

**Reprinted from British Tax  
Review  
Issue 3, 2015**

*Sweet & Maxwell*  
**Friars House  
160 Blackfriars Road  
London  
SE1 8EZ  
(Law Publishers)**

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# The Role of CFC Rules in the BEPS Initiative and in the EU

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## Abstract

*This article discusses the purpose of the controlled foreign companies (CFC) rules in the base erosion and profit shifting (BEPS) initiative, how they contribute to the holistic approach and the meaning of co-ordination among the BEPS actions. It also discusses the compatibility of CFC rules with EU law in the EU BEPS context: whether EU law only sets limits to CFC rules adopted by EU Member States and applied to other EU Member States or if EU law also limits CFC rules adopted by EU Member States towards non-EU jurisdictions. Whereas in the BEPS initiative CFC rules are an element of tension between source and residence States, in the EU, Member States face serious difficulties in adopting effective CFC rules because of the so far too narrow interpretation of avoidance (that is, artificiality) by the Court of Justice of the European Union (CJEU).*

## Introduction

Unilateral tax rules recognise that CFCs are normally treated as autonomous taxpayers and therefore profits attributable to the CFCs are not included in the tax base of the resident shareholder (territoriality principle, or separate entity approach). This means that foreign income of a foreign company is subject to deferral until repatriation.<sup>1</sup>

This recognition of the CFC as an autonomous tax entity occurs both in States that tax worldwide income and in States that apply the exemption system. However, the above-mentioned regime is often subject to the condition that the CFC is sufficiently taxed in the jurisdiction in which it is incorporated.

CFC legislation broadly means that all (active and passive income) or part (passive income) of the CFC's income is annually included in the tax base of its controlling resident shareholders

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<sup>1</sup> G. Kofler, “CFC Rules” in M. Lang, P. Pistone, J. Schuch, C. Staringer (eds), *Common Corporate Consolidated Tax Base* (Linde Verlag Wien, 2008), 727–729. There are recent relevant exceptions to this practice, such as in Brazil (see the Brazilian regime limiting tax deferral and court cases some of which involve the compatibility with the constitution and others on compatibility with tax treaties: DAU, 2, 588, Supreme Federal Court (Supremo Tribunal Federal) April 10, 2013; confirmed in Coamo, 611, 586). See also, *Eagle Distribuidora de Bebidas SA v Second Group of the Revenue Department in Brasilia* Appeal number 148.709; First Council of Taxpayers (Conselho de Contribuintes) (First Chamber), October 19, 2006; Case 2003.51.01.002937-0 Cia Vale do Rio Doc, Case number 2003.51.01.002937-0, Federal Regional Court of the 2nd Region (Tribunal Regional Federal da 2a Região), November 22, 2011.

and taxed at the rates of the jurisdiction of the latter, even if the profits have not been distributed as dividends or realised as gains.<sup>2</sup>

CFC legislation was first adopted in the US in 1962, with its “Subpart F”<sup>3</sup> legislation, and subsequently in various domestic legislation,<sup>4</sup> strongly recommended by the OECD in the 1996 Report on *Controlled Foreign Company Legislation (Studies in Taxation of Foreign Income)* (the 1996 Report on CFCs)<sup>5</sup> and in the 1998 Report on *Harmful Tax Competition* (1998 Report), “[s]ince unilateral measures are easiest for countries to adopt, as they do not require acquiescence of other countries....”<sup>6</sup>

Although dozens of countries have implemented CFC rules, in recent decades profit shifting to affiliates situated in low-tax jurisdictions for tax reasons has also increased and CFC rules have not proved to be totally effective. The G20/OECD BEPS initiative<sup>7</sup> calls for reinforcement of domestic CFC legislation, recognising that insufficient work has been done by the OECD in this area.<sup>8</sup> Action 3<sup>9</sup> was supposed to recommend the design of adequate CFC rules and to clarify their role among the other proposed measures to fight BEPS.

The *Public Discussion Draft BEPS Action 3: Strengthening CFC Rules*, of May 12, 2015 (Public Discussion Draft BEPS Action 3),<sup>10</sup> starts as follows:

“Action Item 3 of the BEPS Action Plan recognises that groups can create low-taxed non-resident affiliates to which they shift income and that these affiliates may be established in low-tax countries wholly or partially for tax reasons rather than for non-tax business reasons.”<sup>11</sup>

And it goes on to mandate OECD Working Party (WP) 11 to develop recommendations on the design of CFC rules.<sup>12</sup> The Public Discussion Draft BEPS Action 3 leaves one important door open: the definition of CFC income (Chapter 5).<sup>13</sup> But the recommendations in the other

<sup>2</sup> See M. Dahlberg and B. Wiman, “General Report”, *Cahiers de Droit Fiscal International*, IFA, 2013, Copenhagen Congress, Vol.98a, 19.

<sup>3</sup> I.R.S. 4.61.7.1 (05-01-2006) Controlled Foreign Corporations (CFC) Subpart F.

<sup>4</sup> Dahlberg and Wiman, above fn.2, 25.

<sup>5</sup> OECD, *Controlled Foreign Company Legislation (Studies in Taxation of Foreign Income)* (OECD, 1996), 120–122.

<sup>6</sup> OECD, Report on *Harmful Tax Competition: An Emerging Global Issue* (OECD, 1998), para.91.

<sup>7</sup> OECD, *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan) (Paris: OECD Publishing, 2013), available at: <http://dx.doi.org/10.1787/9789264202719-en> [Accessed July 13, 2015].

<sup>8</sup> “One area in which the OECD has not done significant work in the past is CFC rules. One of the sources of BEPS concerns is the possibility of creating affiliated non-resident taxpayers and routing income of a resident enterprise through the non-resident affiliate. CFC and other anti-deferral rules have been introduced in many countries to address this issue. However, the CFC rules of many countries do not always counter BEPS in a comprehensive manner. While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have positive spill-over effects in *source countries* because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction”: BEPS Action Plan, above fn.7, 16.

<sup>9</sup> BEPS Action Plan, above fn.7.

<sup>10</sup> OECD, *Public Discussion Draft BEPS Action 3: Strengthening CFC Rules* (May 12, 2015), available at: <http://www.oecd.org/ctp/aggressive/discussion-draft-beps-action-3-strengthening-CFC-rules.pdf> [Accessed July 13, 2015].

<sup>11</sup> Public Discussion Draft BEPS Action 3, above fn.10, 6.

<sup>12</sup> Public Discussion Draft BEPS Action 3, above fn.10, 6.

<sup>13</sup> “Note for consultation This chapter does not yet include recommendations for the building block on the definition of CFC income. Instead, this chapter discusses several possible options for provisions that jurisdictions could implement in order to accurately attribute income that raises BEPS concerns. The 2015 report on Action Item 3 will include recommendations on the definition of CFC income, and the OECD welcomes comments and suggestions during the

chapters should ideally be reduced to clear policy options where CFC rules would have anti-avoidance purposes. Even if a mandate granted to OECD WP 11 is within the OECD procedures, BEPS actions and recommendations are expected to have worldwide repercussions and not to be limited to OECD Member countries. It is thus expected that Action 3 will be substantially more conclusive than the Public Discussion Draft.

Interpreted in isolation, CFC rules protect the interests of residence States or home investment States.<sup>14</sup> They also indirectly protect the interests of the source States by making it unattractive to transfer profits to a haven (considering residence country A, source country B, and affiliated company in low-tax jurisdiction C, the CFC rules might prevent profit shifting from country B to country C, which would benefit country B). But CFC rules in the BEPS initiative are an element of tension between residence and source countries if the latter have competitive tax policies aimed at attracting foreign investment.<sup>15</sup> Although it will be contended below that the OECD is implicitly working on the basis of a single tax principle,<sup>16</sup> it will also be stressed that the OECD is not mandated to give priority to measures that are supposed to mainly benefit the residence States.<sup>17</sup>

In respect of the EU Member States, the above-mentioned issues and the OECD proposals have to be analysed in the light of EU law. Moreover, national CFC rules in the EU Member States have to be articulated with the anti-hybrid rule adopted in the Parent-Subsidiary Directive<sup>18</sup> and, assuming that there will be some progress in the proposal for a directive on a Common Consolidated Corporate Tax Base (CCCTB) and that it may (at some point soon) be approved, articulation with the CFC rule in the CCCTB Directive is also necessary. This article discusses the purpose of CFC rules in the BEPS initiative, how they contribute to the holistic approach and the meaning of co-ordination among the BEPS actions. It also discusses the compatibility of CFC rules with EU law in the EU BEPS context: whether EU law only sets limits to CFC rules adopted by EU Member States and applied to other EU Member States or if EU law also limits CFC rules adopted by EU Member States towards non-EU jurisdictions. In other words, whether it is *acte clair* that CFC rules are assessed in the light of the freedom of establishment or whether they (also) have to be assessed in the light of the free movement of capital (both of these freedoms are principles of the Treaty on the Functioning of the European Union (TFEU)).

Whereas in the BEPS initiative CFC rules are an element of tension between source and residence States, in the EU, Member States face serious difficulties in adopting effective CFC

public consultation about the design of such recommendations”: Public Discussion Draft BEPS Action 3, above fn.10, 34.

<sup>14</sup> See the critical analysis in Y. Brauner, “The Bad, The Worse, and the Ugly: BEPS Action Items 2 and 3” in R. Danon (ed.), *Base Erosion and Profit Shifting (BEPS)* (Zurich, forthcoming), Ch.IV b.

<sup>15</sup> See this argument elaborated in fn.30 below.

<sup>16</sup> See R.S. Avi-Yonah, “Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy” (University of Michigan Public Law, Research Paper Number 318, 2014), available at: <http://ssrn.com/abstract=2226309> [Accessed July 13, 2015].

<sup>17</sup> See Brauner, above fn.14, point IV.

<sup>18</sup> Under Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2014] OJ L219 which modifies Art.4(1)(a) of the Parent-Subsidiary Directive, the EU Member State in which the parent company is located shall “refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary.”

rules because of the so far too narrow interpretation of avoidance (that is, artificiality) by the Court of Justice of the European Union (CJEU).

### CFC rules

CFC rules deny deferral of taxation on income accrued to a CFC or a similar entity that would escape taxation in the residence country. CFC rules are designed in many countries as an exception to the above-mentioned deferral. They often apply to income that is not genuine business income and income derived by the CFC subject to low tax rates in the foreign jurisdiction<sup>19</sup> (although some CFC legislation also covers genuine business income<sup>20</sup> and is independent of the tax rates in the foreign jurisdictions<sup>21</sup>).

The design of CFC rules presents a number of common characteristics in the different jurisdictions adopting them, possibly influenced by the 1996 Report on CFC legislation.<sup>22</sup> CFC legislation can have a broad scope, covering active and passive income (full-inclusion system), or a smaller scope (partial-inclusion system), exclusively aiming at passive income because the mobility of the latter facilitates its routing to low-tax jurisdictions and therefore facilitates tax avoidance. CFCs covered by CFC legislation can include not only foreign corporations but also other entities such as foundations, partnerships, trusts or permanent establishments,<sup>23</sup> in order to avoid circumvention of CFC legislation.

CFC rules apply only to foreign corporations (or equivalent entities) controlled by resident shareholders holding a significant interest in a CFC. The meaning of control also varies in the different CFC legislation (10 per cent or more, depending on the legislation). A minimum amount of participation can also be found as a requirement, often combined with a condition of a minimum interest of the domestic parent company in the CFC.<sup>24</sup>

To ensure CFC rules are not easily circumvented, indirect participations are often covered by CFC legislation.<sup>25</sup> The Public Discussion Draft BEPS Action 3 also recommends that control should be defined to include both direct and indirect control and be applicable not only to corporate entities but all resident taxpayers.<sup>26</sup>

CFC rules may include any income that could have been earned in any jurisdiction other than the CFC jurisdiction.<sup>27</sup> These CFC rules focus on foreign-to-foreign stripping, protecting not only the parent jurisdiction's tax base but also the stripping of other countries' tax bases.<sup>28</sup> In contrast, some CFC rules only protect the base of the parent jurisdiction, defining CFC income

<sup>19</sup> Kofler, above fn.1, 728.

<sup>20</sup> Sweden, for example: A. Gerson, "Sweden", *Cahiers*, above fn.2, 710 (708–710).

<sup>21</sup> A. Gomes de Oliveira, "Brazil", *Cahiers*, above fn.2, 172–174.

<sup>22</sup> This interpretation is also in Dahlberg and Wiman, above fn.2, 29. See the 1996 Report on CFCs, above fn.5 and the reference to similarities in legislation, in OECD, 1998 Report, above fn.6, para.99. See also, A. Rust, "CFC Legislation and EC Law" (2008) 36(11) *Intertax* 492.

<sup>23</sup> Whereas in the case of transparent entities there is a risk of double non-taxation, in respect of permanent establishments that risk exists where the residence jurisdiction applies the exemption method: Public Discussion Draft BEPS Action 3, above fn.10, 16, para.34.

<sup>24</sup> Dahlberg and Wiman, above fn.2, 31–33.

<sup>25</sup> Dahlberg and Wiman, above fn.2, 29. Public Discussion Draft BEPS Action 3, above fn.10, 32, para.78.

<sup>26</sup> Public Discussion Draft BEPS Action 3, above fn.10, 33, para.81.

<sup>27</sup> Public Discussion Draft BEPS Action 3, above fn.10, Ch.4.

<sup>28</sup> Public Discussion Draft BEPS Action 3, above fn.10, 12, para.18.

to include only that part of the income that has been shifted from the parent jurisdiction.<sup>29</sup> CFC rules only focusing on parent jurisdiction stripping are less effective against BEPS arrangements, but it is contended below that the G20/OECD BEPS initiative should dissuade the OECD residence States from introducing CFC rules focused on foreign-to-foreign stripping, unless in the case of passive income and transparent entities.

In order to circumvent CFC rules, residents may defer domestic tax by acquiring shares in foreign mutual funds. If such funds are widely owned, owners of foreign mutual funds will not be subject to CFC rules. To counter this situation, several countries have adopted foreign investment fund (FIF) or equivalent rules. They supplement CFC rules and are either aimed at countering abuse or broadly eliminating deferral for passive investment in foreign entities.<sup>30</sup>

### **The purpose of CFC rules before and after the BEPS initiative**

#### *The purpose of CFC rules before the BEPS initiative*

Until the BEPS initiative, CFC rules have played different roles in international tax law. CFC rules as introduced by the US in 1962 were linked to worldwide taxation, to the protection of the tax base of the state of residence and to anti-avoidance purposes.<sup>31</sup> The promotion of CFC rules by the OECD has been mainly justified by anti-avoidance purposes and the subsequent move towards territoriality by many OECD Member countries has stressed that purpose: preventing the use of low-tax jurisdictions and shifting income from the jurisdiction of the State of residence. In general, conflicting policy goals, such as capital export neutrality (CEN), competitiveness and anti-avoidance underlie the drafting of CFC rules.<sup>32</sup>

In the 1998 Report CFC legislation is defined and explained as follows:

“Under Controlled Foreign Corporations (CFC) rules, certain income of a CFC is attributed to and taxed currently in the hands of its resident shareholders. Because CFC rules are intended to eliminate the benefits of the deferral of domestic tax on some or all of the foreign source income of a CFC in most countries that have already implemented CFC rules, the rules primarily serve the function to counter tax avoidance by discouraging the legal migration of certain types of income, *e.g.*, base company and passive income to non-resident

<sup>29</sup> Public Discussion Draft BEPS Action 3, above fn.10, 12, para.18.

<sup>30</sup> OECD, 1998 Report, above fn.6, paras 101–103. L. Burns, “The Border Between Controlled Foreign Companies and Foreign Investment Fund Regimes” [2000] *University of New South Wales Law Journal* 44: in Australia, the CFC rules applied only to Australian residents who were substantial holders in a non-resident company that was a CFC. The FIF rules were applicable in non-control cases with effect from January 1, 1993 (and repealed in 2010–11), and applied to other Australian residents with interests in non-resident companies. There were exemptions in the FIF regime, the main exemption being for active income: Point II. FIF rules were to be replaced by the Foreign Accumulation Funds (FAF ED) (Bill 2011): Burns, Australia, *Cahiers*, above fn.2, 101.

<sup>31</sup> Kofler, above fn.1, 727–728.

<sup>32</sup> See Dahlberg and Wiman, above fn.2, 19–20; M. Kane, “The Role of Controlled Foreign Company Legislation in the OECD Base Erosion and Profit Shifting Project” (2014) 68(6/7) *Bulletin for International Taxation*, published online on May 12, 2014, point 2; and the current US CFC rules that, by interacting with check-the-box rules, hide subsidies to their multinationals: J. Clifton Fleming, Jr., R.J. Peroni and S.E. Shay, “Worse than Exemption” (2009) 59(1) *Emory Law Journal* 85 esp. 92–104.

companies. Many of them extend the rules to foreign trusts that are used for the same purpose.”<sup>33</sup>

The OECD explains that

“[i]n some cases, the policy focus is on tax avoidance transactions and in others represents a broader limitation on the deferral of tax on income realized through foreign subsidiaries.”

It is further acknowledged in the 1998 Report that

“CFC rules may also apply in situations which do not involve harmful tax practices as defined in this Report. It is recognised that countries retain their right to use such rules in such situations.”<sup>34</sup>

This is the case in the US, where CFC rules are (still) justified as anti-deferral rules, more than anti-avoidance rules.<sup>35</sup>

*The purpose of CFC rules in OECD BEPS Action Plan and in Action 3 (Public Discussion Draft)*

The Public Discussion Draft Action 3 foresees a reinforcement of CFC legislation. In the OECD BEPS Action Plan, Action 3 was “arguably the most open-ended of all the action items.”<sup>36</sup> In fact, it was simply stated: “Develop recommendations regarding controlled foreign company rules. This work will be co-ordinated with other work as necessary.”<sup>37</sup>

Considering that CFC legislation is one of the tools to address BEPS, it is not surprising that both the Action Plan and the Public Discussion Draft on Action 3 adopt an open-ended approach towards the interaction between CFC legislation and the other measures foreseen in other actions. In OECD countries, CFC legislation has traditionally been the backstop to other rules applicable to cross-border movements, such as transfer pricing<sup>38</sup> and corporate tax residence.

The cited reference to co-ordination in the BEPS Action Plan means that the role of CFC rules in the context of the BEPS initiative, the interaction of those rules with transfer pricing (TP) rules, the meaning of corporate tax residence, and the articulation between CFC rules and anti-hybrid measures as proposed in Action 2 have to be addressed.<sup>39</sup>

The Public Discussion Draft BEPS Action 3, delivered in May 2015 by the OECD, sheds some light on the articulation of some of the above-mentioned topics, but in most cases it does so by suggesting an implicit and not explicit articulation.

The above-mentioned Public Discussion Draft puts forward the various policy considerations that are normally taken into account in the design of CFC rules: their purpose; how to strike a balance between taxing foreign income and maintaining competitiveness; how to limit

<sup>33</sup> OECD, 1998 Report, above fn.6, para.97.

<sup>34</sup> OECD, 1998 Report, above fn.6, para.98.

<sup>35</sup> R.S. Avi-Yonah and N. Sartori, “US Subpart F Legislative Proposals: A Comparative Perspective” (University of Michigan Law School University of Michigan Law School Scholarship Repository Law & Economics Working Papers, 2012), 1–5.

<sup>36</sup> See Kane, above fn.32.

<sup>37</sup> BEPS Action Plan, above fn.7, 44.

<sup>38</sup> Public Discussion Draft BEPS Action 3, above fn.10, 13; Fleming, Peroni and Shay, above fn.32, 105–106.

<sup>39</sup> Kane, above fn.32; G. Maisto, “Controlled Foreign Company Legislation, Corporate Residence and Anti-Hybrid Arrangement Rules” (2014) 68(6/7) *Bulletin for International Taxation*, published online May 26, 2014.

administrative and compliance costs; the role of CFC rules as preventive measures; the scope of base stripping prevented by CFC rules; how to ensure that CFC rules do not lead to double taxation; how CFC rules interact with TP rules.<sup>40</sup> The same Public Discussion Draft acknowledges the various policy considerations underlying CFC rules, but it clarifies that the recommendations discussed in the draft on the design of those rules aim to combat base erosion and profit shifting.<sup>41</sup> However, by proposing several designs of CFC rules, the Public Discussion Draft does not elaborate on co-ordination among countries. Furthermore, it is recognised that the CFC rules are closely related to most of the OECD BEPS Actions: Actions Item 1, 2, 4, 5, 8–10, 11, and 15.<sup>42</sup>

### CFC rules and transfer pricing rules

According to the *OECD BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines* (OECD BEPS Actions 8, 9 and 10 Discussion Draft),

“The BEPS Action Plan refers to special measures that are ‘either within or beyond the arm’s length principle.’ Some of these measures could be seen as within the arm’s length principle and others beyond. At this stage, it is not critical to determine whether a potential measure is on one side or the other of the boundary, but the aim is to consider the effectiveness of the measure. It should also not be assumed that, if special measures are introduced that go beyond the arm’s length principle, double taxation may result. The main aim of these special measures is to create transfer pricing outcomes in line with value creation and to limit BEPS risks for governments. It is recognized that consideration needs to be given to the way in which these special measures will be part of the global transfer pricing standards and the way in which double taxation will be prevented. In addition, nothing should be read into the order in which the options are presented in this discussion draft; there is no priority implied.”<sup>43</sup>

The Public Discussion Draft Action 3 does not refer to any hierarchy either, but focuses on justifying the necessity of CFC rules in the BEPS initiative, in relation to other measures, especially in relation to TP rules. It does so, by comparing the role of CFC rules and TP rules,<sup>44</sup> but there is no clear indication as to which set of rules has priority over the other or how they will be co-ordinated.

The Public Discussion Draft refers to TP rules as rules

“intended to adjust the taxable profits of associated enterprises to eliminate distortions arising whenever the prices or other conditions of transactions between those enterprises differ from what they would have been if the enterprises had been unrelated. If TP rules were to fully achieve this objective, they would restore the taxing rights of all jurisdictions

<sup>40</sup> Public Discussion Draft BEPS Action 3, above fn.10, 8.

<sup>41</sup> Public Discussion Draft BEPS Action 3, above fn.10, 7.

<sup>42</sup> Public Discussion Draft BEPS Action 3, above fn.10, 7.

<sup>43</sup> *OECD BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)* (December 1, 2014–February 6, 2015), 39 para.6.

<sup>44</sup> Public Discussion Draft BEPS Action 3, above fn.10, 13–14.



involved. As with CFC rules, TP rules often achieve this objective by deterring business from entering into certain arrangements.”<sup>45</sup>

Improvement of TP rules in the BEPS initiative aims to align the primary taxing rights with value creation (the functional analysis),<sup>46</sup> and TP rules in the above cited paragraph are mainly defined as allocation of taxing rights rules, although it is recognised that they aim to prevent tax avoidance.

### CFC rules as backstop to transfer pricing rules

Transfer pricing rules are the focus of the BEPS initiative.<sup>47</sup> If TP rules are implemented as recommended in Actions 8–10, Actions 12 (mandatory disclosure rules) and 13 (transfer pricing documentation and CbCR),<sup>48</sup> CFC rules will mainly play a secondary role and act as a backstop in cases where TP rules do not work properly.

Even if footnote 3 on page 38 of Part II of the OECD BEPS Actions 8, 9 and 10 Discussion Draft states that “[i]t should not be assumed that the work on strengthening CFC rules will be limited by the options outlined in this discussion draft”,<sup>49</sup> and page 39, paragraph 6 does not refer to a hierarchy, the Public Discussion Draft BEPS Action 3 recognises this secondary role of CFC rules and stresses the complementary role of both sets of rules, for two opposite reasons: because there is no perfect overlapping between them—TP rules were presumably not designed to address profit shifting to low-tax jurisdictions or stateless income; and because both sets of rules can have deterrent effects on profit shifting.<sup>50</sup>

However, if TP rules are based on value creation, any taxable income in a low-tax jurisdiction will only be a result of shifting if the TP rules were not correctly applied (independently of the reason). If taxable income in low-tax jurisdictions is not a result of shifting, application of CFC rules in that situation as a backstop to TP rules goes beyond the G20 mandate to the OECD.<sup>51</sup> In Chapter 5, the Public Discussion Draft BEPS Action 3 seems to discourage such an approach, but it accepts, at the same time, a full-inclusion approach if jurisdictions want to implement

<sup>45</sup> Public Discussion Draft BEPS Action 3, above fn.10, 13, para.21.

<sup>46</sup> Y. Brauner, “Transfer Pricing in BEPS: First Round—Business Interests Win (But, Not in Knock-Out)” (2015) 43(1) *Intertax* 72, 74: “In any event, appropriately, action item 8 (*Intangibles*) is the first transfer pricing action item: ‘Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.’” See OECD BEPS Actions 8, 9 and 10 Discussion Draft, above fn.43, 8–27. BEPS Action Plan, above fn.7, Action 8.

<sup>47</sup> Brauner, above fn.46, 73: “... the OECD expressed a clear (to the extent that it could afford to be clear) intent to shift transfer pricing practice away from the legal and economic reality, mixed approach based on functions, assets and risks, to a more pragmatic, business focus approach, relying on the principle that profits should follow action, or value creation. Such an approach, interestingly, resembles the traditional approach of the United Nations to transfer pricing, an approach rejected to date by the OECD.”

<sup>48</sup> See OECD, *Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (January 30, 2014) (released by the OECD’s WP6); OECD, *Guidance on Transfer Pricing Aspects of Intangibles* (2014) (Action 8: 2014 Deliverable), available at: <http://www.oecd.org/tax/beps-2014-deliverables.htm> [Accessed July 13, 2015].

<sup>49</sup> OECD BEPS Actions 8, 9 and 10 Discussion Draft, above fn.43, 38, fn.3.

<sup>50</sup> Public Discussion Draft BEPS Action 3, above fn.10, 13, para.28.

<sup>51</sup> See “Worldwide taxation of CFCs: not the international standard”, below.

policy aims which are broader than combating profit shifting.<sup>52</sup> The latter position jeopardises the BEPS initiative, its holistic approach and its co-ordination role.

The secondary role of CFC rules vis-à-vis TP rules will be especially true in respect of those CFC rules that are designed as anti-avoidance rules and the application of which depends on the demonstration of avoidance on a case-by-case basis. The latter is required so far by the CJEU within the EU<sup>53</sup> (and as opposed to automatically applicable CFC rules based on an irrebuttable presumption of abuse).

If the reinforced TP rules prevented the artificial shifting of profits to a low-tax jurisdiction, CFC rules applicable to avoidance situations would be superfluous. A perfect functioning of (reinforced) TP rules will not occur, not least because only a few tax administrations will be capable of applying them and CFC rules are presumably easier to apply.

In any case, the role of CFC rules operating automatically will not be substantially reduced by the reinforced TP rules. For example, in the case of non-distribution of profits by a CFC in a low-tax jurisdiction to the (ultimate or not) parent jurisdiction, CFC rules can still be applied by the jurisdiction of the parent and ultimate company, even if TP rules were applied correctly and no artificial shifting of profits has occurred:

“CFC regimes applying a sufficiently high rate of tax may make certain transfer pricing outcomes irrelevant to the MNE by removing the benefit of engaging in transfer pricing manipulation.”<sup>54</sup>

CFC rules will still grant the final right to tax to the capital-exporting country or ultimate parent jurisdiction. If other measures fail, CFC rules will come into play.

In turn, CFC rules do not replace TP rules. A worldwide taxation system with sufficiently high rates, full-inclusion and no deferral of any type of income eliminates any benefit on transfer pricing manipulation (it does not fully deter BEPS). But it shifts income to the state of residence (parent jurisdiction) which may not be the country that suffered profit shifting.<sup>55</sup> The Public Discussion Draft BEPS Action 3 further explains that TP rules have a broader scope and impact than CFC rules. For example, if the tax rate of the parent state is lower than the tax rate applicable to some of the subsidiaries, profit shifting will not be solved by a CFC of the parent state; in the absence of a complete net of CFC rules, companies can be restructured under companies resident in jurisdictions without CFCs; and finally sibling enterprises and other related parties that do

<sup>52</sup> Public Discussion Draft BEPS Action 3, above fn.10, 34, para.83.

<sup>53</sup> *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC (Cadbury Schweppes)* (C-196/04) [2006] ECR I-7995 (September 12, 2006, ECJ) at [64]; *Commission v UK* (C-112/14) EU:C:2014:2369 (November 13, 2014, ECJ) at [27]: “According to settled case-law of the Court, where rules are predicated on an assessment of objective and verifiable elements making it possible to identify the existence of a wholly artificial arrangement entered into for tax reasons alone, they may be regarded as not going beyond what is necessary to prevent tax evasion and tax avoidance, if, on each occasion on which the existence of such an arrangement cannot be ruled out, those rules give the taxpayer an opportunity, without subjecting him to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction (see, to that effect, judgment in *Itelcar*, EU:C:2013:629, paragraph 37 and the case-law cited).”

<sup>54</sup> OECD, *Public Discussion Draft BEPS Action 6: preventing the granting of treaty benefits in inappropriate circumstances* (March 14, 2014–April 9, 2014) (Public Discussion Draft Action 6), available at: <http://www.oecd.org/ctp/treaties/treaty-abuse-discussion-draft-march-2014.pdf> [Accessed July 13, 2015], 13, para.21.

<sup>55</sup> Public Discussion Draft Action 6, above fn.54, 14, paras 23–24.

not have control over each other escape CFC rules but the transactions between them are covered by TP rules.<sup>56</sup> Thus, CFC rules do not fully deter BEPS.

### *Hybrid tax planning*

In the Public Discussion Draft BEPS Action 3, co-ordination of CFC rules with Action 2 and the anti-hybrid rules<sup>57</sup> is taken care of in Chapter 2 (“Definition of a CFC”). The Public Discussion Draft identifies a case where differences in the characterisation of instruments and entities by the parent and CFC jurisdictions can result in payments that fall outside the scope of anti-hybrid rules and CFC rules.

That would be the situation where

“A Co, a company resident in Country A, holds all the shares of B Co, a company resident in Country B. B Co, in turn, holds all the shares in C Co, a company resident in Country C. Country A and Country C are high tax jurisdictions while Country B is a low tax jurisdiction. C Co is a disregarded entity for Country A tax purposes. C Co borrows money from B Co, and because C Co is treated as transparent under the laws of Country A, the payment of interest to B Co is ignored under the laws of Country A and therefore not included within the calculation of CFC income for Country A purposes.”<sup>58</sup>

Public Discussion Draft BEPS Action 3 recommends a modified hybrid mismatch rule allowing the parent company jurisdiction to take into account an intragroup payment to a CFC, when calculating the parent company’s CFC income.<sup>59</sup>

The recommendation suggests that CFC rules act (once again) as backstop to other measures, in this case to anti-hybrid rules which only operate when the mismatch directly occurs between two countries:

“Note that this example would not currently be caught by the rules designed under Action Item 2 since this payment does not create a hybrid mismatch under the rules of either Country B or Country C, which are the resident jurisdictions of the counterparties. Instead, it only creates a hybrid mismatch for purposes of Country A, which is the country that treats C Co as transparent.”<sup>60</sup>

However, there is no reference to the interaction (overlapping, co-ordination, priority) between anti-hybrid rules (primary and secondary responses) as proposed in Action 2 and the CFC rules and this silence may lead to the application of both measures. Apparently, CFC rules in the ultimate parent jurisdiction can always be applied (for example, if they focus on foreign-to-foreign stripping) even if an anti-hybrid rule was applied before. It could be asked whether, in the end, the CFC rules will not be the “stars of the show”.<sup>61</sup>

<sup>56</sup> Public Discussion Draft Action 6, above fn.54, 14, paras 25–27.

<sup>57</sup> OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, 2014).

<sup>58</sup> Public Discussion Draft BEPS Action 3, above fn.10, 17, para.39.

<sup>59</sup> Public Discussion Draft BEPS Action 3, above fn.10, 16, paras 35 and 36–38.

<sup>60</sup> Public Discussion Draft BEPS Action 3, above fn.10, 17, para.39.

<sup>61</sup> See Brauner, above fn.46, 79, designating the Actions on transfer pricing as “Stars of the Show.”

Finally, there is no reference to the meaning of corporate tax residence, which would reduce the scope for tax arbitrage offered by CFC rules. For the sake of legal certainty, both the concrete proposals by the OECD and the subsequent concrete measures adopted by its Member States should co-ordinate any overlapping of measures.

### Definition of CFC income

It has already been mentioned in the Introduction to this article that Chapter 5 in the Public Discussion Draft Action 3 does not include recommendations for the building block on the definition of CFC income, but discusses possible options.<sup>62</sup> The chapter focuses on partial-inclusion systems, since these systems only attribute income that raises profit-shifting issues. However, the right of a full-inclusion approach by some States is not excluded in the Public Discussion Draft.<sup>63</sup> The main reason for the (still) missing recommendations on the definition of income may lie in the current US system<sup>64</sup> and on the constraints that EU Member States face when designing their CFC rules. These constraints may weaken the efficacy of CFC rules.

However, because the constraints faced by the EU Member States are related to the necessity of demonstrating avoidance as a condition for applying CFC rules, those constraints are to a certain extent more in line with the general purpose of the BEPS initiative: to find adequate and co-ordinated measures that may prevent and combat avoidance and aggressive tax planning.

It is acknowledged in the Public Discussion Draft BEPS Action 3 that Member States of the EU (may) need to introduce a case-by-case substance test to ensure their compatibility with the freedom of establishment, since the latter cannot be restricted if income earned originates from genuine economic activities.<sup>65</sup> The Public Discussion Draft stresses the importance of an accurate definition of income in the CFC rules being adopted by the states. The aim is for highly mobile income to be dealt with by CFC rules: so that CFC rules cover

“income earned by CFCs that are holding companies, income earned by CFCs that provide financial and banking services, income earned by CFCs that engage in sales invoicing, income from IP assets, income from digital goods and services, and income from captive insurance and re-insurance. In practical terms, this means that CFC rules must be capable of dealing with at least the following types of income:

- Dividends
- Interest and other financing income
- Insurance income
- Sales and services income
- Royalties and other IP income.”<sup>66</sup>

Definition and attribution of the above-mentioned categories of income can be based on a pure form-based analysis or on a substance-based analysis. A pure form-based analysis is easy to circumvent: the Public Discussion Draft BEPS Action 3 uses the example of income earned

<sup>62</sup> Public Discussion Draft BEPS Action 3, above fn.10, 34, Note for consultation, and above fn.13.

<sup>63</sup> Public Discussion Draft BEPS Action 3, above fn.10, 34, para.83.

<sup>64</sup> Fleming, Peroni and Shay, above fn.32, 80 and following.

<sup>65</sup> Using other words but the same idea: Public Discussion Draft BEPS Action 3, above fn.10, 34, para.83.

<sup>66</sup> Public Discussion Draft BEPS Action 3, above fn.10, 35, para.84.

from the use of an IP asset that may be legally treated as sales income and in this manner escape CFC rules defining income on a pure form-based analysis.<sup>67</sup>

There are three suggestions for the substance-based analysis: substantial contribution analysis; a viable independent entity analysis; an employees and establishment analysis.

The substantial contribution recommends a threshold test to determine whether the employees of the CFC have made a substantial contribution to the income earned by the CFC and once the threshold is achieved all income of the CFC is treated as attributable. This option is potentially incompatible with EU law, since the CJEU has assessed CFC rules as restrictions to the right of establishment and accepted them as a justification (an exception) in case there is no genuine activity.<sup>68</sup>

The other two approaches may be compatible with EU law because they focus on the analysis of genuine activity on a case-by-case basis and especially if they are applied as proportionate tests (and not as “all-or-nothing” tests). But the employees and establishment analysis would use employees and establishment as “a more mechanical way of determining whether the activities required to earn the CFC income are located in the CFC jurisdictions” and would require a comparison that may not be viable: “a comparison of the employees and establishment in the CFC to the employees and establishment that would be required to earn the overall income.”<sup>69</sup>

The viable entity analysis seems to rely on the arm’s length principle,<sup>70</sup> which has been accepted by the CJEU in *Test Claimants in the Thin Cap Group Litigation v IRC (Thin Cap GLO)* and in *Société de Gestion Industrielle SA (SGI) v État belge*.<sup>71</sup> According to the Public Discussion Draft Action 3, the option

“would look at all the significant functions performed by entities within the group to determine whether the CFC is the entity which would be most likely to own particular assets, or undertake particular risks, if the entities were unrelated.”<sup>72</sup>

### **The single tax principle in the BEPS initiative: an interpretive principle of international tax fairness and ability to pay**

Reuven Avi-Yonah claimed two decades ago that the current international tax order is based on the benefits principle and on the single tax principle.<sup>73</sup> The former principle states that active income should be taxed primarily by the country of source and passive income by the country of residence, at its rates. The benefit principle results from the compromise reached in 1923 by four economists and is still included in double tax treaties. The single tax principle then implies that cross-border income should be taxed once at the rate determined by the benefits principle.

According to Avi-Yonah, the single tax principle means taxing cross-border income

<sup>67</sup> Public Discussion Draft BEPS Action 3, above fn.10, 36, para.88.

<sup>68</sup> *Cadbury Schweppes* (C-196/04), above fn.53, [2006] ECR I-7995 at [57]–[72].

<sup>69</sup> Public Discussion Draft BEPS Action 3, above fn.10, 37, paras 89 and 92, respectively.

<sup>70</sup> Public Discussion Draft BEPS Action 3, above fn.10, 36–37, para.89.

<sup>71</sup> *Test Claimants in the Thin Cap Group Litigation v IRC* (C-524/04) [2007] ECR I-2107 (March 13, 2007, ECJ) at [80]–[87]; *Société de Gestion Industrielle SA (SGI) v État belge* (C-311/08) [2010] ECR I-487 (January 21, 2010, ECJ) at [71]–[75].

<sup>72</sup> Public Discussion Draft BEPS Action 3, above fn.10, 40, para.92.

<sup>73</sup> R.S. Avi-Yonah, “International Taxation of Electronic Commerce” (1997) 52 Tax L. Rev 507.

“... not more or less than once, at the rate determined by the benefits principle, i.e., the source country rate for active income and the residence country rate for passive income. But if the preferred country (source for active, residence for passive) does not tax, it is incumbent upon the other country to tax, because otherwise double non-taxation will result, which I argued is just as damaging as double taxation.”<sup>74</sup>

The need for the BEPS initiative demonstrates that the single tax principle is not in force and that national tax policies on cross-border movements and income have prevailed over an idea of international tax fairness and consistency of policies. From the latter perspectives, in a world where multinationals operate without major obstacles, the single tax principle is not in force but it should be, at least as an interpretive principle. In fact, the single tax principle is an expression of the ability-to-pay principle when cross-border income comes into play.

The single tax principle underlies to a certain extent the current OECD approach. It is implicitly being promoted as the guiding principle of the post-BEPS international tax order. The multiple actions and measures, some targeted at the source State, others at the residence State and many at both the source and the residence States indicate that cross-border income has to be taxed once. They aim at eliminating cross-border disparities and gaps in taxation, independently of the allocation of taxing rights between the jurisdictions involved (capital exporting versus capital importing, residence versus source): double taxation and double non-taxation should be eliminated.

The next questions are logically how to implement that principle on a global scale and allocate income to different jurisdictions. Ultimately, this is the question of whether a global order implies one single answer imposed vertically (for example the, or, a G20/OECD standard) or co-ordinated horizontal answers.<sup>75</sup>

The multiple interests at play in the current international order call for co-ordinated horizontal answers (concerning groups of countries with similar interests) and not for a single answer imposed vertically by an omniscient decision-maker. It is no longer possible to simply divide the existing jurisdictions into capital-importing and capital-exporting countries. Countries with natural resources have their specific tax interests regarding taxation of those resources (they often want to reach capital gains accrued by indirect shareholders abroad)<sup>76</sup> and there are several economies in transition from capital importing to capital exporting (Brazil, for example, is severely limiting deferral of taxation of CFCs). This means that it is not that obvious that the benefits principle is still adequate or that it has the same meaning as it originally had and that it fits the interests of the different jurisdictions at play.

However, the BEPS actions rely on the current OECD status, where the benefits principle is basically valid. Whereas CFC rules, the anti-hybrid rules (the primary answer), the savings clause, rules on taxation of royalties and research & development and exit taxes are directed at residence States and their right to tax passive income,<sup>77</sup> improvement of TP rules, rules updating

<sup>74</sup> Avi-Yonah, above fn.73.

<sup>75</sup> See, e.g. Y. Brauner, “The Future of Tax Incentives for Developing Countries” in Y. Brauner and M. Stewart (eds), *Tax, Law and Development* (Cheltenham and Northampton: Elgar, 2013), 25 and following; T. Dagan, “The Tragic Choices of Tax Policy in a Globalized Economy” in *Tax, Law and Development*, above, 57 and following.

<sup>76</sup> See, for example, the Mozambican regime on taxation of indirect capital gains accrued by non residents and regarding the petroleum and mining sectors: Article 29, Law n. 27/2014 (Petroleum Tax Law), 29 September 2014 and Article 39, Law n. 28/2014 (Mining Tax Law) 29 September 2014.

<sup>77</sup> Anti-hybrid measures, however, are also targeted at source States, since they guarantee the single tax principle.

or reinforcing the concept of permanent establishment may benefit the source States and their right to tax active (business) income. Furthermore, anti-hybrid rules, limits on deductibility of interest as well as other anti-abuse rules such as the principal purposes test rule are, in theory, tools that can be used both by residence and source States.

Although the BEPS initiative is motivated by the necessity of implementing the single tax principle, as an expression of the ability-to-pay principle, the fact that there is no clear hierarchy or co-ordination among the different measures aimed at fighting BEPS shows that the single tax principle will hardly be implemented by a single answer or standard. In turn, horizontal co-ordination will also fail if each jurisdiction cherry-picks some of the recommended measures and further research and work on how to co-ordinate the different interests involved, including at the EU level, fails.

Furthermore, without a clear hierarchy in the applicable measures against BEPS or co-ordination among them, the OECD proposals enhance the risk of double taxation: the UK's diverted profits tax is an example of that risk.<sup>78</sup>

### **The single tax principle and the role of CFC rules in the OECD and in the BEPS initiative**

#### *Worldwide taxation of CFCs: not the international standard*

CFC legislation can either be seen as restoring the original right of a jurisdiction to tax its residents on a worldwide tax principle or an exception to the international tax rule that recognises deferral of taxation of profits accrued abroad by foreign entities. The former solution would ultimately imply that taxation of profits accrued by controlled foreign corporations would be the rule (worldwide taxation as the rule), deferral would be an exception (tax expenditure) to promote internationalisation of a few industries and therefore CFC measures would limit that exception.<sup>79</sup>

In the context of the initiatives against base erosion and profit shifting, CFC measures are put forward as one of the tools to fight BEPS and not as *the* tool to address allocation of taxing rights among jurisdictions. The latter solution would not be compatible with the G20 mandate, since it would mean a radical change in the current allocation of taxing rights under paragraph 1 of Article 7 of the OECD Model Tax Convention (MC) between capital-exporting and capital-importing jurisdictions concerning CFCs—a topic that is not addressed in the mandate and that would not generate consensus.<sup>80</sup>

Paragraph 5 of the *Tax Annex to the St. Petersburg G20 Leaders' Declaration* (G20 Leaders' Declaration), of September 2013 makes reference to tax base erosion resulting from international tax planning, and to the interaction of different tax rules being used by multinationals to artificially shift profits:

- “5. International collective efforts must also address the tax base erosion resulting from international tax planning. Base erosion and profit shifting (BEPS) relates chiefly to instances where the interaction of different tax rules result in tax planning

<sup>78</sup> H. Self, “The UK's New Diverted Profits Tax: Compliance with EU Law” (2015) 43(4) *Intertax* 333.

<sup>79</sup> Fleming, Peroni and Shay, above fn.32, 93–98.

<sup>80</sup> OECD Model Tax Convention on Income and on Capital. See Brauner, questioning CFC rules as a legitimate measure to be adopted by the Actions against BEPS, above, fn.14.

that may be used by multinational enterprises (MNEs) to artificially shift profits out of the countries where they are earned, resulting in very low taxes or even double non-taxation. These practices, if left unchecked, undermine the fairness and integrity of our tax systems. They fundamentally distort competition, because businesses that engage in cross-border BEPS strategies gain a competitive advantage compared with enterprises that operate mostly at the domestic level. Fair, transparent and efficient tax systems are not only key pillars for sound public finances, they also provide a sustainable framework for dynamic economies. For these reasons, G20 Leaders identified the need to address BEPS as a priority in their tax agenda at the Los Cabos Summit in June 2012. Additionally, we must achieve better international coordination on taxes. In this regard, we must move forward in fighting BEPS practices so that we ensure a fair contribution of all productive sectors to the financing of public spending in our countries.”<sup>81</sup>

The BEPS Action Plan presumably takes a holistic approach, to be implemented in a co-ordinated manner, against base erosion and profit shifting in the current context of free movement of capital. The international fight against BEPS neither aims to adopt a different allocation of taxing rights rules, nor to clearly change the balance between capital-exporting and capital-importing countries. The G20 mandate and the OECD Action Plan and Actions basically keep the same big picture as is found in the OECD MC and domestic tax legislation on cross-border situations.

Residence countries are not mandated by the G20 to eliminate tax competition in the absence of avoidance (or abuse) and aggressive tax planning. Even though the above-mentioned paragraph of the G20 Leader’s Declaration refers only to abusive practices (an artificial shift of profits), there is a mandate to the States to co-ordinate the current different tax rules the interaction of which is leading to avoidance or double non-taxation.

The mandate not only covers anti-avoidance measures, but also the improvement of the international system by co-ordination, preventing disparities or unintended gaps that emerge from the interaction of two or more jurisdictions (rules that not only react to abuse but also prevent it, such as the improvement of TP rules and anti-hybrids).

Depending on their scope and design, CFC rules may either be seen as reinforcing worldwide taxation or simply as anti-abuse rules. By reinforcing worldwide taxation, they reinforce allocation of taxing rights to the residence State. The issue is then whether CFC rules, by reinforcing taxation in the residence State, may also operate as last resort measures that will (would) guarantee the single tax principle.

The OECD recalls that CFC rules also have some positive spill-over effects on source countries:

“While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have positive spillover effects in *source countries* because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction.”<sup>82</sup>

<sup>81</sup> Russia G20, *Tax Annex to the St. Petersburg G20 Leaders’ Declaration* (September 2013), para.5.

<sup>82</sup> BEPS Action Plan, above fn.7, 16.



But the Public Discussion Draft Action 3 goes too far by suggesting that CFC rules focusing on foreign-to-foreign stripping are more adequate to fight BEPS. To the contrary, it is suggested here that CFC rules focusing on foreign-to-foreign stripping comply neither with the G20 mandate to combat BEPS nor ultimately with the holistic approach, except in two situations: in respect of entities other than CFCs that are set up to circumvent CFC rules, and if CFC rules apply only to passive income.

It is acknowledged here that CFC rules covering foreign-to-foreign stripping are more effective against BEPS, in comparison to CFC rules that only focus on the parent jurisdiction stripping:

“... CFC rules that only focus on the parent jurisdiction stripping may not be as effective against BEPS arrangements for two reasons. First, it may not be possible to determine which country’s base has been stripped (for example, in the case of stateless income). Second, even if it were possible to determine which country’s base was stripped, the BEPS Action Plan aims to prevent erosion of all tax bases, including those of third countries. This issue is of particular relevance for developing countries.”<sup>83</sup>

However, such a broad configuration of CFC rules will exclude any possibility of a more competitive tax policy by developing countries and it will not be in their interest as long as there is (genuine) business activity in their territories. In other words, if competitive tax policy by a developing country manages to attract active investment, there is no reason for the application of a broad CFC rule in the parent country, based on an irrebuttable presumption of abuse. Although it is acknowledged that tax incentives do not prove to attract new foreign direct investment and therefore developing countries (and other capital-importing countries) should not strongly rely on tax incentives,<sup>84</sup> if transparent, well targeted and designed, they still have an important role to play in those countries.

Taking into account that CFC rules will strengthen the role of residence countries (or more exactly of capital-exporting countries), when adopted and applied domestically to all income (active and passive), they will restrict tax competition worldwide, especially when they are automatically applicable. Broad CFC rules applicable to all types of income, and automatically as anti-deferral rules, would ultimately neutralise the policy purpose of tax benefits granted by developing countries and other capital-importing countries. They would have that effect, even if there were no avoidance (even if investment abroad passed the principal purposes test) or artificiality.

In this context, it can be questioned whether the OECD is entitled to reinforce CFC rules especially by suggesting that they may cover foreign-to-foreign stripping and admitting that they can operate automatically (without the need to demonstrate avoidance), closely to a standard of worldwide taxation without deferral.

It is true that the Public Discussion Draft BEPS Action 3 suggests that CFC rules exempts “so-called ‘active’ income that is, or is more likely to be, linked to real economic activity ...” because although “... [t]his approach may not be entirely effective in combating BEPS ... the

<sup>83</sup> Public Discussion Draft BEPS Action 3, above fn.10, 12–13.

<sup>84</sup> Brauner, above fn.75, 25 and following; Dagan, above fn.75, 57 and following.

balance between taxing foreign income and maintaining competitiveness needs to be kept in mind.<sup>85</sup>

But if some countries design their CFC rules to include all types of income in their scope and combine this feature with foreign-to-foreign stripping and automatic application, there will be a clear shift on allocation of taxing rights reinforcing taxing rights of the residence State.

It is questionable that the single tax principle in the G20 Leader's Declaration<sup>86</sup> implies the latter interpretation of the allocation of taxing rights and neutralisation of the source country's policy, when the CFC carries on genuine business activity.

It can thus be claimed that broad CFC rules (covering not only passive but also active income, focusing on foreign-to-foreign stripping and automatically applicable) should not play a major role in the BEPS initiative unless there is co-ordination among different groups of countries and corresponding tax policies related to specific industries (horizontal co-ordination, instead of a single standard).

The situation is, however, different in respect of passive income and transparent entities, where not only CFC rules but also common investment funds (CIFs) should play an important role if income is routed to low-tax jurisdictions. The reason is that TP rules are more difficult to apply to passive income, even if the new concepts around the idea of value creation are introduced. Moreover, transparent entities will escape taxation in the low-tax jurisdiction and therefore it is recommended that the parent jurisdiction tax them as a CFC. CFC and CIF rules will in this case be complementary to TP rules, but their application should not rely on irrebuttable presumptions of avoidance but should instead be assessed on a case-by-case basis and interpreted according to recommendations 2 or 3 of the Public Discussion Draft BEPS Action 3.

At least in the EU, such an assessment is required. Recommendations 2 or 3 of the above-mentioned discussion draft are more adequate to fight BEPS than the *naive* artificiality test as has been applied by the CJEU in *Cadbury Schweppes* and recently in a *Commission v UK* case.<sup>87</sup>

### *Consequences of worldwide taxation of CFCs in the parent company state*

When connected to worldwide taxation of resident taxpayers, it can be contended that deferred taxation of profits accrued in the jurisdiction of a controlled foreign company is an exception to the rule.<sup>88</sup> It can be further contended that the exception is a tax benefit or expenditure, benefiting domestic companies investing abroad to the detriment of domestic companies investing in the domestic market.<sup>89</sup> This perspective further implies that CFC provisions restate the principle of universal taxation, and should be as broad as possible, so that the exception is restricted to specific policy purposes without distorting capital investment options.

The above-mentioned position has been claimed in respect of the US tax system and, according to its defenders, it is not demonstrated that worldwide taxation of corporations without deferral

<sup>85</sup> Public Discussion Draft BEPS Action 3, above fn.10, 9, para.10.

<sup>86</sup> G20 Leaders' Declaration, above fn.81.

<sup>87</sup> *Cadbury Schweppes* (C-196/04), above fn.53, [2006] ECR I-7995 at [64]; and *Commission v UK* (C-112/14), above fn.53, EU:C:2014:2369 at [27].

<sup>88</sup> Fleming, Peroni and Shay, above fn.32, 93–98.

<sup>89</sup> Fleming, Peroni and Shay, above fn.32, 93–98.

would damage the competitive position of US companies abroad.<sup>90</sup> Even if this may be true from a domestic perspective (or capital export neutrality perspective), co-ordination of systems in the BEPS context and the G20 initiative ought to take into account the policy interests of capital-importing countries and also developing countries, if extended as standards to all the world.

The example of two developing countries can illustrate this reasoning: Country One that has no natural resources and an economy dependent on attracting tourism, and therefore tax incentives targeted at tourism investment and activities are considered to be adequate. Monitoring of those tax benefits in the source country will be important in order to avoid abuse and loss of revenue without corresponding substantial activity (adequate TP rules will be important in order to control value creation in the source country). Country Two is rich in natural resources but has no adequate infrastructure allowing efficient exportation of the extracted products, interest rates are high (two digits) and the investment risk is also high (such as political stability and conditions on the repatriation of income, among other risks).

Country Two also relies on some targeted tax benefits in order to attract investment. Application of a worldwide taxation of profits in the parent company State without deferral, even in the case of substantial activity being carried out in the source State, would neutralise the tax incentives. It can be argued that it is not certain that worldwide taxation without deferral will be an obstacle to export investment, and worldwide taxation restores the equality between investment at home and abroad, but this perspective does not take into account existing risks that may accompany investment abroad.<sup>91</sup>

Thus, taking into account the different players and interests in the current global order, CFCs should not be considered to be core measures in the BEPS initiative. This is implicit in the Public Discussion Draft, but it would be good if consensus were reached to make it clear.

### *Capital export neutrality and capital import neutrality*

Capital export neutrality (CEN) and capital import neutrality (CIN) or a combination of both have been used to justify different roles for CFC legislation. Whereas CEN aims at taxing domestic investment abroad in a manner that is not more favourable than taxation of domestic investment within the territory and therefore is linked to worldwide taxation, CIN aims at not taxing incoming investment less favourably than domestic investment and justifies adoption of the territoriality principle (or participation exemption systems).

Despite their validity in a world of cross-border income and different tax jurisdictions—which is in fact still the world underlying the international tax system—neither CEN nor CIN are sufficient to explain that both worldwide taxation regimes and territoriality regimes apply CFC legislation, nor to assess the current BEPS initiative.

There is no international (that is, supra-national) interest that would enforce the single tax principle or the objectives set forth in the G20 Leaders' Declaration.<sup>92</sup> But the fight against avoidance and aggressive tax planning combined with the often-conflicting interests represented

<sup>90</sup> Fleming, Peroni and Shay, above fn.32, 93–98.

<sup>91</sup> See above text accompanying fnn.76 and 82.

<sup>92</sup> G20 Leaders' Declaration, above fn.81.

by different groups of countries and regions (capital exporting, capital importing, natural resources producers, capital-importing countries that are striving to rapidly become capital-exporting countries) again implies that CFC legislation is only used by residence countries in the case of avoidance.

### **CFCs and EU Member States**

#### *The role of CFC rules in the EU: articulation with corporate residence rules*

In some contexts, namely, within the EU, effective CFC rules can simultaneously operate as anti-avoidance rules and neutralise tax competition facilitating abuse, while at the same time guaranteeing that income accrued abroad benefits, as a rule, from deferred taxation. If CFC rules are adopted by EU Member States in respect of third countries, they can have one of two functions: either restating worldwide taxation in those EU jurisdictions adopting the territoriality principle and applying CFC rules in the case of switchover to universality, when low-tax jurisdictions identified in white or black lists come into play; or guaranteeing the single tax principle.

CFC rules within the EU will probably continue to be national CFC rules, with the exception of the CFC rule applicable to groups of companies falling under the CCCTB, if and when it is approved and enters into force. In the context of BEPS, the European Commission (EC) could recommend a common CFC rule to be enacted in each Member State, similar to what it has done in respect of national GAARs. It is reasonable that the EC is waiting for Action 3, also in particular because most EU Member States are OECD Member States. It would also be interesting if the EC were to simultaneously work on and recommend a common meaning of corporate tax residence for the EU Member States, namely regarding the meaning of “place of effective management.” An EU common meaning of corporate tax residence would reduce the necessity of applying mutual agreement procedures in the case of double residence within the EU as well as the necessity of applying CFC rules.

The EU has so far relied on the meaning of corporate tax residence as recognised by tax treaties (Article 2(1)(b) of the Parent-Subsidiary Directive; Article 3(a)(ii) of the Interest-Royalty Directive (Council Directive 2003/49/EC of 3 June [2003] OJ L157/49, 26 June 2003, as amended); Article 6 of the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)). Thus, the BEPS problems raised under international tax law by the meaning of corporate residence are identical within the EU.

In *R. v Secretary of State for Transport Ex p. Factortame Ltd and others (Factortame II)*, the CJEU already recognised that the meaning of corporate residence for the purposes of Article 53 and following of the Treaty establishing the European Economic Community (EEC) (current Articles 54 and following of the TFEU) implies the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period: still, according to the CJEU,

“[c]onsequently, the registration of a vessel does not necessarily involve establishment within the meaning of the Treaty, in particular where the vessel is not used to pursue an economic activity or where the application for registration is made by or on behalf of a

person who is not established, and has no intention of becoming established, in the State concerned.”<sup>93</sup>

The CJEU further considered that a shareholder test is incompatible with the freedom of establishment.<sup>94</sup>

The test of “actual pursuit of an economic activity through a fixed establishment” may correspond to the primacy of the “place of effective management” criterion, but it is still vague and it is mainly linked to a principle of abuse. For the purposes of a common meaning of corporate residence and prevention of double tax residence issues, the above test requires further concretisation. Moreover, and especially, a sufficiently detailed common meaning of corporate residence for tax purposes would reduce the tension between the interests of capital-exporting and capital-importing EU Member States and would avoid qualification conflicts.

#### *CFC rules and the Parent-Subsidiary Directive anti-hybrid rule*

Because of the *Cadbury Schweppes* doctrine,<sup>95</sup> application of CFC rules by EU Member States to other EU Member States is subject to the “artificiality” (“wholly artificial arrangements”) test, which means that CFC rules operate as anti-abuse rules, and cannot simply be used as a tool to preserve the tax base of one or more EU Member States. Even in the absence of harmonisation, it is clear that CFC rules are applicable to “direct investment”<sup>96</sup> and “definite influence”<sup>97</sup> situations, and therefore they have to be compatible with the freedom of establishment. However, as *Fred. Olsen and Others and Petter Olsen and Others v The Norwegian State (Olsen)* illustrates, some CFC legislation may apply

“not only to independent undertakings which enable the holder to exert a definite influence on a company’s decision and to determine its activities but also to capital assets domiciled in low-tax countries, which the taxpayer controls, directly or indirectly, and benefits from.”<sup>98</sup>

According to the EFTA Court,

“shareholdings acquired solely with the intention of making a financial investment without any intention to influence the management and control of the undertaking, are to be examined exclusively in light of the free movement of capital.”<sup>99</sup>

<sup>93</sup> *R. v Secretary of State for Transport Ex p. Factortame Ltd and others* (C-221/89) [1991] ECR I-3905 (July 25, 1991, ECJ) at [20]–[21].

<sup>94</sup> *Factortame II* (C-221/89), above fn.93, [1991] ECR I-3905 at [32].

<sup>95</sup> *Cadbury Schweppes* (C-196/04), above fn.53, [2006] ECR I-7995 and *Commission v UK* (C-112/14), above fn.53, EU:C:2014:2369.

<sup>96</sup> *Test Claimants in the FII Group Litigation v IRC and another* [2012] UKSC 19; [2012] STC 1362.

<sup>97</sup> *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem* (C-251/98) [2000] ECR I-2787.

<sup>98</sup> *Fred. Olsen and Others and Petter Olsen and Others v The Norwegian State* (Joined cases E-3/13 and E-20/13) (July 9, 2014, EFTA) at [115]; *Commission v UK* (C-112/14), above fn.53, EU:C:2014:2369. See A.M. Jimenez, “STJUE (Sala Octava) de 13 de noviembre de 2014, Comisión / Reino Unido, C-112/14, EU: C:2014:2369”, *Revista Española de Derecho Financiero*, n. 166/2015 (in print).

<sup>99</sup> *Olsen* (Joined cases E-3/13 and E-20/13), above fn.98, at [114].

In *Commission v United Kingdom*, the CJEU also concludes that CFC rules can be incompatible with free movement of capital.<sup>100</sup> In both cases (*Olsen* and *Commission v UK*), the CJEU considers that mere investment falls under free movement of capital.<sup>101</sup>

Whereas, as contended above, linking CFC rules to avoidance is in line with the role of the aforementioned rules in the BEPS initiative, the CJEU's interpretation of avoidance in the CFC cases is too narrow. It leaves the EU Member States in serious difficulties as far as the design and application of effective CFC rules are concerned, especially in respect of pure investment activities, where the artificiality test is hardly applicable. It is thus expected that the CJEU will play its role in the BEPS initiative, contributing to the worldwide co-ordination, and accepting the criteria proposed in the Public Discussion Draft Action 3 under a substance analysis—for example, the viable entity analysis.

In most cases, national CFC rules will be applicable together with the Parent-Subsidiary Directive regime. Member States' CFC rules will logically apply before the directive, and it is not certain that the latter will apply, since its application depends on the distribution of profits.

The fact that the Parent-Subsidiary Directive introduced an anti-hybrid rule regarding deductibility of interest and taxation of dividends still implies prior application of CFC rules and the anti-hybrid rule will be subsidiary to the latter. According to Article 4(1)(a), Member States

“shall refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary.”<sup>102</sup>

Taxation by the EU residence State under Article 4(1)(a) of the Directive will still depend upon distribution of profits, but the residence State is not necessarily the ultimate parent or the home State.

Depending on how it is drafted, the application of CFC legislation by the residence State may either be reinforced by the use of the Parent-Subsidiary Directive anti-hybrid rule, or make its use unnecessary.

Moreover, the anti-hybrid rule does not seem to preclude the application of national CFC rules to other parent companies in the chain, by other EU Member States. The fact that CFC rules are envisaged as anti-abuse rules within the EU also favours the (free) application of multiple national CFC rules.

However, it could be interesting to see what the answer of the CJEU would be if it were asked to assess the compatibility of a national CFC rule applicable to dividends that will be taxed under another CFC rule by the EU parent home State (a subsidiary (Sub 2) in Member State S with

<sup>100</sup> *Commission v UK* (C-112/14), above fn.53, EU:C:2014:2369.

<sup>101</sup> See the detailed arguments by W. Schön considering that a mere investment act falls under free movement of capital and not under the freedom of investment: “Kapitalverkehrsfreiheit und Niederlassungsfreiheit” in T. Ackermann / J. Köndgen (eds), *Privat- und Wirtschaftsrecht in Europa - Festschrift für Wulf-Henning Roth zum 70. Geburtstag* (München: C.H. Beck, 2015), 551 at 577–581.

<sup>102</sup> Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different member States [2014] OJ L219, 40–41. See G. Kofler, “Hybrid Loans in the Parent-Subsidiary Directive” in P. Valente (ed.), *Elusione Fiscale Internazionale* (Wolters Kluwer Italia, 2014), 682 and following; “Der EU Aktionsplan zur Verstärkung der Bekämpfung von Steuerbetrug und Steuerhinterziehung” [2015] (1) *IFF Forum für Steuerrecht* 44, 51–54.

low taxation; a parent company (Sub 1) of Sub 2 in Member State R applying a CFC rule in respect of non-distributed dividends by Sub 2; and a parent company of Sub 1 (Member State PC) applying another CFC rule). Ultimately, if the CJEU used the “common parent” criterion as it did in *Thin Cap GLO*, in a different context,<sup>103</sup> a Member State of an intermediate parent (Member State R, in the example) might not legitimately be able to use a CFC rule. But this may not be the case, since in *Thin Cap GLO* the intermediate company of the group (the lending company) did not control the borrowing company, but both were controlled by a common parent.<sup>104</sup>

A combination of anti-hybrid rules plus several CFC rules may be more effective to counter BEPS within the EU,<sup>105</sup> but it will certainly lead to more complexity. In the absence of harmonisation, there is still leeway for an EC Recommendation on the use of only one or multiple CFC rules, that is, CFC rules to be applicable by the ultimate parent home State versus CFC rules to be applicable in the EU Member States of the multiple parent companies involved.

In any case, the pending question raised in the light of BEPS, regarding articulation between anti-hybrid measures and CFC rules, has partially been answered in the EU, in the context of the above anti-hybrid provision included in the Parent-Subsidiary Directive and national CFC rules.

#### *A CFC rule in the CCCTB*

Article 82 of the Proposal for a Council Directive on a CCCTB<sup>106</sup> foresees the inclusion of a CFC rule in the regime for the common tax base. As drafted, the CFC rule is applicable to non-distributed profits of an entity resident in a third country when the EU taxpayer holds more than 50 per cent of the voting rights, more than 50 per cent of capital or is entitled to receive more than 50 per cent of the profits of that entity. The purpose of the draft CFC rule is to combat abuse rather than to allocate taxing rights to EU Member States. Three elements favour this conclusion: the fact that the CCCTB will exempt dividends distributed to the group, rather than adopt a worldwide income approach; the fact that the CFC rule is only applicable to passive income; and the fact that the CFC rule is only applicable if the company is not a company whose principal class of shares is regularly traded on one or more recognised stock exchanges.<sup>107</sup>

In fact, it is foreseen that income consisting of dividends, the proceeds from the disposal of shares held in a company outside the group and the profits of foreign permanent establishments should be exempt:

“In giving relief for double taxation most Member States exempt dividends and proceeds from the disposals of shares since it avoids the need of computing the taxpayer’s entitlement to a credit for the tax paid abroad, in particular where such entitlement must take account of the corporation tax paid by the company distributing dividends. The exemption of income earned abroad meets the same need for simplicity.”<sup>108</sup>

<sup>103</sup> *Thin Cap GLO* (C-524/04), above fn.71, [2007] ECR I-2107 at [102].

<sup>104</sup> *Thin Cap GLO* (C-524/04), above fn.71, [2007] ECR I-2107 at [102].

<sup>105</sup> Maisto, above fn.39.

<sup>106</sup> COM(2011) 121/4, 2011/0058 (CNS) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB).

<sup>107</sup> Proposal for a Council Directive on a CCCTB, above fn.106, Art.82(1)(c).

<sup>108</sup> Proposal for a Council Directive on a CCCTB, above fn.106, 11.

Moreover, as mentioned previously, the CFC rule is only applicable if more than 30 per cent of the income accruing to the entity falls within one or more of the categories set out in paragraph 3(a)(f) of Article 82 of the Proposal for a Council Directive on a CCCTB that is, if it is passive income.

According to paragraph 3,

“the following categories of income must be taken into account for the purposes of point (c) of paragraph 1, in so far as more than 50 % of the category of the entity’s income comes from transactions with the taxpayer or its associated enterprises:

- (a) interest or any other income generated by financial assets;
- (b) royalties or any other income generated by intellectual property;
- (c) dividends and income from the disposal of shares;
- (d) income from movable property;
- (e) income from immovable property, unless the Member State of the taxpayer would not have been entitled to tax the income under an agreement concluded with a third country;
- (f) income from insurance, banking and other financial activities.”<sup>109</sup>

Lastly, the CFC rule is applicable if

“the company is not a company whose principal class of shares is regularly traded on one or more recognised stock exchanges.”<sup>110</sup>

It seems that the CFC rule does not comply with the artificiality test, as a condition for proportionate national CFC rules (*Cadbury Schweppes*<sup>111</sup>). As long as CFC rules are a restriction on the freedom of establishment (if there is an independent undertaking enabling the holder to exert definite influence on the company’s decision and to determine its activities) and not on free movement of capital (investment of funds rather than remuneration for goods and services<sup>112</sup> or capital assets which the taxpayer controls and benefits from),<sup>113</sup> CFC rules applicable to groups of companies under a harmonised CCCTB and targeted at third countries will not raise issues of incompatibility with the TFEU. If, in contrast, free movement of capital applies, the CFC rule applicable to third countries will require the *Cadbury Schweppes* test on proportionality, but it is dubious how the substance test (genuine economic activity versus artificiality) is applicable.<sup>114</sup> Article 82 of the Proposal for a CCCTB could also raise an issue concerning third countries that are parties to the EEA, but paragraph 2 of Article 82 excludes application of the CFC rule where the third country is party to the European Economic Area Agreement (EEAA) and there is an

<sup>109</sup> Proposal for a Council Directive on a CCCTB, above fn.106, Art.82(3)(a)–(f).

<sup>110</sup> Proposal for a Council Directive on a CCCTB, above fn.106, Art.82(1)(d).

<sup>111</sup> *Cadbury Schweppes* (C-196/04), above fn.53, [2006] ECR I-7995.

<sup>112</sup> *Olsen* (Joined cases E-3/13 and E-20/13), above fn.98, at [121].

<sup>113</sup> *Olsen* (Joined cases E-3/13 and E-20/13), above fn.98, at [115].

<sup>114</sup> D.S. Smit, “Substance Requirements for Entities Located in a Harmful Tax Jurisdiction under CFC Rules and the EU Freedom of Establishment” (2014) 16(6) *Derivatives & Financial Instruments* 259 and following.



agreement on the exchange of information comparable to the exchange of information on request provided for in the Directive on administrative cooperation in the field of taxation.<sup>115</sup>

Thus, since the CFC rule in the CCCTB Proposal is neither applicable to EU Member States nor to third countries party to the EEAA where there is an agreement on the exchange of information that is comparable to the EU Mutual Assistance Directive, it is not incompatible with the freedom of establishment, but, in some circumstances, an issue regarding incompatibility with free movement of capital can be raised, taking into account the doctrine in the above-mentioned *Olsen* case.<sup>116</sup>

Under the BEPS initiative, it remains to be seen whether a similar CFC rule could be introduced by Member States in their national legislation and be applicable both to EU Member States and third countries that are parties to the EEAA and to other third countries. Similar to the analysis of the compatibility of Article 82 in the CCCTB Proposal with the fundamental freedoms, national CFC rules applicable to third countries are compatible with the TFEU as long as facts do not fall under the free movement of capital. Furthermore, national CFC rules applicable to third countries that are party to the EEAA will restrict the freedom of establishment (or capital) but can be justified if there is no agreement on the exchange of information comparable to the EU Mutual Assistance Directive. Finally, national CFC rules identical to the one in the CCCTB Proposal and applicable to other Member States would be incompatible with the *Cadbury Schweppes*<sup>117</sup> doctrine on the artificiality test and it is not likely that the CJEU will reverse its case law.

### Concluding remarks

It is expected that Action 3 will put forward clear recommendations on the design of CFC rules. In order to comply with the G20/OECD objectives to fight against BEPS, CFC rules should be designed as anti-avoidance rules and not as anti-deferral rules. As anti-avoidance rules, CFC rules should target passive income and transparent entities and rely as much as possible on a substance analysis even if their application may become more complex. They should be complemented by FIFs applicable to non-control situations. In the BEPS context, active business income should not be covered by CFC rules and automatic application should be avoided.

A level playing field will only be reached if the CJEU and the EFTA Court interpret avoidance in conformity with the purposes of the BEPS initiative, elaborating on the concept of artificiality in a way which is different from the CJEU's approach in CFC cases since *Cadbury Schweppes*<sup>118</sup> and which is closer to the substance analysis that may be recommended by Action 3 (for example, the viable independent entity analysis). ☞

<sup>115</sup> Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC.

<sup>116</sup> *Olsen* (Joined cases E-3/13 and E-20/13), above fn.98.

<sup>117</sup> *Cadbury Schweppes* (C-196/04), above fn.53, [2006] ECR I-7995.

<sup>118</sup> *Cadbury Schweppes* (C-196/04), above fn.53, [2006] ECR I-7995.

☞ Base erosion and profit shifting; Common consolidated corporate tax base; Controlled foreign companies; EU law; OECD; Tax avoidance; Tax planning; Transfer pricing