Controlled Foreign Corporation
Rules and Developing Economies

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CFC Legislation

- introduced in the United States in 1962
- “incorporated pocketbook” legislation introduced in some countries in 1930s
Overview of CFC Legislation

- resident shareholders of a CFC are taxed on *pro rata* share of all or certain income of a CFC when it arises not when it is distributed
- generally targets passive income and “base company” income
- generally not intended to affect “legitimate” foreign industrial or commercial activities
Proliferation of CFC Legislation

• 7 countries introduced CFC legislation between 1962 and 1990
  – United States (1962); Germany (1972); Canada (1976); Japan (1978); France (1980); United Kingdom (1984); New Zealand (1988)

• 14 countries added CFC legislation in the 1990s
  – Sweden (1990); Australia (1990); Norway (1992); Finland (1993); Spain (1994); Indonesia (1995); Portugal (1995); Denmark (1995); Korea (1996); Hungary (1997); Mexico (1997); South Africa (1997); Argentina (1999); Venezuela (1999).

• 4 more added since 2000
  – Italy (2000); Israel (2000); Estonia (2000), Lithuania (2002)
CFC Legislation in Developing Economies

- 10 of 25 regimes in developing countries: Indonesia, Korea, Hungary, Mexico, South Africa, Argentina, Venezuela, Israel, Estonia, Lithuania

- currently being considered by other developing countries
Topics for Discussion

• need for CFC legislation in developing economies

• impact of CFC legislation on developing economies
Developing Countries with CFC Laws: Economy (2003 est.)

<table>
<thead>
<tr>
<th>Country</th>
<th>Rank (by GDP)</th>
<th>GDP (US$ billion)</th>
<th>GDP per capita (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>15</td>
<td>758.8</td>
<td>3,200</td>
</tr>
<tr>
<td>Korea</td>
<td>14</td>
<td>857.8</td>
<td>17,800</td>
</tr>
<tr>
<td>Israel</td>
<td>51</td>
<td>120.9</td>
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<td>Hungary</td>
<td>49</td>
<td>139.8</td>
<td>13,900</td>
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<td>112</td>
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<td>Lithuania</td>
<td>77</td>
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<td>South Africa</td>
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<td>456.7</td>
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<td>Mexico</td>
<td>12</td>
<td>941.2</td>
<td>9,000</td>
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<tr>
<td>Argentina</td>
<td>23</td>
<td>435.5</td>
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<tr>
<td>Venezuela</td>
<td>52</td>
<td>117.9</td>
<td>4,800</td>
</tr>
</tbody>
</table>

Source: CIA, The World Factbook
# Selected Developing Countries: Economy (2003 est.)

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<th>Rank (by GDP)</th>
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<tbody>
<tr>
<td>India</td>
<td>4</td>
<td>3,033.0</td>
<td>2,900</td>
</tr>
<tr>
<td>China</td>
<td>2</td>
<td>6,449.0</td>
<td>5,000</td>
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<tr>
<td>Malaysia</td>
<td>38</td>
<td>207.8</td>
<td>9,000</td>
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<tr>
<td>Russia</td>
<td>10</td>
<td>1,282.0</td>
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<td>Brazil</td>
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<td>Cayman Is.</td>
<td>183</td>
<td>1.3</td>
<td>35,000</td>
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<tr>
<td>Singapore</td>
<td>55</td>
<td>109.4</td>
<td>23,700</td>
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</table>

Source: CIA, *The World Factbook*
## Developing Countries with CFC Laws: Location of MNEs

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Parent Corps</th>
<th>Foreign Affiliates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
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<td>313</td>
<td>2,241</td>
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<tr>
<td>Korea</td>
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<td>7,460</td>
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<tr>
<td>Israel</td>
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<td>30</td>
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<td>Hungary</td>
<td>2000</td>
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<td>Estonia</td>
<td>1999</td>
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<tr>
<td>Lithuania</td>
<td>1999</td>
<td>16</td>
<td>1,893</td>
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<td>South Africa</td>
<td>1998</td>
<td>941</td>
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<td>Mexico</td>
<td>2002</td>
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<td>25,708</td>
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<td>Argentina</td>
<td>2002</td>
<td>--</td>
<td>1,123</td>
</tr>
<tr>
<td>Venezuela</td>
<td>2002</td>
<td>--</td>
<td>743</td>
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Source: UN, *2003 World Investment Report*
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<tbody>
<tr>
<td>India</td>
<td>1995</td>
<td>147</td>
<td>1,146</td>
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<td>China</td>
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<td>363,885</td>
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<td>Malaysia</td>
<td>1999</td>
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<tr>
<td>Brazil</td>
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<td>Cayman Is.</td>
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<tr>
<td>Singapore</td>
<td>2002</td>
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<td>14,052</td>
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</table>

Source: UN, 2003 World Investment Report
Developing Countries with CFC Laws: FDI Outward Stock 1985-2000

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Selected Developing Countries: FDI Outward Stock 1985-2000

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## Developing Countries with CFC Laws: Forbes Lists

<table>
<thead>
<tr>
<th>Country</th>
<th>Forbes Billionaires</th>
<th>Forbes 2000 Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>1</td>
<td>7</td>
</tr>
<tr>
<td>Korea</td>
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<td>Israel</td>
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<td>8</td>
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<td>Hungary</td>
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<td>2</td>
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<td>--</td>
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<tr>
<td>Lithuania</td>
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<tr>
<td>South Africa</td>
<td>2</td>
<td>18</td>
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<tr>
<td>Mexico</td>
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<td>Argentina</td>
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<td>Venezuela</td>
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<td>1</td>
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Source: [www.forbes.com](http://www.forbes.com)
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<tbody>
<tr>
<td>India</td>
<td>8</td>
<td>27</td>
</tr>
<tr>
<td>China</td>
<td>1 (+ 16 in H.K.)</td>
<td>25 (+ 24 in H.K.)</td>
</tr>
<tr>
<td>Malaysia</td>
<td>4</td>
<td>16</td>
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<tr>
<td>Russia</td>
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<td>Czech Rep.</td>
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<td>Brazil</td>
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<td>15</td>
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<td>Cayman Is.</td>
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<td>6</td>
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<tr>
<td>Singapore</td>
<td>6</td>
<td>16</td>
</tr>
</tbody>
</table>

Source: [www.forbes.com](http://www.forbes.com)
Rationale for CFC Legislation

• capital export neutrality
  – taxpayers should be taxed the same whether investing domestically or abroad
  – credit given for taxes paid on foreign-source income

• capital import neutrality
  – taxpayers investing abroad should be taxed the same as residents of the foreign jurisdiction
  – foreign-source income exempt from tax
Rationale for CFC Legislation

• separate taxation of corporations (or other entities, such as trusts)
• income not taxed in resident country until profits of foreign corporation remitted or until shares of foreign corporation sold
• benefit of deferral dependent on:
  – amount of foreign income
  – difference between effective foreign and domestic tax rates
  – time and interest rates
Rationale for CFC Legislation

• foreign jurisdictions that impose tax on all or certain income at rates substantially below rate in residence country
  – “classical tax havens”
  – “preferential tax regimes”
Rationale for CFC Legislation

• removal of capital barriers, such as exchange controls, to trade and investment

• mobile sources of income: portfolio income (individual and corporate); aspects of MNE that are not location specific
CFC Legislation for India?

- foreign exchange controls liberalized in 2000 (Foreign Exchange Management Act, 1999), although still restrictive

- foreign direct investment by Indian companies
  - subsidiary engaged in “bona fide business activity”
  - sale or transfer of shares in accordance with prescribed conditions, including repatriation of proceeds

- foreign portfolio investment
  - shares, rated bonds and fixed income securities of listed foreign companies
  - foreign company has business interest in India
Deferral Opportunities

- India MNE
  - Pays annual insurance premium (deduction allowed)
  - Pays interest on loan (deduction allowed)

- Holding Company

- Barbados Bank Co
  - Preferential Tax Rate
  - Pays interest on loan (deduction allowed)

- Foreign Manufacturing Co
  - Preferential Tax Rate

- Bermuda Insurance Co
  - Preferential Tax Rate (?)
  - Pays interest on loan (deduction allowed)
Types of CFC Legislation

• “transaction approach”
  – “tainted income” of CFC is taxed in the hands of resident shareholders regardless of location of CFC

• “jurisdiction approach”
  – all income or “tainted income” of CFC resident in a “tax haven” is taxed in the hands of resident shareholders
Salient features

- definition of a CFC: control issues
- location of CFC: definition of a tax haven
- attributed income: entity vs. transaction
- domestic taxpayers subject to CFC rules
- exemptions: e.g., industrial/commercial activity
- relief provisions
Definition of a CFC

• “control” by residents
  – generally, more than 50% of shares of CFC must be owned by resident shareholders (indirect and constructive ownership rules)
  – in some countries, CFC legislation applicable if one resident shareholder owns a substantial interest (10 – 25%)
Location of CFC

- transaction approach: “tainted income” attributed
  - location of CFC irrelevant (e.g., US, Canada)

- jurisdiction approach: all or “tainted income” attributed
  - comparable tax test (e.g., foreign tax less than \( \frac{3}{4} \) of tax payable if CFC a resident company)
  - black or white list
Attributed Income

- all income (entity approach)

vs.

- “tainted income” (transaction approach)
  - portfolio income (interest, dividends, royalties, rents)
  - “base company” income: e.g.,
    - certain sales and services income (e.g., inter-affiliate)
    - investment business
    - insurance (e.g., insurance of resident risks)

- shareholders must compute pro rata share of attributed income using domestic tax laws
Domestic taxpayers subject to CFC rules

- all resident shareholders of CFC

vs.

- resident shareholders owning at least \( x\% \) (usually 10\%) of shares of CFC

\[ A \quad B \quad C \quad D \quad E \quad F \quad G \quad H \quad I \quad J \quad K \quad \text{(9.9\% each)} \]
Exemptions

- relevant primarily to “jurisdiction approach” legislation
- genuine industrial/commercial activity
- publicly traded CFC
- *de minimis* (e.g., tainted income does not exceed certain amount)
- other: distribution; motive
Relief from Double Taxation

- foreign taxes: e.g., credit for taxes paid by CFC
- losses: carry-over of losses; consolidation with profits of shareholders not generally permitted
- subsequent dividends: exempt up to amount of previously attributed income
- gain on disposition of shares of CFC: exempt up to amount of previously attributed income
Implementation and Enforcement Concerns

• devil in the details: the more targeted the legislation, the more complex it is

• design issues

• sufficient trained audit staff

• information reporting

• penalties
FIF Legislation

• backstop for CFC legislation

• elimination of deferral for passive income not caught by CFC rules (i.e., widely-held foreign investment entity)

• information reporting concerns
  – alternatives to attribution: mark-to-market; x% of cost of interest in FIF
CFC Legislation and Inbound Investment

• developing economies often offer tax incentives (e.g., tax holidays) to attract FDI

• interaction between tax incentives and CFC legislation
CFC Legislation and Inbound Investment

• preferential tax regime in developing country may qualify as a “tax haven” under CFC legislation

• CFC exemption for industrial/commercial activities

• Canada-Israel Development Ltd. (Tax Court of Canada, 1985) (tax sparing vs. CFC legislation)
CFC Legislation and Inbound Investment

- Canco
  - 100%
  - Israel VC Co
  - 9%
  - Israel Start-up Co
  - 8%
  - Israel Start-up Co
  - 7%
  - Israel Start-up Co
  - 6%
  - Israel Start-up Co
CFC Legislation and Inbound Investment

- *Union of India et al. v. Azadi Bachhao Andolan et al.* [the Mauritius case]

  - Indo-Mauritius treaty exempts gain on disposition of India Co from tax in India
  - Mauritius exempts Mauritius Co from tax on sale of shares
  - Application of CFC legislation by resident state of Investco?
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