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Tax holidays in a BEPS- perspective

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Part I: General Introduction

1 Introduction

1.1 Topic and purpose

A tax holiday is a time-limited exemption from taxation and one of the most commonly employed tax incentives in developing countries.¹ The main objective behind tax incentives is to attract foreign direct investment (FDI), as this is believed to stimulate economic growth and development.²

An exemption from taxation under a tax holiday could encourage investors to invest in developing countries. However, this requires that the benefit under the tax holiday actually accrues to the investor and is not washed out by taxation in the investor's residence country. The subject of this thesis is the interrelation between tax holidays offered in developing countries and the taxation of foreign income in industrialised countries.

In most countries each company is recognized as a separate legal entity (distinct from its shareholders) and a separate taxpayer.³ Hence, profits derived by a non-resident company would usually not be taxed to its resident shareholders until the profits are remitted in form of dividends or otherwise. This is often described as “deferral of domestic tax”, and involves a saving relating to the postponement of taxation.⁴ If a resident parent company carries out investment through a company in a developing country, the profits derived by the company would thus only be subject to the tax regime in the developing country (until the profits are

¹ Easson (2004) *Tax Incentives for Foreign Direct Investment*, pp.111 and 134, UNCTAD (2000) *Tax Incentives and Foreign Direct Investment: A Global Survey* p.12.

² The desire to increase FDI and inbound foreign capital is typically based on the grounds that there is insufficient domestic capital for the desired level of economic development. In addition international investment could bring with it modern technology, management techniques and other positive spillover effects. Tax Law and drafting (2000) p.986, OECD (2001), *Corporate tax incentives for foreign direct investment*, p.25. UNCTAD (2000) pp.12-13. See section 1.3 below.

³ OECD (1996) *Controlled Foreign Company Legislation*, pp.10-15, IFA (2013) *The taxation of foreign passive income for groups of companies*, p.21.

⁴ IFA (2013) p.21. See also section 5.3 below.

remitted). As long as the profits are retained in the tax holiday company there would be no tax levied on the income.

If the parent company is resident in a country that does not tax dividends received from foreign subsidiaries (e.g. under participation exemption rules or tax sparing credit) this would allow investors to receive the full benefit of the tax holiday.⁵ If the benefit under the tax holiday is passed through to the parent company and not consumed under the residence country's tax system the profits will not be taxed anywhere and the investor will achieve a permanent tax saving. This is often referred to as *double non-taxation* (c.f. section 2.2.2).

When a company within a corporate group is exempted from tax under a tax holiday this could encourage profit shifting arrangements within the group. Otherwise taxable income could be shifted to the tax holiday company from other related companies in order to minimize the overall tax liability in the group⁶. If the tax holiday only is used as a tax shelter and no substantial activity is carried out in the developing country, such arrangements could be viewed as an abuse of the tax holiday regime (c.f. section 3.1.1).

The purpose of this thesis is, firstly, to analyse how such abusive profit shifting arrangements under tax holiday regimes could be prevented. The main focus here will be on the relationship between tax holidays and Controlled Foreign Company legislation (CFC legislation), and how such rules could limit or even eliminate the incentive to shift profits to tax holiday companies.

Secondly, it could be questioned whether double non-taxation resulting from the "intended use" of tax holiday (i.e. where no profit shifting is carried out) also should be eliminated under tax legislation in the residence country, e.g. by CFC legislation or the foreign tax credit method. This leads to an overall question whether double non-taxation should be eliminated altogether or whether such tax benefits should be recognized and respected when they are an intended policy measure of developing countries.

⁵ See chapter 5.

⁶ OECD (2001) pp.65-67.

1.2 The BEPS context

The questions raised in this thesis can be viewed in light of the increased international recognition and acknowledgement of the problems related to double non-taxation and profit shifting arrangements. Profit shifting is a significant source of tax base erosion and thus constitutes a serious risk to tax revenues.⁷ These issues have reached the political arena and “BEPS” (base erosion and profit shifting) has become a common term in international tax discussions.

At the request of the G20, the OECD published a report called “Addressing Base Erosion and Profit Shifting”⁸ in February 2013, wherein it presents a comprehensive analysis of the issues related to BEPS. The report identifies how the existing international tax rules can be combined and exploited in ways that lead to BEPS. This report was followed up with an Action Plan on Base Erosion and Profit Shifting (BEPS)⁹ in July 2013. The Action Plan identifies 15 specific actions needed to provide countries with domestic and international instruments aimed at better tackling the problems related to BEPS. The actions outlined in the plan are expected to be delivered within 2014 and 2015.¹⁰

The main focus of the OECD BEPS project is to eliminate double non-taxation.¹¹ How this relates to developing countries’ tax incentives is not specifically addressed, and it is not obvious that double non-taxation under the ordinary use of tax holidays would be seen as unacceptable under the BEPS project.

The OECD highlights that “One of the sources of BEPS concerns is the possibility of creating affiliated non-resident taxpayers and routing income of a resident enterprise through the non-resident affiliate.” Hence, when tax holidays are used in various profit shifting arrangements it would allegedly be regarded as a BEPS concern. The OECD specifically recommends, in action NO.3, that existing CFC rules should be strengthened in order to counter BEPS in a more

⁷ OECD (2013) *Addressing Base Erosion and Profit Shifting*, p5.

⁸ OECD (2013)a. *Addressing Base Erosion and Profits Shifting*.

⁹ OECD (2013)b. *Action Plan on Base Erosion and Profit Shifting*.

¹⁰ OECD (2013)b) p. 29 following.

¹¹ OECD (2013)b) p.13.

comprehensive manner.¹² It is uncertain whether these recommendations will be focused only on profit shifting arrangements or whether elimination of all double non-taxation would be advocated.¹³ If the prevention of double non-taxation would be recommended without any modifications it could have detrimental effects on developing countries' tax incentives.

1.3 Tax holidays

A tax holiday is a time-limited exemption from tax, or a reduced rate of tax, offered to qualifying companies or activities in order to enhance a specific behaviour or activity, normally – foreign direct investment. The exemption from tax is offered on a temporary basis and can vary from e.g. one year to 20 years. The time limitation distinguishes a tax holiday from other tax exemptions and reduced tax rates in general. The exemption can be targeted at all kinds of taxes, but the most common is to exempt corporate income taxation (CIT).¹⁴ This thesis will focus on tax holidays that offer an exemption from CIT.

Tax holidays can be prescribed in legislation and granted automatically when certain conditions are met. Alternatively, the entitlement can be left to the discretion of the respective authorities. Discretionary tax holidays may be granted on application when certain conditions and requirements are met, but they could also form part of various concession agreements between the investor and the developing country.¹⁵

Tax holidays are targeted at types of investment which the developing country views as desirable. The incentive can target new investments in general, investments in specific sectors or industries, or investment in underdeveloped regions in the country. Tax holidays can also be offered to investors that carry out specific activities or at companies that meet certain criteria, e.g. in relation to the size or the nature and importance of the investment project.¹⁶

¹² OECD (2013)b) p.16, Action 3.

¹³ The final recommendations regarding the design of CFC rules are not expected to be delivered until September 2015. OECD (2013) b), Annex A.

¹⁴ Easson (2004) p.135.

¹⁵ Viherkenttä (1991) *Tax Incentives in Developing Countries and International Taxation*, p.16. How tax holidays are designed and applied could have consequences for the application of CFC legislation (c.f. section 6.4).

¹⁶ Viherkenttä (1991) p.16, OECD (2001) pp.25-26. UNCTAD (2000) pp. 11-18.

Tax incentives in developing countries are usually intended for real investment in productive activities rather than investment in financial assets.¹⁷ Developing countries are usually interested in attracting direct investors (as opposed to portfolio investors) that are planning long-term investment that involves substantial business operations.¹⁸ Since tax holidays are time-limited tax incentives, the developing country would hope to gain significant tax revenues from such investments after the tax holiday period is over (as long as the investment project is carried on after the tax holiday period). During the holiday period, the developing country could also achieve higher tax revenues if the investment generates increased employment and increased income for residents in the developing country. Moreover, the developing country would hope to attract investment with positive spillover effects on local companies e.g. in form of a transfer of managerial practices, production methods, marketing techniques, or any other know-how which could increase the country's productivity and international competitiveness. Furthermore, new investment could create a stronger industrial and economic base, improved infra-structure, and increased living standards, which again could lead to more investment.¹⁹

Tax incentive would usually be intended to only cover the income that actually stems from income generating activities carried out by the tax holiday company and not income which has been merely shifted to the company from other companies in the corporate group. Normally, income from passive investments in easily tradable assets would not be intended to benefit from the tax holiday by the host country.²⁰

Even though tax holidays are regarded as an important policy measure for investment by developing countries, this view is usually not shared by theorists and international bodies that advise on tax issues. Tax holidays are allegedly the most criticized tax incentive and the stan-

¹⁷ Tax Law Design and Drafting (2000) p.986, Easson (2004) p. 4.

¹⁸ Easson (2004) pp.4 and 105, OECD (2000)p.17.

¹⁹ OECD (2001)pp.19-21.

²⁰ Viherkenttä (1991) p.6.

standard recommendation from international bodies and industrialized countries is that such tax incentives should be limited, or even abolished.²¹

In order for the tax incentive to be effective and actually provide the investor with an incentive to invest, the tax exemption has to be respected by the investor's residence country. This will not be the case if the investor's residence country subjects this exempted income to current taxation in the residence country in accordance with its CFC regime or use the foreign tax credit method on the remitted income.²²

²¹ A brief overview over the basic criticism against tax holidays is provided in section 7.1.2. c.f. Easson (2004) p.134 and chapter 3.

²² See chapter 7.

2 The approach

2.1 The methodological approach

2.1.1 Reference frame

The interaction between CFC legislation and tax holidays will primarily be analysed with reference to the situation where a *developing country* offers a tax holiday to a company pertaining to a multinational enterprise (MNE), where the ultimate parent company is resident in an *industrialized country*.²³ Tax holidays are used as the primary example since this is one of the most commonly-applied (and allegedly the most abused) tax incentives in developing countries, and also the most criticised form of tax incentive.²⁴

Even though tax incentives also can be found in industrialised countries, tax holidays are much more widespread in developing countries.²⁵ The interrelation between tax legislation in residence countries and tax incentives in host countries is of particular interest when the host country is a developing country. Fundamental principles commonly referred to in international tax policy should then perhaps be modified in order to take any special third-world implications into consideration.

²³ The borderline between developing and industrialized countries is vague and an attempt to define the two “types” of countries will not be made here. When describing several countries as a group any definition would be imprecise (each country could have different legal systems, economic, political and social structures, variable degrees of development and resources etc.). A typical feature relevant here is that developing countries tend to be capital importing countries (i.e. in net terms more capital is invested into the country by foreigners than locals are investing abroad) and thus tend to be dependent on investment by foreigners for their economies to grow. Industrialized countries, on the other hand, tend to be capital exporting countries (i.e. more is being invested overseas by locals than foreigners are investing in the country. Holmes (2007) *International Tax Policy and Double Tax Treaties*, p.2, Viherkenttä (1991) pp.6-7.

²⁴ Easson (2004)p.134. The discussion may however also be relevant for other tax incentives (especially part III), but the discussion in this thesis is limited to tax holidays.

²⁵ While developed countries tend to offer financial incentives such as grants, subsidized loans or loan guarantees, developing countries would usually not have the same possibilities to provide capital upfront and would thus resort to fiscal incentives such as tax holidays. UNCTAD (2000) pp.11-12.

Furthermore, the focus in this thesis is on companies that pertain to multinational corporate groups. Multinational entities, *MNEs*²⁶, acting as global taxpayers engaged in cross-border economic activity, are the main users of the opportunities to exploit the various tax rules in order to artificially eliminate or reduce taxes²⁷. An MNE will have considerable possibilities to allocate its resources, income and expenses between different jurisdictions, and thus take advantage of preferential tax regimes applied in various countries.²⁸

In this thesis, it will be assumed that the investment qualifying for the tax holiday will be carried out through a *subsidiary* established in the developing country.²⁹

The application of CFC legislation will usually require that some general conditions under the regime are met, typically that the foreign company has to be controlled by the resident parent company. Conditions which generally do not give rise to any special issues with respect to tax holiday companies in developing countries will not be further addressed in this thesis. Hence, for the following analysis it is assumed that any control requirement under the CFC regimes is met and that the tax holiday company constitutes a *controlled* foreign company.

CFC legislation is usually targeted at low-tax jurisdictions. In order to highlight some of the issues relating to the applicability of CFC rules to subsidiaries benefitting from a tax holiday in a developing country, it will be assumed that the developing country offering the tax incentive is not a low-tax jurisdiction *per se*, i.e. that the tax rate otherwise applicable under the benchmark system in the developing country (in the absence of the tax holiday) is relatively normal (compared to the tax rate in the country applying the CFC regime). Moreover, the dis-

²⁶ The term “multinational enterprise” can be understood as an enterprise, whether it is of public, mixed, or private ownership, that has its management headquarters in one country, known as the home country, and operates in several other countries, known as host countries. See. OECD (2010) Guidelines for MNEs.

²⁷ OECD (2013)b) p.7-8.

²⁸ IFA (2013) p.20-21.

²⁹ A subsidiary is normally recognized as a separate legal entity and thus its profits are not subject to tax in the residence country of the parent company until remitted. If the investment was carried out through a branch, which is not a legal entity and has the same legal entity as its parent company, the profits derived by the branch would constitute a part of the parent company’s worldwide income and thus be subject to tax in the residence country of the parent company. Easson (2004) pp.45-46.

cussions will concentrate on tax holidays intended for active business operation and not situations where the developing country seeks to attract various kinds of passive investment and create an investment climate which could characterize the country as a classical tax haven.³⁰

2.1.2 Domestic law

There are no international model CFC rules and there is no general agreement as to how foreign income should be taxed. Moreover, tax incentives are not designed and applied in a consistent manner in various developing countries.³¹ Hence, it will not be possible, within the frame of this thesis, to go into detail on any specific country's tax system. Nor is this necessary as the focus here is not to determine the exact outcome of how the CFC legislation (or the taxation of remitted foreign income) in a single industrialised country interacts with a specific tax incentive in a single developing country. The focus is rather to identify and highlight general trends and patterns as well as to point out the main differences in the design and application of domestic tax rules (primarily CFC rules) and how such variations interact with tax holiday regimes.

While examples from various industrialised countries' CFC legislation and their effect on hypothetical investors benefitting from tax holidays in developing countries will be given, the goal is not to establish the exact result in a given situation but rather to give an illustration of the main features. Some generalisation and simplifications of domestic tax systems will thus be inevitable.

The description of various CFC regimes, various alternatives on how to tax remitted foreign income, as well as domestic tax incentives will be based primarily on legal theory.³² The

³⁰ A tax haven could be characterized as a jurisdiction which "imposes no or only nominal taxes (generally or in special circumstances) and offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape tax in their country of residence." OECD (1998) *Harmful Tax Competition – An Emerging Global Issue* p.22. In this OECD report the above is set as the necessary starting point to identify a tax haven. In addition the report lists three other key factors in identifying tax havens, i.e.; i) lack of effective exchange of information, ii) lack of transparency, iii) no substantial activities.

³¹ Viherkenttä (1991) pp.6 and 39.

³² The further analysis of CFC legislation will be mainly based on the 38 branch reports provided in the volume 98a of the International Fiscal Association from the 2013 Congress in Copenhagen and OECD's report on

analysis of Norwegian CFC legislation will however be based on traditional sources of law and generally accepted rules of interpretation of Norwegian law.

2.2 Definitions of basic concepts and terminology

2.2.1 Residence country and Host country

The use of the term “residence country” can be ambiguous here since the developing country offering the tax incentive will be the residence country of the subsidiary, while the country applying its CFC regime will be the residence country of the parent company. In the following, the residence country of the parent company will be referred to as the “residence country”, while the country where the CFC is established and given a tax holiday (the developing country) will be referred to as the “host country” (of the investment). The residence country will typically be a capital exporting country while the host country typically will be a capital importing country. This will have implications for which objectives their tax systems strive to pursue.

2.2.2 Double non-taxation and non-taxation/deferral

“Double non-taxation” relates to situations where an item of income is not being taxed anywhere (or taxed unduly lowly). The OECD also operates with the term “less than single taxation”.³³ Double non-taxation will here be used with reference to the situation where items of income neither are taxed in the host country nor in the residence country (e.g. no *current* taxation and no taxation of *remitted* foreign income).

As long as the benefit of deferral of domestic tax is maintained (no CFC taxation), tax planning arrangements under tax holiday regimes could, however, still be used to obtain a reduction in the overall tax liabilities of the MNE even if remitted profits are taxed.³⁴ Situations

CFC legislation from 1996 (which allegedly has had a considerable impact on the design of various CFC regimes cf. IFA (2013) p.29). The different IFA branch reports represent six continents (wherein 22 out of 38 reported countries have some sort of CFC regimes) and even if they are not exhaustive they provide an overview of the general trends and patterns in various CFC legislations.

³³ See e.g. OECD (2013)a) p.34 and OECD(2013)b) p.10.

³⁴ Fundamentals of International Tax Planning (2007) p.65.

where a tax holiday is offered in the host country and deferral is available in the residence country will be referred to as “non-taxation/deferral”.

The thesis is based on a distinction between intended and unintended double non-taxation, and between intended and unintended non-taxation/deferral under tax holiday regimes.

Unintended double non-taxation will denote situations where double non-taxation is the result of arrangements where profits are shifted away from the jurisdiction where the activities creating those profits take place (e.g. when taxable income is segregated from the activities that generate it) to the tax holiday company, and not taxed when repatriated.³⁵

Unintended non-taxation/deferral will denote the situation where profits are shifted to the tax holiday company and *retained* in this foreign entity (e.g. no dividend distributions are made), and where the residence country of the ultimate parent company offers the benefit of deferral of domestic tax (i.e. no CFC legislation is applied).

Unintended double non-taxation and unintended non-taxation/deferral could also be characterised as *abuse* of tax holidays c.f. section 3.1.1. The relevant question in this regard is whether CFC legislation could be used to effectively prevent such profit shifting arrangements under tax holiday regimes.

Intended double non-taxation or *intended* non-taxation/deferral will denote situations where this is the result of the intended use of tax holidays (i.e. where profits not have been artificially shifted to the tax holiday company merely to escape or reduce taxation in other countries). In such situations the result will be intended, at least from the host country’s perspective (c.f. section 3.1.1.). The relevant question in this regard is whether double non-taxation or non-taxation/deferral resulting from the ordinary use of tax holidays *should* be prevented or not.

³⁵ OECD (2013)b) p.10. In the OECD Action plan both unintended and intended double non-taxation are referred to as double non-taxation.

2.3 Outline

Part II in this thesis will address how MNEs can “abuse” tax holidays in developing countries and whether this could be prevented under CFC rules. A few introductory remarks are made in chapter 3, especially relating to what is meant with “abuse” of tax holidays in this context. Examples on different tax planning arrangements under tax holidays will be provided in chapter 4. The common feature under these arrangements is that profits are shifted away from the jurisdiction or entity where the activity that generates the income takes place and into the tax holiday company. These arrangements would be perceived as resulting in *unintended* non-taxation/deferral, or alternatively, unintended double non-taxation. The overall question addressed in part II is whether CFC legislation could be used to prevent such profit shifting arrangements under tax holiday regimes (c.f. chapter 6).

Part III will address how the tax legislation in the residence country should interact with tax holidays in developing countries in situations where a tax holiday is used in line with its intention and purpose (the intended use of tax holidays). In these situations, double non-taxation will be intended (from the developing country’s point of view). The overall question addressed is whether double non-taxation *should* be eliminated in all respects or whether residence country taxation should be adjusted so as to permit investors to receive the full benefit of developing countries’ tax incentives.

Part II: Tax planning arrangements under tax holiday regimes – “abuse of tax holidays”

3 Reducing the overall tax liability in an MNE under a tax holiday regime

3.1 Introductory clarifications and preconditions

In general, tax planning is an inherent part of the concept of tax holidays. The purpose of offering such tax incentives (for investment) is to influence investment decisions and behaviour and to attract investors who would not otherwise have invested in the country/sector/region had it not been for the tax holiday. Hence, effective and efficient tax holidays would always lead to tax planning among investors that are offered the tax incentive.³⁶ However, tax holidays could also be used in tax planning arrangements where the tax benefit under the tax incentive is artificially extended (by the MNE) to cover income not intended to benefit from the tax holiday. The techniques that MNEs can use to shift profits to tax holiday companies will be illustrated in chapter 4 below.

Common for the examples provided below is that the arrangements could be characterised as an “abuse” of the tax holiday regime. Before illustrating some examples on such abusive arrangements it is necessary to clarify what is meant by abuse in this context (c.f. section 3.1.1). It will also be useful to provide some preliminary remarks on MNEs’ objectives behind such arrangements (cf. subchapter 3.1.2). Furthermore, the possibility for such abusive tax planning arrangements will often depend on the existence of certain preconditions (cf. section 3.1.3).

3.1.1 “Abuse of tax holidays”

MNEs can abuse tax holidays in various tax planning arrangements in order to reduce their overall tax burden and thus increase their overall net profits after tax. Abuse of tax incentives in this context denotes tax planning strategies where MNEs *shift* otherwise taxable income

³⁶ Whether a tax holiday is effective and/or efficient is discussed in section 7.1.2

(typically from companies in relatively high-tax countries) to a tax holiday subsidiary (pertaining to the same corporate group) by the use of intragroup transactions with little or no corresponding change in business operations or economic reality. When income derived by one company is diverted to the tax holiday company there will be an artificial segregation of taxable income from the activities that generate it, and the domestic tax base (in the country from where the profits are shifted) could be eroded.

The focus in this part of the thesis is on situations where the MNE takes advantage of a tax holiday in a developing country for purposes for which the tax incentive was not intended (by the developing country employing the incentive). The tax holiday could be said to be abused in situations where the MNE would benefit from the tax exemption under the tax holiday without carrying out much real business activity in the company that has been granted the incentive (e.g. no or little activity carried out, few people hired, little domestic value added). Hence, the developing country would not achieve the intended result of the tax incentive, i.e. increased employment, production, technology transfer etc.

In general, a distinction could be made between formal and substantive tax planning depending on whether the economic activity in the MNE is substantially changed or not.³⁷ The ordinary use of tax holidays and more substantive tax planning arrangements will not be characterized as abusive in this context.³⁸ This part of the thesis is instead focused on formal tax planning techniques where the substance of the activity in the MNE and the pattern of the economic activity are more or less retained.

For example, a developing country could offer a tax holiday for investors that carry out manufacturing business in a remote area of the country as a means to increase production and employment in an underdeveloped region. An MNE could then be encouraged to move one of its existing manufacturing bases from a high-tax jurisdiction and into a subsidiary established in this developing country in order to benefit from the tax holiday. If the company granted the tax incentive actually is the manufacturer and adds substantive value to the goods produced and carries out substantial activities in the developing country, the arrangement would not be

³⁷Fundamentals of International Tax Planning (2007) p.66.

³⁸ The ordinary use of tax holidays will be addressed in part III.

characterized as an abuse of the tax holiday in this context. The arrangement *would* be a form of tax planning, and it could reduce the overall tax liability in the MNE. However, this arrangement is consistent with the purpose of the tax incentive (i.e. to increase production and employment in the remote region). However, the tax holiday subsidiary could in addition (to the manufacturing activities) be used by the MNE under various profit shifting arrangements. The tax holiday company could, for example, also be used as a special purpose finance company, in which intragroup loans are routed so that the tax holiday company receives interest income from other companies in the MNE. This could be perceived to be a partial abuse of the tax holiday. If such passive income, routed to the tax holiday subsidiary, also could take advantage of the tax exemption under the tax holiday regime, this would usually be contrary to the purpose of the tax incentive.³⁹

Hence, the tax incentive could be said to be abused when an MNE enters into a tax arrangement where the *main* purpose is to reduce its overall tax liability *and* where the obtaining of the tax benefit under the tax holiday in such situations would be contrary to the object and purpose of the tax holiday regime (from the developing country's perspective). The abusive element is thus closely dependent on the objective behind the tax holiday regime in question.

While some tax incentives actually may be intended for passive income⁴⁰, the focus here is rather on situations where the host country has adopted its tax incentives in order to attract investment that involve substantial business operations and real activity in the host country (c.f. section 1.3.)

When MNEs abuse tax holidays under such tax planning arrangements the result could be characterized as *unintended* double non-taxation or unintended non-taxation/deferral – unintended from *both* countries' perspective. The residence country of the parent company may view all double non-taxation of foreign subsidiaries as undesirable, but the essential feature

³⁹ Tax incentives could be obtained by investments not actually eligible to receive them through the abuse of provisions in the relevant laws or regulations either by the investor or officials in the country offering the incentive (i.e. corruption). Zee and others (2002) *Tax incentives for Business Investment: A Primer for Policy Makers in Developing Countries*, p.1498.

⁴⁰ If the host country actually were attempting to attract these passive types of investments and transactions the host country could be characterized as a classical "tax haven", at least for these types of income. OECD (1998), see especially box I letter d) on p.23 and paragraph 55 on p.24.

under the arrangements described here is that also the host country may see this as unintended.⁴¹

Such use of tax holidays would not necessarily be viewed as abuse by all developing countries. The arrangements described below are used to concentrate profits in the MNE in the tax holiday company (as this income often will be exempted from taxation under the incentive regime). These arrangements would increase the amount of income derived (and possibly retained) in the tax holiday company and thus in the developing country. This would in turn increase the inflow of foreign capital to the developing country and would not necessarily be opposed by the developing country. Nevertheless, for the purpose of the following discussions, arrangements where a transfer of profits from companies that do not qualify for the tax holiday (according to how the tax incentive is designed) to a company that does will be characterized as abusive (c.f. section 1.3).

3.1.2 The main objectives of MNEs tax planning arrangements under tax holiday regimes

The rationale behind such profit shifting arrangements is to maximize the income in the tax holiday company (since this entity is exempted from taxation) and usually also to minimize the profits in companies resident in relatively high-tax countries. This could be achieved by shifting otherwise taxable income to the tax holiday subsidiary while expenses are shifted to non-qualifying (i.e. not offered a tax holiday) companies within the corporate group (typically resident in high-tax countries). In this way, income is maximized in the tax holiday company while deductible amounts often are maximized in non-qualifying companies. These arrangements will reduce the profits in some of the non-qualifying companies, but since the transactions are amongst members of the same MNE the total pre-tax income of the MNE remains the same – only the aggregate taxation is reduced.

3.1.3 The benefit of deferral of domestic tax as a prerequisite for the arrangements

If the residence country of the parent company in the MNE has an income tax regime based on “the worldwide income principle”, (i.e. subjects its residents to tax on all their global income regardless of where it is sourced),⁴² a preliminary requirement for these tax planning arrangements to be worthwhile is that the tax holiday subsidiary (as well as the other compa-

⁴¹ Intended double non-taxation from the host country’s perspective will be further addressed in part III.

⁴² Zimmer (2009)a) *Internasjonal inntektsskatterett*, p.34.

nies in the MNE) is recognized as a separate legal entity and as a separate taxable entity, distinct from its shareholders (i.e. the parent company).⁴³

Most countries today adhere to this separate accounting basis of taxation.⁴⁴ Hence, when a resident parent company carries out some of its operations through a separately incorporated foreign company, i.e. the tax holiday subsidiary, the parent would generally not pay any domestic tax in its residence country on the income derived by this foreign company until the income is remitted to the parent company through dividend distributions or otherwise (the deferral principle).⁴⁵ The resident parent company will thus achieve the benefit of deferral of domestic tax on the income derived by its foreign subsidiary (non-taxation/deferral) and in some cases also a permanent tax saving (double non-taxation), cf. chapter 5. As long as the tax holiday company is recognized as a separate entity for tax purposes, it will be possible to shift profits to this subsidiary in order to defer (or even avoid) tax liabilities in the parent company's residence country. A reduction in domestic tax will also be possible in the other countries where the MNE operates (e.g. by shifting profits from one subsidiary in a relatively high-tax country to the tax holiday subsidiary).

After the profits are shifted to the holiday company, and thus sheltered from taxation, they can be transferred back to the parent company/other companies in the MNE. If the residence country of the parent company levies tax on dividends from foreign subsidiaries received by the parent, the arrangement might not achieve a permanent tax saving but rather a temporary one (tax deferral). The effect of repatriation on the final effect such tax planning arrangements have on the MNE's overall tax burden will be further addressed under chapter 5 below.

⁴³ A promoted alternative to separate accounting is a unitary tax system, or formulary apportionment, where the profits earned (or loss incurred) by different companies in a group or an MNE are consolidated as if the entire group is one unity. After the MNE's worldwide income is consolidated into a global united income the net income of the unity is allocated among jurisdiction where the MNE operates according to a common formula reflecting the MNE's worldwide economic activity (as measured by some combination of sales, assets, payroll, property, manufacturing costs, turn-over, capital invested capital stock etc). The FA method is applied within certain federal systems such as the US, Canada and Switzerland. Praktisk internasjonal skatterett og internprising (2013) chapter 2. On 16 March 2011 the European Commission proposed a new system for calculating the tax base for businesses operating in the EU – "Common Consolidated Corporate Tax Base" (CCCTB), which would enable companies to consolidate all the profits and losses incurred across the EU. http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/

⁴⁴ IFA (2013) p.21, Fundamentals of International Tax Planning (2007) p.33.

⁴⁵ Fundamentals of International Tax Planning (2007) p.65.

If the residence country of the parent company has employed CFC rules and these rules are applicable on the tax holiday company (cf. chapter 6), the income exempted from tax in the host country would be subject to current taxation in the residence country. The tax saving under the tax planning arrangements discussed in the following chapter would then be reduced or even eliminated. The main issue in this part of the thesis is the relationship between tax holidays and CFC legislation. CFC rules will be disregarded under the examples in chapter 4 in order to illustrate the need for such anti-avoidance rules. A comprehensive analysis of CFC legislation as a preventive measure will be addressed below in chapter 6. Other anti-avoidance rules might also reduce the tax savings under some of these arrangements. Such rules will be mentioned continuously under the relevant examples.

4 Different techniques to shift profits to a tax holiday company

4.1 Introduction

Through sophisticated and complex structuring of cross-border transactions an MNE could take advantage of the combination of tax deferral in the residence country of the ultimate parent company⁴⁶ and a foreign tax holiday subsidiary in order to reduce its overall tax liability.⁴⁷

The MNE can identify its “portable” profits, generated in relatively high-tax countries, and use various profit migration strategies in order to shift these mobile profits into a separate entity that benefits from a tax exemption under a tax holiday regime.⁴⁸ The profits can either be shifted from the parent company, from other related companies that are resident in relatively high-tax countries, or from related companies resident in the same developing country as the tax holiday company but where they do not qualify for the tax incentive and thus is taxed under the standard benchmark system in the developing country.

One of the most common techniques to allocate income and resources between companies in an MNE is to use artificial transfer prices. Mispricing is, however, usually prevented under transfer pricing rules and thus not necessarily respected under domestic legislation (c.f. section 4.2). An arrangement which could be made within the letter of the law is the use of fi-

⁴⁶ Assuming that there is no applicable CFC-legislation in the residence country.

⁴⁷ According to OECD, any tax planning structure aimed at BEPS “will need to incorporate a number of coordinated strategies, which often can be broken down into four elements: (i) minimisation of taxation in a foreign operating or source country (which often is a medium to high-tax country) either by shifting gross profits via trading structures or reducing net profit by maximising deductions at the level of the payer, (ii) low or no withholding tax at source, (iii) low or no taxation at the level of the recipient (which can be achieved via low-tax jurisdictions, preferential tax regimes or hybrid mismatch arrangements) with entitlement to substantial non-routine profits often built up via intra-group arrangements, as well as (iv) no current taxation of the low-taxed profits (achieved via the first three steps) at the level of the ultimate parent.” OECD (2013)a) p44.

⁴⁸ Fundamentals of International Tax Planning (2007) p. 79-80, Zimmer (2009)a) Chapter 5, OECD (2001) pp.65-67, Easson (2004) pp.141-142.

nancing strategies (c.f. section 4.3). More substantive profit migration strategies could also be used (i.e. transfer of assets, risks and/or IP to the tax holiday company c.f. sections 4.4 and 4.5) but in these situations it will not necessarily be as apparent that the tax holiday regime is being abused. The presence of any abusive elements in such a situation will depend on how tax holidays are designed (the objective behind the incentive) and on the substance of the arrangement (whether it includes any economic reality). The tax holiday period itself can also be artificially extended by the MNE, e.g. by transferring capital from already existing businesses in the developing country to qualifying firms in order to cover income not meant to be exempted under the tax incentive (c.f. section 4.6). Different techniques would often be used in combination.

In the following, no attempt will be made to give a complete or exhaustive description of the possibilities for such tax holiday abuse but rather to give an overview of some of the common examples. These are merely meant as an illustration of BEPS concerns under tax holiday regimes.

4.2 Artificial transfer prices

One of the most common techniques to allocate taxable income and deductions between companies in a corporate group, an MNE, is to apply artificial (non-arm's length) transfer prices in transactions between related parties.⁴⁹ Even if each company in the corporate group generally is recognised as a single legal entity in most jurisdictions, the group will often operate more or less as a single enterprise and follow the same overall business strategy.⁵⁰ Through the pricing of certain intellectual property rights, goods and services sold between companies pertaining to the same corporate group, an MNE could be able to shift profits from companies in high-tax jurisdictions to a tax holiday company.⁵¹ The global amount of income of the MNE subject to tax would then be reduced. Such artificial transfer prices are most commonly

⁴⁹ Zimmer (2009)a pp.40-41, Fundamentals of International Tax Planning (2007) p.80.

⁵⁰ Fundamentals of International Tax Planning (2007) p.33.

⁵¹ OECD (2001) p.67.

applied in the context of intragroup loans (e.g. by setting the interest above market rate) and in the case of intragroup trade in goods, services, and assets (hereunder intangibles).⁵²

However, such mispricing arrangements are often countered by the application of transfer-pricing rules in the residence country/countries of the companies involved in the mispriced transaction.⁵³ The income will then typically be reallocated based on the “arm’s length” principle (i.e. prices should reflect how the transaction would be on the open market between unrelated parties dealing at arm’s length).⁵⁴

4.3 Financing activities

4.3.1 Introduction

Besides transfer mispricing, the most common techniques for profit shifting for tax purposes are financial and leveraging strategies.⁵⁵

As long as interest is deductible, the extent to which various companies in a corporate group are leveraged has a major impact on the split of tax revenue between their respective residence countries. In most countries the tax system makes a fundamental distinction between the tax treatment of debt and that of equity. While the remuneration that a company pays on equity (dividends) as a general rule is non-deductible at the level of the payer (and often enjoys some sort of economic double taxation relief at the level of the recipient), the remunera-

⁵² Zimmer (2009)a) p.150, OECD (2001) p.67. Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.) p.8.

⁵³ For example, The Norwegian Tax Act (NTA) s.13-1, United Nations Model Double Taxation Convention between Developed and Developing Countries (UN MTC) Art.9 and the OECD Model Tax Convention on Income and on Capital (MTC) Art.9. OECD (2010) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. UN (2013) Practical Manual on Transfer Pricing for Developing Countries.

⁵⁴ The arm’s length principle is an international standard to set prices for transactions among related parties and it requires that the amount charged by one related party to another for goods and services must be the same as if the parties were independent and not related. The functions performed, the assets used and the risk borne by an entity in a given transaction should reflect its return. Fundamentals of International Tax Planning (2007) chapter 3, OECD (2010) Transfer Pricing Guidelines.

⁵⁵ OECD (2001) p. 66, Fundamentals of International Tax Planning (2007) p.80.

tion paid for the use of debt (interest) is normally deductible at the level of the payer and subject to tax at ordinary rates in the hands of the recipient.⁵⁶

4.3.2 Using the tax holiday company as an intragroup finance company

A MNE could use a tax holiday subsidiary as an intragroup financing company and route interest payments (or other deductible payments) within the corporate group through this tax holiday company via tax-motivated financial (re)structuring.⁵⁷

A tax holiday company can receive income from other companies tax-free under the tax holiday period. This would usually include interest payments from related companies. Hence, by using the tax holiday company as an intragroup finance company the effective tax charge on intragroup interest income would be reduced.⁵⁸ At the same time the companies paying interest to the tax holiday company would often be able to deduct these payments against their income tax bases. The funds used by the tax holiday company (the financing company) to finance other companies in the group could be provided by the parent company (e.g. the parent company could subscribe for shares in, or make any other type of capital contribution to the tax holiday subsidiary). If the parent company has borrowed the funds from a third party e.g. a bank, a deduction on this loan could also be deductible in the parent jurisdiction. The MNE could then obtain a deduction in the parent jurisdiction for the bank interest and a deduction in other subsidiaries for the loans (i.e. the company/companies financed by the tax holiday company) while no (or little) tax is paid on the intergroup payments on the funds.⁵⁹ Hence, this technique can be used to maximize the income in the tax holiday company while reducing the taxable income in other companies in the corporate group.

This intragroup financing arrangement can be illustrated with an example:⁶⁰

⁵⁶ Gjems-Onstad (2012) *Norsk Bedriftsskatterett*, p.1059, *Fundamentals of International Tax Planning* (2007) pp.107-108.

⁵⁷ OECD (2001) p.66.

⁵⁸ *Fundamentals of International Tax Planning* (2007) pp.117-118.

⁵⁹ OECD (1996) pp.50-51, *Fundamentals of International Tax Planning* (2007) p.117.

⁶⁰ The countries referred to in this example, i.e. Norway, Uganda and Nigeria, are used to illustrate general principles; the same arrangement could be made in other similar countries as well. The mentioned CIT rates used in the example are based on KPMG's corporate tax rates table.

The ultimate parent company in an MNE, “P”, is resident in a relatively high-tax country, e.g. Norway, where the corporate income tax rate (CIT) is 27 %. One of its subsidiaries, “S”, has a plan to expand its business and P wishes to finance this expansion by granting a loan to S. The interest payment on the loan will then usually be deductible against the income tax base of the subsidiary and taxable in the hands of the parent company (i.e. included in its taxable income).⁶¹ The subsidiary S is also resident in a relatively high-tax country, e.g. Uganda, where the CIT is 30%.⁶² Since the CIT rate in Uganda is relatively high a deduction (in respect of the interest paid to P) against the subsidiary’s income tax base could be valuable.

However, if the effective corporate income tax rates in the two countries are similar, the overall tax liability in the corporate group will not be reduced. The benefit of this deduction would be almost offset by the tax charge on the interest income received by the parent company (which is providing the loan) since the parent also is resident in a relative high-tax country. Under this finance arrangement the overall tax liability in this corporate group would only be slightly reduced; the interest payments on the loan (by the parent to the subsidiary) are included in P’s taxable income in Norway (where the CIT rate is 27 %), while S will be able to deduct the interest payment in Uganda (where the CIT rate is 30%).⁶³ If the tax rates had been the same in the two countries the tax result would be a zero-sum game (as the overall net profit after tax would remain the same). If the tax rates had been the opposite (higher in Norway than in Uganda) the overall tax burden would in fact be increased.

If another subsidiary of the MNE qualifies for a tax holiday in its residence county, this tax holiday company could then be used as a financial intermediary in order to reduce the overall

⁶¹ Tax law Design and Drafting (2000) pp.598-612.

⁶² KPMGs corporate tax rates table.

⁶³ Under the Convention between the Republic of Uganda and the Kingdom of Norway for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income art.11 nr.2, Uganda can levy an interest withholding tax of up to 10% on interest payments from a resident in Uganda to the beneficiary owner of the interest. Under the credit method in art.23b) Norway shall allow a credit against Norwegian tax of tax payable in Uganda. The tax on the interest payments is thus divided between Norway and Uganda; e.g. if the interest payments amounted to 100 000 then 10 000 would be payable in tax to Uganda and 17 000 (27000 - 10 000) would be payable in tax to Norway. The total amount of tax would still be 27 000, and the effective tax rate 27%.

tax liabilities in the corporate group. Assume that another subsidiary in the MNE, “TH-S”, is resident in Nigeria (where the general CIT rate is 30%). The Nigerian government has inaugurated several investment incentives to enhance private sector investment, hereunder the grant of pioneer status to qualified industries. Assume that “TH-S” qualifies for this pioneer status and is granted a five-year tax holiday in Nigeria (exemption from the corporate income tax).⁶⁴ Instead of granting a loan from P to S, the loan can instead be provided from TH-S to S. The parent company, P, could borrow funds from an unrelated entity, e.g. a Norwegian bank, and use these funds to inject equity into the tax holiday subsidiary TH-S, (or alternatively funnel existing bank debt). TH-S could then subsequently loan this funds to the other subsidiary, S.

A parent company can generally choose how much equity to provide to their subsidiaries. When the parent and the subsidiary are in different jurisdictions, the amount of equity that the parent provides to the subsidiary will affect the allocation of taxable profits between the two jurisdictions.⁶⁵ When a parent company finances foreign subsidiaries with equity, this would result in revenue loss for the residence country of the parent company. It would be favourable that the tax holiday company has a high proportion of equity capital in relation to debt capital as any interest payments from the tax holiday company to the parent would not be deductible in the residence country of the tax holiday company when this company is exempted from taxation under the tax incentive. Such arrangements may, however, be limited by measures against *thick* capitalization applied in the residence country of the parent company.⁶⁶

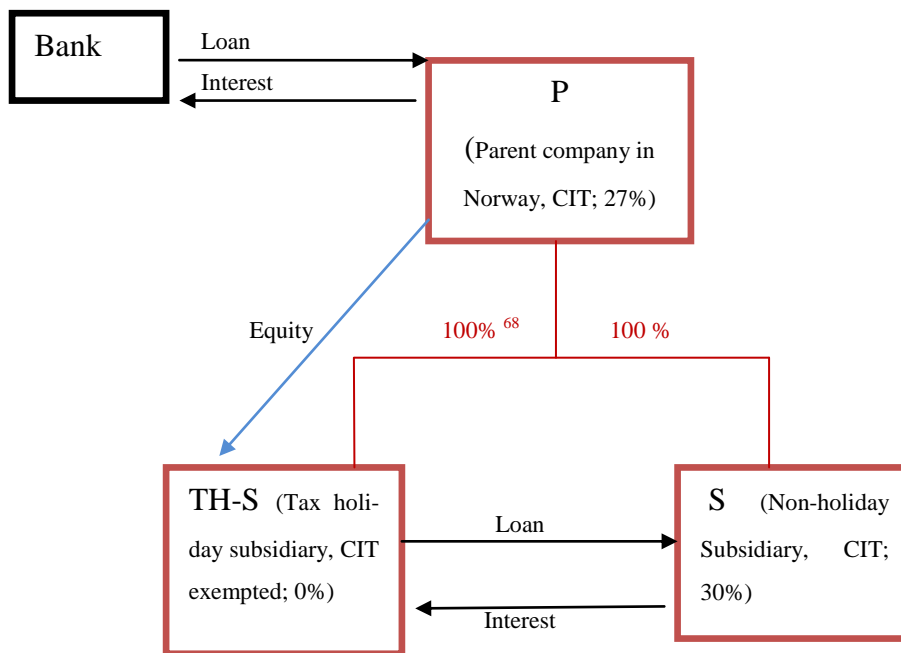
Interest payments from the subsidiary, S (that is given the loan), would then be payable to the tax holiday subsidiary, TH-S (instead of P). The payment received by TH-S would be exempted from taxation under the tax holiday. The parent company, P, would usually be entitled to deduct the interest on its loan from the bank.⁶⁷ The subsidiary (receiving the loan from TH-S), S, would usually also be entitled to a deduction for the interest payment to TH-S.

⁶⁴ About tax incentives in Nigeria, See The Nigerian Investment Promotion Commission (NIPC), Investment Incentives, at <http://www.nipc.gov.ng/investment.html> [Cited on 31.05.2014].

⁶⁵ Fundamentals of International Tax Planning (2007) pp.107-111.

⁶⁶ Gjems-Onstad (2012) pp.1061-1064.

⁶⁷ However, some countries do not allow the deduction of interest expenses on borrowings used to finance equity in subsidiaries (e.g. China, Hong-Kong, South-Africa and Switzerland). Fundamentals of International Tax Planning (2007) p.110.



Under this arrangement one loan from a bank to a parent company gives rise to two deductions within the corporate group while no tax is paid on the intragroup transfer of funds – this is often referred to as “double-dip”.⁶⁹ The interest income is exempted from tax in the hands of TH-S (and possibly also when remitted to P in a later stage, c.f. sections 5.2.3 and 5.2.4). The overall income in the MNE is unchanged but the tax liability is reduced, and thus the overall net profit after tax is increased.

After the interest payments are received tax-free in the tax holiday subsidiary, the profits can later be distributed back to the parent company. If the repatriated funds could be received by the parent without paying tax (e.g. under participation exemption), double non-taxation would be achieved. Even if the parent company is taxed on the remitted profits, a temporary tax sav-

⁶⁸ The red line illustrates the parent company’s ownership in its subsidiaries. The percent of ownership here is just an example. The subsidiaries do not have to be fully-owned, but in order to co-ordinate global management in the MNE the Norwegian headquarters must have some sort of influence or control over the subsidiaries. In this example, where the parent company is a resident in Norway, the tax holiday subsidiary in Nigeria would normally be considered a CFC under the Norwegian tax code sections 10-60 and following, c.f. chapter 6.

⁶⁹ Zimmer (2009)a) p.43. OECD (1996) p.51.

ing could be obtained under deferral of domestic tax – non-taxation/deferral. (How repatriation could affect the overall tax benefit will be further addressed in chapter 5).

The extent to which such arrangements are carried out can vary and the tax holiday financing company could be used to finance several companies within the MNE. Companies in the corporate group that are resident in high-tax jurisdictions could (subject to some limitations)⁷⁰ be financed *entirely* with debt. This could result in situations where the interest payments made from companies resident in high-tax countries are large enough to soak up most of the tax exposure in their residence (high-tax) countries. A loan could alternatively (or in addition) be given from the tax holiday subsidiary to the parent company. The parent could, for example, first contribute equity to the tax holiday subsidiary and re-obtain the contributed funds in the form of a loan.

4.3.2.1 Some key requirements under such financing arrangements

In order for such arrangements to be effective there are, however, some preliminary prerequisites that need to be taken into account (in addition to those referred to in section 3.1.3):

Withholding tax:

As illustrated above, the tax holiday company could receive intra-corporate payments tax free when it is exempted from income tax in the developing country. The payments (of interest) to the tax holiday company from other related companies would then in principle be untaxed. However, the residence country of the company paying interest to the tax holiday company could impose withholding taxes⁷¹ on these interest payments. If the interest paid to the tax holiday company is subject to interest withholding tax in the residence country of the payer (of the interest payments), the tax saving under the abovementioned arrangements would be reduced or even eliminated depending on the withholding tax rate applied. Since the tax holiday company that receives the interest payment is exempted from tax in its residence county under the tax holiday, any foreign tax credit (credit for foreign taxes paid) would be of no value since there are no taxes to credit against.

⁷⁰ C.f. section 4.3.2.1.

⁷¹ Holmes (2007) pp. 9, and 243-245 cf. pp.213-218. Fundamentals of International Tax Planning (2007) p.109.

If withholding taxes are applied, any routing of interest payments through the tax holiday subsidiary, instead of a direct loan between the parent and the financed subsidiary, would not necessarily reduce the overall tax liability in the corporate group.

Withholding tax rates are often reduced under double tax treaties,⁷² but there is no double tax treaty between Uganda and Nigeria.⁷³ Under the Ugandan Income Tax Act 1997 (ITA) Cap.340 section 83(1) tax is normally imposed on every non-resident person who derives interest from sources in Uganda. The tax is withheld at the source (by the payer/withholding agent) at 15% of the gross amount before payment of the interest is made, cf. section 120(1) and section 83 (2). Hence, S would normally have to pay withholding tax at 15 % on its interest payments to TH-S and the tax benefit under this arrangement is thus reduced. (It is possible that Nigeria would provide a tax credit under its domestic tax legislation for taxes paid in Uganda (e.g. similar to the Norwegian Tax Act s. 16-20), but since there are no domestic taxes payable in Nigeria under the tax holiday there would be no taxes to credit against).

Limitation on interest deductions

As illustrated above, it could be possible for the MNE to finance the operations of a foreign subsidiary in a manner that gives rise to deductions in both the residence country of the parent company (for the interest payments to the bank) and in the residence country of the financed subsidiary (for the interest payments to the tax holiday subsidiary) with no tax paid on the inter-corporate payments received by the tax holiday company.

Because of the effect of leverage on the allocation of taxable profits between countries, many jurisdictions have introduced rules to limit the deductibility of interest expense in cases where leverage is regarded as excessive. The most common set of rules used to limit the deduction of interest is the “thin-capitalization” rules. Such provisions are used to ensure that the relation between debt and equity is kept at a reasonable level and would generally disallow an interest deduction when specified debt to equity ratios are exceeded. Such rules are usually applied in situations where the parent company is located in a low-tax jurisdiction and the subsidiary is thinly capitalized (when the loans are made or guaranteed by shareholders of the company). However, such limitations could also be used when the loans stem from other companies in the group, e.g. a loan from one subsidiary to another (and not just from the par-

⁷² Under the DTC between Norway and Uganda the interest withholding tax rate is reduced to 10 %.

⁷³ PKF Worldwide Tax Guide 2013, p.5.

ent to the subsidiary).⁷⁴ If the borrower is subject to limitations concerning the deductibility of interest on certain intra-group loans it could thus affect the overall tax saving of the MNE under such arrangements.⁷⁵

4.4 Transferring income generating assets to the tax holiday company

4.4.1 Introduction

Another technique to reduce the overall tax liability in the MNE could be to let the tax holiday subsidiary own income generating assets (e.g. capital and intellectual property) in the MNE.⁷⁶

This technique can be illustrated in relation to intellectual property, as this often has an important role in international profit shifting.⁷⁷ Intellectual property (IP) (such as trademarks, brands, designs, trade secrets, copyrights, computer software, technical know-how, patents etc.) is often an important element in the value chain in an MNE and its location could thus have a great impact on the allocation of taxable income among the different countries where the MNE operates. This asset class is also highly mobile and its legal ownership may not necessarily coincide with beneficial or economic ownership.⁷⁸

If one of the companies within a corporate group benefits from a tax holiday in its residence country the MNE may, *ceteris paribus*, prefer that the tax holiday company own the IP so that the income generated through the IP is exempted from taxation under the tax incentive.⁷⁹ The

⁷⁴ Fundamentals of International Tax Planning (2007) pp.221-222. IFA (2013) pp.51-52.

⁷⁵ IFA (2013) p.22.

⁷⁶ According to the OECD, an analysis of corporate tax structures in relation to BEPS shows that “their overall effect is a tendency to associate more profit with legal constructs and intangible rights and obligations, and to legally shift risk intra-group, with the result of reducing the share of profits associated with substantive operations.” OECD (2013)a) p.45.

⁷⁷ Many of the large MNE currently accused of tax avoidance, such as Apple Inc. have IP intensive business models. Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.).

⁷⁸ Fundamentals of International Tax Planning (2007) p.77.

⁷⁹ There are, however, several important non-tax considerations that could be decisive for the location of relevant IP. Such non-tax considerations (e.g. that the jurisdiction where the IP is owned offers strong protection of IP rights and provide proper infrastructure and skilled personnel for the management of the IP etc.) could

greater the part of the income in an MNE that derives from IP the greater the tax impact it will have to locate the IP in a jurisdiction that charges a low effective tax rate on the income generated through the IP. Whether or not such arrangements would be characterized as abusive depends on the substance of the arrangement and whether any economic activity and independent decision making is carried out in the tax holiday company. The abusive element will be most evident when such assets are transferred to the tax holiday company from the jurisdiction (and the company) where the assets are created.

4.4.2 Intellectual property management

4.4.2.1 Creating new IP in the tax holiday company

In general, it would be relatively easy for an MNE to ensure that *new* IP is created in the tax holiday company. IP such as e.g. technical know-how and any resulting patents, arising from research and development activities carried out in the tax holiday company, at this company's own risk and expense, would usually be owned by the tax holiday company.⁸⁰ Once IP has been generated the tax holiday company (owning the IP) could exploit it by charging a royalty to other related companies in the corporate group, which in turn use the IP in their own business. A part of the global income of the MNE would then be transferred to the tax holiday company in form of royalty payments (where the income will be exempted from taxation).⁸¹ However, when the research and development activities creating the IP are carried out in the developing country by the tax holiday company this would not be characterized as an abuse of the tax holiday- at least if the royalty payments are supported by arm's length transfer pricing principles.

imply that a developing country not would be the proper location for IP rights. Fundamentals of International Tax Planning (2007) p.171.

⁸⁰ Many tax incentives are designed especially with the purpose of increasing technology transfer into the country and are directed especially towards investment that involves research and development activities. UNCTAD (2000) p.13.

⁸¹ Holmes (2007) pp.359-361, Zimmer (2009)a) pp.43-44. The other companies in the corporate group would usually be able to deduct against their income tax base any royalty's payments for the use of IP, which could be quite valuable if the companies are resident in relatively high-tax countries.

4.4.2.2 Transfer of IP to the tax holiday company

The abusive element is more evident in a situation where IP is initially developed by the parent company (or another company in the group) through research conducted primarily in its residence country while the right to this IP subsequently is transferred to the tax holiday company.⁸² A transfer of IP rights could typically be made in order to support a transfer of manufacturing operations (c.f. section 4.5).

It could be possible for the MNE to ensure that IP is owned by the tax holiday company even if the activities giving rise to the IP are carried out by another company in another jurisdiction.⁸³ One possibility to achieve this could be to have another company in the corporate group carry out the research and development (R&D) on a “contractual research” basis on behalf of the tax holiday company. The tax holiday company would then bear the economic risk in relation to the success of the R&D as well as the cost of financing the development of the IP. The economic and beneficial ownership would then be held by the tax holiday company. Since the economic ownership usually is relevant for tax purposes in most countries, the income generated through the exploitation of the IP (when eventually developed and commercially exploited) would be allocated to the tax holiday company. The tax holiday company would normally have to pay a fee to the company carrying out the R&D as a payment for its services (the creation of the IP). This fee will usually be based on the cost incurred by the R&D Company and marked up in order to give a profit margin proportionate to the functions performed (in order to be consistent with the arm’s length principle).⁸⁴ However, since the R&D company does not take any economic risk, the fee charged for the services could be set very low (and still be considered arm’s length). A drawback under this arrangement is that the

⁸² OECD (2013)a), Annex C. Examples of MNEs’ tax planning structures, pp.74-75.

⁸³ Fundamentals of International Tax Planning (2007) p.172 The MNE could regard the developing country as an inappropriate location for IP creation (e.g. lacking skilled workforce and other important resources). This could also be an alternative if IP already has been created and put into commercial exploitation when one of the subsidiaries in the MNE qualifies for a tax holiday.

⁸⁴ The cost plus method is one of the traditional transaction methods that are used to apply the arm’s length principle. This method begins with the costs incurred by the supplier of services to an associated buyer in a controlled transaction. An appropriate cost plus mark-up is then added to this cost in order to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. See OECD (2010) Transfer Pricing Guidelines, Part II, chapter D.

expenses incurred for the creation of the IP also will be allocated to the tax holiday company.⁸⁵

In order to maximize the deductibility of the expenditure related to the creation of IP and at the same time allocate the income generated through the IP to the tax holiday company, one possibility could be to develop the IP so that it is owned by a company in a high-tax country and subsequently transfer the existing IP to the tax holiday company once the IP has been generated.

However, any transfer of IP could have adverse tax consequences for the MNE since the transfer from one legal entity to another usually is regarded as a taxable transaction in most countries.⁸⁶ The MNE would then be faced with immediate taxation in the country where the IP has been created, upon the transfer. The market value of the IP for tax purposes could be significant. Hence, such arrangements would in practice be limited to situations where the existing IP is located in a country where cross-border transfer of IP would be possible under the domestic laws in that country without triggering any taxation upon the transfer.⁸⁷ Nevertheless, an MNE could find the arrangement desirable from a tax saving perspective if the benefit of having the income generated by the IP received by the tax holiday company outweighs a possible tax impost upon the transfer.

If the MNE wants the tax holiday company to own the economic rights to the MNE's IP used in other countries (and thus receive a large portion of the MNE's offshore earnings), but at the same time avoid any taxable transaction of the IP, an alternative could be to use a "cost-sharing agreement".⁸⁸ A cost-sharing agreement is an agreement between two (or more) related entities that want to use the IP resulting from R&D. The parties could then agree to share the cost of developing an intangible asset and a proportional share of the rights to the

⁸⁵ Fundamentals of International Tax Planning (2007) pp. 172- 175.

⁸⁶ In addition, a cross-border transfer of assets could trigger exit-taxes. E.g. NTA section 9-14. Praktisk internasjonal skatterett og internprising (2013) pp.101-110, Zimmer (2009)a) chapter 27.

⁸⁷ Fundamentals of International Tax Planning (2007) pp.175, 180-182.

⁸⁸ Such cost-sharing agreements are apparently used by several U.S. multinational corporations, such as Apple, as a way to shift billions of dollars in profit away from the U.S. See: Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.) Part III, chapter C. nr.3. See also OECD (2013)a) p.74.

intellectual property that results on the basis of a pre-agreed split of costs.⁸⁹ This could be used to reduce or avoid taxes on the transfer of the IP from the parent company to the tax holiday company, even if both companies are regarded as separate legal entities. The method would produce a partially similar effect to parking IP in the tax holiday company, and it would enable a shift of profits out of the residence country of the parent company (which has developed and own the existing IP). The economic rights of the IP are moved to the tax holiday company while the expenses incurred could be partially attributed to the parent company thus lowering the taxable income of the parent company.

According to a report of the US Senate Permanent Subcommittee on Investigations (PSI) on Apple Inc.'s international tax strategy, Apple Inc. has transferred the economic rights to its IP through a cost-sharing agreement with its own offshore affiliates, and thus achieved a shift of profits offshore to a low-tax jurisdiction and avoided US tax. From 2009-2012 this cost-sharing agreement allegedly facilitated the shift of \$74 billion in worldwide sales income away from the US to Ireland where Apple has negotiated a corporate tax rate of less than two percent.⁹⁰

Under a cost-sharing agreement the parent company and the tax holiday company share the cost of the future modification and enhancement of the IP. Hence, both parties will be able to use the IP, and the IP is not really transferred from one entity to another. Since this arrangement does not involve an actual transfer of IP, the residence country of the parent company might not consider this arrangement as a taxable transaction. (Usually it will only be the economic ownership of the rights to the IP that is owned by the tax holiday company and not the legal ownership). The tax holiday company would share the cost of funding the research and development of the IP, and in return it would be granted the economic rights to use the MNE's intellectual property (typically for goods sold outside the residence country of the parent company). The tax holiday company would then receive parts of the income generated through the IP. Since the tax holiday company would have a joint ownership of the IP rights developed under the cost sharing agreement, no periodic license payment would have to be made to the parent company.

⁸⁹ Fundamentals of International Tax Planning (2007) p.174.

⁹⁰ Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.) p.5.

Such cost-sharing agreements will usually include a buy-in payment from the subsidiary to the parent company. This payment is supposed to compensate the parent company for transferring the rights to the assets to the subsidiary and for incurring the initial costs and risks undertaken in developing or acquiring the intangible assets.⁹¹ The arm's length price for the buy-in payment would be difficult to set since the IP is only partially developed at the time of the transfer and risk is associated with future earnings. The MNE could thus have considerable flexibility in determining the price and would be able to avoid high taxes upon the "transfer".⁹²

4.4.2.3 Anti-avoidance

Besides CFC legislation, these arrangements might be challenged by other anti-avoidance legislation in the residence country of the parent company (and/or the residence country of other companies in the MNE). The transactions may be re-characterized (or "sham" entities disregarded, e.g. by "piercing the corporate veil"). Important factors in this regard would be the parent company's financial support of the tax holiday company's operations, lack of substantial business activities in the tax holiday company (e.g. only business contacts with the parent company), and whether property used in the tax holiday company is jointly owned.⁹³ General anti-avoidance rules (GAARs) could be used in situations where the tax holiday company does not have the appropriate resources to genuinely take the responsibility for the work and there is no actual business activity or any important decision-making regarding the IP development in the tax holiday company.⁹⁴

Transfer pricing legislation could also limit the incentive to transfer IP to tax holiday companies. Under cost-sharing agreements, for instance, the buy-in payment from the subsidiary to the parent company (carrying out the research and development of the IP) could be adjusted under transfer pricing rules, especially when the tax holiday company performs minimal operations in its residence country.

⁹¹ Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.) p. 8.

⁹² An example on how transfer of intangibles can be a key feature under MNEs' tax planning structures (including further sub-licencing) is illustrated in OECD a) pp.74-78.

⁹³ Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.) p. 11.

⁹⁴ Fundamentals of International Tax Planning (2007) pp.175-176.

The residence countries of companies paying royalties to the tax holiday company (for the use of the IP) could also impose high withholding taxes or deduction restriction rules for such royalty payments (c.f. section 4.3.2.2).

4.5 Supply chain management

In order to accumulate profits in the MNE to the tax holiday company, the tax holiday company could be used as a principal company responsible for producing and selling group products without actually altering the economic activities in the MNE. The tax holiday company could contractually assume the responsibility for producing and selling group products and contractually assume the risks associated with the business without actually being the manufacturer or carrying out substantial manufacturing activities. Such transfer of manufacturing activities will often be coordinated with a transfer of supporting intangibles under a cost-sharing agreement.⁹⁵ Hence, if the tax holiday company is the repository of the parent company's offshore IP rights (e.g. under a cost-sharing agreement c.f. section 4.4.2.2), a bulk of the income related to the parent's offshore sales could be received by the tax holiday company.⁹⁶

There could be different reasons why an MNE would use the tax holiday company only as an intermediary and not actually move the manufacturing base to the developing country; e.g. the manufacturing base could already be established elsewhere at the time when the a tax holiday is granted. The MNE may also regard the developing country as an unideal location for manufacturing (e.g. weak infrastructure, unskilled labour, and higher labour costs). Even if the tax holiday company would be exempted from income taxation under the incentive, the developing country could still be a relatively high-tax country for manufacturing. The time limit of the tax holiday period could also be a discouragement for the MNE to move the actual manufacturing base to the tax holiday company.

⁹⁵ OECD (2013)a pp.76-78.

⁹⁶ Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.) part III illustrates how Apple Inc. uses such techniques in order to shift profits away from the US.

The tax holiday company could be used to act as the initial buyer of finished products from a manufacturer in another country (for example, a related company in a high-tax country⁹⁷), re-sell the final products to other companies pertaining to the same corporate group, and retain the resulting profits. One way of achieving this is through “contract manufacturing” where the manufacturing function is segregated from the sales function. The tax holiday company would then be established as a principal company that holds contracts with the MNEs contract manufacturers. The tax holiday company would be the principal of the contract while the manufacturing company would be the contract manufacturer. The actual production could be carried out in the residence country of the contract manufacturer or in a branch of the contract manufacturing company (e.g. in a low-cost manufacturing country).

The contract manufacturer would own its own assets (e.g. factory, plant, machinery etc.) and any raw materials and carry out the manufacturing process. The principal (the tax holiday company) will (on a contractual basis) take title to the goods (at the end of the production process), own the inventory the manufacturer produces, and hold the risk associated with holding the final goods and any risk associated with the sale. When the tax holiday company bears the principal risks associated with the production of the product, the fee paid to the contract manufacturer for the manufacturing would be limited to the direct and indirect cost of production (with a small mark-up).

The manufactured products would be the property of the tax holiday company, which in turn could sell these finished goods to/through related sales, distribution or marketing entities in high-tax countries. If the tax holiday company owns the economic rights to the IP in the group it could take a substantial mark-up before selling the final goods to other related entities. In this way a substantial part of the MNE’s international sales income will be derived by the tax holiday company.⁹⁸

⁹⁷ If the tax holiday company owns the right to the IP, it could licence the rights to manufacturing technology to the contract manufacturer in exchange for a running royalty.

⁹⁸ Fundamentals of International Tax Planning (2007) pp. 183-186. This structuring of the distribution operations combined with cost-sharing agreements has allegedly been used by Apple Inc. See Offshore Profit Shifting and the U.S. Tax Code –Part 2 (Apple Inc.) pp.24-31.

Such arrangements could be more or less formal. Profits from international sales could be concentrated in the tax holiday company even if the tax holiday company has not itself manufactured the products and the residence country of the tax holiday company, i.e. the developing country, is neither the origin nor the destination of the final products. The manufacturing contracts could be negotiated and signed by the parent company on behalf of the tax holiday subsidiary and the tax holiday company might not even take any physical possession of the goods before re-selling them. The goods would not even have to enter the developing country (e.g. by directly shipping the goods to the country of sale from the country where the goods are manufactured). The main purpose for using the tax holiday company as an intermediary could be to benefit from the tax holiday.

Such arrangements could be characterised as an abuse of the tax holiday, especially if a tax incentive is given in order to increase domestic production in the developing country (e.g. increase employment and use of local resources). There could be little substance in the activities of the tax holiday company, and the income derived by the tax holiday company could often not have been earned without substantial and significant assistance from the parent company or other related companies in the MNE (e.g. no independent decision making exercised by the tax holiday company, not employing sufficient staff in the tax holiday company to conduct the volume of the business carried out therein).

If the tax holiday is given in order to promote export from the developing country and improve the host country's foreign exchange position, it could be argued that the incentive is not actually abused under such tax planning arrangements.⁹⁹ When the tax holiday company is used to re-sell the final product to companies in other countries, the incentive would actually be export-promoting and the arrangement could help build the image of the developing country and help the country earn foreign hard currency.

4.6 Artificially extending the tax holiday period

The duration of tax holidays (the tax exemption period) is often highlighted as an element especially prone to abuse and extension.¹⁰⁰ This could also be a problem under the "normal" use of tax holidays when there is no other abusive element (e.g. when substantial business

⁹⁹ This is often an important objective of the employment of tax incentives in developing countries. UNCTAD (2000) pp.12-13. Easson (2004) pp.128-130

¹⁰⁰ OECD (2001) p.65, Easson (2004) pp.111-112, 140-142, and 169, Zee and others (2002) p.1504.

activity is carried out in the developing country). However, the situation where a tax holiday period is artificially prolonged or repeated by the MNE is more abusive where the tax holiday already is used to shelter profits from taxation (e.g. under some of the abovementioned arrangements) .

A tax holiday is usually targeted at new investment projects (however defined).¹⁰¹ Through creative restructuring, an MNE could artificially prolong the duration of the tax holiday period, e.g. old firms could be reconstituted as new ones at the end of the holiday period in order to continue to be tax-exempt.¹⁰² If the MNE has a subsidiary in a developing country where the subsidiary benefits from a tax holiday, e.g. for 10 years, the MNE could transfer existing business assets and capital (from the existing subsidiary), when approaching the end of the tax holiday period, to another company that has been established in order to carry on the existing business. If existing investment is restructured as new investment the tax holiday would in practice be given twice for the same investment project.¹⁰³ The tax holiday period would then be extended without any actual new investment being made in the country. This arrangement could lead to the false impression that new investment has been made in the country when in fact the introduction of a new investment project merely reflects a reduction in the operating capital elsewhere in the economy.¹⁰⁴

Some of these arrangements could be countered by the developing country. The best defence against such abuse would be to draft the eligibility requirements carefully, e.g. by setting simple, objective, and clear qualifying criteria. Discretionary application could be limited (in order to avoid corruption). In addition, transparency could be strengthened under the administration and application of the tax incentive, and the compliance monitored.¹⁰⁵ However, one of the most frequently cited advantages of tax holidays is its simplicity, from the point of

¹⁰¹ Easson (2004) p.112.

¹⁰² This technique is sometimes referred to as the “Aladdin’s lamp” problem (new firms for old). See e.g. OECD (2013), Tax and Development Programme, *Analysis of the Tunisian Tax Incentives Regime*, p.10. available at: http://www.uscib.org/docs/Tunisia_Tax_Incentives_Analysis.pdf

¹⁰³ Easson (2004) p.141.

¹⁰⁴ OECD (2001) p. 65.

¹⁰⁵ Zee and others (2002) p.1510, Easson (2004) chapter 7.

view of both the investor and the tax authorities in the host country.¹⁰⁶ In some cases there would be no need to file, calculate, or audit taxes during the holiday period since no tax is payable in this period. Therefore, it is not always easy for the developing country to distinguish new investment from an old investment “disguised” as new investment.¹⁰⁷ The investor could, for example, close down and then restart the same project under a different name but with the same ultimate ownership.¹⁰⁸

4.7 Other techniques

The techniques illustrated above are just some examples of different tax planning opportunities available for a corporate group that includes a tax holiday subsidiary. Many of the same structures as those typically used in traditional tax havens can be used in relation to a tax holiday subsidiary. The main difference is the time limitation and the fact that the country offering a tax holiday usually would be a developing country (but that could also be the case for a classical tax haven).

The tax holiday company could also be used as a holding company. However, a developing country would perhaps not be an ideal location for a holding company (a low-tax jurisdiction would be a more ideal holding location if the country is a member of the European Union and has an extensive tax treaty network.”)¹⁰⁹

The tax holiday company could also for example be used as a captive insurance company, i.e. a company used to insure the activities and assets of the parent company (or other companies in the group). The parent company could then obtain a tax deduction for the insurance premium paid to the captive (the tax holiday company) while income is accumulated in the captive company.

¹⁰⁶ Easson (2004) p.140, Tax Law Design and Drafting (2000) p.990, Zee and others (2002) p.1503.

¹⁰⁷ Tax Law Design and Drafting (2000) p.999.

¹⁰⁸ Zee and others (2002) p.1504.

¹⁰⁹ Fundamentals of International Tax Planning (2007) p.87.

5 Temporary or permanent tax saving

5.1 Introduction

In order to assess the ultimate tax saving effect of the arrangements described above it is necessary to look into the way the residence country taxes foreign sourced income. The ultimate taxation of the income derived by the tax holiday subsidiary would depend, apart from the host country tax rules (i.e. the exemption under the tax holiday), upon the tax system in the parent company's residence country.¹¹⁰

As long as profits shifted to the tax holiday company are retained in the tax holiday company, there would be no tax levied on the income (i.e. deferral of domestic tax in the residence country and tax exemption in the host country under the incentive c.f. section 3.1.3). Hence, the profit shifting arrangements could be used to achieve (unintended) non-taxation/deferral (as long as the residence country doesn't apply CFC legislation c.f. chapter 6). Non-taxation/deferral is in principle only a temporary tax saving and the parent company would usually be interested in a repatriation of profits, e.g. to fund dividends to its shareholders. Whether or not the tax saving would be permanent, i.e. whether double non-taxation could be achieved, depends on how repatriated profits are treated under the tax system in the residence country of the ultimate parent company. Whether the income shifted to, and accumulated in, the tax holiday company could be repatriated to the parent company tax-free will be addressed in section 5.2 below. The tax treatment in the residence country could be decisive for the MNE's choice on whether to repatriate profits or retain the income in the tax holiday company. The benefit of deferral is addressed in section 5.3.

5.2 Repatriated income and residence taxation

5.2.1 Alternative methods of taxing foreign sourced income

Whether or not the parent company can receive dividends from the tax holiday subsidiary tax-free depends on the domestic tax laws in the residence country of the parent company. Most industrialised major economies adhere to the "worldwide taxation principle" and tax their

¹¹⁰ Viherkenttä (1991) p.36.

residents on all their income regardless of its source.¹¹¹ Hence, in principle, repatriated tax holiday income would be subject to corporate income tax in the residence country. However, the residence country would usually have specific rules meant to alleviate or eliminate double taxation (which would be the case if the tax holiday company actually were taxed in the host country, i.e. in the absence of a tax holiday). How such rules are designed would affect the overall tax liability in the MNE.

The two main methods used in relation to the tax treatment of foreign income derived by a resident taxpayer are either to exempt the foreign income from taxation in the residence country (“the exemption method”), or to tax the foreign income but offer a tax credit for taxes paid in the foreign country (“the foreign tax credit method”).¹¹² When income is derived from a developing country which offers tax incentives, the residence country could alternatively allow tax credits as if the host country were fully taxing the income (“tax sparing”).¹¹³

The following analysis will be limited to situations where the MNE is resident in a country that adheres to the worldwide taxation principle since the major multinational companies usually are resident in such countries, e.g. the US or the UK. Moreover, the analysis will focus on foreign tax credit (c.f. section 5.2.2), tax sparing credit (c.f. section 5.2.3.), and the participation exemption method (c.f. section 5.2.4.), as these are the most important policy alternatives.¹¹⁴

¹¹¹ Zimmer (2009)a) p.34. The worldwide taxation principle is also known as the “residence principle”. The alternative to the worldwide taxation principle is the “territorial taxation principle”, under which the country only taxes income sourced in the territory. This principle is used in several Latin American countries and in France. See also UNCTAD (2000) p.30.

¹¹² Viherkenttä (1991) chapters 4-5.

¹¹³ Viherkenttä (1991) pp.37-39. Other methods could be applied, e.g. the residence country could tax the foreign income without offering any credit (“double taxation”), tax foreign sourced income but allow a deduction for foreign taxes paid in the computation of taxable income in the residence country (“the deduction method”), or tax foreign sourced income at a reduced rate (“the reduced rate method”), but these methods are less common.

¹¹⁴ Viherkenttä (1991) p.39.

The alternative to the worldwide taxation principle is the territorial taxation principle. UNCTAD's World Investment Report 2013¹¹⁵, has ranked the top 20 investor economies in the world. Only 3 out of these top 20 adhere to a territorial tax system: Hong-Kong¹¹⁶, France¹¹⁷, and Singapore¹¹⁸ (respectively nr.4, 11 and 16 of the top 20). A parent company resident in Hong Kong, for example, which derives dividends from a tax holiday subsidiary outside Hong Kong would usually not be required to pay tax in Hong Kong on these profits (provided that the profits are regarded as sourced outside Hong Kong under the domestic legislation).

5.2.2 Foreign tax credit

A widespread method to alleviate international economic double taxation used in countries adhering to the worldwide income principle is the foreign tax credit method. Under this method any foreign sourced income would be taxable in the residence country when received by the resident parent company, but taxes paid on this income in the foreign country would be set off against the residence taxes payable on the foreign income.¹¹⁹

An exemption from tax under a tax holiday in the developing country would eliminate the tax credit in the residence country (as there would be no foreign taxes paid). If the parent company is resident in a country that uses the foreign tax credit method the tax holiday in the host country would have the effect of increasing the tax revenues in the residence country. Since there would be no taxes to give credit for, the exemption from tax in the host country under the tax holiday would then simply result in a correspondingly higher tax burden in the residence country when the income is remitted.¹²⁰ Hence, double non-taxation could not be

¹¹⁵ UNCTAD (2013) United Nations Conference on Trade and Development *World Investment Report 2013, Global Value Chains: Investment and trade for Development*, p.5, fig. 1.6

¹¹⁶ Deloitte (2014) Highlights.

¹¹⁷ IFA (2013) pp.300-301. In principle, France has a territorial system, wherein profits realized by enterprises carried out outside France are not taxable in France. However, foreign passive income received by a French enterprise (such as interest, dividends and royalties) is subject to corporate income tax in France unless the income is effectively connected to an enterprise carrying on a business outside France.

¹¹⁸ However, Singapore taxes foreign income remitted or deemed remitted to Singapore. Hence, if the parent company was resident in Singapore the dividend receipt would most likely be taxable in the parent company. See Deloitte (2014) Highlights.

¹¹⁹ Viherkenttä (1991) p.71.

¹²⁰ UNCTAD (2000) p.28.

achieved if the parent company is resident in a country that uses the foreign tax credit on remitted income.

However, some countries have offered “tax sparing credit”, under which tax credit is extended to taxes not actually paid (a tax credit for “notional tax”). The residence country could also exempt dividends from taxation, especially when received by a company, typically under *participation exemption rules*. How these methods would affect the overall tax burden of the MNE when tax holiday income is repatriated to the MNE will be addressed in the following.

5.2.3 Tax sparing credit

If the residence country of the parent company has employed tax sparing provisions (either in their domestic tax law or in a relevant double tax treaty) a credit could be given for tax that *would* have been paid by the foreign subsidiary had it not been offered a tax incentive – credit for hypothetical tax.¹²¹ Instead of offering a tax credit only for taxes actually paid in the host country, the credit would then be extended to certain notional taxes which are not actually payable in the host country – tax sparing credit.¹²² This would enable the parent company to retain the benefit under the tax incentive and obtain a permanent tax saving, i.e. double non-taxation.¹²³

Tax sparing provisions are usually limited to situations where the dividend is received from a subsidiary established in a developing country that offers tax incentives as a part of their investment policy. If the traditional tax credit is used in these situations, any tax concessions in the developing country would in practise accrue to the treasury of the parent jurisdiction rather than to the investor (or indirectly the host country). In order to prevent such a result the country could employ tax sparing provisions.¹²⁴ Tax sparing would ensure that the residence country’s taxation not will be increased even if the host country has made a unilateral decision

¹²¹ Zimmer (2009a) chapter.18, Holmes (2007) pp. 22-34, Gjems-Onstad (2012) pp.983-988.

¹²² For a comprehensive analysis of tax sparing provisions see Nilsen (2013) *The Concept of Tax Sparing : A general analysis, and an analysis and discussion of the various features of tax sparing provisions* and Viherkenttä (1991) chapter 6.

¹²³ UNCTAD (2000) p.31.

¹²⁴ Norsk skatteavtalerett (2006) pp. 784-785.

not to tax (or not to fully tax) certain investors that operate in the host country, e.g. under a tax holiday.¹²⁵

However, the rationale behind such tax sparing provisions is not as present when the tax holiday is abused (c.f. chapter 3-4) and only used to shelter income shifted from other jurisdictions. Hence, it is not obvious that a tax sparing provision would apply in these situations. Usually tax sparing provisions would include certain conditions (explicitly or implicitly) in order to prevent abuse, e.g. a stipulation of which activities that would qualify for the tax sparing.¹²⁶ If the MNE benefits from the tax holiday in a developing country without actually carrying out any genuine substantial business activity in the developing country (and thus benefits from the tax holiday contrary to its purpose), any repatriated income could then be excluded from the tax sparing provision (and the credit method could be used without tax sparing).

5.2.4 Participation exemption

5.2.4.1 General

The exemption method could be used to alleviate international “juridical” double taxation (i.e. when the same tax subject is taxed twice on the same income). However, as long as the tax holiday subsidiary is recognised as a separate taxpayer (distinct from its shareholders c.f. section 3.1.3) the MNE would be more concerned about exemption methods used to alleviate double (or multiple) “economical”¹²⁷ double taxation. Rules that exempt intercorporate dividends from taxation, e.g. when the tax holiday subsidiary remits profits to a corporate taxpayer, are often referred to as “participation exemption rules”.

If the residence country of the parent company exempts foreign sourced dividends from taxation, the MNE could achieve a permanent tax saving under the abovementioned arrangements, even when the income is repatriated to the parent company. However, since the exemption

¹²⁵ Tax, Law and Development (2013) p.107.

¹²⁶ Nilsen (2013) chapter 8.

¹²⁷ Economical double taxation refers to situations where the same income (the taxable object) is taxed twice, but in the hands of two different taxpayers. Holmes (2007) p.37, Viherkenttä (1991) p.51.

method generally is a tool to eliminate double taxation, the exemption might not be applicable when the income not is taxed in the host country.¹²⁸

In many countries dividends received by a resident company from a foreign (and often also domestic) subsidiary is (partly)¹²⁹ exempted from taxation under certain conditions – often referred to as “participation exemption”.¹³⁰ If dividends received from the tax holiday subsidiary fall under the scope of such exemption provisions, the dividend distribution can be received tax-free by the parent company.

The domestic legislation in countries with participation exemption rules normally requires that the corporate taxpayer holds a certain percent of the shares in the company from which it receives the dividends.¹³¹

For example, under the Norwegian Tax Act (NTA) s. 2-38 (3) d), dividends received by a Norwegian resident limited company from limited companies outside the EEA are exempt if the Norwegian company holds at least 10 % of the shares of the foreign company for a period of at least two years. A 10 % minimum ownership level is very common¹³², but various levels apply. In Russia, for example, the resident company must hold a participation of at least 50 % for at least 365 days; in Japan the shareholding must be 25 % or more for at least six months before the dividend determination date; in Netherlands the

¹²⁸ Viherkettä (1991) pp.59-62.

¹²⁹ Some countries only partially exempt dividends from taxation, e.g. if a minimum ownership level (and period) requirement is satisfied, dividends are 97 % exempt under the NTA s.2-38 (6). While 95 % is exempted in for example Germany and Japan. See Deloitte (2014) Highlights.

¹³⁰ There are several countries that do not exempt dividends from taxation when received from foreign subsidiaries. In China, for example, dividends received from a foreign entity are included in taxable income (but subject to a reduced rate of 15 % if the Chinese company holds at least 26 % of equity shares); the same is the case in Finland if dividends are received from a non- EU/EEA country. Deloitte (2014) Highlights.

¹³¹ In addition, domestic legislation sometimes requires that the resident company owns a certain percentage of the capital in the foreign company, e.g. 10 % under the NTA (art.2-38 (3) d)).

¹³² E.g. a 10 % shareholding is required under the participation exemption in *inter alia*, Switzerland, Belgium, Luxemburg. In addition, or as an alternative, some countries requires that the participation must have a minimum acquisition value (e.g. at least EUR 2.5 million in Belgium, and EUR 1.2 in Luxemburg). Deloitte (2014) Highlights.

minimum level is 5 %, while UK foreign dividends received by UK resident companies are exempted from taxation without any minimum ownership level or period (same in e.g. Italy).¹³³

Such participation requirements would usually be met. However, the participation exemption may also be contingent on the tax treatment in the host country. Such requirements could make the exemption method inapplicable on dividends received from a tax holiday subsidiary.

5.2.4.2 Requirements under participation exemption provisions that could exclude tax holiday income from the exemption

Participation exemption rules could be limited to income from active business.¹³⁴ When income is shifted to the tax holiday company under the various tax planning arrangements, the tax holiday subsidiary could usually not be said to be engaged in genuine active business activities. Hence, if a participation exemption provision requires that the dividend receipts from a foreign subsidiary be exclusively or almost exclusively from active production the exemption might not be available for dividends from a tax holiday company in situations where the tax holiday is abused c.f. chapter 4.

Countries with participation exemption rules could also set taxation in the source country as a condition for the exemption. The exemption could then be limited to situations where the subsidiary actually is subject to income tax in its country of residence, often combined with a minimum tax rate requirement.¹³⁵

Participation exemption rules are designed to prevent chain taxation (economic double taxation) when a corporate taxpayer receives dividends from another company.¹³⁶ If the dividend paying subsidiary is located in a low- or no-tax country the rationale behind participation exemption rules is no longer as apparent¹³⁷ and it could be questioned whether the exemptions should at all be applicable when the income is not taxed in the source country. To some extent, the same rationale could be invoked in relation to

¹³³ Deloitte (2014) Highlights.

¹³⁴ Viherkettä (1991) p.58.

¹³⁵ Viherkettä (1991) p.59-62. Under the Norwegian participation exemption for example, c.f. NTA s. 2-38 (3) a), income from a company resident in a “low-tax country” (lavskattelend) is excluded from the participation exemption provision. The assessment is linked to the same criteria as under the Norwegian CFC-legislation.

¹³⁶ Bedrift, Selskap og skatt (2010) p. 315.

¹³⁷ Bedrift, Selskap og skatt (2010) p.325.

countries that offer tax incentives, such as a tax holiday, even if the country otherwise not would be regarded as a relatively low-tax country (e.g. when the standard tax rate under its benchmark system is comparable to the one in the residence country). However, when the country offering the tax incentive is a developing country, it is not obvious that “low-tax” exception should apply. Such issues are discussed in part III (as regards the ordinary use of tax holidays).

When a country restricts its exemption provisions in cases where the taxation in the host country is low or fully exempted, the rationale is often to exclude dividends received from companies in tax haven countries. However, depending on how the provision is designed, developing countries with tax incentives could be included in the same category.¹³⁸ This could be an unintended effect of the provisions but it could also be a genuine policy choice by the residence country. How tax holiday companies in developing countries are treated under various low-tax exclusions will be further addressed in relation to CFC-legislation in chapter 6 below (especially in section 6.3).

If a low-tax exception to the participation exemption applies to dividends received from tax holiday companies, a relevant question is whether this exception can be circumvented by timing the dividend transfer until after the expiration date of the tax holiday. During a tax holiday period the subsidiary will not be liable for any corporate income tax in the residence country. Thus, dividends paid out from the tax holiday subsidiary to the parent company might be excluded from the participation exemption under a low-tax exception. However, after the holiday period is over, the subsidiary will usually be taxable again under the normal corporate tax rate in the developing country. Depending on the standard tax rates under the benchmark system in the developing country (compared to the tax rates in the residence country), the subsidiary might then no longer be regarded as resident in a low-tax country under the participation exemption rules. By postponing the dividend distribution until after the tax holiday period is over any low-tax exception might be circumvented. Such circumvention would require that the evaluation of whether the tax holiday subsidiary is resident in low-tax country or not is done at the time of the dividend distribution (and not at the time the income was derived by the tax holiday subsidiary).

¹³⁸ Viherkenttä (1991) p.60-61.

5.3 Unremitted income – the benefit of deferral

If the MNE is unable to remit profits from the tax holiday company back to the parent company tax-free, it could choose to retain the income in the tax holiday company and thus benefit from a deferral of domestic tax (in the absence of any applicable CFC legislation).

Compared to the situation where the return on an investment is derived directly by the investor (parent company/shareholder) and taxed annually, the investor will achieve a tax saving by retaining the income in the tax holiday company. The tax saving will depend on the relationship between the tax rates at shareholder level (imposed on the parent company if it derived the income directly) and the corporate level (the tax rate levied on the foreign company by the host country).¹³⁹

The temporary tax saving (under deferral) could be maintained over several years or even indefinitely, and the profits could be shifted to other low-tax jurisdictions, be reinvested, or otherwise spent by the MNE. From the investor's point of view, even if a later profits distribution will be taxed in his residence country (which is not necessarily the case when the investor is a company), the deferral in itself would involve the saving related to postponement of paying tax.¹⁴⁰

However, the parent company would normally be interested in a repatriation of the foreign income, e.g. in order to fund dividend payments to its shareholders.¹⁴¹ MNEs could in some cases be able to achieve repatriation of profits to the parent company without paying any dividend taxation e.g. by transforming the dividends into other types of income given a more favourable tax treatment¹⁴²

¹³⁹ IFA (2013) p.21. The benefits arising from deferral are analysed in Viherkenttä (1991) pp.91-96.

¹⁴⁰ The benefit of deferral is a strong incentive for resident companies to shift profits offshore and retain the profits in foreign affiliates. Allegedly, US corporations, for example, have more than \$1.7 trillion in undistributed foreign earnings and keep at least 60% of their cash overseas. Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.) p.7.

¹⁴¹ OECD (2013)a), p.73.

¹⁴² Zimmer (2009)a) p.43.

Part II: Means to counter tax planning arrangements under tax holiday regimes

6 CFC legislation – as a possible solution to counter the abuse of tax holidays

6.1 Introduction

There are several preventive actions that can be taken by the home country of the investor in order to protect its domestic tax base and reduce the risk of losing domestic tax revenue. General Anti-Avoidance rules (GAARs) and Special Anti-Avoidance rules (SAARs) can be employed to counteract the routing of passive income to low-tax jurisdictions. Provisions not necessarily categorised as anti-avoidance rules can also be used as a method against an artificial allocation of income among jurisdictions. Some of these rules and how they might affect the sought tax benefit are mentioned in chapter 4, and include, inter alia, transfer pricing rules, limitation on interest deduction (e.g. thin capitalization rules), and withholding taxes.¹⁴³ However, the most important tool for preventing the allocation of passive income to low-tax jurisdiction is Controlled Foreign Company Rules (CFC rules).¹⁴⁴ CFC legislation constitutes the most direct and extensive way of dealing with the taxation of income shifted abroad,¹⁴⁵ and the following will be limited to this specific type of preventive measures.

¹⁴³ Any “low-tax” exclusion under various participation exemption rules (c.f. chapter 5.2.4.2) could also be seen under an anti-avoidance perspective since such exceptions could prevent the parent company from receiving dividends from low-tax entities tax-free. The same could be said about any specific criteria or specifications under tax-sparing provisions (c.f. chapter 5.2.3) since they too could contribute to prevent abuse, especially if they limit the tax sparing provision to situations where the income received from a tax-holiday subsidiary stems from genuine and substantial business activities. See Nilsen (2013) section 6.2.1.2. and chapter 8.

¹⁴⁴ Domestic anti-avoidance legislation specifically designed to ensure that “arm’s length” criteria are followed (such as transfer pricing rules and thin capitalization rules) would not prevent the use of foreign corporations to avoid/defer domestic tax when the transactions between the related corporations in the MNE actually are conducted on arm’s length basis. In addition, it would often be difficult to determine whether there actually has been a transaction (e.g. under the shared use of intellectual property) and to determine the “correct” arm’s length price. OECD (1996) p.11.

¹⁴⁵ IFA (2013) pp.19-56.

There is no clear definition of what constitutes CFC legislation. However, the essential feature of CFC rules is that the residence country of the parent company is empowered (under certain conditions and limitations¹⁴⁶) to tax the resident parent company on its proportionate share (however defined) of the income derived by its foreign (non-resident) subsidiary as this income *accrues* and regardless of whether any distributions are made.¹⁴⁷

Profits derived by the tax holiday company are usually only taxed to the shareholders first when they are distributed as dividends or when they are otherwise realised by the shareholders (deferral). When the host country offers a tax holiday the taxation of the profits would thus in general be dependent on whether the profits are remitted back to the parent company or not. And if remitted, the taxation (if any) would depend on how the tax laws in the residence country of the parent company are designed (i.e. whether foreign income is taxed when remitted to the parent company c.f. section 5.2). In situations where otherwise taxable income is shifted to a tax holiday company and the untaxed income accumulates in the foreign entity, the residence country of the parent company would often be interested in taxing this *unremitted* in-

¹⁴⁶ Most CFC-regimes will have a definition on what constitutes a CFC. The legislation will typically be targeted at foreign companies, but other foreign entities may also be included if they are considered as separately taxable for domestic tax purposes, e.g. trusts. Furthermore, the application of CFC-legislation will often require that certain participation or control requirements are met, e.g. that domestic taxpayers have a substantial influence over the foreign entity in form of control or ownership or both. The degree of domestic taxpayers' interest/control/ownership in/over the foreign corporation required for the establishment of a CFC varies between different regimes. There could be certain minimum ownership requirements and/or required that domestic ownership is concentrated within a group. Many CFC regimes include indirect participation and constructive ownership provisions in order to prevent the circumvention of the control requirement. The determination of control is not necessarily coinciding with the determination of which domestic taxpayers to whom income of the CFC is attributed (it could be all shareholders in the CFC or only those shareholders that hold a minimum percentage of shares in the CFC). IFA (2013) pp. 29-33. OECD (1996) Chapter III, A and D.

¹⁴⁷ Holmes (2007) pp.15 and 370. Zimmer (2009)a) p.44, Fundamentals of International Tax Planning (2007) pp.212-213, Viherkenttä (1991) p.76, IFA (2013) pp. 24 and 29, Easson (1999) p. 79.

come. Taxation of unremitted foreign income is enabled under CFC legislation.¹⁴⁸ The benefit of deferral would then be eliminated for the profits covered by the CFC legislation.

6.2 Topic

The overall question addressed here is whether CFC legislation can be used as a preventive measure against the various tax planning arrangements under tax holiday regimes (as described in chapter 4).

In the Action Plan, OECD acknowledges that CFC rules have had a preventive effect on such profit shifting arrangements, but at the same time it is emphasised that existing CFC regimes should be *strengthened* in order to counter such BEPS concerns in a more comprehensive manner.¹⁴⁹

If CFC rules are applicable on the arrangements described in chapter 3 and the enforcement is effective, they would eliminate the tax deferral benefit in cases where profit is retained in foreign tax holiday subsidiaries. This would reduce the possibility of sheltering income from taxation in a tax holiday company and could thus reduce MNEs' incentive to abuse tax holidays in their attempt to avoid tax in their residence countries. Hence, if CFC rules are effective they will protect the residence country (of the parent company) from losing domestic revenue. If the income derived by the tax holiday is subject to current residence taxation, this could also prevent tax base erosion in other countries where the MNE operates (since the incentive to shift income from other companies in the MNE to the tax holiday company would be reduced when the income not would benefit from the tax exemption under the tax holiday).

¹⁴⁸ Deferral is ordinarily a by-product of the fundamental tax principles that a foreign company is a separate taxable entity and (usually considered non-resident for tax purposes) and of not taxing the foreign source income of foreign companies. Hence, there would normally not be explicit rules providing for deferral. However, since current residence taxation of income derived by a non-resident company would be in breach with the fundamental separate corporate personality fiction (i.e. could be seen as "piercing the corporate veil") it would be necessary with special provisions where deferral is not to be applied. CFC-legislation constitutes such rules. Viherkenttä (1991) p75, OECD (1996) p.20.

¹⁴⁹ OECD (2013)b) p.16. The strengthening of CFC rules is set as Action 3, in the OECD Action Plan.

CFC legislations will often have a definition of a “target territory” and a definition of “attributed income”.¹⁵⁰ In order to effectively counter the BEPS concerns about tax holidays, CFC rules would have to be applicable in situations where the CFC is established in a developing country that offers tax holidays. In addition the regime would have to apply on the type of income typically shifted to the tax holiday company under various profit shifting arrangements.

Some CFC regimes are limited to specific designated jurisdictions, i.e. “target territories”. The first question addressed in the following is thus whether a developing country¹⁵¹ that offers tax holidays would be regarded a “target territory” under such CFC regimes c.f. chapter 6.4. This question is especially relevant when the developing country in question has relatively high/normal corporate tax rates under its benchmark system (as compared to the residence country of the shareholders), since such “target territory” definitions usually denote low-tax jurisdictions.

Even if the CFC regime generally is applicable to a tax holiday company established in a developing country (e.g. in situations where the developing country offering the tax holiday is regarded as a “target territory”, or in relation to CFC regimes with no target jurisdictions defined), the application of CFC rules are often limited to specific categories of income. Another question is thus whether CFC regimes would apply on the type of income typically shifted to a tax holiday company (as described in chapter 3-4), c.f. chapter 6.5. The type(s) of CFC income that is attributed to the shareholders under the CFC-regimes is often referred to as “tainted income”, and this term will be used in the following.

¹⁵⁰ OECD (1996) pp.40-43 and 45-54.

¹⁵¹ This thesis is concerned with tax holidays given in developing countries, but the following analysis would, to some extent, be relevant also in situations where the country offering the tax holiday is not a developing country. However, when the country in question is a developing country, specific third world policy issues could impact how the tax system of capital exporting countries is designed. Such third world policy issues are addressed in part III. The discussion in chapter 6 will deal with tax holidays given in non-developing countries only in so far as the CFC legislation in question does not distinguish between developing and non-developing countries in their application of the CFC rules.

The scope of various CFC regimes will usually be influenced by the policy objectives that the legislation is meant to fulfil. Before addressing the main questions regarding the applicability of CFC rules, an overview of the main objectives behind such legislation will be provided.

6.3 Objectives of CFC legislation

CFC legislation today is generally regarded as anti-avoidance legislation with the objective of protecting domestic tax bases against profit shifting (typically of passive income) to low-tax jurisdictions (which otherwise could be possible under the separate corporate fiction, c.f. section 3.1.3.).¹⁵² The emergence of large multinational taxpayers and their increased possibilities to shift profits internationally, combined with preferential tax regimes, has prompted the adoption of such legislation.¹⁵³

The original objective behind the US CFC regime, proposed in 1961 (“Subpart F”) was to prevent tax deferral, but this proposal met resistance in Congress as it was argued that a total elimination of deferral would severely reduce the global competitiveness of US MNEs. As a result, the proposed legislation was considerably narrowed, and the codification of the Subpart F rules in 1962 constituted a compromise between a complete elimination of deferral and prevention against offshore profit shifting.¹⁵⁴

A complete elimination of deferral could be used to establish capital export neutrality (CEN). However, the original objective behind the US proposal of a complete elimination of deferral does not seem to be applied in any other CFC regimes today¹⁵⁵, except perhaps in the Brazil-

¹⁵² IFA (2013) p.26, OECD (1996) p.11, Fundamentals of International Tax Planning (2007) p.213.

¹⁵³ The removal of barriers to capital movement, e.g. a deregulation of foreign exchange controls (making it easier for multinationals to transfer capital across-borders), has been a relevant factor for the introduction of CFC legislation, e.g. in South Korea, Sweden and Norway. IFA (2013) p.28.

¹⁵⁴ IFA (2013) pp. 783-784.

¹⁵⁵ A policy of pure capital export neutrality was pursued under the previous CFC regime in New Zealand (up to 2009) which was intended to eliminate deferral with respect to all forms of foreign investment and applied to all income (both passive and active) of CFCs wherever located (not restricted to low-tax jurisdictions) and whatever their business activities or motives of the establishment. The only limitation was a very short white list of high-tax countries to which the regime did not apply. From 2009 the regime was narrowed, and today

ian CFC legislation.¹⁵⁶ If the objective of a CFC regime is to establish CEN, it should have a more general application than the typical CFC regimes have today (which usually only apply in limited situations, e.g. requirements on control and low or no taxation, and usually only to certain specified types of income).

Even if economic arguments based on fiscal neutrality could be used to justify employing CFC legislation (c.f. section 7.3.2.), the general justification for most CFC regimes is rather to protect the domestic corporate tax base and prevent tax avoidance.¹⁵⁷

The objectives behind a CFC regime are not necessarily constant and they could change and develop over time in adaptation to changes in the country's general tax system. Changes in the general tax system could also trigger the initial employment of CFC legislation. A shift from the territorial principle to a residence-based worldwide taxation principle may be an incentive for a country to introduce CFC legislation, as was the case in South Africa (2001) and Israel (2003).¹⁵⁸ In these situations, it could be argued that the rationale behind the CFC legislation was created by a change in the general tax system.

In a country adhering to the territorial principle for taxation, CFC legislation might seem unnecessary. Under strict territoriality all foreign source income would be exempted from tax in the country, and a country's strong adherence to this principle could imply that CFC legislation not should be applied.¹⁵⁹ However, erosion of the domestic tax base might be a concern

it mainly applies to passive CFC income (but still not limited to low-tax entities). IFA (2013) pp.532-537, OECD (1996) p.25.

¹⁵⁶ Brazil is an example of a country with a much wider scope than the average and its CFC rule does not follow international standards as it is targeting both active and passive income and not stipulating any minimum taxation threshold. The Brazilian CFC regime can be said to consist of a specific anti-deferral rule rather than being a typical CFC rule. The CFC regime is aimed at increasing the federal revenues more than preventing tax avoidance. The Brazilian CFC regime is, however, unique in the international tax scene and not a typical CFC regime. Due to its lack of an abuse element the Brazilian CFC regime has been criticized by scholars and it has recently been under challenge in the Brazilian Supreme Court. IFA (2013) pp. 159-180 (especially section.3).

¹⁵⁷ IFA (2013) pp. 19, 25-29.

¹⁵⁸ IFA (2013) pp. 25, 386 and 661.

¹⁵⁹ Viherkenttä (1991) p.50, OECD (1996) p. 11.

in such countries as well, e.g. when mobile income stemming from activities carried out in the country is shifted out of the jurisdiction. Hence, even if a country in principle adheres to the territoriality principle, it would nevertheless be interested in protecting its tax base from the shifting of otherwise taxable income to a foreign low-taxed entity.¹⁶⁰ France, for example, applies the territoriality principle for taxation, and French corporations are, in principle, only liable to tax on income derived from enterprises operating in France. However, France also has a CFC regime, under which profits made by a CFC benefitting from a privileged tax regime in its country of residence (a foreign country) are subject to tax in France.¹⁶¹

6.4 Various “target territory” definitions

6.4.1 Introduction

Under some CFC regimes the legislation will only apply if the CFC in question is resident in certain designated jurisdictions (the so-called “jurisdictional approach”).¹⁶² Under such CFC

¹⁶⁰ IFA (2013) p.21.

¹⁶¹ IFA (2013) p. 299-319.

¹⁶² OECD (1996) pp.20 and 46. Roughly, a main distinction can be made between CFC regimes that only apply to particular jurisdictions (the jurisdictional approach) typically low-tax jurisdictions, and CFC regimes which apply to CFCs regardless of where they reside as long as the CFC derives particular types of “tainted” income (a transactional approach). The first approach concentrates mainly on the location of the CFC while the latter concentrates on the nature of the income derived by the CFC (and could apply regardless of the foreign tax paid). In its pure form, the jurisdictional approach would apply to all income of a CFC in a designated target territory. Under a pure transactional approach, all tainted income (typically passive income) would be attributed to the domestic shareholders (which are subject to the application of the regime) regardless of the residence country of the CFC. However, few countries operate either approach in its pure form and in practice each approach is modified to incorporate aspects of the other. For example, both the US and the UK apply the transactional approach, but both regimes employ a comparative rate test to exempt certain CFCs. In the U.S, a high-tax kick out is included in the definition of the tainted income (i.e. in the definition of foreign base company income) under which income that is subject to an effective tax rate greater than 90 % of the maximum US corporate tax rate (35%) will be exempted from CFC taxation. Similarly, the UK CFC regime provides an exemption from CFC taxation if the profits of the CFC are taxed with at least 75 % of the amount of UK corporation tax, c.f. IFA (2013) pp.36-37. There are, however, examples of CFC-regimes that apply irrespective of the foreign tax levied i.e. apply a pure transactional approach, e.g. the CFC-regime in Brazil, Canada, Denmark, and New Zealand does not stipulate any minimum tax rate. IFA

regimes the legislation can include a definition of what constitutes a “target territory” or the targeted territories may be specifically designated.¹⁶³

A “target territory” under such CFC regimes will typically be low-tax jurisdictions or classical tax havens. A country offering tax holidays is not necessarily a tax haven in the classic sense. Nor would the country necessarily be regarded a low-tax country when the standard tax rates under its benchmark tax system is relatively normal (as compared to the country applying the CFC legislation) c.f. section 2.1.1. An interesting question is thus whether the “target territory” definition would take special tax incentives, like a tax holiday, into account.

There are several alternatives for identifying a target territory. However, two principal methods (with some variation) could be distinguished, namely the “designated-jurisdiction approach” and the “comparable tax approach”.¹⁶⁴ A CFC regime will often have features of both of these approaches and a “designated jurisdiction” approach will seldom be used on its own but rather in some sort of conjunction with a general definition of a target territory. In order to illustrate the differences between these main methods it is, however, useful to look at how they apply in their pure form.

In the next subchapters the main “target territory” definitions will be addressed with a special focus on how these affect how CFC rules are application to tax holiday CFCs in developing countries where the benchmark tax rate is relatively normal.

6.4.2 The designated jurisdictions approach

Under a pure “designated jurisdiction” approach, the application of the CFC regime is restricted to explicitly identified jurisdictions. Under this approach, the target territories for the CFC regime will often be explicitly identified in designated lists of countries either excluded

(2013) pp. 172, 190, 269, 535. Both approaches tend to reach similar results, largely through either the exemption of either certain locations within the transactional approach (e.g. because of “acceptable” tax rates), or the exemption of certain CFCs where the jurisdiction approach is used.

¹⁶³ Easson (1999) p.80.

¹⁶⁴ OECD (1996) pp.40-45. Fundamentals of International Tax Planning (2007) p.213. IFA (2013) p.29.

from the legislation because they have acceptable tax levels (a “white list”) or included under the legislation because they have unacceptable tax levels (a “black list”).¹⁶⁵

If the CFC regime is based exclusively on white and black lists, the developing country would only be regarded as a target territory if it is enlisted on a black list (or excluded from a white list). However, the designated jurisdiction approach could also be quite sophisticated. The lists need not be made on an all-or-nothing basis and could take special incentives (and similar exemptions from the general tax system in the foreign country) into account.¹⁶⁶

A CFC regime will rarely be based exclusively on a list of designated countries.¹⁶⁷ Even if a country operates with white and black lists, this is often used to supplement a “comparable tax” approach c.f. section 6.4.3. The lists would then be of a more administrative character and only provide a presumption as to the general status of the particular countries listed (i.e. “grey” lists).¹⁶⁸

6.4.3 The comparable tax approach

6.4.3.1 Various alternatives used for the comparison

Under the “comparable tax” approach, the application of the CFC regime will be based on a stipulation of a specific threshold of what constitutes low taxation. The host country of the CFC in question would be regarded as a “target territory” under such CFC regimes if the tax rates applied in this host country fail to meet this threshold.¹⁶⁹

¹⁶⁵ OECD (1996) pp. 40-45, Fundamentals of International Tax Planning (2007) p.213. Holmes (2007) p.15, IFA (2013) pp.36-38.

¹⁶⁶ OECD (1996) p.45.

¹⁶⁷ IFA (2013) p.108. Under the Australian CFC regime for example a legislative white list of seven closely comparable tax countries is the only target territory definition used, so that all countries not on the list are potential targets for the CFC regime (if they derive “tainted income”). However, even if a country is included in the white list certain income of a CFC located in such country will be subject to CFC taxation if the income benefits from a preferential tax regime.

¹⁶⁸ OECD (1996) pp.43-45.

¹⁶⁹ OECD (1996) p.41.

The choice of what to use as the basis for the comparison can be critical for the question of whether CFC regimes would be effective in countering tax-planning arrangements under tax holiday regimes. Whether such CFC regimes are applicable on a tax holiday subsidiary would mainly depend on whether specific incentives are taken into consideration under the comparison or not. The main focus here is on developing countries that offer tax holidays while at the same time applying relatively normal tax rates under their benchmark system (c.f. section 2.1.1). The question is thus whether special tax incentives, such as tax holidays, are taken into account under the main variants of the comparable tax approach. A relevant issue in this regard is whether the developing country could affect the result by the way the tax holiday is designed and applied (possibly in collaboration with the investor).

The determination of what constitutes a low-tax jurisdiction will usually be made with some reference to the level of taxation in the country applying the CFC legislation, but it can also be a fixed minimum rate. The CFC regime will apply to any country where the tax imposed on the CFC is less than a specified tax rate or less than a specified percentage of the tax hypothetically payable had the CFC been resident in the residence country (the country applying the CFC regime).

The specified rate chosen for the comparison can generally take three main forms: a) a *nominal tax rate* (i.e. statutory); b) the *effective average tax rates*; or c) the *actual foreign tax paid*. The last choice of comparison is the most frequently applied among countries that use a comparable tax approach as this determines the exact benefit the foreign company has derived from being located in a particular foreign country.¹⁷⁰

6.4.3.2 A comparison based on the nominal tax rates

If the comparable tax approach is based solely on *nominal tax rates*, the CFC regime will only apply to CFCs located in countries where the *statutory* tax rates are below a pre-stipulated threshold. A comparison based on the statutory tax rates will make the CFC rules easy to ad-

¹⁷⁰ OECD (1996) pp.42-43. Fundamentals of International Tax Planning (2007) p.213. IFA (2013) pp.29 and 36.

minister but they will usually not be applicable to CFCs offered a tax holiday in a relatively high/normal tax country.¹⁷¹

However, a comparison based on nominal tax rates does not necessarily have to refer only to the standard nominal corporate tax rates in the host country. The comparison could also include statutory tax concessions applied to the type of CFC in question. Under such prerequisites, a tax holiday company could be subjected to the CFC legislation. Nonetheless, this would usually require that the eligibility criteria for tax holidays are specified in the legislation of the host country (and, in addition, that the tax holiday would be given automatically when the prescribed conditions are met). If the tax holiday is given discretionally, e.g. in a concession agreement between the investor and the host country, the application of the CFC regime could be circumvented. Hence, CFC regimes based on a comparison between the nominal rates would hardly be an effective prevention against the profit shifting arrangements described above (in chapter 4).

CFC regimes rarely use nominal rates as the sole basis for the comparison under the comparable tax approach.¹⁷²

6.4.3.3 A comparison based on the effective average tax rates

Another alternative under the comparative tax approach is to base the comparison on *average effective tax rates*. “Average” in this context means the average level of effective taxation applied in the two countries (on all companies in general or the type of companies comparable to the CFC, i.e. not on the particular CFC in question c.f. section 6.4.3.4).

Whether such CFC regimes will be applicable to a CFC granted a tax holiday in the host country (when the host country has relatively normal standard tax rates in the absence of the tax incentives c.f. section 2.1) will mainly depend on how the average effective tax rates are

¹⁷¹ The fact that some countries have high tax rates while several types of income are subject to low taxation was highlighted in the preparatory works to the Norwegian CFC rules as an argument against basing the comparison on statutory tax rates since this was argued to make the rules ineffective. Ot.prp.nr.16 (1991-1992) pp.78-80.

¹⁷² OECD (1996) p.42.

calculated and the basis for comparison. This is due to one of the inherent characteristics of tax incentives, i.e. their targeting. Unlike general tax measures, tax incentives are selective in their application and only certain types of investment and/or specified investors are eligible to receive the preferential tax treatment under a tax holiday.¹⁷³ Hence, even if some companies are granted a tax holiday, the average effective corporate income tax rates in the country will not necessarily reflect this. Depending on the calculation of the average effective tax rates, the design and application of the tax holiday in the foreign country could also impact the application of the CFC regime.

The following analysis will be based on the Norwegian CFC regime, as Norway is one of few countries that base their comparable tax approach on average effective tax rates.¹⁷⁴ The goal here is not to give a comprehensive presentation of the Norwegian regime, but rather to illustrate how an average effective tax rate comparison can affect the application of CFC regimes when the country (where the CFC is established) offers tax holidays to designated investors but otherwise has relatively high tax rates under its benchmark system. However, some detail is necessary since the nuances in the legislation could affect the CFC regime's applicability on tax holiday CFCs.

The Norwegian CFC legislation is based on a jurisdictional approach in the sense that it only applies to entities located in target territories. Target territories are defined as jurisdictions considered low-tax countries cf. the Norwegian Tax Act (NTA) section 10-60.

A "low-tax country" is defined in NTA section.10-63¹⁷⁵ as a country in which the general income tax levied on the company constitutes less than two-thirds of the tax that the CFC would have been levied if it had been resident in Norway for tax purposes.

The preparatory works emphasizes that the low-tax country assessment should be based on a general comparison of the difference in the level of ordinary effective income tax in Norway

¹⁷³ Easson (2004) p.105.

¹⁷⁴ IFA (2013).

¹⁷⁵ NTA s.10-63: "Som lavskattland regnes land hvor den alminnelige inntektsskatt på selskapet eller innretningens samlede overskudd utgjør mindre enn to tredjedeler av den skatten selskapet eller innretningen ville ha blitt ilignet dersom det/den hadde vært hjemmehørende i Norge."

and in the other State for this type of company.¹⁷⁶ It is further specified that if the foreign company in a single year pays a tax which is less than two-thirds of the Norwegian equivalent, this will not be decisive for the low-tax country assessment. Accordingly, the comparison of the level of taxation should be based on an assessment of the average effective income tax rates, for companies similar to the CFC, in the two States over a period of more than one year.¹⁷⁷

This clarification in the preparatory works has been followed up in case law, by the tax authorities, and in legal theory. Important guidelines for the low-tax assessment can be found in the “Cermaq-case” from 2006 (Court of Appeal)¹⁷⁸, which has been followed up in later cases, most recently in a judgment of the Supreme Court in 2014, the “Aban-case”.¹⁷⁹ In the Cermaq-case, the Court referred to the preparatory works and stated that low-tax assessment should not be based on the specific company's individual tax position. Rather, it should be based on a more general comparison of the difference in the level of ordinary income in Norway and the foreign country, adjusted to the particular type of company and industry.

¹⁷⁶ Ot.prp.nr.16 (1991-1992) p.79: “Det må i stedet foretas en mer generell sammenligning av forskjellen i nivået på den alminnelige inntektsskatt i Norge og i den annen stat for denne typen selskaper.”

¹⁷⁷ Ot.prp.nr.16 (1991-1992) pp. 79 and 154. Similarly in Ot.prp.nr.1 (2004-05) p.65, and Ot.prp.nr.1 (2007-2008) p.56. The preparatory works specify that it is not the *actual* tax difference for the individual company in each fiscal year that is central for the “low-tax country” evaluation, and thus no specific tax calculation is required.

¹⁷⁸ Borgarting lagmannsretts dom av 21.august 2006, Utv.2006 s.1151. In the Cermaq case, the question was whether the Norwegian shareholders of a Chilean company in the fish food and fish farming industry would be subject to CFC taxation. This was dependent on whether Chile should be considered a “low-tax country” or not, and the Court started with a general clarification of how this assessment should be made. With reference to the preparatory works, the Court emphasized that the assessment should be based on a comparison between the average effective income tax rates in Norway and Chile. However, the court further stated that conditions that may be of importance in the assessment of the effective tax rate, but which must be attributed to individual and not industry-related conditions, should, in principle, not be taken into consideration. This could suggest that a tax holiday granted to certain types of businesses, sectors, activities or income usually will be taken into account when calculating the effective average tax rates under the Norwegian CFC regime. However, tax incentives given only to a few investors in a specific sector would not necessarily be taken into consideration.

¹⁷⁹ Rt.2014 s.196. The issue in the case was the participation exemption method in NTA section 2-38 (3) a, but the provision refers to NTA section 10-63 and the same low-tax assessment is made under the two provisions.

When a comparable tax approach is based on the effective average tax rates, a relevant question in relation to tax holidays is whether the estimate of the average effective rates is based on all companies operating in the foreign country or if it is limited to companies engaged in the same sector/industry/activities as the CFC. The basis for the comparison (i.e. which companies that are included in the average) would be crucial for the applicability of CFC rules to a tax holiday subsidiary established in a country where the standard corporate tax rate otherwise is relatively high.

For example, with a Norwegian corporate tax rate of 27 %, the threshold of two-thirds under the Norwegian CFC regime will be met if the effective average corporate income tax in the CFC's residence country is at least 18 % (two-thirds of 27 %). If we assume that the residence country of the CFC has relatively high corporate tax rates under their benchmark system, e.g. a corporate tax rate of 30%, like in Nigeria¹⁸⁰, and a tax holiday is given only to foreign companies operating in a few specified sectors/industries, the average effective tax rate on corporate income in this country (when taking all companies operating in the country into consideration and not just the ones qualifying for the tax incentive) will very likely be higher than the low-tax threshold (18% if the parent company is Norwegian) even if the particular CFC actually qualifies for a tax holiday and enjoys an effective tax rate of 0%.

In order for the CFC regime to be applicable on tax holiday companies (established in a country with relatively high corporate tax rates), the calculation of average effective tax rates used under the comparable tax approach should at least be based on the host country's tax treatment of companies similar to the CFC, i.e. companies operating in the same sector and industry and performing the same activities as the CFC in question (because tax incentives often are given to the same types of companies/investments). To ensure that the rules are even more effective the comparison could alternatively be based on the average effective tax rates applied to companies benefitting from tax holidays (or other specific tax incentives) in the host country.

If the assessment of the average effective tax rates under the low-tax definition is adapted to the particular type of companies similar to the CFC, the host country will be more likely to fall under the low-tax definition. If the calculation of average effective tax rates are based on companies operating in the same sector/industry/region as the CFC, and to companies that

¹⁸⁰ KPMG, Corporate tax rates table.

perform similar activities as the CFC, it is likely that special tax incentives will be taken into account under the calculation, at least if the tax holiday is granted automatically to all companies that meet certain conditions.

Tax holidays (as well as other tax incentives) can be specified in the host country's legislation and offered automatically to any investments that fall under the scope of the provisions.¹⁸¹ The preconditions for the incentive would then typically be specified in the legislative material in the country (e.g. by listing which specific regions/designated geographical areas or industries/sectors qualify for the tax holiday and what kind of companies and activities are eligible for the beneficial tax treatment).

However, the granting of incentives can be left to the discretion of the respective authorities and be granted either by application or after negotiations between the foreign investor and the host country (e.g. as a part of a broad concession agreement).¹⁸² And even if the incentive is specified in the legislation, it can, in these cases too, be available only after prior approval by the authorities (and perhaps under certain conditions and contingent upon the fulfilment of certain requirements). A common feature of tax incentives offered by developing countries is that the margin of discretion available to the respective authorities often is wide. The authorities can usually exercise considerable discretion in granting a tax holiday, especially in the case of concession agreements.¹⁸³

In the case of discretionary tax holidays, it is not that obvious that the CFC regime in the residence country of the investor will apply to the CFC offered such special tax treatment. Under a concession agreement, for example, various requirements and conditions can be set for the granting of a tax holiday and the design and application of the tax holiday can thus vary from one investor to another. The differences in the application of the discretionary powers of the authorities may easily lead to huge differences in the tax treatment of similar investors, and the legislative material of a country can thus give a misleading picture of a country's invest-

¹⁸¹ Viherkenettä (1991) p. 16. Easson (2004) p.162.

¹⁸² Viherkenttä (1991) p.16.

¹⁸³ Viherkenttä (1991) p.20.

ment policy.¹⁸⁴ The individual CFC can be given a tax treatment quite distinct from similar types of companies, even when they operate in the same industry and region, and perform similar activities. Hence, even if the comparison under the CFC regime is based on the average effective tax rate that apply to companies *similar* to the CFC, this may not reflect the real tax treatment of the individual CFC. Average effective tax rates will perhaps in these cases not be able to provide an accurate picture of the taxation of the specific CFC.

This may indicate that discretionary applied tax holidays can more easily escape the scope of capital exporting countries' CFC regimes (when they use a comparable tax approach based on the average effective tax rates). If a CFC is granted a tax holiday based on a specific application and under certain requirements and conditions set by the authorities, it is possible that this special tax treatment not will be taken into consideration under an average effective tax rate assessment. This outcome is perhaps even more obvious if a tax holiday is granted in a concession agreement between the foreign investor and the host country, for example, one in which taxation is just one of several issues negotiated and possibly a trade-off for other aspects (e.g. in exchange for the undertaking of developing the infrastructure, use local resources, or other performance requirements).

The question of whether the "low-tax country" assessment should take specific tax incentives into consideration has occurred in Norwegian administrative practice, e.g. in decision 2009-082KV. In this case, the question was whether Egypt should be considered a "low-tax country" because the company in question was offered a reduced tax rate in Egypt. Under this tax incentive the company was offered a reduction in the tax rate (from 20 to 10%) for a five-year period. The tax administration concluded that this incentive not should be included in the basis for the comparison. Egypt was thus not considered a "low-tax country" in this situation. There were, however, several factors in this case that led to this conclusion: The incentive was granted as a response to recessions in the economy with the objective of strengthening and rebuilding the domestic business. The incentive was only granted by specific application and only given to a few companies. Furthermore, the tax reduction was only given for a short time period, and the eligibility was dependent on several strict requirements and conditions (e.g. the company had to build a new factory, significantly increase and develop the production capacity, hire several new employees, increase the share capital, and implement environmental protection measures). The tax authorities stated in the case that the outcome would be the opposite as regards "normal" tax holidays in Egypt, i.e. tax reductions that applied more generally in certain economic zones/geographic

¹⁸⁴ Viherkenttä (1991) p.20.

areas (and where qualifying companies not would have to offer any favors in return (such as an increase in the production), and would normally apply to a larger group of companies or more types of business operations.¹⁸⁵

A CFC regime based on the comparable tax approach using average effective tax rates as a basis for comparison will not necessarily be effective in countering the tax planning arrangements under a tax holiday regime. This will of course depend both on how the tax holiday is designed and applied and on how the average effective tax level is calculated.

6.4.3.4 A comparison based on the actual foreign tax paid

CFC regimes that apply the comparable tax approach usually base the comparison between domestic versus foreign tax on the *actual* foreign tax paid by a particular CFC (i.e. the effective tax rate levied, in the host country, on the CFC in question).¹⁸⁶ Under this method the focus is on a *particular* CFC and the benefit derived from it being based in an exact country. The actual tax impost on each individual company would then be established.

Under this approach the country could either specify an effective (minimum) rate of foreign tax (as is done in e.g. Japan¹⁸⁷ and Germany¹⁸⁸) or set a threshold based on a percentage of the domestic tax payable had the CFC been resident in the country applying the CFC rules (this is the method used in France¹⁸⁹ and Sweden¹⁹⁰ for example). If the actual foreign tax paid on the income by the CFC is less than this prescribed rate the CFC regime would then apply.

Under this approach, it is wholly possible for the CFC regime to apply to a CFC in a high-tax jurisdiction (a country with a relatively high effective tax level) if the system of relief or exemptions (e.g. under a tax holiday) in the host country would result in a low effective tax rate

¹⁸⁵ This case is referred in *Praktisk internasjonal skatterett og internprising* (2013), pp.260-261.

¹⁸⁶ IFA (2013) p. 36. OECD (1996) p.42.

¹⁸⁷ The actual effective tax paid is calculated by taking the amount of tax imposed on the income of the foreign affiliate in the fiscal year and dividing this by the amount of income of the foreign affiliate in the fiscal year.

¹⁸⁸ The German CFC regime applies if the passive (see chapter 8.3) income of a CFC is subject to an effective tax burden of less than 25%. IFA (2013) p.332.

¹⁸⁹ IFA (2013) pp. 299-319 (especially section 4.4).

¹⁹⁰ IFA (2013) pp.703-722.

for the specific CFC in question.¹⁹¹ A comparison based on the *actual* foreign tax paid would normally be the most effective way of designing a CFC regime in order to ensure applicability to CFCs offered a tax holiday in a developing country with relatively normal standard tax rates as compared to the residence country. Such CFC regimes *would* take special tax incentives into considerations as this method determines the exact benefit the CFC has derived from being established in the particular foreign country (i.e. been granted the tax incentive).¹⁹²

When the comparison under the comparable tax approach is based on the actual foreign tax paid, a CFC benefitting from a tax holiday will normally fall under this “target territory” definition. CFC regimes that apply this alternative will thus often be effective in preventing profit shifting to a foreign tax holiday company.

6.5 Are CFC regimes applicable to income shifted to tax holiday companies?

6.5.1 Introduction

The application of CFC rules is often dependent on the nature of the income derived by the tax holiday CFC. Most CFC regimes will only apply to certain categories of income earned by the CFC, namely so-called “tainted income”. The CFC legislation would then need to define the type of income attributable to domestic shareholders.¹⁹³ The question addressed in this chapter is whether the type of income typically shifted to tax holiday companies (e.g. under the tax planning techniques described in chapter 4) will fall under the scope of various CFC regimes’ “tainted income” definitions.

A tax planning arrangement under tax holiday regimes will usually include a transfer/shift of mobile forms of income, i.e. income that easily can be diverted to foreign entities subject to low or no residence taxation. In order for CFC rules to counter profit shifting to foreign tax holiday companies, the CFC regimes have to cover income typically derived from highly mobile investments (and which can be easily shifted to low-tax jurisdictions).

¹⁹¹ Russo (2007) p.213.

¹⁹² OECD (1996) p.42.

¹⁹³ OECD (1996) p.45. IFA (2013) p.34.

There are generally two primary methods for determining what income is subject to attribution – the transactional approach (c.f. section 6.5.2) and the entity approach (c.f. section 6.5.3). In the former, only tainted income is attributed to the resident shareholders of the CFC, whereas in the latter, either all or none of the CFC’s income is attributable to the resident shareholders of the CFC.¹⁹⁴

6.5.2 Transactional approach

Under a transactional approach, current shareholder taxation only applies to certain categories of the CFCs income. This method concentrates on the nature of the income derived by the CFC and applies only to tainted CFC income. The relevant question in relation to profit shifting arrangements under tax holiday regimes is thus whether various tainted income definitions would include the type of income typically shifted under such arrangements.

A distinction is often made between passive and active income. Generally, CFC regimes seek to eliminate the benefit of deferral for passive income whereas active business income normally will be excluded from the regime (i.e. not is regarded as tainted income).¹⁹⁵ Passive income such as interest, portfolio dividends, royalties, and rents received by the CFC would then normally be subject to attribution. This is the most portable form of income and easily able to be transferred cross-border to foreign entities (e.g. in order to defer or avoid domestic tax). However, the meaning of passive income varies from country to country.¹⁹⁶

Under the profit shifting arrangements described in chapter 4, the income derived by the tax holiday company would usually be characterized as passive income. Under financing activities (c.f. section 4.3), or when IP rights are transferred to the tax holiday CFC (c.f. section 4.4), the income shifted to the tax holiday CFC would normally be of a passive nature, e.g.

¹⁹⁴ Fundamentals of International Tax Planning (2007) p.213.

¹⁹⁵ OECD (1996) p.46.

¹⁹⁶ OECD (1996) p.49. Passive income may be defined directly by listing the typical types of income covered, which is done in the UK (through various “gateway” provisions) and in the US (as Subpart F income), or indirectly by defining passive income in the negative as income other than a corporation’s active business income, which is done in Germany (in a conclusive catalogue of activities considered to produce active income). IFA (2013) pp. 771-775, 795-798, 333-335 respectively.

interest and royalty payments. This type of shifted profit would usually be covered by tainted income definitions. In addition, the use of artificial transfer prices (c.f. section 4.2), would often be corrected under transfer pricing rules.¹⁹⁷ Profits shifted to the tax holiday CFC under supply chain management (c.f. section 4.5), on the other hand, would often be characterised as active income, e.g. sales and service income, and would not necessarily be covered by a tainted income definition.

However, such general observations are often modified under domestic CFC legislations. Income which normally would be regarded passive could be excluded from the tainted income definition under certain conditions (c.f. section 6.5.2.1). Similarly, income which normally would be regarded as active income could fall under the tainted income definitions in some situations. Such special provisions could affect the application of the CFC rules to the profits typically shifted to the tax holiday company under the profit shifting arrangements described in chapter 4.

The modifications in the general distinction between active and passive income relates to specific nuances in the CFC legislation. In order to illustrate such modifications it is thus necessary to incorporate rather detailed examples from domestic CFC rules. The examples are mainly based on the CFC rules in three of the major important industrialized capital exporting countries that apply a transactional approach, namely the UK, the USA and Germany.¹⁹⁸ However, the attempt here is not to provide a comprehensive presentation of the CFC legislation of any country but rather to illustrate some examples that are particularly relevant in relation to the profit shifting arrangements described in chapter 4.

¹⁹⁷ However, the effect of applying an “arm’s length rule” to the transactions will only be to make sure that the market price is used, and is not an effective measure against routing of passive income. Where the transaction between the related companies is conducted on arm’s length basis, any corrections under transfer pricing rules will not be applicable. If CFC-rules also apply to related party transactions, i.e. where the income derived by the CFC is disproportionate to the amount of economic activity exercised by the CFC, such CFC legislation could be used to reinforce transfer pricing rules. However, this would require that the CFC regime applies on all types of income, active as well as passive. Otherwise it will be of limited use in this respect. IFA (2013) p.51. OECD (1996) p.11.

¹⁹⁸ The US, the UK and Germany were ranked respectively as number 5, 1 and 6 of the top 20 investor economies in 2012 in UNCTAD’s World Investment Report, 2013.

6.5.2.1 Passive income excluded from the CFC regime

Passive income under CFC legislation would generally denote interest, royalties, portfolio dividends and rents (and under some circumstances also capital gains).¹⁹⁹

One type of passive income which requires particular attention is the treatment of inter-affiliate payments of interest (c.f. section 4.3).²⁰⁰ In general, interest income is considered passive income and would usually be included in a “tainted income” definition and thus subject to CFC taxation. This is the case in Germany, for example, where interest on loans received by a CFC from a related entity always is considered passive income under the CFC regime.²⁰¹ However, such intra-group payments might be given a special treatment under some CFC regimes.

Under some CFC regimes the arrangements where a CFC is used by the MNE to finance the activities of various companies in the group could be excluded from the application of CFC legislation if the financed companies conduct legitimate business activities. All companies in an MNE are normally regarded as separate legal entities (c.f. section 3.1.3). The characterisation of payments received from one company to another, e.g. interest payments, would usually not depend on how the income is characterised in the paying company. However, under some CFC regimes the characterisation of interest income received by a CFC from a related company could depend on the use to which the lent funds are put in the related company. When the financed related company uses the borrowed funds in its *active* business, the source of the interest income would usually be the active business of the financed company. It could thus be argued that the interest received by the lender (the CFC) not should be treated as passive income.²⁰²

¹⁹⁹ OECD (1996) pp.49-54, IFA (2013) p.34.

²⁰⁰ Banks and other financial institutions where interest is the main source of business income is often also excluded from tainted income definitions under various CFC-regimes. Some minimum presence (in the host country) and/or arm’s length dealing requirements will often be attached to such exemptions. OECD (1996) p.50.

²⁰¹ Under exceptional circumstances, interest may qualify as active income under the German CFC regime but in practice interest income would be regarded as passive income. IFA (2013) p.333-336. OECD (1996) p. 51.

²⁰² OECD (1996) pp.49-52.

Under the Canadian CFC regime for example, interest received by a CFC from a related company is regarded as active business income of the CFC if the loan was used to earn active income in the related company.²⁰³ Hence, when a tax holiday subsidiary is used as an intragroup finance intermediary (c.f. section 4.3.2.) the application of CFC legislation might depend on how the loan provided from the tax holiday company is used by the lending subsidiary (S).

Under the US CFC regime there is an important exception to the general rule of inclusion for passive income earned through US CFCs.

One of the main categories of passive income (subpart F income) subject to the US CFC regime is called FPHC (Foreign Personal Holding Company Income). FPHC consists of passive income such as dividends, royalties, rents and interest. The payment of e.g. interest or royalties from one CFC to another would, in principle, be treated as taxable income for the US parent under the CFC regime. One important exception to this is the “same country exception”. When the payment to the CFC is made from i) a related entity ii) which is organized and operates in the same foreign country as the CFC and iii) the payer’s assets are used in trade or business located in the payer’s country of incorporation (which also is the country of incorporation of the related CFC), the payment would not be regarded as tainted income of the CFC.²⁰⁴ Hence, if the CFC receives interest payments from a related company organised and carrying out genuine business activities in the same country as the CFC the income would usually not be covered by the US CFC regime. Rental income or royalty income derived from

²⁰³ An exemption from the tainted income definition (passive income is defined as foreign accrual property income, “FAPI”) for interest income earned by an offshore financing affiliate of a Canadian corporation provided that the loan was used (by the borrowing affiliate) to earn active business income (and that the loan was given to another foreign affiliate of the Canadian taxpayer in which the Canadian corporation has a qualifying interest, i.e. at least 10% of the shares). In such circumstances the interest income earned by the financing affiliate is not included in the tainted income definition (FAPI income) and thus not subject to CFC taxation. Under some conditions, the interest income may also be repatriated to Canada without Canadian tax. This will thus result in double non-taxation. IFA (2013) pp.194-195. OECD (1996) pp.50-51.

²⁰⁴ OECD (1996) pp.50-51, IFA (2013) p.795.

the active conduct of trade or business may also be excluded from the tainted income definition.²⁰⁵

This exception is allegedly based on the theory that when both companies are established in the same country they would usually be subject to the same tax regime and thus have little incentive to engage in tax transactions aimed at avoiding US tax.²⁰⁶ However, this is not necessarily the case when the CFC is established in a country that offers tax holidays to certain qualifying companies. Hence, if the tax holiday company is used to finance related companies established in the same developing country (e.g. a related company not qualifying for the tax holiday and thus subject to the standard corporate income tax in the developing country) and the related company is engaged in trade or business operations in the developing country, the interest payments received by the CFC would not fall under the target territory definition under the US CFC regime. Hence, such financing arrangements (c.f. section 4.3) could, under these conditions, be used to reduce the overall tax burden of the MNE when the parent company is resident in the US.

Under the UK CFC regime, there is also an exemption for group finance companies in some circumstances (c.f. section 4.3.).²⁰⁷ The UK CFC regime includes an exception for so-called “qualifying loan relationships” (QLR), which could be exempt (either partially or fully)²⁰⁸ from CFC taxation when certain conditions are met. In order for these rules to apply, the CFC must have a physical presence in its territory of residence. A lending relationship of a CFC would qualify as a QLR when the CFC is the creditor of the loan and the ultimate debtor is a (non-UK resident) company which is controlled by the same UK resident(s) that controls the

²⁰⁵ IFA (2013) pp.795-796. The same “same country” exclusion exists for certain dividends, rents and royalties.

²⁰⁶ Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.) part II, chapter H, p.15.

²⁰⁷ Under the UK CFC regime (non-trading) finance profits derived by the CFC from lending to other members of the MNE would, in principle, be subject to CFC taxation where either the funding for the loan is provided from UK capital investment (e.g. if the UK parent company or a UK connected company subscribes for shares in, or makes any other type of capital contributions to the CFC) or to the extent that the key management functions relating to the loans and their associated risks are undertaken by UK persons. Draft HMRC guidance, Overview of CFC rules section 21, see also Draft HMRC guidance, The CFC charge gateway: Chapter 5: non-trading finance profits.

²⁰⁸ When this exception applies the general rule is that 75 % of the profits of the qualifying loan relationships of the CFC will be exempt.

CFC providing the loan. However, when the loan is given to another CFC this exception is more limited; if this financed company (another CFC) derives profits that falls under the tainted income definition (under the UK CFC regime), and if the debtor's costs with respect to the loan would reduce the amount which would be taxable under the UK CFC regime, the loan would not qualify for the exception. In addition, the loan cannot be part of arrangements which have tax avoidance purposes.²⁰⁹

Under these domestic provisions the profit shifting arrangements under inter-affiliate financing arrangements (c.f. section 4.3) could in some circumstances be possible without the interference of CFC legislation. The essence of such exceptions is that the inter-affiliate payments (of in principle passive income) are regarded active income in some circumstances. This would typically be the case when the CFC has a physical presence in the host country and the payments are made from related companies that carry out genuine business activities.

If interest payments are not covered by the tainted income definitions, it could be possible for the MNE to achieve a “double dip”, i.e. one loan (from a bank to the parent company) could give rise to two interest deductions within the group (the parent company could claim deductions for the interest paid to the bank, and the financed subsidiary could claim deductions for the interest paid to the tax holiday CFC). At the same time no tax would be paid on the intragroup transfer of funds (since the payments are received by a CFC offered an exemption from tax under a tax holiday, and the CFC regime in the parent jurisdiction does not characterise the payments as passive income, c.f. chapter 4.3.2). This is not necessarily a problem with the CFC legislation as such, but could rather be alleged to be a problem with any domestic rules that allow resident companies to deduct interest on loans used in intragroup financing. The effect under such arrangements could be reduced by implementing limitations on interest deductions (e.g. thin capitalization rules).

²⁰⁹ IFA (2013) pp.773-774, 776-77, Draft HMRC guidance, Exemptions for profits from qualifying loan relationships: Chapter 9 (see especially sections 28-29).

6.5.2.2 Tainted “active” income

When a tax holiday company is used in a supply chain arrangement as a sales or distribution centre (c.f. chapter 4.5) it would receive service or sales income. This type of income is usually regarded active income. Under certain circumstances, however, such sales or service income could fall under tainted income definitions – often referred to as “tainted base company income”.

Whether such income would be regarded tainted depends on the circumstances in which the income is derived. A primary consideration in this regard is the geographic location of the transactions, i.e. in which market the CFC derives the income (i.e. whether the transaction is made in the domestic jurisdiction where the controlling shareholders are resident, the country in which the CFC is established - in the local market - or a third market). Another consideration is the relationship between the parties of the transaction, e.g. whether the base company income is derived from related or unrelated parties.²¹⁰ When the transaction is between related parties, a relevant consideration is often whether the income derived by the CFC is disproportionate in relation to the activities it undertakes. Such tainted income definitions could thus be used to strengthen transfer pricing rules.²¹¹

Under the German CFC regime, trading activities and the providing of services are generally considered active business. However, this is not the case if the transactions are carried out with related parties, i.e. between the CFC and domestic shareholders or a party related to the shareholders. Income derived from such related-party transactions would usually be regarded as tainted income and thus subject to the CFC taxation. Nevertheless, if the taxpayer proves that, although trading with related parties, the CFC carries out a genuine and independent business operation and earns income without the participation of its controlling shareholders or other related persons, the income could be excluded from CFC taxation.²¹² Relevant factors

²¹⁰ What constitutes related parties under various CFC regimes may vary. However, when one corporation is controlled by another, or when two or more corporations are controlled by the same person, they would usually be considered related parties. A CFC would thus be considered related to its parent company and usually also to other companies in the same corporate group. OECD (1996) p.57.

²¹¹ OECD (1996) p.55, IFA (2013) pp.34-35.

²¹² OECD (1996) pp.57-58, IFA (2013) pp.333-334.

under this assessment are whether the CFC is independently managed, has a fixed place of business and sufficient employees to carry out the business.²¹³

To submit such proof would be difficult when the tax holiday CFC is used in a supply chain management arrangement where the main aim is to reduce the overall tax burden in the MNE and where the arrangements is mainly formal (i.e. the economic activities are not substantially altered). In the example in section 4.5 above the CFC is used to act as the initial buyer of finished products from a manufacturer in another country, re-sell the final products to other companies pertaining to the same corporate group, and retain the resulting profits without actually carrying out much substantial activity in the host country. The income derived by the CFC in such situations would then normally be regarded as tainted income if the parent company is resident in Germany.

The CFC regime in the US would also apply to a CFC's sales income derived from transactions with related parties when the transactions do not have a specified connection²¹⁴ to the CFC's residence country (the country of organization).²¹⁵

Under the US CFC regime, income derived by the CFC from the sale of personal property (e.g. inventory) in the *ordinary* course of its trade or business would in principle not be included in the tainted income definition (i.e. not fall within the definition of Foreign Base Company Sales Income, FBCS, which is a category of Subpart F income). However, this is not the case if the sales transaction is made between related parties²¹⁶ and the residence country of the CFC (its country of incorporation) is neither the origin nor the destination of the

²¹³ OECD (1996) p.60.

²¹⁴ The transaction would usually be considered to have a special connection to the CFC's country of organization if the products sold by the CFC are manufactured in this country or the products are sold for use in this country.

²¹⁵ Similarly, income from *services* provided by the CFC would be regarded as tainted base company income if the services are performed for, or on behalf of, a related person outside of the CFC's country of organization (e.g. outside the local market). IFA (2013) p.797.

²¹⁶ A transaction would be considered made between related parties if the CFC purchases property from a related person and sells it to an unrelated person or purchases property from an unrelated person and sells it to a related person. The same would apply when the CFC acts on behalf of a related person with respect to the purchase or sale of property and receives a commission.

goods (transactions made outside the local market). When the tax holiday is used to buy final goods from a manufacturer in another jurisdiction and then resell the goods to a related company for the use in a third jurisdiction (as described in chapter 4.5.), the U.S CFC regime would usually apply to the income retained by the tax holiday company from such transactions. When the CFC regime applies to CFC income derived from sale of personal property which is both produced outside the CFCs country of organization and distributed or sold for use outside that country, the rules will discourage MNEs from splitting the manufacturing function from the sales function (which otherwise could be done in order to shift income to the tax holiday company, c.f. chapter 4.5).²¹⁷

However, the US CFC regime provides a “manufacturing exception” which excludes income from the sale of property manufactured or produced *by the* CFC from the tainted income definition (FBCS). Under the arrangements described above in chapter 4.5 the CFC would usually not meet either of the two (alternative) physical manufacturing tests required to claim this exception, namely a substantial transformation test and a substantial activity test. However, a CFC might also qualify for the exception if the CFC makes, through its own employees, a “substantial contribution” to the products sold. A substantial contribution would include activities such as the “oversight and direction of the production of the activities or the process”.²¹⁸ This exception would allegedly be easy to claim.²¹⁹ Under certain circumstances, this exception (from the tainted income definition) could thus ensure that the arrangement described in chapter 4.5 would avoid the application of the US CFC regime.²²⁰

In some situations, trading profits derived by a CFC would also be regarded tainted income under the **UK CFC regime**. Tainted income would in general include CFC profits that are

²¹⁷ Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.) part II, chapter I, pp. 15-16.

²¹⁸ IFA (2013) pp.796-797.

²¹⁹ Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.) part II, chapter I, pp.15-16..

²²⁰ Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.) Part II, chapters H and I.

considered artificially diverted from the UK.²²¹ Hence, if the CFC's profits are linked to UK activities they would, in principle, be subject to a CFC charge.²²²

Trading income will only be excluded from the UK CFC regime if a number of (accumulative) conditions are met. The CFC would first have to meet a "business premise condition", i.e. the CFC must have a business establishment (a physical presence) in its territory of residence, from which its activities in that territory are carried out. Secondly, the CFC must meet an "income condition", which limits the extent to which the CFC's relevant trading income²²³ can arise from the UK (i.e. from UK residents or UK permanent establishments). This is to ensure that CFCs with a significant level of operations in the UK are subject to CFC taxation. Thirdly, the CFC has to meet an "export of goods condition", which limits the extent to which the CFC can generate income by exporting goods from the UK. This condition would restrict routing operations, which generates sales income for the CFC but which rely on the supply of goods from the UK. Fourthly, the CFC has to meet an "Intellectual Property (IP) condition", which limits the extent to which CFC profits can be derived from IP transferred (directly or indirectly) from related parties in the UK.²²⁴ This could limit the possibility to use cost-sharing agreements in order to shift profits between related companies. Fifthly, the CFC has to meet the "management expenditure condition", which limits the amount of management of the CFC's business that can be undertaken in the UK. In order to meet this condition, only a limited percentage (not exceeding 20%) of the overall expenditure (incurred by the CFC and

²²¹ Profits which fall within one of the "gateway" provisions under the UK CFC rules would be considered artificially diverted from the UK. Draft HMRC guidance, Overview of CFC rules.

²²² Profits earned by a CFC with respect to assets held and/or risks born, where the majority of the key management functions in relation to those assets or risks are undertaken by UK connected persons, would be considered attributable to UK activities where the arrangements giving rise to those profits wouldn't occur if the key management function undertaken in the UK were to be undertaken by third parties and where any non-fiscal benefits realised from the arrangements do not represent a substantial proportion of the overall benefits provided by the arrangements. IFA (2013) pp.771-772, Draft HMRC guidance, The CFC charge gateway: Chapter 4: Profits Attributable to UK Activities.

²²³ "Relevant trading income" does not include UK income from sale of goods produced in the CFC's residence country. Draft HMRC guidance, The CFC charge gateway: Chapter 4: Profits Attributable to UK Activities.

²²⁴ Limitations can also be found under the German CFC regime. The income derived by the tax holiday company (the CFC) from its exploitation of IP would only qualify as an active business activity if the IP is a product of the CFC's own research and development activity. IFA (2013) p. 334.

related companies) on the management or control of assets and risks²²⁵ from which the CFC's profit arises, can be incurred in relation to management functions carried out in the UK.²²⁶

In addition all these conditions for an exclusion from CFC taxation in the UK are subject to an anti-avoidance rule. Hence, even if the above conditions are met, this exclusion from the tainted income definition would not apply if the corporate group (of which the CFC in question pertains) has (re)organized a significant part of its business with a main purpose of securing that the exclusion applies.²²⁷

In general, even if a CFC is not involved in related party transactions, related persons could provide substantial assistance to the CFC in earning its sales or service income. Where such assistance is provided, the income might be subject to CFC taxation, at least in circumstances where such income could not have been earned without the assistance of the parent or a related company. Both the US, UK and the German CFC legislation includes specific rules which treat income earned by a CFC as tainted income where the assistance provided by related parties to the CFC constitutes a significant factor in the earning of the income.²²⁸ In addition, any exceptions would usually require that the CFC has a substantial and independent business operation in its country of establishment (i.e. it is independently managed, has a fixed place of business and sufficient employees to carry out its business).

6.5.3 Entity approach

Some CFC regimes apply an all-or-nothing approach when determining what income is subject to attribution. Once it is established that the CFC rules should apply to the CFC (typically based on a target territory assessment), the CFC regime is applied on all the profits of the CFC. Under such CFC regimes the attribution is not restricted to tainted types of income, and

²²⁵ E.g. expenditure in relation to any member of staff that carries out relevant management functions in the UK.

²²⁶ Draft HMRC guidance, The CFC charge gateway: Chapter 4: Profits Attributable to UK Activities, Section 74-112, IFA (2013) p.773.

²²⁷ IFA (2013) p.773, Draft HMRC guidance, The CFC charge gateway: Chapter 4: Profits Attributable to UK Activities, Section 108-112.

²²⁸ IFA (2013) pp.771-772, 797-798, OECD (1996) pp. 59-60.

the shareholder's share of the CFC's entire income is either taxed or not taxed. This all-or-nothing approach is often referred to as an "entity approach"²²⁹

There are a few countries that subject all the CFC's income to domestic shareholders once it is established that the CFC is resident in a "target territory" (unless any exemptions apply). This is, for example, the case under the French, Japanese, Norwegian and Swedish CFC regimes.²³⁰ When the entity approach is used, the legislation will often provide certain exemptions from the regime, typically if the CFC in question is engaged primarily in genuine business activities (typically commercial or industrial activities).²³¹ Whether the rules would apply on a tax holiday company would then depend on how the exemptions are designed. Any exemption would apply to the CFC itself, rather than to (parts) of its income.

Important in this context a common exemption for CFCs engaged in genuine business activities.²³² If the tax holiday CFC is regarded to be engaged primarily in genuine industrial or commercial activities this exemption would often apply, and the CFC would then be completely excluded from the CFC regime (all-or-nothing approach).²³³ In order to qualify for this exemption the type of business carried out by the CFC and the nature and extent of the CFC's presence in its country of establishment will be relevant. In addition the nature of the income derived by the CFC will often be relevant in order to claim this exemption. These criteria are similar to the features used by countries which utilise a transactional approach in defining base company income, (c.f. section 6.5.2.2).²³⁴ Hence, if the tax holiday income is derived with substantial assistance from related parties and little activity is carried out in the

²²⁹ OECD (1996) s.48, Viherkettä (1991) pp.85-86.

²³⁰ IFA (2013) pp. 308-312, 426-438, and 708-717. NTA section 10-61.

²³¹ OECD (1996) p.69. Under the French CFC regime, for example, an exemption from CFC taxation is provided for CFCs that carry out an "effective industrial and commercial activity" in the territory where the CFC is established, i.e. in the local market ("safe harbour clause"). IFA (2013) p.311.

²³² OECD (1996) pp.67-76. Other exemptions include, inter alia, exemptions for CFCs that distribute a certain percentage of their income in a year, a motive exemption for CFCs which are not established for the purpose of avoiding domestic tax, and a de minimis exemption where the total income or tainted income of the CFC, or a shareholder's pro rata share of such income, does not exceed a certain amount.

²³³ Viherkettä (1991) p.85.

²³⁴ OECD (1996) p.70.

territory where it is established (the local market) the CFC would usually not fall under the exemption (c.f.6.5.2.2).

Under the Norwegian CFC regime, for example, the regime is limited to situations where the CFC's income is *mainly* of a tainted kind (this exemption is only available for CFCs that are resident in a country with which Norway has concluded a tax treaty).²³⁵ Hence, the Norwegian CFC regime will only apply if the income derived by the CFC is of a mainly passive character, and if so, all the income of the CFC will be attributed to domestic shareholders.²³⁶

A CFC regime based on the entity approach could be prone to abuse, especially when an exemption is provided for CFCs that *mainly* derive untainted income (or *primarily* is engaged in genuine business activities). The MNE could then ensure that the portion of passive income shifted to the tax holiday CFC is just below the threshold and thus circumvent the CFC charge. The tax holiday company would normally be required (under the tax incentive regime) to carry out some genuine business activities in the host country in order to benefit from the tax holiday (e.g. if a tax holiday is granted to investment in specific sectors such as agriculture, tourism or manufacturing). If the amount of income derived from such active business would be sufficient to qualify for an exemption under the CFC regime (e.g. the exemption for CFCs engaged in genuine business activities or an exemption for CFCs that derives mainly active income), the tax holiday CFC could be used to shelter passive income without being subject to the CFC regime. For example, if the CFC only is subject to CFC taxation if it mainly derives passive income, (and "mainly" is interpreted as more than 50 per cent), passive assets of the CFC could generate 50% of the CFC's income before the CFC regime is applied. Under the entity approach all the income of the CFC would then be exempted from CFC taxation (even if 50% of the income could be regarded tainted income).

If the entity approach is used without any exemptions, the application will be solely dependent on whether the host country of the CFC is regarded as a target territory, c.f. section 6.4.

²³⁵C.f. NTA s.10-64(1) a. "Selskapet eller innretningen er omfattet av avtale Norge har inngått med annen stat til unngåelse av dobbeltbeskatning, og selskapets eller innretningens inntekter ikke *hovedsakelig er av passiv karakter*".

²³⁶ A definition of passive income is not provided in the legislation but a number of specific examples are given in the preparatory works c.f. Ot.Prp.nr.16 (1991-1992) p.155.

Hence, once it is established that host country is a target territory, the entire CFC's income will be attributed to the shareholders. An entity approach without any exemptions provided is rarely used, but some examples exist, for example in Norway (under certain conditions). For CFCs resident in a country with which Norway *doesn't* have a tax treaty (and where the CFC is established outside the EEA) the entity approach would be used without further exemptions.²³⁷ Even if Norway has an extensive tax treaty network, far from every developing country is covered.²³⁸ If the tax holiday CFC is established in a country with which Norway doesn't have a tax treaty, the entire CFC's income would be attributed to a Norwegian parent company (if the host country is regarded a "low-tax country" cf. section 6.4.3.3.). If the host country is regarded as a low-tax country, income shifted to the CFC under various profit shifting arrangements would then be covered by the Norwegian CFC rules without any further characterisation of the income.

6.6 Recap

Whether or not CFC legislation would be an effective preventive measure against profit shifting under tax holiday regimes depends on how the CFC regime is designed and applied. To what extent a country's CFC legislation would apply to the income shifted to a tax holiday CFC under various profit shifting arrangements would vary from country to country.

Whether the various target territory definitions are applicable to developing countries that offer tax holidays depends on whether special tax incentives are taken into account under the target territory definition and the associated low-tax assessments. The most common approach under target territory definitions is to apply a comparable tax approach and base the comparison on the actual foreign tax paid by the CFC in the host country (c.f. section 6.4.3.4). Since this approach would reflect the effective tax rate imposed on the CFC in question (which would be 0% under a tax holiday offering an exemption from CIT), the developing country would usually be regarded as a target territory.

²³⁷ NTA section 10-64(1)a) and b). The exemption for CFCs resident in a EEA country requires that a substance requirement is met (i.e. that the CFC is genuinely established and conducts a genuine economic activity). A similar exemption is provided under the Swedish CFC regime. IFA (2013) p.717.

²³⁸ See, Overview of General tax conventions between Norway and other States.

Whether the CFC regime will cover the type of income typically shifted to tax holiday companies will mainly depend on how tainted income is defined under the legislation. Tainted income would normally include passive income and certain types of tainted base company income, c.f. chapter 6.4. If the CFC regime includes both passive income and certain types of base company income (e.g. sales and service income derived from transactions with related parties) under their tainted income definitions, the income typically shifted to the tax holiday CFC would usually be subject to CFC taxation. This would especially be the case when the income has been artificially diverted from activities carried out in the residence country of the parent company or when the income otherwise would be perceived resulting from activities carried out by, or with substantial assistance from, related persons.

When CFC legislation applies to a tax holiday company and to the income shifted to this entity, the legislation will provide the current taxation of the resident shareholders (the parent company) on their share²³⁹ of the undistributed profits of the tax holiday company. When the income derived in the tax holiday company is subject to current taxation in the residence country of the parent company, the incentive for an MNE to shift otherwise taxable income to a foreign tax holiday subsidiary will be reduced or even removed. When such profit shifting is prevented, the CFC regime would protect the domestic tax base against erosion (at least in the residence country of the ultimate parent company).

²³⁹ The income is usually apportioned based on the proportionate interest of the resident shareholders in the CFC. OECD (1996) pp.62-65.

Part III: Intended double non-taxation

7 Intended use of tax holidays

7.1 General introduction and topic

7.1.1 The main issue and focus

The OECD BEPS project suggests that CFC rules should be strengthened. This is one of several actions in their strategy to end double non-taxation.²⁴⁰ While the application of CFC rules on foreign companies established in classical tax havens generally would be regarded as justified, this is not as obvious when the CFC benefits from a tax holiday in a developing country.

Tax holidays are not specifically dealt with in the OECD Action Plan on BEPS, and the final recommendations regarding the design of CFC rules are not expected to be finalised before September 2015.²⁴¹ If the residence country taxes their resident taxpayers on foreign CFC income on a current basis, a benefit under a tax incentive in the host country will not accrue to the investor (and indirectly not to the host country in form of increased investment) but rather to the residence country's treasury. Whether the OECD recommendations will suggest that CFC legislation should be applicable on all low- or no-tax CFCs, or whether developing countries' tax incentives should be preserved under the legislation, is uncertain. This provides an opportunity to evaluate whether CFC legislation *should* be applicable to CFC income when the CFC in question benefits from a tax incentive in a developing country.

The discussion in the following will be limited to the ordinary use of tax holidays offered in developing countries, i.e. where the tax holiday is *not* abused under MNEs' profit shifting arrangements (c.f. chapter 3.1.1). When an MNE takes advantage of a tax holiday in a developing country for purposes for which the tax incentive was intended (by the developing country employing the incentive), any resulting double non-taxation or non-taxation/deferral of the CFCs profits could be regarded as *intended* (c.f. chapter 4.1.1). In this context, it will be discussed how tax laws of the residence country *should* interact with tax holidays in developing

²⁴⁰ OECD (2013)a), and OECD (2013)b) (especially action 3).

²⁴¹ OECD (2013)b), Annex A.

countries. When the residence country applies CFC legislation and the foreign tax credit on income exempted from tax under a tax holiday in a developing country, double non-taxation would usually be eliminated. However, this would also comprise a frustration of the developing country's tax incentives.

The following discussion will be limited to *tax holidays* employed in developing countries, but the arguments may also be relevant for other tax incentives. The main focus here is on CFC legislation and tax laws applied on remitted tax holiday CFC income. Both CFC legislation, and the residence country's tax rules applied to remitted foreign income, could pose a (direct or indirect) threat to the preservation of the tax benefits provided under developing countries' tax incentives. There are various available methods of taxing foreign sourced income. However, this discussion focuses primarily on CFC legislation, the exemption method, foreign tax credit and tax sparing (c.f. section 5.2).

By extending the CFC legislation to CFCs benefitting from a tax holiday in a developing country, the benefit under the tax incentive will be ineffective as it would merely result in a shift of tax revenue from the host country to the residence country. Similarly, if the residence country tax remitted tax holiday CFC income (e.g. dividend distribution received by a resident taxpayer) the benefit under the tax holiday could also be reduced or even eliminated. By using the foreign tax credit method (c.f. section 5.2.2) on remitted CFC income, the benefit under the tax incentive would usually not be preserved. Exemption from tax in the host country under a tax holiday would then result in correspondingly higher tax in the residence country (since there would be no foreign tax to give credit for). This result could be offset by using the exemption method (c.f. section 5.2.4) or with tax sparing provisions (credit for tax that would have been paid by the tax holiday company had it not been given a tax holiday, c.f. section 5.2.3).²⁴² However, if the exemption method is used, a preservation of the benefit under the tax holiday will not necessarily be achieved if there are certain low-tax exceptions from the rules (c.f. section 5.2.4.2). The arguments for the use of tax sparing provisions, or to use the exemption method, on remitted foreign sourced income in relation to tax incentives are, to some extent, similar to the arguments against applying CFC legislation on CFCs benefitting from a tax incentive.²⁴³ However, there is a principal difference – foreign tax credit provisions etc. deal with the taxation of income that is distributed to a resident

²⁴² Zimmer (2009a) chapter.18, Holmes (2007) pp.22-34, Gjems-Onstad (2012) pp.983-988.

²⁴³ A general analysis of how alternative tax rules in capital exporting countries affect the impact that a tax concession in a developing country has upon the final tax burden of a foreign investor is given in Viherkenttä (1991).

taxpayer, i.e. the parent company, while CFC legislation also concerns the taxation of income retained in the foreign company.

Before discussing the respect (if any) that a national legislator should grant to the tax incentives of a developing country, an overview of the basic criticism against the concept of tax holidays will be provided.

7.1.2 The basic criticism against tax holidays

The policy discussion on how CFC legislation in capital exporting countries should respond to tax incentives offered to CFCs in capital importing countries is closely linked to the discussion on whether it is reasonable for developing countries to offer tax incentives at all.

The conventional view among international bodies involved with tax matters (e.g. the OECD, the World Bank and the IMF) and most academics in the tax field is that tax incentives for investment are *not* recommended.²⁴⁴ The main arguments used against tax incentives are that they usually are both ineffective and inefficient, that they cause distortions (both intended and unintended), and that they lead to a harmful tax competition.

The principal theoretic criticism against the use of tax incentives is that tax incentives are *intended* to cause distortions (of both business decisions and competition). Tax incentives represent a deviation from the benchmark tax system and they may result in an ineffective allocation of resources (e.g. by stimulating investment decisions that would not otherwise have been made).²⁴⁵

However, objections based on the distortionary effect of tax incentives could be viewed as irrelevant because this, in fact, is the purpose of offering such incentives (i.e. to distort investment decisions and influence the allocation of investment resources).²⁴⁶ The distortionary effects of tax incentives might be justified as a compensation for various market imperfections

²⁴⁴ See Easson (2004) p.63 with further references to other studies and literature. OECD (2000) *Policy Competition for Foreign Direct Investment: A study of Competition among Governments to Attract FDI*.

²⁴⁵ Easson (2004) pp.64-65.

²⁴⁶ Viherkenttä (1991) p.132

in the investment environment.²⁴⁷ When used properly, tax incentives might compensate for other deficiencies in the business environment in less developed countries or in peripheral regions within a country in order to correct market failures that might be difficult to fix. To invest in a developing country is often perceived by investors to involve a higher risk than investment in industrialised countries. It could be argued that this extra risk should be balanced with a tax reduction for investments made in such countries.²⁴⁸ Special tax incentives could be viewed as necessary to offset non-tax disadvantages, including any additional cost from investing in such areas.²⁴⁹ For unintended distortions on the other side, the objection based on the distortionary effects will be relevant.²⁵⁰

Another pragmatic objection to tax incentives is that they do not work – i.e. that they are both ineffective and inefficient. A tax incentive for investment would be considered effective if it actually resulted in investment (of the desired type) that would not have come in the absence of such incentives (incremental investment).²⁵¹ And even if the incentive is effective in actually inducing such new investment, it would only be considered efficient (cost-effective) if the cost of granting such incentives is lower than the value of the benefits that result from granting the incentives.²⁵²

To assess whether tax incentives are effective can be very difficult and several studies have been made without a consistent conclusion. The answer will vary from country to country, between different types of tax incentives, depending on how they are designed, to whom they are offered, and the type of investment they are seeking to attract. Other fundamental determinants, such as political and economic conditions, the domestic market size, and access to resources, raw materials and skilled labour are generally viewed as more relevant for a coun-

²⁴⁷ Easson (1999) p.22.

²⁴⁸ Viherkenttä (1991) p.132. On the other side, it could be argued that if the additional risks are real they should be appropriately reflected in the investment decisions under neutral tax rules.

²⁴⁹ OECD (1998) p.15.

²⁵⁰ Easson (2004) pp.65-66.

²⁵¹ Easson (1999) p.21.

²⁵² Easson (2004) pp.66-78.

try's attractiveness to foreign investors than specific incentives.²⁵³ Even if investors view potential tax incentives as a relevant factor, it is rarely a decisive factor for an investment.²⁵⁴

Tax incentives are presumably most likely to be a decisive factor for investors that have made a tentative decision to invest in a particular region and are deciding between a few similar locations where other investment factors (which influence investment performance²⁵⁵) are more or less equal.²⁵⁶ Only for those countries that have passed through the initial selection (based on an evaluation of more fundamental determinants) will tax incentives become more important for the final investment decision.²⁵⁷ If the possible host countries that the investor chooses between are all developing countries, the tax incentive will only affect the allocation of investment among developing countries and will not affect the overall inflow of capital to the region. This, again, could lead to a harmful tax competition between developing countries in the same region. Various countries in the region may then end up in bidding wars of continuously offering more extensive incentives in order to outbid other countries in the competition for investment. This could lead to "a race to the bottom" that benefits the foreign investors at the expense of the region as a group.²⁵⁸ Regardless of the disputed effectiveness and efficiency of tax holidays, this is one of the main arguments against such tax incentives.

Even if a tax incentive is effective, it is not necessarily efficient. If tax incentives are granted only to investors who would not have invested in the absence of such incentives and are ex-

²⁵³ Viherkenttä (1991) p.15, UNCTAD (2000) p.11.

²⁵⁴ In UNCTAD's World Investment Report 2013, tax incentives are listed as one of several factors that would determine a transnational corporation's choice of host country locations. Other factors listed include economic characteristics (e.g. market size, growth potential, infrastructure, labour availability and skills), the policy framework (e.g. rules governing investment behaviour, trade agreements and the intellectual property regime) and business facilitation policies (e.g. cost of doing business). UNCTAD (2013) p.144.

²⁵⁵ Easson (2004) pp.19-34 gives an analysis of various factors that usually would affect the choice of location.

²⁵⁶ The International Finance Corporation and the World Bank (2001) *Using tax incentives to compete for foreign investment - Are they worth the costs?* p.92. Easson (2004) pp.52-61.

²⁵⁷ UNCTAD (2000) p.11.

²⁵⁸ E.g. OECD (2000), OECD (2013b) pp.17-18 (Action 5), OECD (2013a) pp.28-29, The International Finance Corporation and the World Bank (2001) p. 92, OECD (1998) p.34. OECD (2011) A report to the G-20 Development Working Group by the IMF, OECD, UN and World Bank, *Supporting the Development of More Effective Tax Systems*, p.10.

actly the amount necessary to attract the desired investment (not over-generous), there will be no revenue loss from the incentives. However, this is difficult to achieve. Tax incentives would often result in a “windfall” gain for the investors that would have come even without the incentives or at less extensive incentive. This will result in revenue forgone for the developing country.²⁵⁹ This revenue loss must be paid for, e.g. by an increase in other taxes or by reducing government spending (such as education, health and infrastructure).²⁶⁰ Revenue loss resulting from tax incentives could otherwise be more effectively used for development purposes and used to improve the fundamental investment factors such as political and economic conditions.²⁶¹

To assess whether a tax incentive is efficient will be very difficult as it would require an estimate of both the costs related to the offering of such tax incentives and the benefits derived from attracting investment. The cost of tax incentives is not limited to revenue forgone but can also include costs of unintended distortions, increased administrative costs and compliance costs, and costs in the form of corruption and abuse of the incentives.²⁶²

Residence taxation of foreign-sourced income benefitting from tax incentives in developing countries, has been advocated on the grounds that this actually would benefit the developing country as such incentives are viewed as detrimental policy measures. However, this would be seen by the developing countries as a patronising position.²⁶³

²⁵⁹ The proportion of investors receiving tax privileges that would have made the same investment decisions without the inducement of the incentive is often referred to as “the redundancy rate”. Easson (2004) pp.75-76, The International Finance Corporation and the World Bank (2001), p.22.

²⁶⁰ Easson (1999) pp.20-22, Tax Law Design and Drafting (2000) pp.988-990.

²⁶¹ OECD (2007) *Tax incentives for Investment – A global Perspective: experiences in MENA and non-MENA countries*.

However, offering incentives is easier than changing more fundamental factors in a country and is often used as a “quick-fix” to the more essential underlying challenges

²⁶² The International Finance Corporation and the World Bank (2001), especially pp.21-26, Easson (2004) pp.76-77. Discretionary tax incentives have been especially criticised for fostering corruption and rent-seeking behaviour.

²⁶³ Viherkenttä (1991) p.138

Trying to determine whether or not developing countries benefit from offering tax incentives call for more empirical research to be done (and any comprehensive empirical evidence on these questions can be very difficult, if not impossible, to collect). It is not the intention here to discuss whether tax holidays should be applied or not (*lex ferenda*). Nor will it be discussed whether the policy rationale behind tax incentives, i.e. to attract FDI into the country (as this is seen to increase economic growth and development in the country), is well-founded.

The following discussion is based on the assumption that tax holidays are used by developing countries today and that developing countries see this as a rational measure in their investment and development policy. The focus here is on how the tax laws of capital exporting industrialised countries should interact with tax incentives offered in developing countries.

7.2 Various alternatives

When evaluating how CFC legislation should interact with developing countries' tax incentives, there are a variety of alternatives. However, three main alternatives can be distinguished.

One alternative is to apply CFC legislation on all the income of CFCs benefitting from a tax holiday, regardless of the nature of the income derived by the CFC and regardless of where the CFC is established (i.e. even when the incentive is offered in a developing country).²⁶⁴ All the income derived by the tax holiday company would then be taxed to the investors (the controlling shareholders) by their residence countries on a current basis, and no categorisation of the CFC income would be necessary. This would constitute a total elimination of non-taxation/deferral of CFCs' income under tax incentive regimes. The benefit under the tax holiday would then be correspondingly washed out.

A second alternative is to limit the CFC legislation to situations where the tax holiday is abused under various tax planning alternatives (c.f. section 3.1.1). If CFC legislation is in-

²⁶⁴ This is done under the Norwegian CFC-regime (as long as the CFC is not resident in a country with which Norway has a double tax treaty or in the EEA), c.f. NTA section 10-64 a), but for most countries this alternative would imply an extension of their existing CFC legislation.

tended to be a pure anti-avoidance regime, it would not be necessary to cover the income derived by the tax holiday company from its business activities under an intended use of the tax holiday. This approach is, to a greater or lesser extent, already used under most CFC regimes today, since non-taxation/deferral is maintained for income that does not fall under the scope of various “tainted income” definitions (c.f. section 6.5).

However, in order to permit the investors to receive the full benefits of the ordinary use of developing countries’ tax holidays any tainted income definition should only cover income that has been artificially shifted to the tax holiday company (i.e. in situations where the tax holiday has been abused). If the tainted income, for example, covers all passive income, this could also include income derived under the ordinary use of tax holidays. Passive income is not automatically resulting from profit shifting arrangements.²⁶⁵

If an exemption from CFC taxation should be offered to CFCs that benefit from a *tax incentive* in a *developing country*, it would be necessary to provide a definition of what constitutes a “tax incentive” and a “developing country”. Defining tax incentives could be difficult considering the variety of different incentives both in their design and their application. Establishing a definition of what constitutes a developing country could also be difficult. The residence country would presumably want to limit any exemptions from the CFC regime to developing countries that not would be regarded as classical tax havens. This could be difficult as there is not necessarily a clear dividing line between a developing country and a classical tax haven since a tax haven also can be a developing country.

A third alternative is to exclude CFCs that benefit from a tax holiday in a developing country from the CFC regime altogether. The benefit under tax incentives would then be preserved for all CFC income (at least until income is distributed or otherwise realized by the parent company). This alternative requires that the residence country of the investor tolerates profit shifting to such foreign tax holiday companies and generally accept that untaxed income can accumulate in a foreign subsidiary.

²⁶⁵ The tax holiday company could, for example, derive passive income under the ordinary use of the tax holiday, (e.g. if the tax holiday is a genuine R&D company, and generates IP, it would often receive royalty payments under its active business).

The taxation (if any) of remitted CFC income could be adjusted to how the CFC legislation is designed. The credit method could be used on all remitted income from a CFC; this would usually eliminate all double non-taxation. Or, a tax sparing credit could be offered to all or parts (e.g. the part of the income stemming from genuine business activities under the ordinary use of a tax holiday) of remitted income when the CFC has been offered a tax holiday in a developing country. Alternatively, the residence country could use the exemption method on remitted tax holiday CFC income.

Which alternative a country should choose depends on the tax policy in each country and the weight given to the various policy arguments. The overall consideration would be which objectives the country would pursue under the legislation, i.e. whether the objective is to eliminate double non-taxation in all respects or whether the legislation should be mostly concerned with the protection of the domestic tax base and function as an anti-avoidance regime (assumed that the ordinary use of tax holidays in developing countries not is regarded as avoidance).

Capital exporting countries would usually argue in favour of the application of CFC legislation and, to some extent, in favour of taxing remitted CFC income. Developing countries that offer such tax incentives would usually have the opposite opinion. Representatives from the business community could also be in favour of residence tax legislation that respects tax incentives. When designing CFC rules, the various arguments should be carefully evaluated. In the following, some of the main arguments will be further analysed.

7.3 Policy aspects

7.3.1 Introduction

The evaluation of different tax policies could be viewed in the light of fundamental principles underlying international taxation. The main objectives of international tax rules should thus be taken into account when discussing the design of CFC rules and other domestic measures that could produce similar effects. The criteria commonly used when evaluating tax policy

issues can be roughly attributed to the two fundamental tax principles of *economic efficiency* (neutrality) and *tax equity*.²⁶⁶

When discussing international taxation in relation to tax incentives offered in developing countries, arguments based only on the traditional concepts of tax equity and neutrality would be inadequate. Tax incentives are often an intended deviation from these fundamental principles and thus the principle of *national economic sovereignty* of each country could lead to modification in the traditional argumentation. The objective of encouraging investment in developing countries would also be relevant in this discussion.²⁶⁷

The various tax policy aspects will be further addressed in the following. The overriding question is whether double non-taxation *should* be eliminated in all respects when it is the result of tax incentives in developing countries.

7.3.2 Economic efficiency and neutrality

Revenue authorities and tax legislators will often try to ensure that tax does not produce unintended and distortive effects on trade and investments. The fundamental tax principle of economic efficiency implies that a country should strive to make its tax system as neutral as possible so that tax legislation does not distort the optimal allocation of resources and the choices made by economic agents.²⁶⁸

From an economic perspective the most efficient allocation of investment resources can be determined by the market rate²⁶⁹ of return on the investment. Investment decisions based on where the highest pre-tax return can be achieved is considered as the optimal choice.²⁷⁰ Rational investors will make investment decisions based on what generates the maximum return to them – resulting in the most efficient allocation of resources (from an economic point of view). Hence, under a neutral tax system²⁷¹ the tax-

²⁶⁶ E.g. Zimmer (2009a) p.34-36, Holmes (2007) pp.4-6, Viherkenttä (1991) pp.40-43.

²⁶⁷ Viherkenttä (1991) p.40.

²⁶⁸ Viherkenttä (1991) p.42, Holmes (2007) pp.4-6.

²⁶⁹ The market indicator of efficiency is the pre-tax returns, which investees are willing to offer.

²⁷⁰ Holmes (2007) p.12-13.

²⁷¹ Gjems-Onstad (2012) p.59.

payer would, *ceteris paribus*, allocate his investment resources in the most (economically) efficient way.²⁷²

The concept of neutrality will often include ambiguous arguments depending on whether the focus is on Capital Export Neutrality (CEN) or on Capital Import Neutrality (CIN). While tax legislators in a capital exporting country (typically the residence country of the investor) usually would emphasise arguments based on CEN, a capital importing country (typically the host country of the investment company) would be more concerned about CIN.²⁷³ Hence, this difference in perspective would affect how countries view the relationship between tax holidays and residence taxation.

A tax system based on CEN would imply that taxpayers should be subject to the same amount of tax regardless of where they invest. Tax factors would then not affect a domestic investor's choice between investing at home or abroad (or between two foreign countries). When some domestic taxpayers are offered a tax holiday in a foreign country, these incentives may stimulate taxpayers to act in ways that they not otherwise would do if purely economic considerations were taken into consideration. By applying CFC legislation in such situations, a domestic taxpayer will (under certain conditions) be subject to the same amount of tax on income from investments irrespective of whether the taxpayer derives the income directly (as part of his worldwide income) or diverts and retains the income to/in a foreign subsidiary (since the possibility of deferral of domestic tax is eliminated).

Similarly, if the credit method is used on remitted income, the taxpayer would be subject to the same amount of tax regardless of where the investment is made, i.e. subject to the tax rate in the residence country. CEN could thus be used as a strong argument in favour of CFC legislation, as well as an argument in favour of the credit method since tax incentives then would have less effect (or even none) on the investment decisions of an MNE. Neutrality arguments

²⁷² Neutrality is not achieved when tax issues affect the choices made by economic agents. In order to achieve the optimal allocation of resources, tax imposts on pre-tax return from investment should not distort the after-tax return on the investment as this could steer investment decisions from areas of investment where the pre-tax return is highest and into investment activities where the after-tax return is highest. Eide (2008) *Rettsøkonomi*, pp.442-449, Holmes (2007) p.4.

²⁷³ Zimmer (2009)a) pp.34-35.

based solely on CEN would thus indicate that CFC legislation should be used on unremitted CFC income that benefits from tax incentives (and that the credit method should be used if the income is remitted).

CFC taxation (as well as the credit method) is also advocated on the grounds that it will not encourage foreign investment at the cost of domestic investment and domestic jobs.²⁷⁴ By extending the CFC regime to CFCs benefitting from tax holidays, the tax system would be neutral in the sense that it would not produce a bias in favouring foreign investments over domestic investments. If foreign tax incentives and various tax planning arrangements are available, a cross-border investment will often be more favourable than an equivalent domestic investment in the residence country of the investor (even if the pre-tax return would be the same or even higher by investing domestically).²⁷⁵ According to CEN, the investment decision of an investor when deciding between making an investment domestically or abroad should not be influenced by the uneven tax impact on the post-tax returns.

The host country of the investment, on the other hand, will be more concerned about CIN and the taxation of inward investment. Capital importing countries would normally strive to achieve a system where all (similar) investments made *in* the country are subject to the same amount of tax irrespective of where the investor is resident (foreign or local).²⁷⁶ CIN would usually be an argument against the elimination of deferral, i.e. against CFC legislation. It could also be used as an argument against the foreign tax credit method used in the residence country of investors investing in the host country. According to CIN, all investors (both foreign and local) who carry out economic activities in the country should be subject to the same tax rules, i.e. the tax rules of the source country.²⁷⁷

Some countries offer tax incentives only to a few selected companies or investment activities. This could be argued to be contrary to CIN as this normally would imply that all investments made in a single country should be subject to the equivalent amount of tax. However, the essence of CIN is not nec-

²⁷⁴ Viherkenttä (1991) pp.130-134.

²⁷⁵ OECD (1996) p.17.

²⁷⁶ Zimmer (2009)a) pp.34-35. Holmes (2007) pp.6-7.

²⁷⁷ Zimmer (2009)a) pp.34-35.

essarily that all investments should be treated equally under the tax system, but rather that the host country should set the tax terms for these investments.

If the tax legislation in capital exporting countries influences how investments made in a foreign country ultimately are taxed, investors (from various countries) operating and competing in the same host country would not be subject to the same tax on equal investments. Investors from relatively high-tax countries will then have a competitive disadvantage compared to investors from relatively low-tax countries. According to CIN, all investors that make the same investments in a country should be subject to the same amount of tax, irrespective of where they are resident. In this way, they compete on equal terms when investing in the same country – also referred to as international *competitive neutrality*.²⁷⁸ Competitive neutrality has often been advocated by the business community (at least among companies that operate internationally, typically MNEs).²⁷⁹

Competitive neutrality is not just relevant for the host country. Normally, the residence country would also be interested in ensuring that its domestic investors can compete effectively internationally. When a domestic investor carries out business in a foreign country that offers tax holidays and the residence country of the investor subjects the income derived in the foreign country to taxation on an accrual basis, in accordance with its CFC legislation, the domestic investor would have a competitive disadvantage compared to investors from other countries (if these investors benefit from a deferral of domestic tax in their residence countries). A similar effect would occur if the residence country uses the credit method while other residence countries might exempt foreign sourced income derived by their resident investors or offer tax sparing provisions. Under the Canadian CFC regime for instance, one of the main objectives behind the regime is to ensure that Canadian corporations can compete effectively internationally. To achieve this objective, active business income of a foreign affiliate of a Canadian taxpayer is not taxed on an accrual basis under the Canadian CFC regime.²⁸⁰

²⁷⁸ Viherkenttä (1991) p.42.

²⁷⁹ Viherkenttä (1991) pp.41.

²⁸⁰ IFA (2013) p.181.

While competitive neutrality could be an important argument both for capital exporting countries and capital importing countries, arguments based on CEN and arguments based on CIN would usually not be compatible.

7.3.3 Tax Equity

Tax equity is another fundamental principle for countries' design and application of tax rules and one of the main objectives underlying a country's incorporation of tax rules.²⁸¹

Tax equity between taxpayers implies that taxpayers with equal income or equal ability to pay should be subject to the same tax burden regardless of where the income is sourced and regardless of the type of income and the legal structures through which the income is derived.²⁸² Arguments based on equity will have a great ethical value when individual taxpayers are concerned. However, this principle will have less value in the area of corporate taxation.²⁸³

However, tax equity could indicate that the competition between domestic corporations should be fair. Equity between companies could suggest that companies resident in the same country should be subject to the same effective tax rate regardless of where they carry out investment. This could imply that tax incentives offered to foreign subsidiaries of a resident company should not have any impact on the company's overall tax burden and that this burden should be determined by the residence country tax level. Current taxation and foreign tax credit could thus be advocated on the basis that they would secure tax equity between corporate taxpayers resident in the same country.²⁸⁴

Companies which operate cross-border can profit from various tax planning opportunities and the opportunity to benefit from low-tax entities, such as tax holiday subsidiaries, and they would thus have a competitive advantage compared to other companies that cannot easily use such opportunities. As long as tax incentives offered in foreign countries would reduce the

²⁸¹ Zimmer (2009b) *Lærebok i skatterett*, p.31 Holmes (2007) p.4.

²⁸² Holmes (2007) p.4, Zimmer (2009b) p.31.

²⁸³ Viherkenettä (1991) p.41, Zimmer (2009b) p.31.

²⁸⁴ Viherkenttä (1991) p.133.

overall tax burden of domestic companies operating abroad, other domestic companies that are constrained to invest their capital in the domestic market could complain that they are treated inequitably by the residence country's tax system (compared to other resident companies with the possibility to invest capital abroad). Not all investors have the opportunity to invest abroad, typically small and medium-sized companies, e.g. if their investment capital is not movable, such as land.²⁸⁵ This could be used as an argument for CFC legislation – when CFC legislation is applied, a domestic investor would pay the same amount of tax on investments carried out abroad through a tax holiday company (a CFC) as he would on investments carried out domestically. Corporate tax equity could thus imply that tax systems should be as neutral as possible and not interfere with competition.²⁸⁶

On the other side, a domestic company operating cross-border could argue that it should not be compared to domestic companies that only operate in the local market, but rather be compared to other multinational companies (international competitive neutrality, c.f. section 7.3.2). Furthermore, if tax incentives are recaptured from the investors they were meant to benefit, the investors could view the tax system in their residence country as unfair. However, it is not necessarily obvious that a company's (the CFC's) competitiveness would be substantially weakened by the taxation of its shareholders.²⁸⁷

7.3.4 National economic sovereignty

National economic sovereignty is often used as the main argument against residence taxation that would frustrate tax incentives in developing countries. When a developing country abstains from fully exploiting its available tax base as an integral part of its economic policy and the residence country correspondingly increases its tax take, this could be seen as an unjustified interference with the economic sovereignty of the developing country.²⁸⁸

²⁸⁵ Holmes (2007) p. 12. OECD (2013)a) p.8.

²⁸⁶ Viherkenttä (1991) p. 41.

²⁸⁷ Viherkenttä (1991) pp.135-136.

²⁸⁸ Viherkenttä (1991) pp.41-42.

If the residence country taxes CFCs on a current basis and uses the foreign tax credit method on remitted income, the total tax burden on the taxpayer may be fully determined by the residence country. The residence country could then unilaterally determine the final tax impost of the investor and thus deprive the host country of an economic policy measure. When the host country is unable to affect the final tax burden of investors operating within its jurisdiction it will be deprived of the possibility to affect the behaviour of these taxpayers through tax measures.²⁸⁹ Hence, tax incentive policies cannot be effectively employed by developing countries. This would limit the policy options that the developing country otherwise would have and which they often would regard as crucial for their investment policy. This could be claimed to be an undue pressure on the decision making in developing countries and an interference with host countries' economic sovereignty.²⁹⁰

Current taxation (i.e. CFC taxation) would involve a stronger interference with the national economic sovereignty of the host country than the foreign tax credit method. Under the foreign tax credit, a frustration of the tax incentive would be dependent on the distribution behaviour of the company while a nullification of the tax incentive will be inevitable under current taxation. The deferral period may be so long (e.g. it may last for an indefinite period of time), that any eventual residence taxation may not be seen as a major threat to the value of the tax holiday benefit (c.f. section 5.3). Nevertheless, foreign tax credit will by no means *support* such tax incentives in developing countries (contrary to tax sparing credit, which is the only instrument of international tax law which has been specifically developed to preserve the benefit under developing countries' tax incentives).²⁹¹

It could be argued that the residence country should have the exclusive right to tax its residents, especially when income is remitted back to the residence country. However, this argument is not as convincing when the residence country subjects *undistributed* profits of foreign subsidiaries to current taxation. For such separate legal entities the host country would be the residence country, and it could be argued that the host country should have the primary right to decide the final tax impost on these companies. Off course, taxing parent companies on

²⁸⁹ Viherkenttä (1991) p.135.

²⁹⁰ Viherkenttä (1991) pp.43-44.

²⁹¹ Viherkenttä (1991) pp.139 and 175.

their “share” of the foreign subsidiary’s income (CFC taxation) is not inherently the same as subjecting these subsidiaries directly to tax in the residence country. Under CFC legislation the tax is levied on the parent company and not directly on the subsidiary. However, even if no tax is formally imposed on the CFC, from the point of view of the investor, CFC taxation would lead to economically similar results as if the tax was imposed directly on the CFC. Even though the tax subject is different, the taxable object is nevertheless the same.²⁹²

7.4 Concluding remarks

When discussing whether tax incentives in developing countries should be preserved under the tax legislation of the residence country, two main arguments have to be balanced - elimination of double non-taxation and the national economic sovereignty of the developing country.

CFC legislation and foreign tax credit could be advocated on the grounds that double non-taxation should be eliminated. Such arguments are of great importance when discussing the abusive use of tax holiday in relation to profit shifting arrangements. However, when double non-taxation is the result of the intended use of tax incentives, these arguments are not as relevant. CFC regimes covering all income from worldwide business would not be necessary to protect the domestic tax base. Support of this view can also be found in the OECD Action Plan, as it states that double non-taxation, *per se*, is not a concern, “but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.”²⁹³

When the CFC’s income stems from genuine business activities carried out by the CFC in the host country, it is not reasonable to claim that the tax base of the residence country is eroded. In the absence of a tax holiday, this income would usually be taxed by the *host* country. An adequate protection of the domestic tax base could be achieved by taxing CFC income that has been artificially diverted from the residence country.

²⁹² Viherkenttä (1991) pp. 136-138.

²⁹³ OECD (2013)b) p.10.

Even though CEN would be a strong argument for both the application of CFC legislation and the use of the credit method on remitted income, it is not obvious that the highest rate of return should be used as the sole criterion of the preferred allocation of capital globally. If tax incentives distort investment decisions and channel investment into developing countries, this is not necessarily something that should be prevented under the tax system in capital exporting countries. A deviation from the fundamental principles of neutrality and economic efficiency could be justified as means to reduce the existing imbalance in the global allocation of capital.²⁹⁴

Furthermore, even if CFC legislation in general, is advocated on grounds that it would make the tax system more neutral and ensure that foreign investment is not encouraged over domestic investment, these arguments have a more ambiguous value when the foreign country in question is a developing country. The objective of encouraging investment in developing countries could be highly relevant for capital exporting countries as well.²⁹⁵ If tax incentives are used to correct market failures and compensate for various disadvantages related to investment in a developing country, they could be characterised as a correction of *disincentives*.²⁹⁶ Hence, economic efficiency could even be used as an argument against residence taxation that would frustrate such incentives. If tax incentives are respected under capital exporting countries' tax systems, it could in fact make the tax system more neutral since they correct market failures.

By respecting developing countries' tax incentives under its tax system, a capital exporting country could support investment in developing countries. When the opposite approach is taken (e.g. CFC legislation and the credit method) the residence country would in fact shift tax revenue from the developing country to its own treasury. If the residence country taxes income derived by the tax holiday company (either currently under CFC legislation, or under the credit method when income is remitted), the taxes waived by the developing country would simply increase the revenue in the residence country and merely result in a shift of tax

²⁹⁴ Viherkenttä (1991) p.132.

²⁹⁵ Viherkenttä (1991) pp.44-45.

²⁹⁶ Gjems-Onstad (2012) pp.58-59.

revenue from the developing country to the residence country²⁹⁷, often referred to as “aid in reverse”.²⁹⁸ This effect is particularly detrimental when the host country is a developing country and the residence country a (rich) industrialised country.

The question of how tax legislation in industrialised countries should interrelate with tax incentives in developing countries and whether resident taxpayers should be permitted to receive the full benefit from tax incentives in developing countries call for political discussions. Developing countries should have a say in the discussion on the development of international tax principles and recommendations and have the right to influence the final solutions, especially when such rules and recommendations could pose a threat to their policy measures.

When the OECD prepares the final recommendations regarding the strengthening of CFC rules, it is important that it considers the special concerns of developing countries. Respect for the economical national sovereignty of third-world countries could imply that the intended use of tax holidays should be respected under the tax laws of industrialised countries. CFC legislation should thus concentrate on areas where the potential for tax avoidance is greatest. Hence, the main focus under CFC rules should be on profit shifting arrangements that segregate taxable income from the activities that generate it. As long as the income exempted under tax holidays are generated in the host country by the tax holiday company, any resulting double non-taxation should perhaps be accepted.

²⁹⁷ OECD (1996) pp.16-17, UNCTAD (2000) p.28.

²⁹⁸ Viherkenttä (1991) p.2, The International Finance Corporation and the World Bank (2001), p. 8.

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