CFC Legislation in an International Tax Perspective

CFC (Controlled Foreign Company) legislation is one of the unilateral defence measures against tax evasion used by most OECD member states. The objective of CFC legislation is to protect the domestic tax base from erosion, caused by the outflow of capital to low tax jurisdictions.

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By the use of a foreign company, profits that arise in the company are generally not taxed in the shareholder’s country until the shareholder receives dividends or disposes of the shares in the (foreign) company, implying that taxation in the shareholder’s residence state is deferred. This is beneficial to the extent that the foreign tax payable is lower than the residence state’s tax payable by the shareholder. The deferral thus encourages residents to divert income to low tax jurisdictions and to accumulate such income there instead of repatriating the funds to the residence state.

CFC rules imply that resident shareholders must include in their taxable income their pro rata share of some or all of the undistributed income of the CFC. The conditions for applying the CFC rules vary between countries. Generally, in order to qualify as a CFC, the company must be owned or controlled to a certain extent by resident shareholders of a state. Moreover, either the nature of the activity or the income and/or the jurisdiction in which the foreign company is established will characterize the company as a CFC. Furthermore, the taxation that the CFC is subject to in its residence state must be considered as (too) low in comparison with the tax in the shareholder’s residence state.

It can be noted that Switzerland does not have these types of rules. However, in view of the preferential tax regimes offered both on the cantonal and the federal level, companies established in Switzerland may be considered as CFCs by other countries and thus imply unfavourable tax treatment for the Swiss companies’ foreign shareholders.

CFC legislation in an international law perspective

Both the EU and the OECD continuously work on strategies to tackle harmful tax competition. OECD encourages the member states to introduce anti-abuse tax legislation. However, when introducing national unilateral measures, the question arises whether such rules are compatible with, e.g., bilateral treaties or, for members of the EU, with EC law, since both these legal systems are considered to take precedence over domestic law.

The question seems to have become topical in recent case law development. It has come before, e.g., the courts in France, the United Kingdom and Sweden, and we expect the European Court of Justice (ECJ) to give its view with regard to EC law in the near future.

CFC legislation versus treaty law

A tax treaty is normally a bilateral treaty between two states aiming to reduce or avoid double taxation of the same income. A treaty is preceded by negotiations between the states involved concerning, e.g., the interpretation of the different treaty articles and possible limitation of the treaty benefits for certain tax subjects.

The tax treaty determines the taxing right of a state as well as the method for avoidance of double taxation. In some cases the state can fully apply its domestic tax rules on a certain income but should credit any foreign taxes on the same income. In other cases, the treaty stipulates that only one of the contracting states may tax the income. In such a case, the other state has thus agreed by bilateral negotiations to give up its taxing right, even though
the income may be taxable under domestic rules.

Situations sometimes arise where the contracting states interpret the rules of a concluded treaty differently. There are also situations where a contracting state changes its domestic tax law, either by introducing very attractive special tax regimes or the contrary, unilateral anti-abuse rules. The question to ask is whether such unilateral measures can be applied even when there is a tax treaty in force.

In the commentary to the OECD Tax Model Convention ("the OECD Convention"), it is stated that when CFC legislation is structured in a certain way, it should not be considered contrary to treaty provisions. In fact, the OECD recognizes such rules provided that they aim only at abusive use of base companies and not at income which has been subject to taxation comparable to that in the country of residence of the taxpayer.

Nevertheless, the CFC rules in such cases may be considered to override a certain article in the tax treaty, e.g. the article on business profits. According to this article, following the OECD Convention, the right of taxation of industrial and commercial profits of a foreign entity is given exclusively to the country where the enterprise is established, provided the entity has no permanent establishment in the other state. Thus, if the other state applies its CFC rules and taxes the income, it means that it disregards the treaty by which it has previously given up its taxing right.

Another view would be to say that the article on business profits does not limit the right to apply CFC rules since the tax so levied by a state on its own residents does not reduce the profits of the foreign company in the other contracting state and may not, therefore, be said to have been levied on such profits.

**CFC legislation versus EC law**

The EC treaty stipulates that obstacles to an internal market shall be abolished in order to guarantee steady expansion, balanced trade and fair competition within the EU and expresses the desire to progressively abolish restrictions on international trade. For this purpose, the so-called fundamental freedoms, including the freedom of establishment, the freedom to provide services, the free movement of persons and the free movement of capital, need to be respected by all EU member states.

In this respect, the question is whether CFC rules are considered to infringe on the principles of the right of establishment (article 43 of the EC treaty) and the free movement of capital (articles 56 to 60 of the EC treaty).

*Implication for third states*
The EC treaty also prohibits all restrictions on the movement of capital between member states and third countries (non-EU member states), such as Switzerland. However, it stipulates that it does not prejudice the right of member states to apply provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested, nor to take necessary measures to prevent infringements of national law and regulations, in particular in the field of taxation, or to take measures which are justified on grounds of public policy or public security, provided that such measures do not constitute a means of arbitrary discrimination. The question is thus whether the right to take certain measures implies a right to apply CFC rules.

**Sweden**

Following the introduction in 2004 of the modified CFC rules, the first two advanced rulings on this topic were published in April 2005. The two cases concerned subsidiaries established in Luxembourg and in Switzerland respectively, both involved in captive insurance activities, generating such financial income that is taxable under the CFC rules. The Swedish parent company asked whether the CFC rules were compatible with (1) the EC rules on the freedom of establishment and the free movement of capital and (2) the applicable tax treaty.

In both cases the CFC legislation was ruled to be incompatible with the freedom of establishment. The Council ruled that the CFC rules imply a difference in treatment between holdings in Swedish companies and holdings in foreign subsidiaries and that this difference risked preventing residents from establishment abroad. Thus, the CFC rules constitute an infringement with the EC treaty. It furthermore ruled that this discrimination vis-à-vis Luxembourg, based on current ECJ case law, could not be justified for the prevention of tax evasion since the rules are too general and not only aimed at artificial setups of companies.

However, in the case with Switzerland, the infringement was considered justified. The reason for the opposite outcome compared to the Luxembourg case was based on the fact that Switzerland is a third country and not a EU member state. The Council stated that, even though case law from the ECJ seems to confirm that there should not be a difference in treatment between capital movements within the EU and those towards third countries, the purpose and object of the EC treaty rules, namely the elimination of all obstacles to an internal market, is an essential aspect. Since the reason behind the liberalisation towards third countries is less obvious and the treaty reserves the right for the member states to keep or introduce protective rules towards third countries, limitation of the free movement towards third countries could, according to the Council, more easily be justified. The rules were also considered proportionally appropriate.

As for the tax treaties, the CFC rules were not considered to be incompatible (contrary to the French case, see below). The justification for this was that the taxable income at the level of the foreign company was not considered to be "the same income" as the one taxable under the CFC rules at the level of the parent company in Sweden.

The Council further discussed which article in the treaty was applicable. It stated that the income should not be considered as dividends but rather as income from business activities or other income under the tax treaty, and under those articles, the Swedish parent company, as tax resident in Sweden, may be taxed in Sweden.
Therefore, the taxation was ruled to be in accordance with the treaty rules. It should be noted that both cases have been referred to the Supreme Administrative Court. It will be interesting to see whether they will also be referred to the ECJ.

France
On June 28, 2002, the French Supreme Court ruled in the so-called Schneider case that the French CFC legislation could not be applied where the subsidiary was located in a country that had signed a tax treaty with France, drafted in accordance with the OECD Convention, since the article on business profits in the treaty stipulated that tax on profits could be levied only by the country in which the company ran its business. Consequently, tax treaty law was ruled to prevent the application of the CFC rules.

The French authorities attempted to surmount this decision by inserting clauses in 25 renegotiated treaties. However, the French government considered that the tax law also needed to be changed since it was incompatible with EC law. Therefore, the taxation was ruled to be in accordance with the treaty rules.

The debate whether unilateral CFC rules are incompatible with countries’ obligations on the international level, such as tax treaties and EC law, is not new. In tax treaty law, different views have been stated but there is no higher international court to rule on the question. OECD recognizes CFC rules as an efficient anti-abuse measure but underlines that such rules should only be applied in specific situations and with specific limitations.

So what will the concerned states do? If the CFC rules are considered incompatible with tax treaty obligations, possible solutions would be either to add a new provision to the treaties allowing the application of the CFC rules, or characterize the income subject to the CFC rules differently, for example as deemed dividend, as seen in the French example. It is, however, also possible that some states will continue arguing that there is no infringement with treaty law as done in the Swedish cases.

The first country to have “assumed its responsibilities” is France, which has led to renegotiated tax treaties as well as amended CFC legislation. It will be interesting to see if other countries will follow.

As for EC law, it is likely that the ECJ will shortly hold the British CFC rules incompatible with the fundamental freedoms in the EC treaty. It is also likely that many other countries’ CFC rules will be tried and rejected unless the countries ex officio modify or abolish their rules.

A question also worth following is to what extent this development will have an influence on non-EU countries, especially Switzerland, which, with its bilateral conventions with the EU, comes closer and closer to being treated as a member state.

In general, the development of the CFC rules will have an important impact for countries like Switzerland, sometimes considered as a CFC jurisdiction. It will most likely open up new opportunities for countries to offer preferential tax regimes to foreign investors. Whereas there are many efforts made towards tax harmonization within Europe, this development may even make way for more tax competition between the countries.

Making Way for More International Tax Competition

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