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Comments on OECD Discussion Draft on BEPS Action 3: Strengthening CFC Rules

Dear Mr. Pross:

EY appreciates the opportunity to submit these comments to the OECD on the Discussion Draft on BEPS Action 3: Strengthening CFC Rules dated 3 April 2015.

Action 3 represents a new area of focus for the OECD. The OECD has not previously done any substantial work on questions related to the design or operation of CFC regimes. As has been the case with other BEPS discussion drafts, the Action 3 discussion draft includes a caveat that the recommendations it contains do not reflect a consensus view. Moreover, with respect to the core question of what income should be covered by a CFC regime, the lack of consensus is such that the discussion draft includes possible options rather than recommendations. However, it is stated that the final report on Action 3, which is to be issued later this year, will include recommendations with respect to the income to be covered by a CFC regime in addition to recommendations with respect to the other core design elements of a CFC regime. We are concerned that this plan for comprehensive recommendations with respect to CFC rules is unrealistic and that allowing this work to be driven by artificial deadlines would be imprudent. Our concern about the timetable for completion of this work is heightened by the fact that there is so much work yet to done with respect to the other BEPS Actions. We believe that the more prudent course of action would be to take a more deliberative approach to the work on Action 3, even if that means delaying delivery of the final report.

The aim of CFC rules is commonly considered to be protection of the taxing rights of the country where the parent company is located. CFC rules are designed to achieve this objective and the effectiveness of CFC regimes is measured against this objective. However, in its July 2013 Action Plan on BEPS, the OECD identified another potential objective behind CFC rules, which is to help protect the tax bases of third countries. This seems to be quite a novel perspective on CFC rules. The discussion draft alludes to this protection of third countries concept, but does not develop it in any detail. It is not clear to what extent the recommendations and options contained in the discussion draft are aimed at this new and novel objective rather than at the traditional objective of protecting the tax base of the headquarters country. As the work on Action 3 continues to move forward, we urge the OECD to be clear about the objectives it is seeking to further with its recommendations and options relating to the core elements of a CFC regime.

In our view, CFC rules should function mainly as anti-abuse rules. In this regard, as the discussion draft details, the anti-abuse nature of CFC regimes is the basis on which such rules have been found to be acceptable under the treaty governing relationships in the European Union. Taxation of the foreign earnings of a CFC to its parent company under a CFC regime is a departure from general international tax concepts and the generally accepted notion of country sovereignty. In keeping with the anti-abuse rule role, we believe that CFC rules should be narrowly targeted. The discussion draft, however, takes a much broader approach – too broad an approach in our view. We believe that the OECD should revisit these issues and should develop a CFC design approach that better aligns with the anti-abuse rule function of CFC regimes.

It is important to recognize that countries have made very different choices with respect to CFC rules. Some countries do not use CFC rules at all. Countries that do use CFC rules have chosen a broad range of approaches with respect to the scope and reach of such rules. Underlying these choices are decisions countries have made regarding competitiveness and encouraging investment. For these reasons, we do not believe that a single set of CFC design recommendations is a realistic or appropriate goal. Indeed, even developing best practices recommendations will be challenging in light of the different objectives that are served by CFC rules. We believe that the OECD should consider an approach that would associate best practices recommendations for design of CFC rules with the different objectives that could be served by such rules.

In connection with any best practices recommendations, we encourage the OECD to address those situations where multiple anti-abuse rules could be applicable, such as where multiple CFC regimes could apply to the income of a CFC held by a chain of entities. Moreover, the OECD should address the double taxation risk that arises where the source country denies the deduction for payments that are not sufficiently taxed in the receiving jurisdiction but the amount is subject to a CFC inclusion in a parent company of the receiving entity. The work on Action 3 should include development of ordering rules in the full range of situations where there is risk of multiple taxation of the same income.

The Action 3 discussion draft includes a reference to a proposal for a secondary rule that would apply where an entity is not subject to sufficient tax under CFC rules and that would allow other countries to tax the entity's income on some undefined basis. The discussion draft indicates that consideration has not been given to whether this proposal should be taken forward. Such a rule would be a radical departure from international tax norms and would seem to be unworkable. We urge the OECD not to advance this idea any further.

Finally, we would note that there is significant interaction between this BEPS Action 3 and several other BEPS Actions. The discussion draft acknowledges the need to coordinate the Action 3 work with the work on multiple Actions, including Action 1 on the digital economy, Action 2 on hybrid mismatch arrangements, Action 4 on limitations on interest deductibility, Action 5 on harmful tax practices, and Actions 8-10 on transfer pricing. We agree that close coordination is essential and therefore we are concerned about the practicalities of accomplishing such coordination under the BEPS timeline while the work on these other Actions is still in progress.

We urge the OECD to take the time to evaluate the outcomes of the other BEPS Actions and also to reassess the objectives of the Action 3 work. Given all the issues with respect to this focus area, we would recommend that work with respect to Action 3 should be deferred until the work on the other Actions is completed so that it can be approached with clearer focus and with due consideration of the implications of the measures that result from the other interconnected Actions.

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If you have questions or would like further information regarding any of the points discussed above, please contact Barbara Angus (barbara.angus@ey.com), Jim Tobin (james.tobin@ey.com) or me, Alex Postma (alex.postma@ey.com).

Yours sincerely
On behalf of EY

Alex Postma