without the interference of the tax administration.

In a bid to circumvent that very issue, the CFC draft attaches importance to the substance analysis. In some ways, this test can be seen as some type of functional analysis. But the wording used in paragraph 89 of the draft also echoes global formulary apportionment literature on the definition of the unitary business and the design of the apportioning mechanism.¹⁰

Employee Head Count

Three options are briefly reviewed in the CFC draft: substantial contribution analysis, viable independent entity analysis, and employees and establishment analysis.

⁹ See note 6, above.

¹⁰ See, for example, Ana Agundez-Garcia (2006), “The Delineation and Apportionment of an EU-Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: A Review of Issues and Options,” Paper No. 9, European Commission Taxation, Brussels, Belgium, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_09_complete_en.pdf.

The philosophical precept behind these frameworks also is similar to the general framework put forward by the public discussion draft on the use of profit splits in the context of global value chains, which basically reduces the analysis of the contributions of the parties to value creation to the employee head count.¹¹ The reference in paragraph 92 of the CFC draft to the authorized OECD approach¹² should not deceive the reader into thinking that any semblance of functional analysis based on the arm’s-length principle ultimately is envisioned. As indicated in the same paragraph, “it requires a fact-intensive analysis involving an element of judgment, which would increase administrative complexity and compliance costs and may lead to uncertainty.” Therefore, the CFC draft leaves little doubt that mechanical processes are preferred over any other possible approaches, including any type of functional analysis.

Coming back to the relevance of sales and services income and royalties and other IP income in the CFC income determination, paragraphs 105-110 send an alarming message about the future of the arm’s-length principle in international taxation. For instance, paragraph 106 states that these streams of business income should be included in CFC income provided that the “CFC lacked the substance to earn the income itself.”

IP Income

IP income, as a legitimate business income stream, also gets a bad name in the CFC draft. Based on the discussion in Chapter 5 of the draft, IP income is indeed the black sheep for CFC rules purposes. The argument in paragraphs 107-110 that both form-based and substance-based analyses may be circumvented by manipulation is, in the author’s view, absurd. As a corollary, to suggest from an economic perspective that income deriving from any IP is passive in nature is disingenuous. It illustrates a discourse focused on the agenda of the industrialized countries. On that specific matter, the description of the excess profits approach in paragraphs 117-125 ends with something that bears a striking resemblance to formulary apportionment: a “mechanical approach” based on a “normal return” with fixed formulaic metrics based on “economic studies.”

In a highly integrated world, where even arm’s-length parties regularly enter into partnerships, joint ventures and other types of commercial associations to do business, this reflects a crude understanding of the activities of a multinational enterprise. It also reverts back to the practical impossibility of distinguishing tax purposes from commercial purposes. In short, the CFC draft is running in circles on that matter.

Tax Rules as a Deterrent

Paragraph 7 of the CFC draft indicates that CFC rules typically are used to “prevent shifting income ei-

¹¹ OECD public discussion draft on BEPS Action 10 (available at 23 *Transfer Pricing Report* 1170, 1/8/15), para 38. The RACI model describes the roles of participants based on who is “responsible, accountable, consulted and informed” for each task in a business process or project.

¹² OECD (2010), Report on the Attribution of Profits to Permanent Establishments. See <http://www.oecd.org/tax/transfer-pricing/45689524.pdf>.

ther from the parent jurisdiction or from the parent and other tax jurisdiction.” They chiefly act as an anti-avoidance tool for tax administrations, according to paragraph 16 of the draft. Few, if any, would challenge this view with respect to CFC rules. It echoes the general intent of CFC rules around the world that, however, typically exempt business income from their scope.

As such, the discussion on the interaction between CFC rules and transfer pricing in paragraphs 21-28 of the CFC draft does not go unnoticed. Although never specifically mentioned, it is the relationship between the arm’s-length principle and CFC rules that is highlighted in that section. Paragraph 21 explains that transfer pricing rules are meant to restore “the taxing rights of all jurisdictions involved” in any type of controlled transactions. Remarkably, the draft posit that the arm’s-length principle “often achieves this objective by deterring business from entering into certain arrangements.”

This view of the arm’s-length principle could hardly be further from its true meaning. On the one hand, it implicitly suggests that the recharacterization process included in the OECD transfer pricing guidelines¹³ is the norm instead of the exception. This view is contrary to the intent of that controversial and litigious process. Even the non-recognition section in the OECD public discussion draft on risk, recharacterization and special measures¹⁴ does not institute the recharacterization process as a norm in international taxation.

As a side note, one might make a case that the U.K.’s new diverted profits tax that came into force on April 1 reveals the beginning of a new trend on that matter, especially if the joint working group piloted by Australia and the U.K. through the Group of 20 countries—to further consider the diverted profits tax—gets off the ground.¹⁵ But this philosophical shift in international taxation motivated by the non-recognition or recharacterization of legitimate commercial transactions would undermine seriously the viability of the arm’s-length principle, which is based on the freedom of contract that is the core of modern open economies. All this to say that recharacterization remains an exceptional process, not the norm, in international taxation, contrary to the claim in the CFC draft.

On the other hand, suggesting that the arm’s-length principle acts as a deterrent basically reduces it to an international taxation watchdog. The author suggest that the near century-long development of the arm’s-length principle by the League of Nations and, thereafter by the OECD member countries, has been motivated by a willingness to enable economic growth in an increasingly international world, not to generate deterrence. This curious interpretation with respect to the significance of the arm’s-length principle clearly goes against almost a century of development in international taxation.

On a related topic, paragraph 21 of the CFC draft suggests that CFC rules do not supplement transfer pricing rules for domestic taxation purposes. A technical argument can indeed be raised on this matter, as

¹³ OECD guidelines, paras. 1.64 - 1.69.

¹⁴ Available at 23 *Transfer Pricing Report* 1170, 1/8/15; see, specifically, section D.4.

¹⁵ See “UK and Australia agree to collaborate on multinational tax,” available at <http://jbh.ministers.treasury.gov.au/media-release/030-2015/>.

both sets of rules, at least theoretically, are not meant to apply to similar income sources. But in the end, it is the characterization or recharacterization of the income source by the tax administration that renders conceivable the application of one or the other set of rules—and, in some cases, both sets. In short, this perceived lack of coordination between transfer pricing and CFC rules does not hinder tax administrations in their attempt to cover all bases whether through the audit process or in tax court. Paragraph 28 of the draft reiterates this imperfect overlapping of the rules to the dismay of industrialized countries.

All these higher-level considerations lead the OECD into surprisingly dangerous international tax territories. Indeed, paragraph 23 of the CFC draft states that the type of CFC rules that would “most effectively replace transfer pricing rules for transactions within the same control group would be a full-inclusion system.” In its most basic form, a full-inclusion system entails simply unilateral taxation by each tax administration where there is no exemption for income arising from economic activity undertaken by the CFC. It creates plain vanilla double taxation. Paragraphs 24-27 of the draft go down that very slippery slope but abruptly conclude that even this international tax regime would not “capture transfer pricing or arbitrage transactions between related parties that are not in the same control group.”

What is worrisome from a public policy perspective, and even more so when one considers the health of the international tax regime, is that this type of mix of international taxation and protectionist thinking, which is reminiscent of the 19th century, has made its way into a 2015 draft on the alleged BEPS phenomenon. The intellectual connection with the burgeoning diverted profits tax initiative becomes obvious. Industrialized countries now are creating a new discussion space parallel to the OECD BEPS initiative. But recently, the OECD committed significant resources to recruiting developing countries to its BEPS work, which effort culminated in a series of regional meetings.¹⁶ How is that for international tax policy coherence?

Conclusion

To any poker player, the CFC draft is full of noteworthy “tells.” It is clear from the general wording of the draft that it is meant to enable industrialized countries to increase their taxation rights on multinational profits. As discussed above, this draft reveals an intention to replace the arm’s-length principle with various methods of mechanical analysis for the determination of transfer prices.

¹⁶ See OECD, “A Report to G20 Development Working Group on the Impact of BEPS in Developing Countries,” July, August 2014. Part 1 of the OECD report is available at <http://www.oecd.org/ctp/tax-global/part-1-of-report-to-g20-dwg-on-the-impact-of-beeps-in-low-income-countries.pdf>; Part 2 is available at <http://www.oecd.org/ctp/tax-global/part-2-of-report-to-g20-dwg-on-the-impact-of-beeps-in-low-income-countries.pdf>, and OECD, “The BEPS Project and Developing Countries: from Consultation to Participation” (November 2014). The regional meetings took place Dec. 10-12, 2014 (strategic dialogue and workshop); Feb. 12-13, 2015 (Asia); Feb. 26-27 (Latin America); Feb. 27, 2015 (Centre de Rencontre des Administrations Fiscales, or CREDAF—an organization of Francophone African nations); March 5-6, 2015 (Eurasia); and March 16-17, 2015 (global meeting).

The reader nonetheless may find some comfort in the fact that the “document does not necessarily reflect consensus views of either the Committee of Fiscal Affairs or of Working Party 11 regarding the issues it ad-

resses.”¹⁷ This may explain the action of some countries. What else can justify, for example, the unilateral design of the diverted profits tax schemes in spite of the ongoing BEPS initiative?

¹⁷ CFC discussion draft, note 1, above, p. 3 (OECD version).