CHAPTER 7

# Anti-avoidance Measures

## 7.1 INTRODUCTION

International transactions provide many opportunities for the avoidance of tax. In this context, tax avoidance must be distinguished from **tax evasion**, which is illegal and usually involves the intentional nondisclosure of income or fraud. **Tax avoidance** is difficult to define precisely, but generally means transactions or arrangements entered into by a taxpayer in order to minimize the amount of tax payable in a lawful manner.

The ways of avoiding tax through international transactions are far too numerous to itemize. The following examples, however, illustrate the range of possibilities:

- A taxpayer can shift his or her residence from one country to another country that levies lower or no taxes.
- A taxpayer can divert domestic source income to a controlled foreign entity, such as a trust or a corporation, established in a tax haven.
- A taxpayer can establish a tax haven subsidiary to earn foreign source income or to receive dividends from subsidiaries in other foreign countries.
- If advantageous treaties exist, a taxpayer can route dividends, interest, royalties, and other amounts through subsidiaries established in foreign countries in order to reduce the amount of withholding tax on such amounts.

Not surprisingly, most countries have anti-avoidance rules to deal with certain types of international tax avoidance, and some countries still have exchange controls to regulate foreign investments and transactions by residents. Although these controls can be effective in preventing international tax avoidance, over the past several decades countries have abandoned exchange controls in favor of the free movement of capital.

Countries that do not use exchange controls employ a wide variety of tax measures to combat international tax avoidance. Some important examples of such

measures are described briefly below, with references in some instances to more detailed treatment elsewhere in the Primer.

*Anti-avoidance rules and doctrines.* Many countries have judicial anti-avoidance doctrines or statutory anti-avoidance rules under which transactions may be disregarded for income tax purposes. These doctrines and rules apply generally to tax avoidance transactions or arrangements, including international transactions. Judicial anti-avoidance doctrines include the sham transaction, substance-over-form, business purpose, step transaction and abuse of law doctrines. For example, the existence of a holding company established in a tax haven may be disregarded as a sham if it does not engage in any genuine commercial activities. Statutory anti-avoidance rules include specific and general anti-avoidance rules. Specific anti-avoidance rules include transfer pricing rules, thin capitalization and earnings-stripping rules, controlled foreign corporation (CFC) rules, and foreign investment fund rules. General anti-avoidance rules (often referred to by the acronym "GAAR") are intended to be sufficiently broad to deal with most or all types of abusive tax avoidance, including international tax avoidance transactions. Typically, GAARs apply when the principal purpose or one of the principal purposes of a transaction or a series of transactions is to avoid tax and the transaction abuses, frustrates, or defeats, or is inconsistent with, the object and purpose of the relevant tax legislation.

*Special tax haven provisions.* Some countries have specific provisions designed to deal with particular tax haven abuses. For example, Germany imposes a special tax on persons who move their domicile to a tax haven. Other countries disallow the deduction of interest and royalty payments or payments for services made to a tax haven entity unless the taxpayer establishes that the transactions are genuine; in other words, the onus of proof is placed on the taxpayer to justify such deductions.

*Transfer pricing rules.* Most countries have intercompany or transfer pricing rules to prevent related taxpayers from carrying out transactions at artificially high or low prices in order to shift income and expenses from one country to another. It is arguable whether these rules are properly classified as international anti-avoidance rules or whether they are just part of a country's basic tax system. Transfer pricing rules are discussed in detail in Chapter 6.

*CFC rules.* Several countries have adopted CFC rules to prevent the diversion of passive and certain other income to, and the accumulation of such income in, a CFC established in a tax haven. These rules are discussed in section 7.3 below. Some countries have similar rules with respect to foreign trusts.

*Foreign investment fund rules.* Several countries have adopted foreign investment fund rules to prevent the deferral of domestic tax by residents investing in foreign mutual funds, unit trusts, or similar entities. These rules are discussed in section 7.4 below.

*Anti-treaty shopping rules.* Several countries insist on the inclusion of provisions in their tax treaties and/or in their domestic legislation to prevent treaty shopping. Treaty shopping typically involves the establishment of a legal entity in a country by

nonresidents in order to obtain the benefits of the country's tax treaties. Treaty shopping is discussed in Chapter 8, section 8.8.2.2.

*Thin capitalization and earnings-stripping rules.* Several countries have adopted **thin capitalization** and **earnings-stripping rules** to limit the deduction of interest by resident corporations and other legal entities. Thin capitalization rules are intended to prevent nonresident shareholders of resident corporations from using excessive debt capital to extract corporate profits in the form of deductible interest rather than non-deductible dividends. Earnings-stripping rules are more broadly targeted at resident corporations and other entities that claim disproportionately large interest deductions. These rules are discussed in section 7.2 below.

*Taxation of gains on transfers of property abroad and on expatriation.* When appreciated property - property with an accrued gain - is transferred to a related nonresident, some countries deem the property to have been sold for its fair market value so that the accrued gain is subject to tax. Otherwise, domestic tax on the gain might be avoided entirely. Further, some countries impose tax on accrued gains when a taxpayer ceases to be resident or for a temporary period after a taxpayer ceases to be resident; such exit or departure taxes and trailing taxes are discussed in Chapter 3, sections 3.4.1 and 3.4.2.

*Back-to-back arrangements.* **Back-to-back arrangements** are commonly used as a tax planning device to obtain tax benefits that would not otherwise be available to a taxpayer directly. For example, a country may have rules dealing with related-party transactions; these rules can sometimes be avoided by inserting an arm's-length intermediary between the related parties. Similarly, the benefits of a country's treaties, such as reductions in withholding taxes, may be inappropriately obtained through back-to-back arrangements. Such arrangements are particularly common with respect to financial transactions, since funds can be funneled through an arm's-length financial institution with relative ease. For example, assume that Country A exempts interest payments by corporations resident in Country A to arm's-length nonresidents from its withholding tax on interest. If ACo, a corporation resident in Country A, pays interest to BCo, a related corporation resident in Country B, the interest would be subject to Country A's withholding tax. However, if BCo puts funds on deposit with a financial institution that deals at arm's length with both ACo and BCo and the financial institution loans an equivalent amount to ACo, Country A's withholding tax would not apply to the interest payments by ACo to the financial institution.

*Hybrid entities and hybrid financial instruments.* A "hybrid" arrangement refers to situations in which two countries treat entities, transactions, or arrangements differently and the different treatment is exploited to produce tax benefits. For example, if one country treats preferred shares issued by a resident corporation in accordance with their legal form as shares on which dividends are paid, but another country treats the shares as debt on which is interest is paid, this inconsistent treatment can be exploited to produce tax savings. If the country in which the corporation is resident treats the payments on the shares as interest, the payments will be deductible

and reduce that country's tax base. If the country in which the recipient of the payments is resident treats the payments as dividends, it may exempt those dividends from tax as a result of its participation exemption. Hybrid arrangements are discussed in more detail in Chapter 9, section 9.3.

## 7.2 RESTRICTIONS ON THE DEDUCTION OF INTEREST: THIN CAPITALIZATION AND EARNINGS-STRIPPING RULES

### 7.2.1 Introduction

When a resident corporation pays interest to nonresidents, the interest is usually deductible by the payer in computing income unless there are special rules to the contrary. The interest payments may be subject to withholding tax, but the rate of withholding tax may be substantially reduced or completely eliminated pursuant to an applicable tax treaty. The nonresident lender may or may not be subject to tax on the interest in its country of residence. If the nonresident lender is also the controlling shareholder of the resident corporation, the nonresident lender/shareholder will usually have a choice of financing its subsidiary with debt or equity and extract the profits of the subsidiary by receiving either dividends or interest.

Unlike interest, dividends paid by a resident corporation generally are not deductible. Accordingly, income earned by a resident corporation and distributed to its shareholders is subject to two levels of tax – corporate tax when the income is earned by the corporation, and shareholder tax when the income is distributed to the shareholders as a dividend. If the shareholder is a nonresident, the shareholder tax is usually imposed as a withholding tax.

In contrast, income earned by a resident corporation and distributed in the form of interest to a nonresident lender who is also a shareholder of the corporation is subject to only one level of tax. Because the interest is deductible by the corporation, usually the only source country tax is the withholding tax on the interest payment to the nonresident, and many countries have reduced or eliminated their withholding taxes on interest, either unilaterally or under their tax treaties. The advantage of paying interest to nonresident shareholders compared to paying dividends constitutes an inherent bias in favor of debt financing of resident corporations by nonresident investors. This bias is illustrated in the following example.

NCo, a nonresident corporation, owns all the shares of RCo, a resident corporation. RCo requires capital of one million to finance its business activities. To provide that capital, NCo can either subscribe for one million in additional shares of RCo, or it can loan RCo one million (or some combination of debt and equity). RCo earns income, before the payment of interest or dividends, of 100,000 and distributes its entire after-tax income as a dividend. The arm's-length interest rate payable on loans is 10 percent, and the applicable rates of withholding tax are 5 percent on dividends and 10 percent on interest. A comparison of the tax results of advancing funds by way of debt and equity are set out in Table 7.1.

*Table 7.1 Relative Advantages of Debt and Equity Finance*

| | *Debt* | *Equity* |
|---|---|---|
| Corporate income before payment of interest or dividends | 100,000 | 100,000 |
| Deduction of interest | 100,000 | not applicable |
| Taxable income | nil | 100,000 |
| Corporate tax (40%) | Nil | 40,000 |
| Dividends | not applicable | 60,000 |
| Withholding tax (10%, 5%) | 10,000 | 3,000 |
| Total tax | 10,000 | 43,000 |

As this example illustrates, financing a resident corporation with debt is considerably more effective in reducing the source country tax than financing with equity. The major reason is that interest is deductible, whereas dividends are not deductible. In addition, a resident corporation can repay a loan at any time without triggering tax, whereas it may not be able to repay equity investments (redeem shares or reduce capital) without triggering a taxable dividend.

In response to the bias in favor of debt compared with equity, several countries have adopted restrictions on the deduction of interest paid to nonresidents, or on the deduction of interest more generally. Under "thin capitalization" rules, the deduction for interest paid by a resident corporation to a nonresident controlling shareholder is denied to the extent that interest deductions claimed by the corporation are considered to be excessive. Under these rules, interest is considered to be excessive to the extent that the corporation's debt relative to its equity exceeds a fixed debt:equity ratio (often 1.5:1 or 2:1). The term "thin capitalization" is apt because the rules apply only when a corporation's equity capital is small in relation to its debt. Under earnings-stripping rules, interest is considered to be excessive if it exceeds a financial formula based on the earnings of the corporation (often 25-30 percent of earnings before the deduction of interest, taxes, depreciation and amortization, or "EBITDA").

The problem of deductible interest payments that erode a country's tax base relates primarily to payments to nonresidents. Interest payments to residents are not generally problematic because the residents receiving the payments are usually taxable on those payments. However, EU countries are prohibited from discriminating against residents of other EU countries, and the European Court of Justice has ruled that thin capitalization rules that are applicable only to interest payments to nonresidents are invalid insofar as they apply to residents of other EU countries. Consequently, some European countries have revised their thin capitalization rues so that they apply to all interest payments by resident corporations, including such payments to residents. Other countries have adopted earnings-stripping rules that apply to all interest payments by resident corporations irrespective of the residence of the recipient.

Some countries try to deal with the problem of excessive interest deductions by adopting statutory thin capitalization or earnings-stripping rules; others rely on

administrative guidelines or practices. Still others have applied transfer pricing or GAARs. The statutory rules of the various countries differ considerably. In some countries, thin capitalization rules are seen as specific transfer pricing rules for interest that are limited to interest payments to related or non-arm's-length parties. In other countries, the rules are targeted at interest payments that are viewed as disguised dividends: in other words, debt held by nonresident shareholders with a substantial interest in a resident corporation. Other countries consider the rules to be aimed at interest payments generally.

Although most countries' thin capitalization rules are targeted at certain interest payments – rather than all interest payments – to nonresidents, it must be recognized that all deductible interest payments by residents to nonresidents reduce or erode a country's tax base. Nevertheless, not all base-eroding payments are objectionable; many deductible payments by residents to nonresidents, including interest, represent legitimate income-earning expenses.

### 7.2.2 The Structural Features of Thin Capitalization and Earnings-Stripping Rules

Typically, thin capitalization and earnings-stripping rules have most of the following structural features.

*Nonresident lenders.* Thin capitalization and earnings-stripping rules generally apply only to interest paid to nonresidents who own a significant percentage of the shares of a resident corporation. The level of share ownership varies from a substantial interest in the shares (10-25 percent) to control (more than 50 percent of the shares) of the resident corporation. However, some countries, such as Australia, also apply their rules to resident corporations that use debt to finance foreign investment (so-called outbound thin capitalization rules). Moreover, as noted above, several European countries apply their rules to interest paid to both resident and nonresident lenders.

*Domestic entities.* The thin capitalization rules of most countries apply only to resident corporations. However, the stripping of profits through the payment of excessive interest to related persons may also arise with respect to partnerships and trusts and branches (PEs) of nonresident corporations. As a result, countries are increasingly extending the application of their thin capitalization rules to these entities.

*Determination of excessive interest.* Generally, thin capitalization and earnings-stripping rules apply only to certain "excessive" interest paid to nonresidents by resident corporations. Countries use a variety of different approaches to determine what constitutes excessive interest; there is no international consensus on this issue. The most common approach is the use of a fixed debt:equity ratio, under which only interest on a corporation's debt that is artificially large in relation to its equity – in effect, debt that is disguised equity – is not deductible. An alternative approach, recommended by the OECD for tax treaties, attempts to characterize debt and equity by reference to all the facts and circumstances, including the debt:equity ratio of the resident corporation. According to the OECD, this approach is consistent with the

arm's-length standard used for transfer pricing generally and avoids the inflexibility and arbitrariness of applying a fixed debt:equity ratio.

Under the earnings-stripping rules used by the United States (US) and several European countries, excessive interest is determined by reference to the relationship between a corporation's interest expenses and its income. A corporation is generally not entitled to deduct interest paid to certain nonresident shareholders to the extent that the interest exceeds a percentage of its income. The US approach is a combination of an earnings-stripping rule, under which interest in excess of 50 percent of a corporation's income is not deductible, and a thin capitalization rule, under which corporations that have a debt:equity ratio of no greater than 1.5:1 are not subject to the earnings-stripping rule. Under the German earnings-stripping rules, the deduction of interest by Germanresident corporations that are part of a corporate group is denied if the interest exceeds 30 percent of EBITDA, unless the German corporation is excessively leveraged compared to the group as a whole.

The OECD's BEPS Action 4: *Limiting Base Erosion Through Interest Payments and Other Financial Payments* recommends that countries should restrict interest deductions based on the net interest expense of the worldwide group as a percentage of the group's earnings (EBITDA). Thus, interest deductions of any resident corporation would be limited by reference to the earnings of the group as a whole rather than by an arbitrary debt:equity ratio. One of the difficulties with this approach is that it requires the tax authorities to have information about the interest expenses and earnings of the worldwide group.

One significant difference between the determination of excessive interest on the basis of earnings or a fixed debt:equity ratio is that earnings are sensitive to fluctuations in interest rates, whereas a fixed debt:equity rule is not. Thus, although a corporation may be better able to carry additional debt if interest rates decline, this fact is irrelevant under a fixed debt:equity ratio. However, under an earnings approach, taxpayers have an incentive to reduce their debt during periods of rising interest rates in order to avoid restrictions on the deduction of interest.

*Computation of a debt:equity ratio.* A debt:equity ratio for purposes of thin capitalization rules can be established either:

- as an arbitrary ratio, computed on a **consolidated** basis, ignoring any intercompany debt and equity; or
- by reference to the average debt:equity ratio for all resident corporations or all resident corporations engaged in a particular industrial or commercial sector.

Most countries seem to use an arbitrary debt:equity ratio of 1.5:1 to 3:1, sometimes with a higher ratio for financial institutions. The calculation of debt and equity as components of the ratio necessitates many subsidiary tax policy decisions. For example, should all debt held by nonresidents be taken into account, or just debt held by substantial nonresident shareholders? Should equity include contributed surplus or only share capital and retained earnings? How should hybrid securities such as preferred shares be classified? Should debt that is guaranteed by a nonresident shareholder be taken into account? Should a corporation's gross debt be reduced by

any cash on hand, especially since such cash may be earning interest income? A similar issue arises under an earnings-stripping rule: Should the limitation on interest deductions be based on a corporation's gross or net interest?

*Consequences.* The effect of the application of the thin capitalization or earnings-stripping rules is generally that excessive interest is not deductible. In some countries, this excessive interest is treated as a dividend. In other countries, excessive interest that is not deductible in one year can be carried forward and deducted in a subsequent year, assuming that it is not subject to the limitation on the deduction of interest in that year.

Tax authorities must be aware that their thin capitalization rules can be avoided if taxpayers channel their intercompany loans through back-to-back arrangements with international banks and other financial intermediaries. Assume, for example, that FCo, organized in Country F, lends money to B, an unrelated bank, which then relends the money to ACo, organized in Country A. FCo and ACo are members of an affiliated group of companies. The loan from B to ACo may not be subject to Country A's thin capitalization rules because it appears to be an arm's-length loan. Therefore, some countries' thin capitalization rules contain provisions that attempt to prevent the use of back-to-back loans and similar tax avoidance devices.

## 7.3 CFC RULES

### 7.3.1 Introduction

As noted in Chapter 3, section 3.3.1, one of the most effective ways for residents to avoid tax on their worldwide income is the use of CFCs and other legal entities to earn foreign source income. Domestic tax on foreign source income can easily be deferred or avoided completely by establishing a foreign corporation or other legal entity, such as a trust, to earn the income. Because the foreign corporation or trust is generally considered to be a separate taxable entity and not resident in the country where its controlling shareholders or beneficiaries are resident, those shareholders or beneficiaries are not taxable when the income is earned by the foreign corporation or trust.

When distributions from the corporation or trust are paid, the shareholders or beneficiaries may be taxable by the residence country. However, many countries exempt dividends from foreign corporations from residence country tax if the dividends are received on shares owned by a resident corporation with a substantial interest in the foreign corporation. Even if the distributions are taxable, the residence country tax is postponed until distributions are received, which may be several years after the foreign entity earns the income. Thus, earning income through a foreign entity may result in the deferral or complete avoidance of residence country tax. The benefit is greatest when the foreign tax on the income of the foreign corporation or trust is low or nil. Therefore, the problem arises primarily from the establishment of CFCs or trusts in tax havens.

The problem of tax avoidance and deferral through the use of controlled foreign entities is most pronounced with respect to passive investment income because such

income can be easily diverted to or accumulated in an offshore entity in a tax haven. For example, assume that a corporation resident in Country A earns interest income of 1,000 from bonds and the tax rate in Country A is 40 percent. If the corporation establishes a wholly owned subsidiary in a tax haven that does not impose tax, it can defer tax of 400 by transferring the bonds to the subsidiary. The interest income derived by the subsidiary may not be subject to Country A's withholding tax, either because the interest is not sourced in Country A or because the interest is exempt from withholding tax. However, even if the interest is subject to Country A's withholding tax, the corporation can defer Country A's tax to the extent of the difference between the corporate tax rate and the withholding tax rate (which may be substantial). The tax benefit from the transfer of the bonds to the subsidiary will be even greater if Country A provides a participation exemption for dividends received from foreign corporations.

Where a residence country imposes tax on distributions from foreign corporations and other entities, residence country tax is deferred, but not avoided entirely. When a foreign subsidiary distributes dividends to its resident parent corporation or when the parent corporation disposes of its shares in the foreign subsidiary, the residence country will presumably tax the distribution or gain. Therefore, the benefit of deferral in any particular case depends on the difference between the domestic and foreign tax rates, the rate of return on the deferred taxes, and the period of deferral. Under standard present value calculations, indefinite deferral is nearly equivalent to exemption.

Several countries have adopted detailed statutory rules to prevent or restrict the use of CFCs to defer or avoid domestic tax. The US was the first country to adopt CFC rules (Subpart F) in 1962; the rules were based on similar rules (the foreign personal holding company rules), adopted in 1937, that were targeted at the use of foreign corporations by individuals. The adoption of the Subpart F rules was very controversial. The rules that were finally enacted represented a compromise between the original proposal to eliminate deferral for all income of CFCs and the arguments of US-based multinationals that deferral should be eliminated only with respect to clearly passive income. Subpart F remains controversial today. For many years, US multinationals have argued that the Subpart F rules are broader and tougher than the CFC rules of other countries and that they put US multinationals at a competitive disadvantage. In January 2001, the US Treasury issued a report on Subpart F (*The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study*, December 2000), which concluded that the basic policy of Subpart F was appropriate and there was no convincing evidence that the international competitiveness of US multinationals was adversely affected by the rules.

Since the US adopted Subpart F in 1962, several other capital-exporting countries have enacted CFC rules to protect their tax base. As of 2015, over thirty countries had enacted CFC rules. This is a well-established trend that will likely continue.

The basic pattern of CFC legislation is similar in all countries. Resident shareholders that control, or have a substantial interest in, a foreign corporation established in a no-tax or low-tax country are subject to residence country tax currently on their proportionate share of all or some of the income of the foreign corporation, whether or not the income is actually distributed to them. If a foreign corporation is engaged in

legitimate commercial activities offshore, however, the CFC rules do not generally apply to the income generated by those activities. For example, assume that ACo, a resident of Country A, owns all the shares of a CFC resident in a low-tax country. The CFC earns passive income of 1,000 and pays tax of 100 on that income to its country of residence. The CFC does not distribute any of its after-tax income to ACo. If Country A has CFC rules, ACo would be subject to tax by Country A on the CFC's income of 1,000 (despite the fact that ACo has not received any distribution of that income from the CFC) and would receive credit for the tax paid by the CFC of 100. Thus, if Country A imposes tax at a rate of 40 percent, ACo would pay tax of 300 (400 less a foreign tax credit of 100), which is exactly the amount of tax that ACo would have paid if it had earned the income directly.

The basic structure of CFC legislation reflects two competing policies. First, there is a desire to prevent tax avoidance and to advance the traditional goals of fairness and economic efficiency discussed in Chapter 1, section 1.3. At the same time, countries generally do not want to interfere unreasonably in the ability of resident corporations to compete in foreign markets. In every country with CFC measures, there is a balancing of these two policies, although the balance is struck differently in every country. Other than Brazil, no country eliminates entirely the benefits from the use of CFCs, and most countries limit the application of their CFC rules to CFCs established in low-tax countries and to passive income earned by CFCs. In contrast, the Brazilian CFC rules apply to all of the income, active and passive, of all CFCs in which Brazilian residents own 20 percent or more of the shares, irrespective of the country in which the CFCs are resident. The original New Zealand CFC rules also differed markedly from other countries' CFC rules and came close to eliminating deferral entirely; they applied to all the income, active and passive, of all CFCs controlled by New Zealand residents, except those established in seven listed countries. However, the New Zealand CFC rules were revised in 2010 to exclude active business income from the application of the CFC rules.

### 7.3.2 Structural Features of CFC Rules

Although CFC rules vary considerably, several fundamental structural aspects of the rules are the same in most countries. These aspects of the taxation of CFCs are discussed below.

#### *7.3.2.1 Definition of a CFC*

With a few exceptions, countries restrict the scope of their CFC rules to income derived by entities (1) that are nonresident, (2) that are corporations or similar entitles taxed separately from their owners, and (3) that are controlled by domestic shareholders or in which domestic shareholders have a substantial interest. Entities (such as partnerships) that are taxable on a conduit or flow-through basis are not within the scope of the CFC rules if the resident partners of a foreign partnership are subject to residence country tax on their share of the partnership's income. The status of an entity as a

nonresident is established in accordance with the residence country's normal residence rules for legal entities (place of incorporation or place of management, or both). The residence rules for corporations and legal entities are discussed in Chapter 2, section 2.2.2.

Although it may seem strange, some countries, such as France, apply their CFC rules to foreign branches or PEs. The extension of CFC rules to foreign branches or PEs is necessary where a country exempts income earned through a foreign branch or PE and the exempt income includes passive income that, if earned by a CFC, would be subject to the country's CFC rules. The application of the CFC rules to foreign branches or PEs is not necessary if the exemption for income earned through foreign branches or PEs is limited to active business income (i.e., income that would not be subject to the CFC rules if it were earned by a CFC).

Not surprisingly, given the title of "controlled foreign corporation" rules, most CFC legislation applies only to foreign corporations that are *controlled* by certain domestic shareholders. In general, control means the ownership of more than 50 percent of the outstanding voting shares. Some countries extend the concept of control to include ownership of shares having a value equal to more than 50 percent of the total value of the outstanding shares of the corporation. Other countries have rules that presume residents to control a foreign corporation in certain circumstances even if they own less than 50 percent of the voting shares. For example, the Australian and New Zealand CFC rules deem a resident to control a foreign corporation if the resident owns 40 percent or more of the voting shares of the foreign corporation and no nonresident person has voting control of the corporation.

Only a few countries have adopted a de facto control test as a supplement to the basic de jure control test. Under a de facto control test, a resident taxpayer is considered to control a foreign corporation if, based on all the facts and circumstances, the taxpayer has the means to control the affairs of the corporation even where it does not have voting control. For example, a taxpayer that owns 20 percent of the shares of a corporation may have de facto control of the corporation if the rest of the shares are widely held. A de facto control test involves considerable uncertainty for taxpayers and is also difficult for the tax authorities to apply.

The rationale for the control requirement is fairness. It would be unfair to tax resident shareholders on the undistributed income of a foreign corporation if they do not have sufficient legal or actual power or influence over the foreign corporation to determine the activities it engages in (i.e., whether it is subject to the CFC rules) and to require it to distribute its income.

A few countries, such as Brazil, Denmark, and Portugal, have rejected the complexity and the limitations of a control test. They apply their CFC rules to foreign corporations in which residents have a substantial (20 percent in the case of Brazil; 25 percent for Portugal and Denmark) ownership interest. Until 2004, France applied its CFC rules to French residents owning 10 percent or more of the shares of a CFC.

Control for purposes of CFC rules includes indirect control. The CFC rules cannot be avoided by having the shares of a tax haven corporation owned by another foreign corporation that is controlled by residents. For example, if a resident owns 60 percent of the voting shares of ACo, which in turn owns more than 50 percent of the voting

shares of a second foreign corporation, BCo, BCo is considered to be a CFC of the resident. Indirect control is usually determined by multiplying a taxpayer's interest in one corporation by the corporation's interest in other corporations, and so on. For example, if ACo owns 40 percent of the shares of BCo and BCo owns 30 percent of the shares of CCo, ACo is considered to own 12 percent of CCo. However, if one corporation controls another corporation, that corporation should be considered to own all the shares of any other corporations owned by it. For example, if ACo owns 51 percent of the shares of BCo and BCo owns 51 percent of the shares of CCo, ACo would be considered to own all the shares of CCo owned by BCo, rather than just 26.01 percent (51 percent × 51 percent). Therefore, ACo would be considered to control BCo and CCo (and any corporations controlled by CCo).

Most countries also have constructive ownership rules to prevent taxpayers from avoiding the CFC rules by fragmenting the ownership of shares among related persons. For example, if one resident corporation owns 40 percent and another resident corporation owns 20 percent of the voting shares of a foreign corporation, the foreign corporation will be a CFC of both resident corporations if they are related because, for example, they are both wholly owned subsidiaries of another resident corporation. Whether persons are related for this purpose is determined under the country's domestic law.

In some countries, control must be concentrated in a small number of resident shareholders in order for the CFC rules to apply. For example, Australia, Canada, and New Zealand require that control of a foreign corporation must be concentrated in five or fewer resident shareholders. Under the US Subpart F rules, only US shareholders owning at least 10 percent of the shares of the foreign corporation are counted in determining whether the foreign corporation is a CFC. In other countries, such as Norway and Germany, even foreign corporations that are widely held by resident shareholders are considered to be CFCs.

The concentrated-ownership requirement is related to the rationale for a control test. Whenever the shares of a foreign corporation are widely held by resident shareholders, those shareholders are unlikely to be able to exercise sufficient power over the corporation to determine its income-earning activities or require it to make distributions. A concentrated-ownership requirement requires constructive ownership rules and perhaps anti-avoidance rules.

#### *7.3.2.2 Designated Jurisdiction or Global Approach*

The primary focus of CFC rules is tax haven entities. As a result, the CFC rules of most countries are limited to CFCs located in countries that are defined and designated to be tax havens (the "**designated jurisdiction approach**"). However, a few countries, such as Brazil, Canada, and the US, apply their CFC rules to certain specified categories of income earned or received by a CFC, regardless of whether the CFC is resident in a tax haven or a high-tax country (the "**global approach**").

Under the designated jurisdiction approach, the residence of a foreign corporation in a designated tax haven is crucial to the application of the CFC rules. Because all

foreign corporations established in countries that are not designated as tax havens are exempt from the CFC rules, the compliance and administrative burden of the rules is reduced compared to the global approach. Under the global approach, the residence of the foreign corporation is irrelevant. The theory behind this approach is that all countries, even generally high-tax countries, have aspects of their tax system that permit the earning of preferentially or low-taxed income. Under the designated jurisdiction approach, the legislation usually provides a general definition of what constitutes a tax haven; the tax authorities then supplement that definition by issuing a list of countries that are regarded as tax haven countries, or that are not regarded as tax havens. However, some countries simply use a list of tax haven or non-tax haven countries without any statutory definition of what constitutes a tax haven.

The general definition of a tax haven is invariably based on a comparison of the taxes levied in the foreign country and in the residence country. If the foreign country actually levies taxes at approximately the same rates as the residence country, the foreign country should not be considered to be a tax haven because it cannot be used to defer or avoid a significant amount of residence country tax. The comparison of domestic and foreign tax rates can be based on:

- nominal tax rates;
- effective tax rates; or
- the actual foreign tax paid by a particular CFC.

The use of nominal tax rates to identify tax havens is problematic because it ignores generous deductions, exemptions, credits, or allowances that may be afforded by a foreign country. The use of effective tax rates is also problematic, because effective tax rates are difficult to determine and would have to be determined annually for every country in which a CFC of a resident corporation is resident. Moreover, just because a country has high effective tax rates does not mean that a particular CFC resident in that country may not be subject to low foreign taxes. A few countries use the effective-tax-rate approach. Most countries, however, focus on the actual foreign tax paid by a CFC.

The comparison of the actual foreign tax paid by a CFC and the notional domestic tax that the CFC would have paid as a resident corporation is the theoretically correct approach because it focuses on the situation of each particular CFC. However, this approach imposes onerous compliance burdens on taxpayers because the income of a CFC must be recomputed in accordance with residence country rules in order to determine the amount of the notional domestic tax.

The specific relationship between the foreign tax and the residence country tax varies considerably. Some countries define a tax haven as a country whose tax rate is less than 55 percent (Sweden), 60 percent (Finland), 66 2/3 percent (France and Norway) or 75 percent (Spain and the United Kingdom (UK)) of the residence country rate. Other countries define a tax haven simply by reference to the foreign rate. For example, Germany and Japan define a tax haven as a country that levies tax of less than 25 percent; Korea uses 15 percent. Even a small difference between the foreign and domestic tax rates may be sufficient to induce resident taxpayers to shift passive income (which is easily shifted) to a CFC in a foreign country.

As a result of the difficulties that arise in defining a tax haven by comparing its tax rate to the domestic tax rate – in particular, uncertainty for both taxpayers and tax authorities – most countries that use a designated jurisdiction approach have supplemented their definition of a tax haven with a list of tax haven countries, or non-tax haven countries, or both. The list may be either legislative (included in the legislation making up the CFC rules) or administrative (issued by the tax authorities). Such a list is intended to provide taxpayers and tax officials with concrete guidance. The lists vary widely: some are determinative (legally binding) of a country's status as a tax haven or a non-tax haven, while others merely establish rebuttable presumptions. The more sophisticated lists recognize that a country that generally is a high-tax country may nevertheless impose little or no tax on certain types of income or entities. Consequently, such countries may be placed on a non-tax haven list, subject to certain exceptions for preferentially taxed income or entities. As a result, CFCs that do not qualify for those countries' low-tax regimes will be exempt from the CFC rules.

The global approach is more precise than the designated jurisdiction approach. As mentioned above, under the global approach, the country of residence of the CFC is irrelevant and therefore, every transaction engaged in by all CFCs of all resident taxpayers must be examined in order to determine the nature of the income from the transaction. If the corporation has **"tainted" income**, as discussed below, the income is attributed to the domestic shareholders of the corporation and is subject to tax in their hands, with a credit for any foreign taxes on the income. Consequently, the CFC rules potentially apply even to CFCs in high-tax countries if they earn tainted income. In contrast, although the designated jurisdiction approach is not as precise, it minimizes the compliance and administrative burdens of the CFC rules.

#### *7.3.2.3 Definition and Computation of Attributable Income*

Some countries employ what may be called an **entity approach** in taxing the income of a CFC to its domestic shareholders. Under this approach, the CFC rules usually provide an exemption for certain CFCs that are engaged primarily in genuine business activities. This exemption is discussed in section 7.3.2.4 below. If a CFC does not qualify for any of the exemptions, all its income is attributable to its domestic shareholders. If, however, the CFC qualifies for the exemption, none of its income, even its passive income, is attributable to its domestic shareholders. This all-or-nothing result is the essential characteristic of the entity approach.

In contrast, other countries follow a **transactional approach**, under which only certain types of income (referred to as "tainted income") derived by a CFC are subject to attribution. Under a transactional approach, each transaction entered into by a CFC must be analyzed to determine whether it produces tainted or other income and, for this purpose, tainted income is determined by applying residence country tax rules. Although the entity approach is less precise than the transactional approach, it minimizes the compliance and administrative burden of CFC rules. Some countries use a hybrid approach that combines elements of the transactional and entity approaches. For example, some countries, such as Australia, New Zealand, and the US, use a

transactional approach but provide an exemption for CFCs whose tainted income is less than a specified percentage of its total income.

Tainted income usually consists of passive investment income and **base company income**. Passive income consists of dividends, interest, rents, royalties, and capital gains. All countries with CFC rules consider passive income to be tainted income, although they define passive income differently. Perhaps the most difficult issue in defining passive income for purposes of CFC rules is identifying situations in which passive income should be classified as active business income. For example, interest earned by a genuine financial institution is generally considered to be active business income and therefore exempt from CFC rules. Similar issues arise with respect to rents and royalties.

The term "base company income" is used to refer to any income, other than passive income, that is considered to be tainted income for purposes of CFC rules. The definition of base company income is often quite complex and the scope of the definition for purposes of various countries' CFC rules varies considerably.

In general, there are three major components of base company income:

(1) *Income derived by a CFC from the country in which its controlling shareholders are resident.* If such income is not taxable by the residence country, that country's tax base is eroded. Many countries consider the erosion of their tax base by a CFC in this manner to be inappropriate, especially since in many situations the income could be earned by the parent of the CFC directly.

(2) *Income derived by a CFC from transactions with related parties.* The treatment of income from related-party transactions as tainted income is usually intended to bolster a country's transfer pricing rules. Transfer pricing rules are intended to prevent the diversion of income to related foreign corporations through the non-arm's-length pricing of sales, services, and other transactions. (See Chapter 6.) These rules are notoriously difficult to enforce. By treating such income as tainted income for purposes of CFC rules, countries can avoid the necessity of applying their transfer pricing rules.

(3) *Income derived by a CFC from transactions outside the country in which it is resident.* The rationale for treating income from transactions outside the CFC's local market as tainted income relates to considerations of international competitiveness. Income from local market transactions is usually exempt because the current imposition of residence country tax on such income of a CFC would adversely affect the ability of the multinational enterprise of which the CFC is part to compete in that country. Where, however, the CFC derives income outside its local market, the deferral of residence country tax is not necessary for the CFC to compete in its local market. Moreover, where a CFC does business in its country of residence, there are probably good commercial reasons for it to be established there.

These three categories of base company income are not mutually exclusive. Thus, for example, some countries limit the definition of base company income to income derived from related-party transactions outside a CFC's country of residence or

to income from the country in which the controlling shareholders are resident as a result of related-party transactions.

One key aspect of the definition of tainted income concerns income from intercompany transactions between CFCs. For example, significant tax savings can be achieved if a CFC that is resident in a high-tax country pays interest, royalties, or other deductible amounts to a CFC resident in a low-tax country. In the absence of special rules, interest, royalties, and other amounts received by a CFC would likely be considered to be passive income subject to the CFC rules. However, many countries have adopted special rules to exclude such intercompany payments from the scope of tainted income. Thus, in general, multinational enterprises can establish group finance companies or holding companies for intellectual property in order to reduce foreign taxes without becoming subject to the CFC rules.

Any tainted income of a CFC that is attributable to its domestic shareholders should be computed in accordance with domestic tax rules and in domestic currency. This obligation presents many difficulties because of differences between foreign and domestic tax laws. Generally, a CFC is not allowed to consolidate its profits and losses with the profits and losses of other CFCs of the same domestic shareholders.

#### *7.3.2.4 Nature and Scope of Exemptions*

Countries may provide a variety of exemptions that limit the scope of their CFC rules. The most important of these exemptions are described below. The exemptions vary depending on whether a country uses an entity or transactional approach, as described above. All countries with CFC legislation provide at least some of these exemptions.

*Exemption for genuine business activities or active business income.* An exemption is usually granted, expressly or implicitly, for CFCs engaged primarily or exclusively in genuine business activities or for active business income earned by CFCs. Countries that use a transactional approach, as described above, tax only the tainted income of a CFC. Inherent in this approach is the exemption of active business income, since such income is not considered to be tainted income. Other countries use an entity approach, under which each CFC is tested and either all or none of its income is attributed to its domestic shareholders. Under the entity approach, an exemption is invariably provided for CFCs engaged primarily or almost exclusively in genuine business activities. This exemption is generally available only if: (1) the CFC is engaged in certain defined active businesses or is not engaged in investment activities; (2) it has a substantial presence in the foreign country; and (3) less than a certain percentage (usually 50 percent) of its income is tainted income (generally passive income and base company income).

Only the CFC rules of Sweden and Brazil do not distinguish between active business income and other income. Under their CFC rules, all the income of a CFC that is not exempt is attributable to its domestic shareholders. However, Sweden provides broad exemptions from the CFC rules; virtually all CFCs established in countries with which Sweden has a tax treaty, as well as other high-tax countries, are exempt.

*Distribution exemption.* To the extent that a CFC distributes dividends out of its current profits to its resident shareholders that are subject to residence country tax, there is arguably no need to apply the CFC rules, since residence country tax is neither avoided nor deferred. Despite the theoretical justification for a distribution exemption, no country currently provides such an exemption from the CFC rules. Part of the reason for the absence of a distribution exemption is that many countries exempt dividends from CFCs; another reason is that distribution exemptions are surprisingly complex and some countries that had initially adopted such exemptions later eliminated them.

*De minimis exemption.* A *de minimis* exemption is frequently granted for CFCs whose income (or tainted income) does not exceed a minimum amount. *De minimis* exemptions vary widely, and several countries do not provide any such exemption. The Canadian exemption is available only if the CFC's tainted income is CAN 5,000 (approximately USD 3,750 as of late 2015 - a meaninglessly small amount) or less. Other countries provide sizeable *de minimis* exemptions, although they are difficult to justify on tax policy grounds. *De minimis* exemptions appear to be largely motivated by political considerations in order to allay fears that CFC rules will impose significant compliance costs on taxpayers in respect of relatively small amounts of income subject to tax.

*Other exemptions.* A few countries provide an exemption for CFCs that are not used for the purpose of avoiding or reducing tax (a "motive" exemption). Although a motive exemption is perhaps consistent with the anti-avoidance purpose of CFC legislation, it gives the tax authorities considerable discretion. It may be a simple way of limiting the scope of the rules without the legislative complexity necessitated by more specific exceptions.

The UK provides an exemption for CFCs that earn low profit margins.

#### *7.3.2.5 Resident Taxpayers Subject to Tax*

In most countries, both individual and corporate shareholders are subject to tax under the CFC rules; in a few countries, the rules apply only to resident corporations. There does not appear to be any good reason why the rules should not apply to individuals.

In most countries, the undistributed income of a CFC is attributed to resident shareholders who own shares in the corporation at the end of its taxation year. This approach may appear to be unfair because it taxes shareholders on their pro rata share of the CFC's income for the entire year despite the possibility that they may have owned their shares for only part of the year. However, this approach is much simpler, although less precise, than determining a taxpayer's share of the income of a CFC for part of a year. In addition, once the end-of-the-year rule is well understood, persons acquiring shares of a CFC can be expected to take the rule into account in setting the purchase price of the shares.

In most countries, resident shareholders of a CFC are not taxable on their share of the undistributed income of the foreign corporation unless they meet a minimum

share ownership requirement (usually 10 percent). The reason for this exemption for shareholders with small investments in a CFC is that they may not have sufficient influence over the foreign corporation to require it to distribute its income or obtain access to the information necessary to compute their share of the income. Nevertheless, these small shareholders may be counted in determining whether a foreign corporation is controlled by resident shareholders.

#### *7.3.2.6 Relief Provisions*

Typically, countries provide some relief from double taxation that may otherwise occur from the operation of their CFC rules. Because the basic taxing mechanism under CFC rules is to tax the resident shareholders of a CFC on their share of its undistributed income, the possibility of double taxation arises where the CFC's income is subject to foreign tax and where a shareholder receives dividends from a CFC or disposes of its shares in the corporation. Most countries provide relief for foreign taxes and subsequent dividends out of previously taxed income of a CFC, but few countries provide relief for capital gains from the disposal of shares of a CFC that reflect previously taxed income of the CFC. These double taxation issues are illustrated in the following example.

PCo, a resident of Country P, owns all the shares of SCo, a resident of Country S. In 2016, SCo earns passive income of 1,000 in Country S and pays tax of 100 to Country S on its income. Under Country P's CFC rules, PCo is taxable on SCo's income of 1,000 at a rate of 40 percent (or 400) and qualifies for a foreign tax credit of 100 for the tax paid by SCo to Country S of 100. In 2018, SCo pays a dividend to PCo of 900. Since PCo has already been taxed on the income out of which the dividend was paid, the dividend should be exempt from Country P tax if it is otherwise taxable under the laws of Country P. If Country S imposes withholding tax of 10 percent on the dividend, Country P should also provide relief for that withholding tax, perhaps by allowing it to be carried back and claimed as a foreign tax credit in 2016 or by allowing it to be claimed against any tax on CFC income for 2018 or future years.

If PCo sells the shares of SCo in 2018 without receiving a dividend, the proceeds of sale will presumably reflect SCo's after-tax income for 2016 of 900. Since PCo has already paid tax to Country P on that amount, it should not be required to pay tax on the capital gain realized on the sale of the shares of SCo. If no relief is provided by Country P in this situation, PCo is likely to consider having SCo pay a dividend of 900 (which will probably be exempt from tax by Country P, as explained above) to reduce the capital gain on the sale of the shares.

Losses of a CFC are not generally attributable to its resident shareholders. Most countries permit such losses to be carried forward and deducted in computing the attributable income of the CFC in future years.

Most countries' CFC rules do not provide specific relief from double taxation resulting from the application of the CFC rules of two or more countries. For example, assume that ACo, resident in Country A, owns all the shares of BCo, resident in Country

B. BCo owns all the shares of a corporation that is established in a tax haven and earns passive income. If Country A and Country B both have CFC rules, the passive income of the tax haven corporation may be subject to tax to ACo by Country A and to BCo by Country B. Although it may appear that Country A should give credit for the tax levied by Country B pursuant to its CFC rules, Country A may take the position that the passive income of the tax haven corporation was shifted from Country A and should be taxable in Country A. Some countries provide specific relief, by way of deduction or credit, for foreign taxes levied pursuant to another country's CFC rules. Other countries provide no relief, although relief might be available under the mutual agreement procedure of an applicable tax treaty. This double-tax problem is becoming more serious as more countries adopt CFC rules.

### 7.3.3 Tax Treaties and CFC Rules

The relationship between tax treaties and CFC rules is controversial. In Finland, France, Japan, Sweden, and the UK taxpayers have challenged the application of CFC rules to foreign subsidiaries as a violation of an applicable tax treaty. The taxpayers have argued that the business profits article of the typical tax treaty (Article 7 of the OECD and UN Model Treaties) provides that a country (the country with CFC rules) cannot impose tax on the business profits of a corporation resident in the other country (even if controlled by residents of the first country) except to the extent that the corporation has a PE in the first country and the profits are attributable to the PE. In response, the tax authorities have argued that under CFC rules, tax is imposed on the resident shareholders of the foreign corporation, not the CFC, and nothing in a tax treaty prevents a country from taxing its own residents.

The strength of these arguments varies depending on the particular country's CFC rules and the specific provision of the treaty. As noted above, most countries' CFC rules do not apply to active business income; moreover, several countries do not apply their CFC rules to CFCs resident in treaty countries. As a result, the potential conflict between tax treaties and CFC rules is limited. The cases have been decided uniformly in favor of the tax authorities, except in France, where the highest French court held that Article 7 of the France-Switzerland treaty prevented the application of the French CFC rules to a Swiss subsidiary of a French corporation.

The Commentary on Article 1 of the OECD Model Treaty was revised in 2003 to clarify that, according to the OECD, there is no conflict between CFC rules and tax treaties; therefore, tax treaties do not prevent the application of CFC rules. Further, the revisions to the Commentary clarified that it is not necessary for countries with CFC rules to put an explicit provision in their treaties allowing the application of CFC rules. A few countries – Belgium, Luxembourg, the Netherlands, and Switzerland – have registered their disagreement with this aspect of the Commentary. The Commentary does caution countries not to apply their CFC rules to companies resident in treaty countries that are subject to tax in those countries comparable to the tax imposed by the resident country.

## 7.4 NONRESIDENT TRUSTS

Trusts are legal relationships under which the legal ownership and management of property is separated from its beneficial ownership. Trusts originated under English law as part of the common law and are recognized under the laws of most common law countries. Some civil law countries have adopted legislation to allow the establishment of trusts or trust-like relationships. Typically, a trust involves a **settlor** (the person who establishes the trust and transfers (settles) property to the trust) and a **trustee** (the person who has legal ownership and management of the property for the benefit of one or more **beneficiaries** (the persons who are the beneficial owners of the property)). A trust is a particularly flexible arrangement because the settlor of the trust may also be a trustee and a beneficiary. Trusts may be either discretionary or nondiscretionary. Under a nondiscretionary trust, the interests of the beneficiaries are fixed and cannot be altered without the amendment of the trust. In contrast, under a discretionary trust, the trustee has discretion with respect to the amount of income or capital payable to any particular beneficiary.

The flexibility of trusts makes them difficult to tax, and the difficulty is magnified with respect to nonresident trusts. In many countries that recognize trusts, they are taxed as entities, at least to the extent that they accumulate their income.

Beneficiaries are generally taxable on trust income that is distributed to them, but not on distributions of the capital of the trust, which generally includes the after-tax income of the trust (in other words, the income earned or received by a trust in a year is usually added to the trust's capital if it is not distributed in the year).

If a resident of Country A establishes a trust in a tax haven (and many tax havens, especially former UK colonies, have adopted flexible trust legislation to facilitate this practice) for the benefit of family members who are also resident in Country A, in the absence of special rules, Country A may be unable to tax the income of the trust unless the beneficiaries receive current distributions out of the trust's income. The trust itself is not a resident of Country A and therefore is not taxable by Country A except to the extent that it derives income from Country A. In most cases, any income earned by the trust in a year will be accumulated in the trust and distributed to the beneficiaries only in subsequent years as tax-free capital distributions or after they have ceased to be resident in Country A.

To prevent this type of tax avoidance, some countries have adopted special rules that attempt to impose tax if a resident transfers property to a nonresident trust with resident beneficiaries. Taxpayers may attempt to avoid these rules by establishing foreign trusts with a recognized international charity as the only named beneficiary, but with a power in the trustee or a protector (usually a trusted friend or adviser who is a nonresident) to add new beneficiaries to the trust at any time. Alternatively, some tax havens allow the establishment of purpose trusts, which do not require any named beneficiaries. In response, some countries have extended their nonresident trust rules to tax the resident settlor (any resident who transfers property to a nonresident trust) on the income of the trust. This measure may be considered to be draconian because legally the settlor has no right to obtain any funds from the trust. However, it is

intended to stop residents from transferring funds to nonresident trusts in the first place, in recognition of the difficulty that countries have in taxing the income of such trusts, either by taxing the trust or its resident beneficiaries.

## 7.5 FOREIGN INVESTMENT FUNDS

As discussed in section 7.3.2.1 above, CFC legislation generally applies only to foreign corporations that are controlled by resident shareholders, and in some countries, only to foreign corporations that are controlled by a small group of resident shareholders. Moreover, the CFC rules of several countries apply only to resident shareholders that own a minimum percentage (usually 5-10 percent) of the shares of the foreign corporation. As a result, it is relatively easy for foreign investment companies, mutual funds, or unit trusts to be established in low-tax countries without being subject to the CFC rules. Such foreign investment funds allow resident taxpayers to defer domestic tax on their passive investment income. Foreign investment funds may also permit taxpayers to convert what would otherwise be ordinary income into capital gains on the disposition of interests in the fund.

Several countries have enacted detailed legislation to prevent the deferral of domestic tax through the use of foreign investment funds. For some countries, the purpose of these rules is to prevent the avoidance of CFC legislation. For some other countries, the foreign investment fund rules have a much broader purpose: they are intended to eliminate the benefit of deferral for all investments in passive foreign corporations and other entities that are not subject to the CFC rules.

When thinking about foreign investment fund rules, it is useful to compare the tax consequences of three alternative investments: (1) an investment in a foreign investment fund; (2) an investment in a domestic investment fund; and (3) a direct foreign investment (e.g., purchase of a foreign bond or rental real property located offshore). The essential difference between the tax consequences for a resident investing in a domestic investment fund as compared to a foreign investment fund is that residence country tax is deferred with respect to a foreign fund until the resident receives distributions or disposes of the interest in the fund. In contrast, domestic tax is customarily imposed on the income derived by a domestic investment fund.

The benefit of an investment in a foreign investment fund compared to a direct foreign investment is that the income from the fund can be effectively converted into capital gains if the fund accumulates its income. This conversion of investment income into capital gains may also occur with respect to investments in shares of resident corporations. However, resident corporations are subject to current corporate tax in the residence country on their income, whereas foreign corporations are not.

As a result, the tax systems of many countries contain an incentive for resident individuals to invest in foreign corporations as compared to resident corporations whenever (1) foreign taxes on the foreign corporation's income are less than the domestic taxes on the equivalent amount of income of a resident corporation, and (2) the foreign corporation accumulates at least part of its income. The incentive is greatest where the foreign corporation is based in a tax haven and accumulates all of its income.

Countries use several different approaches to deal with investments in foreign investment funds, and in certain circumstances, some countries use more than one method. The methods are described briefly below.

*CFC rules.* In some countries, such as Germany, the foreign investment fund rules form part of the CFC rules. The CFC rules apply to small investors in foreign corporations and other entities controlled by residents if the entities earn primarily passive income.

*Purpose test.* Some countries, such as Canada, have a purpose-based specific anti-avoidance rule to deal with residents that own interests in a foreign investment fund. Thus, residents who hold an interest in a foreign investment fund are taxable on imputed income if one of the primary purposes for the acquisition or holding of the interest in the fund is to avoid tax.

*Mark-to-market method.* A mark-to-market method is essentially an accrual-based capital gains tax under which any increase or decrease in the value of a resident taxpayer's interest in a foreign fund must be included in computing the taxpayer's income for each year. For example, if a taxpayer's interest in a foreign investment fund has a value of 300 at the start of a year and 500 at the end of the year, the taxpayer would be subject to tax on a gain of 200. If the value of the interest declined to 200 at the end of the following year, the taxpayer would have a loss of 300.

The mark-to-market method is easy to apply if the foreign investment fund is actively traded on a stock exchange or if the fund provides information on the current value of interests in the fund (usually for the purpose of redeeming investors' interests). In other circumstances, it may be quite difficult to value interests in a foreign investment fund except when they are sold.

*Imputed income approach.* Under an imputed income or deemed rate of return approach, the resident taxpayer is considered to have earned income on the amount invested in the offshore fund at a specified rate, irrespective of the actual income earned by the fund. For example, if the specified rate of return is 10 percent, an individual who invests 10,000 in the fund would be taxable on deemed income of 1,000. Any deemed income for a year would then be added to the cost of the interest in the fund. Thus, assuming no distributions from the fund are made, the individual would be taxable on deemed income of 1,100 (10 percent of 11,000) for the *following* year.

The advantage of the imputed income method is that it is simple to apply and minimizes the compliance burden on taxpayers and the administrative burden on the tax authorities because it is unnecessary for them to obtain specific information about the income of the foreign investment fund. However, the imputed income method may result in the under- or over-taxation of investors.

*Deemed distribution approach.* Under this approach, resident shareholders are subject to tax on their pro rata share of the income of the foreign fund regardless of whether the income of the fund is distributed. This approach is the same as the method of taxation under CFC rules: it requires taxpayers to have access to sufficient information in order to compute their share of the foreign investment fund's income. As a result, it is sometimes limited to taxpayers who own a substantial interest in the offshore entity.

*Deferral charge approach.* Under this approach, residence country tax is not imposed until distributions are received or gains are realized. However, at that time an interest charge is imposed to eliminate the benefits of deferral that the taxpayer has enjoyed.

Most countries that have foreign investment fund rules generally apply their rules only to foreign entities that earn primarily passive income or whose assets consist primarily of passive assets such as marketable securities. Exemptions are often provided for foreign entities that are principally engaged in an active business or that distribute virtually all of their income currently. The distinction between active and passive income or assets is a difficult one to make in a satisfactory manner and usually requires complex rules. Most countries provide double-tax relief for foreign taxes, actual distributions, and capital gains on the disposition of ownership rights in the fund. These relief mechanisms are similar to those provided in comparable circumstances for income derived through CFCs (see section 7.3.2.6 above).