Historical background to CFC-rules and policy considerations

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1. Introduction

Controlled Foreign Companies (hereafter CFC) are common rules among EU Member States and OECD countries that have been adopted since the late 1960s in order to counteract the practice of corporations setting up companies in low tax jurisdictions.

The history of CFCs, although it can be considered quite short since its first introduction in the United States, has rapidly evolved in the past decade due to the implementation of BEPS[1] in 2015 and, more recently, with the introduction of the ATAD Directive[2] by the EU. The following chapter aims to briefly analyse the history of the CFC rules and the policy considerations behind the introduction of such rules.

While approaching the topic of controlled foreign companies and the reason why so many countries have, sooner or later, introduced CFC regulations is the definition and meaning behind the term 'deferral' that has been continuously used since 1913 in relation to tax matters. According to the Merriam-Webster vocabulary,[3] it is the act of delaying or deferring something; in tax, more specifically, deferral means the postponement of taxation to a later time.

According to international law and, more specifically, treaty law, income may be taxable under the laws of a country based on a link or '*nexus between that Country and the income or activities that generated the income*'[4] meaning that a country has the right to tax income generated within its territory (source taxation). On the other hand, a country '*may also impose tax on income because of a nexus between the country and the person earning the income*'[5] meaning that it has the right to tax income generated by its residents regardless of where the income is produced (residence taxation).[6]

Taxation of income at an international level is deemed to be based on simple principles:

- countries have a right to tax based on the source of income and on the basis of residence of the taxpayer;

1 OECD (2015), Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264241152-en.

2 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, OJ L 193, 19.7.2016, p. 1–14.

3 Merriam-Webster vocabulary, online edition https://www.merriam-webster.com/thesaurus/deferral, check on print edition or other English vocabularies.

4 Brian J. Arnold, International Tax Primer, Wolters Kluwer, 3rd edition, 2016.

5 Ibid.

6 Based on the residence jurisdiction, persons are generally taxed on their worldwide income without reference to the source of such income. See also Brian J. Arnold, International Tax Primer, Wolters Kluwer, 3rd edition, 2016.

- the source state has the first right to tax; and
- the residence state has the right to tax the worldwide income while granting relief for income already subject to taxation in the source country.[7]

Based on the allocation rules laid down among countries in their respective double tax treaties, the approach chosen is that the residence state may have an unlimited right to tax while the source state may have a limited tax liability. This approach is the one chosen by the OECD in its model tax convention (OECD MTC) which has served as the basis for the majority of the existing double tax treaties among OECD members. The consequence of such an approach is that source state, based on the relevant allocation rule as provided in the tax treaty, may have the first right to tax.

According to Article 7[8] of the OECD MTC, each entity is therefore taxed in its state of residence. In order to avoid such taxation, companies resident in high tax jurisdictions have started to set up CFCs in low tax jurisdictions and move the passive income there and retain the profits generated. The subsidiaries would have eventually distributed the profits generated in such low taxed countries in the form of a dividend to the parent company. In such cases, taxes can be postponed or deferred until the income is either distributed as a dividend or the resident taxpayers sell the foreign subsidiary's shares.[9]

Given that, over the years, domestic corporations have formed foreign corporations with the aim of avoiding or deferring taxation, countries have started to introduce CFC legislation in their domestic tax law to both tackle tax avoidance schemes and protect their domestic tax revenues. With no CFC rules, taxpayers will be free to establish companies with no economic substance in low tax jurisdictions with the sole purpose of transferring profits.[10]

The policy objectives behind the introduction of CFC rules differ among the states that have enacted such legislation. However, fundamentally, CFC legislation is typically seen as an instrument to guard against the unjustifiable erosion of the domestic tax base by the export of investments to non-resident corporations.[11] Many states have implemented CFC legislation throughout the years, but not all regimes are the same. The different rules and the reason behind them have been partially explained by the fact that some states mainly follow a doctrine of

7 Arnold, evolution on CFC, December 2019.
8 Article 7, OECD Model Tax Convention on Income and on Capital, 2017.
9 Revuen Avi-Yonah and Oz Halabi, "US Subpart F legislative proposals: a comparative perspective" 2012, Law & Economics Working Papers 69. https://repository.law.umich.edu/law_econ_current/69.
10 Renata Fontana The Uncertain Future of CFC Regimes in the Member States of the European Union – Part 1, European Taxation, 2006 IBFD.
11 Peter K. Schmidt, Taxation of Controlled Foreign Companies in Context of the OECD/G20 Project on Base Erosion and Profit Shifting as well as the EU Proposal for the Anti-Tax Avoidance Directive – an Intermin Nordic Assessment.

capital export neutrality whereas others follow a doctrine of capital import neutrality.[12]

Capital export neutrality (CEN) is achieved when countries tax their residents on their worldwide income, including income earned by their foreign subsidiaries, while capital import neutrality is achieved when '*taxpayers doing business in a country should be subject to the same tax burden irrespective of where they are resident*'.[13] Jurisdictions taxing on a worldwide basis are indeed following the CEN principle while countries that do not impose tax on foreign source income earned by foreign corporations controlled by residents are consistent with the capital import neutrality (CIN) principle. The balance between the aims of these two principles, between taxing foreign income and maintaining competitiveness without causing distortions in a world with no harmonized tax rates, has affected how states have designed their CFC rules. However, a clear and definitive adoption of those two principles has never been achieved, and countries usually adopt some variations.[14]

2. The very beginning: CFC rules in the United States

It has now become common knowledge, at least common among those approaching and studying CFCs rules, that the starting point is, indeed, the United States. They were the first country ever to introduce such legislation in the 1960s, and such legislation have paved the way and became the role model for CFC rules applied worldwide. The implementation of CFC regulations in the United States has been a long process that first started in the late 1930s, leading up to the introduction in 1962 of the first anti-deferral rule.[15] This was followed up by amendments over the past 50 years to the current reforms and proposals and also due to the introduction of OECD BEPS Project,[16] the Tax Cuts and Jobs Act (TCJA),[17] and the Global Intangible Low-Taxed Income (GILTI).[18]

From a historical point of view, before the implementation of the Revenue Act of 1913,[19] starting from the first revenue acts after the Civil War, there was no separation from a corporation and its owner and, generally, the principle of worldwide taxa-

12 Peter K. Schmidt, Taxation of Controlled Foreign Companies in Context of the OECD/G20 Project on Base Erosion and Profit Shifting as well as the EU Proposal for the Anti-Tax Avoidance Directive – an Intermin Nordic Assessment.
13 Brian J. Arnold, International Tax Primer, Worlters Kluwer, 3rd edition, 2016.
14 Ibid.
15 Revenue Act of 1962, Public Law 87-334, October 16, 1962, Section 12.
16 OECD (2013) Base Erosion Profit Shifting, OECD Publishing, https://doi.org/10.1787/23132612.
17 Tax Cut and Jobs Act TCJA, Public Law no. 115- 2017, 115th US Congress Public Law 97, 22/12/2017.
18 Global Intangible Low-Tax Income, GILTI, US Treasury Department n. 9866, section 951A.
19 Revenue Act 1913, An Act to reduce tariff duties and to provide revenue for the Government, 38 Stat.114 Public Law 63-16.

tion was not applied.[20] Thus, with the Revenue Act of 1913,[21] corporations have been formally treated as separate entities from their shareholders unless these corporations were '*created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of the graduated surtax on individuals*'.[22] If so, shareholders of such corporations were required to include in their income the corporation's gains and profits whether or not they were distributed.[23]

Other revenue acts followed after the 1913 act and, in 1934, the Revenue Act[24] introduced one of the first anti-avoidance and postponement measures specifically to tackle the practice of US taxpayers forming a corporation '*and exchange for its stock his personal holding in stock, bonds or other income-producing property*'[25]; therefore, with such an exchange that was defined by congress as an 'incorporated pocketbook',[26] the income generated at the level of the corporation, unless later distributed, was not taxed at the level of the shareholders. In order to tackle this scheme, the Revenue Act of 1934 introduced an additional tax on undistributed profits of all corporations that fell under the definition of a 'personal holding company'.[27]

By 1937, tax avoidance schemes were put in place, one example being the scheme of 'foreign personal holding companies' established in tax havens to avoid taxation. On a request addressed to the congress by President Roosevelt,[28] a proposal was made to include the non-distributed income of such corporations into the gross income of their shareholders.

As stated by the joint committee[29] that proposed such a measure, the introduction of such legislation would definitely have not solved tax avoidance problems for the future.[30] Following the expansion of US investments in Europe and international markets after the end of World War II, by the 1950s, the increase of incorporation

20 The Deferral of Income Earned Though U.S. Controlled Foreign Corporations, A Policy Study, Office of Tax Policy, Department of the Treasury, December 2000.
21 Revenue Act 1913, An Act to reduce tariff duties and to provide revenue for the Government, 38 Stat.114 Public Law 63-16.
22 The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study, Office of Tax Policy, Department of the Treasury, pg.105 – December 2000.
23 Ibid.
24 Revenue Act 1934, An Act to provide revenue, equalize taxation, and for other purposes, 73rd Congress, Session II, 24 May 1934.
25 The Deferral of Income Earned Though U.S. Controlled Foreign Corporations, A Policy Study, Office of Tax Policy, Department of the Treasury, pg.107, December 2000.
26 Also Prof. Avi Yonah, Back to the Future? The Potential Revival of Territoriality, Bulletin for International Taxation, October 2008.
27 The Deferral of Income Earned Though U.S. Controlled Foreign Corporations, A Policy Study, Office of Tax Policy, Department of the Treasury, pg.107, December 2000.
28 The Deferral of Income Earned Though U.S. Controlled Foreign Corporations, A Policy Study, Office of Tax Policy, Department of the Treasury, December 2000.
29 Ibid. with particular reference to the Joint committee intervention and letter of 1937, pg 7.
30 Ibid.

of foreign subsidiaries, deferral schemes, and tax advantages related to investments in either low-tax countries or tax havens rose again. As stressed by President Kennedy in his 1961 message to the congress the '*outflow of capital from the United States into investment companies created abroad whose principal justification lies in the tax benefits which their method of operation produces*'.[31] The Kennedy Administration then proposed a complete elimination of deferral by including the income of the foreign corporation at the level of the US shareholder. However, this proposal was not accepted by the congress due to concerns over CEN reasons.[32] At that time, congress assumed that most of active income earned outside the United States would have been taxed in countries with similar tax rates as those applicable by the United States so the CEN principle would not have been violated.[33] While one of the main concerns over the introduction of Subpart F was the relationship between capital export neutrality as proposed by the Kennedy Administration and capital import neutrality as supported by congress, many reasons were and still are the core policies to CFC legislation in the United States.

In 1962, although some concerns of President Kennedy were not included and therefore resulted in a '*political compromise*',[34] CFC rules were finally introduced in the Internal Revenue Code[35] as Subpart F, requiring US shareholders to include in their gross income the pro-rata share of the passive income of the CFC and excluding the active income of the CFC.

As stated by the US Department of the Treasury,[36] the enactment of Subpart F rules was the result of five main reasons:

i. preventing tax haven abuse;
ii. taxing passive income in a timely manner regardless that such income was earned through a tax haven or not;
iii. promoting equity among US taxpayers through the concept of tax neutrality or efficiency;
iv. promoting economic efficiency; and
iv. competitiveness of US owned foreign corporations with the aim of stimulating investments abroad.

31 President Kennedy, H.R. Rep. No. 1447, 87th Cong., 2nd session 1962.
32 R.E. Krever, Chapter 1: Controlled Foreign Company Legislation: General Report in Controlled Foreign Company Legislation (G.W. Kofler et al. eds., IBFD 2020), Books IBFD.
33 Prof. Reuven S. Avi-Yonah, the U.S. Treasury's Subpart F report: plus ca change, plus c'est la meme chose?, IBFD 2001.
34 Yarif Brauner & C.A. Davis, Chapter 42: Controlled Foreign Company Legislation in the United States, in Controlled Foreign Company Legislation (G.W. Koflere et al. eds., IBFD 2020), Books IBFD.
35 Revenue Act 1962, An Act to amend the Revenue Act of 1954 to provide a credit for investment in certain depreciable property, to eliminate certain deficits and inequities and for other purposes, 87th Congress, May 11 and 12 1962.
36 The Deferral of Income Earned Though U.S. Controlled Foreign Corporations, A Policy Study, Office of Tax Policy, Department of the Treasury, chapter 2, December 2000.

Through the years, some authors have suggested the total repeal of Subpart F rules based on the assumption that the CEN should be followed rigorously, and the deferral mechanism was unnecessary and should be repealed. Others have suggested a more limited restructuring such as treating all European Union countries as one state for Subpart F purposes.[37]

Although some changes were made throughout the years, Subpart F and its scope remains intact. Both in 1976 and in 1986, the income categories of Subpart F were broadened,[38] and other anti-deferral rules have been enacted, most particularly, the Passive Foreign Investment Company (hereafter PFIC) regime in 1986.[39] The latter regime has been specifically designed to target portfolio investments made by US individuals in foreign corporations with the purpose of minimizing US tax liability.

As the years went by, different studies have shown[40] that the use of complex foreign corporation's structures was a common practice to keep US multinational profits abroad. Hence, with the enactment of the TCJA, new provisions were introduced such as the Foreign Derived Intangible Income (FDII), Base Erosion and Anti-Abuse Tax (BEAT), and the GILTI.

Before the introduction of the TCJA, it has been estimated that US multinationals held USD 2.6 trillion of foreign earnings outside the United States.[41] Some of the measures included in the TCJA, such as the ones mentioned above, directly aimed to reduce such a situation and encourage US MNEs to repatriate foreign investments while adding business tax incentives. One of the main consequence of TCJA is a shift from a worldwide taxation system to a partial territorial system.

The GILTI, though quite complex in calculation, can be defined as an 'estimate of the intangible income earned by a U.S. shareholder"[42] and provides that U.S. shareholders of "*any CFC must include its GILTI in gross income for a taxable year in a manner similar to inclusions of Subpart F income*".[43]According the GILTI provision, US companies are subject to a minimum tax of 10.5% on income

37 Paul R. McDaniel, James R. Repetti, Diane M.Ring, Introduction to United States International Taxation, sixth edition, Wolters Kluwer Law&Business, 2014.

38 Yarif Brauner & C.A. Davis, Chapter 42: Controlled Foreign Company Legislation in the United States, in Controlled Foreign Company Legislation (G.W. Koflere et al. eds., IBFD 2020), Books IBFD.

39 Tax Reform Act of 1986, Public Law n.99-514, 99th U.S. Congress, October 22, 1986, Section 1235.

40 Sebastian Duenas, CFC Rules Around the World, Fiscal Fact, Tax Foundation, no.659, June 2019, with particular reference to pages 18–19.

41 Sebastian Duenas, CFC rules around the world, Tax Foundation, Fiscal Fact no.659, June 2019.

42 Yarif Brauner & C.A. Davis, Chapter 42: Controlled Foreign Company Legislation in the United States, in Controlled Foreign Company Legislation (G.W. Koflere et al. eds., IBFD 2020), Books IBFD.

43 Yarif Brauner & C.A. Davis, Chapter 42: Controlled Foreign Company Legislation in the United States, in Controlled Foreign Company Legislation (G.W. Koflere et al. eds., IBFD 2020), Books IBFD.

earned by CFC from a notional return of 10% on all intangible assets, like patents, trademarks and copyrights.[44]

The GILTI has been described by congress as 'the all-American adaptation of international anti-avoidance standards intended to dissuade MNEs from the pernicious practice of sheltering profits in low-taxed jurisdictions'.[45] The BEAT, on the other hand, targets the deduction of 'base-eroding payments made to foreign related parties'[46] such as interest, royalties, and service payments by adding back to US companies' taxable income such payments and taxing them at a rate of 10% (12.5% after 2025).

The GILTI is an expansion of the current CFC regimes in the United States but with a broader scope since it 'applies to all CFCs with GILTI, irrespective of the country in which the CFC is resident or the amount of foreign tax it pays'.[47] Therefore, it is an application that is, indeed, very different from the designated-jurisdiction approach used by most countries in their CFC rules.[48]

The TCJA has undoubtedly brought many benefits to US corporations that invested in the US market but, indeed, it raised many questions on whether it would be compatible at an international level. First of all, the tax on the GILTI imposed on CFC earnings could be seen as unfavourable in comparison to the CFC regimes applicable to most of the major trading partners of the United States[49] and, secondly, it will have major effects on the international fiscal policy, particularly at an European level.[50]

The approach taken by the United States is quite different from that taken by the OECD; following the introduction of Action 3 of OECD/G20 BEPS[51] that required the adoption or the extension of CFC rules, the OECD moved forward with the proposal included in the Inclusive Framework. In particular, the proposal included in Pillar Two regarding the Global Anti-Base Erosion (GloBE) consists of two rules: an income inclusion rule and a base eroding payments rule. The main outcome is the introduction of a minimum tax rate which should be

44 Brian J. Arnold, The Evolution of Controlled Foreign Corporation Rules and Beyond, Bulletin for International Taxation, December 2019.

45 C. Pérez Gautrin, US Tax Cuts and Jobs Act: Part 1 – Global Intangible Low-Taxed Income (GILTI), 73 Bulletin for International Taxation. 1 (2019), Journal Articles & Opinion Pieces IBFD.

46 Brian J. Arnold, The Evolution of Controlled Foreign Corporation Rules and Beyond, Bulletin for International Taxation, December 2019.

47 Ibid.

48 Ibid.

49 Hannelore Niesten, European Union/United States Unraveling the Recent Tax Reform: a Paradigm Shift in the International and EU landscape, European taxation, October 2018, Vol.58, n.10.

50 Ibid. The author also pointed out that, right after the TCJA was approved in 2017, the Finance Ministers of Germany, France, the United Kingdom, Italy, and Spain expressed their concerns about the GILTI arguing that it could discriminate against EU companies, increase the risk of double taxation, and distort international trade.

51 OECD, BEPS Action 3.

uniform throughout all countries and so applicable to all MNEs therefore aiming to target the same income as the CFC rules.

However, the chances to coordinate and harmonize a proposal on a minimum tax rate are indeed scarce; regardless of the lack of coordination and criticisms on the complexity of introducing a minimum tax rate, it is highly questionable whether the introduction of a minimum tax rate could entirely replace the current CFCs rules without any sort of implications and inequalities.

It is still an open issue if CFCs rules around the world, or at least the ones applicable by the trade leaders such as the United States and the EU, can be replaced in favour of other solutions or whether the countries should simply expand the application of their current CFCs rules to all income, active and passive, in order to tackle the threat of base erosion problem.

With the recent implementation of the GILTI, the United States has taken a step forward and taken another approach and direction compared to other OECD Member States. I do, however, wonder if such an approach would ultimately produce a positive effect and whether other countries shall follow the example set forth by the United States. The GILTI regime has been highly criticized for being too complex, and I suggest that it would eventually remain restricted to the United States if not repealed at all in the coming years in favour of a more coordinated approach.

3. The German CFC regime

CFC legislation was enacted in Germany in 1972, exactly eleven years after the implementation in the United States and, at that time, it was the only other country in the world and the first in Europe ever to introduce it. The rules, introduced as part of the Foreign Tax Act,[52] were based on US subpart F legislation and, although later revised in 1992 and 2003, only a few changes have been made to the rules while its overall system remained unchanged. (check again different opinions on this: see Rust in cfc legislation 2004)

Different from the policy reasons that led to the introduction of subpart F in the United States that were previously discussed, the policy considerations in Germany were not as clear.[53] Before the CFC rules were enacted, German companies were able to defer tax on profit of foreign companies until those profits were distributed and, therefore, one of the main reasons behind the introduction of CFC rules, and therefore to tackle deferral schemes, was to 'eliminate cross-border tax advantages and equate them with domestic situations'.[54]

52 Foreign Tax Act (FTA), September 8 1972.

53 J. Gerbracht, Chapter 17: Controlled Foreign Company Legislation in Germany, in Controlled Foreign Company Legislation (G.W: Kofler et al. eds., IBFD 2020), Books IBFD.

54 Ibid.

Another reason behind the introduction of CFC rules in Germany was to raise the foreign tax burden to the domestic level, as can be found in the parliamentary documents of 1971. '*Explicitly the legislator stated that there was no intention to penalize foreign activities hence the taxes suffered by a foreign subsidiary on passive income may be credited against corporate income taxes due in Germany*'.[55] However, given that domestic taxes on CFC income is subject to corporation and trade tax and there is no credit on trade tax, the overall result is a higher tax burden.

The structure of CFC legislation in Germany, also considering the changes that were made throughout the year, has basically remained static. According to German legislation, a CFC is a foreign corporation that shares capital or voting rights, is directly or indirectly majority owned by German resident shareholders, and generates passive income subjected to low taxation, i.e. income that is taxed at a tax rate below a threshold of 25%.[56]

German CFC rules have always targeted low-taxed passive business income and left out income from active business[57] (or, more specifically, all income that is not covered in the list of active income) and, until 2003, only some categories of passive income were targeted that were, in particular, ordinary passive income,[58] passive capital investment income, and passive capital investment income from intra-group financing activities.[59]

In 2003, the Tax Benefit Reduction Act eliminated the category of passive capital investment income from intra-group financing activities and changed the way resident German shareholders should include their passive income in their total income based on the proportional share of all CFC low-taxed passive income.[60]

Germany has enacted, through time, different types of CFC legislation, i.e. a simple and an extended version. According to the simple version, passive low taxed income is calculated at the level of the CFC and, if the criteria of passive income and low taxation are satisfied, then '*the low taxed passive income is deemed to be distributed to the shareholder in proportion to his holdings … and the taxes paid by the foreign company can be deducted from the attributed income*'.[61] If the profits of a CFC are later distributed, the dividend is then tax exempted. This way, double

55 Stefan Weber and Martin Weiss, Legal Uncertainty in the Application of the German CFC Rules, Bulletin for International Taxation, June 2016.
56 Martin Weiss, recent development in the German tax treatment of CFCs, European taxation, 2015.
57 Guido Forster, Dirk Schmidtmann, CFC Legislation in Germany, Intertax, Vol.32, Issue 10, 2004; see also Weiss and Weber *at supra* note 49.
58 Ordinary passive income was taxed to German resident shareholders as if the income was distributed to them and is therefore defined as a deemed dividend; see also Guido Forster, Dirk Schmidtmann, CFC Legislation in Germany, Intertax, Vol.32, Issue 10, 2004.
59 Guido Forster, Dirk Schmidtmann, CFC Legislation in Germany, Intertax, Vol.32, Issue 10, 2004.
60 Guido Forster, Dirk Schmidtmann, CFC Legislation in Germany, Intertax, Vol.32, Issue 10, 2004.
61 A. Rust in M.Lang, H.J. Aigner, U. Scheuerle and M. Stefane, CFC Legislation, Tax Treaties and EC Law, Eucotax, Kluwer Law International,2004.