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Controlled Foreign Corporation

Certificate Course on International Taxation, Chennai

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Background

- Spread of CFC legislation across the world in last 30-40 years
  - US-perhaps first country to adopt CFC rules in 1962
- Developed countries with CFC rules
  - Canada(1972), Germany (1972), Japan (1978), France (1980), UK (1984), NZ (1988), Australia (1990) etc.
- Emerging countries to have joined the “CFC club”
  - Mexico, Argentina, Indonesia, South Africa, Estonia, China
- OECD report on Harmful Tax Competition encourages countries to introduce CFC legislation to counter use of tax heavens
- India introduced the concept in Direct Taxes Code Bill 2010
  - However, this is yet to be enacted into law

CFC as a Concept

- CFC Regulations typically provides for taxation of artificially transferred income in the year of its accrual irrespective of whether it is distributed as dividend or not to the parent company
  - Aim is to end tax deferral
- Undistributed income earned by the foreign company included as income of resident shareholder
  - Prevention of accumulation of funds in Low Tax Jurisdiction (LTJ)
- DTC 2010 proposal : Resident's taxable income to include:
  - Attributable income of CFC
  - Wealth tax on value of shares in CFC
  - Subsequent actual distribution by CFC to be deductible for resident

Popular Approaches to CFC

Jurisdictional approach

- Tainted/Black listed jurisdictions
- All income of targets in LTJ jurisdictions

Transactional approach

- Tainted Income is considered for CFC
- Generally, restricted to passive / portable income

Entity level approach

- CFC trigger w.r.t 'tainted income' in 'tainted jurisdiction' (i.e. Passive income in LTJ)
- Hybrid (combining Transaction/jurisdictional) approach
- All-or-nothing approach

Indian CFC proposes 'Entity Level Approach'

Indian Legislative Intent

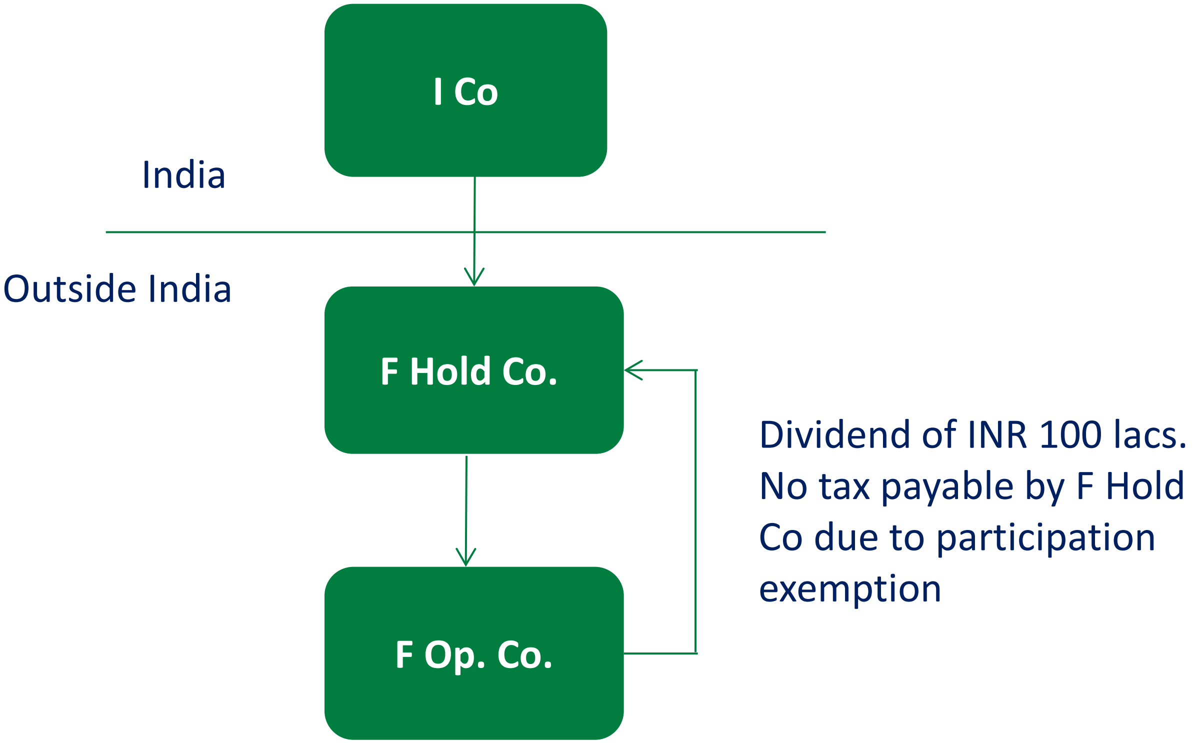
- Taxation of passive income proposed as per RDP, June 2010
  - . .. As an anti-avoidance measure, in line with internationally accepted practices, it is also proposed to introduce Controlled Foreign Corporation provisions so as to provide that passive income earned by a foreign company which is controlled directly or indirectly by a resident in India, and where such income is not distributed to shareholders resulting in deferrals of taxes, shall be deemed to have been distributed. Consequently, it would be taxable in India in the hands of resident shareholders as dividend received from the foreign company…

Conditions for CFC

A foreign entity would be regarded as Controlled Foreign Company if **all** the following conditions are fulfilled

Incorporation	• Foreign Entity should be 'foreign company'
Indian Control	• Person(s) resident in India, individually or collectively exercise control
Tainted Income	• It is not engaged in active trade or business
No Public Interest	• Shares of the entity are not listed on recognized stock exchange of the country of residence
Low Taxation	• Entity is resident of territory with low rate of taxation
Threshold	• Specified income of the entity exceeds INR 2.5 million

Impact



- F Hold Co is CFC
- Entire dividend of INR 100 lacs taxable in I Co hand

Incorporation

- CFC is defined to mean a foreign company which fulfills other conditions
- Foreign company would mean any body corporate incorporated outside India
- Each entity would need to be considered based on its constitution
  - If incorporated, whether regarded as company in foreign country or not, it will be foreign company
  - Limited Liability Partnership in India is an incorporated entity whereas General Partnerships are not
- Foreign LLPs if they are incorporated they would be considered foreign company and consequently would need to be tested for CFC

Unincorporated Entity as Holding Entity

Income Composition

- Foreign company not engaged in active trade or business would be governed by CFC.
- Two cumulative conditions to satisfy that it is engaged in active trade or business
    - Actively participates in industrial, commercial or financial undertaking through employees other personnel in economic life of that country; and
    - Specified income (mainly include passive income and income from certain related party transactions) should be less than 50% of the income for the year.
- Income comparison is to be done at gross level
    - If entity is engaged in trading as well as investment activity, sale value of goods would be compared with interest / dividend income

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Active Business Test

- Meaning of 'actively participates in **economic life of that country'?**
  - Does it require that it should also have dealings in the local market also?
  - Whether International Trading Hub of MNC (where goods are directly dispatched to the customer) can be regarded as engaged in active business?
  - Whether actual amount spend in the residence country would be relevant criterion to consider participation in economic life of that country? (similar to criterion prescribed under India – Singapore DTAA)
  - Whether foreign branches would be reckoned for the active business criterion?

Low / Fair Taxation Test

- Foreign company would not be treated as CFC if it is not tax resident of Low Tax Jurisdiction (LTJ)
- Territories is with LTJ if :
  - Tax ‘paid’ in the country of CFC residence < 50% of corresponding tax payable under DTC
  - Profits of FC needs re computation under DTC as if FC is a ‘domestic company’ for computing corresponding tax in India
- Detailed Rules are provided to determine where the FC is resident of more than one territory

Low / Fair Taxation Mechanism

1. Ascertain tax paid by FC in the country of residence
2. Presume as if FC is a domestic company
3. Determine hypothetical taxable income of FC in India as if it is a domestic company
4. Compare tax paid in overseas with tax as would have been hypothetically payable in India
5. Find out tax liability of FC in India as if it is a domestic company

Low / Fair Taxation Test

- Whether ‘tax paid’ include foreign tax credit?
- In different words, whether ‘foreign tax credit’ is relief from tax or is it mode of payment of tax?
- Mauritius considers ‘tax payable’ as tax determined before granting foreign tax credit
- DTC considers foreign tax credit as part of ‘pre-paid taxes’
- DTC proposes to consider amounts treated as ‘tax paid’ as per laws of foreign countries
  - Therefore, necessary to consider each country law separately
  - However, the DTC definition could have persuasive value to answer the question.

Double Taxation Relief

- Deduction available at the time of receipt of dividend if the same is already taxed under CFC

- CFC taxability arises in respect of each of downstream subsidiaries while deduction would be available only in case of dividend received from immediate subsidiary

- Withholding Tax Credit
  - In the year of attribution of income, no tax withheld and hence no credit – full tax paid in India
  - In the year of declaration of dividend, equivalent deduction is granted
  - Effectively no tax is paid on such dividend
  - DTAA restricts tax credit to the tax payable on such income
  - No credit of taxes withheld even in the year of dividend receipt

- No Cost Step Up
  - Where shares are sold, no deduction in respect of CFC income already considered
  - Effectively, same income of CFC taxed twice

Position in Select Countries

- United Kingdom (until 2012)
  - Entity level approach
    - Entity subject to tax less than 75% of UK tax rate
  - Exclusion
    - ‘While List’ country exclusion with 90% local income
    - De minimus: Accounting profit less than GBP 200,000 or chargeable profit less than GBP 50,000
    - Exempt activities with conditions
  - Nature of income irrelevant
    - All income except Capital Gains is covered by CFC

Position in Select Countries

- United Kingdom (2013 onwards)
  - Transactional level approach
    - Only diverted income of CFC is taxed
  - Exclusion
    - Broadly the exemption continue with certain modifications
    - Additionally, low profit margin exemption has been provided
      - Profit of less than 10% of expense of CFC would effectively get exemption

Position in Select Countries

- United States [Sub-part F Rules]
  - Control
    - 10% holding with aggregate US holding 50%
  - Transaction level approach
    - Identified income of CFC is taxed
      - Insurance income
      - Passive Income
      - Base company sales or service income
  - Complex rules for exemption
    - Inter-linkage with other tax provisions requires in-depth examination

No CFC Regime

- Belgium
- Czech Republic
- Poland
- Russia
- Malaysia
- Philippines
- Thailand
- Netherlands
- Mauritius
- Singapore
- Luxembourg
- Cyprus
- Switzerland
- Ireland

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