

BEPS Provides Guidance on Definition of CFCs

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The Organization for Economic Co-operation and Development (OECD) released the final report of Base Erosion and Profit Shifting ([BEPS](#)) on October 5, 2015. The report seeks to make a more [uniform global legal system](#) to recover deferred tax revenues from multinational corporations who engage in aggressive international tax planning.

Because the report is not self-executing, individual countries must modify their own tax rules to implement BEPS-suggested changes. While the OECD intended to create a coordinated set of rules, the rules may have the [opposite effect](#). As some countries will likely adopt the suggestions more swiftly than others, the rules may create an even more complex global tax system.

The report consists of 15 Actions dealing with a comprehensive set of international tax issues. [Action 3](#), which deals with controlled foreign corporations (CFCs), seeks to prevent corporations from deferring taxation by shifting income into foreign subsidiaries.

Typically, CFCs are subsidiary corporations that are incorporated in a foreign jurisdiction and “controlled” directly or indirectly by domestic shareholders of a given country. Satisfaction of the CFC definition subjects the subsidiary to current domestic taxation of certain qualified income, with certain exceptions.

With regards to the definition of a CFC, Action 3 provides some discussions with occasional guidance regarding 1) the scope of entities and 2) the control requirement.

Action 3 suggests broadening of the scope of entities subject to the CFC rules to include other types of foreign entities such as trusts, partnerships, and permanent establishments not already subject to domestic taxation. Many countries, including the US, only subject subsidiaries to the CFC regime if they are treated as corporations for tax purposes.

Action 3 also explores what constitutes “control.” It first discusses bases for evaluating control. Some [tests](#), like the US’s, are formalistic and based solely on voting or equity, while others, like Mexico’s, rely on a more de facto (facts-and-circumstances) regime. The Action suggests that a good minimum standard for control would be a combination of legal and economic control. Control tests based on de facto or consolidations are complex and may unnecessarily increase compliance costs.

Second, Action 3 discusses what level of “control” is sufficient to apply the CFC rules. Most countries, including the US, require more than 50%. Some countries require 50%, while others acknowledge that control could be exercised at even less. The Action suggests that all three approaches are acceptable.

Finally, the Action discusses ways to address “control” when minorities control in concert. The first way is a facts-and-circumstances “acting-in-concert” test, which sacrifices administrative efficiency for accuracy. The second way, the “related party” test, aggregates shares of related parties; it is less accurate but more administratively efficient than the “acting-in-concert” test.

The third way, the “concentrated ownership” test, aggregates shares of owners in a given country who own a substantial amount of the foreign subsidiary. The US uses a version of this approach; it aggregates shares of US shareholders who own 10% or more of the subsidiary. This approach is the least accurate but most administratively efficient. All three ways are acceptable as long as both direct and indirect control is accounted for. Interests held by non-resident taxpayers may or may not be considered in the evaluation.