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**Via E-Mail**

[CTPCFC@oecd.org](mailto:CTPCFC@oecd.org)

Mr. Achim Pross  
Head International Co-operation and Tax Administration Division  
OECD Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris Cedex 16  
France

**Comments of SwissHoldings on the BEPS Action 3 Discussion Draft (Strengthening CFC Rules) of 12 May 2015**

Dear Mr. Pross

The business federation SwissHoldings represents the interests of 61 Swiss based multinational enterprises from the manufacturing and service sectors (excluding the financial sector). SwissHoldings is pleased to provide comments on the BEPS Action 3 Discussion Draft (Strengthening CFC Rules) (hereafter referred to as “the Draft”). Our comments mainly endorse comments made by BIAC and/or BUSINESSEUROPE.

**I. General Comments**

**Clear Policy Objective**

SwissHoldings strongly believes that the OECD’s Discussion Draft lacks a clearly articulated policy objective. At present, the Discussion Draft attempts to satisfy multiple competing objectives, resulting in a set of complicated and conflicting proposals. Before refining the existing recommendations, it is critical to determine exactly what the purpose of CFC rules should be. Attempting to pursue conflicting policy objectives will naturally result in confused and problematic proposals.

It seems wrong to deliver a minimum standard for income inclusion if no minimum standard exists to protect legitimate active income resulting from real and substantive business activity. The Discussion Draft, as it stands, risks substantially increasing the compliance burden faced by business, and bringing into scope legitimate transactions that ought not be subject to CFC rules.

**Complexity and Interaction with other BEPS Actions**

The OECD’s proposals and options risk creating substantial complexity for taxpayers and tax administrations alike. Many recommendations and options would require additional detailed guidance to fully understand how they could be implemented and applied in practice. Without such guidance, proposals may be interpreted and implemented by countries in different ways – presenting taxpayers with an increasingly complex web of rules.

Having a broad range of substantially different CFC rules, even if loosely based on the same 'minimum standard', would substantially increase compliance costs for taxpayers, and would risk creating double taxation.

SwissHoldings supports the development and implementation of clear and consistent CFC rules that are designed to target specific behaviours and do not impose an undue compliance or reporting burden on business. However, there is a risk that a recommendation that only sets out policy options will not result in clear or consistent implementation and interpretation of CFC rules and will lead to greater compliance cost and uncertainty, with an effect on foreign direct investment.

The BEPS Action Plan will deliver a range of proposals that will be implemented in various ways (for example, a new multilateral tool, bilateral treaties, domestic legislation and Transfer Pricing Guidelines). We are increasingly concerned that, when proposals and recommendations are taken together, taxpayers will be presented with an almost insurmountable compliance burden, detracting resources from real commercial activity.

The Discussion Draft states that the work on CFCs is closely associated with other BEPS Action Items (including Actions 1, 2, 5, 8-10, 11, 14 and 15). Due to the overlapping nature of the Action Plan, specific abuses may be targeted (and addressed) through multiple recommendations. A holistic and detailed review process is critical prior to delivering the package of actions to develop clear agreement over i) which abuses should be targeted by which Actions, and ii) how the proposals should be implemented and ordered so to mitigate unnecessary rules and compliance costs.

#### **Targeting BEPS: Transfer Pricing vs. CFC rules**

The Discussion Draft explains that Transfer Pricing and CFC rules can be closely related in several ways, and that both types of rules can exist side-by-side to fulfil different roles. SwissHoldings however fears that the CFC proposals could undermine the detailed work being undertaken by Working Party 6, for example, in the area of risk and capital, and go beyond tackling base eroding or profit shifting activities.

Targeted CFC rules that can be clearly and objectively applied may well be an appropriate solution to target 'cash box' (i.e., highly capitalised low substance) entities, but we are concerned that very broad rules could implicate commercial transactions with appropriate substance, simply because the tax-rate applied is low when compared to the parent country. One of the primary objectives of the BEPS Action Plan is to realign profits with substance - well drafted Transfer Pricing guidance should be capable of doing this in many instances, without the need for additional rules (and associated compliance burdens). In this regard, the Discussion Draft states that the Excess Profits Approach would only "apply to income that remained after transfer pricing rules had been applied," suggesting that countries do not have confidence that work being delivered by Working Party 6 will provide the tools to challenge transfer pricing issues through the application of Article 9. We are concerned that some of the OECD's CFC proposals would have the impact of undermining legitimate and substantive transactions that have been priced and evidenced in accordance with Article 9 and the OECD's Transfer Pricing Guidelines. Countries could seek to apply such an approach to transfer pricing results solely based on the applicable tax rate, rather than because profits and substance have been misaligned.

#### **Excess Profits Approach**

SwissHoldings believes that the Excess Profits Approach is overly broad, and is not sufficiently targeted at BEPS to warrant inclusion in the OECD's recommendations. We are particularly concerned about:

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- *Timing differences and distortions* (including any differences in the parent-jurisdiction vs. local-jurisdiction accrual of income, deductions, or the treatment of Net Operating Losses) – Any attempt to use multi-year averaging to correct for such differences will be complex or not correct for longer-period timing differences (e.g., different depreciation rates, or a growing asset base).
- *Determining the “excess profits” with accuracy* – Although proposed as a mechanical approach, the Discussion Draft sets out a number of complicated calculations, where a range of answers could be possible.
- *Overriding exemption or deferral systems* – In its application, the Excess Profits Approach will risk overriding the intended application of exemption or deferral tax systems to legitimate transactions in many cases.
- *Anti-competitive consequences* – No country has yet adopted such a rule. The implementation of an Excess Profits Approach would likely have substantial anti-competitive effects. Given the untested nature of this proposal, it should not be considered a ‘best practice’.

### **Hierarchy of Rules**

Ensuring proper and effective relief from double taxation is critical to the success of Action 3 and the wider BEPS project. A clear common hierarchy of rules that would apply across different CFC regimes and between CFC regimes, Transfer Pricing rules and actions on interest deductions should be developed as a matter of priority. Broad consensus among the participants in the BEPS process on the hierarchy should be achieved to reduce the risk of disputes between countries and MNEs over the order of utilizing different measures. Furthermore, within CFC rules there should be clear guidance on the order of foreign tax relief methods to ensure that effective relief is available for foreign taxes paid on both ordinary income and CFC income.

As with other BEPS Actions, the design and implementation of an effective and efficient dispute resolution process is very important and needs to be linked with the hierarchy of CFC rules and double tax relief. Thereby it shall be ensured that any practical failures to give effective relief across different country regimes can be rectified promptly.

### **Secondary Rule**

Following from the previous point, the Discussion Draft notes that some countries have proposed a “secondary rule” that could be “applied to income earned by CFCs that did not give rise to sufficient CFC taxation in the parent jurisdiction.” We are concerned that such a proposal would cut against the original intention of the BEPS Action Plan, and would reallocate taxing rights purely based on the level of taxation imposed in a particular country. SwissHoldings does not believe that CFC rules applying to substantive activity simply because the applicable tax rate is low is the right approach. Such an approach could have a substantial negative impact on competition and cross-border trade.

In Paragraph 19 of the Draft, in a discussion on the scope of base stripping, there is an implied recommendation that CFC rules should be designed to protect against both base stripping in the parent company jurisdiction and “foreign to foreign” stripping, as the BEPS plan is intended to prevent erosion of all tax bases. This expands the scope of many current CFC rules and creates great uncertainty over taxing rights, double taxation and the applicability of double taxation conventions. This proposal, combined with the reference to potential consideration of a secondary CFC rule, leads to the conclusion that the aim of Action 3 may go beyond the development of best practice in the design and implementation of CFC rules that balance administrative costs with targeted action on abusive structures (SwissHoldings supports the latter two objectives). The broader objective appears to be the design of a principle of minimum taxation to be applied for all international businesses where transfer pricing, loan interest restrictions, hybrids and

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other rules, together with action on harmful tax practices of countries does not lead to an effective tax rate that is within an (undefined) acceptable range. If this is indeed the intent of Action 3, the principle requires detailed explanation and justification as a fundamental change in current international tax policy and practice.

## II. Specific Comments

### CHAPTER 1: POLICY CONSIDERATIONS

SwissHoldings welcomes consideration of the impact of EU Law on the OECD's proposals, and the need to bear the EU freedoms in mind when developing minimum standard rules. We strongly agree that MNEs not based EU Member States should not be at a competitive disadvantage compared to those that are.

**No unequal treatment of EU and non-EU countries:** As a business organization representing the interests of companies not based in EU Member States we are disappointed that the Discussion Draft already indicates the possibility of parallel standards, stating in Paragraph 13 that "EU Member States may need to modify these recommendations to comply with EU law". We encourage the OECD to develop its minimum standard in a way that is EU Law compliant, so that it is capable of consistent adoption.

SwissHoldings fully agrees that effective rules should not unduly increase compliance costs and administrative burdens to taxpayers and tax administrations, and that "CFC rules must strike a balance between the reduced complexity inherent in mechanical rules and the effectiveness of more subjective rules." (Paragraph 15). With that in mind, we are concerned that many of the options and recommendations identified in the Discussion Draft lean towards more subjective tests that would vastly increase the difficulty of application. We also note that in a significant number of areas, the OECD has not made clear recommendations, providing countries with full flexibility to adopt substantially different approaches.

### CHAPTER 2: DEFINITION OF A CFC

*OECD Questions for Consultation:*

1. Would any particular practical issues arise from treating transparent entities as separate entities in the cases listed above? If so, what are they and how could they be dealt with?
2. Should the recommendations consider any other issues related to determining which entities could be considered to be CFCs?
3. Are there any practical problems with either the narrow or the broad version of the modified hybrid mismatch rule mentioned above?

Any rules for the treatment of transparent entities as separate entities should be consistently interpreted and applied across all countries and appropriate consideration given to the treatment of the entity in intervening jurisdictions as well as the parent's jurisdiction.

CFC rules that apply on an entity basis rely on the calculation of profits and taxes paid or payable in that entity. Where the entity is transparent and is not required to prepare separate accounts, or is a branch or PE and full separate accounts are not prepared, there may be administrative and compliance challenges in

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obtaining the information required to make CFC calculations: some flexibility in compliance with CFC requirements where accounts are not available would be helpful.

Paragraph 1 of the Discussion Draft states that “the objective is to develop recommendations for CFC rules that are effective in dealing with base erosion and profit shifting.” Given that broader rules are likely to bring more income into scope, creating additional compliance burdens and risk of double taxation, we would recommend narrow approaches that clearly target BEPS related issues.

### CHAPTER 3: THRESHOLD REQUIREMENTS

*OECD Questions for Consultation:*

4. What practical problems, if any, arise when applying a low-tax threshold based on an effective tax rate calculation?
5. How could these problems be addressed or mitigated?
6. Does the discussion above correctly address the situation of permanent establishments that are subject to a different tax rate than CFCs?

Paragraph 57 recommends the use of the effective tax rate (ETR) of a CFC to determine the low-tax threshold. Paragraph 58 goes on to suggest that the ETR would need to be calculated based on rules of the parent/shareholder's country or International Financial Reporting Standards (IFRS). For MNEs operating a substantial number of subsidiaries, perhaps owned by parents in different jurisdiction, the application of different rules and accounting standards would substantially increase the cost of complying with CFC Rules. Even differing definitions of income can cause substantial difficulties and anomalies. Clear and effective threshold rules would be welcomed to remove many low-risk entities from the scope of such calculations.

Experience of applying low-tax threshold tests in practice is that a critical issue is the availability of data to allow the calculation of the threshold test to be carried out. This would be exacerbated where PEs and other transparent entities are included where accounting and tax information is not currently available. The availability of information becomes more of a challenge where parent company CFC reporting or calculation requirements are required at an early date before local accounting and tax reporting has been completed. A consistency in the timing of CFC calculations of several months after the accounting year would be helpful.

Calculation of effective tax rates is frequently affected by differences in the capitalization, amortization or tax depreciation of assets or differences in timing of revenue recognition between different accounting and tax regimes. This can cause wide fluctuation in effective tax rates, and temporary low effective rates in higher tax countries where timing differences, investment incentives or tax holidays are part of the local tax policy.

### CHAPTER 4: DEFINITION OF CONTROL

*OECD Questions for Consultation:*

7. What practical problems, if any, arise when applying a control test?
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8. Are there particular practical problems that arise when applying a control test that considers interests held by unrelated or non-resident parties? If so, what are they, and how can they be dealt with?

Control tests that include criteria other than readily available legal ownership or economic control using data that is relatively easy to establish or calculate can create significant practical problems. De facto control is difficult to establish without retrospective review of actions and analysis of facts and circumstances and will in most cases also involve an element of subjective determination. Unless it could be clearly demonstrated that a de facto control test was a requirement to address particular circumstances where significant BEPS behaviors were evident, the cost and complexity of this test would not be justified.

For most international businesses legal ownership and consolidation tests, which are generally carefully examined by external auditors, would be sufficient to establish which entities are controlled and which are not and these tests are unlikely to produce a different result from an economic control test for most MNEs.

## CHAPTER 5: DEFINITION OF CFC INCOME

*OECD Questions for Consultation:*

9. What are the practical problems with any of the three substance analyses set out above? How could these practical problems be dealt with?
10. Do you have experience with applying substance analyses in existing CFC rules? If so, how can these be made more mechanical while still accurately attributing income?

All of the substance analyses have some practical problems and require a greater or lesser level of functional analysis to arrive at a reasonable conclusion with a suitable audit trail and rationale. Some tests are highly complex to interpret and apply, depending on the drafting and interpretation of the CFC laws in the parent jurisdiction. While there may be some common ground between the substantial contribution analysis and functional analysis required for transfer pricing documentation, the tests and analysis are not identical and it should not be assumed that a substantial contribution analysis can be easily developed from existing transfer pricing documentation.

Of the three the viable independent entity analysis requires the greatest level of subjectivity and is therefore more at risk of dispute and controversy, and is less easy to support with a clear audit trail. The employees and establishment test is in theory more mechanical and easier to apply, but in determining whether the CFC has the necessary premises, establishment and employee functions, the analysis becomes in practice similar to a viable independent entity analysis with a requirement to use judgement. As different MNEs have a range of business activities, accounting systems and levels of internal management and control, there is no single type of analysis that works equally effectively for all. Therefore an approach that permits the reporting group to use its own preferred method to initially determine and document which CFCs have sufficient substance, using one or a combination of the three types of analysis may be more effective and efficient.

*OECD Questions for Consultation:*

11. How can CFC rules accurately attribute income that raises concerns about BEPS (i) in a business that is licensed under an appropriate regulatory body and is market-facing in a particular jurisdiction,

(ii) in a reinsurance business carried on by a CFC of a multinational insurance group or (iii) in a “captive” insurance business of a CFC that is not part of an insurance group? Are there practical problems with current rules that distinguish between these two situations? If so, what are they and how can they be dealt with?

12. Are there practical problems with applying the same rule to sales and services income and IP income?
13. Are there existing CFC rules that accurately attribute any or all of these categories of income while also reducing administrative and compliance burdens?
14. Does the discussion above consider all categories of income that should be attributed under CFC rules?

The Draft appears to be based on a view of international business that most transactions relate to high value products with significant IP content where sales or service income includes or could include an embedded royalty or other return for an intangible asset so that CFC treatment of sales and service income is appropriate. The default position as proposed at paragraph 114 is that all sales and service income should be treated as passive unless one of the substance analysis requirements can be met. There are many international business transactions where these assumptions are not appropriate and where there is no direct link between sales or service income and any valuable IP and this is reflected in the active trade or business test found in some existing CFC regimes. Reversing the burden of proof on the basis of the limited analysis in paragraphs 105-106 is unjustified, particularly as enforcement of appropriate transfer pricing rules would address most of the issues relating to invoicing companies and the correct reward for IP.

For the many businesses following a more traditional business model, any CFC rules that define attributable income should therefore be clear that sales and service income are only included where there are significant related party transactions or other characteristics that would justify CFC treatment.

*OECD Questions for Consultation:*

15. Is it clear how the two approaches above would work? If not, what further detail is required to clarify the approach?
16. What practical problems arise with applying the categorical approach and the excess profits approach?
17. How could the practical problems be addressed or mitigated?
18. Which approach is most likely to accurately attribute income that gives rise to BEPS concerns? Is one approach likely to be more effective than the other in terms of dealing with IP income?
19. Could the excess profits approach be applied to income other than IP income and what would be the practical implications of this?
20. What other approaches could be considered for determining excess profits or excess returns?

It is not clear how the two approaches would work and in particular, it is not clear how the excess profits approach would work, or how it would be consistent with the other established principles of international taxation included in the OECD guidelines. The approach may be a “simpler and more mechanical”

approach as claimed in the Draft, but it introduces a novel principle that seems inconsistent with other BEPS actions as well as the Arm's Length Principle and some EU law principles.

If the excess profits approach is based on current or proposed domestic legislation in any country, providing more details of that legislation and, in particular, the criteria for including or excluding entities from the test would be required before any informed response to the questions posed in the Draft could be made. It would also be necessary to understand why this approach would be needed if all the other recommendations of the BEPS Action Items were implemented. In what circumstances would there still be an "excess return" in a company and would a more targeted measure aimed at those particular circumstances be more effective and efficient than a broad measure that could require calculation and reporting for many entities where no adjustment would be required.

As the excess profits approach applies a hypothetical "normal" return on almost any investment in a CFC, it is difficult to see how this approach could "accurately attribute income that gives rise to BEPS concerns". If the purpose of the Draft is to target particular BEPS concerns accurately, the categorical approach would be the more appropriate of the two.

*OECD Questions for Consultation:*

21. What difficulties or practical problems arise in applying an entity approach or a transactional approach?
22. What concerns arise from the two approaches in terms of administrative burdens and compliance costs?
23. How could these concerns and/or practical problems be dealt with while still ensuring that the CFC rules achieve an accurate result and attribute income that raises BEPS concerns?

The likely practical problem that would arise from the transactional approach is the difficulty of obtaining sufficient accurate data to apply CFC rules on a transactional basis. Experience with existing CFC regimes is that information can be obtained relating to local entity activities and financial results so that existing financial systems can be used, with suitable adaptation and additional information, to compute income attribution. Depending on how the "transaction" is defined, preparing an accurate determination of the profit attributable to that transactional stream could be complex and may require allocation of costs against income that would need to be based on estimates or allocation keys and therefore subject to dispute on audit.

As information at an entity level is more easily available, SwissHoldings would recommend that best practice would be for attribution to be made on an entity level in most cases, as it is likely that there would be no benefit in carrying out a transactional level analysis for most CFCs. Using some appropriate threshold to identify those entities where further analysis on a transactional level was required to address the concerns noted in paragraphs 128-9 would reduce overall administrative costs and focus on those entities where there could be a material adjustment.

## **CHAPTER 6: RULES FOR COMPUTING INCOME**

*OECD Questions for Consultation:*

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24. Do the rules on computing the income of a CFC present any difficulties in practice? If so, what are these and how could they be dealt with?
25. Does this chapter accurately reflect the issues that could arise with losses or are there any other situations that need to be considered?

Many businesses experience practical difficulties to a greater or lesser extent in computing the income of CFCs, particularly where local reporting, accounting and tax information is not in the same system as the parent and where there are differences between local accounting and tax rules and those of the parent.

Effectively, many businesses are obliged to prepare duplicate accounting and tax reporting for the CFC to compute income under the same principles as the parent, and to maintain this data for several years to deal with balance carry forwards and tax adjustments. The Draft recommends the use of the parent jurisdiction's rules, which will result in the continuation of the existing practical difficulties that many businesses experience.

If more countries decide to implement CFC rules as a result of this Action, there would be an additional level of complexity. For each tier of CFC reporting, data analysis and calculation would be required in the local rules of that tier of CFC, so that several different calculations could be required if the business has several tiers of ownership, which many do for historical reasons rather than tax planning.

## **CHAPTER 7: RULES FOR ATTRIBUTING INCOME**

*OECD Questions for Consultation:*

26. What difficulties, if any, arise under existing CFC provisions for attributing income?
27. Does the description of a top-up tax set out all the advantages and disadvantages of such an approach?

The description of the top-up tax, which is limited to a single paragraph does not set out all the advantages and disadvantages of this approach as little detail of how this might work in practice is provided. The fundamental principle of whether a top up tax that targets a minimum acceptable tax rate has not been explained in detail, but the top-up tax would probably only be appropriate for some jurisdictions that operate a worldwide taxation approach.

## **CHAPTER 8: RULES TO PREVENT OR ELIMINATE DOUBLE TAXATION**

*OECD Questions for Consultation:*

28. Are there any other double taxation issues that arise in the context of CFC rules that are not dealt with here?
29. What administrative or practical difficulties arise currently in respect of double tax relief rules and how could these be mitigated or dealt with?

Many countries have complex rules relating to the use of foreign tax credits against taxes due in the parent company jurisdiction and their complexity is made more challenging through audit adjustments to domestic and overseas income and taxes which can arise several years after the end of the accounting period. It is

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rarely a simple matter to obtain full relief for all foreign taxes paid and this is often made more difficult where the nature of the income received by the parent is dividend or deemed dividend income or some other non-trading income. In many countries (also in Switzerland) foreign tax credits are not carried forward, so loss making parents are subject to double taxation (using their losses up to the CFC income inclusion and losing the benefit of foreign tax credits).

The participation exemption regimes of some countries provide for a 95% or similar exemption, giving an effective tax on 5% of each dividend. A successive dividend through such regimes creates an effective additional tax at each level that is difficult to obtain relief for.

Therefore, while the Draft notes the principal issues, it appears to underestimate significantly the actual complexity in calculating double taxation relief and makes an apparent assumption that effective relief will be available which is often not the case.

The draft suggests a hierarchy of CFC rules and tax relief applied from the lowest tier upwards, with full relief being granted for CFC taxes paid in each lower tier before calculation of the tax due in that jurisdiction. As this hierarchy is critical to improving the chances of effective relief of double taxation, it should be a much clearer recommendation than a single sentence in one paragraph of the Draft, the process for notification of lower tier CFC adjustments and their treatment in the higher tier jurisdiction should be the subject of clear and precise recommendations. The principle of how each tier of CFCs should deal with income and taxes of lower tiers appears to SwissHoldings to be fundamental to the development of best practice in CFC rules and should therefore be given much greater priority and prominence in the Draft.

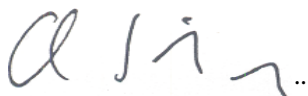
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We kindly ask you to take our comments and proposals into due consideration.

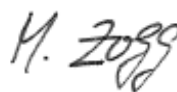
Yours sincerely

**SwissHoldings**

Federation of Industrial and Service Groups in Switzerland



Christian Stiefel  
CEO



Dr. Martin Zogg  
Member Executive Committee

- Cc: - SwissHoldings Board  
- Will Morris, Chair BIAC Tax Committee Bureau  
- Krister Andersson, Chair BUSINESSEUROPE Tax Policy Group
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