CONTROLLED FOREIGN COMPANIES (CFC) RULES AND BEPS PILLAR 2 PROPOSALS: What's in it for developing countries?

TRANSCRIPT FOLLOWING THE ROUNTABLE DISCUSSION WITH PKN STAN UNIVERISTY ORGANISED BY CAPABUILD

PKN STAN is an Indonesian vocational college under the Ministry of Finance which provide diploma program education in the field of state finance.

The Capabuild Project is a private public initiative, assisting developing countries to build and develop their tax academies and tax programs with the purpose of increasing tax revenue and improving their investment climate.

Lai'Latif & Co is a specialised law firm engaging in training and consulting for international organisations, tertiary institutions, governments and think tanks on intersections across fiscal policy and practice

Capabuild:
Your view on CFC really depends on what you think is value of corporate tax. What do you think of corporate tax – is it a good tax or a bad tax? Or just a tax?

Lyla Latif:
Let's interrogate this question: The international tax system was devised in the early 20th century when MNCs were in their infancy and Africa was decolonising. The tax system that was conceptualised by the imperial powers was adopted by these post-colonial states whose tax systems have not kept up with profound changes in the global economy of today – this is not to say, that tax reforms aren't taking place, they are, following technical tax capacity of African states and public knowledge on the problem of IFFs followed by state and private sector accountability. CFC rules are national and international tax coordination is required since MNC are internationally dispersed. To what extent do CFC rules concern Africa? How many African corporations have a transnational presence with African majority shareholder control in foreign jurisdictions? Isn't it the other way round, where you have foreign corporations establishing subsidiaries in African states that present them with a favourable or low tax rate? So, whether corporate tax is good, bad or ugly, depends on the extent to which an African state is able to tax a foreign company based on its activities within its jurisdiction that generates income for this company as a fair share of its global profits and in so far as tax avoidance and dubious tax strategies are not applied to erode the tax base. Corporate tax can be obsolete when corporates minimise their tax liability to the extent that the state is unable to meet and finance its development needs. But the clamour against illicit financial flows, in the form of corporate tax abuses, when curtailed, will result in corporate taxes that are beneficial for state building and social improvement. Another thing is that, corporate tax in the context of the African environment can be sustained as a good tax when compared with the income tax – which usually is prohibitive and burdensome for the ordinary natural tax payer who probably is employed in the informal sector and has to deal with the daily problems that poverty encapsulated around him or her.

Capabuild:
There has been big publicity by OECD re consensus about OECD pillar 1 and 2 – 1: giving bit of excess profit by Tech co 's to market countries like Indonesia, 2: global minimum tax rate of say 15% - is this pillar 1 and 2 proposal the same as CFC rules? How will it impact the CFC rules?

Lyla Latif:

I want to answer this question by reflecting on how CFC rules worked when applied through tax treaties and what that means with the Pillar proposals. CFC rules required African states that had a treaty with the TNCs home state to apply the exemption method – practically allowing the resident state to tax all profits. That was one aspect of CFC enabled tax base erosion of the African revenue space. Pillar 2 is designed to ensure that MNCs pay a minimum level of tax regardless of where they are headquarted or the jurisdictions they operate in. For Africa it means capacity to tax. The principal mechanism to achieve this outcome is the income inclusion rule together with the undertaxed payments rule acting as a backstop. The operation of the IIR is in some respects based on the traditional CFC rules – it triggers inclusion at the level of the shareholder where the income of a CFC is taxed at below the effective minimum tax rate. It is complemented by a switch-over rule that removes treaty obstacles from its application to certain branch structures and applies where an income tax treaty obligates a contracting state to use the exemption method. This will be good for African states. What share of the 15% can be claimed by an African state is another challenge. The percentage has already been rejected by African states and African civil societies that have alleged that the proposed allocation of 15% is to the exclusive benefit of wealthy countries – it would be allocated to the countries in which MNE are headquartered. My answer to the question on whether pillar 2 is the same as CFC rules is – that there is a difference. CFC rules do not apply to all the subsidiaries in an MNE Group and when they do apply, they usually only capture certain types of low tax passive income. Pillar 2 rules formed under GLoBE (global anti base erosion) will apply to subsidiaries in the group and all types of income. For African states, these GLoBE rules provide them with the legality to block shifting of profits to low tax jurisdictions under the undertaxed payments rule.

Capabuild:

CFC rules were probably the first sign that corp tax was complicated by the desire to fight tax avoidance. OECD pillar 1 and 2 is ultimate perversion of the idea of a simple tax solution. Is complexity killing corporate tax? Do we still need a corporate tax like this?

Lyla Latif:

Companies must pay the corporate tax. That is how many African states finance development. In as much as there is the large-scale problem of tax evasion and illicit financial flows out of these corporations, the corporate tax they pay supports the fiscal state. For example, in 2020 the telecommunication company Safaricom in Kenya paid Kshs 98billion in taxes. In 2019, the taxes this company paid to the

Kenyan government contributed to 6.5% of the country's GDP. Of course, this is a domestic company. Karuturi, a CFC in Kenya on the other hand in 2012 avoided paying the Kenyan government $11million in taxes. Clearly, the problem with the corporate tax is where a CFC exists. What we need is the exercise of tax sovereignty by each state in whose jurisdiction a CFC is incorporated. It should be subject to tax domestically on its business and financial activities conducted territorially. Kenya applies this approach. Each subsidiary of a foreign company is taxed as a domestic corporate. The challenge is in identifying the tax avoidance strategies. To go back to the question on whether complexity is killing the corporate tax, I would say that by applying the high tax rate to the low taxed profit, CFC rules eliminate the incentives of a TNC to transfer profit to a tax haven or a low tax jurisdiction. To some extent the rules are needed in order to price controlled transactions and minimize instances of base erosion.

Capabuild:
Action 3 of BEPS does handle CFC rules – I can see CFC being important for rich countries like the US or the UK but is CFC really a priority low-income countries?

Lyla Latif:
The CFC regime rests on 3 tests. One, ownership or control (to identify an ultimate parent). Two, passive income and three, low tax. All have proved difficult to apply. The first test on ownership and control, is rendered otiose as MNCs have become more decentralized and regionalized and many have adopted multi-tier structures. The second test on passive income, doesn't account for the growing importance of services and other activities which can be virtual, and the third test on low tax, most fiscal regimes are exploring preferential tax regimes that offer production havens. While some African states are thinking of, others have set up international financial centres subject to separate tax laws. CFC rules, therefore, are seemingly becoming unimportant. In terms of priority for low-income countries, Pillar 2 propose to give priority to MNEs home countries to tax undertaxed profits, this is not very fair for host African countries, so when we see it from this perspective, CFC rules are locked in for home countries, underprioritizing the host state. However, Pillar 2 also provides for STTR which is the favoured ATAF position– that allows the application of WHT at source, which would have priority over the IIR. The problem with this STTR is that it would require changes to tax treaties, effectively handing a veto to countries that have designed their treaties and other measures to enable sheltering of low taxed income. As CFC rules respond to the risk of base erosion from parent company (residence) jurisdictions, they tend to be less relevant to developing countries.

Capabuild:

What do you think of the following statement: with a good anti- abuse rule in domestic law you do not need complicated CFC rules. CFC rules are a bazooka with a manual no one understands. anti-abuse rules work like snipers: precise, simple and effective.

Lyla Latif:

CFC rules deter diversion of income from source countries. MNC can pressurize their home countries for relaxation of CFC rules, by threatening to relocate and in some cases have done so, hence the governments have duly obliged. For example the US has allowed subpart F to be emasculated by the check the box and pass through rules. So instead of the CFC regime that can be manipulated, a good anti-abuse rule in domestic law would be more prudent.

Capabuild:

CFC rules usually have a safe harbour rule – arguing that if there is a minimum tax rate applicable on the CFC, the rules will not apply. Is with pillar 2 minimum tax of 15% CFC become out of date or obsolete.

Lyla Latif:

As per 1 July 2021 OECD statement further work on the design of safe harbour will need to be undertaken to determine the current gateways under SH esp. where independent company arrangements are concerned and also the GLoBE rules and how they address trading profits of MNEs will need some work in my estimation before a solid yes or no can be given on this.

Final remarks:

Preferential regimes have been set out – OECD, UN, unilateral measures and this is all subject to freedom to contract under international law – contracting states can opt out of applying the OECD tax treaty model or the ATAF model and instead opt for domestic law approach of the host country which has a lower tax rate. Uber is in Kenya – based on the NL/Kenya DTA the profits aren't taxed but VAT is applied at POS – it's the consumer taking up the burden…of this digital intermediary that makes huge profits out of the country. If these digital business models were serious about supporting the development of the states they operate in and the consumer whose income they target they would not pressurise their home states to reject UN Model Article 12B. This article also contemplates that, in lieu of withholding, the beneficial owner of income from automated digital services can request that its "qualified profits" from automated digital services be taxed at the rate provided under the domestic *laws of the Contracting State. Kenya has the DST legislation capping the tax at 1.5%. Art 12B places it between 3-4%. There are alternatives and complexities in also getting to know what profits were made by Uber in Kenya. Like it was earlier said implementation will take a lot of time.*