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STRENGTHENING CFC RULES: OECD PUBLIC DISCUSSION DRAFT

ICAEW welcomes the opportunity to comment on the public discussion draft *Strengthening CFC rules* published by OECD on 3 April 2015.

This response of 1 May 2015 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

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INTRODUCTION

1. We welcome the opportunity to comment on the public discussion draft Strengthening CFC rules published by OECD on 3 April 2015.

GENERAL COMMENTS

Overall comment

2. The CFC rules of a parent company/entity jurisdiction should not seek to tax the activities of overseas controlled companies/entities where (1) there are genuine economic activities in the overseas territories and (2) within an EU context those activities are not wholly artificial; the latter concept is important and should not be confused with a balanced application of taxing rights, which is a separate concept. We comment separately on these EU issues in paragraphs 6 to 13 below

Definition of CFC income

3. We think that the success, or otherwise, of the ultimate OECD recommendations on CFCs will depend on the definition of CFC income. It is accepted in paragraph 83 that full inclusion and excessively broad partial inclusion systems go beyond what is necessary to prevent BEPS and may ultimately impact negatively on international trade and growth. We believe that the objective of CFC rules should be to seek to tax activities in the territories where there are genuine economic activities.

Countries taking unilateral action

4. We are concerned that if a number of the 62 countries now engaged in the BEPS Action Plan decided to take unilateral action, as the UK has done with its Diverted Profits Tax, which Australia may also now introduce when it announces its Budget on 11 May this could lead to disastrous confusion and a serious undermining of the BEPS project which is supposed to create international coordination and a collective approach to international tax recalibration.

CFC rules should not be asymmetric

5. If a CFC makes a profit, then a loss and then a profit in three succeeding accounting periods then any CFC rules should take into account the intervening loss in determining what element of the second profit, in the third accounting period, should be attributed to the “parent” company.

CFC rules applied to EU Member States (MSs) must comply with the judgments of the Court of Justice of the European Union (CJEU)

6. In the rest of this submission we present an analysis of CJEU judgments as it will be important to ensure that the final recommendations of OECD are compliant with EU law and can, potentially, be adopted by the 28 EU Member States.

7. The need to comply with the judgments of the CJEU is recognised at paragraph 11 of the discussion draft:

“…it is generally acknowledged that the European Court of Justice’s case law imposes limitations on CFC rules that apply within the EU (European Union).”

8. We have some concerns with the analysis of the CJEU judgments in the subsequent paragraphs of the discussion draft.

9. The Thin Cap Group Litigation and SGI cases mentioned at bullet points 3 and 4 in paragraph 14 were in relation to transfer pricing and not CFCs. There is a distinction as to the application of the wholly artificial concept for CFCs (under Cadbury Schweppes) and a balanced allocation of taxing rights in relation to transfer pricing.

10. We also do not believe that the final statement in the second bullet point of paragraph 14 is correct “if a CFC rules treats domestic subsidiaries the same as cross-border subsidiaries, it arguably should not be treated as discriminatory under the case law of the ECJ (sic)” and footnote 10 cites the legislation in Denmark. Our reason for this is because in the CJEU’s Cadbury decision, the Court compared the position of subsidiaries established in different MSs, and not just Irish versus domestic subsidiaries.

11. Moreover, Deutsche Shell shows that the restriction of forex losses with regard to a Permanent Establishment in another Member State was an unlawful restriction on Freedom of Establishment even where there could be no domestic comparator, as German law prohibited accounting for German operations in anything other than the D-mark. So extending CFC to domestic subsidiaries may still be an impermissible restriction even though no longer discriminatory.

12. To summarise, in Cadbury Schweppes the CJEU used a second comparison of Irish subs (held to be a CFC) compared with Dutch subsidiaries, which were not CFCs (because they did not benefit from a low tax rate), so the discussion draft does not take into account either the Deutsche Shell restriction case or the second comparison in the Cadbury Schweppes case even though quoted in paragraph 14.

13. We do have more sympathy with the Thin Cap GLO comment, but we believe it is incomplete. Paragraph 81 which is quoted in the text does indeed state that the Court should determine "whether the transaction represents, in whole or in part, a purely artificial arrangement". But paragraphs 92 and 133 use the phrase "the existence of a purely artificial arrangement". Paragraph 81 is of course a reference to the excess over arm's length being a distribution or otherwise disallowed, so it is understandable that the CJEI in this context refers to the transaction being “in whole or part, a purely artificial arrangement” .

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax).