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Summary

This policy brief makes the following key points:

- The G20/OECD Base Erosion and Profit Shifting (**BEPS**) Project is an international initiative intended to strengthen the international tax system through the adoption of a 15 point plan, and the 2021 Pillar One and Pillar Two consensus proposals.
- BEPS Action 3 aims to prevent aggressive tax planning, profit shifting and permanent tax deferral through the earning of income in Controlled Foreign Companies(**CFCs**)of multinational enterprises (**MNEs**). Without special rules targeting CFCs, the foreign controlled income may go untaxed by the country in which the parent or controlling company is resident.
- The Action 3 Final Report sets out six specific building blocks which address the key points that a legislator must address when implementing CFC rules.
- In some countries, CFC rules date back to the 1960s. Since then, CFC rules have gradually spread around the world, but are still only adopted in about 40 countries, mainly those where outbound investment is dominant (capital-exporting countries). However, CFC rules may also be important to protect the tax base of capital importing countries, as they can help to prevent base erosion and profit shifting from these countries.
- Australia has an up-to-date and comprehensive set of CFC rules and does not intend to amend them following the Action 3 report.
- In terms of global implementation, many countries have not implemented the Action 3 recommendations.
- The Inclusive Framework Pillar Two proposal for a global corporate minimum tax will operate, to some extent, like a global CFC rule (see Policy Brief 17/2021). This may assist many countries that do not have CFC rules in their domestic law. Where countries already have CFC rules, issues arise about the interaction of these rules with the rules proposed for global enactment in Pillar Two.

Introduction

The G20/OECD Base Erosion and Profit Shifting (**BEPS**) Project is an international initiative intended to strengthen the international tax system through the adoption of a 15 point plan, and the 2021 Pillar One and Pillar Two consensus proposals.

One way in which multinational enterprises (**MNE**s) shift profits is by the use of controlled foreign companies (**CFC**s). By establishing wholly-owned or controlled separate entities in low-taxed foreign countries, MNEs may lower their global tax liability, through deriving income in those entities. The CFCs may do little, or no, real operational or economic activity, but exist mainly to receive income flows at a low tax rate. Some countries have enacted CFC rules in their tax law that seek to tax the income derived in these foreign controlled entities. These CFC rules may have broad or narrow coverage. However, many countries around the world do not have CFC rules.

The BEPS Action 3 report is directed at the creation of effective CFC rules in countries that wish to adopt this policy, taking into account the diverse policy considerations and preferences of states.

This policy brief describes the reasons why CFC rules may be important, presents the main recommendations presented in the Action 3 report and analyse their application globally and in Australia. Finally, it examines the impact that Action 3 has had on the international taxation scenario, and considers future challenges in the area.

1 What is BEPS?

The G20 declared the era of bank secrecy over in 2009 and later called for action to strengthen international taxation standards. The OECD responded with a 15-point Action Plan to address taxation issues with digitalisation (Action 1); and reform the international tax system to bring cohesion (Actions 2-5), restore substance (Actions 6-10), improve transparency (Actions 11-14), and develop a multilateral instrument (Action 15). This launched the international project to prevent Base Erosion (or double non-taxation) and Profit Shifting from jurisdictions where profitable activities take place: the BEPS Project.

OECD working groups developed technical policy proposals (released October 2015), recommending updates to the model tax convention, OECD-issued guidance, and domestic policy. From November 2016, the Multilateral Instrument would update more than half of the world's bilateral tax agreements.

OECD/G20 BEPS project participation is now almost global with the launch of multiple global forums and the Inclusive Framework (now 141 jurisdictions), membership of which requires commitment to the BEPS four 'minimum standards'. Having broadly addressed its mandate to implement the proposed package, the Inclusive Framework delivered in October 2021 Pillar-One (on a new nexus approach) and Pillar-Two (on a minimum global tax) as consensus proposals to tackle the digitalising global economy.

2 Action 3: Designing Effective Controlled Foreign Company Rules

What is the issue?

In an era of high capital mobility, digital businesses and lack of physical attachment to jurisdictions, MNEs headquartered in one jurisdiction can easily create or gain control of companies that are resident in one or more foreign jurisdictions. In combination with professional tax planning, these non-resident wholly-owned or controlled affiliates can be used as mechanisms for shifting profits from the MNE headquarters country of residence to low-tax jurisdictions. Income such as royalties, services fees, interest and sales receipts can be earned in foreign affiliates to take advantage of low taxes. Income may be held long-term in foreign jurisdictions, thereby deferring tax owing on repatriation to the parent entity in the home country. In this way, the corporate tax base of the residence country may be eroded.

CFC rules were developed by countries with significant outbound investment (capital-exporting countries). The first CFC rules were implemented by the US in the 1960s so that the US could enforce its corporate income tax on worldwide income and as a way to gather information about its companies overseas, and more specifically on subsidiaries of resident US parent companies (Dueñas, 2019). The US CFC rules provided exclusions for active foreign business income and sought to tax passive income derived by CFCs of US parent companies. It took 11 years for Germany to become the second state to implement CFC rules. In the following 40 years, many developed nations would implement their own CFC rules to tax income in foreign low-taxed affiliates to the MNE headquarters residence company. However, many countries still do not have CFC rules, while others have CFC rules which are inadequate to deal with contemporary tax planning by MNEs.

The BEPS Action 3 report has the goal of improving the design of CFC rules and encouraging their adoption in the tax legislation of countries around the world. The report develops recommendations regarding the design of CFC rules (OECD, 2015) to support states to create their own CFC regime in an effective manner, following standard guidelines for the main elements of a CFC regime.

What do CFC rules aim to achieve?

The aim of CFC rules is to attribute and tax some categories of income derived by foreign controlled entities to the "home" country MNE parent or controlling company of the foreign entity. The attributed income will be taxed to the controlling company at its home country tax rate on an "accrual" basis, even if it is not distributed by way of a dividend. Essentially, CFC rules allow the government of the resident entity in the MNE group to tax the profits held offshore in CFCs.

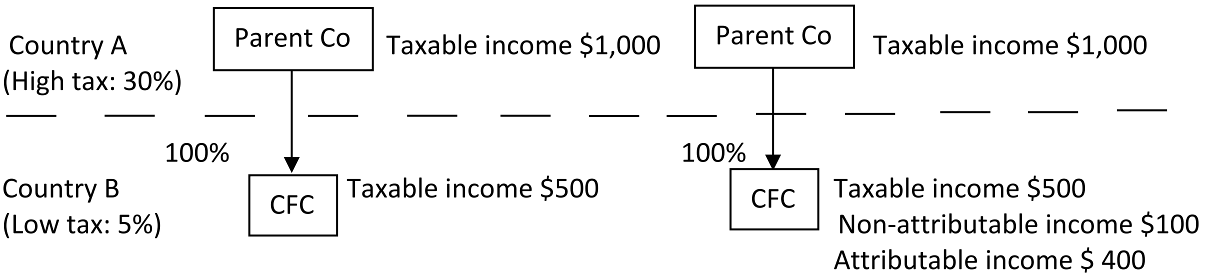
The conditions for application of CFC rules depend on a variety of factors. These include the type of income, for example, whether it is passive income such as royalties or interest, or active business income; the participation of a related company; and the level of substantive business activity in the CFC. Although the OECD affirms that jurisdictions vary in their definitions of CFC income, in practice most countries adhere to some type of active/passive income distinction (Hey,2021).

The introduction of CFC rules can generate significant complexity and could also generate adverse economic effects. If not complemented by other rules, CFC rules could lead to economic double taxation, while also being a competitive disadvantage for the implementing state compared to a state with no CFC rules, as foreign subsidiaries of its resident companies will be taxed more. The Action 3 report acknowledges both of these points and recommends that states consider their unique policy goals and economic context in deciding whether to introduce or update CFC rules.

Figure 1 shows the basic operation of CFC rules.

Figure 1

Scenario 1: without CFC rules   Scenario 2: with CFC rules



Parent Co in Country A has a CFC in Country B. Country A has a corporate tax rate of 30%, while Country B has an effective corporate tax rate of 5%. The CFC earns $500 of net taxable income under country B laws, while Parent Co earns $1,000 of net taxable income under Country A laws.

In Scenario 1, Parent Co would be liable for tax of $300 to Country A (30% of 1000) and the CFC would be liable for a tax of $25to Country B (5% of 500). The group as a whole would pay $325 on the total $1,500 of global earnings. The effective tax rate of the global group is 21.7%.

In Scenario 2, the CFC would be liable for $25 in taxes to Country B (5% of $500) as before. It is assumed that under the Country A CFC rules,$400 of the CFC's income is attributable and the remaining $100 is not. The $400 attributable income will be taxed to Parent Co by Country A (e.g., because the income comprises a passive low-taxed royalty). Parent Co would be liable for $300 in tax on its Country A income plus an additional $120 on $400 of attributable income from the CFC, or a total of $420. This applies even though there is no distribution of CFC profit to Parent Co.

Usually, Country A will provide a tax credit for the foreign tax paid to Country B of $20 on the attributable income of $400. Consequently, Parent Co would pay a net tax of $400, while the CFC will pay a tax of $25 on its income. The group as a whole would be liable for tax of $425on its global earnings of $1,500. The effective tax rate on the global group is much higher, at 28.3%. The extra tax accrues to the high-taxing residence country of the Parent Co. If CFC subsequently distributes a dividend to Parent Co, this dividend will be exempt to the extent of previously taxed attributable income.

What does the OECD Recommend?

The 2015 Action 3 Report presents a set of recommendations for the effective design of CFC rules. The report breaks down the basic elements for CFC rules into 6 main "building blocks". For each building block, the report presents a brief description of the element, explains its relevance within the CFC rule system, issues concrete recommendations and provides an explanation for the recommendation. The recommendations for each building block cover the most critical issues to consider when creating or updating CFC legislation. The Report also presents a summary of policy considerations that states must take into account when drafting their CFC legislation.

Building block 1
The first building block concerns the definition of a controlled foreign company (**CFC**). The Action 3 report recommends a broad definition, encompassing companies and other entities such as trusts and partnerships. Regarding the control of the CFC by the parent company, the Action 3 Report describes the different possible types of control, advises on the levels of control that states can require, notices the tests by which multiple shareholders' interests can be aggregated, and recommends considering both indirect and direct control of a CFC.

Building block 2
The second building block deals with exemptions and threshold requirements for CFCs. Acknowledging that to a certain degree the limitation of the scope of the CFC rules can be beneficial, the Report provides three rules for the states to choose in order to exclude their application. The "de minimis threshold", an anti-avoidance requirement, and a tax rate exemption are deemed acceptable mechanisms to reduce the effective span of the CFC rules.

Building block 3
The definition of CFC attributable income is the third building block. This is one of the most crucial elements as these rules are used to determine whether the income earned by a CFC falls within scope. The 2015 Report proposes three possible types of analysis to formulate this determination, categorical analysis, substance analysis, and excess profit analysis. It observes that these analyses can be done both with a transactional approach or an entity approach.

Building block 4
The fourth building block is concerned with the computation of attributable income of the CFC. In this chapter, the recommendations are directed to the rules that should be used to calculate the taxable income of the CFC and in particular the treatment of its losses. In this sense, the Report suggests the use of the parent jurisdiction rules to avoid administrative burdens and compliance costs.

Building block 5
Building block 5 deals with the rules for attributing CFC income to the CFC shareholders. The Report recommends linking the rules of attribution and control; to attribute income for the relevant fiscal year and on the basis of ownership on the last day of the accounting year or period of ownership; to operate by deeming the income to be a dividend received by the shareholder or as income earned by the shareholder directly; and to apply the parent jurisdiction's tax rate or apply a top-up rate to account for the difference in tax rates between the parent jurisdiction and the CFC jurisdiction.

Building block 6
The Action 3 report focuses on three possible ways in which double taxation can occur and how to avoid it. It suggests the use of a tax credit to avoid economical double taxation when the attributed CFC income is also subject to foreign corporate tax, or when the CFC rules of multiple jurisdictions apply to the same CFC. Lastly, it recommends a tax exemption for dividends of CFC shares that have previously been subject to CFC taxation and for the gains on the disposition of CFC shares if the income has previously been subject to CFC taxation.

Table A at the end of this policy brief presents a simplified version of the Action 3 main recommendations and their Australian application in domestic legislation.

3 How has the Action Been Implemented Globally?

At the commencement of the BEPS Action Plan in 2013, a majority of countries around the world did not have CFC rules, while the CFC rules of many of the countries that did have them were not fully comprehensive (OECD, 2015).

Since the Action 3 Final Report, some further countries have enacted CFC rules. The OECD counts in total 50 states that have adopted CFC rules out of a total of 129 investigated countries (OECD, 2021). Of these, 30 are European countries, eight are American countries (5 from South America and 3 from North America), eight are Asian countries, and Oceania and Africa are only represented in the list with two jurisdictions each. Of the remaining 79 states in its 2021 study, the OECD has confirmed no CFC legislation in 72 states, while the seven remaining states in the study had no available data. Additionally, there are also states whose CFC legislation is not comprehensive. Consequently, the total number of jurisdictions with effective CFC rules is quite limited.

Japan was one of the first states to enact CFC, in 1978. To determine the existence of a CFC, the Japanese CFC rules apply an equity ownership test and a de facto test. In contrast, the Chinese rules complement the shareholding test with an economic substance test. Furthermore, the Chinese rules apply a “white list” of jurisdictions where the level of tax is considered sufficient, while the Japanese rules narrow the scope of their legislation through a de minimis rule on passive income (Dueñas, 2019). Australia and New Zealand adopted CFC rules in the 1990s.

The high inclusion of European states is not a coincidence. All EU member states have adopted CFC legislation following European Commission Directive 2016/1164. Directives are mandates made by the EC for the member states, requiring the enactment of domestic legislation consistent with the Directive. This Directive set the time limit for legislation of CFC rules as 2018 and led to 28 of the 30 EU member states (in addition to France and Germany) to introduce CFC legislation. The actual implementation of the EC Directive is left to the member states and therefore every state will have its own, unique legislation. For example, the EU states take various approaches to defining CFC income. Some define it as passive income, others as the total income of the CFC or total income of the CFC that is not subject to a "genuine arrangement"(Christians and Shay, 2017).

While the US, Canada and Mexico already had CFC rules, BEPS Action 3 has had a significant impact on take-up of CFC rules in South America. For example, CFC rules came into effect in Colombia in 2017, Chile in 2014 and Peru in 2013 (Toledo and Adriazola, 2017). All three countries limit their CFC taxation to passive income (defined with a fairly wide scope) and implement a "de minimis" threshold in their CFC rules.

Other countries that have recently adopted CFC rules include Pakistan (2019), Russia (2015), and China (2008) (although they were mostly not enforced in China until 2014) (Dueñas, 2019,34). In Africa, only South Africa and, recently, Mauritius (in 2019) have adopted CFC rules.

Today, the US remains the world's largest outbound investor (UNDTAC, 2018). The adoption of CFC rules by capital exporting states is not a mere historic fact. Since the BEPS project, most capital importing countries have not followed their lead. Only two members of the G20 (India and Saudi Arabia) and two members of the OECD members (Costa Rica and Switzerland) have not implemented CFC rules, while of the 50 states that have CFC rules, 42 are members of one or both of these organizations. This trend can be explained by the very nature of CFC rules which aim to prevent BEPS by outbound capital investment of a resident parent corporation. The OECD has discussed this distinction in the Action 3 Report and seeks the inclusion of these norms by all states.

4 How has Australia Implemented the Action?

Australia enacted its CFCs rules in 1991 in the *Income Tax Assessment Act 1936*, Part X based on the US model. Australia's CFC rules have not been substantially updated since they were introduced. Draft legislation to rewrite the CFC regime was released in 2011 but later put on hold, pending the OECD Action 3 Report. In 2013, the CFC reform was set aside with other pending reforms.

Since the Action 3 Report in 2015, the Australian Treasurer has stated that the Australian CFC rules meet these best practices and no further work has been undertaken to change the rules. The vast majority of recommendations in the Action 3 Report are included in the Australian legislation which complies with most recommended practices. Indeed, there are examples where the Australian CFC regime goes beyond the ordinary recommendations, to combine multiple possible approaches. In some respects, the Australian CFC regime is stronger than the regime in comparable countries. This leads to more complex rules, and substantial obligations, administrative burdens and compliance costs on Australian outbound MNEs. As the OECD 2015 Report recognizes, this is the cost that is assumed to reduce the chances of tax avoidance.

An example of a broader approach to CFC rules in Australia can be seen in the test for identification of a CFC through "control" by a parent entity. The Australian rules implement all three of the recommended control measures identified in the Action 3 report: legal control, economic control, and de facto control. In general, the Action 3 report acknowledges that legal control is not sufficient, suggesting that states should complement it with economic control. It can be difficult to identify a CFC where control of the foreign company is exercised by multiple minority shareholders. For such cases, the Action 3 Report provides four types of tests: acting in concert test, relationship test, and two variants of a test to identify a concentrated ownership. While any of those tests is accepted as sufficient in the Action 3 Report, Australia uses a combination of all of them.

The Australian Taxation Office (**ATO**) provides administrative guidance in its Foreign Income Return Form, with a chapter on CFCs. This guide aids the taxpayer by presenting a step by step application of the Australian CFC rules. This is a comprehensive guide that is business-friendly while accurate and precise in the use of complex concepts.

In summary, Australia's implementation of Action 3 has been successful. Australia had previously legislated the vast majority of the recommendations of the Action 3Report and has applied administrative documents to aid taxpayers with the understanding and application of said rules.

5 Impact

Most academic commentary on the Action 3 Final Report observes that it is too soon to consider the full impact of these proposals (Christians and Shay, 2017; Hey, 2021). Some have expressed concern about the OECD proposals for rewriting CFC rules given that outcomes following the BEPS project have not been fully realised yet (Mehboob, 2020). Others have ventured an opinion on the impact of CFC rules on BEPS. Daniel Bunn argues that CFC rules present trade-offs (Bunn, 2019]. He contends that while there is evidence that CFC rules and other BEPS policies can gain tax revenue for implementing states, they also create an administrative and economic burden. These norms will increase the cost of capital and may reduce employment and cross-border investment. Policymakers should be aware of these trade-offs when implementing CFC rules or changing their tax policies in ways that increase taxes on foreign subsidiaries.

Sebastian Dueñas questions the effectiveness of the CFC rules to achieve the goal of addressing BEPS (Dueñas, 2019). Even in the US, CFC rules have not fully achieved their purpose, largely because of exclusions enacted or tolerated by the legislation and the adoption of US "check-the-box" entity rules which together enabled US MNEs to hold low-taxed related income offshore in tax havens. This practice was ultimately stopped through the Tax Cuts and Jobs Act 2017 and specifically the application of an anti-deferral tax regime for previously accumulated offshore profits and the tax on Global Intangible Low-Taxed Income (**GILTI**).

A major concern that works against the implementation of CFC rules globally is their inevitable complexity. Developing countries with fewer resources face challenges in building the bureaucracy necessary to implement CFC rules as a priority and may perceive that it "may not be cost-effective to incorporate CFC rules" (Dueñas, 2019: 34).

6 What comes next?

For Australia, the government considers that its legislation is fully compliant with the Action 3 Final Report and further legislative action is not expected in the short term. However, the Inclusive Framework Two-Pillar Solution may lead to further changes in international tax policy that adopt some elements of CFC rules into a broader corporate minimum tax.

In 2019, the Inclusive Framework on BEPS, now 141 jurisdictions, introduced its plan to establish a global base-eroding tax (GloBE), which has become known as a global minimum tax, to address the challenges of a digitalized economy. This was denominated as "Pillar Two" by the Inclusive Framework. In November 2020, the "Blueprint on Pillar Two" was released, proposing various technical and operative rules for such a tax. The Inclusive Framework released a consensus statement on Pillar Two in October 2021 and more details on the framework were released in November 2021. For more on Pillar Two, see Policy Brief 17/2021.

One element of the Pillar Two proposal is directly relevant to the application of CFC rules. The Income Inclusion Rule is, in some respects, based on traditional CFC principles. The Income Inclusion Rule will trigger an inclusion of income at the level of the parent entity where the income of a controlled foreign entity is taxed below the effective minimum tax rate of 15% (OECD, 2020). This may assist many countries that do not have, or propose to enact, CFC rules in their domestic law. The Pillar Two blueprint states that both regimes can coexist as their policy objectives are different. Where countries already have CFC rules, issues arise regarding the interaction of the CFC rules with the Income Inclusion Rule proposed for global enactment in Pillar Two. Australia's CFC rules are significantly stronger than some of the elements of Pillar Two.

The Pillar Two proposal also includes an activity or substance exemption which is similar to the main "active income" exclusion in most CFC regimes. The Pillar Two exclusion is calculated applying a formulaic substance carve-out which excludes a fixed return based on a percentage of employees and physical assets in a jurisdiction, which will not directly match the passive/active distinction. Pillar Two will be limited to MNEs with a consolidated group revenue of €750 million or more. In contrast, most countries apply CFC rules to all taxpayers, apart from de minimis exceptions, without regard to the group's overall revenue.

Large MNEs that are subject to the GloBE will face extra compliance burdens as they will have to reconcile the GloBE with the application of CFC rules to the same situation. However, CFC rules generally apply the domestic corporate tax rate, which will usually be a higher rate than the GloBE, which is limited to 15%.In view of Australia's broad CFC rules, and a relatively high corporate tax rate of 30%, it will be important for the Australian government to consider how the Pillar Two GloBE rule will interact with its CFC regime, and to anticipate the challenges and complications that will surely arise from the coexistence and coordination between Pillar Two and Action 3.

Appendix

The Action 3 Building Blocks of CFC Rules and the Australian Approach

Building block	Main issue	Recommendations	Australian approach
1 - CFC Definition	Jurisdictions must consider whether the foreign entity is of the CFC type and whether the parent has sufficient control over it.	1. Broad inclusion of entities in the definition 2. Inclusion of economic or de facto control 3. Minimum 50% control 4. include tests for entities acting in cohort.	1. Includes companies, trusts and partnerships. 2. Includes economic, de fact and legal control 3. 50% control for multiple shareholders and 40% for single Australian entities 4. Combines all recommended test for entities acting in cohort.
2 - Thresholds and exemptions	Thresholds and exemptions are used to limit the scope of CFC rules, thus targeting high-risk cases only.	Limitation of CFC rules through "de minimis" thresholds, anti-avoidance requirements or a tax rate exemption.	Combines a tax rate exemption method and a white list approach.
3 - CFC income definition	States must determine whether the income earned by the CFC falls within the scope of the CFC rules.	1. Use categorical, substance or excess profit analysis to determine whether the income is attributable to the parent 2. Define if (1) will be applied on an entity-by-entity basis or on a transactional approach	1. Uses a substance analysis through the application of an income test 2. Implements an entity-by entity approach
4 - Rules for computing income	Once CFC rules have determined that income is attributable, they must then consider how much income is attributable.	1. Calculate the taxable income using the parent jurisdiction's rules for income tax. 2. Allow loses offsets against profits of similar character and only on the same CFC and other CFCs in the same jurisdiction.	1. Follows stated recommendation. 2. Losses can only be deducted from the notional assessable income of the eligible CFC. The is no restriction as to the type of profit it can be deducted against.

Building block	Main issue	Recommendations	Australian approach
5 - Income attribution	Once the amount of CFC income has been calculated, the rules for its attribution to the shareholders must be applied.	1. The same rule should be applied for determining control over the CFC by the parent and for determining the attributable taxpayers. 2. attribution should be measured based on ownership on the last day of the year (if it represents the taxpayer's influence on the CFC accurately) or on the period of ownership. 3. The attributed income can be treated as a dividend or as income earned indirectly. 4. The applicable tax rate can either be the applicable one at the parent jurisdiction or a top-up rate.	1. An entity is considered an attributable taxpayer if it has a 10% associate-inclusive control. 2. Ownership is considered at the end of the statutory accounting period 3. Attributed income is included in the assessable income of the taxpayer 4. Australian tax rates apply.
6 - Double taxation relief	As the application of the CFC rules can lead to double taxation, they must also include mechanisms to prevent it.	1. Allow for a tax credit on foreign tax actually paid. 2. Exempt dividends of CFC shares if the income has previously been subject to CFC tax	1. A tax credit is given for the foreign tax paid or to be paid. 2. A tax exemption is given amounting to the whole or the part of the grossed-up assessable component of the dividend, when such amount has been paid of the attributable income of the CFC for the period.

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