UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL

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Re: USCIB Comment Letter on the OECD discussion draft on BEPS Action 3: Strengthening CFC Rules

Dear Mr. Pross,

General Comments

USCIB appreciates the opportunity to provide comments on the OECD discussion draft on Action 3: Strengthening CFC Rules. USCIB believes that additional work is needed to create a proposal that effectively facilitates public discussion of these important issues. This is the case for two reasons: first, the discussion draft does not have a coherent framework from a policy perspective; and second, because of the absence of a coherent policy framework, the mechanics are either missing, unclear or potentially in conflict. We believe that CFC rules can and should be a critical component of dealing with BEPS, particularly when part of a coherent plan which includes other BEPS actions. This is why any draft has to establish a consistent approach with clear principles and recommendations. Before adopting any recommendations on CFC rules, USCIB believes it would be necessary to publish a new comprehensive draft with a coherent framework with detailed mechanics and permit an extended period of stakeholder input into those new comprehensive proposals.

Because of the extremely short comment period (less than 30 days on a lengthy document on a topic that the OECD has never dealt with before), USCIB has focused its comments on a few high-level issues. The lack of comments on other sections of the discussion draft should not be considered an endorsement of the proposals contained therein. USCIB is aware of the pressure to complete the Action Items within the self-imposed two-year deadline. This time pressure is leading to poorly thought out proposals and inadequate time to solicit or consider stakeholder input and resolve issues that are raised. Rather than adopting poorly thought out CFC recommendations, the OECD/G20 should consider, at this point, providing a summary of the various types of CFC rules and the context in which they are adopted. That would be more helpful than the proposals contained in this draft.

In our view, the lack of a coherent framework is broadly attributable to lack of agreement on the purpose of CFC rules and the difference between territorial systems and worldwide systems. No country has a pure territorial or worldwide system and it is unlikely that such a system would be adopted. There are, however, important distinctions that should be addressed. At its core a territorial system would permit an exemption for active business income regardless of the tax rate. At its core a worldwide system would collect residual tax on all lower-tax earnings. If the countries involved in the BEPS process are to reach agreement on "best practices" for CFC regimes, they need to resolve these core issues. Are countries intending to allow an exemption for income earned in a low-tax jurisdiction[1], are they intending to tax it, or something in between? It is primarily the lack of agreement on this goal that in our view causes the discussion draft to lack direction. Clarity on this point is essential given that the recommendations are intended to serve as building blocks for countries. The building blocks that countries will select will depend on what it is they want to "build".

A secondary reason for the lack of coherent policy framework seems to be the inability to reject any country's existing standards. That is, rather than reflecting "best practices" the discussion draft seems to endorse – at least as an acceptable alternative – anything that any country currently does. Recommendations ought to be based on "best practices" or at least good ideas and therefore non-best practices/bad ideas should be rejected. If the OECD/G20 cannot reject bad ideas because of political constraints, they should simply describe what countries currently do and why. Countries are and will be free to make their own sovereign choices based on their view of what may work best for them, but the OECD should not put a tax policy stamp of approval on bad ideas.

Although Chapter 5 does not currently include recommendations on the definition of CFC income, the draft asserts that the 2015 Report on Action Item 3 will include such

[1] "No or low taxation *per se* is not a cause of concern," BEPS Action Plan, page 10.

recommendations. Given that the approaches set forth in the discussion draft are so far apart, it is difficult to see how agreement could be reached other than by the expedient of blessing all of the alternatives, which is not a recommendation with respect to "best practices".

Finally, throughout this letter we use the word "seems". The reason for this is that the operation of the proposed recommendations is not clear, particularly in those cases where different sections interact with each other.

Specific Comments

Policy considerations

- As a representative of US-based business, it is important to us and our members that the OECD not make recommendations that set up a two-tier system[2] that disadvantages US headquartered business and effectively exempts European business because of self-imposed European restrictions on the ability to tax CFC income within the EU. That is, if the OECD accepts that CFC rules which only apply to "wholly artificial arrangements which do not reflect economic reality and whose only purpose would be to obtain a tax advantage" are a "best practice" and therefore adequate, then the OECD/G20 should not be recommending a different more onerous standard for others. If the EU's standard is not a "best practice" and is inadequate, then the OECD/G20 should not endorse its use by anyone.
- USCIB has pointed out in prior comment letters (including its letter on permanent establishments) that the OECD/G20 should be considering the impact of the BEPS proposals on trade and investment. Tightening of CFC rules in ways that require more substance in a particular jurisdiction may well result in shifting of substance, including jobs, to jurisdictions with more competitive tax systems.

Definition of control

- Concerning the level of control required to create a CFC, the discussion draft says that the majority of rules require more than 50% control. Nevertheless, jurisdictions are free to lower their threshold below 50%.[3] Either more than 50% control is a "best practice" or it is not. USCIB believes that the more than 50% standard is appropriate for a variety of reasons, including the difficulty of obtaining information to apply the rules for

[2] Discussion draft paragraph 13.
[3] Discussion draft paragraph 65.

determining and attributing income and taxes if the enterprise controls 50% or less of a CFC.

Definition of CFC income

Categorical approach

- It is not at all clear that the operation of the categorical approach[4] has been well thought out in that it appears to suggest that a given category of income will always give rise to CFC income regardless of whether substantial business activity gives rise to that income.
- Alternatively, the draft can also be read so that under the categorical approach passive income would be defined as includable income,[5] but subject to a "kick-out" if the CFC engaged in sufficient substantive activities under one of three tests.[6] It also seems that active income would be initially excluded but included or "kicked-in" if the CFC did not meet one of the substance tests.[7] Thus, the categorical approach seems to boil down to a substance approach in all cases. (It seems dividends from active income cannot be "kicked-in"; presumably this is because the substance approach is applied to the underlying active income to make it active to begin with and it retains that character as it comes up through the tiers.)
- The rules for defining dividend and interest income as active or passive differ. At least in the case of financial services businesses, both types of income will generally be active and the standard for determining whether this income should be active should be the same. This also illustrates the potential need for rules that distinguish and apply different CFC rules to different industries.
- It may be difficult to distinguish sales and services income from IP income particularly in the technology sector. By lumping sales, services, royalties and IP income together the discussion draft essentially abandons any attempt to define IP income.[8] All of this income would be treated as passive and includable unless the CFC had the required substance to earn the income itself, including the development of the IP.[9] This approach is overbroad. Companies can earn active income from sales and services that should not be subject to tax merely because they do not engage in IP development.

[4] Discussion draft paragraphs 112 through 116.
[5] Discussion draft paragraph 113.
[6] Discussion draft paragraph 114.
[7] Discussion draft paragraph 114.
[8] Discussion draft paragraph 113.
[9] Does this mean that all of the IP that contributes value to a product would have to be developed by the entity claiming exemption from the CFC rules? If so, this standard is unlikely to ever be satisfied.

- Under this standard, would any company with a valuable global brand necessarily earn passive income for all of its sales through subsidiaries anywhere in the world regardless of the level of local country activity? For example, an MNE resident in Country A operates globally-recognized branded restaurants in Country B both through franchise arrangements and locally owned subsidiaries. Both franchisees and subsidiaries pay royalties for the use of MNEs intellectual property. Both franchisees and subsidiaries operate the branded restaurant in Country B. Neither the franchisees nor the subsidiaries contribute to the development of the IP including the global brand. Under the proposed rule, the income from operating the subsidiaries would be includable as passive and would not be able to kicked-out because the subsidiaries did not develop the IP.
- Similarly, it seems that any sales of any product that includes the results of research, development or engineering could not be sold outside of the country in which that research, etc. took place without the income being treated as passive and included under the proposed rule.
- These situations are extremely common and taxing what are clearly local activities (the sales and services income earned locally) will distort competition between locally-owned business (the franchisee in the above example) and the foreign-owned business (the subsidiaries in the above example). There is no justification for this distortion.
- The substance tests are problematic. The "viable independent entity analysis"[10] and "employees and establishment analysis"[11] seem to undercut the arm's length standard (ALS). The "viable independent entity analysis" attempts to determine whether the CFC is the entity which would be most likely to own particular assets, or undertake particular risks, if the business relationship was between independent enterprises. If not, the income should be included as CFC income. It is fundamental to the ALS that related parties do not have to structure their arrangements in the same manner as unrelated parties. Basing CFC inclusion on this standard therefore undercuts the ALS. The "viable independent entity analysis" also seems contrary to the ALS because it would apply after an appropriate transfer price has been determined, presumably after the transaction has been properly delineated and subjected to non-recognition rules. So even though the transaction has been properly delineated, recognized, and priced, this rule would effectively tax that income on the basis that assets would not have been owned or the risks assumed by the CFC. If this were the case, then the transaction should not have been recognized under the transfer pricing guidelines and therefore the income would not be earned by this entity.

[10] Discussion draft paragraph 89.
[11] Discussion draft paragraph 89.

- The "employees and establishment analysis" does not require "an analysis of risks or asset ownership."[12] In particular this test does not identify IP assets, ignores ownership of those assets, and ignores management and control of risk. The OECD has published multiple transfer pricing discussion drafts attempting to take those items into account for transfer pricing purposes. Adopting CFC rules that ignore that those activities have substance and are entitled to a profit is fundamentally inconsistent with the proposals on intangibles and risk. Adoption of such an approach would move the OECD to a formulary approach to determining entitlement to tax income.
- If the OECD/G20 wish to abandon the ALS, they may do so. However, continuing to espouse the ALS, while at the same time undercutting it in fundamental ways is inappropriate. Therefore, neither the "viable independent entity analysis" nor the "employees and establishment analysis" should be used to determine whether a CFC has substance.

Excess profits approach

- Whether one would support or oppose the use of an excess profits approach depends on the fundamental structure of a country's tax system and the purpose of its CFC rules. In our view, an excess profits approach would never be appropriate in the context of a territorial system of taxation.[13] USCIB and its members support a territorial approach to taxation and thus oppose any recommendations that would encourage the adoption of a worldwide system combined with an excess profits approach.
- Even in the context of a worldwide system, USCIB opposes the adoption of an excess profits approach. The excess profits approach essentially ends deferral. It is USCIB's view that under a worldwide system deferral is appropriate. Therefore, an MNE parent should not be subject to tax on the properly defined active income of its subsidiaries. Further, although the excess profits approach is described as simpler and mechanical[14], the discussion draft sets forth a number of complex, first-impression issues[15] that would need to be resolved in order to make the excess profits approach work appropriately. These rules would need to cover all industries, including those where IP is generally thought not to be a material driver of profits. The questions raised by the excess profits proposal have not been adequately addressed in the discussion draft and there is not

[12] Discussion draft paragraph 89.
[13] As described above, at its core a territorial system would permit an exemption for active business income regardless of the rate. At its core a worldwide system would collect residual tax on low-tax active earnings. So "exempting" high tax active business income and currently taxing low active business income is at its core a worldwide system without deferral. A territorial system would allow an exemption regardless of the rate of tax if the income were earned from activities within the other country.
[14] Discussion draft paragraph 117.
[15] These include the rate of return, the risk-free rate of return, the equity premium, and eligible equity.

enough time to develop detailed proposals, consult with stakeholders and reach consensus on the proposals.

Foreign tax credit/double taxation

- The draft raises complicated foreign tax issues such as how to relieve double taxation on the distribution of previously included CFC income[16] and adjust foreign taxes when there is additional withholding tax on income that was previously included as CFC income[17], but provides essentially no guidance on how those rules ought to operate. If the purpose of the report is to provide "building blocks" for countries wishing to adopt CFC rules, then more detailed proposals on the operation of the foreign tax credit ought to be provided.
- This lack of direction again seems to be the result of the divide between territorial systems and worldwide systems. The discussion draft seems to assume that if a country operates a territorial system, then it will exempt the dividend coming out of CFC income and that additional foreign tax credits or adjustments to previously claimed FTC will not be required. The discussion draft, however, suggests an effective rate threshold to get into a CFC regime[18] and recommends a foreign tax credit as the appropriate method for relieving double taxation on CFC inclusions.[19] If adopted, these will require rules for determining how taxes are associated with income and issues relating to the computation of indirect FTCs.
- The discussion draft requires companies to determine effective rates taking into account rebates or refunds of foreign taxes, presumably this requires some form of tracking of taxes to income and years.[20] Further, taxpayers should be entitled to a credit against the tax paid under a CFC regime for additional taxes, such as withholding taxes, paid on that included income, otherwise double taxation will result from that failure. Therefore, even exemption systems should track earnings, taxes, and adjustments to taxes through tiers of ownership.
- Paragraph 166 of the discussion draft states: "it may be appropriate to provide a refund for CFC taxes paid equal to the amount of the withholding tax, if the dividend was paid out of profits that were subject to CFC tax, since this would essentially be equal to a credit had the CFC jurisdiction imposed tax on the income itself." The OECD should take

[16] Discussion draft paragraph 164.
[17] Discussion draft paragraph 166.
[18] Discussion draft paragraphs 53 through 63.
[19] Discussion draft paragraph 158.
[20] Can income become CFC income in a later year if a foreign tax previously paid is refunded? Or would the refund be reflected with respect to the current year taxes and affect whether there is an inclusion in the year of the refund?

a stronger position on this issue and recommend that a refund be provided. Failure to provide a refund in this case will result in double taxation. USCIB believes there is no recommendation on this point because the tracking and tracing required by this is simply too difficult. Given the complexity that the BEPS proposals will impose on taxpayers to create a single level of taxation,[21] countries should not shy away from relieving double taxation simply because it is complex.

- Unless appropriate guidance is provided on these complex issues and foreign taxes are properly accounted for there will be double taxation.

Sincerely,

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[21] See for example the proposals on hybrids, interest deductibility and harmful tax competition.