AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

BDO KNOWS: BASE EROSION AND PROFIT SHIFTING (BEPS)

SUBJECT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD) ISSUES FINAL REPORT ON ACTION ITEM 3, DESIGNING EFFECTIVE CONTROLLED FOREIGN COMPANY ("CFC") RULES

SUMMARY

This tax alert is one installment in a series of alerts on the release of the OECD/G20 Base Erosion and Profit Shifting Project (the BEPS Project).

On October 5, 2015, the OECD released the final report (the "Report") of the BEPS Project. This alert discusses Action Item 3, Designing Effective Controlled Foreign Company rules.

The OECD, a non-governmental forum established to promote economic growth, has developed a 15-point action plan to shape "fair, effective and efficient tax systems." The OECD's project regarding BEPS has addressed issues arising from tax planning strategies that exploit gaps or mismatches in member countries' tax rules.

BACKGROUND AND DETAILS

In an effort to address BEPS issues in a coordinated and comprehensive manner, the G20 finance ministers called on the OECD to develop an action plan to equip countries with instruments that will better align tax with economic activity. Action Item 3 of the BEPS Project specifically addresses the need for developing a global framework for CFC rules, which is consistent with the global business environment critical to counteracting BEPS. CFC rules generally

CONTACT:

ROBERT PEDERSEN, International Tax Practice Leader
(212) 885-8398 / rpedersen@bdo.com

JOE CALIANNO, Partner and International Technical Tax Practice Leader
National Tax Office
(202) 904-2402 / jcalianno@bdo.com

ROBERT M. BROWN, Partner
(412) 281-6018 / rmbrown@bdo.com

MICHIKO HAMADA, Senior Director, Transfer Pricing
(212) 885-8577 / mhamada@bdo.com

SCOTT HENDON, Partner
(214) 665-0750 / shendon@bdo.com

MONIKA LOVING, Partner
(404) 979-7188 / mloving@bdo.com

CHIP MORGAN, Partner
(310) 557-7517 / cmorgan@bdo.com

BRAD RODE, Partner
(312) 233-1869 / brode@bdo.com

WILLIAM F. ROTH III, Partner,
National Tax Office
(616) 776-3761 / wfroth@bdo.com

JERRY SEADE, Principal
(713) 986-3108 / jseade@bdo.com

provide an anti-deferral mechanism within a taxation system to trigger current taxation of an item of income as a means to prevent shifting income between jurisdictions.

The OECD recognizes in the Report that CFC provisions are an area where significant work has not previously been undertaken. Working toward better engagement on this issue, the OECD developed six building blocks upon which its recommendations can be utilized as a foundation for effective CFC rules. These six building blocks are:

- Definition of a CFC;
- CFC Exemptions and Threshold Requirements;
- Definition of income;
- Computation of income;
- Attribution of income; and
- Prevention and Elimination of Double Taxation.

The Report provides broad recommendations of proposed actions as well as examples from existing CFC regimes on each of these building blocks. Action Item 3 recommendations were designed around the principle of flexibility in allowing each country to implement CFC rules which would fit into its taxation system in a manner that best addresses the BEPS concerns of that jurisdiction.

Enacted in 1962, "Subpart F," which commonly refers to Internal Revenue Code Section 951 through 965 and the regulations thereunder, addresses the US CFC provisions. The recommendations contained in Action Item 3 share numerous similarities (and some differences) with the US CFC rules.

ACTION ITEM 3 QUICK REFERENCE GUIDE COMPARING OECD RECOMMENDATIONS WITH US CFC RULES

CFC BUILDING BLOCKS	OECD RECOMMENDATION	US TAX CONCEPT
Definition of a CFC	Includes corporate entities, permanent establishments ("PE"), and certain transparent entities; addresses possibility for hybrid entity mismatch arrangements; applies legal and economic control tests with a view to more than 50-percent direct and indirect control.	Includes foreign corporations with a more than 50-percent ownership, by US shareholders, threshold primarily based upon direct, indirect and constructive control. Not applicable to PEs and transparent entities.
Exemptions and Thresholds	Utilizes a subject-to-tax exemption at an effective rate of tax substantially similar to the parent company tax rate. Consideration could also be given to a "white list" of countries with advance approval of appropriately similar statutory tax rates to the parent jurisdiction.	US CFC rules include numerous statutory exemptions including: de minimis income thresholds, same-country income exemptions, and a high-taxed income exemption. Temporary exceptions are also available for certain active financing income and certain income generated from an underlying active business in another CFC.
Definition of CFC Income	Domestic legislation should take a risk-based approach to identify types of income with the greatest potential for BEPS. The CFC rules should include a definition of CFC income that reflects this BEPS risk from the parent jurisdiction perspective. Must capture "cash box" income and should include elements of a	CFC income defined through domestic law provisions focused on passive-type income. Subject to various exceptions, the following categories of CFC income are currently taxed to US shareholders as subpart F income, including but not limited to: "Foreign base company income," which covers certain dividends

	substance-based analysis. Suggestion for a potential to focus on excess profits analysis.	interest, rents, royalties, gains and notional principal contract income; income from certain sales involving related parties; income from certain services performed outside the CFC's country of incorporation, for or on behalf of related parties; and certain oil related income.
Computation of Income	Parent jurisdiction CFC rules should control the computation of CFC income. To the extent permitted, loss offset provisions can apply only on a CFC-by-CFC basis or CFCs in same country.	US CFC rules provide mechanical guidance on computation of CFC income which includes allowance for deductions. The rules also provide certain rules relating to qualified deficits of a CFC and chain deficits of CFCs in same country relating to certain types of income.
Attribution of Income	A five-step process has been developed for the process of attribution of income tied to control and is calculated by reference to ownership percentage and period of ownership.	Control and ownership percentage and period tests apply in determining amount of CFC income subject to current taxation.
Prevention and Elimination of Double Taxation	CFC rules should not result in double taxation. Recommendations include application of a foreign tax credit against CFC income as well as potential for dividend and capital gain exemptions for previously taxed income.	US international tax rules contain a complex foreign tax credit system to allow for relief from double taxation. US CFC income previously subject to taxation is exempt from secondary taxation.

BDO INSIGHTS

It is worth noting that the final version of the Report supersedes the discussion draft issued in April 2015. Additional recommendations have been made in response to gaining consensus between jurisdictions with regards to a worldwide and territorial system of taxation. Significant concerns were raised after the release of the April discussion draft on the need to address situations where double taxation could result, as well as how to manage administrative complexity. Moreover, there were questions raised as to whether any global action was needed on CFC rules in light of the BEPS recommendations to be issued on the other action points. While the Report recognizes these comments, multinational companies must still address the practical problems that may arise in the administration of the granular details of each "building block."

The Tax Practice at BDO is among the largest tax advisory practices in the United States. With 63 offices and more than 450 independent alliance firm locations in the United States, BDO has the bench strength and coverage to serve you.

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through 63 offices and over 450 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multinational clients through a global network of 1,328 offices in 152 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information, please visit www.bdo.com.

Material discussed in this tax alert is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

© 2015 BDO USA, LLP. All rights reserved. www.bdo.com