International Fiscal Association

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YIN SESSION IFA CANADA

CANADIAN AND SELECT EUROPEAN CONTROLLED FOREIGN COMPANY/FOREIGN AFFILIATE RULES

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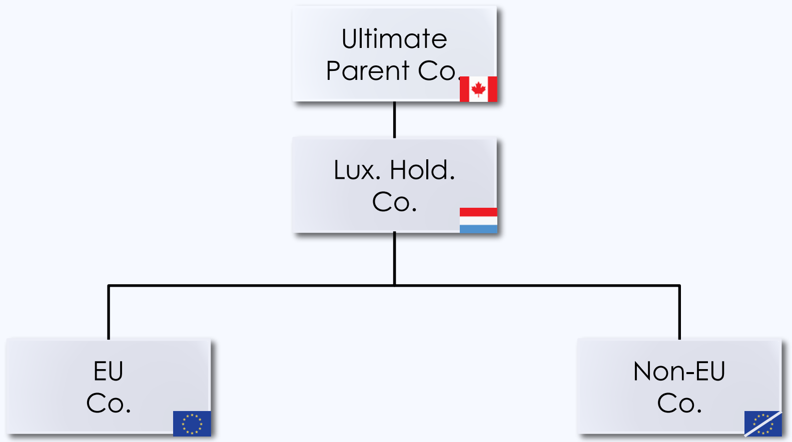
OUTLINE

1. Focus on Canadian CFC rules
2. Focus on EU CFC rules
3. Overview of certain EU implementations
4. Interaction with double tax treaties
5. EU Low-taxation and Control test
6. Questions?

CANADIAN CFC RULES



WHAT IS A CFC UNDER CANADIAN RULES

Foreign affiliate

Generally a non-resident corporation that is not resident of Canada, in respect of which the taxpayer's equity percentage (generally looks to the equity ownership of the FA) is not less than 1% and the total equity percentages of the taxpayer and persons related to it are at least 10%

Controlled foreign affiliate

Is a foreign affiliate that is controlled (ie. is there the right due to the shareholdings to elect the majority of the board of directors) by the taxpayer, or would be controlled by the taxpayer if the taxpayer also held the shares held by i) related persons, and ii) up 4 other persons resident in Canada (do not need to act as group or be related)

RESIDENCY

CFC (FA/CFA) resident (central management and control) in a DTC

A designated treaty county ("DTC") is one with which Canada has a Tax Treaty or Tax Information Exchange Agreement ("TIEA") with

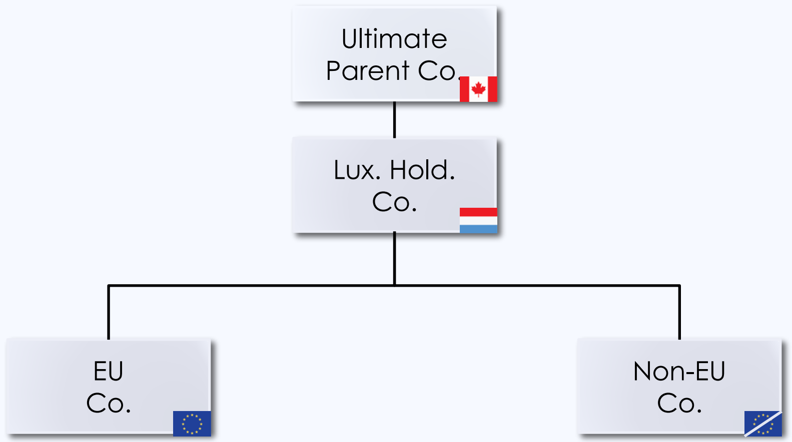
CFC (FA/CFA) resident in a country that is not a DTC

Active business income will not be FAPI, but is included in the taxable (not exempt) surplus pool. Result is a potential inclusion in CDN income if distributed

CFC (CA/CFA) resident in a country that is a non-qualifying country

There are currently few non-qualifying countries – any income earned will be FAPI

FOCUS ON CANADIAN CFC RULES



FAPI (Foreign accrual property income)

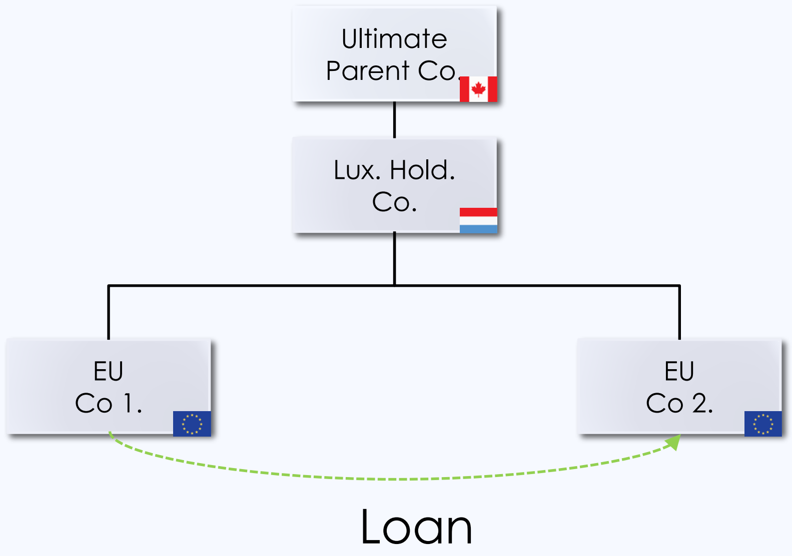
Aim: discouraging taxpayers from shifting passive income or income deemed to be base eroding into a CFC (FA/CFA)

Effect: current attribution of the income (as computed using Canadian tax laws, generally using Canadian dollars (or functional currency of Canadian taxpayer)) of the CFA to the Canadian taxpayer with relief for foreign tax ("FAT")

Includes:

1. income from property (e.g. income from investment business,)
2. income from business other than active business (e.g. 95(2)(a.1) to (a.4))
3. income from a "non-qualifying business" (e.g. operations in Liberia)

FOCUS ON CANADIAN CFC RULES

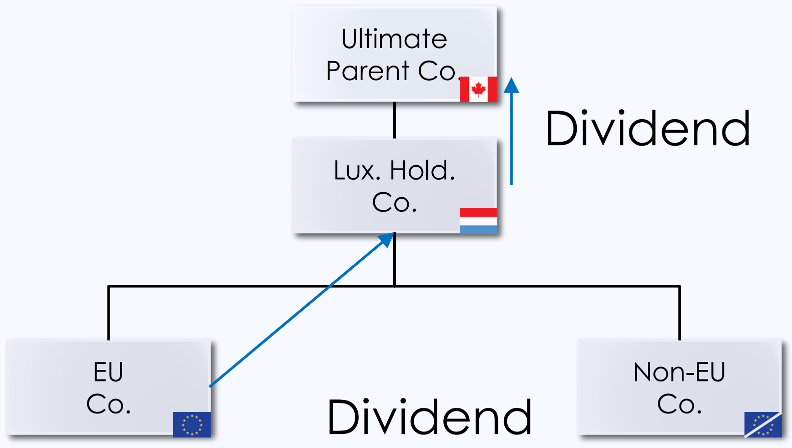


Recharacterization of income from transactions between affiliates

Effect: transactions such as loans or royalty agreements between affiliates may give rise to income that without the recharacterization rules would be income from property (and thus FAPI)

Example: interest paid from EU Co 2 to EU Co 1 may be able to be recharacterized as income from an active business to EU Co 1 if EU Co 2 is carrying on an active business and interest payments are deductible by it in computing its earnings from an active business (other than in Canada)

FOCUS ON CANADIAN CFC RULES



Distributions (Surplus Regime)

The Canadian tax treatment of distributions received from a FA/CFA depends on what surplus account(s) it is paid from

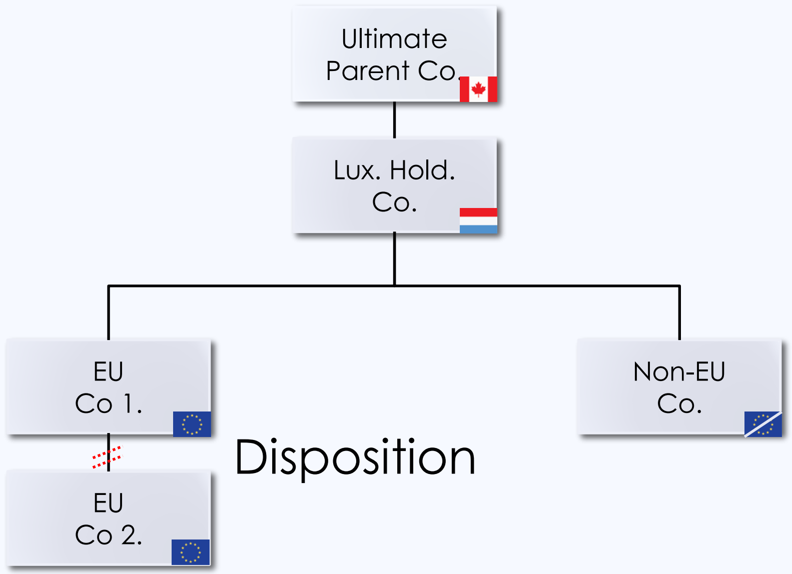
Effect: very generally active business income net of foreign tax can be repatriated to Canada on a fully deductible basis

Surplus accounts:

1. Exempt
2. Taxable
3. Hybrid
4. Pre-acquisition (*)

SURPLUS POOL	TREATMENT
Exempt	• Generally includes active business income earned by an affiliate in a DTC, and is computed based on the taxable income of the affiliate (as determined under the applicable foreign tax law) net of the foreign income tax (subject to adjustments as prescribed by the Regs to the ITA) • Distributions to corporate shareholder resident in Canada are fully deductible
Taxable	• Generally includes income earned by the affiliate that is FAPI, or active business income earned in a jurisdiction that is not a DTC • Distributions are taxable with a deduction for the underlying foreign tax * RTF (currently 4)
Hybrid	• Generally includes the capital gains in respect of the sale of another affiliate net of any foreign income tax paid on that gain • Half of the distribution to a corporate shareholder resident in Canada is deductible, and a deduction is also available for any 'hybrid underlying tax' or withholding tax applicable
Pre-acquisition	• Residual concept – not an account having a balance (where no other surplus, distribution will be from "PAS" • Distributions are fully deductible, with a corresponding adjustment to the ACB of the shares of the affiliate held by the shareholder. If this reduction exceeds the basis of the shares, the excess is deemed to be a capital gain.

FOCUS ON CANADIAN CFC RULES



Dispositions

The Canadian tax treatment of dispositions of a FA/CFA by a FA/CFA depends on whether the shares of the affiliate are "excluded property"

Effect: generally the disposition by an affiliate of shares that are:

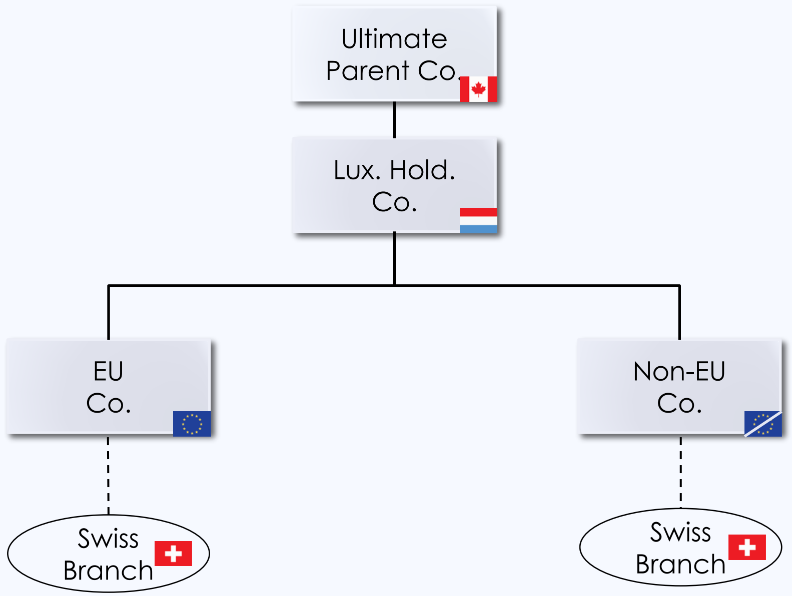
(i) excluded property will not be subject to current taxation in Canada (i.e. not be FAPI). Half of the gain will be deductible upon repatriation to Canada, and the other half will be included in income with a deduction for foreign tax, and

(ii) not excluded property will be subject to current taxation in Canada whether proceeds are distributed or not (FAPI) with credit (FAT) for foreign taxes.

Excluded property:

The shares of a FA will be excluded property where all or substantially all of the FMV of the FA's property is excluded property (that is property used or held by the affiliate for producing income from an active business). This is a point in time test.

FOCUS ON EU CFC RULES



BEPS Action 3 (2015) designs effective CFC Rules.

Aim: preventing a taxpayer from **shifting income into a CFC established in a low or no-tax jurisdictions**.

Effect: re-allocating the income of a low-taxed controlled entity to its parent company.

ATAD 1 (2016) introduces CFC rules in EU (art. 7&8)

- Implementation deadline: 1 January 2019
- CFC rules apply to both third country and EU CFCs.

Functioning:

1. Is the entity or PE a CFC?
2. If yes, the non distributed income of the CFC is taxed in the Member State of the parent taxpayer under either entity/categorical approach (Model A) or transactional approach (Model B).

MODEL A	MODEL B
Re-allocated income = undistributed passive income (i.e., interest, royalties, dividend, capital gains shares, leasing income, insurance income, banking income, income from invoicing companies). Unless substantive economic activity supported by staff, equipment, assets and premises (optional for non-EU CFC)	CFC income = undistributed income from non-genuine arrangements (i.e., when the essential purpose is to obtain a tax advantage). Income (assets/risks) only because of significant people functions of a controlling company.
Exclusions: • 1/3rd or less is from interest (etc.) • Financial undertakings	**Exclusions:** the CFC's accounting profits are: • lower than € 750,000, or • less than 10% of its operating costs for a given year.
Sweden, Denmark, Lithuania, Germany, Poland, Czech Republic, Austria, Italy, Slovenia, Croatia, Romania, Portugal, Spain, Greece	Estonia, Latvia, Ireland, United Kingdom, Belgium, Luxembourg*, the Netherlands (combination)*, Slovakia, Hungary, Malta, Cyprus

OVERVIEW OF CERTAIN EU IMPLEMENTATIONS

LUXEMBOURG

Introduced for **FY starting as from January 1, 2019**.

A CFC is a foreign entity or PE,

1. **Control-test**: in which a Luxembourg taxpayer holds a direct or indirect participation of more than 50% of the voting rights, the capital or the entitlement to profits of such entity, and
2. **Low-taxation test**: subject to an effective tax lower than 50% of the Luxembourg CIT (i.e., for 2021, 8.5%) that would be due by the entity or PE if it were established in Luxembourg.

Model **B** (ATAD 1). Lux taxpayer is subject to Lux CIT (but not to MBT) on the undistributed net income of the CFC

- *Pro rata* to their ownership or control of the entity,
- To the extent such income is related to significant functions carried out by the Lux corporate taxpayer, and only if
- **The relevant CFC has been put in place essentially for the purpose of obtaining a tax advantage.**

The exceptions of Model B apply (see previous slide).

THE NETHERLANDS

Introduced as of **January 1, 2019**, based on ATAD 1.

A CFC is a foreign subsidiary or PE,

1. **Control-test:** in which a Dutch shareholder (alone or together with an associated enterprise or person) holds directly or indirectly an equity interest of more than 50% in the subsidiary, and
2. **Jurisdiction test**: established in a jurisdiction included on either the Dutch MoF blacklist or the European list of non-cooperative jurisdictions.

Combination of models. The Netherlands opted for implementation of option B through existing domestic TP rules and on top of that a very limited implementation of model A.

Certain undistributed passive income of such CFC are included in the tax base of the Dutch taxpayer.

However, certain exceptions apply, including if the subsidiary or PE has '*real economic activities*' (safe harbor: € 100,000 salary costs, 24 months office space at disposal).

OVERVIEW OF CERTAIN EU IMPLEMENTATIONS

FRANCE

Introduced in 1980 but amended in **2019 and 2020** due to ATAD 1.

A CFC is a foreign entity or PE,

1. **Control-test**: owned or controlled for more than 50% by a French taxpayer, and
2. **Low-taxation test**: subject to an effective tax lower than 50% of the French CIT rate (i.e., the income calculated under French GAAP) that would be due by the entity or PE if it were established in France.

Neither Model A nor Model B. The French company is taxed on its pro rata share of the income deemed to be received from its PE or branch or distributed income from its subsidiary.

Income paid to companies located in a noncooperative country may be subject to a 75% WHT and dividends received from such companies are excluded from the benefit of the participation exemption.

Nonetheless, are outside the scope of the CFC rules:

- EU companies, unless the structure was put in place to avoid tax.
- the operations of the foreign entity has an object and effect other than to transfer profits in a State or territory providing a preferential tax regime (e.g., has an industrial or commercial activity).

GERMANY

Introduced in 1972 but changes based on ATAD 1 are expected.

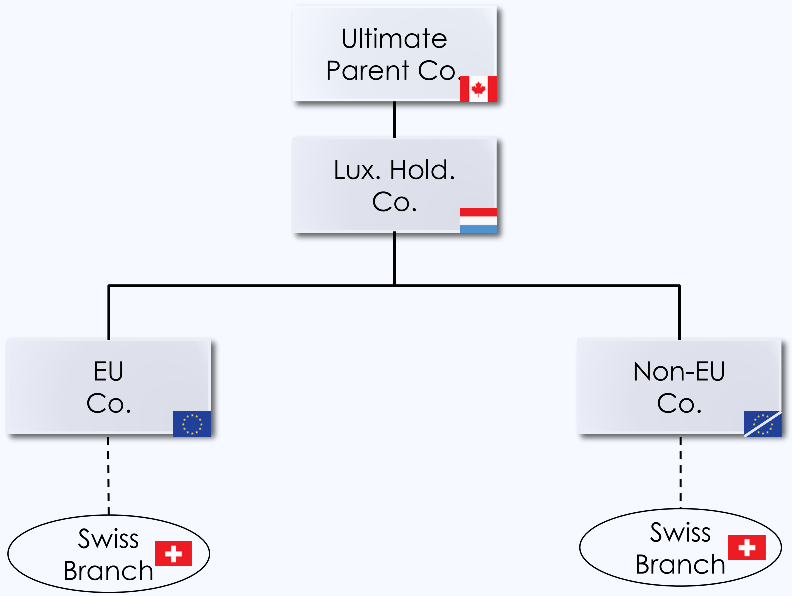
A CFC is a foreign entity

1. Realizing passive income (i.e., not listed in Section 8(1) AStG) but, under a Draft Law, in some instances, dividends and capital gains will no longer qualify as active income,
2. **Control-test:** in which German tax resident shareholders (regardless of whether they are related or not) hold a stake of more than 50% (shares or voting rights),
3. **Low-taxation test:** subject to taxation on its passive income at a rate of less than 25%.

Model A. German company could be subject to taxation on the passive income of such CFC, irrespective of a distribution.

However, a **motive test** allows it to prove that the CFC pursues an actual economic activity as far as its registered office is in an EU-member State.

INTERACTION WITH DOUBLE TAX TREATIES (DTT)



LUXEMBOURG

CFC/PE located in an EU Member State
application of national CFC rules (primacy of EU law), regardless the fact that DTT exclusively allocates the taxing right to the CFC's Home State.

CFC/PE located in a third country
application of DTT (primacy of international treaties)

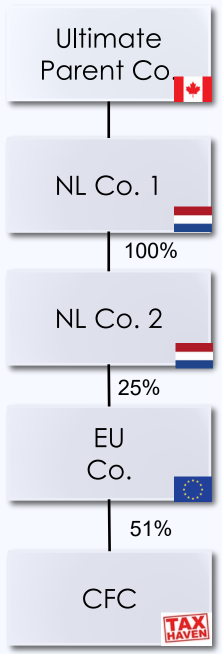
Where the Swiss Branch constitutes a CFC, as Switzerland is not an EU Member State, **the DTT should prevail** over the Luxembourg CFC rules.

THE NETHERLANDS

CFC located in an EU Member State
Option B is implemented through Dutch TP rules which should be in line with art. 9 of DTTs. In case of older DTTs, doubts may arise.

CFC located in a third country
Option A could be incompatible with DTT concluded with third country only for CFC in the form of a PE in a treaty country in case no switch over in tax treaty. Option B: same comments as for EU Member State.

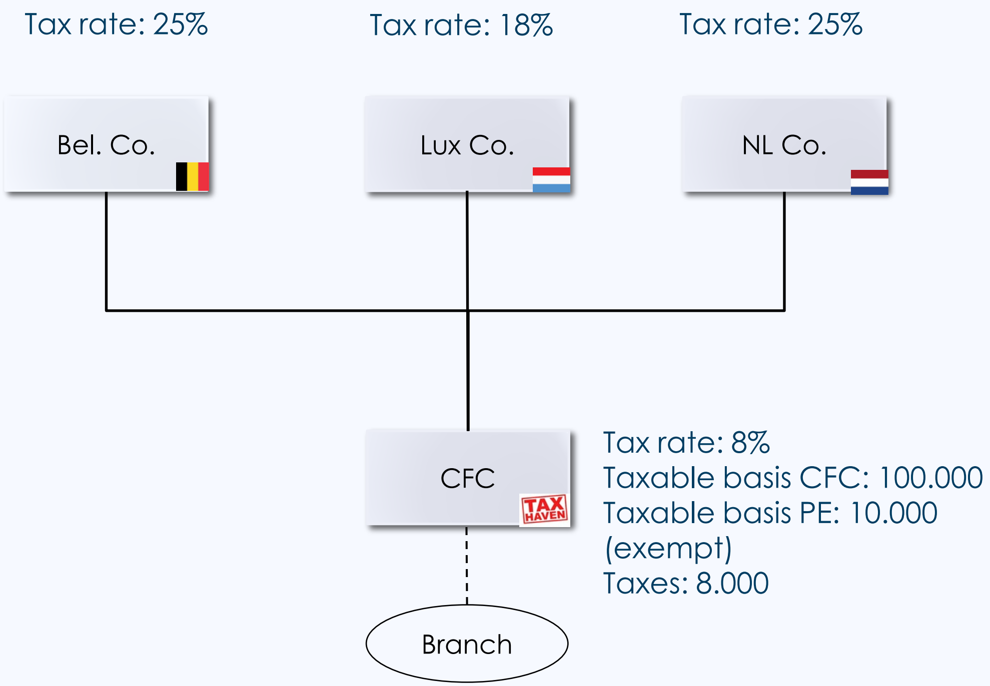
MODEL A NL – (MORE THAN) DOUBLE TAXATION POSSIBLE



CFC inclusion of income CFC possible in:

- EU
- BV 1
- BV 2

LOW-TAXATION TEST AND CONTROL TEST



Taxation-test fulfilled in BE?

- Taxable basis to be determined as if CFC was established in BE
- Determine taxable income according to BE rules
- PE income of CFC not taken into account if it is exempt under DTT
- Assuming taxable income equals 100.000 as well, taxes of 25.000 would be due
- 8.000 < 12.500 (25.000/2) ➔ taxation-test fulfilled

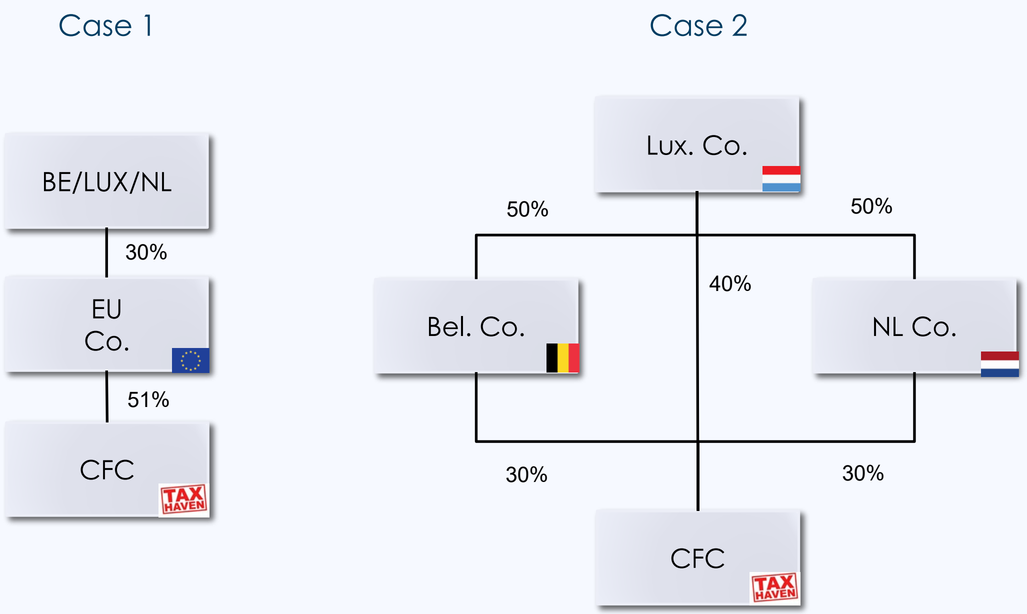
Taxation-test fulfilled in LUX?

- Taxable basis to be determined as if CFC was established in LUX
- Determine taxable income according to LUX rules
- PE income of CFC not taken into account if it is not taxable or exempt under the laws of the CFC State
- Assuming taxable income equals 100.000 as well, taxes of 18.000 would be due
- 8.000 < 9000 (18.000/2) ➔ taxation-test fulfilled

Taxation-test fulfilled in NL?

- Model A: only listed jurisdictions, taxation in PE is irrelevant for statutory tax rate test in CFC country
- Model B: no tax rate test

LOW-TAXATION TEST AND CONTROL TEST



CFC is controlled by BE?

- Case 1 and case 2: BE does not own directly or indirectly > 50%
- No control in case 1 and 2 because interest of associated enterprises not to be aggregated? Interpretation in accordance with Directive or law amendment seems required
- ≥ 50% = stricter than ATAD

CFC is controlled by LUX?

- Case 1: Lux is associated with EU and since EU > 50%, CFC is controlled by LUX
- Case 2: LUX is associated with BE and NL and since the aggregated interest of the associated entities > 50%, CFC is controlled by LUX.

CFC is controlled by NL?

- Case 1: NL is associated with EU and since EU > 50%, CFC is controlled by NL
- Case 2: NL is associated with BE and LUX and since the aggregated interest > 50%, CFC is controlled by NL

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Questions?