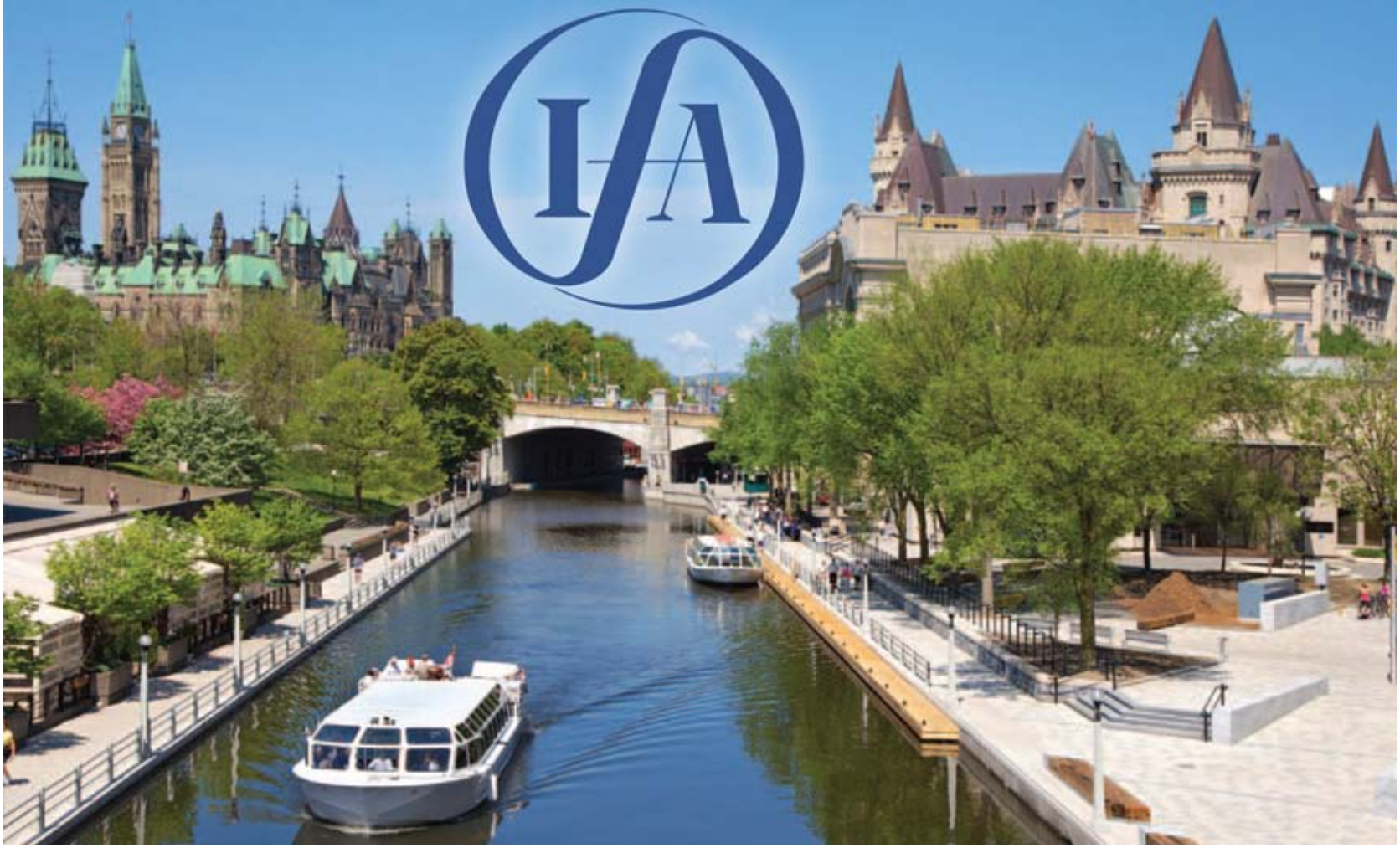

Global CFC Developments: Policy Choices and Practical Implications

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Global CFC Developments: Policy Choices and Practical Implications

Focus of Discussion

Pressure points and policy choices, in light of increased *globalization* of trade and commerce and the trend in many countries towards exempting *foreign business* profits from domestic taxation, in designing a CFC system that *protects* the domestic tax base while facilitating *global competitiveness*

Global CFC Developments: Policy Choices and Practical Implications

Outline of Discussion

- Taxation of Foreign Source Income – Overview
- Relevant Financial Data and Statistics
- Taxation of Foreign Source Income – Recent Developments
- Pressures on Scope of Current CFC Rules
- Competitiveness v. Protecting Tax Base – Which One Trumps?
- Concluding Comments

Taxation of Foreign Source Income Overview

Worldwide or accrual system - domestic and foreign source income earned directly or indirectly by a taxpayer is taxable in the taxpayer's country of residence on an accrual basis, with a tax credit for underlying foreign tax

Territorial or full exemption system - foreign source income (including capital gains on the sale of assets and shares of a foreign company) is exempt from domestic taxation when earned and when a dividend is paid to domestic corporate shareholders, with no tax credit for underlying foreign tax

- Usually restricted to foreign active business income

Deferral with credit system - the taxation of foreign income (usually active business income) earned through a foreign entity (usually a corporation) is deferred until such income is repatriated to domestic shareholders (usually as dividends), with a credit for underlying foreign tax

Taxation of Foreign Source Income Overview

	United Kingdom	Canada	United States
Active business income (treaty country)	Territorial	Territorial	Deferral w/credit
Active business income (non-treaty country)	Territorial	Deferral w/credit	Deferral w/credit
Passive income	Hybrid	Worldwide	Worldwide
Capital gains on sale of active/trading CFCs	Territorial	Worldwide/ Deferral w/credit	Worldwide

Relevant Financial Data and Statistics

	United Kingdom	Canada	United States
Population (millions)	61.3	34.1	309.1
GDP ($ billions)	$2,233.9	$1,327.3	$14,582.4
GDP per Capita	$36,413	$38,915	$47,184
Exports ($ billions)	$656.4	$455.8	$1,822.6
Exports as a % of GDP	29.4%	34.3%	12.5%
Imports ($ billions)	$734.1	$483.2	$2,360.6
Imports as a % of GDP	32.9%	36.4%	16.2%

Source: OECD Factbook 2011-2012. Accessed April 2012.

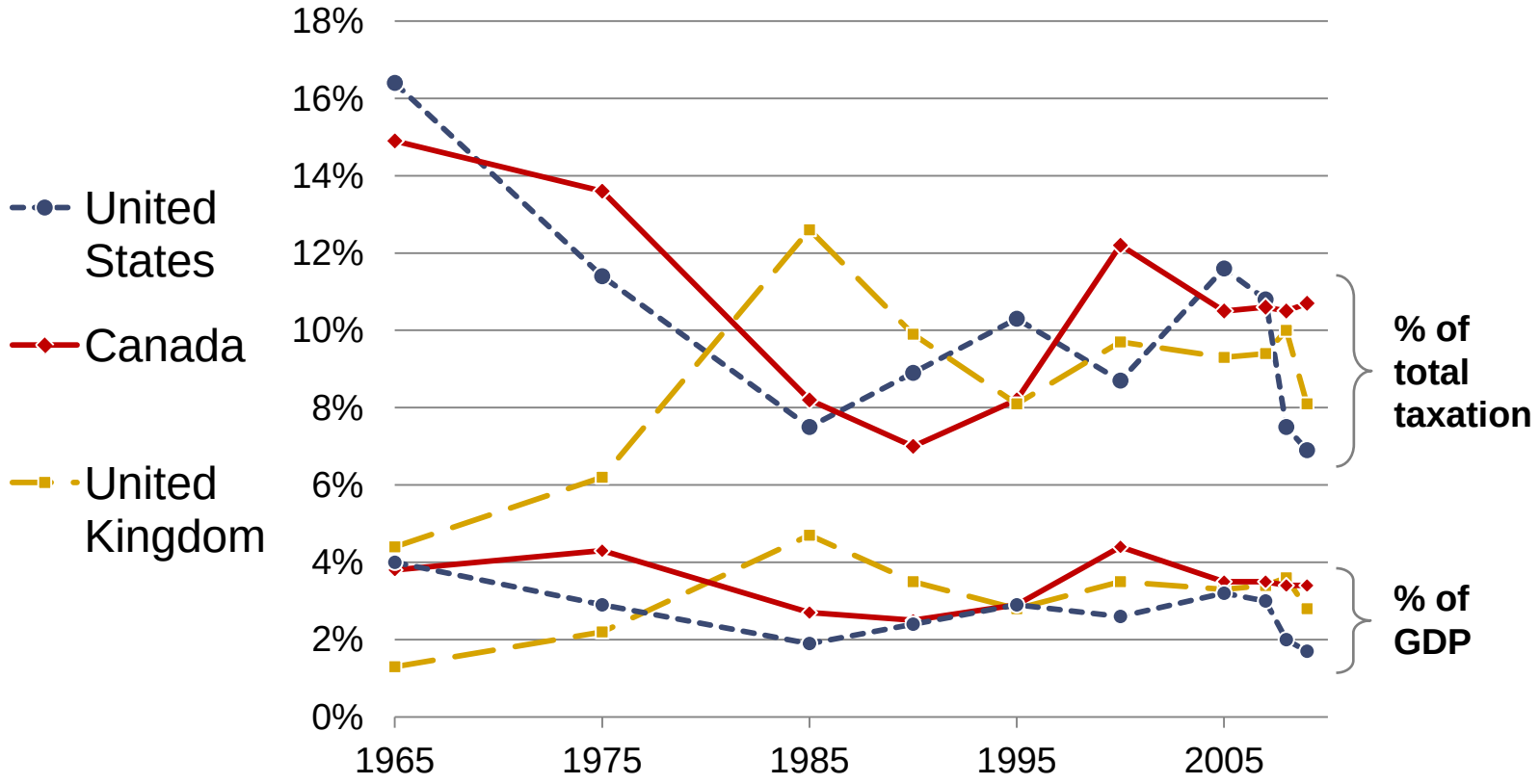
Relevant Financial Data and Statistics

	United Kingdom[1]	Canada[2]	United States[3]
Market value of domestic corporate entities owned by foreign residents (2010)(est)	40%	13%	16%

1 Source: Office for National Statistics (UK) - 2012
2 Source: Statistics Canada, National Balance Sheet
3 Source: Board of Governors of the Federal Reserve System, “Flow of Funds Accounts of the United States: Annual Flows and Outstandings, 2005-2010.”

Relevant Financial Data and Statistics

Total tax on corporate income (1965-2009)



Taxation of Foreign Source Income Recent Developments – United Kingdom

- Corporate tax system moving towards a territorial system with respect to foreign profits; dividend exemption 2009, opt-in exemption for foreign branches 2011
- New CFC rules reflect this more territorial approach
- CFC reform process started in 2006; change of Government May 2010; Government published Corporate Tax Road Map November 2010 which included CFC proposals; new rules to be legislated in 2012
- Key features:
  - legislation defines artificial diversion of UK profits
  - foreign to foreign activity outside the scope of the rules
  - proportionate – only profits that are artificially diverted are taxed rather than the total profits of an entity
  - separate finance company rules
  - some entity level exemptions retained but modernised

Taxation of Foreign Source Income Recent Developments – United Kingdom

- UK's aim is to create the most competitive corporate tax regime in the G20
- Corporate Tax Road Map set out principles for the UK's CT system:
  - lowering rates while maintaining the tax base; maintaining stability; being aligned with modern business practice; avoiding complexity; and maintaining a level playing field for taxpayers
- For CFCs – a modernised CFC regime that strikes the right balance between making the corporate tax system more competitive and providing adequate protection of the UK tax base
- Rules have to comply with EU law
- Extensive consultation on options, proposals, and legislation before implementing significant changes

Taxation of Foreign Source Income Recent Developments – Canada

- Current system conceived on basis of worldwide taxation but evolving towards a territorial system with respect to foreign active business income earned by foreign affiliates
- 2002 and 2004 proposals (now largely abandoned) and 2011 upstream loan, “hybrid” and exempt surplus anti-avoidance proposals intended to preserve integrity of “deferral” aspect of current system
- 2008 Advisory Panel recommendations included:
  - full exemption for foreign active business income, including capital gains on the sale of shares of active foreign affiliates
  - modernize FAPI rules and reduce overlap with other anti-deferral regimes
  - allow interest deductibility on FA investments except for “debt dumping”
- Access to foreign affiliate system being limited to “Canadian-controlled” Canadian companies; e.g., 2012 foreign affiliate dumping proposals

Taxation of Foreign Source Income Recent Developments – Canada

Advisory Panel on Canada's System of International Taxation – Principles to guide international tax policy

- System for Canadian business investment abroad should be competitive
- Level playing field for domestic business investors, while ensuring Canadian-source income is properly measured and taxed
- Protect the Canadian tax base
- System should be straightforward to understand, comply, administer and enforce
- Full consultations before implementing significant changes
- Benchmark Canada's system on a regular basis

Taxation of Foreign Source Income Recent Developments – United States

- Generally employs a deferral with credit system; the US was the first country to adopt CFC rules (1962)
- Dividends, interest, rents, and royalties received/accrued are taxed on a worldwide basis under the US Subpart F regime with exceptions
  - 2006 – CFC look-through enacted to exclude passive income received or accrued by one CFC from a related CFC to the extent attributable to non-Subpart F income earned by the related CFC
  - 1997 – active finance exemption enacted to exclude income derived by a CFC in the active conduct of a banking, financing or insurance business from Subpart F provisions
- Deferral with credit system is believed to have created a “lockout” effect as other countries corporate tax rates have fallen relative to the US, increasing the residual US tax on foreign earnings repatriated to the US

Taxation of Foreign Source Income Recent Developments – United States

- Homeland Investment Act (2004) provided a temporary incentive to repatriate foreign profits at reduced US tax; legislation has been introduced that would reprise the repatriation holiday
- Corporate tax reform has been proposed by the Obama Administration and in Congress
  - Obama Administration has proposed restricting deferral via a corporate minimum tax
  - Congressional proposals range from a territorial system to a worldwide system
  - Obama Administration and Congressional territorial proposals include anti-base erosion provisions
- No formal consultation process though the Administration convened an advisory board, council, and commission, all of which recommended tax reform options, and the most comprehensive international tax reform legislation was released as a discussion draft

Pressures on Scope of Current CFC Rules

Current application of accrual based taxation to passive income earned by CFCs

	United Kingdom	Canada	United States
Imputation only for controlled foreign corporations	Yes	Yes	Yes
Other rules to impute income for non-controlled foreign entities	Limited rules	Limited rules	Limited rules
Recharacterization of passive income as active based on foreign level of tax	No	No	Yes
Transactional/source based v. entity based approach	Entity but transactional elements for EEA	Transactional	Transactional
Ability to offset CFC losses against domestic passive income	No	No	No
Ability to offset CFC capital gains against domestic capital losses	Gains exempt from regime	No	No
Domestic sale of CFC shares taxed differently than foreign sale of CFC shares	Yes – subject to SSE	Yes	Yes, but some similarities

Pressure Points on Current CFC Rules – Canada

- FAPI rules apply only to "controlled foreign affiliates“ – should rules include non-controlled foreign affiliates? What is interaction with “FIE” regime?
- FAPI rules based on passive character of income derived from a particular transaction or source – should an entity based approach be considered?
- FAPI and “recharacterization" rules not dependent on the level of foreign tax – concerns about double “non-taxation”?
- No ability to offset foreign accrual property losses (“FAPLs”) against domestic income or for capital gains included in FAPI to apply against domestic capital losses – a territorial feature?
- Capital gain on direct sale of a foreign affiliate by Canadian taxpayer taxable (subject to 93(1) election); not currently taxable if affiliate sold by another affiliate and shares are "excluded property”
- Scope of base erosion (versus relying on transfer pricing) and investment business definition

Pressure Points on Current CFC Rules – United Kingdom

New rules

- Will apply consistently to foreign subsidiaries and exempt foreign branches of UK companies
- Reflect a more territorial system; foreign transactions that do not erode the UK tax base are exempt
- Are proportionate so that only profits that are artificially diverted from the UK are taxed; existing rules tax an entity's total profits
- Are dependent on level of foreign tax with an exemption for companies located in countries with tax rates at or above 75% of the UK rate
- For finance income reflect a more territorial system but take account of current UK rules for deductions for interest; restricting deductions for interest in the UK on a territorial basis would be too disruptive and potentially damaging to investment
- Exclude capital gains/losses

Pressure Points on Current CFC Rules – United States

- Check the box impact on Subpart F
- Transfer pricing concerns
  - mobility of risk
  - continued decrease in foreign corporate tax rates relative to US
- Temporary nature of tax code (CFC look-through, active finance)
- Different rules for branches, CFCs, portfolio ownership (<50%)

Competitiveness v. Protecting Tax Base Which One Trumps?

Proposition: CFC rules protect tax base and prevent double taxation but must do so in a way that does not inhibit current global business practices

- Pressure points include:
  - globalization – business supply chains are global
  - capital and labour more mobile
  - increased use of centralized resources to create efficiency
  - increased importance of intellectual property
  - declining corporate tax rates
  - OECD concerns over double non-taxation
  - revenue needs
  - Obama administration assertion that deferral creates off-shoring incentive

Competitiveness v. Protecting Tax Base Which One Trumps?

Our new Controlled Foreign Company rules will be legislated for in the coming Finance Bill and will stop global firms leaving Britain as they were, and encourage them to start coming here

UK Budget 2012 statement by the Chancellor of the Exchequer
The Right Honourable George Osborne
March 21, 2012

Competitiveness v. Protecting Tax Base Which One Trumps? – United Kingdom

Role for CFC rules

- Ensure that the UK is appropriately rewarded for profits generated by activities carried out in UK to prevent those profits being diverted to low tax jurisdictions
- Provides carefully targeted protection in addition to that provided by transfer pricing rules

Competitiveness

- Reform of CFC rules seen by business as a key priority needed to improve the UK's tax competitiveness; existing rules can place artificial constraints on the global operations of business
- Rules need to strike the right balance between a more competitive tax system and adequate protection of the UK tax base
- A more territorial approach considered more competitive
- Artificial diversion based on profits being shifted to low tax jurisdictions; specifically defined in the new rules

Competitiveness v. Protecting Tax Base Which One Trumps? – United Kingdom

- Slide 10 sets out the basis for the new CFC rules due to be legislated in 2012; specific rules include:
  - a Gateway defines what is meant by artificial diversion of profits allowing groups to identify more easily whether or not they are within the scope of the rules; aims to minimise compliance burdens
  - finance company rules: a pragmatic approach to the difficult issue of overseas intra-group finance profits; generally provides a three-quarters exemption for these profits
  - no specific rules for IP profits so the CFC rules will catch IP profits where there is a substantial tax-driven mismatch between the key profit generating activities that are performed in the UK and the allocation of the profit arising from that activity
  - a patent box will be introduced in 2012 to allow companies to elect to apply a 10% tax rate to profits attributable to patent and certain other qualifying intellectual property; aims to encourage innovative business to invest in the UK

Competitiveness v. Protecting Tax Base Which One Trumps? – United States

- Administration
  - budget proposals – FTC pooling, defer US deductions for foreign deferred income, “excess returns”
  - tax reform framework - minimum tax on overseas profits
- Congress
  - runaway plant – deny deferral to companies reducing US business and expanding similar business overseas and selling back into US
  - tax haven abuse – country by country reporting requirement
  - Camp international discussion draft
    - “excess returns” effective tax rate cutoff, carrot and stick for intangible income
  - repeal of deferral with credit and worldwide replacement

Competitiveness v. Protecting Tax Base Which One Trumps? – United States

- 2012 Presidential and Congressional election outcome
- Economic situation
  - US continues to have favorable geography, population and resources
  - budget deficits/growing federal debt
- US dominance could fade quickly: In 1960, it took 20 years for a third of the Fortune 500 companies to change; today *The Economist* has estimated that it takes four years

Competitiveness v. Protecting Tax Base Which One Trumps? – Canada

- Current "base erosion" rules in the FAPI regime can prevent Canadian businesses from effectively managing global supply chain
  - budget 2012 proposed changes to alleviate tax cost to Canadian banks of using excess liquidity of their foreign affiliates in their Canadian operations and to ensure that certain securities transactions in the course of the bank's business of facilitating trades for arm's length customers are not inappropriately caught by the base erosion rules
  - are other changes to come for other industries?
- Carrot or stick approach to dealing with innovation and IP migration? i.e., patent/innovation box (UK) v. taxing excess returns of IP transferred offshore (Obama)
- Enhancing the Canadian tax base – *"Why Not Kenora?"*

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Concluding Comments

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Thank You!!