Advisory Panel on
Canada's System of
International Taxation

Controlled Foreign Company Taxation Regimes in Selected Countries

KPMG LLP

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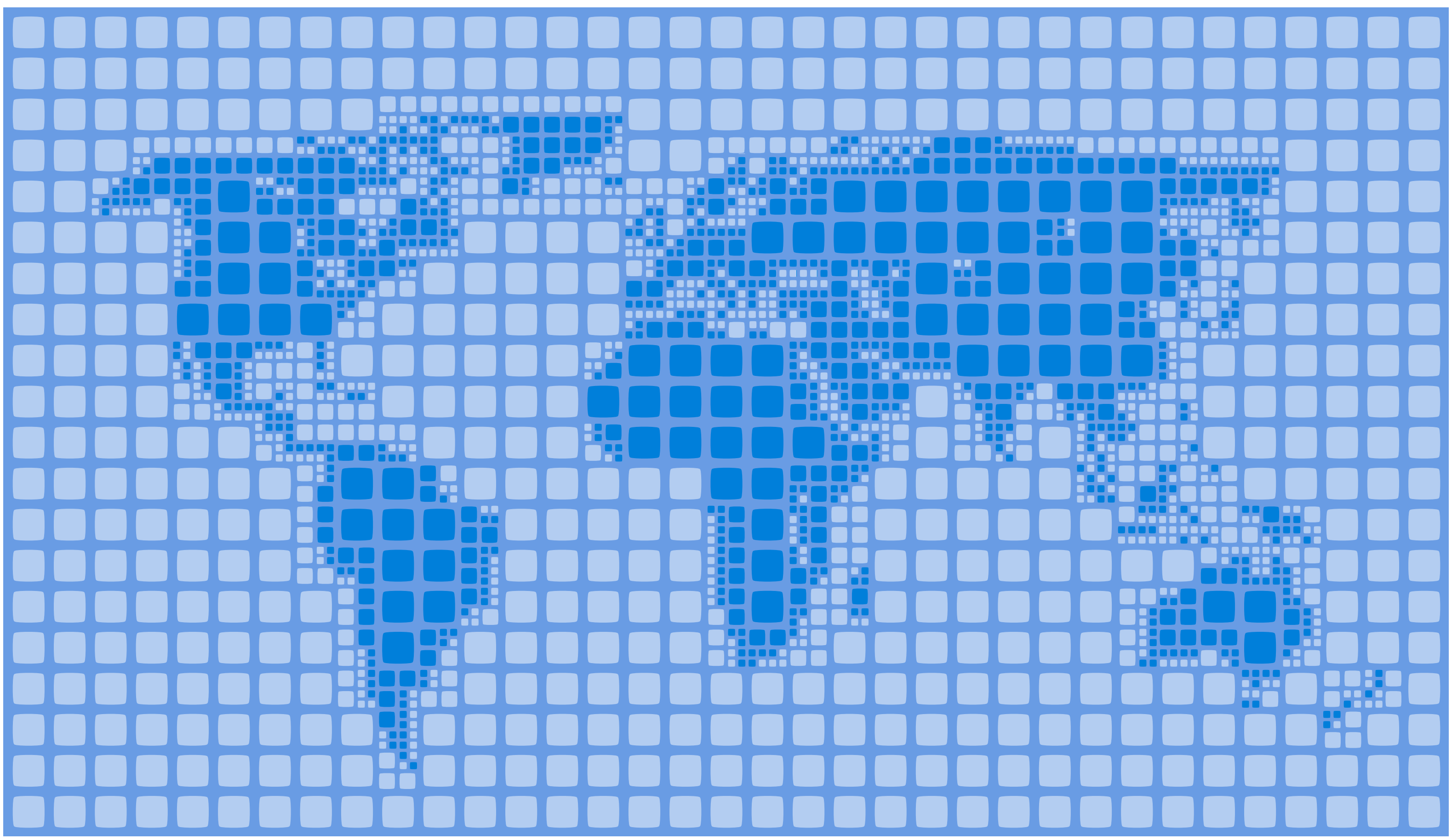

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Introduction

This report summarizes information on the rules governing the taxation of controlled foreign corporation (CFC) income in the following countries:

- Australia
- France
- Germany
- Italy
- Japan
- Netherlands
- New Zealand
- Sweden
- United Kingdom
- United States

Note that CFC tax regimes generally are comprised of a complex set of technical rules. For the purpose of this report, however, we have provided a basic outline of the important and applicable CFC rules, without going into a great level of technical detail or complexity.

The format of this report is based on a specific set of questions outlined by the Advisory Panel on Canada's System of International Taxation. We have attempted to include all relevant information related to CFC regimes but this report is not exhaustive. Furthermore, the information contained herein is current as of the date of this report.

If you have questions or require further clarification, please contact Firoz Talakshi (403-691-8226) or Shawn Brade (403-691-7951) of KPMG LLP.

Australia

1. Current domestic rules

1.1 Taxpayers and forms of enterprise subject to the rules

The Australian CFC rules apply to Australian partnerships, Australian trusts, and other entities that are a resident of Australia. This includes individuals and companies but not Australian branches of foreign resident companies.

A company is resident in Australia if it is incorporated in Australia or if it carries on a business in Australia and either its place of central management and control is in Australia or its controlling shareholders are residents of Australia.

An individual is broadly considered a resident of Australia when they are domiciled in Australia or have spent more than 183 days in Australia.

1.2 Type of approach

Australia's approach to the taxation of CFCs is generally a transaction/income-based approach, but it is also dependent upon country of residence and location of operations of a CFC.

1.3 Threshold for application of rules

Definition of controlled foreign corporation

A company is a CFC if it is a resident of a foreign country and any of the following tests apply:

- *"Strict control test"*: Five or fewer "Australian one percent entities" together with their associates own or are entitled to acquire a "control interest" of at least 50 percent in the company, where control may be direct or indirect and does not require that each entity/associate be related or collude.
- *"Objective* de facto *control test"*: A single Australian entity together with its associates owns or is entitled to acquire a control interest of at least 40 percent in the company.
- *"Subjective* de facto *control test"*: Five or fewer Australian entities together with their associates effectively control the company. This is only relevant where the above thresholds of 50 percent and 40 percent are not reached. In order to ascertain whether control exists considerations may extend to such factors as influence on dividend policy, controlling the appointment of directors, day to day management, ability to alter the legal rights, and entitlements of the constituents.

An "Australian one percent entity" is an Australian entity that together with its associates holds a control interest in the company of at least one percent. The term "associate" is very widely defined.

Control: De jure or de facto

"Control interests" comprise both direct and indirect control interests. The direct control interest is the greatest percentage that the taxpayer holds or is entitled to acquire in any of the following:

- the total paid-up share capital of the company;
- the total rights to vote or to participate in decision making concerning:
  - distributions of capital or profits;
  - the constituent document of the company; or
  - variation of the share capital;
- the total rights to distributions of capital or profits on winding-up;
- the total rights to distributions of capital or profits other than on winding-up.

Indirect control interests exist where control interests are held through one or more intermediary controlled foreign entities (CFCs, partnerships or trusts) and are determined by multiplying the taxpayer's direct control interest in the intermediary entity by the intermediary's direct control interest in the ultimate entity.

De minimis exceptions

If a CFC is a resident in a listed country,[1] there is a minimum threshold below which there is no attribution. The minimum threshold is either based on five percent of gross turnover where the CFC's gross turnover is under AUD one million, or AUD 50,000 where the CFC's gross turnover is above AUD one million. There is no minimum threshold exemption for CFCs that are resident in unlisted countries.

Where the required level of control is not met, such that the foreign company is not a CFC, then Australia's foreign investment fund (FIF) rules may apply. The FIF rules provide increased flexibility in attributing income such that the investor can elect to attribute income based on a deemed rate of return, market value or calculation method basis.

1 Listed countries are countries with comparable tax regimes: Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States. All other countries are unlisted.

1.4 *Mechanics of attribution*

A CFC's income is attributed to an Australian taxpayer based on that taxpayer's "percentage attribution interest" in the CFC. In general terms, a taxpayer's "percentage attribution interest" is equal to its control interest in that CFC (i.e., greatest percentage of paid-up capital, rights to vote, etc., as outlined above).

Where the aggregate of percentage attribution interests in a particular CFC exceeds 100 percent, the aggregate is reduced to 100 percent by reducing each attributable taxpayer's interest proportionately.

1.5 *Scope of income captured by rules*

Listed countries

For CFCs resident in listed countries, generally no portion of its income (whether it be active or passive income) is taxable under the CFC regime. The narrow exception is specifically identified types of income (called "eligible designated concession income") which is generally not subject to tax or taxed at a reduced rate of tax under a concession granted by the foreign jurisdiction.

Income derived by a listed country CFC from investments in lower-tier FIFs, trusts and partnerships may be subject to Australian tax under the CFC rules.

Unlisted countries

For CFCs resident in unlisted countries, generally, income from its active business operations ("active income") is not subject to tax under the CFC regime. However, passive income (e.g., certain interest, dividends, rents and royalties income) may be subject to Australian tax under the CFC regime, where the CFC fails the "active income test".

The significant types of passive income include:

- *Tainted sales income*: Where an associate of the CFC has a connection with Australia and sells goods to the CFC, the proceeds from the on-sale of those goods by the CFC will be attributable income and accordingly assessed Australian tax.

- *Tainted services income*: Where the CFC supplies services to an Australian resident or where the CFC supplies services to an Australian branch of a non-resident, such income will be attributable and assessed Australian tax.

- *Tainted royalty income*: Royalty income is subject to Australian tax where it is not derived in the course of a business carried on by the CFC, or is received from an associate of the CFC, or where the CFC has not substantially enhanced the market value of the underlying matter or thing giving rise to the royalty.

- *Tainted rental income*: Rental income of a CFC will be passive income (and therefore attributable) where it is derived other than as a result of providing labour intensive property management services in connection with the lease of land.

1.6 *Exceptions for application of rules*

Broadly, an exception to the CFC rules is provided for foreign companies which are engaged in deriving active income. Active income will consist of all income which is not considered passive income. Australia's CFC rules provide for this exception provided the active income of the foreign company exceeds 95 percent of its total income. Where this is the case, no attributable income will arise in Australia.

1.7 *Relieving measures*

Foreign tax credit

Australia's CFC regime provides for a dual system of accounting for foreign tax paid by a CFC. Generally, where the CFC pays foreign tax, it will be entitled to a notional allowable deduction against its notional assessable income. However, where the foreign tax paid satisfies Australia's foreign tax offset rules, the foreign tax paid is "added back" to the notional assessable income of the CFC and a foreign tax offset is allowed against the Australian tax payable.

Deduction of related expenses

Broadly, a notional allowable deduction is allowed against notional assessable income of the CFC. However, since the notional assessable income will only include certain types of income consideration must be had for whether the deductions relate to the notional assessable income.

Adjustments to cost base of CFC shares

Where a CFC has an attribution surplus (that is an excess of attributed income which has not been paid up to the parent entity but which has been taxed in Australia) the "capital proceeds" which the parent entity received from the disposal of the CFC is reduced by any attribution surplus. We note that any potential capital loss is limited to capital proceeds received.

CFC losses

Australia's CFC rules allow for the CFC to be in a loss position. Broadly, a CFC loss is created where its notional allowable deductions exceed the notional assessable income of the CFC. The CFC losses can be carried forward to be used in future income years; these losses will be applied as a notional allowable deduction to the extent that it would not exceed the notional assessable income of that CFC in the future years.

Subsequent distributions

Subsequent distributions of attributed income by a CFC are not subject to tax.

2. Brief summary of any clearly enunciated policy rationales for the rules

Australia's CFC rules operate to prevent the deferral of Australian tax on passive and mobile income of Australian companies which is derived in jurisdictions without a comparative tax system. Accordingly, this provides the policy rationale for both the active income exemption and the restricted types of income attributable for listed countries.

3. Description of basic tax planning undertaken by taxpayers to minimize the unfavourable impact of these rules

The significant planning opportunities exist in falling into the FIF rules as opposed to the CFC rules, since the FIF rules provide a more flexible approach to attributing income. Accordingly, the planning opportunities arise around the idea of control and what constitutes control. However it is noted that the "subjective control test" is sufficiently wide to capture many planning techniques.

Overall, we would consider Australia's CFC regime "reasonable with some planning opportunities available."

4. Impact of tax conventions or other supra-national legislation on the CFC regime

Not applicable.

5. Pending or expected changes to CFC regime

In January 2008, the Board of Taxation (a body independent of the Government and the revenue authorities) completed a review of the CFC/FIF and transferor trust regimes. The review identified a need to focus on the policy reasoning behind the CFC/FIF rules with the objectives being:

- to reduce the complexity and compliance costs of the attribution regimes, including whether the regimes can be collapsed into a single regime; and
- to examine whether the attribution regimes strike an appropriate balance between countering tax deferral and unnecessarily inhibiting Australians from competing in the global economy.

Since the report has only recently been released, no legislation has been introduced to Parliament and thus the details of any changes at the time of writing are uncertain.

France

1. Current domestic rules

1.1 Taxpayers and forms of enterprise subject to the rules

A "French resident company" is one that has its legal seat in France or its place of effective management in France. A French resident company may have any legal form but must be subject to corporate income tax (CIT) by effect of law or by way of election. Effective payment of a CIT burden is not required.

The minimum holding percentage in foreign companies required for the application of the CFC rules to French companies subject to CIT is 50 percent, as outlined more fully below.

French individuals, partnerships and trusts not subject to French CIT that directly or indirectly hold an interest in foreign companies, permanent establishment (PE) or any entity (with or without legal personality) also fall into the scope of CFC rules. The CFC rules are applicable if the French individuals/partnerships/trusts hold, directly or indirectly, at least 10 percent of the shares, financial rights or voting rights of the foreign company, PE or any similar entity.

1.2 Type of approach

The main French CFC rules, codified under Article 209 B of the French Tax Code, are entity-based.

Another set of rules, codified under Article 238 A of the French Tax Code, is transaction-based. According to these rules, any French resident entity that makes payments to the benefit of a foreign entity benefiting from a privileged tax treatment (i.e., that bears a local income tax that is lower than 50 percent of the CIT it would have borne had it been a French tax resident) must justify the reality of the underlying operation so as to maintain the corresponding deductibility of the payment from the French CIT base.

For simplicity purposes, all comments below exclusively focus on the CFC rules in Article 209 B of the French Tax Code.

1.3 Threshold for application of rules

Definition of controlled foreign corporation

The French CFC rules will generally apply to a French resident company if:

- The French resident company is subject to French CIT.
- The French resident company has a branch/PE or subsidiary in another country that is at least 50 percent directly or indirectly held.[2] The 50-percent holding test is based on the proportion of shares, financial rights or voting rights held by the French company and by certain affiliated persons.[3] Different categories (voting/ financial rights) are not aggregated to determine whether the 50-percent threshold is reached.
- The branch/PE or subsidiary is benefiting from a "privileged tax treatment", i.e., less than 50 percent of the French CIT that would have been borne in France in the same conditions.

All conditions of the French CFC rules are cumulative. Should one of the conditions not be met (e.g., if the tax treatment of the foreign entity is not considered, under the French tax law, as "privileged"), the CFC rules are not applicable.

The scope of the French CFC rules is broad. The CFC rules are applicable when the concerned French company has a branch/PE or subsidiary in another country, notwithstanding the consistence or type of organization of the foreign entity (no requirement of legal entity).

EU resident branch/PE or subsidiary exception

For an EU resident branch/PE or subsidiary, an artificial scheme aiming at circumventing French taxes must exist before the CFC rules apply.

Non-EU resident branch/PE or subsidiary

For a non-EU resident branch/PE or subsidiary:

- the CFC rules will not apply if the income is entirely derived from an effective industrial or commercial activity;
- the CFC rules are automatically applicable if the entity has no industrial or commercial activity and the conditions mentioned above are met (i.e., ownership threshold and privileged tax treatment);

2 This indirect participation corresponds to any shares, financial rights or voting rights (hereafter collectively referred to as "Rights") held by direct and indirect subsidiaries of the French company, as well as Rights held through a "Community of Interest" (i.e., any Rights held in the foreign CFC by individuals also holding Rights in the French company; Rights held by employees or managers or by a commercial partner of the French company or Rights directly or indirectly held by any affiliated entity when one of the shareholders of that entity also holds a direct or indirect participation in the French company, assuming that this shareholder has, directly or indirectly, the most important number of voting rights in the entity and in the French company).

3 As outlined in note 2.

- the CFC rules will apply if the activity is (i) partly industrial or commercial, (ii) intra-group passive income is greater than 20 percent, or passive income and intra-group services is greater than 50 percent, and (iii) there is no other "main effect than tax effect".

Control: De jure or de facto

An anti-abuse provision reduces the ownership threshold from 50 percent to five percent in situations where more than 50 percent of the shares in the foreign entity are owned by French companies or by foreign entities directly or indirectly controlled by a French company. To apply this anti-abuse provision, the tax administration must demonstrate that the French companies acted together to avoid the application of the CFC rules.

De minimis exceptions

Not applicable.

1.4 Mechanics of attribution

Foreign entities subject to CFC legislation are assessed to tax in France on a pro rata amount of the income received (when the foreign entity is not a separate legal entity), or deemed received (when the foreign entity has the legal personality), from such entity or permanent establishment. The pro rata amount is based on the proportion of the financial interests held directly or indirectly by the French taxpayer. Financial rights are understood as those which would give right to the receipt of dividends and/or access to the liquidation proceeds. Voting rights held by the French company are not taken into account in determining the proportion of income taxable at the level of the French company. Rights held through a community of interest (i.e., rights held by employees, managers, shareholders or commercial partner of the French company), which are relevant in determining whether the CFC rules apply to a French company, are not considered to be financial rights for the purposes of the determination of the taxable pro rata amount.

The French parent/subsidiary regime applicable to dividends is not applicable to deemed distributed income received by the French parent from the foreign entity under the CFC rules. This regime would nevertheless be applicable to actual dividends received by the French parent, even from a CFC.

The attributed CFC income is no longer taxed separately (in contrast to the former rules applicable before January 1, 2006) from the French entity's other income. Accordingly, losses from the French legal entity may be offset against CFC profits. In contrast, losses from CFCs may not be offset against profits from the French company, but may be carried forward at the level of the foreign entity under certain conditions.

See also "Relieving Measures" below.

1.5 *Scope of income captured by rules*

All of the CFC's net profits are attributable to the French resident company, regardless of whether the CFC earns business or passive income (French tax law does not clearly distinguish business or passive income as other national tax legislations do).

1.6 *Exceptions for application of rules*

As noted above, the foreign branch or company must benefit from a "privileged tax treatment", i.e., less than 50 percent of the French corporate income taxation that would have been borne in France in the same conditions.

In the event where the foreign branch or entity is located in an EU Member State and benefits from a "privileged tax treatment", the application of the CFC rules depends upon the existence of an artificial scheme aiming at circumventing French taxes.

1.7 *Relieving measures*

Foreign tax credit

The foreign tax due on the profits falling under the CFC rules is credited against the corresponding French tax, provided that the foreign tax is comparable to French corporate tax. In addition, withholding taxes on passive income received by the foreign entity and levied by third countries that have concluded a treaty with France containing an administrative assistance clause may be credited against the French tax due on such income up to the amount provided for by the treaty.

Deductions of related expenses

As CFC income is based on a foreign entity's net profits, there is an inherent deduction of related expenses. There is no denial of expenses incurred at the level of French parent in case of application of the French CFC rules.

Adjustments to cost base of CFC for imputed income

Not applicable.

CFC losses

Losses from CFCs may not be offset against profits from the French company, but may be carried forward under certain conditions.

Subsequent distributions

Subsequent dividend distributions paid by CFC are exempt under certain conditions.

2. Brief summary of any clearly enunciated policy rationales for the rules

New French CFC rules (in force as from 2006) have been implemented to make them compatible with tax treaties.

3. Description of basic tax planning undertaken by taxpayers to minimize the unfavourable impact of these rules.

There are reasonable planning opportunities available to plan around the CFC regime, including:

- Locating compliant business activity in the concerned CFC; and
- Utilizing EU finance vehicles with actual substance.

4. Impact of tax conventions or other supra-national legislation on CFC regime

French Tax Authorities consider the new French CFC rules to be compliant with both tax treaty law and EU law.

No case law on these new rules is available to date. According to a 2001 decision of the French highest Administrative Court (*Conseil d'Etat*), certain tax treaties may prevent the application of the CFC rules on income derived from foreign PEs benefiting locally from a privileged tax regime. However, it should be noted this case should effectively not apply where the CFC is a legal entity in the foreign jurisdiction and is deemed to distribute dividends to the French parent.

5. Pending or expected changes to CFC regime

Not applicable.

Germany

1. Current domestic rules

1.1 Taxpayers and forms of enterprise subject to the rules

Germany's CFC rules apply to German resident companies and individuals. They do not apply to partnerships, branches or other entities. However, special attribution rules apply to prevent avoidance by interposing a partnership or branch between a German tax resident and a CFC.

1.2 Type of approach

Germany's approach applies at the entity-level based on income that is, or is deemed to be, passive.

1.3 Threshold for application of rules

Definition of controlled foreign corporation

Four requirements must all be met in order for the CFC rules to apply:

1. The CFC is not subject to the rules of the German Investment Tax Act.

2. The foreign entity is controlled by German tax residents (related or unrelated). Control is therefore assumed where German tax residents jointly own more than 50 percent although none of them individually exercises control. Control is determined based on the percentage ownership in the capital or on voting rights. For example, where a German company held 100 percent of the Class A shares of a CFC (which had other classes of shares outstanding that were held by non-residents) and those Class A shares represented 60 percent of all the CFC's stated capital and fair market value, but only 10 percent of all votes, the CFC would be considered to be controlled by German tax residents. Alternatively, German tax residents would also be considered to control the CFC where the Class A shares represented only 10 percent of all the CFC's stated capital, but 60 percent of all votes.

   - Control test only applies to German tax residents (i.e., subject to tax in Germany on their worldwide income); control held by non-German tax residents subject to German tax only on their German source income is not relevant.

   - Control means more than 50-percent direct or indirect ownership (determined based on votes or value).

   - There is no minimum ownership requirement that a particular German taxpayer must have in the non-resident entity in order for the CFC rules to apply to that particular taxpayer (i.e., regardless of how nominal an investment that a particular German taxpayer may have in the foreign entity, it would be subject to the CFC rules in respect of that foreign entity where the foreign entity is controlled by German tax residents).

- In addition, for foreign entities that generate passive investment income (see below), as opposed to other types of passive income or income from passive activities, an alternative requirement of a one-percent ownership applies (i.e., passive investment income is subject to the CFC rules if either German tax residents jointly own more than 50-percent of the foreign entity as outlined above or the particular German tax resident owns a stake of at least one percent of the foreign entity). Should the foreign entity generate almost exclusively passive investment income, a participation lower than one percent is sufficient unless the shares in the foreign entity are regularly traded on a recognized stock exchange.

3. The income is passive in nature (includes regular passive income, passive investment income and income from passive activities) — see "Scope of income captured by rules" below.

4. The income is subject to low taxation, as follows:

   - CFC's passive income must be taxed at an effective rate of less than 25 percent.

   - Foreign income tax imposed on passive income (no mixing) is applied against taxable passive income as computed under German tax principles for CFC purposes to compute the effective tax rate.

   The statutory tax rate of a foreign jurisdiction serves as an indicator only of whether a certain jurisdiction is low taxing or not. The German tax regulations clearly state that a statutory tax rate of 25 percent or more may still result in low taxation if for example the tax base applied abroad is smaller than the domestic one.

De minimis exceptions

The CFC rules do not apply to a particular CFC if the passive income of that CFC does not exceed € 80,000 and 10 percent of the total gross income of that CFC.

1.4 *Mechanics of attribution*

Under the CFC rules, passive income (including passive investment income) or income from passive activities (as determined in accordance with German accounting and tax principles) is deemed to have been distributed, with a deduction for foreign taxes (alternatively, a tax credit applies upon application). Technically, the CFC income that is deemed to have been distributed (and therefore attributed for CFC purposes) to the German resident is not regarded as a dividend and so, in particular, the participation exemption applicable to dividends for corporate shareholders does not apply.

The income of the CFC is generally attributed to a German shareholder based on its percentage ownership in the CFC's nominal capital (i.e., legal stated capital). However, if the CFC does not have a legal stated capital or if the dividend entitlement deviates from the participation in the CFC's legal stated capital, the attribution of CFC income is based on the dividend entitlement.

1.5 Scope of income captured by rules

The CFC rules apply to passive income (which includes passive investment income) and income from passive activities. Regular passive income and passive investment income need to be distinguished as more stringent ownership requirements apply in respect of foreign entities earning passive investment income as outlined above.

Passive investment income refers to income of a foreign entity that is derived from the holding, management, value preservation, or value appreciation of cash and cash equivalents, receivables, securities, ownership interests or similar assets. Therefore passive investment income would generally include interest and dividends on portfolio investments.

German tax law provides for an "activity" and "income" approach. Regular passive income is income that is subject to a low rate of taxation and is *not* derived from the following:

- agriculture and forestry;
- the manufacture, machining, processing, or assembly of tangible property, the generation of energy, and the exploration for and extraction of mineral resources;
- the operation of banks and insurance companies that, for their business, maintain an organization that is equipped in a commercial manner, provided such business is not transacted predominantly with German resident taxpayers holding ownership interests in the foreign company or with parties that are related to such taxpayers;
- trade activities, but with certain exceptions where the trade activity involves transactions with a taxpayer that is a German resident shareholder or a related person unless the taxpayer proves that the foreign company maintains a business organization that is equipped in a commercial manner for such transactions and carries out the activities associated with the transactions without the involvement of any such taxpayer or related person;
- services, except where either
  - the foreign company in performing the services relies on a taxpayer that is a German resident shareholder or a related person to perform the services and the income earned by the German resident shareholder in assisting the foreign company is subject to tax in Germany, or

  - the foreign company renders the service to such a taxpayer or related party (unless the taxpayer proves that the foreign company maintains a business organization that is equipped to render such services and carries out the activities associated with the service without the involvement of any such taxpayer or any such related party);

- rental and leasing, excluding

  - licensing the use of rights, plans, samples, procedures, experience, and knowledge, unless the taxpayer proves that the foreign company is exploiting the results of its own research and development work which was carried out without the involvement of a taxpayer that holds an ownership interest in it or a party that is related to such a taxpayer

  - the rental or lease of land, unless the taxpayer proves that the income there from would be exempt from German tax under the terms of a tax convention if it had been directly derived by the German resident taxpayer that holds ownership interests in the foreign company; and

  - the rental or lease of tangible moveable property, unless the taxpayer proves that the foreign company maintains a commercial rental or leasing business and carries out all activities associated with such business without the involvement of a resident taxpayer that holds an ownership interest in the foreign company or of a party that is related to such a taxpayer;

- borrowing and lending capital, if the taxpayer proves that such capital is borrowed solely on foreign capital markets and not from a party that is related to the taxpayer or to the foreign company, and that such capital is provided either to non-German business entities or permanent establishments which derive their gross revenue exclusively or almost exclusively from the business activities listed in the bullet points above, or to business entities or permanent establishments located within the German territory.

Certain other items of income are treated as active including the following:

- dividends and constructive dividends (as the approach is to tax passive income only when it is generated, but not when such income is distributed by way of a profit distribution irrespective of any participation quota requirement);

- capital gains from the sale of CFCs (or similar events like a liquidation or capital reduction) unless the capital gain is attributable to a CFC that generates passive investment income (burden of proof shifted to taxpayer); and

- reorganizations in foreign jurisdictions if (i) such reorganization could be consummated tax neutral under the German Reorganisation Tax Act; and (ii) to the extent the involved CFCs do not generate passive investment income.

1.6 *Exceptions for application of rules*

As noted, the CFC rules do not apply where the CFC tax burden, in general, is more than 25 percent.

An exemption from the CFC rules applies for a CFC that has its registered office or place of management in a member country of the European Union or European Economic Area, provided the company carries on genuine economic activities in that country. Genuine economic activities require a full-fledged business with an appropriate office, employees and technical equipment. Foreign entities which carry out financing activities on a continuing basis (with appropriate office, equipment and employees) should generally fit the genuine economic activities criteria. Only such income that is attributable to the genuine economic activity which is derived by that particular activity (and only insofar as the arm's length principle is observed in respect of that income) is exempt from the CFC rules. This exemption was introduced in response to the European Court of Justice's *Cadbury Schweppes* decision.

1.7 *Relieving measures*

Deduction/credit of foreign taxes against CFC income

Paid foreign taxes are either deducted from the CFC income or, upon request, a credit of foreign taxes against the domestic tax due on the CFC income is granted.

Deduction of related expenses

Expenses attributable to the passive income are deductible in computing the CFC income subject to tax.

Adjustments to cost base of CFC shares

No adjustments are required. A capital gain on the sale of the shares in the CFC is exempt from tax in Germany.

CFC losses

Losses incurred by a CFC can be used to shelter passive income earned by that CFC in a previous or subsequent year. The loss carry back or forward is available under the same principles as in a domestic situation.

Subsequent distributions

If the CFC actually distributes its profits, the dividend received is fully exempt at the level of the German shareholder. This rule applies for CFC income subject to tax in Germany in the year of profit distribution and the preceding seven years. Should CFC income not be distributed within the seven-year period, then regular rules apply (95-percent exemption for corporate shareholders and 50-percent exemption for individuals, special rules for trade income tax purposes to be observed). The underlying concept is to tax passive income when it accrues, but not subsequent distributions of this income.

2. Brief summary of any clearly enunciated policy rationales for the rules

Income shifting to jurisdictions with low taxation should be prevented.

3. Description of basic tax planning undertaken by taxpayers to minimize the unfavourable impact of these rules

Germany's CFC rules are considered restrictive.

4. Impact of tax conventions or other supra-national legislation on CFC regime

The European Court of Justice ruling in *Cadbury Schweppes* was implemented in German CFC legislation as of January 1, 2008 (see above).

The CFC rules are seen by the legislator as a (permissible) treaty override. Therefore, tax conventions are not regarded as an obstacle to either implementing further CFC legislation or amending existing CFC legislation.

5. Pending or expected changes to the CFC regime

Not applicable.

Italy

1. Current domestic rules

1.1 Taxpayers and forms of enterprise subject to the rules

Italy's CFC regime applies to individuals, corporations, partnerships, trusts and other entities (e.g., commercial legal entities governed by public or private law and non-commercial legal entities governed by public or private law) resident for tax purposes in Italy. Branches of foreign entities are excluded unless indirectly owned by Italian entities.

1.2 Type of approach

Italy utilizes an entity-based "jurisdiction approach" that concentrates on the location of the foreign entity (typically a low-tax jurisdiction).

1.3 Threshold for application of rules

Definition of controlled foreign corporation

According to the CFC legislation, profits of a non-resident entity are deemed to be profits of an Italian resident if:

- the resident controls, directly or indirectly (or constructively), the non-resident entity (generally shares held by related persons are also included); and
- the non-resident entity is resident or carries on business through a PE in a "privileged tax regime" (i.e., "tax haven"), as indirectly defined in a white list containing a number of countries and territories (i.e., a country or territory not included in the white list is considered to be a "tax haven"). The white list has been recently introduced by the 2008 Budget Law; it will be finalized though a Decree by the Ministry of Finance and will be based on the following criteria:
  - effective exchange of information and
  - a "non-noticeably lower level of taxation" (no criteria have been fixed yet).

Control: De jure or de facto

An entity is deemed to be controlled if:[4]

- a person holds, directly or indirectly, the majority of the votes at the shareholders' meeting (i.e., more than 50 percent — de jure control);

4 Article 2359 of the Italian Civil Code.

- a person holds, directly or indirectly, sufficient votes to exert a decisive influence in the shareholders' meeting (de facto control);
- the entity is under the dominant influence of another person due to a special contractual relationship (de facto control).

In addition, the Italian CFC attribution of profits also applies to "associated" (i.e., direct/indirect holding of more than 20 percent or a lower investment of 10 percent in the case of associated companies listed on a stock exchange).

De minimis exceptions

Not applicable.

1.4 Mechanics of attribution

"Controlled" CFCs

In the case of "controlled" CFCs, the income of a foreign-controlled entity is computed by applying the Italian tax provisions (with some adjustments) regulating the computation of business income. In general, this computation is completed as though the CFC is deemed to be taxed as a PE of the Italian resident.

The income calculated and attributed to the Italian taxpayer is taxed separately (i.e., the CFC income cannot be offset by the Italian parent's losses) with a tax rate not lower than 27 percent. The attribution calculation is based on the percentage of shares directly/indirectly held; more specifically, income is allocated in proportion to the shareholder's economic entitlement, whether direct or indirect, in the financial results of the foreign entity. The Italian resident entity is not subject to tax on dividends received from a CFC to the extent the dividends have already been taxed under the CFC rules.

"Associated" CFCs

The CFC legislation for associated companies (i.e., direct/indirect holding of more than 20 percent or 10 percent for listed companies) generally follows the same rules provided for controlled CFCs but with a peculiar determination of the income attributable.

The associated CFC regime does not apply to profits of foreign subsidiaries resident in a "white list" country earned through their PEs situated in a tax haven.

Income attributable to Italian resident entities is determined as the higher between: (A) the pre-tax profits resulting from the profit and loss account of the CFC; and (B) the income resulting from the lump sum deriving from the application of certain coefficients (i.e., presumptions) to the assets held by the CFC.

The calculation of the second parameter (B) is formula driven and cannot easily be simplified. The following coefficients apply:

- one percent of the value of shares and other participation rights, bonds and other securities and receivables held;

- four percent of the value of real estate and ships held; and
- 15 percent of the value of other fixed assets held.

The values utilized for the above calculations (A and B) must be certified by an audit firm.

The income calculated and attributed to the Italian taxpayer is taxed separately (i.e., the CFC income cannot be offset by the Italian parent's losses) with a tax rate not lower than 27 percent.

1.5 Scope of income captured by rules

The CFC rules apply to all of the non-resident entity's profits (capital gains included).

1.6 Exceptions for application of rules

As previously indicated, the CFC regime does not apply where a foreign entity is resident, or carries on business, in a "white list" country.

Under safe harbour rules, the application of the CFC rules can be avoided if the resident person proves that:

- the foreign entity predominantly carries on an actual industrial or commercial activity in the state or territory in which it is located, or
- the participation in the foreign entity does not achieve the localization of income in tax haven countries or territories (e.g., more than 75 percent of the CFC's earnings are produced through a branch located in a "white list" country and fully subject to ordinary taxation).

In both cases, the taxpayer must apply to the Ministry of Finance for an advance ruling (after the setting up of the CFC but, in any case, before filing the Italian taxpayer's annual tax return).

1.7 Relieving measures

Foreign tax credits

Foreign taxes paid abroad by the CFC are creditable against the Italian taxes levied on the CFC income.

Deduction of related expenses

As attributed CFC income is based on net profits of a foreign entity (as determined in accordance with Italian tax rules), there is an inherent deduction of related expenses.

Basis adjustments

The amount of income of the foreign entity subject to tax in Italy under the CFC regime also increases the value of the participation held by the Italian Parent in the CFC; correspondingly, subsequent dividend distributions decrease the value of the same participation.

CFC losses

Losses of a CFC can be carried forward to reduce and/or eliminate the CFC's possible future profits.

Subsequent distributions

Dividends subsequently distributed by the foreign entity are taxable only up to the amount exceeding the income that has already been taxed in the hands of the Italian recipient under the CFC regime. Foreign withholding taxes suffered on the above distribution are only partially creditable against the Italian taxes levied on the CFC income.

2. Brief summary of any clearly enunciated policy rationales for the rules

Not applicable.

3. Description of basic tax planning undertaken by taxpayers to minimize the unfavourable impact of these rules

Italy's CFC rules are considered restrictive.

4. Impact of tax conventions or other supra-national legislation on CFC regime

There may be a potential conflict with article 7 of the OECD Model Convention (Italian doctrine's interpretation), however the Italian Tax Authorities' interpretation does not perceive such conflict.

5. Pending or expected changes to CFC regime

Not applicable.

Japan

1. Current domestic rules

1.1 Taxpayers and forms of enterprise subject to the rules

Japan's CFC rules apply to a Japanese company, a resident individual or a specific trust shareholder (i.e., a special purpose trust or an investment trust with certain exceptions).

The CFC rules do not apply to partnerships and Japanese branches of foreign companies.

1.2 Type of approach

Japan's approach is entity-based.

1.3 Threshold for application of rules

Definition of controlled foreign corporation

Japan's CFC rules apply based on ownership, directly or indirectly, of five percent or more (measured at the end of the tax haven subsidiary's business year) of the total voting and income participating shares issued by a tax haven subsidiary. The five-percent test includes shares held by other related companies.

A "tax haven subsidiary" is a foreign company whose head office is located in a tax haven (i.e., effective tax rate of less than 25 percent) and 50 percent or more of whose voting shares or total shares are directly or indirectly owned by Japanese companies, Japanese resident individuals or non-resident directors of Japanese companies. In determining whether a foreign company has its head or principal office in a tax haven jurisdiction, the effective tax rate is calculated based on the foreign tax paid relative to the foreign company's taxable income as computed in accordance with the tax laws of the country in which the company's head office is located.

In determining the more than 50-percent ownership, although the percentage of the total outstanding shares has been used before the 2007 tax reform, for fiscal years beginning on or after April 1, 2007 for the tax haven subsidiary, the largest percentage of the following is now used:

- the percentage of the total outstanding shares;
- the percentage of the total voting rights; or
- the percentage of earnings allocable to shares based on dividend distribution rights.

De minimis exceptions

There is no minimum level of income that can be earned by a CFC before the CFC rules apply.

1.4 *Mechanics of attribution*

The undistributed profits of a CFC are allocated or attributed to a Japanese taxpayer as if the profits of the CFC had been distributed concurrently to the shareholders on a pro rata basis, based on the distribution entitlements of the shares held in the CFC. Such income will be subject to normal corporate or income tax along with the investor's other taxable income.

1.5 *Scope of income captured by rules*

Japan's CFC rules apply to all of the non-resident entity's profits.

1.6 *Exceptions for application of rules*

A high tax exception applies if the effective tax rate of the CFC is greater than 25 percent.

The undistributed profits of certain operating companies can be exempted even if they are established in tax haven countries. The tax haven rules will not be applied to a company which would otherwise be a tax haven subsidiary in a situation where the company meets certain substance and operational exemptions. These exemptions are broadly described as follows:

1. The tax haven subsidiary maintains an office, store, factory or other fixed place of business necessary to conduct its business in the country in which the head office of the subsidiary is located.
2. The tax haven subsidiary functions with its own administration, control and management in the country in which the head office of the subsidiary is located.
3. The business of the tax haven subsidiary is conducted mainly in the country in which the head office of the subsidiary is located.
4. The business of the tax haven subsidiary is conducted mainly with unrelated parties (i.e., more than 50 percent of the business must be conducted with unrelated persons).

A company conducting wholesale, banking, trust, securities, insurance, ocean transport or air transport business is required to meet tests (1), (2), and (4) above. A company conducting other forms of business is required to meet tests (1), (2) and (3). Certain businesses, however, including the holding of shares or securities, licensing of rights, or leasing of ships and aircraft, cannot qualify for the exemption.

By virtue of the 2005 tax reform in Japan, when a tax haven subsidiary satisfies tests (1) and (2) but not (3) or (4), its undistributed income subject to income inclusion under the anti-tax haven rule is reduced by 10 percent of certain of its salary costs. This amendment applies to applicable retained earnings of the tax haven subsidiary during fiscal years ending on or after April 1, 2005.

1.7 *Relieving measures*

Credit or deduction for foreign taxes

Generally, a foreign tax credit is available, to the extent of foreign taxes paid by the tax haven subsidiary, to alleviate the Japanese taxation of the attributed CFC income.

Deduction of expenses

As CFC imputed income is based on a CFC's net profits, there is an inherent deduction for expenses.

Adjustments to cost base of CFC

Imputed CFC income is not added to the adjusted cost base of the shares of the CFC.

CFC losses

Any net loss may be carried forward for a period of seven years. The net loss is based on a taxation year in which the subsidiary is regarded as a tax haven subsidiary. There is no loss carryback.

2. Brief summary of any clearly enunciated policy rationales for the rules

Not applicable.

3. Description of basic tax planning undertaken by taxpayers to minimize the unfavourable impact of these rules

The following alternatives may be available as tax planning methods:

- *Alternative 1*: The designated tax haven subsidiary establishes a branch office in a jurisdiction in which the corporate tax rate is higher than 25 percent. If the overall tax rate of the tax haven subsidiary and its branch office is higher than 25 percent, then the tax haven subsidiary is exempt from Japanese CFC rules. For example, assume that the tax rate in countries of the tax haven subsidiary and its branch office is 15 percent and 40 percent respectively. Taxable income of the tax haven subsidiary and its branch office is 100 each. The overall tax rate is 27.5 percent, which is higher than 25 percent.

- *Alternative 2*: Carry out both direct and indirect investments in a tax haven subsidiary through a joint venture (JV) structure (of a Japanese parent company and a non-Japanese third party), which then will further invest in the tax haven subsidiary. For example, assume that the Japanese parent has a direct investment in the tax haven subsidiary of 14 percent and indirect investment in the JV of 51 percent. The JV holds shares in the tax haven subsidiary of 70 percent. The remaining ratios belong to the non-Japanese third party. With this structure, the Japanese parent company would hold total shares of 49.7 percent in the tax haven subsidiary, which is lower than the required 50 percent.

Overall, however, we regard the Japanese CFC regime as quite restrictive in planning opportunities.

4. Impact of tax conventions or other supra-national legislation on CFC regime

Not applicable.

5. Pending or expected changes to CFC regime

Not applicable.

Netherlands

1. Current domestic rules

1.1 Taxpayers and forms of enterprise subject to the rules

The Netherlands does not have CFC legislation. It does, however, have some other anti-avoidance measures, including a mandatory revaluation to fair market value rule; these are described briefly below.

1.2 Anti-avoidance measures

The anti-avoidance provisions in the Netherlands include:

- Limitation of interest deduction; while generally not considered CFC legislation it does contain CFC elements:
  - Interest paid on a loan from a related person may be treated as non-deductible where the proceeds from the loan are used for certain purposes enumerated by law, such as acquisitions of subsidiaries and certain financial transactions and reorganizations. However, where the taxpayer shows proof that both the loan and the transaction funded thereby were predominantly entered into for business reasons then interest may be deductible. Such deductions are also allowed where the taxpayer shows that the interest income on the loan is taxed at an effective rate of 10 percent or greater in the hands of the creditor. Meeting the 10-percent criterion is, however, not a safe haven when the tax authorities are able to establish that the loan or the transaction connected therewith were not predominantly entered into for business reasons.
- Limitation of interest deduction based on thin capitalization rules.
- Mandatory yearly revaluation to fair market value of a 25 percent or greater interest in a subsidiary where 90 percent or more of assets of a foreign subsidiary are considered passive assets (other than real estate) and the subsidiary is taxed at an effective rate below 10 percent. The revaluation amount is taxable as the participation exemption is not available.
- Taxable mandatory yearly revaluation to fair market value, regardless of the size of the interest in the subsidiary, where the taxpayer has an interest in certain passive investment owning entities that are tax exempt.
- Restrictions to the participation exemption (which would otherwise exempt from taxation dividends from foreign subsidiaries and capital gains realized on the sale of shares in a foreign subsidiary) where the subsidiary is a "low-taxed passive investment subsidiary".

- Taxation of private individuals owning a "substantial interest" (as defined) in certain investment-owning entities on a notional basis (deemed income in the amount of four percent/year of fair market value), with adjustments in case actual dividends are received.

2. Brief summary of any clearly enunciated policy rationales for the rules

In parliamentary proceedings (in the parliamentary year 2005–2006), the government outlined its position for proposing a foreign tax credit mechanism with regard to income derived by a Dutch company from a "low taxed investment subsidiary" as opposed to other mechanisms for treating such income. The government recognized the comparatively high complexity of a foreign tax credit system but preferred using such a system rather than the introduction of CFC legislation. In a note the following explanation was given (as translated):

> CFC legislation means that the profit of a foreign subsidiary is attributed to and taxed in the hands of the domestic parent company. CFC legislation is considered by many countries as the best anti-abuse measure in a parent-subsidiary context, but might possibly be vulnerable in an EU law context. At this moment the EU Court of Justice is trying the *Cadbury Schweppes* case in which the UK CFC legislation is under fire. In addition, the introduction of CFC legislation is being regarded as a negative signal to the outside world by the business community and tax advisors. In cases where CFC legislation is applied, (legal) reality is disregarded, unless the enterprise shows that there has been no undesirable use of the legal structure. This implies that a comparatively high burden of proof is imposed on the enterprise.

3. Description of basic tax planning undertaken by taxpayers to minimize the unfavourable impact of these rules

Not applicable.

4. Impact of tax conventions or other supra-national legislation on CFC regime

Not applicable.

5. Pending or expected changes to CFC regime

Not applicable.

New Zealand

1. Current domestic rules

1.1 Taxpayers and forms of enterprise subject to the rules

Income from interests in CFCs is included in the income of New Zealand residents. A company is resident in New Zealand if:

- it is incorporated in New Zealand;
- it has its head office in New Zealand;
- it has its centre of management in New Zealand; or
- control of the company by the directors, acting in their capacity as directors, is exercised in New Zealand, whether or not their decision making is confined to New Zealand.

An individual is a resident in New Zealand if:

- he or she has a permanent place of abode in New Zealand, regardless of whether he or she also has a permanent place of abode in another country; or
- he or she is present in New Zealand for more than 183 days in any 12-month period. Residence begins with the first day of such a period of presence in New Zealand.

Unincorporated bodies, partnerships and trusts are essentially look-through entities, and so it is the residence/identity of the members of the unincorporated body, the partners or the settler of a trust that is relevant for CFC tax purposes.

1.2 Type of approach

New Zealand's approach is entity-based with exceptions for "grey list" countries or other foreign companies under certain conditions (see "Exceptions for application of rules" below).

1.3 *Threshold for application of rules*

Definition of controlled foreign corporation

A "foreign company" is a CFC if:

- more than 50 percent of the company is controlled by five or fewer New Zealand residents;
- more than 40 percent of the company is controlled by a single New Zealand resident;[5] or
- the exercise of the shareholder decision-making rights is controlled by a group of five or fewer New Zealand residents.

For these purposes, control is measured in terms of the aggregate of "direct and indirect control interests" held by the New Zealand resident or by "associated persons" of the New Zealand resident at any time during the accounting period of the foreign company.

Foreign company

A company is a "foreign company" for the purposes of the CFC regime if it is a non-resident company or a company that is resident in New Zealand but treated as non-resident under a double taxation agreement and consequently not taxed on all or part of its income in New Zealand.

Direct control interests

The following rights give rise to a direct control interest:

- shares in the company;
- decision-making rights in the company;
- rights to receive income from the company; or
- rights to receive distributions of the company's net assets.

Indirect control interests

A person has an indirect control interest if a CFC, in which they have an interest, holds direct control interests in another foreign company or where there are chains of such companies.

5 The presumption of control may be rebutted where a non-resident who is not associated with the single New Zealand resident has control over the company which is equal to or greater than that of the New Zealand resident.

Associated persons

For the purpose of calculating the control or income interests of a New Zealand resident, a shareholder does not need to be a resident of New Zealand. Control exercised by non-residents and income interests held by non-residents will be taken into account in determining the control or income interest of residents if those non-residents are associated to the residents. Associated persons are widely defined and the definition has not been included in this report.

De minimis exception

Not applicable.

1.4 *Mechanics of attribution*

Where a New Zealand resident together with associated persons holds an "income interest" of 10 percent or more in a CFC which is not resident in one of the grey list countries, it is obliged to take into account in calculating its assessable income the proportion of the income or loss of the CFC attributable to its gross interest. The branch equivalent basis is used to attribute the income or loss — using New Zealand tax law, with some exceptions, the person's income interest is multiplied by the branch equivalent net income or loss of the CFC for the year.

An "income interest" consists of the aggregate of direct and indirect income interests. Direct income interests are calculated as a percentage of:

- the total shares of the CFC, measured by reference to its available subscribed capital;
- decision-making rights that the taxpayer holds in the CFC;[6]
- distributable income to which the resident would be entitled for the accounting period of the CFC; and
- the value of net assets of the CFC to which the resident would be entitled upon distribution.

If the percentages vary between these categories, the person's direct income interest is the highest percentage.

Indirect interests arise where a person has a direct interest in a CFC that has a direct interest in another CFC (and so on if there is a chain of interests).

Where the aggregate income interests of New Zealand residents exceed 100 percent, those interests will be apportioned down to 100 percent.

6 The classes of rights that are taken into account are the same as those used to determine control interests (see above). Where a resident holds different percentages of two or more classes of rights, the highest percentage is taken.

1.5 *Scope of income captured by rules*

The CFC's income or loss for an accounting period (i.e., all sources of income) is calculated according to New Zealand income tax principles, subject to certain modifications, the amount so calculated being referred to as the branch equivalent income or loss. The branch equivalent income or loss is then multiplied by the New Zealand resident's percentage income interest to compute the attributed foreign income or loss. Attributed foreign income is included in the income of the New Zealand resident taxpayer for the income year in which the CFC derived the branch equivalent income.

1.6 *Exceptions for application of rules*

If the CFC is resident in Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom or the United States ("grey list" countries), the New Zealand resident investors in the CFC are not required to attribute the income of the CFC for New Zealand tax purposes.

1.7 *Relieving measures*

Foreign tax credit

A tax credit is available to taxpayers liable to tax on attributed foreign income for income tax paid or payable (in any country including New Zealand) by a CFC in respect of that income. The tax credit is calculated by multiplying the tax paid or payable by the CFC by the taxpayer's percentage income interest.

Deduction of related expenses

As the attributable foreign income is based on net income for New Zealand tax purposes, related expenses are inherently deductible.

Adjustments to cost base

There are no adjustments to the cost base, as New Zealand does not have a capital gains tax.

CFC losses

An attributed foreign loss may be set off against attributed foreign income derived in the same income year from CFCs resident in the same country as the CFC giving rise to the loss. Any loss not utilized in this way may be carried forward and set off against attributed foreign income earned by the CFC or other CFCs resident in the same jurisdiction in subsequent years, provided shareholder continuity of 49 percent is maintained. Alternatively, the attributed foreign loss may be offset against foreign investment fund income calculated using the branch equivalent method derived in the same income year by a foreign investment fund resident in the same country.

Where an attributed foreign loss exceeds the economic or financial loss incurred, for example, because of a call or put option, the amount of the CFC loss is limited to the amount of the economic or financial loss.

Subsequent distributions

As companies with an income interest in a CFC pay tax on a branch equivalent basis, if the CFC's income was subsequently distributed to a New Zealand shareholder as a dividend, double taxation would arise. The branch equivalent tax account (BETA) is intended to prevent such double taxation. A company with a BETA records debits and credits to the account, and credit balances in the BETA (being income tax paid by the company on its CFC income) offset withholding payment liabilities of dividends received from branch equivalent investments.

Non-resident shareholders

The overreaching effect of the CFC rules on non-resident shareholders of New Zealand holding companies is modified somewhat with the introduction of relief for "conduit" tax provisions. Conduit tax relief relieves New Zealand resident companies from the CFC rules to the extent of the company's non-resident shareholders. Specifically to CFCs, tax payable by a New Zealand-resident company is reduced in proportion to its non-resident shareholders when and to the extent that income is derived as attributed foreign income from CFCs.

2. Brief summary of any clearly enunciated policy rationales for the rules

New Zealand's international tax regime taxes offshore income as it accrues, with credits given for foreign taxes that have been paid. Under the CFC rules, which are a fundamental part of the regime, New Zealand resident individuals, companies and other entities with an income interest in a CFC are liable to pay tax on a branch equivalent basis, that is, they pay tax on the income of the CFC as if it were a branch.

3. Description of basic tax planning undertaken by taxpayers to minimize the unfavourable impact of these rules

Given the scope of New Zealand's CFC regime, it is difficult to plan around. We consider the CFC system to be restrictive.

4. Impact of tax conventions or other supra-national legislation on CFC regime

Not applicable.

5. Pending or expected changes to CFC regime

The Government has proposed significant changes to the international tax regime, the main proposal of which is to relax the CFC rules by introducing a tax exemption for active income from the offshore operations of New Zealand businesses. Government is currently consulting interested parties on the development of the rules and expects to introduce legislation in late June 2008.

Sweden

1. Current domestic rules

1.1 Taxpayers and forms of enterprise subject to the rules

A resident company and individual, as well as any non-resident with a permanent establishment in Sweden are subject to the CFC rules.

The following types of resident entities are liable to Swedish corporate income tax and therefore subject to the CFC rules:

- public and private companies registered/incorporated in Sweden;
- economic associations registered in Sweden;
- foundations registered in Sweden or formed under Swedish law; and
- certain other associations and groups enumerated in the law.

All companies not registered in Sweden are non-resident legal entities.

1.2 Type of approach

Sweden's approach is entity-based, although some income of the CFC may not be deemed to be low-tax income subject to the CFC rules.

1.3 Threshold for application of rules

Definition of controlled foreign corporation

A taxpayer who is subject to the CFC rules that maintains a holding in a "foreign legal entity" is liable to Swedish tax on his or her share of the foreign legal entity's worldwide low-taxed net profit, provided that:

- the income of the foreign legal entity is "deemed to be subject to low taxation"; and
- at the end of the income year at least 25 percent of the capital or voting rights in the foreign legal entity is held or controlled, directly or indirectly, by the shareholder alone or together with persons with whom the shareholder is affiliated.

Control for these purposes does not only refer to voting ownership but also applies where a company participates in the management of the foreign company.

In general, the income of a controlled foreign legal entity is "deemed to be subject to low taxation" if it is subject to tax that is lower than 15.4 percent (55 percent of the Swedish tax rate of 28 percent), calculated under Swedish tax rules. In other words, the entire income of the foreign legal entity is recalculated under Swedish tax rules and if the effective tax rate is lower than 15.4 percent, the foreign legal entity would be deemed subject to low taxation.

A foreign enterprise is defined as a "foreign legal entity" if in its country of incorporation:

- it can obtain rights and undertake obligations;
- it can sue and be sued in its own name; and
- the shareholders/members cannot utilize the foreign enterprise's wealth.

A foreign enterprise which does not qualify as a foreign legal entity is a disregarded entity for Swedish tax purposes (i.e., the Swedish shareholder is deemed to own the assets and liabilities of the foreign enterprise directly) such that the CFC rules would not apply.

Note that, for CFC purposes, a foreign branch of a foreign legal entity should be deemed to be an independent foreign legal entity on its own, if its income is exempt in its head office's country of residence.

Furthermore, a foreign legal entity which is a foreign partnership cannot be deemed a CFC.

De minimis exceptions

Not applicable.

1.4 Mechanics of attribution

The shareholder is only taxable on its share of the low taxed income of the CFC. The shareholder is taxable in relation to its proportionate ownership and control of the shares in the foreign legal entity being deemed to be a CFC, with the determination of proportionate ownership being based on the legal stated capital of the CFC.

1.5 Scope of income captured by rules

The CFC rules generally apply to all of the foreign legal entity's worldwide net profit if it is deemed to be subject to low taxation (the low-tax test). However, the CFC rules do not apply in all situations where a company is low-taxed (see below).

1.6 Exceptions for application of rules

Income of a foreign legal entity should not be deemed subject to low tax, if it is covered by:

- the "white list" (i.e., the entity is resident and subject to income tax in a geographical area on the white list),
- the "international shipping exemption", or
- the "substance exemption".

The white list comprises countries in the European Economic Area (EEA) and other countries.

From the "white list", however, certain income has been expressly excluded such that the CFC rules would apply to it. Such excluded income is generally income that is attributable to banking, financing and insurance operations. Within the EEA, the excluded income only refers to income attributable to the direct or indirect financing (or reinsurance) of companies with which the foreign legal entity is affiliated.

Furthermore, if there is an income tax treaty between Sweden and a country on the white list, the list only applies to income which is covered by the treaty. In other words, income that is not covered by the treaty would be subject to the CFC rules where it was deemed to be low-taxed.

"International shipping exemption" income derived from a foreign legal entity engaged in international shipping activities should not be deemed subject to low tax, provided that the shareholder is also engaged in shipping activities, whether directly or indirectly through a legal person resident in the EEA.

The "substance exemption" was introduced on January 1, 2008 and states that a foreign legal entity should not be deemed subject to low tax where:

- it is resident in an EEA member state;
- it is actually established in its state of residence; and
- it carries on activities motivated by business reasons in that state.

The law states that all three criteria should be taken into account when doing this substance analysis.

1.7 *Relieving measures*

Foreign tax credit

The credit is first set off against national (corporate or individual) income tax and any remaining amount against municipal tax in the year in which the low-taxed income is taxed in Sweden. The credit is limited to the Swedish tax on the shareholder's part of the CFC income. Any excess credit may be carried forward for three years.

Deduction of related expenses

As the CFC regime is based on a foreign legal entity's worldwide net profit, deduction of related expenses is inherently permitted.

CFC losses

Losses of a CFC may be carried forward for up to three years for that CFC when calculating the taxable income of that CFC.

Subsequent distributions

A shareholder is not liable to Swedish tax on any actual distribution derived from the entity to the extent that the shareholder is liable to Swedish CFC taxation on its share of the entity's net profit.

2. Brief summary of any clearly enunciated policy rationales for the rules

The current set of CFC rules were introduced on January 1, 2004. The major difference between the old CFC rules and the current CFC rules are that the current CFC rules also apply to *indirect* shareholdings. The current CFC rules were introduced shortly after Sweden adopted a new participation exemption regime on dividends and capital gains.

3. Description of basic tax planning undertaken by taxpayers to minimize the unfavourable impact of these rules

The CFC rules are rather restrictive, however there are some tax planning opportunities available.

4. Impact of tax conventions or other supra-national legislation on CFC regime

The Swedish Supreme Administrative Court will this spring evaluate and determine whether the Swedish CFC rules are in conflict with EU law and subsequently with tax treaties.

5. Pending or expected changes to CFC regime

The CFC rules were recently updated on January 1, 2008, when the "substance exemption" was introduced and some amendments were made to the white list.

United Kingdom

1. Current domestic rules

1.1 Taxpayers and forms of enterprise subject to the rules

Companies resident in the United Kingdom (wherever incorporated) may be assessed UK income tax on the undistributed profits of certain UK-controlled non-resident companies in which the resident company has an interest. The CFC rules generally cannot be avoided by holding the non-resident company through a partnership or a trust.

The CFC rules do not apply to individuals or UK branches.

1.2 Type of approach

The UK approach is entity-based.

1.3 Threshold for application of rules

Definition of controlled foreign corporation

Under the CFC regime, a resident company may be assessed UK corporate tax on the undistributed profits of a non-resident company if:

- the resident company has an interest (together with associates) in at least 25 percent of the undistributed profits of the non-resident company where:
  - if the CFC only has ordinary shares, the ownership interest is determined by looking at the shareholding;
  - in other cases, it is determined on a "just and reasonable" basis;
- the non-resident company is controlled by UK tax residents, where:
  - control means the ability to control the company through holding of shares, voting power or any document regulating the company (not necessarily the majority ownership of share capital);
  - under an amendment in the Finance Bill 2008 it will be extended to cover a shareholder which is entitled to more than 50 percent of the profits or assets on a winding up;
  - greater then 40 percent voting control by UK residents counts as control if a UK non-resident controls 40 percent to 55 percent of other shares and together the two persons control the non-resident (the UK resident and UK non-resident do not have to be related persons in order for this test to apply); and

- the controlled company is resident in a low-tax country (a corporate tax rate is considered low if it is less than 75 percent of the UK corporation tax rate).

De minimis exception

The CFC rules do not apply where profit of the individual CFC is less than £50,000.

1.4 Mechanics of attribution

The "chargeable profits" of the CFC are calculated on the assumption that it was UK resident and they are then apportioned to the UK shareholder(s). If the CFC only has ordinary shares, the apportionment is determined by looking at the shareholding; in other cases, the apportionment is determined on a "just and reasonable" basis. There are no prescribed rules outlining how "just and reasonable" is to be determined.

1.5 Scope of income captured by rules

The CFC rules apply to all types of income earned by a CFC but not to capital gains. The charge is based on the CFC's profits, as notionally computed for UK corporation tax. The rules become extremely complex in cases where there is a chain of non-resident CFCs.

A separate charging/attribution regime applies to capital gains and only applies where, very broadly, the non-resident company is controlled by five or fewer people.

1.6 Exceptions for application of rules

In addition to the de minimis exception, the following are other exceptions to the CFC regime:

Acceptable Distribution Policy

A dividend (which is taxable in the United Kingdom) of at least 90 percent of profits must be paid within 18 months of year-end to UK residents.

Exempt Activities Test

This test requires a foreign business establishment and employees carrying out the business activity. It does not apply to financial activities, inter-group services or to related party buy/sell arrangements. There are special rules for holding companies which, broadly, can only receive dividends (and interest, where the interest income comes from a company resident in the same jurisdiction).

White List

The United Kingdom maintains a white list of countries with exceptions. The exception only applies if the company in question has not been involved in a scheme or arrangement to avoid UK tax (a quasi motive test). Non-local source income of the company must be less than 10 percent of its total income.

Motive Test

This test applies where the main reason or one of the main reasons for company's existence is not to divert profits from the United Kingdom. However, it is very difficult to reach agreement with the UK tax authorities that this exception applies. The main practical use for this exception is in the case of takeovers where the target has low taxed subsidiaries.

EEA Companies

The CFC rules do not apply to European Economic Area (EEA) companies with sufficient personnel in the EEA country concerned. These rules only apply to value added by the EEA-based individuals and not value attributable to capital. This means that finance companies would still be CFCs even if based in Luxembourg or Ireland.

1.7 Relieving measures

Foreign tax credit

Where the UK company is charged to corporation tax on a proportion of the profits of the CFC, credit will be given for the relevant portion of any foreign tax paid by the CFC on those profits.

Deductions of related expenses

As the CFC regime takes an entity-based approach based on net income earned by a CFC (as computed in accordance with UK tax principles), related expenses are inherently deductible.

Adjustments to cost base

The imputed income is not added to the adjusted cost base of the CFC shares.

CFC losses

Losses incurred by one CFC cannot be offset against profits in another CFC (regardless of jurisdiction) but are available to shelter that CFC's income earned in a later year provided that the usual UK loss carry forward rules are complied with.

2. Brief summary of any clearly enunciated policy rationales for the rules

The Treasury has reserve powers whereby regulations may be made at any time specifying jurisdictions within which all UK-controlled companies would be within the scope of the CFC legislation, regardless of whether such companies are trading or derive passive income. The charge is aimed at protecting the UK tax base from harmful tax practices.

3. Description of basic tax planning undertaken by taxpayers to minimize the unfavourable impact of these rules.

Overall, we consider the UK CFC regime to be restrictive. Two planning techniques that have been stopped by the 2008 UK budget are as follows:

- *Decontrol* — A low-tax finance company lends to high-tax affiliates. The low-tax finance company issues preference shares with low value but 56 percent of vote to a trust (typically an Employee Benefit Trust). The UK resident company does not control the low-tax finance company and is not caught by the joint control rules as trust has 56 percent of vote.

- *Exempt Holding Company* — A low-tax foreign partnership lends to high-tax affiliates. In books of foreign holding company, the foreign partnership is treated as a separate entity (i.e., income accrues until partnership distributes profits). The foreign holding company is not caught by CFC rules until the period in which the foreign partnership distributes profits.

4. Impact of tax conventions or other supra-national legislation on CFC regime

The European Court of Justice has found that the UK rules cannot be applied to an EU company unless it has no economic substance (*Cadbury Schweppes*). The UK courts will now need to determine what economic substance actually means on the facts of the case.

Treaties do not override the UK CFC rules.

5. Pending or expected changes to CFC regime

Various changes have been introduced in the 2008 Budget (see above) to extend the definition of control, prevent interest income being earned in an exempt holding company through a partnership, and stop the use of trusts to avoid a CFC charge.

United States

1. Current domestic rules

1.1 Taxpayers and forms of enterprise subject to the rules

The U.S. CFC rules apply to "U.S. Shareholders", which includes U.S. citizens, U.S. residents, domestic corporations, domestic partnerships, domestic trusts and domestic estates that own (directly, indirectly or constructively) 10 percent or more of the CFC's voting stock.

1.2 Type of approach

The U.S. approach is transaction-based.

1.3 Threshold for application of rules

Definition of controlled foreign corporation

A corporation is a CFC if greater than 50 percent of its votes or value owned by U.S. Shareholders (as defined above). The U.S. Shareholders do not need to be related.

De minimis exceptions

There is no inclusion of subpart F income (defined below) if Foreign Base Company Income/insurance income is less than both $1 million and five percent of CFC total gross income.

1.4 Mechanics of attribution

Each U.S. Shareholder of the CFC is required to include in income its pro rata share of the subpart F income of the CFC and its pro rata share of the net earnings of a CFC that are invested in U.S. property. Pro rata share amounts are generally computed based on the U.S. Shareholders' entitlements to dividends. The CFC must be owned on the last day of the CFC's tax year and must be a CFC for at least 30 days during the tax year.

All gross income is treated as subpart F inclusion if subpart F income is greater than 70 percent of current-year gross income.

Upon the sale of shares of a CFC, U.S. Shareholders are required to treat any gain recognized as dividend income, and not capital gains, to the extent of the earnings of the CFC that:

- were accumulated during the period the shares were owned by the U.S. Shareholder; and
- were not previously taxed under the subpart F provisions.

1.5 *Scope of income captured by rules*

Subpart F income

Generally, the subpart F regime is designed to capture tainted types of income, including:

- *Foreign Personal Holding Company Income*, which is generally passive income such as dividends, rents, interest, royalties, annuities and net gains from sales of property that give rise to the foregoing types of income;
- *Foreign Base Company (FBC) Sales Income*, which is generally income from sales, where product is purchased from or sold to a related party outside the country in which the CFC is created or organized;
- *Foreign Base Company Services Income*, which is generally income derived from providing services to a related party outside the country in which the CFC is created or organized;
- *Foreign Base Company Oil Related Income*, which is generally income from certain oil and gas activities that take place outside the country in which the CFC is created or organized; and
- certain insurance income.

CFC Earnings Invested in U.S. property

The CFC investment in U.S. property regime is designed to capture tainted investments held by the CFC. Generally if a CFC has non-subpart F earnings, the U.S. Shareholders of that CFC will have an income inclusion to the extent that the CFC has an investment in "U.S. Property", which includes:

- tangible property in the United States;
- related domestic corporation stock;
- U.S. debt obligations; and
- right to use intangibles in the United States.

Third-party loans to U.S. Shareholders that contain CFC guarantees or a pledge of CFC stock could also be subject to this regime.

Exceptions to the U.S. Property definition include:

- stock or obligations of unrelated parties;
- regular business transactions;
- bank deposits/U.S. treasury debt.

1.6 *Exceptions for application of rules*

Same-country exceptions

Generally, CFCs incorporated in one country can earn income from transactions with related CFCs incorporated in that same country without implicating subpart F.

High-tax exception

Taxpayers may elect to exclude items of subpart F income that were subject to foreign taxes of at least 90 percent of highest U.S. corporate income tax rate (currently 90 percent x 35 percent = 31.5 percent).

E&P Limitation

Subpart F income in any year is limited to the earnings and profits (E&P) of the CFC. Generally, prior-year deficits in E&P can be brought forward to reduce current-year subpart F income.

There is a temporary "look-through" exception for dividends, interest, rents and royalties received by a CFC to the extent received from a related CFC, regardless of the country of incorporation, where the payment is allocable/attributable to non-subpart F income. This temporary provision only applies to tax years of controlled foreign corporations beginning after December 31, 2005 and before January 1, 2009.

1.7 *Relieving measures*

Foreign tax credit

Foreign income taxes paid by a CFC which are attributable to subpart F income of the CFC are creditable against the U.S. tax payable by the U.S. Shareholder upon an inclusion of the subpart F income in the U.S. Shareholder's taxable income.

Deduction of related expenses

Allocation or apportionment of expenses is allowed against subpart F income and against earnings from an investment in U.S. Property.

CFC losses

Losses incurred by a CFC are generally available for carry forward through the E&P limitation (see above).

2. Brief summary of any clearly enunciated policy rationales for the rules

These provisions date back to the early 1960s. The general policy of the provisions was to prevent U.S. persons from parking "tainted income" in a corporation in a foreign jurisdiction (subpart F provisions) and to prevent U.S. persons from not reporting "disguised" dividends from such corporations (investment in U.S. property provisions).

3. Description of basic tax planning undertaken by taxpayers to minimize the unfavourable impact of these rules

The U.S. CFC rules are fairly restrictive, overly complex and fairly difficult to plan around.

"Super Holdco" Structure

A foreign holding company is established to own all the interest in a U.S. company's CFCs. All CFCs below the holding company elect to be disregarded entities for U.S. tax purposes such that any transactions among them are disregarded for U.S. tax purposes. A disregarded finance entity is established in a low-tax jurisdiction below the holding company to loan funds to foreign operating disregarded entities. No subpart F income arises on interest received by a financing entity.

4. Impact of tax conventions or other supra-national legislation on CFC regime

Not applicable.

5. Pending or expected changes to CFC regime

Not applicable.