# Key Corporate Tax Haven Indicators

## Haven Indicator 19:

## Controlled Foreign Company Rules

### What is measured?

This indicator assesses whether jurisdictions apply robust non-transactional controlled foreign company (CFC) rules. CFC rules are a type of specific anti-avoidance rules that target particular taxpayers or transactions. Like other types of specific anti-avoidance rules, CFC rules are more effective than general anti-avoidance rules in capturing the specific type of tax avoidance on which they focus.[1] The rules clamp down on tax avoidance by residents who divert income to their companies in low or no-tax jurisdictions. CFC rules aim to prevent the sheltering of income in controlled companies based in low or no-tax jurisdictions. All use the same mechanism: "The pro rata shares of undistributed income of the CFC, in whole or in part, is attributed to and included in the income of the resident taxpayer who holds an interest in the CFC".[2]

There are two types of CFC rules:

1. Non-transactional type of rules are applied based on an analysis of categories of income (e.g. passive income);

2. Transaction-based rules allow profits to be attributed to the CFC on a transactional basis using the arm's length principle, e.g. OECD Transfer Pricing Guidelines.

Transaction-based CFC rules are much harder to enforce than non-transaction-based rules because of the many different, and sometimes conflicting, ways to implement and interpret the Organisation for Economic Co-operation and Development (OECD) transfer pricing rules. To administer transaction-based rules, the burden of proof is on the tax administrations to justify applying the CFC rules on each individual transaction. In contrast, under non-transaction-based CFC rules, the burden of proof to justify each transaction within the scope of the CFC rules would normally fall on the taxpayer.

A haven score of 100 is given if there are no CFC rules whatsoever in the jurisdiction. In cases where there are CFC rules, but these are only transactional-based type of rules, the haven score is reduced to 75. A zero-haven score is given if a jurisdiction has CFC rules and they are non-transactional CFC rules.

The data for this indicator was collected primarily from country analyses and country surveys in the International Bureau of Fiscal Documentation (IBFD) database.[3] In some instances, we have also consulted additional websites and reports of accountancy firms, academic journals and other local websites.

The scoring matrix is shown in Table 19.1, with full details of the assessment logic presented in Table 19.3 below.

### Table 19.1. Scoring Matrix Haven Indicator 19

| Regulation | Haven Score [100 = maximum risk; 0 = minimum risk] |
|---|---|
| **No CFC rules**<br>There are no CFC rules whatsoever. | 100 |
| **CFC rules are transactional**<br>While the jurisdiction applies CFC rules, these are only transactional type of rules which allow profits to be attributed to the CFC according to the arm's length principle, e.g. OECD Transfer Pricing Guidelines. | 75 |
| **CFC rules are non-transactional**<br>The jurisdiction applies non-transactional CFC rules. | 0 |

All underlying data can be accessed freely in the CTHI database.[4] To see the sources we are using for particular jurisdictions please consult the assessment logic in Table 19.3 and search for the corresponding info ID (ID 522) in the database report of the respective jurisdiction.

### Why is this important?

Controlled foreign companies[5] are treated as separate entities from their corporate or individual shareholders in the jurisdiction where they are controlled, i.e., the parent jurisdiction. This is based on the corporate personality doctrine, also known as legal personality.[6] They are perceived as autonomous taxpayers under classical corporate tax systems, and their profits are taxed independently from the tax base of shareholders. As such, the profits of the controlled foreign companies are subject to tax in their resident jurisdiction, whereas the controlling shareholders are subject to tax on their CFC income only when profits are distributed as dividends. Consequently, CFC income is often deferred until it is repatriated to the parent jurisdiction.[7]

If the resident jurisdiction of the CFC imposes low or no-taxes, this structure creates two concerns for the tax base of the resident state of the controlling shareholders. First, the controlling shareholders can take advantage of the time period until the CFC profits are distributed and reinvest the deferred taxes at a market or above-market interest rate.[8] Second, the controlling shareholders can divert income generated in the CFC's resident jurisdiction by making base eroding payments to other controlled subsidiaries in foreign jurisdictions. By doing this, the tax burden is reduced in the CFC's resident state and then taxation is avoided until the income is distributed by the CFCs. This is further exacerbated if the controlling resident state exempts distributed foreign-source (active) business income and enables the repatriated income to be permanently tax exempt, as is the case in the United Kingdom and Japan.[9] The CFC rules thus aim to eliminate profit shifting to controlled companies based in low or no-tax jurisdictions.

There is a dearth of economic studies estimating the scale of profit shifting income by controlling companies into foreign subsidiaries due to poor quality of data.[10] However, recent estimates presented in research by Cobham & Jansky (2018), Crivelli, de Mooij and Keen (2015), Clausing (2016) and Tørsløv, Wier and Zucman (2018) largely indicate a huge amount of lost revenues as a result of shifting income into CFCs based in low or no-tax jurisdictions.[11] These findings are in line with the efforts of many countries to introduce CFC rules to protect their tax base[12] and the public perception that multinational companies often use CFCs to avoid taxes.[13]

In 2013, the OECD stated that weak CFC rules are one of the main sources of base erosion and profit shifting. This was highlighted as part of the OECD and G20 Base Erosion and Profit Shifting (BEPS) project[14]. The BEPS project published a standalone report on CFC rules in 2015 (Action 3: "Designing Effective Controlled Foreign Company Rules").[15] The report indicates several weaknesses of CFC rules and recommends improving their effectiveness by addressing six building blocks. These are, the definition of a CFC, CFC exemptions and threshold requirements, the definition of CFC income, computation of CFC income, attribution of CFC income, and prevention and elimination of double taxation.[16]

Although CFC rules were not included in the minimum standards[17] of the Inclusive Framework on BEPS,[18] which the OECD and G20 countries have agreed to implement, the European Union included CFC rules in the Anti-Tax Avoidance Directive (2016/1164/EU), which EU member states were required to transpose into domestic legislation by 1 January 2019.[19] Articles 7 and 8 of the Anti-Tax Avoidance Directive introduce two alternative methods (models) for calculating CFC income. This is based on how the tax base is determined for the application of CFC rules.[20] Model A (non-transactional) allows countries to tax a range of passive income in foreign CFCs, unless that CFC carries out substantive (genuine) economic activity[21]. Model B (transactional) puts an onus on the tax authority to demonstrate that the scheme was put in place "for the essential purpose of obtaining a tax advantage".[22]

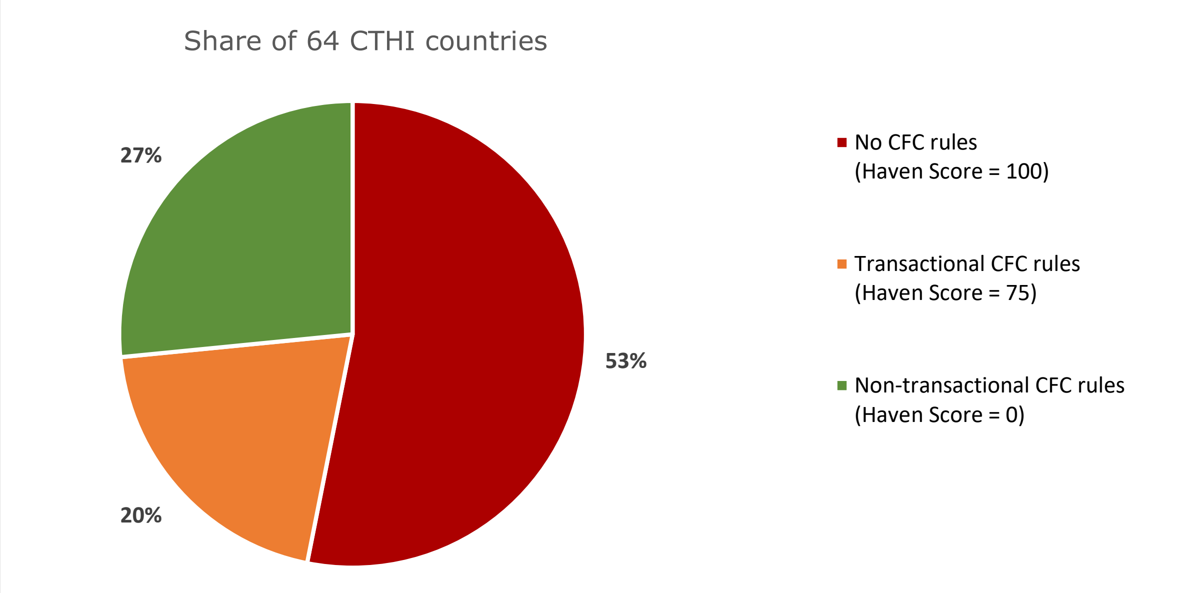
The two models of CFC rules contained in Article 7 of the Anti-Tax Avoidance Directive draw on Germany's and the United Kingdom's experience of implementing CFC rules. Model A in article 7(2)(a) takes into account Germany's experience. These rules take the non-transaction approach and use passive income catalogue based on the analysis of categories of income.[23] Inspired by the United Kingdom, Model B in article 7(2)(b) uses the "principal purpose test" based on substance analysis.[24] As mentioned above, Model B is considered to be weaker than Model A, mainly because the transaction-based rules impose the burden of proof on tax administrations to assess whether applying CFC rules on each transaction is justified.

However, the strength of Model A may be weakened by jurisdictions that choose to abuse the substantive economic activity requirement. This requirement was introduced as a result of the Cadbury-Schweppes court ruling in 2006.[25] In the Cadbury-Schweppes case, the European Court of Justice set precedent when it ruled that the United Kingdom's CFC rules ran contrary to the European Union's Freedom of Establishment rules and the rules could only be justified in relation to wholly artificial arrangements. The implication of this ruling is that in cases where a transaction is almost entirely tax-driven with only a minor economic justification, the European Union's rules would strike down the CFC rules. In order to comply with the requirements set out in the Cadbury-Schweppes case, the Anti-Tax Avoidance Directive has introduced an exception[26] for the application of Model A. Model A shall not be applied when the controlled foreign company carries out substantive economic activity supported by staff, equipment, assets and premises. In other words, if a jurisdiction chooses to introduce a weak substantive economic activity requirement, it may avoid applying CFC rules even in cases where it has adopted Model A.[27]

This optional approach is likely to lead to substantially different legal consequences, even though the underlying facts of the case are identical. Thus, "it must be expected that CFC Rules implemented by the respective Member States according to Anti-Tax Avoidance Directive will most likely still be quite heterogeneous in the future".[28] Prior to Anti-Tax Avoidance Directive, only the following 13 of 28 European Union member states included CFC rules in their domestic legislation: Denmark, Finland, France, Germany, Greece, Hungary, Italy, Lithuania, Poland, Portugal, Spain, Sweden and the United Kingdom.[29]

## Results Overview

### Graph 19.1. Controlled Foreign Company Rules




## Results Detail

### Table 19.2. Controlled Foreign Company Rules – Haven Indicator Scores

| Country Name | Score | ISO | Country Name | Score | ISO |
|---|---|---|---|---|---|
| Andorra | 100 | AD | Kenya | 100 | KE |
| Anguilla | 100 | AI | Latvia | 75 | LV |
| Aruba | 100 | AW | Lebanon | 100 | LB |
| Austria | 0 | AT | Liberia | 100 | LR |
| Bahamas | 100 | BS | Liechtenstein | 100 | LI |
| Belgium | 75 | BE | Lithuania | 0 | LT |
| Bermuda | 100 | BM | Luxembourg | 75 | LU |
| Botswana | 100 | BW | Macao | 100 | MO |
| British Virgin Islands | 100 | VG | Malta | 75 | MT |
| Bulgaria | 100 | BG | Mauritius | 100 | MU |
| Cayman Islands | 100 | KY | Monaco | 100 | MC |
| China | 75 | CN | Montserrat | 100 | MS |
| Croatia | 0 | HR | Netherlands | 75 | NL |
| Curacao | 100 | CW | Panama | 100 | PA |
| Cyprus | 100 | CY | Poland | 0 | PL |
| Czech Republic | 100 | CZ | Portugal (Madeira) | 0 | PT |
| Denmark | 0 | DK | Romania | 0 | RO |
| Estonia | 75 | EE | San Marino | 100 | SM |
| Finland | 0 | FI | Seychelles | 100 | SC |
| France | 0 | FR | Singapore | 100 | SG |
| Gambia | 100 | GM | Slovakia | 75 | SK |
| Germany | 0 | DE | Slovenia | 0 | SI |
| Ghana | 100 | GH | South Africa | 0 | ZA |

| Country Name | Score | ISO | | Country Name | Score | ISO |
|---|---|---|---|---|---|---|
| Gibraltar | 100 | GI | | Spain | 0 | ES |
| Greece | 0 | GR | | Sweden | 0 | SE |
| Guernsey | 100 | GG | | Switzerland | 100 | CH |
| Hong Kong | 100 | HK | | Taiwan | 75 | TW |
| Hungary | 75 | HU | | Tanzania | 75 | TZ |
| Ireland | 75 | IE | | Turks and Caicos Islands | 100 | TC |
| Isle of Man | 100 | IM | | United Arab Emirates (Dubai) | 100 | AE |
| Italy | 0 | IT | | United Kingdom | 75 | GB |
| Jersey | 100 | JE | | USA | 0 | US |

| Maximum Risk (Haven Score 100) | Haven Score 76 - 99 | Haven Score 51 - 75 | Haven Score 26 - 50 | Haven Score 1 - 25 | Minimum Risk (Haven Score 0) |
|---|---|---|---|---|---|

## Table 19.3. Assessment Logic

| **Info_ID** | **Text_Info_ID** | **Answers**<br>(Codes applicable for all questions: -2: Unknown; -3: Not Applicable) | **Valuation Haven Score** |
|---|---|---|---|
| **522** | CFC-Rules: Does the jurisdiction apply robust non-transactional CFC rules? | 0: NONE: No, there are no CFC rules whatsoever; 1: NO, TRANSACTIONAL: While there are CFC rules, these are only transactional type of rules which allow attribution of profit to the CFC according to the arm's length principle, e.g. OECD Transfer Pricing Guidelines; 2: YES, NON-TRANSACTIONAL: Yes, there are non-transactional CFC rules. | <=0: 100<br>1: 75<br>2: 0 |

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[1] Ana Paula Dourado, 'The Role of CFC Rules in the BEPS Initiative and in the EU', *British Tax Review*, 3, 2015, 25.

[2] Luc De Broe, *International Tax Planning and Prevention of Abuse*, 2008, 124.

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[6] Even if the corporate personality doctrine covers all type of companies (single or group), it has significant effects on group companies since it makes possible for them "to have various companies grouped together carrying out various functions that could otherwise be carried out by a single company" (see Alex Magaisa, *Corporate Groups and Victims of Corporate Torts - Towards a New Architecture of Corporate Law in a Dynamic Marketplace* (2002) <https://warwick.ac.uk/fac/soc/law/elj/lgd/2002_1/magaisa/> [accessed 6 May 2019].

[7] Dourado, 'The Role of CFC Rules in the BEPS Initiative and in the EU', 340.

[8] Daniel W Blum, 'Controlled Foreign Companies: Selected Policy Issues – or the Missing Elements of BEPS Action 3 and the Anti- Tax Avoidance Directive', *INTERTAX*, 46/4, 301.

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[12] In 2010, the International Fiscal Association branch reports showed a plethora of CFC rules as well as other specific anti-avoidance rules, see, Stef van Weeghel, 'General Report', in *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, IFA Cahiers, 95a., p. 23.

[13] See Rochelle Toplensky, 'Multinationals Pay Lower Taxes than a Decade Ago', *Financial Times*, 2018 <https://www.ft.com/content/2b356956-17fc-11e8-9376-4a6390addb44> [accessed 6 May 2019].

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[21] *Council Directive (EU) 2016/ 1164 - of 12 July 2016 - Laying down Rules against Tax Avoidance Practices That Directly Affect the Functioning of the Internal Market, art 7(2)(a).*

[22] *Council Directive (EU) 2016/ 1164 - of 12 July 2016 - Laying down Rules against Tax Avoidance Practices That Directly Affect the Functioning of the Internal Market, art 7(2)(b).*

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[27] For example, the Netherlands chose to set a weak substantive economic activity requirement according to which the CFC should be considered to carry out genuine economic activity in the foreign jurisdiction if it: "(i) meets the Dutch minimum substance requirements in its country of residence; (ii) has at least €100,000 of (internally or externally rendered) labor costs; and (iii) owns or rents an office space that is used to perform its activities for at least 24 months." See 'Netherlands Enacts New CFC Legislation - Impact on Multinational Enterprises' <https://www.ey.com/gl/en/services/tax/international-tax/alert--netherlands-enacts-new-cfc-legislation---impact-on-multinational-enterprises> [accessed 12 May 2019].

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