Controlled Foreign Corporation Rules and Developing Economies

Daniel Sandler
Faculty of Law
The University of Western Ontario

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.)

Country	Rank (by GDP)	GDP (US$billion)	GDP per capita (US$)
Indonesia	15	758.8	3,200
Korea	14	857.8	17,800
Israel	51	120.9	19,800
Hungary	49	139.8	13,900
Estonia	112	17.4	12,300
Lithuania	77	40.9	11,400
South Africa	22	456.7	10,700
Mexico	12	941.2	9,000
Argentina	23	435.5	11,200
Venezuela	52	117.9	4,800

Source: CIA, *The World Factbook*

Selected Developing Countries: Economy (2003 est.)

Country	Rank (by GDP)	GDP (US$billion)	GDP per capita US$)
India	4	3,033.0	2,900
China	2	6,449.0	5,000
Malaysia	38	207.8	9,000
Russia	10	1,282.0	8,900
Czech Rep.	44	161.1	15,700
Brazil	9	1,375.0	7,600
Cayman Is.	183	1.3	35,000
Singapore	55	109.4	23,700

Source: CIA, *The World Factbook*

Developing Countries with CFC Laws: Location of MNEs

Country	Year	Parent Corps	Foreign Affiliates
Indonesia	1999	313	2,241
Korea	2002	7,460	12,909
Israel	2002	--	30
Hungary	2000	--	26,645
Estonia	1999	--	3,066
Lithuania	1999	16	1,893
South Africa	1998	941	2,044
Mexico	2002	--	25,708
Argentina	2002	--	1,123
Venezuela	2002	--	743

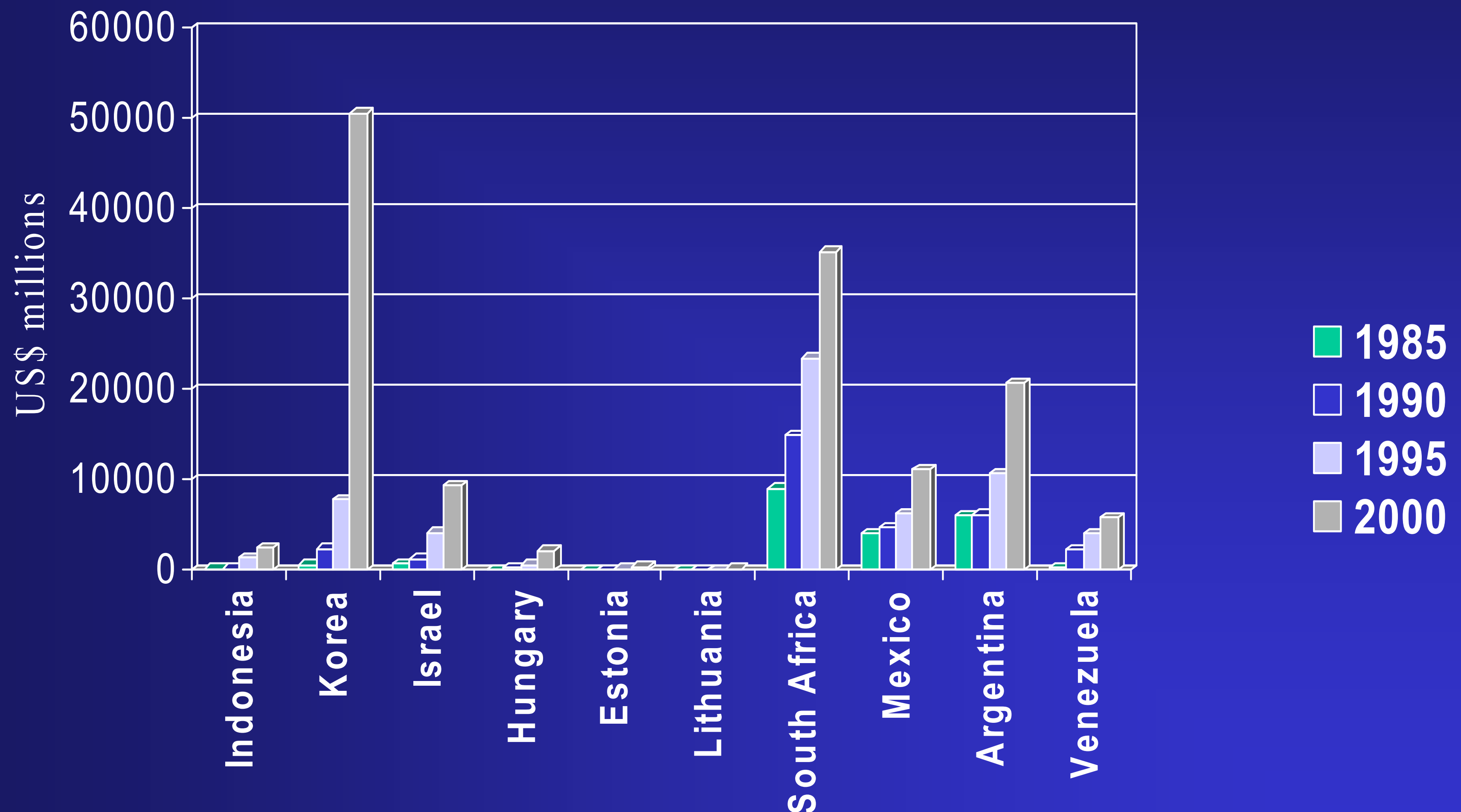
Source: UN, *2003 World Investment Report*

Selected Developing Countries: Location of MNEs

Country	Year	Parent Corps	Foreign Affiliates
India	1995	147	1,146
China	2002	350	363,885
Malaysia	1999	--	15,567
Russia	1994	--	7,793
Czech Rep.	1999	660	71,385
Brazil	1998	1,225	8,050
Cayman Is.	2002	--	283
Singapore	2002	--	14,052

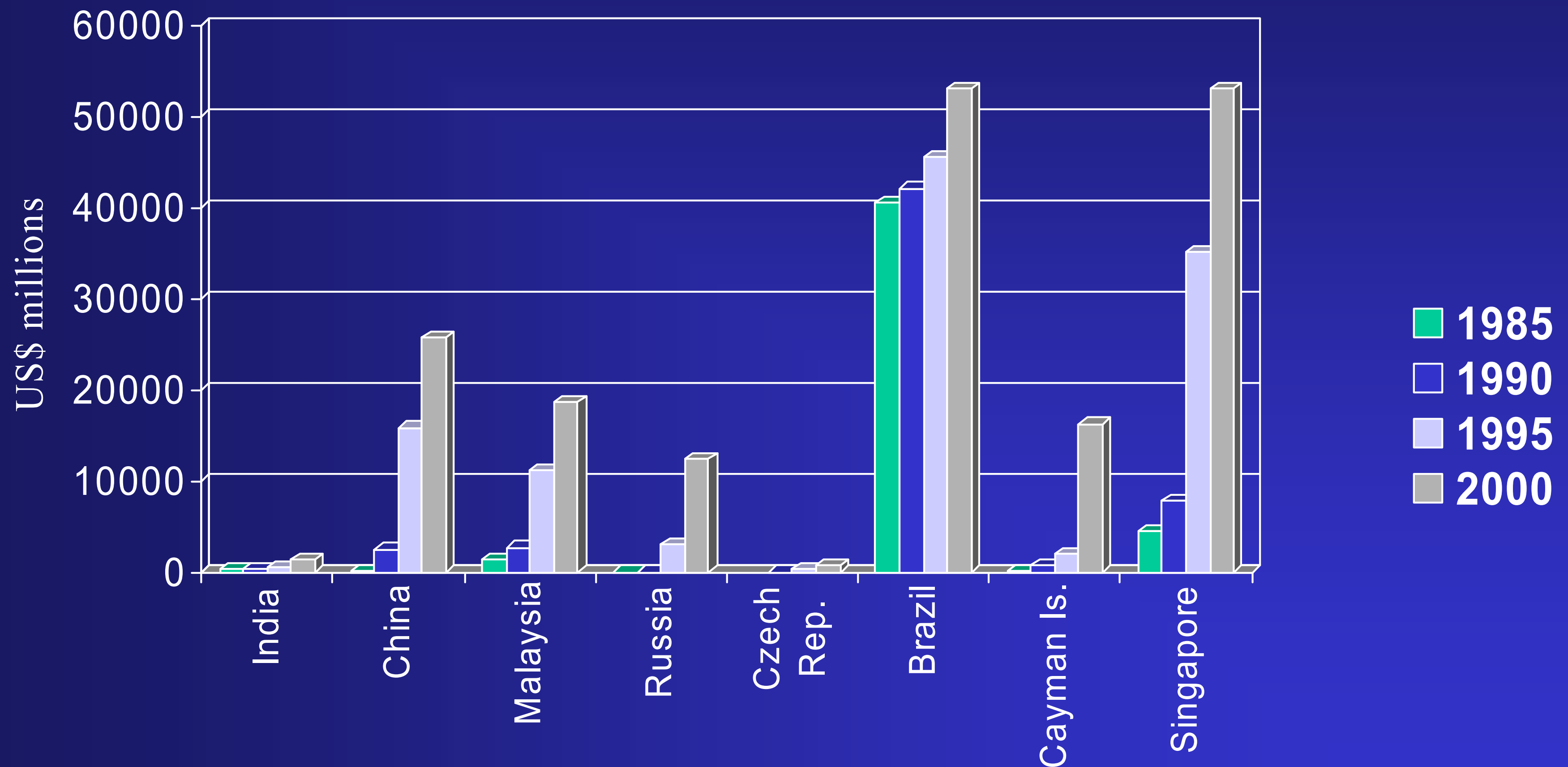
Source: UN, *2003 World Investment Report*

Developing Countries with CFC Laws: FDI Outward Stock 1985-2000



Source: UN, *2003 World Investment Report*

Selected Developing Countries: FDI Outward Stock 1985-2000



Source: UN, *2003 World Investment Report*

Developing Countries with CFC Laws: Forbes Lists

Country	Forbes Billionaires	Forbes 2000 Companies
Indonesia	1	7
Korea	2	49
Israel	4	8
Hungary	--	2
Estonia	--	--
Lithuania	--	--
South Africa	2	18
Mexico	11	17
Argentina	1	--
Venezuela	2	1

Source: www.forbes.com

Selected Developing Countries
Forbes Lists

Country	Forbes Billionaires	Forbes 2000 Companies
India	8	27
China	1 (+ 16 in H.K.)	25 (+ 24 in H.K.)
Malaysia	4	16
Russia	26	12
Czech Rep.	--	2
Brazil	5	15
Cayman Is.	--	6
Singapore	6	16

Source: 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

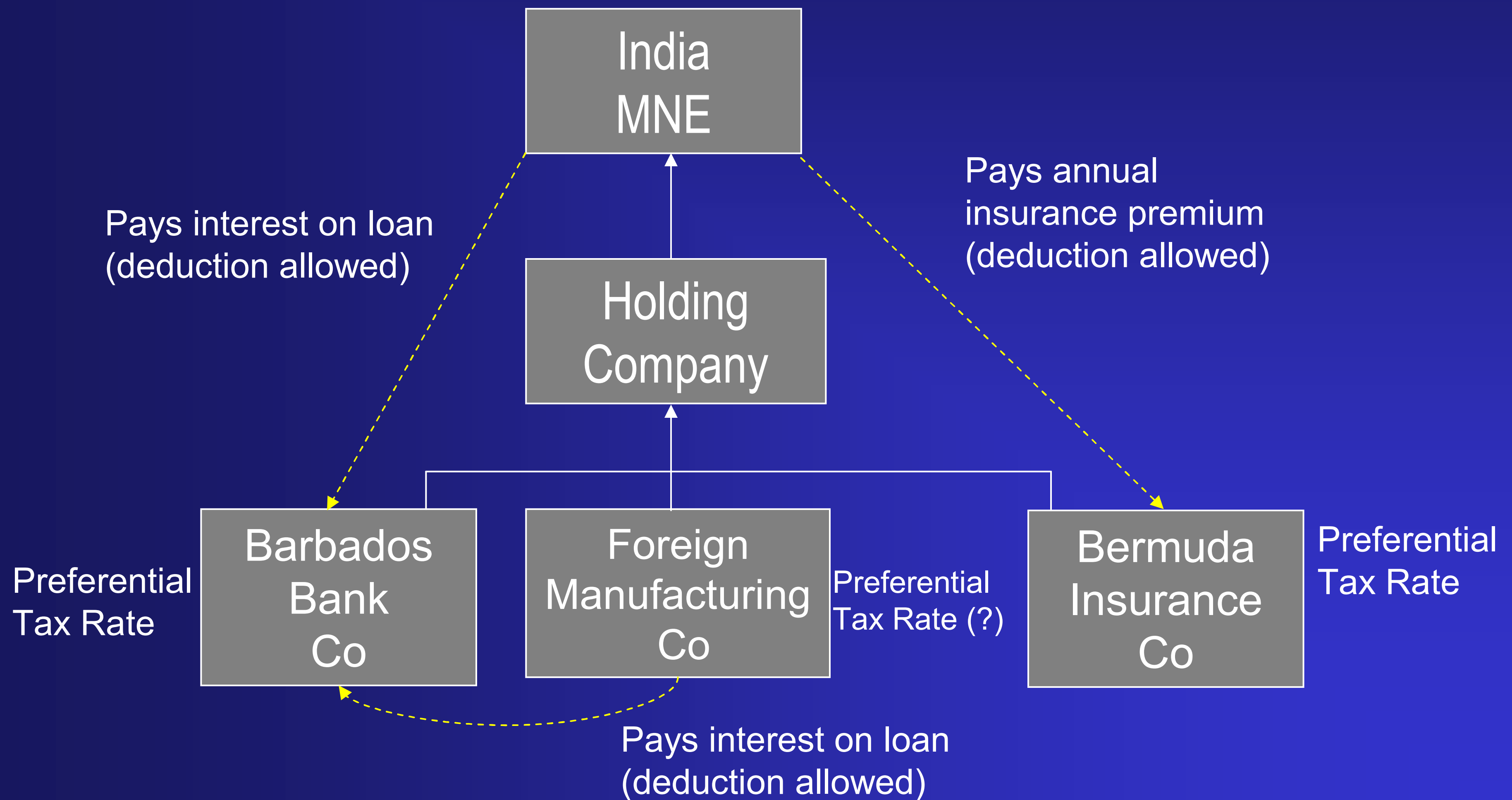
- removal of capital barriers, such as exchange controls, to trade and investment

- 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



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 ¾ of tax payable if CFC a resident company)
  - black or white list

Attributed Income

- all income (entity approach)

vs.

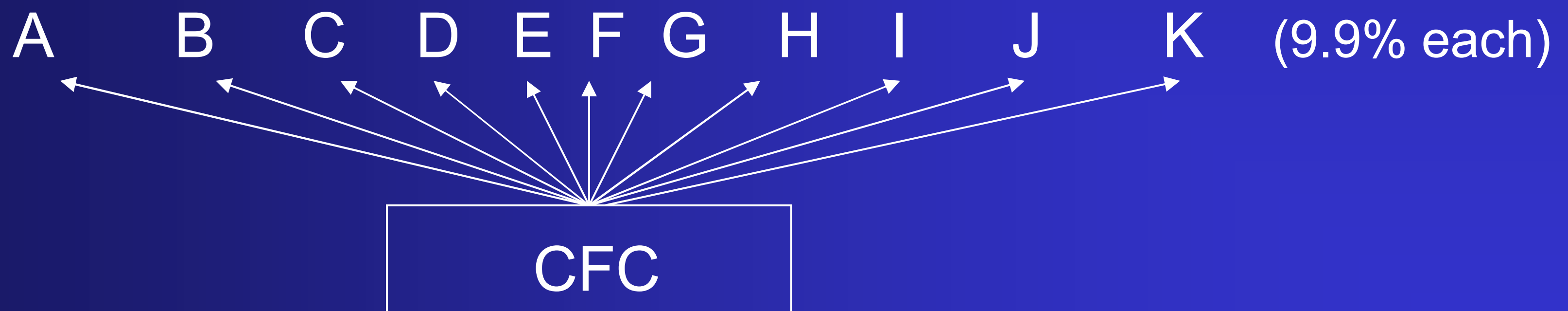
- "tainted income" (transaction approach)
  - portfolio income (interest, dividends, royalties, rents)
  - "base company" income: e.g.,
    - certain sales and services income (e.g., inter-affiliate)
    - investment business
    - insurance (e.g., insurance of resident risks)
- shareholders must compute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



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

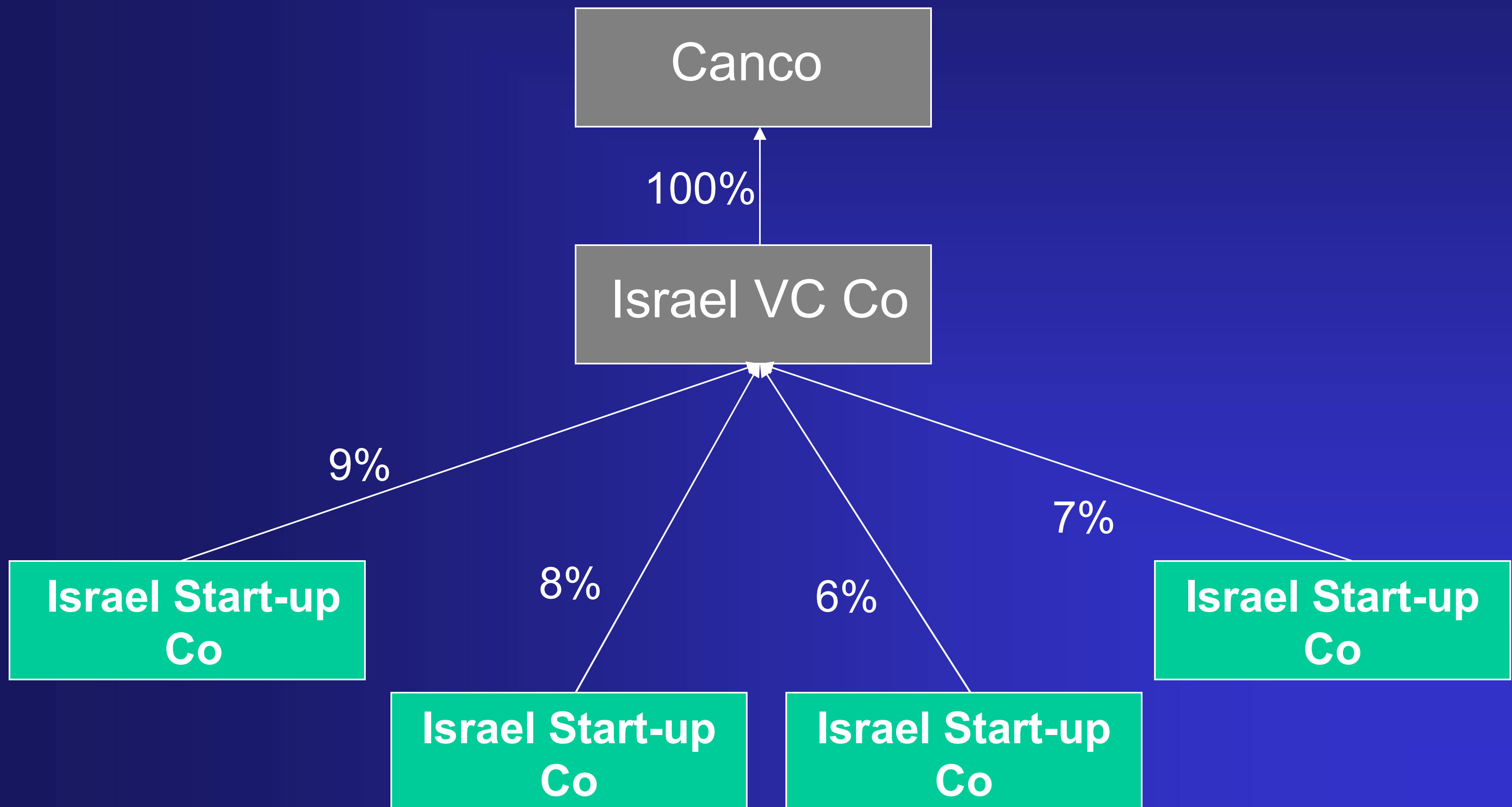
CFC Legislation and Inbound Investment

- 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

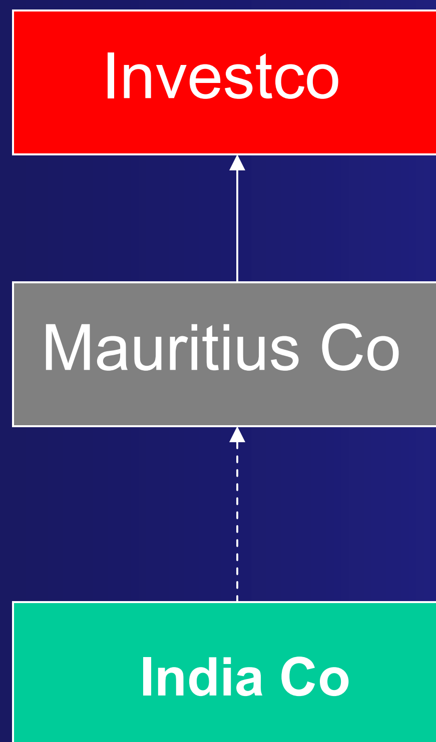
- preferential tax regime in developing country may qualify as a “tax haven” under CFC legislation
- CFC exemption for industrial/commercial activities
- *Canada-Israel Development Ltd.* (Tax Court of Canada, 1985) (tax sparing vs. CFC legislation)

CFC Legislation and Inbound Investment



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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