International Chamber of Commerce
The world business organization

ICC Policy Statement

ICC Statement on Controlled Foreign Corporations (CFC) Rules

Prepared by the Task Force on CFC legislation

Introduction

The objective of this policy statement is to draw the attention of domestic and international tax policy makers to the problems created for enterprises engaged in cross-border activities by the application of a variety of country specific Controlled Foreign Corporations Rules (CFC rules).

Globalisation has led to a tremendous increase in foreign direct investment worldwide in the last two decades. Many countries have removed or reduced barriers to the free flow of capital and investment. The number of companies having foreign entities has grown considerably and amounts to over 65,000 transnational corporations which themselves have more than 850,000 affiliates abroad. These developments have improved the functioning of the economies in all countries and have enhanced the possibilities for improving welfare and the economic conditions for the broader public.

However, in parallel with this development, we have also witnessed the proliferation of rules directed against tax avoidance and evasion: general anti-abuse clauses in domestic law, anti-avoidance rules in bilateral tax treaties, or specific domestic rules designed to counteract transactions considered as abusive, such as CFC rules. The US introduced CFC as subpart F rules in 1962, and in particular in the last decade, an important number of other countries followed and created their own CFC rules.

CFC rules hinder international exchanges

CFC legislation can be broadly defined as a technical provision that allows the shareholder's country of residence, to tax on a current basis, the income produced by a foreign company which is controlled by the shareholder. CFC rules apply to individuals and corporations as shareholders with a controlling interest. In principle, double taxation is avoided by a tax credit for taxes paid abroad.

Depending on how the CFC rules are designed and implemented, these rules will pose a hindrance to the free movement of capital. Multinational enterprises (MNEs) risk being confronted with a number of country specific CFC rules and conflicting requirements. The owners of companies in the same country may face very different taxation rules depending on where their business is carried out.

The reasons for the introduction of CFC rules vary. CFC legislation in some countries is implemented as a provision to ensure that capital export neutrality (CEN) is achieved (i.e. income from foreign operation shall be taxed the same way as domestic income). However, in an increasingly economically integrated world, capital import neutrality (CIN, i.e. foreign income shall be taxed in the foreign state according to domestic rules) will become more and more important to ensure overall economic efficiency and to improve the competitiveness of enterprises with international activities.

ICC position: CFC rules may considerably hinder international exchanges, in particular for MNEs. The price for the protection of the national tax base is a loss of economic efficiency for that country in the longer term. ICC therefore believes that governments must carefully weigh the short-term advantages of CFC rules against competitive disadvantages in terms of location for business

and for its enterprises operating abroad. It is generally recognized that the arm's length principle in transfer pricing is an effective measure to protect the national tax base.

Entity versus transactional approach

National CFC rules vary considerably. As far as the common features of CFC legislation implemented in the OECD countries are concerned, they can be classified essentially under two different models:
- Transactional approach
- Entity or jurisdictional approach.

Under the transactional approach, the tax characterization of income attributed to resident shareholders depends on the type of income. Usually, passive income is considered as "tainted". The entity approach provides for the imputation of the total amount of income earned by the CFC in a given jurisdiction. This "all-or-nothing" effect is seen as one of the weaknesses of the entity approach.

ICC position: In order to make sure that double taxation is avoided in practice (by domestic rules or tax treaties) CFC rules which are based on an entity approach must always provide for a clause under which a foreign company can be excluded from the application of the CFC legislation if it carries out a real business activity. Under such an approach, the overall business activity must be taken into consideration. The notion of real business activity should not be limited to industrial or commercial activities, but also include financial or holding activities as an integrated part of multinational corporations. Furthermore, it is very important that the rules for determining whether certain activities may render an enterprise subject to CFC legislation are clearly specified, practicable and transparent. The method of doing business may not have an impact in this respect. Business carried out through the Internet should not be regarded as generating "tainted" income.

Identification of low tax regimes

CFC rules generally provide that the income produced by controlled foreign companies which is subject to a lower tax rate in their country compared to the tax rate applicable to the resident shareholders, or which benefits from a favorable foreign tax treatment, will be classified as CFC income.

Within a CFC context, jurisdictions may be classified as follows:
- a designated list of countries that are excluded from ("a white list") or are included in the CFC legislation ("black list"), based on criteria which are considered as "acceptable" in the former, or as "harmful" in the latter case.
- a comparative approach, according to wh ich the CFC legislation will apply to certain items of income where the amount of taxes paid by the CFC is less than a specified rate or amount. For this purpose, withholding taxes on interests, dividends and royalties must also be taken into account.

ICC position: The identification of low tax regimes or low tax income is a crucial issue for the application of CFC rules. ICC urges governments to give careful consideration to the selection of criteria on the basis of which such identification is made. It must also be made sure that the criteria are applied in a non-

discriminatory manner.

Relationship with "harmful" tax competition

The OECD Report of 1998 on Harmful Tax Competition recommended the introduction of CFC rules as means of curbing harmful tax practices. The fact is, however, that CFC rules go in many cases much further. Since CFC income is attributed to the shareholder and taxed in its country of residence, CFC rules tend to totally negate the effects of international tax competition. There is a widespread consensus that competition among countries in the field of taxation is necessary and healthy. Based on generally accepted criteria, a tax regime shall not be considered as harmful if it is transparent and if sufficient information is available. When the OECD comes to the conclusion that these conditions are fulfilled, CFC rules are no longer justified and should not be applied.

ICC position: The international business community is convinced that international tax competition contributes to enhancing economic efficiency. ICC is strictly against any attempts to harmonize tax burdens or tax systems on a world-wide scale. On the other hand, governments should refrain from applying domestic CFC rules when a foreign tax regime is considered transparent and an effective international exchange of information is possible. This would exclude the application of CFC rules to regimes that are not considered harmful.

Conflicts between CFC legislation and international obligations

There can be a number of conflicts between a CFC legislation and international obligations of a country. Such conflicts may arise in particular from international tax treaties or from the obligations as a member in an economic organization, such as the European Union.

The superiority of international over domestic law is established as a principle in many countries. In such case, domestic law may not override engagements resulting from international conventions. In other countries, domestic law passed after the entry into force of international agreements takes precedence. But even if the principle of superiority of international law is not acceptable for a country, all countries are obliged to respect their international engagements (pacta sunt servanda - international customary law and Vienna Convention on the law of treaties).

Compatibility with tax treaties

The question of whether CFC rules must be compatible with international tax treaties has been a subject of debate for many years. Although the commentaries to the OECD model tax convention speak in favour of a position under which CFC rules are regarded as independent from tax treaties, the arguments brought forward for such a position are rather formalistic and seem to be contrary to the general principles underlying the OECD model and the spirit of tax treaties. For these reasons, an increasing number of OECD Members do not support the views expressed in the OECD commentaries regarding the relationship between CFC and tax treaties. On the other hand, there is consensus that countries may agree on tax treaty clauses allowing them in clearly specified situations to exclude certain kinds of income or certain entities from the advantages of the tax treaty (e.g. limitation of benefits clauses).

ICC position: The international business community is of the view that if a

country has the intention to limit the scope of its conventional obligations by domestic CFC rules, it can do so only if its tax treaty partners agree. In no case shall it be done if the CFC rules would be in conflict with the wording or the intentions of a treaty partner in the (former) negotiations. Countries that consider the introduction, extension or application of CFC rules must in all cases inform their treaty partners and provide for the necessary adjustments in the tax treaties.

Compatibility with the treaty of the European Union

The question of whether CFC rules may be in conflict with the obligations resulting for members of an economic organization, and in particular the European Union, is also under debate. A number of EU countries already take this view and limit their CFC rules to countries outside the Union. From an economic point of view, it is clear that the use of CFC legislation is an obstacle to the objective of creating a single market. It is also evident that CFC rules can impede the free flow of persons, capital and services, and that they may affect the right of establishment.

ICC position: ICC is of the view that CFC rules and their application must be compatible with the rules and objectives governing regional organizations. Particularly within the European Union, CFC rules are no longer justified (Code of conduct) and must be abolished in order to preserve the freedoms guaranteed by the EC Treaty of the European Union. From an economic point of view, CFC rules are clearly an obstacle to the objective of creating a single market.

Conclusions

ICC has come to the conclusion that the advantages of CFC measures must be carefully weighed against their disadvantages, such as the loss of international competitivene ss and negative effects on the overall economic efficiency of a country.

ICC sees in particular the following dangers for enterprises with international business activities:
- The proliferation of national CFC rules increases the risk of conflicting taxation claims;
- Conflicting CFC approaches and local requirements, together with anti-abuse clauses in tax treaties, lead to uncertainty for international business, and in particular for multinational enterprises active in a large number of countries;
- Documentation requirements resulting from national CFC rules constitute a heavy burden on international business, in particular if enterprises are obliged to justify their business structures;
- CFC rules tend to reduce sound tax competition and have a negative effect on the competitive position of a business location as such, or on the enterprises doing international business from that location.

For these reasons ICC recommends that:

- CFC legislation should in no case apply to enterprises that carry out real business activities in a low tax jurisdiction, which is transparent and provides for an effective exchange of information;
- CFC legislation must be clear, practicable and transparent and should not be discriminatory;
- CFC legislation has to always be in line with obligations resulting from tax treaties and from membership in a regional organization, such as the European Union;

- CFC legislation shall be used as a last resort only by countries to counteract purely tax driven transactions that are not part of a normal business;
- where a tax treaty exists, clearly defined anti-abuse provision should be put in the tax treaty; and
- CFC legislation may in no case be used as means for reintroducing restrictions to the free flow of capital or investments.

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17 September 2003

Document 180-52/1rev.2Final