
The author examines whether there is a need for both transfer pricing rules and CFC provisions, and what outcomes should be expected where these rules are applied concurrently. An analysis is provided of the structure known as the Double Irish with a Dutch Sandwich and the structure involving a so-called cash-box company in an operating lease arrangement. Moreover, the author considers (i) whether CFC rules can act as a backstop to transfer pricing rules and (ii) whether the application of these two sets of rules could lead to double taxation.

1. Introduction

This article will analyse the interaction of transfer pricing rules and controlled foreign company (CFC) provisions. More specifically, it will examine whether there is a need for both sets of rules and what outcomes should be expected where these rules are applied concurrently. The most frequently applied tax planning structures for purposes of minimizing tax liabilities are discussed. First, an analysis is provided of the structure known as the Double Irish with a Dutch Sandwich and the structure involving a so-called cash-box company in an operating lease arrangement. Moreover, the article will demonstrate (i) whether CFC rules can act as a backstop to transfer pricing rules and (ii) whether the application of these two sets of rules could lead to double taxation.

2. The Use of Tax Effective Structures

2.1. Background

Presently, countries are highly concerned by the activities of multinational enterprise (MNE) groups implementing tax planning structures and artificially reducing their tax liability. Several well-known MNEs have been accused of having used such structures, including Starbucks, Google, Apple and Amazon. The effective tax rates that these MNEs paid were significantly low. In May 2013, Reuters reported that the effective tax rate paid by Apple was 2% for the past three years, while Amazon’s effective tax rate in the United States was 5.4% for the past five years. Moreover, Kleinbard states that Starbucks had incurred losses in the United Kingdom in almost all years of its presence, even though it had 31% of the UK market share. Such activities of MNE groups resulted in massive public protests.

MNE groups achieve very low effective tax rates by exploiting the loopholes created by international tax law, as well as due to inconsistencies among domestic tax laws of various countries. Consequently, the G20 Finance Ministers requested that the OECD commence working on an Action Plan that would target the issues of the base erosion and profit shifting (BEPS). As a result, the OECD issued an Action Plan consisting of 15 Actions. The Actions relevant for purposes of this article are those that are exclusively on transfer pricing (i.e. Actions 8, 9 and 10) and on CFC rules (i.e. Action 3).

2.2. Double Irish with a Dutch Sandwich

2.2.1. Description of the structure

In the February 2013 report, ’Addressing Base Erosion and Profit Shifting’, the OECD provides several examples of the profit shifting structures. One of the significant structures described in the Report is the e-commerce structure – one which has been used by a number of US multinational enterprises. For example, Kleinbard mentions that Google has lowered its effective tax rate to 2.4% by using a similar structure. The example discussed below is based on the example provided in the OECD report, ’Addressing Base Erosion and Profit Shifting’.

Company A, a parent of the MNE group, is established in Country A. Company A developed intangible property (IP) in Country A and it is the legal owner of this IP. Company C is a company registered in Country B, but managed and controlled in Country C. Company C is a tax resident in Country C under both Country C and Country B tax law. Country C is a tax haven or low-tax jurisdiction. Company A and Company C enter into a cost-sharing agreement. Under the agreement, Company A transfers to Company C previously developed IP. Under the agreement, Company A...
C must make a buy-in payment for the IP transferred by Company A to Company C. Moreover, the participants of the cost-sharing agreement agree to share the costs of the further development in accordance with the anticipated benefits to be obtained from the developed technology. The buy-in payment paid by Company C is taxable in Country A. Each participant of the cost-sharing agreement obtains economic ownership in the IP resulting from the agreement. Company C licenses the IP resulting from the cost-sharing agreement to Company D, a member of the same MNE group. Company D is a company established and tax resident in Country D. Company D sub-licenses the IP to Company B, which is established and tax resident in Country B.

2.2.2. Elements of the structure

2.2.2.1. Transfer of IP under a cost-sharing arrangement

The essential element of this tax-planning structure is that the buy-in payment made for acquiring the rights in the IP transferred under a cost-sharing agreement may not be arm’s length. MNE groups are capable of transferring the IP within the group at a non-arm’s length price, as the application of the arm’s length principle with regard to the IP can be very challenging due to the lack of comparable uncontrolled transactions. A non-arm’s length transfer price would allow the other associated enterprise (i.e. the enterprise paying the lower price than it should have paid if the enterprises were independent) to realize extraordinary returns. Consequently, if this structure is properly implemented, it would enable the MNE groups to accumulate a considerable amount of profit in a low-tax jurisdiction and therefore, retain that profit untaxed or lowly taxed before the repatriation to shareholders.

The fact that MNE groups manipulate tax bases and seek to minimize the taxes payable is also mentioned in the document, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing", prepared by the Staff of the Joint Committee on Taxation of the US Congress ("the Document" or "the Joint Committee Document"). The Joint Committee Document states that the IP rights may be centralized in a low-tax jurisdiction or in a country where the local entity can receive a favourable advance pricing agreement. According to the Document, such relocations of IP could lead to a reduction of the US tax base. Moreover, it states that one way to transfer the IP to a low-tax jurisdiction could be to make a buy-in payment for the rights to the existing IP and to agree to share the future development costs (i.e. to enter into a cost-sharing agreement). According to the Joint Committee Document, another way to transfer the IP could be the licensing of the rights to make and sell the products outside the low-tax jurisdiction.

10. SJCfT, supra n. 9, at 10.
11. Id.
the United States. Further, the Document provides that regardless of the manner in which the buy-in payment is made, it should equal the net present value of the transferred IP rights. The Document also provides that if the buy-in payment is not arm’s length, the foreign associated enterprise (usually tax resident in a low-tax jurisdiction) will benefit from the IP transfer.

The difficulty in applying the arm’s length principle to high profit potential IP is recognized by many countries, including the United States. According to the Joint Committee Document, as a consequence of this difficulty, Congress amended section 482 of the Internal Revenue Code in 1986 by adding the commensurate-with-income principle. The Document implies that this amendment was required due to severe transfer pricing problems regarding the valuation of high profit potential IP. According to the Document:

the commensurate with income principle was intended to address these problems by shifting the focus of transfer pricing analysis to the income actually derived from exploitation of the transferred intangible, and away from the identification of questionably comparable third party transactions.

Moreover, the Document states that, by this amendment, Congress wanted IP valuation to be based on the profits actually realized, and to make appropriate adjustments in the case of substantial differences. Therefore, by introducing the commensurate-with-income principle, Congress attempted to end transfer pricing manipulations regarding transfers of high profit potential IP.

According to the Internal Revenue Service (IRS), the method of valuation of high profit potential intangibles or rights in intangibles for which, at the time of their transfer, uncertainties existed and unrelated parties would have agreed on an appropriate transfer price. The IRS considers the commensurate-with-income standard as a clarification of the existing arm’s length principle.

The Document continues that, according to the IRS, the commensurate-with-income principle would indicate the amount of profit that the taxpayer should have reasonably anticipated at the time of the transfer of the IP under the controlled transaction.

Another country taking into consideration the specificities of the IP is Germany. Germany carried out a corporate income tax reform in 2007. That reform introduced a standard that resembles the US commensurate-with-income principle. The particular provision was incorporated in section 1, paragraph 3, sentence 11 of the Foreign Tax Code (Aussensteuergesetz). Eigelshoven and Stember state that it is not clear whether the legislation applies only to the transfers of intangible property or to transfers of functions as well. Cauwenbergh and Lucas Mas provide the following unofficial translation of the German provision:

[If in cases of 5th and 9th sentences essential intangible assets and advantages are object of the business dealing and the actual profits development differs substantially from the profit development that was the basis for the estimation of the transfer prices, it has to be assumed disputable that at the time when the deal was concluded uncertainties concerning the price agreements existed and unrelated parties would have agreed on an appropriate adjustment provision.]

Therefore, according to German law, the significant differences between expectations and the actual outcomes indicate that uncertainties existed at the time the transaction took place – which may warrant the revision of the transfer price as initially agreed upon the transfer. Thus, independent enterprises would have included a price adjustment clause in such circumstances. Eigelshoven and Stember state that the legal presumption of German law regarding the inclusion of adjustment clauses is rebuttable. Moreover, they state that the German tax authorities have a right to retroactively adjust the taxpayer’s income if the substantial difference occurs within ten years after the controlled transaction took place. Further, according to them, the adjustment may be made only in the year following that in which the significant difference occurred. Moreover, Eigelshoven and Stember note that a substantial difference is deemed to occur where “the transfer price determined on the basis of the actual profit development is outside the original range of potential adjustments”. According to them, the new transfer price would be calculated based on a range, the minimum and maximum value of which will be the supplier’s original minimum transfer price and the purchaser’s new maximum price respectively.

Recently, the OECD has also suggested amendments to existing guidance with regard to hard-to-value intangibles (HTVI). The term “HTVI”, as used by the OECD, covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transactions was [sic] entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangibles are highly uncertain, making it
Therefore, the OECD considers HTVI as a specific IP, the valuation of which is difficult due to the lack of data on comparable uncontrolled transactions and reliable projections on the income to be derived from such intangible property. The Actions 8-10 Final Reports identify the following features of HTVI:

- The intangible is only partially developed at the time of the transfer.
- The intangible is not expected to be exploited commercially until several years following the transaction.
- The intangible does not itself fall within the definition of HTVI in paragraph 6.189 but is integral to the development or enhancement of other intangibles which fall within that definition of HTVI.
- The intangible is expected to be exploited in a manner that is novel at the time of the transfer and the absence of a track record of development or exploitation of similar intangibles makes projections highly uncertain.
- The intangible, meeting the definition of HTVI under paragraph 6.189, has been transferred to an associated enterprise for a lump sum payment.
- The intangible is either used in connection with or developed under a CCA or similar arrangements.

The OECD approves of the use of ex-post information in the determination of the arm’s length transfer price of HTVI. According to the OECD, in certain circumstances, the use of ex-post information may prove to be necessary to deal with the mispricing of the HTVI. On the other hand, the OECD emphasizes that ex-post information is to be taken into account only in certain specific circumstances. In particular, it asserts that if there is no other information, based on which the tax administration could confirm the reliability of the information used by the taxpayer to determine a transfer price of HTVI, the use of ex-post information could be justified. The OECD stresses the need to ensure that the stated approach is used only in situations where the difference between the ex-post outcomes and ex-ante projections is significant. Moreover, according to the OECD, this methodology should be applied where such significant difference is due to foreseeable developments or events.

Consequently, the OECD provides exceptions to the application of this approach. The OECD lists four different cases where the ex-post approach should not be applied. The first exception consists of two cumulative conditions: (i) the taxpayer must provide detailed information on the projections used to determine the arm’s length transfer price of the IP and (ii) the taxpayer must also provide evidence that any significant difference is due to unforeseeable events that could not have been anticipated at the time when the transaction took place. Further, the application of the ex-post approach will not be justified where the HTVI is covered by a bilateral or multilateral advance pricing agreement. Moreover, the ex-post approach should not be used where the difference between the ex-ante projections and ex-post outcomes does not increase or decrease the compensation that an associated enterprise made by more than 20% of the compensation as determined at the time when the controlled transaction took place. Lastly, the mentioned approach should not be applied if the five-year commercialization period ended following the year in which the HTVI generated the income from an uncontrolled transaction and where, during this commercialization period, the difference between the ex-ante projections and ex-post outcomes was not above 20% of the projections for that period. Therefore, the Actions 8-10 Final Reports preclude tax administrations from using the ex-post approach where at least one of the conditions for the exception is satisfied, even though the IP transferred under the controlled transaction is HTVI.

2.2.2.2. Almost no taxation in the residence state of the operating company (Company B)

Company B is an operating company established and tax resident in Country B. Company B has substantial operations in Country B. However, the taxable base is significantly low due to the royalty payments made to associated Company D. Company D sub-licensed the IP to Company B. Therefore, at arm’s length the latter must pay appropriate royalty fees. Moreover, no withholding tax might be applied to payments made to Company D, either because there is no withholding tax applicable under the domestic law of Country B or the EU Interest and Royalty Directive (2003/49) eliminates such taxation (assuming the requirements of this Directive have been satisfied). Also, no withholding tax might be due as the result of an income tax treaty between Country B and Country D. In such case, it is also critical to ensure that there be no taxable presence (e.g. no permanent establishment to which the income from such royalty payments would be attributable) in Country B. As a consequence, the taxes payable by the MNE group in Country B might be reduced to almost nil.

2.2.2.3. Almost no taxation in the residence state of the conduit company (Company D)

Company D, a member of the same MNE group, is established and tax resident in Country D. Even though Company D receives substantial royalty payments from Company B, taxable profit in Country D is very low. The low taxable profit is due to the significant royalty payments that Company D makes to an associated enterprise tax resident in a low-tax jurisdiction (i.e. to Company D)

31. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10 Final Reports, supra n. 31, para. 6.190.
32. OECD, Actions 8-10 Final Reports, supra n. 31, para. 6.190.
33. OECD, Actions 8-10 Final Reports, supra n. 31, para. 6.189 and 6.191.
34. OECD, Actions 8-10 Final Reports, supra n. 31, para. 6.191.
35. Id.
36. Id.
37. OECD, Actions 8-10 Final Reports, supra n. 31, para. 6.193.
38. Id.
39. OECD, Actions 8-10 Final Reports, supra n. 31, para. 6.193.
40. OECD, Actions 8-10 Final Reports, supra n. 31, para. 6.194.
C). As a result, Company D is taxable only on the difference between the payments received and payments made. This difference is usually exceptionally low. Moreover, Company D is typically eligible to apply for an advance pricing agreement and obtain certainty on the amount of the taxable profit in Country D. Furthermore, Country D might not levy withholding tax on payments of royalties under its domestic law. Therefore, the royalties leave Country D without any taxation. Company D performs no significant function, has no assets and bears little or no risk. Thus, the main reason for interposing this entity between Company B and Company C is to channel the royalty income untaxed to the tax haven jurisdiction (if the payments were made directly by Company B to Company C, Country B would have applied its royalty withholding tax).

2.2.2.4. No taxation of the IP holding company (Company C)

Company C is established in Country B, and managed and controlled in Country C (a tax haven jurisdiction). Under the rules of Country B, Company C is not considered to be a tax resident therein, as it is managed and controlled in Country C. Therefore, Country B does not impose any corporate income tax on the profit of Company C. Moreover, Company C has no taxable presence in Country B and no income sourced therein. Furthermore, Company C is not subject to taxation in Country C, as the corporate income tax rate in Country C is 0%. Consequently, the royalty payments are accumulated at the level of Company C untaxed before repatriation to shareholders.

2.2.2.5. Inefficiency of existing CFC rules

In order to limit the tax deferral described above, some countries have implemented CFC legislation. These CFC rules allow the taxation of resident companies on the share of income derived through controlled foreign entities. However, most CFC rules currently in force provide for exceptions. For example, as a general rule, active income of a foreign controlled entity is not subject to current taxation in the jurisdiction of the shareholder. In the structure described above, existing CFC regimes would have been able to capture the income, as royalty is typically regarded as a passive income. Therefore, in general, royalty payments fall under CFC rules and, consequently, are subject to taxation on a current basis. Taxpayers usually make use of hybrid entities in order to avoid taxation in a jurisdiction of the shareholder on a year-end basis.

For instance, an MNE group could apply a check-the-box regime and disregard Company B and Company D for Country A tax purposes. Consequently, Country A would not see Company B and Company D as separate legal entities. As a result, it would not see any royalty payments made from Company B to Company D nor from Company D to Company C. Country A would see only that Company C derives active income (because Company B is disregarded for Country A tax purposes, active income derived by this company is attributed to Company C) and therefore, that active income of Company C would not fall under the CFC legislation of Country A. As a consequence, the income of Company C would remain untaxed until its repatriation to shareholders. Usually, MNEs achieve such deferral for an unlimited time period. In some cases the jurisdiction of the ultimate parent company may not have any CFC rules at all. Therefore, it may not be able to tax its residents on their share of income derived through foreign controlled entities, even if it sees passive income that raises base erosion issues.

2.3. Example illustrating the tax effectiveness of the Double Irish with a Dutch Sandwich structure

This example illustrates the effectiveness of the Double Irish with a Dutch Sandwich structure. For this purpose, the example will discuss two scenarios. In the first scenario, the MNE group is assumed not to have implemented a tax effective structure. In the second scenario, the MNE group is assumed to have a tax effective structure in place.

**Scenario 1: No tax effective structure in place**

Company A, which is established and tax resident in Country A, has a wholly owned subsidiary that is tax resident in Country B. In both Country A and Country B, the corporate income tax rate is 30%. Company A licenses its intangible property to Company B. Under the licence agreement, Company B may make and sell P1, for region B. In accordance with the arm’s length principle, Company B must pay to Company A a royalty fee of EUR 1,800. The income of Company B for Year 1 is EUR 2,000. For simplicity, assume that Company B has no other expenses. Consequently, Company B would have taxable profit in Country B of EUR 200. As the corporate income tax rate is 30%, Company B would have to pay EUR 60 (200 × 30%). Further assume that there is no withholding tax payable in Country B on the royalty payment.

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42. The term ‘hybrid entity’ is defined in the International Tax Glossary published by IBFD as follows: ‘Generally, an entity that is characterized as transparent for tax purposes (e.g. as a partnership) in one jurisdiction and non-transparent (e.g. as a corporation) in another jurisdiction. In some cases, an entity is a hybrid when it is treated from the point of view of a particular jurisdiction as transparent in that jurisdiction and as non-transparent in the other jurisdiction. This is sometimes referred to as a regular hybrid. In contrast, an entity is a reverse hybrid when it is treated from the point of view of a particular jurisdiction as non-transparent and as transparent in the other. A hybrid entity is therefore also always a reverse hybrid, the difference depending on whether the classification is being made from the point of view of the jurisdiction treating the entity as transparent (hybrid) or as non-transparent (reverse hybrid).’ See IBFD, International Tax Glossary. 6th revised edition (IBFD 2009), at 222, Glossary IBFD.

43. Such check-the-box regulations exist, for example, in the United States. The regulations were implemented in 1997 in order to simplify the classification of an entity for US tax purposes for both the tax authorities and taxpayers. Under the regulations, taxpayers may select how they want a specific entity to be classified for US tax purposes. They may opt to classify an entity as a corporation, partnership or disregarded entity. However, taxpayers may make a choice only if an entity is not listed as a ‘per se corporation’ The check-the-box regime is extended to foreign entities as well, which allows for tax planning opportunities. For example, taxpayers may create hybrid entities and manage to defer taxation before the income is ultimately repatriated to the United States.
The income of the MNE group in Country A would be EUR 1,800 (assuming it has no other income). The tax payable on this income would be EUR 540 (1,800 ⨉ 30%).

Therefore, the overall tax payable by the MNE group would be EUR 600 (540 + 60). The effective tax rate of the MNE group would be 30% (600 ÷ 2,000).

Scenario 2: Double Irish with a Dutch Sandwich structure implemented

Assume that, under this scenario, the same MNE group has implemented the Double Irish with a Dutch Sandwich structure as shown in Figure 1. Consequently, MNE group members would have to pay:

- in Country B: Company B has an income of EUR 2,000, but it must pay royalty fees of EUR 1,800 to Company D for the licence. Therefore, the taxable profit in Country B would be equal to EUR 200 (assuming that Company B has no other expenses). As the corporate income tax rate is 30%, the tax to be paid in Country B would be EUR 60. As mentioned in the description of the structure, there is no withholding tax to be paid on the royalty payments from Company B to Company D;
- in Country D: Company D has an income of EUR 1,800; however, it must pay royalties of EUR 1,790 to Company C. Therefore, the taxable profit in Country D equals EUR 10 (assuming that Company D has no other income or expenses). As the corporate income tax rate in Country D is 25%, Company D would have to pay EUR 2.5 (10 × 25%) in Country D. As mentioned in the description of the structure, Company D imposes no royalty withholding tax under its domestic law. Therefore, no additional tax is payable on the royalty payments to Company C;
- in Country C: Company C is a tax haven jurisdiction where the corporate income tax rate is 0%. Therefore, Company C does not have to pay any tax on the income derived;
- in Country A: the income of Company C does not fall under the CFC legislation of Country A due to the reasons described above (e.g. due to the use of hybrid entities). Therefore, no tax is payable in Country A on the income derived by Company C; and
- overall, the total amount of tax to be payable by the MNE group is EUR 62.5 (60 + 2.5). The effective tax rate of the MNE group would be 3.125% (62.5 ÷ 2,000).

A comparison of the outcomes of the above two scenarios demonstrates that MNE groups can obtain considerable tax benefits (i.e. a difference of 26.875 percentage points) by implementing such tax-effective structures.

2.4. Use of cash-box companies in operating leasing of assets

2.4.1. Description of the structure

Operating lease agreements are very common in the oil and gas industry. According to Coronado and McCarthy, typically, offshore companies are the owners of the vessels and equipment that are being used by the major oil and gas companies in their business.44 More specifically, they mention that this equipment is utilized for “locating, drilling and producing offshore oil and gas”45 Many countries have concerns regarding the leasing of assets, as such scenarios have the possibility to create base eroding payments. For instance Casley and Wlazlowski state that the UK government has proposed to apply a cap on lease payments paid by UK residents for oil and gas vessels.46

![Figure 2: Operating lease structure](image-url)

Company A is established and tax resident in Country A. Company A establishes a wholly owned subsidiary in Country B and finances it with capital. Country B is a tax haven jurisdiction where the corporate income tax rate is 0%. Company B establishes a wholly owned subsidiary in Country C. Both Country A and Country C are high-tax countries where the corporate tax rate is 30%. Company B purchases an asset and leases it to Company C under an operating lease agreement. Company B performs no significant functions and bears only investment risk in relation to this asset. On the other hand, Company C performs significant functions and bears significant risk in relation to the commercial opportunity in which this asset is used. Even though Company C derives substantial income, its taxable profits in Country C is very low, which is due to the lease payments that Company C makes to Company B.

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44. L. Coronado & J. McCarthy, Transfer Pricing Considerations for the Oil and Gas Industry: An Asian Perspective, 19 Asia-Pac. Tax Bull. 3 (2013), at 208, 213, Journals IBFD.
45. Coronado & McCarthy, supra n. 44, at 213.
2.4.2. Elements of the structure

2.4.2.1. No taxation of the cash-box company in the source state (Company B)

The issue to be considered is whether the lease payments are subject to withholding tax in the country of the tax residence of the payer. If there is no tax treaty between Country B and Country C, the applicability of withholding tax to such payments would depend on the domestic law of Country C. However, if Country C and Country B have a tax treaty that is consistent with the OECD Model Convention, the lease payments would not be subject to withholding tax.

2.4.2.2. Almost no taxation of the lessee

Even though Company C derives substantial income from its activities in Country C, its taxable profit in Country C is very low due to the lease payments made to Company B. Therefore, MNE groups succeed in minimizing the taxes payable in a high-tax country (i.e., Country C) and transfer most of their profits to a low-tax jurisdiction such as Country B under this example.

2.4.2.3. No taxation of the cash-box company

Cash-box companies are typically tax resident in the tax haven countries, where the corporate income tax rate is 0% or exceptionally low. In the example at stake, such a low-tax jurisdiction is Country B, where Company B is tax resident. Therefore, Company B would not have to pay any tax on its income in Country B, leading to an accumulation of tax-free income therein – possibly for many years.

2.4.2.4. Inefficiency of existing CFC rules

As mentioned, for purposes of limiting tax deferral, some countries have implemented CFC rules. In the structure described above, existing CFC regimes might have been able to capture the income of Company B. Therefore, the income of the cash-box company would have been taxed on a current basis. However, as a consequence of the exceptions to the application of CFC rules, where the active income is not taxed on a current basis, the MNE groups manage to avoid the current taxation of CFC income. Such a result is achieved, as mentioned in section 2.2.2.5., by means of hybrid entities. For example, an MNE group could have applied a check-the-box regime and disregarded Company C for Country A tax purposes. Thus, Country A would not see Company C as a separate legal entity and it would not see any lease payments made between Company C and Company B. As a result, Country A would see only Company B directly deriving the active income, which is usually exempt under most existing CFC legislation.

2.4.2.5. Remuneration of cash-box companies under BEPS Actions 8, 9 and 10

The amendments to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations under the OECD/G20 BEPS project address issues related to cash-box companies. According to the new guidance, companies providing financing would not be eligible to the residual profits realized unless they exercise control over the risks associated with that financing. In particular, the OECD distinguishes between two situations, namely (i) where an enterprise providing an investment exercises the control over the investment risk and (ii) where an enterprise providing an investment does not even have a control over the investment risk. In the first situation, the enterprise providing the funding would be eligible for the risk-adjusted returns, while in the second situation the mentioned enterprise would obtain only the risk-free return on its investment. Moreover, in certain circumstances, such enterprises might not even be eligible to obtain a risk-free return, where the controlled transaction under consideration is not commercially rational and, as a consequence, the guidance on non-recognition of transactions applies.

The new guidance given by the OECD with respect to companies providing investment without exercising control over the relevant risks, will impact the cash-box company structure as presented in section 2.3.1. In particular, it would impact the remuneration that Company B receives from Company C. As a consequence, the amount of profit to be taxable in Country C would increase. Therefore, MNE groups might no longer have incentives to engage in such transactions without providing enough substance in Company B, in order to demonstrate that the fees paid to the mentioned company are arm’s length, considering the updated guidance.

3. Are CFC Provisions a Backstop to Transfer Pricing Rules?

3.1. Introduction

According to the OECD, CFC rules can be considered to be at a backstop to transfer pricing rules where they are able to “restore the taxing rights of all jurisdictions involved.” The Discussion Draft on BEPS Action 3: Strengthening CFC Rules (Action 3 Discussion Draft) states that CFC rules generally attempt to capture the income earned by a foreign subsidiary that might not have been earned if the transfer price in the controlled transaction were at arm’s length at the time the controlled transaction took place. Even though it seems that transfer pricing rules and CFC legislation address the same income, this might not always be the case. Although CFC legislation is unable to restore the arm’s length pricing of transactions in all cases, the OECD considers that by applying the high tax rate to the low-taxed profit, CFC rules eliminate the incentives of an MNE group to transfer profit to a tax haven or a low-tax jurisdiction. The OECD states that transfer pricing rules and CFC legislation do not eliminate the need for the other

47. OECD, Actions 8-10 Final Reports, supra n. 31, at 65.
48. OECD, Actions 8-10 Final Reports, supra n. 31, at 11.
50. OECD, Action 3 Discussion Draft, supra n. 49, para. 21.
51. OECD, Action 3 Discussion Draft, supra n. 49, para. 22.
52. OECD, Action 3 Discussion Draft, supra n. 49, para. 21.

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set of rules. To the contrary, both of them are needed in order to price controlled transactions and minimize instances of base erosion. The reasons why CFC rules and transfer pricing legislation do not eliminate the need for each other include:

- different types of CFC legislation;
- CFC legislation restores the taxation right of the parent company’s jurisdiction only;
- the lower tax rate in the parent company’s jurisdiction compared to the tax rate in the jurisdiction of the subsidiary;
- a loss in the jurisdiction of the parent company or of the subsidiary;
- the possibility for cross-crediting;
- multinational enterprises might be based in a jurisdiction without CFC legislation; and
- as a general rule, CFC legislation is applicable to the relationship between the parent company and its subsidiaries. Therefore, it does not apply to the relationship between sister companies (i.e. where there is no controlling interest).

3.2. Different types of CFC legislation

There can be two types of CFC rules, namely (i) those with a full inclusion system and (ii) those with a partial inclusion system. The latter may not be able to capture income from transfer pricing manipulation in all circumstances, as it is applicable only to certain types of income, while other types of income are exempt. For example most CFC legislation exempts active income from taxation on a year-end basis (e.g. the United States does not tax active income under subpart F rules). Therefore, if the transfer pricing manipulation is related to active income, most CFC legislation currently in force would not be able to capture it. As regards a full inclusion system, the OECD considers such a system to be “the most complete example of the backstop effect.” However, the OECD also states that CFC legislation providing for a full inclusion system may still not be able to eliminate the need for transfer pricing rules.

3.3. CFC legislation restores the taxation right of the parent’s jurisdiction only

As mentioned, CFC legislation restores only the taxation right of the parent company’s jurisdiction. More specifically, the profits of the controlled foreign company are taxable only in the parent company’s jurisdiction and not in any other jurisdiction from which the taxable profit might have been transferred (e.g. from a high-tax subsidiary). Consequently, CFC legislation would not be able to restore the taxing rights of all the states involved in the foreign-to-foreign base erosion cases (see Example 1).

Example 1: Foreign-to-foreign base erosion

Parent Co, resident in Country A, has two subsidiaries, Sub B and CFC, in Country B and the CFC country respectively. The corporate income tax rate in both Country A and Country B is 30%. On the other hand, the corporate income tax rate in the CFC country is 0%. CFC sells P to Sub B for a price of EUR 100 per unit. For simplicity, assume that the costs related to P are EUR 0 (i.e. the full amount of EUR 100 is a profit from each unit of P sold to Sub B). Furthermore, Country A has CFC legislation, under which it taxes the profits of the CFC falling under CFC legislation on a current basis. Assuming that the profit from the sales of P falls under Country A’s CFC legislation, the MNE group would have to pay tax on EUR 100 in Country A on a current basis. The amount of tax to be paid would be EUR 30 (100 × 30%). Therefore, even though the profits were shifted from Country B, CFC legislation grants the taxation right to Country A. However, if the profits were shifted from Country A to the CFC country, the CFC legislation would be able to restore the taxation right of the states involved. As a consequence, CFC legislation would have been a backstop to transfer pricing rules if the MNE group eroded the tax base of the parent company’s jurisdiction.

3.4. Tax rate in the parent company’s jurisdiction is lower than in the jurisdiction of the subsidiary

According to the OECD, when the tax rate in the jurisdiction of the parent company is lower than the tax rate in the jurisdiction of the subsidiary, MNE groups will still have incentives to transfer the profit from a subsidiary tax resident in a high-tax jurisdiction. The profits earned by a subsidiary tax resident in a high-tax jurisdiction could be transferred either to the parent company or to the CFC in another state. In such cases, CFC legislation in the jurisdiction of the parent company cannot be considered as an obstacle to base erosion, because the shifted profits will still be taxable at a lower rate. Therefore, where the jurisdiction of the parent company has a lower tax rate compared to the jurisdiction of the subsidiary, CFC legislation would not eliminate the incentives of MNE groups to transfer profit to lower-tax jurisdictions.

For example, assume that the tax rate in the jurisdiction of the subsidiary is 35%, while in the parent company’s jurisdiction the tax rate is 25%. The MNE group would benefit from transferring profits, for example, to the parent company’s jurisdiction due to the 10 percentage point difference between the tax rates in the subsidiary’s and parent company’s jurisdictions. The CFC legislation would be unlikely to restore the arm’s length pricing in such cases.

53. OECD, Action 3 Discussion Draft, supra n. 49, para. 22.
54. Id.
55. OECD, Action 3 Discussion Draft, supra n. 49, para. 23.
56. OECD, Action 3 Discussion Draft, supra n. 49, para. 24.
57. OECD, Action 3 Discussion Draft, supra n. 49, para. 25.
59. OECD, Action 3 Discussion Draft, supra n. 49, para. 27.
60. OECD, Action 3 Discussion Draft, supra n. 49, para. 28.
61. OECD, Action 3 Discussion Draft, supra n. 49, para. 29.
63. Id.
64. OECD, Action 3 Discussion Draft, supra n. 49, para. 25.
3.5. Loss in the jurisdiction of the parent company or the subsidiary

If an MNE group has a profitable subsidiary in one jurisdiction and a loss-making subsidiary or a parent company in another jurisdiction, it will have an incentive to transfer profit to the loss-making company in order to achieve a tax efficient outcome (see Example 2).

Example 2: Loss-making parent company

Parent Co, in Country P, has a wholly owned subsidiary, Sub B in Country B. The corporate income tax rate in both Country P and Country B is 35%. Assume that in Year1:
- Parent Co has a loss of EUR 1,000 and no profit to set the loss against; and
- Sub B has a profit of EUR 1,500.

Furthermore, assume that in Year2:
- Parent Co has a profit of EUR 1,000; and
- Sub B has a profit of EUR 1,000.

Due to the mispricing of intra-group transactions, the MNE group may be able to manage and transfer a profit of EUR 1,000 to Country P. Consequently, the MNE group will be able to make use of the loss in Year1. For purposes of illustrating the benefits from the profit shifting, one should compare two scenarios, i.e. the scenario were the profit has not been shifted and scenario were the profit has been shifted.

Scenario 1: Profit has not been shifted to Parent Co

If the controlled transactions were at arm’s length and the profit was not shifted from Sub B to the Parent Co, the result would be as follows:
- Year1: corporate income tax to be paid in Country P would be EUR 0, as Parent Co has a loss. Furthermore, Parent Co would have a loss of EUR 1,000 to be carried forward. Moreover, in Country B the MNE group would have to pay EUR 525 (1,500 × 35%) in tax. Overall, the MNE group would have to pay EUR 525 (525 + 0) in tax. However, it would have EUR 1,000 losses to be carried forward.
- Year2: corporate income tax to be paid in Country P would be EUR 0, as the parent company has EUR 0 profit. Furthermore, Parent Co would have no loss to be carried forward. Moreover, in Country B the MNE group would have to pay EUR 350 (1,000 × 35%) in tax. Overall, the MNE group would have to pay EUR 350 (350 + 0) in tax. Additionally, it would have no losses to be carried forward.
- Overall result: for Year1 and Year2, the MNE group would have to pay EUR 875 (525 + 350) in tax. At the end of Year2, it would have no loss to carry forward for the next year.

Therefore, the example indicates that the transfer of profit with the intention to make use of losses earlier than would be possible by means of mispricing the controlled transactions, would have only the effect of deferral. Nevertheless, MNE groups may still have an incentive to exploit this possibility (e.g. due to the time value of money). Moreover, even if, in this case, the jurisdiction of the parent company had CFC legislation, it would not be able to deter the MNE group from mispricing the controlled transaction. Only effective transfer pricing rules could have been an obstacle in this specific case.

3.6. Possibility for cross-crediting

Some countries allow taxpayers to cross-credit taxes on the foreign-source income.65 For example, since 2007 the United States has had a two-income-category basket limitation system, under which there is a passive-income category basket and general-income category basket.66 According to Fleming, Peroni and Shay, such a system allows taxpayers to cross-credit within a specific income category basket.67 Moreover, they state that any foreign tax credits may encourage MNE groups to transfer profit. In this case, CFC legislation would not be able to prevent the mispricing of controlled transactions (see Example 3).
Example 3: Incentive to shift profits due to excess foreign tax credits
Parent Co, in Country P, has a wholly owned subsidiary, Sub B, in Country B. Country P and Country B are both high-tax jurisdictions. The corporate income tax rate in Country P is 25%. Parent Co sells P₁ to Sub B for EUR 200 per unit. Income obtained from these sales is considered to be foreign-source income. Moreover, assume that no expenses are attributable to this income. Therefore, the entire amount of EUR 200 would be profit from the sale of each unit of P₁. Moreover, the application of the transfer pricing legislation shows that the transfer price of P₁ is higher than the price to which the independent parties would have agreed. Additionally, assume that the income from the sales of P₁ is not taxed in Country B. Furthermore, Parent Co has other foreign-source income of EUR 500 and which has been taxed at a 35% rate. Therefore, the taxpayer has already paid EUR 175 (500 × 35%) in tax. Country P tax attributable to the income of EUR 500 is EUR 125 (500 × 25%). Therefore, the taxpayer would not be able to use the foreign tax credit in full, i.e. it would have an excess foreign tax credit of EUR 50 (175 – 125). If it is further assumed that these two streams of income fall under the same basket of income for foreign tax credit purposes, Country P tax attributable to the total foreign-source income would be EUR 175 ((500 + 200) × 25%). Thus, the MNE would benefit from transfer pricing manipulation in this case, as it would be able to make use of the excess foreign tax credits.

Therefore, if there were no transfer pricing rules, the MNE group would be able to transfer the profits from Sub B to Parent Co. The MNE group would obtain a deduction in the jurisdiction of the parent company applying the CFC legislation on a current basis. Assuming the profit from the sales of P₁ falls under Country A’s CFC legislation, the profit of the CFC in the CFC country, there would be no tax paid in the CFC country. Consequently, the CFC country would not be able to grant a refund for the additional taxes paid due to the transfer pricing adjustment made in Country B.

Example 4: Transfer pricing adjustment in Country B (a decrease in deductible costs)
Parent Co, resident in Country A, has two subsidiaries, Sub B and CFC, in Country B and the CFC country respectively. The corporate income tax rates in Country A, Country B and the CFC country are 35%, 30% and 0% respectively. CFC sells P₁ to Sub B for a price of EUR 100 per unit. For simplicity assume that the costs related to P₁ are EUR 0 (i.e. the full amount of EUR 100 is a profit from each unit of P₁ sold to Sub B). Furthermore, Country A has CFC legislation, under which it taxes the profit of CFCs falling under the CFC legislation on a current basis. Assuming the profit from the sales of P₁ falls under Country A’s CFC legislation, the MNE group would have to pay tax on EUR 100 in Country A on a current basis. The amount of tax to be paid would be EUR 35 (100 × 35%). In a later year, Country B makes a transfer pricing adjustment to the controlled transaction between Sub B and the CFC. In particular, it decreases the transfer price of EUR 100 to EUR 50. Therefore, Sub B must pay tax on EUR 50 in Country B, even though this EUR 50 was already taxed in Country A. Thus, EUR 50 is taxed twice.

The double taxation arising from the concurrent application of the transfer pricing and CFC rules needs to be resolved – otherwise it would have a negative impact on international trade and foreign direct investment inflows (as mentioned above). In the process of resolving the double taxation, one should decide which country is to grant the relief from double taxation and in what amount. The remainder of the example discusses these two issues in turn.

In order to determine which states involved must provide relief from the double taxation described above, the perspectives of Country B, the CFC country and Country A are discussed separately:

– Should Country B refrain from making an adjustment? Country B should not be prevented from making a transfer pricing adjustment if it is performed in accordance with the arm’s length principle. As the value adding functions were performed in Country B, it has a primary right to tax that profit. As a consequence, Country B has legitimately increased the taxable profit and should not be asked to provide relief for the unresolved double taxation in the case at stake.

– Should the CFC country provide relief from the double taxation? Assuming that no tax is applicable to the profit of the CFC in the CFC country, there would be no tax paid in the CFC country. Consequently, the CFC country would not be able to grant a refund for the additional taxes paid due to the transfer pricing adjustment made in Country B.

– Should Country A grant relief from the double taxation? Country A should be asked to grant relief from the double taxation. The main aim of CFC legislation is to prevent an MNE group from entering into
base-eroding transactions and to counter the tax deferral. In this example, the transfer pricing adjustment made in Country B ensures that the profit is sufficiently taxed and no deferral is present. Moreover, as mentioned, Country B has a primary taxing right on the profit earned in its jurisdiction. Therefore, Country A should provide relief from double taxation.

Another issue to be addressed is the amount of the refund to be provided. Parent Co paid EUR 17.5 (50 × 35%) in tax in Country A, while Sub B paid EUR 15 (50 × 30%) in tax in Country B. The amounts of tax paid in Country A and in Country B are clearly different. In order to be able to determine how much of a refund to grant, another significant question must be answered, namely whether the income of Sub B falls under the CFC legislation of Country A. If the response to this question is positive, Country A would most likely grant the refund only for taxes actually paid by Sub B on the income taxed twice. Generally, countries applying CFC legislation grant tax credits for taxes actually paid on the CFC income. Thus, if these additional taxes were paid in Country B in the year when the profits were earned, Country A would grant a credit only for the taxes actually paid in Country B (i.e. EUR 15). On the other hand, if the answer to the above question is negative, Country A should grant a refund of EUR 17.5. In this case, the higher amount of the refund is justified, because if the profit had been attributed to Sub B in the year when they were earned, Country A would not have taxed it under its CFC legislation.

The same analysis and recommended solution would apply to a situation where Sub B sells products at a non-arm’s length price to the CFC, and Country B makes a transfer pricing adjustment increasing the sale price of the products sold at a later date.

5. Conclusion

In order to analyse the interaction between transfer pricing rules and CFC provisions, this article presented the most frequently used structures in tax planning, and demonstrated how these structures operate and how MNE groups realize tax benefits. New developments within the framework of the BEPS project would influence the use of such tax effective structures.

Moreover, one should consider whether CFC provisions could be regarded as a backstop to transfer pricing rules. In this regard, seven different cases were presented where CFC rules cannot be considered to be a backstop to transfer pricing rules. CFC rules cannot be considered to be a backstop to transfer pricing rules, as countries might implement different types of CFC rules; CFC rules restore the taxation right of the parent company’s jurisdiction only and generally do not apply to the relationship between sister companies (i.e. where there is no controlling interest); MNEs might have an incentive to transfer profit from a high-tax jurisdiction, for example when there is a loss in the parent company’s jurisdiction or where there is a possibility for cross-crediting the foreign tax credit. As a consequence, CFC provisions cannot be considered to be a backstop to transfer pricing rules. Therefore, countries should implement both transfer pricing rules and CFC rules in order to deal with tax-avoidance cases.

Simultaneous application of transfer pricing rules and CFC provisions could lead to double taxation that needs to be resolved. In this regard, the critical questions to be answered are (i) who should provide the relief from double taxation and (ii) in what amount. If a transfer pricing adjustment made is in accordance with the arm’s length principle, the country to provide the relief from double taxation is the country applying the CFC legislation. Furthermore, the amount of the double taxation relief to be granted depends on whether the income of the subsidiary, the profit of which was adjusted under transfer pricing rules, falls under the CFC legislation of the parent company’s jurisdiction. In particular, where the tax rates of the high-tax subsidiary and the parent company’s jurisdiction differ, the parent company’s jurisdiction should grant relief from double taxation equal to taxes actually paid in the jurisdiction of the subsidiary if the income of the mentioned subsidiary falls under its CFC rules. Otherwise, the parent company’s jurisdiction should refund the full amount of tax paid on that income, because if this profit were attributed to the high-tax subsidiary initially, there would not be any additional taxation.