The Evolution of Controlled Foreign Corporation Rules and Beyond

This article traces the evolution of controlled foreign corporation (CFC) rules, including their compatibility with treaty provisions. It argues that CFC rules would be preferable to the Inclusive Framework proposal on the OECD/G20 Base Erosion and Profit Shifting Project (Pillar Two) for a uniform minimum tax on all CFC income.

1. Introduction

This article is based on the 2019 Parsons Lecture, which I delivered at the University of Sydney Law School in November 2019. I was honoured to have been invited to follow in the footsteps of the distinguished group of tax academics who have given the Parsons Lectures in the past, especially as I had the opportunity to meet Professor Ross Parsons and discuss tax issues with him during my first trip to Australia in 1984.

The topics of this article are controlled foreign corporation (CFC) rules and the recent minimum tax proposals of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) of the OECD/G20 Project.1 CFC rules have a rich history, going back to 1962, i.e. when the United States first adopted the rules. Since then, so many other countries have enacted CFC rules that they have become a standard part of the international tax systems of most developed countries. In light of the remarkable spread of CFC rules, it seems appropriate to review the evolution of CFC rules and reassess their role in the international tax system. Such a review is timely because of the current work of the Inclusive Framework, i.e. the body responsible for the implementation of the OECD/G20 BEPS Project, on the tax challenges of the digital economy, which includes consideration of a new minimum tax on the income of CFCs. This new minimum tax shares many of the fundamental design features of CFC rules and raises a basic question, namely, whether, instead of developing a whole new approach to the issue of taxing offshore income, it would be preferable to extend and harmonize the application of CFC rules.

Section 2. begins the article with a description of the fundamental principles of international tax as background and context for a review of the role of CFC rules in the broader international tax system.

Section 3, after a brief discussion of the tax policy underlying CFC rules and their basic operation, examines the scope of the rules to determine their effectiveness, including their potential effectiveness, in preventing base erosion. In this context, it is noted that the scope of CFC rules is determined by the following three features: (1) the foreign entities to which the rules apply; (2) the level of foreign tax on a CFC’s income; and (3) the nature of the income of a CFC that is attributable to its resident shareholders.

Section 4. traces the spread of CFC rules since 1962, when the United States became the first country to adopt what were at that time very controversial rules, to the present, where CFC rules are clearly considered to be legitimate measures to protect a country’s tax base and have been adopted not only by most capital-exporting developed countries, but also by many developing countries. The article then briefly describes the major events that may have influenced the spread of CFC rules, namely the 1998 OECD Report on Harmful Tax Competition,2 the 2015 Final Report on Action 3 on Controlled Foreign Company Rules of the OECD/G20 BEPS Project3 and the Anti-Tax Avoidance Directive (2016/1164), or ATAD 1, of the European Union.4

Section 5. describes how the spread of CFC rules and their gradual acceptance as part of the international tax system have been supplemented and reinforced by the evolution of the relationship between CFC rules and tax treaties as reflected in the Commentaries on the OECD Model5 and the UN Model.6

Section 6. examines the recent proposals of the Inclusive Framework to deal with the digital economy and, in particular, Pillar Two of those proposals, which involves a minimum tax on the entire income of CFCs. It describes the Pillar Two proposal as well as the US minimum tax on Global Intangible Low-Taxed Income (GILTI) and the

1. As of October 2019, the Inclusive Framework consisted of 135 member countries, which had all agreed to implement the minimum standards of the OECD/G20 BEPS Project.

5. Most recently, OECD Model Tax Convention on Income and on Capital (21 Nov. 2017), Treaties & Models IBFD.
6. UN Model Double Taxation Convention between Developed and Developing Countries (1 Jan. 2017), Treaties & Models IBFD.
Base Erosion and Anti-Abuse Tax (BEAT) adopted as part of the 2017 US tax reform\(^7\) on which Pillar Two appears to be based. The Pillar Two proposals are then critiqued and the obvious question considered, i.e. whether it would be preferable to extend CFC rules rather than introduce a new minimum tax.

Section 7. discusses the perspective of developing countries on the Pillar Two proposals. Finally, a brief conclusion to the article follows in section 8.

2. The Background: The Principles of International Taxation

In order to understand the role that CFC rules are intended to play in a country’s tax system, it is useful to briefly review the international consensus with regard to the allocation of taxing rights between source and residence countries that forms the context for CFC rules. This consensus was formed through the work of the League of Nations in the first half of the 20th century and later by the OECD in the second half of that century. It has proven to be quite stable for about 75 years, although the digitalization of the economy is currently threatening that consensus.

The existing international consensus is based on the following three fundamental principles:

1. Countries have the right to tax on the basis of both the source of income, i.e. income derived, earned or arising in a country, and on the basis of the residence of the taxpayer, i.e. a taxpayer’s close personal and economic connections to a country.

2. The country in which income arises, i.e. the source country, has the first right to tax that income.

3. The country in which a taxpayer is resident, i.e. the residence country, has the right to tax the taxpayer’s worldwide income in accordance with the first principle. However, it has a corresponding obligation to provide relief from the international double taxation of foreign-source income subject to tax in another country.

Although the early work on international taxation recognized that “all incomes would be taxed once and only once”,\(^8\) the “single tax principle” did not receive much attention until the OECD/G20 BEPS Project. Instead, the primary emphasis was on eliminating double taxation rather than preventing double non-taxation.\(^9\) Consequently, in my view, based on the provisions of the domestic tax laws of most countries and tax treaties, it is unjustified revisionism to consider the prevention of double non-taxation to be a fundamental principle of the international tax system for the past 75 years.\(^10\) Whether it has become such a principle as a result of the OECD/G20 BEPS Project remains to be seen.\(^11\)

These three fundamental principles are supplemented by the following four subsidiary principles:

1. Source countries are entitled to impose tax on passive investment income, i.e. dividends, interest, rent and royalties, through withholding taxes on the gross payments, usually at reduced rates under the provisions of tax treaties.\(^12\)

2. Source countries should tax most business profits earned by a non-resident only if the non-resident has a substantial economic involvement in the source country, generally, a permanent establishment (PE). However, this situation applies only to the extent that the profits are attributable to the PE. In addition, the profits should be subject to net-basis taxation.\(^13\)

3. Source countries should not discriminate against non-residents carrying on business in their countries, against resident corporations owned or controlled by non-residents or against resident corporations making deductible payments to non-residents.\(^14\)

4. Residence countries should treat foreign subsidiaries of resident corporations as separate taxable entities, which was, perhaps, more of an unstated assumption than an explicitly articulated principle. In addition, source countries should not treat resident subsidiaries of foreign parent corporations as PEs of those foreign parents, i.e. the separate-entity principle.\(^15\)

Convincing evidence for these general principles can be found in the domestic tax systems of developed countries and their bilateral tax treaties for most of the 20th century.\(^16\) I do not mean to suggest that all countries adhered strictly to all these general principles. Many examples of

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10. Even if the single-tax principle is viewed as a fundamental principle of the international tax system, that principle was not acted on signifi-
11. The OECD/G20 BEPS Project can be regarded as targeting the lack of coherence in the international tax system and the opportunities for tax avoidance that such incoherence made possible rather than as pursuing the single-tax principle.
12. Arts. 6, 10, and 11 OECD Model (2017) and arts. 6, 10-12 and 21 UN Model (2017).
13. Art. 7 OECD Model (2017) and UN Model (2017). Technically, net-basis taxation of non-residents is required by art. 24 OECD Model (2017) and UN Model (2017) only if residents in the same circumstances are taxed on a net basis.
15. Art. 5(7) OECD Model (2017) and UN Model (2017). Conversely, residence countries should not treat resident parent corporations as PEs of their foreign subsidiaries.
The fundamental tax policy objective of CFC rules is to prevent taxpayers resident in one country from shifting departures from these principles could be found, and can still be found, in the domestic laws and tax treaties of most countries. Nevertheless, despite the many exceptions and the vagueness of the principles, I suggest that, for most of the 20th century and at least until the implementation of the OECD/G20 BEPS Project, the international taxation of cross-border business transactions and investment flows generally conformed to these principles. As a result, double taxation was reduced significantly, although not eliminated completely.

Two important points about these general principles should be noted. First, most of the principles concern limitations on source country taxation. Residence country taxation is unlimited, although residence countries must provide relief for source country taxes. This residence-country bias is not surprising given that the general principles were formulated by the largest developed capital-exporting countries.

Second, the general principles have been eroding from the outset. Accordingly, for example, many Central and South American countries, as well as India, were not content to tax only business profits arising in their countries. Rather, these countries extended their (source) jurisdiction to tax through withholding taxes on consulting, technical and management fees paid to non-resident service providers. This extension of source country taxation was legitimized by the addition of article 12A of the UN Model (2017). Similarly, the treaty PE threshold for the taxation of business profits derived by non-residents in source countries has been steadily reduced partly by changes to article 5, most recently in the OECD Model (2017) and the UN Model (2017), but generally through changes to the related Commentary on Article 5 of the OECD Model and the UN Model. Of primary relevance for this article, the principle that residence countries should treat foreign subsidiaries of resident parent corporations as separate taxable entities has been eroded steadily since the United States adopted its CFC (the Subpart F) rules in 1962. In section 3., the tax policy considerations underlying CFC rules, their basic operation and scope are discussed.

3. CFC Rules: Policy, Basic Operation and Scope

3.1. The tax policy of CFC rules

The intimate relationship between CFC rules and beyond the treatment of non-portfolio dividends and the exemption of foreign PE profits is critical to an understanding of the policy, operation and scope of CFC rules. This issue is analyzed below.

Where a country’s domestic tax base includes non-portfolio dividends from foreign corporations. CFC rules are intended to prevent the deferral of domestic tax on income earned by and accumulated in CFCs until that income is distributed to the resident shareholders of the CFC, which it usually is not, as the US experience before 2017 clearly illustrates. Where a country’s tax base does not include non-portfolio dividends from foreign corporations, i.e. such dividends are exempt, CFC rules are intended to prevent the complete avoidance of domestic tax on income earned by and accumulated in CFCs, as such income, which would be subject to residence country tax if earned directly, can be earned without residence country tax by a CFC and then repatriated to a CFC’s resident shareholders as tax-exempt dividends. Consequently, CFC rules protect the integrity of the deferral of domestic tax afforded to income earned by CFCs under an indirect credit system and also protect the integrity of the exemption of non-portfolio dividends under an exemption system.

Similarly, where a country does not tax foreign-source income attributable to a foreign PE, resident taxpayers of the country may divert domestic source income to such a PE to avoid domestic tax. As a result, some countries restrict the exemption of foreign profits attributable to a PE to profits that would not be subject to the CFC rules if the PE were a CFC. Alternatively, other countries apply

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17. For instance, Australia did not use the PE threshold or any other threshold for taxing non-residents, thereby choosing instead to tax any income sourced in Australia. In addition, until recently, it refused to agree not to discriminate against non-residents for tax purposes.
18. Although residence countries are prohibited from discriminating against non-residents in three respects, as noted in section 2., these treaty non-discrimination provisions are really intended to benefit taxpayers in capital-exporting residence countries carrying on business in source countries, investing in subsidiaries in those source countries or making deductible payments to residents of those countries.
19. Until the changes to art. 5 OECD Model (2017), I cannot think of one instance in which the PE threshold has been raised!
CFC rules to prevent the exemption for foreign PE profits from being used to avoid domestic tax.  

For all countries, the fundamental purpose of CFC rules reflects the tension or balance between capital export neutrality (CEN), under which residents of a country should be subject to the same tax on foreign-source income as on domestic source income, and capital import neutrality (CIN), under which residents of a country should be subject to the same tax on business income earned in another country as other taxpayers carrying on business in that country. Under a comprehensive policy of CEN, a country would apply its CFC rules to all the income of all CFCs, whereas under a comprehensive policy of CIN, a country would not apply CFC rules at all, as it would not tax any foreign-source income, i.e. it would be a “territorial” tax system.

Although the CFC rules of countries can be found at various places along this spectrum, no country’s CFC rules are to be found at either end. In designing their CFC rules, all countries attempt to realize a balance between protecting their domestic tax base and not interfering with the ability of their residents to carry on legitimate business activities abroad, i.e. to promote international competitiveness. As a result, CFC rules are usually restricted to CFCs based in low-tax countries and earning passive investment income or business income that is easily diverted to CFCs. However, there is no inherent limitation on the scope of CFC rules. They could be extended to:

- all CFCs wherever resident, i.e. whether or not resident in a low-tax country, as is the case with the Brazilian, Canadian, Danish and US CFC rules;
- all foreign corporations in which resident taxpayers have a substantial interest, say, 10% or more, as under the original Brazilian and French CFC rules, thereby making CFC rules coextensive with the exemption or indirect credit for non-portfolio dividends; and
- all income earned by CFCs or all income other than active business income from third parties.

Unilateral action by one country to extend its CFC rules in these ways would put its resident multinational enterprises (MNEs) at a competitive disadvantage. As a result, it is generally accepted that any significant extension of CFC rules requires coordinated action by the major developed countries where most of the large MNEs are based. Such coordinated multilateral action is the driving force behind the OECD/G20 BEPS Project and the ongoing work of the Inclusive Framework. However, following the failure of Action 3 of the OECD/G20 BEPS Project, CFC rules seem to have been abandoned as an option for dealing with base erosion other than base erosion with regard to passive income and limited types of business income.

Although it is important to understand the fundamental purpose of CFC rules, which is the same for all countries, other tax policy objectives may be taken into account in designing CFC rules. For instance, the chosen design of a particular country’s rules inevitably reflects trade-offs between the breadth of the rules and concerns about tax compliance and tax administration. Other tax policy considerations that may be taken into account in designing the scope of CFC rules include:

- the use of CFC rules as a backstop to transfer pricing rules;
- the relationship with foreign investment fund rules; and
- the extension of CFC rules to situations involving the use of CFCs to avoid foreign tax.

### 3.2. The basic operation of CFC rules

CFC rules operate in the same basic way in all countries. Where a CFC is subject to the CFC rules, the appropriate portion of its attributable income, often referred to as tainted income, which usually includes passive income and certain limited types of business income, is included in the income of its resident shareholders and is subject to residence country tax. Accordingly, in effect, the status of the CFC as a separate legal and taxable entity is ignored and the resident shareholders are taxed on their share of its tainted income when the CFC earns that income and as if they had earned that income directly. Although many detailed, but largely mechanical, rules are necessary for this purpose, the basic operation of CFC rules is quite straightforward.

As resident shareholders of a CFC are taxable on their share of its income as if they had earned the income directly, they should be entitled to a credit against any residence country tax payable for their proportionate share of any foreign tax paid by the CFC with regard to its tainted income. Such a foreign tax credit is necessary to eliminate double taxation in accordance with the fundamental principle of the international tax system described in section 2. Similarly, dividends paid by CFCs to their resident shareholders out of income that has been previously subject to tax under the CFC rules should be exempt from residence country tax to avoid double taxation.

23. For instance, where CFC rules apply only to foreign corporations controlled by a concentrated group of residents, the rules can be avoided by having the shares of the CFC widely held by residents. Similar planning can be used to avoid CFC rules if only shareholders owning a certain percentage of the shares of the foreign corporation are taken into account in determining whether the foreign corporation is a CFC. As a result, some countries have enacted foreign investment fund rules to counteract this type of planning, while other countries, such as Germany, have applied their CFC rules to small interests in a CFC. See B.J. Arnold, International Tax Primer 4th edn. pp. 138–40 (Kluwer L. Intl. 2019); and J. Prebble edd., Taxing Offshore Investment Income: A Comparative Review of Structural Issues ( Fiscal Publications 2006).

24. See Arnold, Comparative Perspective, supra n. 20, at pp. 492–493.

25. For instance, rules are necessary to determine each shareholder’s interest in the CFC, the timing of the income inclusion, the character of the income and whether the income is taxed separately or aggregated with a shareholder’s other income. In addition, many countries impose tax only on resident shareholders that own a minimum percentage, often 10%, of the shares of a CFC.

26. In light of the well-established principle that double taxation should be eliminated, it is surprising that many countries do not provide full relief for foreign tax as part of their CFC rules. For instance, some countries, for example Portugal and Sweden, permit only a deduction for the foreign tax.

27. In addition, residence country tax on capital gains realized on the disposition of shares of a CFC should be reduced to the extent that the capital
3.3. The scope of the application of CFC rules

3.3.1. Opening comments

The effectiveness of CFC rules in preventing base erosion and profit shifting is determined by the scope of application of the rules and their enforcement. A detailed discussion of the enforcement of CFC rules is beyond the scope of this article. Nevertheless, in general, because CFC rules tend to be among the most complex provisions of a country’s tax system, they require tax officials to have considerable technical expertise backed by a significant commitment of administrative resources, which presents a difficult challenge for many countries, especially developing countries. However, it should also be remembered that CFC rules are intended to be prophylactic and are most effective if taxpayers are discouraged from diverting the relevant income to CFCs.

The scope of CFC rules is determined by the following three fundamental features of the rules:

1. The definition of a CFC;
2. The level of foreign tax on a CFC; and
3. The nature of the income earned by a CFC that is attributed to its resident shareholders.

There is considerable variation in the CFC rules of countries with respect to these three features. Some countries apply their rules only to foreign corporations that are legally controlled by residents, whereas other countries apply their rules to foreign corporations in which residents have a substantial interest, for example, Brazil, Denmark and Portugal. Most countries apply their rules only to foreign corporations that are subject to low foreign tax, but other countries apply their rules to all CFCs irrespective of the level of foreign tax, for instance, Brazil, Canada, Denmark and the United States. Some countries apply their rules only to passive income and limited forms of business income earned by CFCs, whereas other countries tax all of the income earned by CFCs, for example, Brazil and Sweden.

The broader the scope of a country’s CFC rules, the more effective they are in protecting the country’s tax base. However, the broader the rules are, the more likely it is that they adversely affect the international competitiveness of a country’s MNEs and the more onerous the compliance and administrative burden of the rules will be. There should be a balancing of the scope of the rules and the costs of compliance with and administration of the rules. Theoretically, CFC rules that are intended to deal comprehensively with base erosion should apply to all substantial interests held by residents in foreign corporations and should impose residence country tax on the proportionate share of resident shareholders of all the income of those corporations irrespective of the foreign tax paid by the foreign corporation, although any foreign tax paid should be creditable against the residence country tax paid.

3.3.2. The definition of a CFC

Although the term “controlled foreign company” rules strongly suggests that CFC rules apply only to foreign companies that are “controlled” by resident shareholders, some countries apply their rules to foreign corporations in which resident shareholders have a substantial interest, often 10% or more of the shares. Despite the fact that a substantial-interest threshold for the application of CFC rules may give rise to compliance difficulties for resident shareholders with less than a controlling interest in a foreign corporation, such a threshold can be justified on the basis of the relationship between the CFC rules and the treatment of non-portfolio dividends from foreign corporations.

CFC rules are intended to protect the integrity of the exemption and indirect credit systems for non-portfolio dividends. Those systems typically apply to dividends from foreign corporations in which a resident corporation owns a substantial equity interest, usually 10% or more of the shares. Where a country’s CFC rules apply only to foreign corporations controlled by residents, a resident corporation owning between 10% and 50% of the shares of a foreign corporation would receive the benefit of the exemption or indirect credit system for dividends, but would not be subject to the CFC rules. Accordingly, any tainted income earned by the foreign corporation would not be attributed to the resident shareholder under the CFC rules, but, nevertheless, that income could be distributed to the resident shareholder tax-free or with an indirect foreign tax credit.

For most countries that apply their CFC rules only to foreign corporations controlled by residents, the crucial issue is the meaning of “control” for this purpose. Many countries use a de jure control test, under which a CFC is a foreign corporation only if residents or a concentrated group of residents own more than 50% of the shares by reference to the voting rights or the value of the shares.

28. This balancing is considered in more detail in section 5.3. in connection with the comparison of CFC rules and the Pillar Two proposal to adopt a minimum tax.

29. For instance, Brazil applies its CFC rules to any foreign corporation over which a Brazilian-resident corporation has a “significant influence”, which means an equity interest in the foreign corporation of 20% or more. Similarly, the French CFC rules originally applied to any foreign corporation in which a French corporation held 10% or more of the shares. Denmark and Portugal use a 25% or greater share ownership test. See Arnold, Comparative Perspective, supra n. 20, at n. 28.

30. For instance, Brazil applies its CFC rules to any foreign corporation over which a Brazilian-resident corporation has a “significant influence”, which means an equity interest in the foreign corporation of 20% or more. Similarly, the French CFC rules originally applied to any foreign corporation in which a French corporation held 10% or more of the shares. Denmark and Portugal use a 25% or greater share ownership test. See Arnold, Comparative Perspective, supra n. 20, at n. 28.

31. Some countries have enacted foreign investment fund rules to deal with residents holding non-controlling investments in foreign entities that hold primarily passive investments.
Several countries extend the de jure control test slightly to prevent avoidance of the basic test. As a result, for example, several countries supplement the share-ownership test by a test based on the ownership of rights to distribution of the profits, capital or assets of a foreign corporation. Australia has a 50%-or-more test to cover situations in which an Australian resident and a foreign resident each own exactly 50% of the shares of a foreign corporation. The United Kingdom has a rule under which the ownership of 40% of the shares of a foreign corporation is presumed to be controlled unless a single non-resident owns more than 50% of the shares of the corporation, i.e. that non-resident has de jure control of the corporation. However, very few countries have adopted a de facto control test, probably because of the uncertainty for taxpayers and tax authorities with regard to the application of such a test.

Most countries have rules to deal with CFCs that are indirectly controlled by residents and with situations in which control is exercised by related parties, parties acting in concert, or a small group of resident taxpayers. There are also many other detailed aspects of the definition of a CFC that affect the scope of a country’s CFC rules, but these aspects are beyond the scope of this article.

### 3.3.3. The level of foreign tax on a CFC

The level of foreign tax on a CFC is an important feature of every country’s CFC rules. This is not surprising, as the use of a CFC is beneficial only if the foreign tax on the CFC’s tainted income is less than the residence country tax. Countries typically use the following three general approaches with regard to how foreign tax paid by a CFC is taken into account:

1. **a global approach, as used by Canada, under which CFC rules are applied to all CFCs irrespective of where they are resident or the amount of foreign tax on their income;**
2. **a low-taxed-income approach, as used by Germany and the United States, under which countries adopt a global approach but provide an exemption for income that is subject to a minimum level of foreign tax;** and
3. **a designated-jurisdiction approach, the approach used by most countries, under which CFC rules apply only to CFCs in defined or listed low-tax countries.**

33. Italy applies its CFC rules where a resident has sufficient votes or a contractual relationship to exercise dominant influence over a foreign corporation.

34. For instance, some countries apply their rules only to foreign corporations that are controlled by resident corporations, i.e. the CFC rules do not apply to resident individuals. Some countries, for example Italy and Korea (Rep.), require control to be held by a single corporation. Other countries, for example China and the United States, take into account only resident shareholders owning more than 10% of the shares of a foreign corporation, i.e. a minimum ownership requirement, for the purpose of determining whether a foreign corporation is a CFC, whereas other countries, for example Norway, take all resident shareholders into account, with the result that a foreign corporation that is widely held by residents is a CFC.

35. See Arnold, Comparative Perspective, supra n. 20, at pp 483–487.

36. However, it should be noted that Germany continues to apply its CFC rules to CFCs that are subject to foreign tax of less than 25%, despite the fact that the German corporate rate is currently only 15%.

37. Germany had a similar approach for CFC income that was subject to foreign tax of less than 25%. This approach became redundant when German corporate tax rates were reduced to less than 25%.
sary for taxpayers and tax officials to compute the residence country tax that a CFC would pay where a CFC is not resident in a low-tax country. Countries use a variety of approaches in defining or listing countries. Some countries, such as China, Japan and Korea (Rep.), define a low-tax country without supplementing the definition with a list of such countries. A low-tax country is typically held to be a country that levies tax at a rate lower than a specified rate or a percentage, being 50% in the case of Italy, 55% in the case of Sweden, 60% in the case of Finland, 66.6% in the case of France and Norway, or 75% in the case of Spain and the United Kingdom, of the residence country’s corporate tax rate. However, most countries using a designated-jurisdiction approach have one or more lists of low-tax or non-low-tax countries to provide certainty for taxpayers and tax authorities.

There are two basic types of list:

1. a blacklist of low-tax countries: CFCs resident in a country on the blacklist are subject to the CFC rules and other CFCs may or may not be subject to the rules; and
2. a white list of high-tax countries: CFCs resident in a country on the white list are exempt from the CFC rules and other CFCs may or may not be subject to the rules.

The simplest listed-country approach involves an explicit black, or white, list with all CFCs resident in a listed country subject to the CFC rules, or exempt, and all other CFCs exempt, or subject to the CFC rules. A simple blacklist is easily avoided and most countries that originally adopted blacklists have abandoned them. However, a simple white list of major high-tax countries, especially those countries in which most of a country’s CFCs are resident, can reduce the compliance and administrative burden of CFC rules. Countries can use black and white lists to provide certainty by identifying countries that are clearly low-tax or high-tax countries. Moreover, a white list can be quite sophisticated. For instance, a CFC resident in a white-list country may be exempt from the CFC rules only if it meets certain conditions, for example, if it does not derive certain preferentially taxed income, such as capital gains or exempt foreign-source income.

The designated-jurisdiction approach reflects the fundamental policy of CFC rules, namely to prevent shifting profits to CFCs, moderated by tax administration and compliance considerations, i.e. taxpayers are unlikely to establish and maintain CFCs where the tax savings generated through the use of those CFCs is small. The cost of realizing substantial simplification of the CFC rules through a designated-jurisdiction approach is the need for the residence country to tolerate a certain amount of base erosion and the resulting loss of tax revenue. In effect, CFC rules using a designated-jurisdiction approach target the worst cases of abusive profit shifting but not all profit shifting.

3.3.4. The definition of attributable or tainted income

The nature of the income of a CFC that is attributable to its resident shareholders is perhaps the most important factor in determining the scope of CFC rules. CFC rules can apply to all the income of a CFC, as is the case with the Brazilian and Swedish CFC rules, or only to certain tainted income, as is the case for most other countries. In general, tainted income includes passive investment income, such as dividends, interest, royalties and capital gains, unless they are derived in an active business of financing, licensing or leasing, and limited types of business income, which is often referred to as base company income, but does not include active business income. The exclusion of active business income reflects one aspect of the fundamental policy objective of CFC rules, i.e. not to interfere with the ability of resident companies to carry on foreign commercial activities. The types of business income included in tainted income are usually limited to the following three categories:

1. income derived by a CFC from the residence country;
2. income from related-party transactions; and
3. income from transactions outside the country in which a CFC is resident.

Most countries are concerned about the first category, as it reflects the direct erosion of the residence country’s tax base, which is precisely what CFC rules are intended to prevent. If the CFC rules do not apply to this type of income, the only protection against base erosion through the use of a CFC to derive income from the residence country is usually the residence country’s transfer pricing rules.

Income derived by a CFC from transactions with related parties may also erode the residence country’s tax base. For instance, a parent corporation may transfer or license intangible property to a CFC, which the CFC then licenses to related or unrelated foreign parties. Again, if the CFC rules do not apply to this income, the only protection is the application of transfer pricing rules or domestic anti-avoidance rules.

Not surprisingly, there is considerable variation in the definitions of tainted income for the purposes of the CFC rules of countries. The important point is that, other than Brazil, very few countries apply their CFC rules to all of the active business income earned by CFCs, and those that do limit the scope of application of their CFC rules to a CFC so that MNEs would likely consider shifting large amounts of capital, even where the difference in tax rates is small.

38. The specified rate is obviously determined by reference to the residence country’s corporate tax rate, but must be adjusted when the residence country rate changes, whereas a percentage test adjusts automatically.
39. For instance, Norway uses both a blacklist and a white list for purposes of its CFC rules.
40. Australia. New Zealand and the United Kingdom have similar sophisticated lists. See Arnold, Comparative Perspective, supra n. 20, at p. 485; OECD, supra n. 20, at pp. 43-45; and Sandler, supra n. 20, at p. 29.
41. It must be recognized that, in some cases, the costs of establishing a CFC may be negligible and the tax savings from shifting funds to the CFC may be substantial, even where the tax rate differential between the CFC’s country of residence and the controlling shareholder’s country of residence is small. For instance, it may be easy to transfer passive income

BULLETIN FOR INTERNATIONAL TAXATION DECEMBER 2019 | 637

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in other ways.\textsuperscript{44} The types of business income captured by the rules are typically quite limited.

Perhaps, the type of income that best illustrates the limited scope of CFC rules in most countries is income derived by a CFC from other CFCs controlled by the same parent corporation. For instance, where a CFC established in a low-tax country loans funds, licenses intangibles or provides services to CFCs resident in high-tax countries, only tax in the high-tax foreign countries, and not the residence country, is avoided. If all countries applied their CFC rules to these types of transactions between CFCs, base erosion by MNEs would be significantly reduced. In other words, they would be unable, or less able, to reduce tax in high-tax countries by having CFCs in those countries make deductible payments of interest, royalties or fees for services to CFCs in low-tax countries. However, in most countries, the use of CFCs to reduce tax in other countries is acceptable tax planning\textsuperscript{45} and, in fact, some countries explicitly facilitate this type of tax planning.\textsuperscript{46} This treatment of payments between CFCs reflects the conflicting attitudes underlying the OECD/G20 BEPS Project, i.e. developed countries are determined to protect their domestic tax base, but are reluctant to prevent their MNEs from eroding the tax base of other countries.

### 4. The Spread of CFC Rules since 1962

#### 4.1. Opening comments

In 1962, the United States became the first country to adopt CFC rules.\textsuperscript{47} Other capital-exporting countries did not follow the US example until over a decade had passed. Canada and Germany enacted their CFC rules in 1972, although the Canadian rules did not become effective until 1976. By 1984, three more countries, i.e. Japan (1978), France (1980) and the United Kingdom (1984), had enacted CFC rules. New Zealand adopted its CFC rules in 1988 and Australia followed in 1990.

Since 1990, the clear trend has been for more countries to adopt CFC rules. Currently, most of the major capital-exporting countries, including several major developing

\textsuperscript{44} For instance, Sweden limits the application of its CFC rules to CFCs resident in countries with which Sweden has not concluded a tax treaty. Several countries use an entity approach, under which all or none of the income of a CFC is attributed to its resident shareholders, depending usually on the nature of the income.

\textsuperscript{45} Although the US Subpart F rules nominally apply where CFCs are used to reduce foreign tax, the rules can easily be avoided through the use of the check-the-box rules. Under these rules, where the payer CFC and the recipient CFC are checked as disregarded entities, the payment is deductible for the purposes of the high-tax country in which the payer is resident, but is not taxable in the hands of the US parent corporation under the Subpart F rules.

\textsuperscript{46} For instance, Canada deems deductible payments received by a CFC from an affiliated foreign corporation, i.e. a 10% or greater interest, that would otherwise be tainted income to be active business income that is exempt from the CFC rules as long as those payments are deductible in computing income from an active business carried on by the payer CFC. The US Subpart F rules contain broadly similar look-through rules to preserve the character of payments out of the active business income of a CFC.

\textsuperscript{47} The rules are contained in US Internal Revenue Code, Subpart F. The model for the Subpart F rules was the foreign personal holding company rules, which were adopted in 1937, but those rules applied only to individuals avoiding US tax by earning passive income through CFCs.

### 4.2. The OECD Harmful Tax Competition Report

By 1998, when the OECD issued its report on Harmful Tax Competition,\textsuperscript{48} 19 countries had adopted CFC rules. The Harmful Tax Competition Report, which laid the groundwork for the OECD/ G20 BEPS Project, recommended that OECD member countries adopt CFC rules as a method for combating harmful tax competition.\textsuperscript{50} In retrospect, it is unclear whether any countries adopted CFC rules in response to the OECD’s recommendation. Nevertheless, by the time the OECD/G20 BEPS Project began in 2013, 28 countries had enacted CFC rules.

The Harmful Tax Competition Report targeted harmful preferential tax regimes in both OECD member countries and non-OECD member countries, but low or no tax by itself was not considered to be abusive.\textsuperscript{51} The follow-up implementation of the Report led to the establishment of the Forum on Harmful Tax Practices and a peer review process to identify harmful regimes and monitor their removal.\textsuperscript{52} The Forum and the peer review process, which, since 2016, have been administered through the Inclusive Framework, have been quite successful in eliminating preferential regimes.\textsuperscript{53} In response, countries shifted their strategies to attract foreign investment and began to compete with regard to tax rates. Tax competition in respect of rates has continued fiercely and steadily, and the deep cut in the US corporate rate in 2017 from 35% to 21% has triggered another round of reductions.

\textsuperscript{48} Durst, supra n. 20, at p. 44 concludes that “US CFC rules have been of little effect in limiting the participation of US-based multinationals in BEPS-style tax planning since 1997” and that “overall [worldwide] CFC rules have operated at a low level of efficacy”.

\textsuperscript{49} OECD, supra n. 2.

\textsuperscript{50} Id., at pp. 40-41.

\textsuperscript{51} The additional factors were: ring-fencing of a regime from the domestic economy, a lack of transparency and the absence of exchange of information with respect to the regime. Instead of ring-fencing, tax havens were classified as harmful if they did not require substantial activities as a condition for access to the regime.

\textsuperscript{52} See www.oecd.org.

4.3. The Final Report on Action 3 of the OECD/G20 BEPS Project

The 2015 Final Report on Action 3 of the OECD/G20 BEPS Project established a set of best practices for countries to follow in designing CFC rules. However, it did not make the adoption of CFC rules a minimum standard or even recommend that countries adopt CFC rules. Although a detailed description of the Final Report on Action 3 is beyond the scope of this article, it is worthwhile to describe briefly its recommendations with regard to the three features of CFC rules that determine the scope of application of the rules:

1. the foreign entities to which the CFC rules apply;
2. the level of foreign tax on a CFC's income; and
3. the type of income attributable to a CFC's shareholders.

The Final Report on Action 3 of the OECD/G20 BEPS Project recommends that control should be based on the ownership of more than 50% of either legal control, i.e. the ownership of shares of the CFC, or economic control, i.e. the right to the profits, capital or assets of a CFC. Countries wanting to broaden the scope of their CFC rules can supplement the legal and/or economic control test with a de facto control test if it achieves the same results as a legal and economic control test, although how a de facto control test can be enforced effectively is a mystery. Countries are also free to reduce the level of control to less than 50% “to achieve broader policy goals” or prevent avoidance of the rules. However, there is no mention of the relationship between CFC rules and the rules for taxing dividends received by resident corporations from foreign corporations in which they have a substantial interest, which is one of the fundamental tax policy issues underlying CFC rules.

The Final Report on Action 3 of the OECD/G20 BEPS Project recommends that countries should not apply their CFC rules to CFCs that are subject to foreign tax comparable to residence country tax, and further suggests that this exemption or limitation on the scope of CFC rules could be implemented through a listed-country approach. Most countries use a designated-jurisdiction approach under which CFC rules are targeted at CFCs established in countries that impose tax at rates substantially lower than residence country rates.

With regard to the single most important aspect of CFC rules, i.e. the scope of the income caught by the rules, the Final Report on Action 3 of the OECD/G20 BEPS Project provides, in effect, no recommendation at all. Attributable income should include income “that raises BEPS concerns”, but “jurisdictions are free to choose their rules for defining CFC income.” The Final Report on Action 3 provides a list of non-exhaustive approaches for defining tainted income, ranging from the inclusion of the entire income of a CFC to a minimalist approach, under which only the funding return of a CFC used as a low-function cash box would be subject to attribution.

In summary, the Final Report on Action 3 of the OECD/G20 BEPS Project was a total failure. Not only did it fail to require, or even recommend, that countries adopt CFC rules, but it also failed to provide any solid tax-design guidance for countries that might want to adopt CFC rules or improve their existing CFC rules. Why was Action 3 such a complete failure when other action items of the OECD/G20 BEPS Project resulted in minimum standards and firm recommendations that were taken up by several countries? My guess is that the failure of Action 3 reflects the schizophrenic attitude of developed countries to the OECD/G20 BEPS Project.


Another recent development affecting domestic CFC rules was the Anti-Tax Avoidance Directive (2016/1164), or ATAD 1, of the European Union, requiring that all of the Member States adopt CFC rules meeting certain minimum standards with effect from 1 January 2019. Although many Member States already had CFC rules, the Anti-Tax Avoidance Directive (2016/1164) resulted in several more Member States adopting CFC rules. That said, the CFC rules required by the Anti-Tax Avoidance Directive (2016/1164) are rudimentary, perhaps reflecting the fact that some Member States are not highly developed countries.

In accordance with the Anti-Tax Avoidance Directive (2016/1164), the CFC rules of a Member State must apply to foreign entities and exempt foreign PEs that:

- are controlled directly or indirectly by a resident taxpayer and associated enterprises;
- pay foreign tax on their profits of less than the difference between the tax that they would have paid to the country in which their controlling shareholders are resident and the foreign tax paid.

In effect, the CFC rules in the Anti-Tax Avoidance Directive (2016/1164) apply only where a CFC pays foreign tax that is less than 50% of the residence country tax. Consequently, the European Union is prepared to tolerate base erosion up to 50% of a country’s tax, which seems quite generous.

Where the CFC rules apply, the controlling shareholders must include in their income their share of either:

- the CFC’s interest, royalties, dividends, gains from the disposal of shares, income from financial leasing, insurance, banking and financial activities and income from sales and services purchased from and

54. OECD, Action 3 Final Report (2015), supra n. 3.
55. Id., at para. 25.
56. Id., at para. 25.
57. As discussed in section 5, a similar requirement was eliminated in the OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 (17 July 2010), Treaties & Models IBFD.
60. For this purpose, “control” means the ownership of more than 50% of the votes, capital, or entitlement to the profits of the entity.
62. For instance, if a CFC pays foreign tax of 10 but would pay residence country tax of 30, the CFC rules apply, as the foreign tax paid is less than 20, i.e. the difference between the residence country tax and the foreign tax. However, if the foreign tax is 15, the CFC rules would not apply.
sold to associated enterprises, if little or no value is added. However, the CFC rules do not apply to CFCs engaged in substantive economic activity supported by staff, equipment, assets and premises. Moreover, countries may choose to exempt CFCs where less than one-third of their total income is derived from the specified types of income or the CFC’s income from “non-genuine arrangements” entered into for the essential purpose of obtaining a tax benefit. For this purpose, an arrangement is non-genuine to the extent that a CFC would not own the assets or bear the risks if it were not controlled by a company whose people functions related to those assets and risks are instrumental in generating the CFC’s income. Under this alternative, countries can choose to exclude CFCs whose accounting profits do not exceed EUR 750,000 and whose non-trading profits do not exceed EUR 75,000 or do not exceed 10% of its operating costs.

Although the European Union has required the Member States to enact CFC rules, in contrast to the OECD/ G20 BEPS Project, which could not even make a firm recommendation for countries to adopt CFC rules, the minimum standards for the rules are not rigorous and are unlikely to be very effective. Not surprisingly, countries such as Belgium, Luxembourg and the Netherlands, which have traditionally acted as hospitable jurisdictions in which MNEs may establish CFCs, have adopted the weakest form of CFC rules possible.

5. The Relationship between CFC Rules and Tax Treaties

The evolution of the relationship between CFC rules and tax treaties provides a fascinating story that reflects both the increasing acceptance of CFC rules as a legitimate non-controversial part of the international tax system and a growing awareness that tax treaties were being used to facilitate abusive tax avoidance. Although a detailed discussion of the changing relationship between CFC rules and tax treaties is beyond the scope of this article, it is revealing to trace the evolution of the relationship over the past 50 years.

As noted in section 2, in the period when the international tax system was being developed, corporations were treated as separate taxable entities by both residence and source countries. Accordingly, source countries imposed tax on the income of resident corporations, not on their non-resident controlling shareholders, and residence countries did not tax the income earned by foreign-resident subsidiaries of resident parent corporations. However, once countries started to adopt CFC rules, the application of those rules was tantamount to a rejection of the separate taxable entity principle and the issue arose whether the provisions of tax treaties prevented or limited the application of CFC rules. With regard to the United States, the first country to adopt CFC rules, the issue was not a concern because of the saving clause in all US tax treaties. For other early adopters of CFC rules, i.e. Canada, France, Germany, Japan and the United Kingdom, the issue was a serious concern, as the tax treaties that these countries had concluded did not contain any saving clause. After adopting CFC rules in 1972, Canada insisted on a specific provision authorizing the application of those rules in all of its tax treaties. However, the other four countries did not take any such precautions, despite the fact that the Commentary on Article 1 of the OECD Model (1977) indicated that the provisions of tax treaties prevailed over domestic law in the event of a conflict and that countries wishing to preserve their domestic anti-abuse rules should insert a specific provision in their tax treaties to do so.

Up to, and including, the 2014 version of the Commentary, the Commentary on Article 1 of the OECD Model dealing with CFC rules went through various iterations. The Commentary on Article 1 of the OECD Model (1992) was revised to reflect the recommendations of the OECD Reports on base and conduit companies, and indicated that “the large majority of OECD Member countries” considered CFC rules to be domestic rules used to determine the facts giving rise to tax liability and that “these rules are not addressed in tax treaties and are therefore not affected by them.” However, the OECD Commentary on Article 69.

69. Except where a foreign subsidiary could be considered to be a resident of the country in which its controlling shareholder was resident under a place-of-management test of corporate residence or where the residence country ignored the existence of the foreign subsidiary pursuant to the sham or other anti-abuse rules.

70. The arguments that the provisions of the OECD Model prevented the application of CFC rules were based on articles 7(1) and 10(5). See M. Rigby, A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism, 8 Austrl. Tax Forum 3, p. 301 (1991); and R. Vann, A Model Treaty for the Asia-Pacific Region, 45 Bull. Intl. Fiscal Docn. 3 (1991).

71. The saving clause explicitly provides that, subject to certain exceptions that are not relevant to CFC rules, the provisions of a tax treaty do not limit the ability of the United States to tax its own residents or citizens. As CFC rules operate by means of tax imposed on the resident shareholders of a CFC on their share of the income of the CFC, the saving clause ensured that tax treaties did not limit the application of CFC rules.

72. See, for example, Convention between Canada and Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income art. 26A (21 May 1980) (as amended through 2002). Treaties & Models IBFD, which provides that “[i]n nothing in this Convention shall be construed as preventing Canada from imposing a tax on amounts included in the income of a resident of Canada with respect to a partnership, trust, or controlled foreign affiliate, in which that resident has an interest.”

73. OECD Model Tax Convention on Income and Capital: Commentary on Article 1 para. 7 (31 Apr. 1977), Treaties & Models IBFD. Given that only three countries, i.e. Canada, Germany and the United States, had CFC rules in 1977, it is not surprising that the OECD Model Commentary on Article 1 (1977) did not deal with the relationship between CFC rules and the provisions of tax treaties.

74. For a detailed discussion on this topic, see Arnold, supra n. 10.

75. OECD Model Tax Convention on Income and Capital: Commentary on Article 1 para. 23 (1 Sept. 1992), Treaties & Models IBFD. This statement was retained in subsequent versions of the Commentary on Article 1.
1 (1992) also recognized the minority view of some countries, i.e. that CFC rules were inconsistent with tax treaties, thereby leaving the issue unresolved. Also, the Commentary on Article 1 of the OECD Model (2003) was revised to add for the first time a clear statement that one of the purposes of tax treaties is to prevent tax avoidance.76

Only the Commentary on Article 1 of the OECD Model (2003) contained a clear statement that CFC rules were internationally recognized as a legitimate measure to protect the tax bases of countries and did not conflict with the provisions of tax treaties. However, even then the statement was subject to the following two caveats: (1) CFC rules should not be applied to CFCs subject to tax rates comparable to the rates in the controlling shareholder’s country of residence; or (2) to income from commercial activities. The first caveat was eliminated from the Commentary on Article 1 of the OECD Model (2010) and the second from the Commentary on Article 1 of the OECD Model (2017). When the saving clause, i.e. article 1(3), was added to the OECD Model (2017), it became completely clear that tax treaties containing a saving clause did not prevent countries from taxing their residents as they see fit, including through the application of CFC rules. The Commentary on Article 1 of both the OECD Model (2017) and UN Model (2017) also confirms the same result for tax treaties that do not contain a saving clause:

The same conclusion [that CFC rules are in accordance with the convention] must be reached in the case of conventions that do not include a provision similar to paragraph 3 of Article 1.77

Consequently, the OECD Commentary on Article 1 (2017) and UN Commentary on Article 1 (2017) are explicit to the effect that CFC rules are not contrary to the provisions of the OECD Model and the UN Model, irrespective of their scope.78

In summary, the relationship between CFC rules and tax treaties has evolved dramatically since the OECD Model (1977).79 In the OECD Model (1977), CFC rules were viewed as generally unacceptable and incompatible with the provisions of tax treaties based on the OECD Model. The onus was placed on countries with CFC rules to put an explicit provision in the tax treaties that they concluded to permit the application of the rules. As more countries, and more influential ones, adopted CFC rules, these rules were recognized in the Commentary on Article 1 of the OECD Model by a large majority of OECD member countries as legitimate measures to protect a country’s tax base. However, the contrary views of a minority of OECD member countries were also recognized and the onus continued to be on countries with CFC rules to ensure that their tax treaties contained an explicit provision allowing the application of CFC rules. In addition, the OECD Commentary on Article 1 indicated expressly that CFC rules should not apply to CFCs in countries with tax rates comparable to the tax rate in the residence country or to commercial or industrial income earned by CFCs. These exceptions were gradually eliminated until, finally, CFC rules were explicitly considered to be in accordance with the provisions of tax treaties based on the OECD Model (2017) or the UN Model (2017), irrespective of the scope of the CFC rules or the inclusion of a saving clause in a tax treaty.

This remarkable journey of CFC rules, i.e. from unacceptable, to acceptable only if the scope of the rules was restricted, to unquestionably acceptable irrespective of the scope of the rules, reflects the rejection of the fundamental principle that non-resident corporations should be treated as taxable entities separate from their resident controlling shareholders. This shift also alters the allocation of taxing rights between source and residence countries. Originally, countries in which CFCs were resident had the exclusive right to tax the income derived by those CFCs and countries in which the controlling shareholders were resident had a residual right to tax dividends received by resident shareholders from those CFCs. With the acceptance of CFC rules, source and residence countries have shared taxing rights with respect to the income of CFCs. In this situation, the source country, i.e. the country in which a CFC is resident, has the first right to tax the CFC’s income, and the residence country, i.e. the country in which the controlling shareholders are resident, has a corresponding obligation to provide relief for the source country tax in accordance with the fundamental principles of the international tax system (see section 2).80 However, although most countries with CFC rules allowed a credit for foreign taxes paid by a CFC on the income taxable by the residence country under their CFC rules, some countries did not grant a credit and, instead, allowed only a deduction for such foreign taxes. Moreover, the provisions of tax treaties do not require countries with CFC rules to provide relief for foreign tax paid by a CFC, although the Commentary on Article 1 of the OECD Model and the UN Model suggested that they should do so.81

but was not included in the 2017 version of the OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 (21 Nov. 2017). Treaties & Models IBFD.


77. Para. 81 OECD Model: Commentary on Article 1 (2017) and UN Model Double Taxation Convention between Developed and Developing Countries: Commentary on Article 1 para. 40 (1 Jan. 2017). Treaties & Models IBFD are identical except for some minor differences in wording.

78. The final sentence of para. 81 OECD Model: Commentary on Article 1 (2017) and para. 40 UN Model: Commentary on Article 1 (2017) includes the words “structured in this way”, which appears to suggest that only CFC rules structured in a particular way are compatible with tax treaties. However, this wording seems to be a holdover from the wording of the OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 (26 July 2014). Treaties & Models IBFD, and the UN Model Double Taxation Convention between Developed and Developing Countries: Commentary on Article 1 para. 40 (1 Jan. 2011). Treaties & Models IBFD, which was retained by mistake.


80. This result is consistent with the treatment of the income of a foreign branch of a resident corporation.

81. See para. 80 OECD Model: Commentary on Article 1 (2017) and para. 47 UN Model: Commentary on Article 1 (2017). However, these comments are limited to situations involving the application of domestic judicial anti-avoidance doctrines.

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6.1. In general

CFC rules have evolved from a controversial exception to the established principle that corporations are separate taxable entities to a widely recognized and acceptable part of the international tax system. However, the scope of CFC rules has not been extended beyond passive income and limited types of business income. Although Action 3 of the OECD/G20 BEPS Project represented an opportunity not only to require more countries to adopt CFC rules, but also to extend the scope of the rules, for whatever reason it failed in this regard. However, as the OECD/G20 BEPS Project moved into its implementation phase, it became apparent that there continued to be a pressing need for further action against base erosion by MNEs.

On 31 May 2019, as part of the ongoing work on the taxation of the digital economy, the Inclusive Framework issued a description of two major proposals, i.e. Pillar One and Pillar Two, which were under consideration by the members of the Inclusive Framework to deal with the digital economy and remaining base-erosion issues.82 Pillar One involves proposals to adopt new nexus and profit allocation rules to allow countries to tax where the customers or users of digital goods or services are based in those countries, but where the goods or services are provided remotely by sellers in other countries without any, or only a limited, physical presence in the source country. Pillar One is relevant, but not the primary focus of this article and, therefore, is not discussed further.83 Pillar Two, which is discussed in detail in section 6.3, proposes the introduction of a uniform minimum tax to be imposed by countries on all of the income of CFCs of resident corporations and supplemented by a minimum tax on the domestic operations of resident corporations whose income is reduced by deductible payments to related foreign parties. The Pillar Two proposals are based on the US GILTI and BEAT measures that were introduced as part of the 2017 US tax reform and are described briefly in section 6.2.

6.2. US GILTI and BEAT

6.2.1. In general

The 2017 US tax reform contains the following two measures that are arguably inconsistent with existing international tax norms: (1) a minimum tax on GILTI; and (2) a BEAT to counter base erosion. No measures of this type were referred to in the reports stemming from the OECD/G20 BEPS Project, although they have been picked up in the most recent proposals of the Inclusive Framework. In addition, some commentators have suggested that the US minimum taxes provide a model for the rest of the world to follow in dealing with continuing base-erosion concerns and the allocation of taxing rights between source and residence countries.84 The US rules appear to be the basis for the Pillar Two proposals.

6.2.2. US GILTI

Under the new GILTI rules, the United States imposes a minimum tax on the income earned by a CFC of a US company in excess of a 10% notional return on the CFC’s tangible assets. The US tax on GILTI is 10.5%, i.e. one half of the regular US corporate rate, up to 2025, and 13.125% thereafter. The Subpart F Income of a CFC, i.e. its passive income and base company income, is excluded from GILTI, as it is subject to current US tax at the full rate under the CFC rules. Only 80% of any foreign tax paid by a CFC on its GILTI is creditable against US tax and any excess credits cannot be carried forward or back. There is a separate basket for GILTI for purposes of the limitation on the foreign credit, which means that the averaging of foreign tax on GILTI with foreign taxes on income in other baskets is not permitted. However, the limitation on the credit for foreign tax on GILTI operates on a worldwide or overall basis rather than on a per-country basis, so that high foreign tax on GILTI in some countries is averaged with low foreign tax on GILTI in other countries.

The GILTI rules apply to all CFCs with GILTI, irrespective of the country in which the CFC is resident or the amount of foreign tax it pays. This global application of the Subpart F and GILTI rules differs from the designated-jurisdiction approach used by most countries in their CFC rules and the minimum tax proposal under consideration by the Inclusive Framework.

The US tax rules as now structured discriminate against foreign-source income earned directly by US corporations through foreign branches, as such income is taxed at 21%, whereas GILTI earned through CFCs is taxed at 10.5%. There is no tax policy justification for taxing GILTI of CFCs at half of the regular US tax rate, while retaining full tax on foreign branch income.85 Nor is there any justification, other than revenue raising, for arbitrarily limiting the foreign tax credit with regard to GILTI to 80% of foreign tax paid, especially where foreign taxes on both foreign branch income and taxable CFC income are fully creditable. The GILTI rules are inconsistent with the clear international trend to exempt foreign-source active business income from residence country taxation. Indeed, they represent an attempt to assert worldwide taxation of resident corporations, although not at the full residence country corporate tax rate. Moreover, the GILTI rules are incredibly complex, largely because, unlike CFC rules,

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83. On 9 October 2019, the OECD issued the following proposals for public consultation on Pillar One: OECD, Public Consultation Document, Secretariat Proposal for a “Unified Approach” under Pillar One (OECD 2019) [hereinafter Unified Approach], available at www.oecd.org
85. However, the incentive for foreign-derived intangible income (FDII), which provides for a deduction of 37.5% of foreign income from specified activities in excess of a deemed return on tangible assets, resulting in an effective tax rate of 13.125%, may offset the disadvantage of earning income through a foreign branch.
many of the calculations must be made at the US shareholder’s level.86 In addition, the rules must be coordinated with the Subpart F rules, which continue to apply.

6.2.3. **US BEAT**

Under the BEAT, deductible base-eroding payments made to foreign related parties, i.e. CFCs, by US companies are added back to taxable income and taxed at a rate of 10% (12.5% after 2025). This special tax is payable only if it exceeds a US company’s regular tax payable. The amount of foreign tax payable by the foreign recipient of a base-eroding payment is irrelevant, in contrast to the deduction-denial proposal in Pillar Two of the Inclusive Framework’s current work. The base-eroding payments subject to the BEAT encompass all deductible payments to foreign related parties, including payments for the cost of property qualifying for depreciation.

It is unclear whether the BEAT violates the non-discrimination clause in the tax treaties that the United States has concluded.87 Consequently, if the United States intends to apply the BEAT to payments to related parties resident in treaty countries, it may have to override its own tax treaties, which it seems to be prepared to do.88

6.2.4. **Austria and Germany and other comments**

It should be noted that Austria and Germany have similar but simpler rules, under which the deduction of interest and royalty payments to related foreign parties is denied where the payments are subject to low foreign tax.89 It should also be noted that if a country’s CFC rules extend to low-taxed payments received by CFCs from related parties, including the CFC’s parent company, deduction-denial rules similar to the BEAT would be unnecessary.

6.3. **The Global Anti-Base Erosion (GloBE) Proposal: Pillar Two**

6.3.1. **In general**

Pillar Two is intended to supplement the OECD/G20 BEPS Project and provide a “comprehensive solution” to the problem of profit shifting to low-taxed entities. Pillar Two is not limited to digital activities, although those activities are clearly the central focus of the proposal. According to the Inclusive Framework Programme of Work, Pillar Two is necessary “to stop a harmful race to the bottom” with the “risk of uncoordinated, unilateral action, both to attract more tax base and to protect existing tax base, with adverse consequences for all countries.”90 Accordingly, one of the purposes of Pillar Two is to:

- effectively shield developing countries from the pressure [from business] to offer inefficient incentives and in doing so help them in better mobilizing domestic resources by ensuring that they will be able to effectively tax returns on investment made in their countries.91

In general, Pillar Two is intended to limit “the distortive impact of direct taxes on investment and business location decisions”92 and to provide a “backstop” for Pillar One “where the relevant profit is booked in a tax rate environment below the minimum rate.”93 Pillar Two proposes to achieve these objectives mainly by ensuring that “all internationally operating businesses pay a minimum level of tax.”94

Specifically, Pillar Two consists of the following two complementary rules:

1. an income-inclusion rule, under which the income of a low-taxed branch or CFC would be subject to residence country tax at a minimum tax rate; and

2. a base-eroding payments rule, under which otherwise deductible payments made to low-taxed related parties would be made non-deductible or subject to a minimum source country withholding tax.

One key to the income-inclusion rule is the establishment of the minimum tax rate. The Inclusive Framework Programme of Work suggests that the rate should be uniform for all countries so that a level playing field is established for all countries and MNEs. Consequently, the document rejects a minimum rate based on a percentage of a country’s corporate tax rate.95 Where a CFC’s income is subject to a rate below the minimum rate, the income would be subject to additional residence country tax, so that the total tax on the income would be equal to the minimum rate.96 The other key feature is the applicable rules for the computation of the low-taxed foreign-source income. In order to ensure that the income is subject to the agreed minimum rate, the income must be computed in accordance with the same or reasonably similar rules. In the case of CFC rules, most countries require the income of a CFC that is subject to residence country tax to be recomputed in accordance with the residence country’s compu-

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86. See Herzfeld, supra n. 84, at p. 309.
87. This issue is beyond the scope of this article. US commentaries have differing views as to whether the BEAT violates the non-discrimination article in US tax treaties. See, for example, D. Rosenbloom, International Aspects of U.S. Tax Reform – Is This Really Where We Want to Go?, Intl. Tax Rpt. (2 Jan. 2018), available at www.internationaltaxreport.com/corporate-taxes/international-aspects-of-us-tax-reform-is-this-really-where-we-want-to-go-127955.htm; B. Wells, Get With the BEAT, 158 Tax Notes 1023 (19 Feb. 2018); T. Ware, The BEAT and Bilateral Tax Treaties: Where Might the Tensions Lead?, 37 American Bar Assn. 3 (Spring 2018); B. Wells, Get With the BEAT, 158 Tax Notes 1023 (19 Feb. 2018); T. Ware, The BEAT and Bilateral Tax Treaties: Where Might the Tensions Lead?, 37 American Bar Assn. 3 (Spring 2018).
88. As noted in section 6.3.2., some countries cannot override their tax treaties as a matter of domestic constitutional law.
89. Herzfeld, supra n. 84, at p. 310, and Blum, supra n. 84, at p. 518.
90. OECD, Inclusive Framework Programme of Work, supra n. 82, at p. 25, para. 34. The only evidence presented for this claim is the proliferation of inefficient tax incentives by developing countries.
91. Id.
92. Id.
93. Id.
94. Id., at p. 26, para. 55.
95. Theoretically, a minimum tax on CFC income should be based on each country’s corporate tax rate, as the difference between the minimum tax and a country’s corporate rate reflects the extent of tax revenue loss arising through base erosion. A uniform minimum tax rate establishes a level playing field for all MNEs doing business in a particular country, but so would no tax at all on CFCs in low-tax countries.
96. It is unclear as to whether low-tax countries in which MNEs are based would be expected to impose this minimum tax where they do not levy any corporate income tax or levy tax at a rate less than the minimum tax.
Where income earned through a foreign branch is exempt from residence country tax, the Pillar Two proposal recommends that the residence country adopt a switch-over approach and move from the exemption method to the credit method if the branch income is subject to low foreign tax. However, it is unclear why the rule for foreign branches should not be the same as for foreign subsidiaries, i.e. the low-taxed foreign income should be recomputed in accordance with the residence country’s computational rules and topped up by residence country tax to the minimum rate.

The second aspect of Pillar Two is a minimum tax on base-eroding payments to related foreign entities where those payments are not subject to tax at the required minimum rate in the hands of the recipient. The country of residence of the payer would be entitled to deny the deduction of the payments or impose withholding tax on the payments. In addition, the Inclusive Framework Programme of Work proposes that tax treaties should be amended to deny treaty benefits in respect of certain income items unless the income was subject to a minimum tax rate.

Like the income-inclusion rule, the base-eroding payments rule appears to be based on the US BEAT, which supplements the GILTI rules. The rationale for the US BEAT and the base-eroding payments aspect of Pillar Two is that the minimum tax on the income of CFCs would be insufficient by itself to deter MNEs from establishing subsidiaries in low-tax jurisdictions, as, for most high-tax developed countries, the benefit of the deduction of the base-eroding payments would be greater than the cost of the minimum tax on the income of CFCs. It is not completely clear as to whether the base-eroding payments rules would be designed to top up the foreign tax to ensure that the payments would be subject to the agreed minimum tax rate or whether the payments would be subject to full corporate tax by the payer’s country of residence.

6.3.2. Critique of the Pillar Two proposal

The Inclusive Framework’s rationale for Pillar Two, described in section 6.3.1., is not clearly articulated and does not stand up to scrutiny. If the problem is unfinished business, i.e. dealing with profit shifting to low-taxed foreign entities that was not effectively dealt with by the recommendations of the OECD/G20 BEPS Project, the obvious response would appear to be to reassess these recommendations, in particular Action 3 on CFC rules. Profit shifting to low-taxed foreign entities is a problem primarily for capital-exporting countries, to which those countries could have responded effectively through more robust CFC rules. However, the OECD/G20 BEPS Project failed in that regard. The Inclusive Framework Document appears to put the blame for the problem on developing countries because of their ineffective tax incentives, and then compounds this accusation by implicitly suggesting, in a paternalistic manner, that developing countries are unable to stop themselves from providing such incentives. The Inclusive Framework Programme of Work then predicts that, if Pillar Two is not adopted, a disastrous race to the bottom will arise. In the absence of convincing empirical evidence, I am sceptical about the disappearance of the corporate tax unless a multilateral global minimum tax is adopted.

However, there is some solid tax policy justification for coordinated international action in response to the problem of base erosion that both developed and developing countries are experiencing. A number of countries have not been content to wait for an international solution to be worked out. Instead, at the invitation of the European Union and the OECD, these countries have taken a variety of temporary uncoordinated unilateral measures, for example, digital services taxes, equalization levies, expansion of the PE threshold to encompass a substantial economic presence in a country and broad anti-avoidance rules, like the UK diverted profits tax (DPT) and the Australian multinational anti-avoidance rule. These measures may be more or less effective in dealing with base erosion from the perspective of source countries, but they will inevitably result in double taxation and inappropriate compliance costs for taxpayers. An international coordinated response is clearly preferable. The question is, what type of response is best? According to the Inclusive Framework’s Pillar Two proposal, the problem appears to be foreign income earned directly through PEs and by CFCs, hence the obvious response would appear to be to reassess these recommendations, in particular Action 3 on CFC rules. Moreover, even if a minimum tax is effective in eliminating inefficient tax incentives, some countries are likely to respond by replacing tax incentives with aid to attract foreign investment.
is more appropriate than source country taxation to deal with the problem, I argue that extending CFC rules would be a better response than a minimum tax.

Perhaps the most serious deficiency in the proposed minimum tax is that it does not even attempt to prevent base erosion comprehensively. Instead, it would implicitly legitimize base erosion to the extent of the difference between the agreed minimum tax rate and a country’s normal corporate tax rate. Countries with corporate tax rates in the 20% to 40% range are naïve if they think that their resident corporations would not establish CFCs in other countries where the tax payable on the income of those CFCs is significantly less than if earned directly by the resident corporations. The income of a CFC would be subject only to the minimum tax, either because the foreign country taxes the income at the minimum tax rate or, if the foreign country taxes the income at less than the minimum rate, because the residence country imposes sufficient tax on the CFC’s income to top up the foreign tax to the minimum tax rate.

Another major difficulty with the Pillar Two proposal is its complexity. Although the technical details of the income-inclusion and base-eroding payments aspects of the proposal have not yet been spelled out,101 it appears to be obvious that the changes proposed to domestic law would involve complex legislation102 and would necessitate changes to tax treaties. The domestic legislation would require detailed rules similar to CFC rules to deal with the definition of a CFC, threshold requirements, attribution of income to a CFC’s shareholders, the computation of a CFC’s income, relief of double tax and other issues. The duplication between the minimum tax rules and CFC rules would be a source of enormous complexity and would require rules to ensure that the overlap did not result in double taxation. The domestic legislation for the related-party payments aspect of Pillar Two would be almost equally complex.

It is unclear whether Pillar Two would require all countries to have broadly similar or harmonized technical rules, or only an agreed rate of minimum tax. Although it might be possible to get agreement on a minimum rate, it appears to be fanciful to think that countries would be able to reach agreement on all the major features of a minimum tax, and yet some degree of harmonization seems to be essential for the rules to work properly. Any tax can be reduced or even eliminated depending on its technical details, as the experience with the CFC rules of several countries, including the United States, indicates. Undoubtedly, some countries would explore ways in which to draft, or perhaps enforce, their minimum tax legislation so that it would not be effective and, therefore, their resident MNEs would have an advantage over the MNEs of other countries.

The necessary treaty changes would also present problems. The minimum tax should not require any change to tax treaties that contain a saving clause similar to article 1(3) of the OECD Model and the UN Model, as the tax would be imposed on a country’s resident corporations. However, the Commentary on Article 1 of both the OECD Model and the UN Model would require amendment to clarify that tax treaties without a saving clause should not be interpreted to prevent countries from imposing the minimum tax. Such a change to the OECD and UN Commentary on Article 1 might not be sufficient to ensure that national courts would not interpret the provisions of the tax treaties that a country has concluded to prevent it from imposing a minimum tax.

Although the Commentary on Article 1 of the OECD Model (2017) and the UN Model (2017) is explicit that tax treaties without a saving clause do not prevent the application of CFC rules, it is not clear that the result would be the same with regard to a minimum tax. After all, the OECD and UN Commentary on Article 1 has a long history of dealing with the relationship between tax treaties and CFC rules. Moreover, there is a substantial body of case law involving this issue which, with some exceptions, supports the position in the OECD and UN Commentary on Article 1.103 In contrast, the compatibility of a minimum tax on CFCs with the provisions of tax treaties is a novel issue. In addition, any tax treaties with tax-sparing provisions would need to be reviewed carefully to determine whether they would prevent the application of a minimum tax.

As with the minimum tax, the base-eroding payments rule of Pillar Two is intended primarily to protect the tax base of residence countries. Although the base-eroding payments rule is framed in the Inclusive Framework Document as protecting the tax base of source countries,104 it

101. The 8 Nov. 2019 OECD Consultation Document, supra n. 97, provides additional information about, and requests stakeholder input on, three major design features of the Pillar Two proposal: the use of financial accounts as the starting point for the determination of an enterprise’s profits, the averaging of high and low foreign taxes, and possible thresholds and exemptions or exclusions. Although the Consultation Document suggests that several design features could be adopted to simplify the application of the rules, the complexity involved in situations where the rules apply is daunting. For example, the determination of whether an enterprise has paid foreign tax on its foreign source income that is less than the minimum rate must be made by each enterprise for each taxation year. Under most countries’ CFC rules, this compliance and administrative burden is eliminated by using a list of countries as a proxy for either high or low tax countries.

102. The design of each country’s legislation would determine the compliance burden for taxpayers and the tax administration burden for the tax authorities.

103. I am not suggesting that the position set out in the OECD Model: Commentary on Article 1 (2017) and UN Model: Commentary on Article 1 (2017) is binding on taxpayers or domestic courts, which, of course, it is not. However, for many countries with courts that are willing to consider all the relevant evidence to decide whether there is a conflict between CFC rules and the provisions of tax treaties, the OECD Model Commentary on Article 1 (2017) and UN Model Commentary on Article 1 (2017) provide persuasive authority to support the appropriate result.

104. See OECD, Inclusive Framework Document, supra n. 82, at para. 73, which reads: “by allowing a source jurisdiction to protect itself from the risk of base eroding payments”. As noted in section 6.3.1, the base-eroding payments rule is designed to eliminate any tax incentive for MNEs to establish low-tax foreign subsidiaries to which deductible payments can be made. However, the rule would also benefit high-tax developing countries in which foreign-based MNEs have established operating subsidiaries. The proposed base-eroding payments rule would allow them to deny the deduction of payments to related entities or impose withholding tax on such payments, where they are not subject to tax in the hands of the recipients at the agreed minimum rate.
is really intended to supplement the minimum tax and prevent MNEs based in high-tax developed countries from establishing foreign entities in low-tax countries, and then using related-party payments to such entities to erode the tax base of the country in which the parent company is resident. However, the base-eroding payments rule could be applied equally by developing countries to protect their tax bases and independently of any minimum tax on the income of CFCs. The base-eroding payments rule, like the US BEAT, could violate the non-discrimination article of the OECD Model and the UN Model, as the Inclusive Framework Programme of Work acknowledges and, therefore, changes to tax treaties would be necessary. While some countries, like the United States, may be able to override the tax treaties that they have concluded by way of domestic legislation, others cannot override their tax treaties because of constitutional considerations. Consequently, treaty overrides are not a complete answer to the potential conflict between the base-eroding payments rule and the non-discrimination provision of tax treaties.

Another difficulty with the Pillar Two minimum tax proposal is that it is unprincipled and arguably unsustainable. There is no tax policy justification for taxing the income of CFCs at an arbitrary rate that is less than a residence country’s normal corporate tax rate. In my view, the unprincipled nature of the minimum tax proposal could undermine its ability to function as a stable part of the international tax system, in providing certainty to both taxpayers and tax administrations.

In contrast, CFC rules can provide a better, simpler and principled response to the base-erosion problems that the Pillar Two minimum tax proposal is intended to deal with. The compatibility of CFC rules and tax treaties has been well established, irrespective of how broad the CFC rules are, whereas the compatibility of a minimum tax on CFCs and tax treaties is unclear. CFC rules can easily be extended to apply to all the income of all CFCs controlled by resident corporations or in which resident corporations own a substantial interest. In addition, it would be easy to exempt CFCs that are subject to foreign tax that is equal to, or greater than, whatever the agreed minimum tax rate would be. This type of exemption could operate in practice as a minimum tax. In other words, where MNEs establish CFCs in countries with no tax or tax at less than the minimum tax, those CFCs would be subject to residence country tax at the full rate. Most likely, the result would be that tax havens would quickly raise their tax rates to the minimum rate.

With regard to countries that currently have CFC rules, the rules would require amendment to comply with the new broader CFC rules agreed by the Inclusive Framework. However, in most cases making the required amendments would be much simpler than adopting the completely new minimum tax approach and these countries would have only one set of rules, i.e. CFC rules, to administer and enforce, rather than both CFC rules and a minimum tax. With regard to countries that currently do not have CFC rules, the enactment of CFC rules would be no more difficult than adopting the minimum tax approach, and these countries would also end up with only one set of CFC rules.

Another advantage of using CFC rules to deal with the remaining base erosion issues is that it would make the base-eroding payments aspect of Pillar Two unnecessary. If CFC rules were extended to all the income of CFCs, that income would include any deductible payments received by a CFC in a low-tax country from a related party in a higher-tax country. As a result, the incentive for MNEs to use CFCs to avoid both residence country and foreign country tax to erode their tax base would be eliminated. It would be unnecessary for countries to adopt a separate set of complex rules to deal with such base-eroding payments, as proposed in Pillar Two, or rules to ensure that there is no overlap between the income inclusion and base-eroding payments rules.

Finally, CFC rules have the advantage of being familiar to most of the international tax community. The design features, operation, and flaws in the rules are reasonably well-known, whereas a uniform minimum tax on CFCs is largely uncharted territory.

Some might argue that the minimum tax approach is necessary because getting an international agreement on CFC rules is impossible, as the Final Report on Action 3 of the OECD/G20 BEPS Project demonstrated. However, the international tax climate has changed since 2015. Agreement on Pillar Two would have been impossible in 2015. In my view, if a multilateral agreement on a minimum tax is possible today, I cannot see any good reason why a similar agreement is not possible with regard to CFC rules.

7. A Developing Country Perspective on the Pillar Two Proposal

As is well known, developing countries tend to rely more on corporate tax revenues than developed countries and, because of the inadequacy of their administrative resources, they are generally more susceptible to base erosion. However, it is important to recognize that, although there is no generally accepted definition of a developing country, there are broad differences among the countries that are generally categorized as developing countries. For example, some developing countries, such as Brazil, Russia, India, China and South Africa (the BRICS), whose resident corporations have substantial foreign investment, may have interests similar to those of developed countries. Nevertheless, many developing countries do not have residents, other than wealthy individuals, with substantial foreign investment so that the protection of the domestic tax base and the extension of source country taxing rights are their dominant concerns.

Despite the spread of CFC rules, few developing countries have enacted CFC rules. However, these countries have attempted to protect their domestic tax base by rules that deal with deductible payments by residents to non-

105 See Herzfeld, supra n. 84, at p. 513; and Blum, supra n. 84, at pp. 518-519. However, as noted in this section, developing countries that do not have or need CFC rules could adopt the base-eroding payments aspect of Pillar Two.
idents, especially those to related non-residents. In this regard, it is interesting to compare the base-eroding payments aspect of Pillar Two with the alternative to article 12A of the UN Model (2017) as set out in the Commentary on Article 12A of the UN Model (2017). Article 12A was added to the UN Model (2017) to permit source countries to impose withholding tax at a negotiated rate on fees for managerial, technical and consulting services paid to a service provider resident in one state by a client resident, or with a PE, in the other state, irrespective of where the services are performed.

Article 12A of the UN Model (2017) was very controversial and was strongly opposed by the members of the UN Committee of Experts from the United Kingdom and the United States. Those members insisted on the inclusion of an alternative provision in the Commentary on Article 12 of the UN Model dealing with royalties, based on the deeply flawed provision in the India-United States Income Tax Treaty (1989),106 which expands article 12 to deal with fees for services that are directly and inextricably related to the use of intangible property for which royalties are paid.107 They rejected a compromise that would have expanded article 12A of the UN Model to all fees for services, not just fees for managerial, technical and consulting services, but would have restricted article 12A to arm’s length services performed in the source country. Consequently, this version of article 12A of the UN Model would have allowed a source country to tax any fees for related-party services performed within the source country, but not fees for arm’s length services provided outside the source country. This compromise, which is included in the Commentary on Article 12A of the UN Model (2017) as an alternative provision that countries might adopt,108 would eliminate the need for any definition of “fees for technical services”, which is the source of enormous uncertainty regarding article 12A of the UN Model (2017).

Although the alternative provision to article 12A of the UN Model (2017) targeting fees for related-party services was included only in the Commentary on Article 12A of the UN Model (2017), it had been under discussion by the UN Committee of Experts during the previous two years and before the adoption of the German interest and royalty barrier rules, the US BEAT and the base-eroding payments rule of Pillar Two of the Inclusive Framework’s Global Anti-Base Erosion (GloBE) proposal. However, the alternative to article 12A of the UN Model (2017) and article 12A itself have received little attention from the OECD and the Inclusive Framework, just as income from services received no attention in the OECD/G20 BEPS Project. The reason for this discrepancy in the attitude to the alternative to article 12A of the UN Model (2017), and to base-eroding payments more generally, is either that developed countries changed their minds dramatically as the OECD/G20 BEPS Project progressed or that they care primarily about protecting their own tax bases. As developed countries are for the most part exporters of services or both exporters and importers of services, they are not as concerned as developing countries about fees for services, especially high-value related-party technical services, as a serious base erosion problem, despite the US BEAT and the related-party payments rule of Pillar Two.

Stripped down to its bare essentials, Pillar Two can be regarded simply as an ultimatum from a few powerful developed countries to the rest of the world to the effect that they must tax the income of resident companies at the agreed minimum tax rate, otherwise the capital-exporting residence countries would do it for them. The minimum tax would effectively limit the ability of developing countries to use tax incentives to attract investment by reducing their tax to an amount less than the minimum tax.

In this regard, the minimum tax proposal is reminiscent of the tax-sparing issue.109 Residence country tax on the worldwide income of resident corporations has the effect of depriving those corporations of any tax incentives offered by source countries. Any reduction in source country tax has the effect of increasing the residence country tax, as the foreign tax credit for source country tax is reduced correspondingly. Developing countries have traditionally objected to this result as an infringement of their sovereignty and demanded that tax-sparing provisions be included in their tax treaties with developed countries to preserve the benefit of their tax incentives for foreign investors. The situation is essentially the same with respect to the proposed minimum tax. Where a developing country gives a tax holiday to CFCs, the residence country would continue to collect tax at the stipulated minimum tax rate. I am surprised that developing countries are not objecting to the reference in the Inclusive Framework Programme of Work of the need to:

effectively shield developing countries from the pressure to offer inefficient tax incentives and in doing so help them in better mobilizing domestic resources by ensuring that they will be able to effectively tax returns on investment made in their countries.110

This paternalistic language is arguably inappropriate and does not ring true.

No doubt some commentators, the OECD, and the members of the Inclusive Framework will reject my characterization of the work of the Inclusive Framework, as the institutional process involves all the members of the Inclusive Framework participating on an equal footing. This may be true theoretically, and it may even be true as


107. Due to an oversight, the alternative provision was not included in the UN Model Commentary on Article 12 (2017). However, the text of the alternative provision is available in various draft documents reviewed by the Committee in its pre-2017 meetings. See two documents (Revised Commentary on Article 12A: Fees for Technical Services, E/C.18/2017/CRP1 and Proposed Addition to the Commentary on Article 12: Fees for Included Services E/C.18/2017/CRP2) prepared for the Fourteenth Session of the United Nations Committee of Experts on International Cooperation in Tax Matters, available at www.un.org/esa/fd/pi/dfd-follow-up-tax-committee.html (click on “Sessions”, click on “Fourteenth Session” and click on “Background”).


110. See OECD, Unified Approach, supra n. 83, at para. 54.
a practical matter for some of the BRICS. However, most developing countries do not have the capacity to participate in the work of the Inclusive Framework as equal partners with countries such as France, Germany, Japan, the United Kingdom and the United States. The constant repetition of the mantra that all members of the Inclusive Framework participate as equal partners also does not ring true.

Even if Pillar Two is soundly based on the informed consent of all members of the Inclusive Framework, it amounts to an admission that, not only is unilateral action to protect their tax base impossible, which is understandable, but that effective action to shut down the use of tax havens and low-tax regimes is impossible without some type of minimum tax. I reject this conclusion. If the members of the Inclusive Framework, or the countries providing the driving force for the Inclusive Framework, depending on your view, agreed to rigorous concerted action against tax havens and low-tax regimes, they could be eliminated quickly. A direct assault on the primary tax offenders could consist of the denial of a deduction for any payments, or certain payments, to residents of listed tax havens, a mark-to-market capital gains tax, i.e. the application of a tax on gains with respect to interests in entities resident in listed tax havens, and the application of supercharged CFC rules to entities resident in listed tax havens under which all the income of such entities would be subject to full residence country corporate tax. Although the related-party payments aspect of Pillar Two would assist developing countries in protecting their tax base from erosion, the minimum tax would prevent them from using tax incentives that reduce their tax below the minimum. Moreover, Pillar Two is likely to have the consequence of encouraging developing countries to impose tax at the minimum rate to attract investment without taxpayers incurring any additional residence country tax.

Developing countries should carefully consider the Pillar Two proposals to determine whether those proposals are the best way for them to counter base erosion. In general, they should examine how the Pillar Two proposals would fit into their domestic tax law and what changes, if any, would be required in their tax treaties. In particular, they should consider whether they have the administrative capacity to handle the complexity of the domestic tax rules necessary to implement the Pillar Two proposals. Developing countries with CFC rules may wish to consider broadening the scope of those rules consistent with the underlying rationale of the proposed Pillar Two minimum tax and adopting a withholding tax on all payments by residents to related non-residents as a simpler alternative to the related-party payments aspect of Pillar Two.

8. Conclusion

This article has reviewed the history of CFC rules and their role in the international tax system. It demonstrates that CFC rules have become recognized internationally as a legitimate tax policy instrument, which is consistent with the provisions of tax treaties, to control base erosion. However, given concerns regarding international competitiveness, CFC rules have generally been limited to foreign corporations controlled by residents, to CFCs resident in low-tax countries and to the passive and limited types of business income earned by CFCs. CFC rules do not usually apply to active business income or to deductible payments received from related parties. Consequently, while CFC rules are reasonably effective in preventing resident taxpayers from diverting passive income and limited types of business income to CFCs, they do not prevent all types of base erosion. However, CFC rules could easily be extended to deal comprehensively with base erosion by extending the rules to:

- low-taxed foreign corporations in which resident corporations have a substantial interest, usually 10%, but no control, so that the CFC rules would be coextensive with the exemption and indirect foreign tax credit systems for non-portfolio dividends; and
- all of the income of low-taxed CFCs, including their active business income.

Nevertheless, it would appear that the Inclusive Framework has rejected the extension of CFC rules in this manner and opted for a minimum-tax approach.

In my view, the extension of CFC rules is preferable to the minimum-tax approach of Pillar Two. CFC rules have been widely accepted as legitimate measures to protect a country’s domestic tax base, they have been proven to be reasonably effective, and they can be broadened without creating any conflict with the provisions of tax treaties. Even if a minimum tax is adopted, it would not eliminate the need for CFC rules to deal with passive income and certain limited types of business income. However, the adoption of a minimum tax on CFCs would make it necessary for countries with CFC rules to ensure that there is no overlap between the minimum tax and CFC rules. The duplication of CFC rules and a minimum tax on CFCs would inevitably introduce unnecessary complexity into an already complex system and is an unwelcome international development. At the very least, the Inclusive Framework should take the time to study and consult with the public on the possibility of extending CFC rules, as suggested in this article, instead of adopting the minimum tax of Pillar Two.

111. The US experience with GILTI and Subpart F rules illustrates the potential difficulties.