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## MIT MASTER CLASS SERIES

# Controlled foreign company rules under the Anti-Tax Avoidance Directive: interaction with EU fundamental freedoms and the potential effects on tax planning

**7 August 2019**

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# Controlled foreign company rules under the Anti-Tax Avoidance Directive: interaction with EU fundamental freedoms and the potential effects on tax planning

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# Introduction

The Malta Institute of Taxation continued its Master Class Series on 18 February 2019, with the most recent session focusing on the controlled foreign company ('**CFC**') rule contained in the EU's Anti-Tax Avoidance Directive ('**ATAD**'). The session was presented by Professor Alexander Rust* (the '**Speaker**'). This paper outlines the various issues raised by the Speaker that were discussed among the participants, and sets out the Malta Institute of Taxation's views on some of the key points.

Section 1 explores the main policy objectives underpinning CFC legislation. In particular, this section identifies those structural features of a corporate tax system that create tensions resulting in the need for anti-deferral legislation.

Section 2 provides a brief overview of the legislative history of CFC legislation worldwide, beginning with President J.F. Kennedy's 1961 pledge to end tax deferral privileges for United States ('**US**') taxpayers, up to the European Union's ('**EU**') present-day drive to act as the standard-bearer in the fight against aggressive tax planning practices.

Section 3 undertakes a review of the major deliberations concerning the interpretation of the framework laid down by articles 7 and 8 of ATAD that took place during the Master Class. These have, where possible, been supplemented by additional material and background in order to provide the reader with adequate context.

Finally, section 4 provides a round-up of the main takeaways of the session, and general reflections of the floor as to the adequacy or otherwise of the ATAD CFC ruleset.

## *1. Concerning the policy objectives underpinning CFC legislation*

CFC rules are a form of specific anti-avoidance legislation that discourage the deferral of income, i.e. '*the postponement of current taxation on the net income or gain economically accrued by a taxpayer.*'[1] This is typically achieved through the deflection of income generated by highly mobile assets to foreign taxpayers situated in low or zero tax jurisdictions. The tax benefit generated by deferral results in a cash-flow advantage by securing a lower overall effective tax rate when compared to income generated domestically,until such time the income is repatriated to the residence jurisdiction. This, in turn, incentivises outbound indirect investment and places domestic taxpayers investing indirectly on a purely domestic level at a comparative disadvantage.[2]

[1] Office of Tax Policy, Department of the Treasury, 'The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study' (December 2000).
[2] Interestingly, the CJEU considered UK CFC rules dis-incentivising this type of behaviour tantamount to a hindrance of the exercise of freedom of establishment within the European Union, see Cadbury Schweppes (2006) at paras. 44-46.

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Deferral is the result of tension between two structural features of a jurisdiction's corporate tax system, namely (i) a worldwide basis of taxing domestic taxpayers and (ii) the treatment of certain legal forms as separate taxable persons.[3] A foreign corporate taxpayer (controlled by a domestic taxpayer) deriving foreign source income is not taxable in the resident State of the domestic taxpayer (the '**Home State**') until such time the income is repatriated to the Home State. The interposition of a separate taxable person therefore creates a distortion by restricting the Home State's jurisdiction to tax income derived through a separate taxable person to a remittance basis system.

CFC rules seek to neutralise the impact of deferral from a corporate tax perspective. This is typically achieved through either a deemed distribution rule[4], or alternatively by means of a direct allocation of artificially deflected income ('**tainted income**') to the controlling entity. Whilst the precise mechanics of individual systems may vary, the principle underpinning CFC regimes is largely consistent in that the Home State asserts the right to currently tax foreign source income derived by a foreign taxpayer by means of an income inclusion at the level of the domestic controlling taxpayer. By equating domestic taxpayers investing locally with domestic taxpayers investing abroad, anti-deferral rules purport to preserve capital export neutrality.

Although anti-deferral is typically identified as the driving tax policy goal behind CFC rules, there are possible ulterior motives for introducing such a regime into a jurisdiction's legislative framework. CFC rules are, in some quarters, seen as a backstop to ineffective, or otherwise absent, transfer pricing legislation. This line of argumentation is somewhat imperfect, as transfer pricing rules are predominantly concerned with the allocation of an appropriate return to a group entity that is commensurate to the functions performed, assets owned and risks assumed by that entity. Whilst transfer pricing rules and CFC rules can, and do, overlap, their object and purpose are different. Nevertheless, this school of thought has gained some traction and is reflected in the Final Report on the Base Erosion and Profit Shifting ('**BEPS**') Action 3[5] and the EU legislator's inclusion of Option B of article 7(2) of ATAD.

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[3] Both of these features constitute basic tenets of the Income Tax Act ("ITA"). A worldwide basis of taxation emerges from the opening paragraph of article 4(1) of the ITA: '*income tax shall be payable […] upon the income of any person accruing in or derived from Malta or elsewhere, and whether received in Malta or not […]*'. The default position is subsequently tapered by means of the first proviso to article 4(1) of the ITA, which limits Malta's jurisdiction to tax in the event that the taxpayer in question is a person that is either not ordinarily resident, or not domiciled in, Malta. In certain instances, Malta operates a territorial system of taxation for foreign source dividends, capital gains on the disposal of shares and income attributable to a permanent establishment outside of Malta. Furthermore, article 2(1) of the ITA coupled with article 56(6) of the ITA, amongst others, provide the legal basis for the separate taxation of '*companies*'. Malta's imputation system (achieved through the cumulative application of articles 31, 59 and 60-68 of the ITA) ensures that, from a Malta income tax perspective, economic double taxation does not result.

[4] A deemed dividend approach has the effect of unwinding the deferral element.

[5] OECD/G20 Base Erosion and Profit Shifting Project, *Designing Effectivbe Controlled Foreign Company Rules, Action 3: 2015 Final Report* (OECD, 2015), at paras. 8-9.



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CFC rules can also provide support to a corporate tax system whose rules can easily be circumvented through income classification arbitrage: in many instances weak income classification rules can transform high-taxed active income into low-taxed or exempt dividends of capital gains. The use of CFC rules that preserve the character and source of tainted income acts as an effective backstop to this particular subset of arbitrage.

## *2. Concerning the development of CFC legislation globally*

Ever since the passage of the 1913 Revenue Act, and the consequent development of the world's first foreign tax credit system[6], the US has been a vocal proponent of a worldwide basis of taxation through the marriage of strong source State taxing rights coupled with a residual right of residence States to tax foreign source income. The US' international tax policy was designed in an era when the US was still largely a capital importer, although its economic standing rapidly evolved in the aftermath of the First World War.[7] Later still, the onset of the Marshall Plan ushered in an unprecedented wave of American foreign direct investment into Europe, and effectively cemented the US' position as a global exporter of capital. In the period spanning from 1945 to 1962, income earned by US investors from overseas investments increased by 150%.[8] Persistently high domestic tax rates[9] coupled with the rise of tax havens created an environment that incentivised US-based business to resort to deferral type structures. In 1961 President J.F. Kennedy's proposal to end '*tax deferral privileges in developed countries*'[10], coupled with a drive to improve the US' balance of payments resulted in Congress enacting the now infamous Subpart F rules.[11] Congress' legislative initiative was slowly, but surely, replicated by other large capital exporting nations over the course of the following decades.[12]

As corporate tax rates across OECD Member States steadily dropped over the last three decades of the twentieth century, the scope of application of CFC rules narrowed considerably, with their popularity waning. The ruleset's efficacy was further impaired by the growing practice of corporate inversions, which disengaged CFC legislation through an effective expatriation of the corporate parent. Within the context of the European Union, much furore was created by the Court of Justice of the European Union's ('**CJEU**') 2006 decision in Cadbury Schweppes, wherein CFC rules were declared, as a

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[6] The development of the foreign tax credit system can be largely attributed to the work renowned, but underappreciated, economist T.S. Adams. *Vide,* Michael J. Graetz & Michael M. O'Hear, *'The Original Intent of U.S. International Taxation*', Duke Law Journal Vol. 46 at pp. 1021-1109.
[7] The foreign tax credit was, at least in part, favoured in view of the '*substantial quantity of American capital […] channelled to rebuild post-War Europe*.' *Vide* Graetz and O'Hear (n. 6) at p. 1051.
[8] Department of Treasury, (n. 1) at p. 8.
[9] *ibid.*
[10] *ibid* at p. 12.
[11] The US Subpart F rules regulate (i) amounts included in the gross income of US shareholders and (ii) global intangible low-taxed income included in the gross income of US shareholders. The US Subpart F rules are nestled in a section of the Inland Revenue Code entitled 'Income from sources without the United States'.
[12] Germany introduced CFC rules in 1972, Japan in 1978 and the United Kingdom in 1984.



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matter of principle, to run contrary to the freedom of establishment and could only be justified to the extent that they targeted '*wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.*'[13] The fallout of the decision resulted in multinational enterprises clamouring to imbue their CFCs with increased '*substance*' by means of adequate premises, staff and assets that were commensurate to the economic activity being performed.

The OECD's initiative precipitated the reversal in the restrictive precedents set by the CJEU in *Cadbury Schweppes.* The Final Report on BEPS Action 3 outlined common approaches and best standards in connection with the introduction, and/or strengthening of, CFC rules, including recommendations, within an EU context, on preserving compliance with the fundamental freedoms. The Council of the European Union, in its efforts to secure a harmonised approach to combatting BEPS, included as part of ATAD a CFC rule. The rule was to be transposed in all EU Member States by 1 January 2019.

Whereas the debate around BEPS has centred on the taxation of income where value is created (i.e. strengthening source state taxing rights), the OECD's 2019 Public Consultation Document entitled '*Addressing the Tax Challenges of the Digitalisation of the Economy*' has veered, rather boldly, in a different direction. The report endorses the further strengthening of residence taxation through the establishment of a minimum tax at shareholder level achieved through an income inclusion rule. The OECD's present position is that such a rule would '*supplement rather than replace a jurisdiction's CFC rules.*'[14] The present thinking appears to be conditioned by the US experience following the introduction of the Global Intangible Low Taxed Income ('**GILTI**') rules further to the promulgation of the US Tax Cuts and Jobs Act 2017.[15] GILTI subjects to tax in the US any non-Subpart F income derived by CFCs where such income has not been earned through the deployment of tangible assets. Notwithstanding its stated purpose and construction, GILTI is viewed, in some quarters, as an extension to the existing CFC ruleset.[16]

### *3. Concerning the construction of articles 7 and 8 of ATAD*

Articles 7 and 8 of ATAD provide the basic framework of the minimum standard required for EU CFC rules. In essence, the ruleset is comprised of the following aspects (which aspects have been largely replicated *verbatim* in regulations 7 and 8 of Legal Notice 411 of 2018):

[13] Cadbury Schweppes at para. 55.
[14] Public Consultation Document para. 96 at p. 25.
[15] Section 951A of the Internal Revenue Code.
[16] *Vide,* for example, Carlos Petrez Gautrin, *US Tax Cuts and Jobs Act: Part 1 – Global Intangible Low-Taxed Income (GILTI)*, Bulletin for International Journal, Volume 73, No. 1 (IBFD, 2019).



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i. Does an entity (the '**test entity**') qualify as a CFC of a domestic taxpayer?
ii. If the answer to (i) is in the affirmative, does the CFC derive artificially deflected income ('**tainted income**')?
iii. If the answer to (ii) is in the affirmative, how much of that CFC's tainted income ought to be attributed to the domestic taxpayer and taxed in the Home State?

### *4. Concerning the determination of CFC status in terms of article 7(1) of ATAD*

A preliminary discussion point developed around the territorial and substantive scope of article 7(1) of ATAD. Two points were raised in this respect. Firstly, whereas the subject of ATAD, i.e. the '*taxpayer*', is clearly defined in article 1 of ATAD[17], the profile of those legal persons that qualify as CFCs, i.e. *'entities'*, is ambiguous. In particular, it is unclear whether the CFC rules would, in principle, apply to other forms of legal arrangements (which may not necessarily be entities *per se*), such as trusts and foundation that may be subject to tax in the same manner as companies in a foreign jurisdiction. It was noted by the floor that a test entity treated as fiscally transparent in both the Home State and the foreign state should not, in principle, fall within the purview of the CFC rule.

Secondly, whereas the heading of article 7 of ATAD specifically describes the term '*controlled company*' using the qualifier '*foreign*', this limitation does not appear to emerge clearly from the text of article 7(1) of ATAD. Indeed, the opening paragraph of article 7(1) of ATAD indicates that the CFC rule applies to '*an entity [...] the profits of which are not subject to tax or are exempt to tax in that Member State*'.[18] A hypothetical fact pattern was presented to the floor: consider a company incorporated under the laws of Malta ('**MT 1**') that holds 100% of the shares in a company incorporated outside of Malta that is tax resident in Malta ('**MT 2**'), where the latter derives foreign source income that is not remitted to, or otherwise received in, Malta. In principle, MT 2 satisfies the conditions laid down in the opening paragraph of article 7(1) of ATAD in view of the fact that it is an entity the profits of which are (not?) subject to tax in Malta.[19] Therefore, MT 2 could, to the extent the other tests are satisfied, fall to be considered as a CFC of MT 1. This could have the effect of rendering the CFC rule a controlled domestic company ('**CDC**') rule in certain instances. The principle of this outcome was generally agreed upon by the floor. The floor raised a question concerning the potential overlap of the CDC rule with the deemed distribution rule in article 43(1) of the Income Tax Act ('**ITA**')[20], although no conclusions were reached on this particular point.

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[17] And even more precisely in regulation 2(2) of Legal Notice 411 of 2018.
[18] Article 7(1) of ATAD.
[19] Moreover, it is highly likely that such entity would satisfy the low-taxed test, in view of the differing bases of taxation for Malta incorporated and Malta tax resident and non-domiciled companies.
[20] Article 43(1) of the ITA stated that: *'Where the Commissioner is of the opinion that any company (other than a company incorporated or registered outside Malta and not resident therein) has not distributed as dividends its profits or some part of its profits and that the effect of such non-distribution is the avoidance or reduction of tax otherwise payable by the shareholders, he may order by notice in writing that such undistributed profits or part thereof shall be deemed, for the purposes of this Act, to have been distributed by way of dividend by the company in such amount, and on such date or dates,*



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### *5. Concerning article 7(1)(a) of ATAD: the control test*

Article 7(1)(a) of ATAD (hereinafter the '**control test**') reads as follows: '[the control test is satisfied where] *in the case of an entity, the taxpayer by itself, or together with its associated enterprises holds a direct or indirect participation of more than 50 percent of the voting rights, or owns directly or indirectly more than 50 percent of capital or is entitled to receive more than 50 percent of the profits of that entity;* '[21]

The control test is a minimum standard, and therefore Member States are at liberty to lay down stricter control rules should they desire to do so. The principle underpinning this test is a factual assessment of whether a domestic taxpayer is in a position to coerce the test entity to distribute its profits. If the result of that determination is in the affirmative, then the test entity's income can be deemed to have economically accrued to the domestic controlling taxpayer.

The base test laid down by ATAD is drafted broadly with a view to minimising the potential for arbitrage through the splitting or segregation of controlling interests by an EU parent. This is achieved through the aggregation of direct, indirect and interests held by associated enterprises in the test entity. The control test does not elaborate on the workings of the aggregation mechanism, and in view of this the floor moved on to discuss its ambiguity and potential for over-taxation. In the context of this debate, a number of hypothetical scenarios were discussed, one of which is explored in detail below.

The floor considered the position of a company incorporated in Luxembourg ('**LuxCo Grandparent**') that holds 25% of the shares in FranceCo Parent, a company incorporated and tax resident in France. FranceCo Parent, in turn, holds 60% of the shares in CFC, a company incorporated and tax resident in a low tax country.

During the discussion the Speaker expressed the view that the 60% direct holding of LuxCo Grandparent's associated enterprise (i.e. FranceCo Parent) in CFC should be attributed to LuxCo Grandparent. According to this view, the control test is satisfied notwithstanding the fact that LuxCo Grandparent only has an indirect participation of 15% in CFC. According to the Speaker, this mechanism would subsequently be moderated by a proportionate attribution of CFC's tainted income,

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*as to him appears to be reasonable, and the shareholders concerned shall be assessed thereon accordingly […]'.* Admittedly the prerogative vests in the Commissioner for Revenue and is contingent upon the exercise of his subjective discretion, as opposed to a reporting position that is obligatory upon the taxpayer as would be the case in terms of regulations 7 and 8 of Legal Notice 411 of 2018. Therefore, whereas article 43(1) of the ITA is designed to discourage and curtail deferral based structures in purely domestic scenarios, its mechanics are far removed from those employed in the context of ATAD. Moreover, article 43(1) of the ITA has assumed the role of a legacy provision whose merits were, pre-ATAD at least, questionable in view of the fact that the top marginal rate of income tax on individuals is equivalent to the corporate tax rate applicable to companies. The object and purpose of the two provisions, therefore, are not perfectly aligned.

[21] Article 7(1)(a) of ATAD.



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if any (i.e. capped at 15% - i.e. LuxCo's Grandparent's indirect entitlement). The Speaker's view is aligned with that found in the Final Report on BEPS Action 3, which takes the approach that to the extent that the LuxCo Grandparent has sufficient control over FranceCo Parent, then the control of FranceCo Parent over CFC should be directly attributed to LuxCo Grandparent.[22]

A large segment of the floor expressed their disagreement with this approach, noting that a direct attribution of an associated enterprise's direct holding in a test entity raises several concerns, mostly in connection with perceptions of fairness and administrative practicality. Rebutting, the Speaker argued that this mechanism was intended by the legislator to dis-incentivise control arbitrage through the interposition of non-EU intermediate controlling entities. Whereas in the example provided France would, in principle, be obliged to include in FranceCo Parent's tax base any tainted income derived by CFC, the same outcome would not have been secured had FranceCo Parent been established or tax resident in a third State with no CFC legislation. The mechanism is thus protective of the EU's tax base. However, where both LuxCo Grandparent and FranceCo parent are tax resident in the EU, this approach exposes the group to over-taxation resulting from a double inclusion of CFC's tainted income in LuxCo Grandparent's and FranceCo Parent's respective tax bases. ATAD does not contemplate a mechanism to relieve the impact of this unique type of double taxation.[23] The Speaker noted that the only solution that could effectively disengage a double inclusion outcome is an immediate distribution of all tainted income up the chain.

A tangential query was raised by the floor in connection with the Speaker's reading of the aggregate rule. For the purposes of establishing whether a domestic taxpayer exercises control over a test entity, and in view of the expression '*together with*', should the indirect holdings of a domestic taxpayer be aggregated with the direct holdings of an associated enterprise, or does the inclusion of the latter require the domestic taxpayer to disregard the former?[24] The Speaker expressed the opinion that a direct holding of an associated enterprise in a test entity should be attributed directly to the domestic taxpayer, as a result of which any indirect holding linked to that direct holding should be ignored. The point was not considered further by the floor.

A further discussion ensued as to whether a hierarchy of norms ought to be established in the event that a subsidiary of a domestic taxpayer includes tainted income of a third State CFC in its tax base. The Final Report on BEPS Action 3 recommends the use of priority rules, with the OECD endorsing

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[22] *Vide* para. 47 of the Final Report on BEPS Action 3: '*In this example, Parent has a 70% interest in A Co, which holds a 60% interest in CFC. There is therefore more than 50% control at each tier, but Parent itself only has an interest of 42% (70% x 60%) of CFC. Despite this limited legal control, A Co has enough economic control to influence CFC and Parent has enough economic control to influence A Co, so it is recommended that CFC rules should find Parent to have sufficient influence over CFC to meet the control threshold since the control threshold is met at each level in the chain of ownership*.'

[23] The double taxation relief provision contemplated in article 8(7) of ATAD is restricted solely to a credit for taxes paid **by the CFC** or the **permanent establishment of the domestic taxpayer.** The rules makes no mention of taxes on a CFC income inclusion at the level of intermediate entities. The language employed by article 8(7) of ATAD has been largely retained by regulation 8(f) of Legal Notice 411 of 2018.

[24] Where, of course, the direct and indirect holdings create an overlap for computational purposes.



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the prioritisation of '*CFC rules of the jurisdiction whose resident shareholder is closer to the CFC in the chain of ownership.*'[25] Following this train of thought, a query was raised concerning the application, or otherwise, of the indirect foreign tax credit rule contemplated in article 82 of the ITA. Article 82 of the ITA provides for an indirect foreign tax credit where a Malta tax resident taxpayer derives dividends distributed by a company tax resident outside of Malta. If that non-Malta tax resident company suffers foreign tax as a result of a CFC income inclusion, then this foreign tax could, in principle, be set-off against any Malta tax suffered by the domestic taxpayer upon a distribution of profits. However, applying this rule may pose some difficulty in the event that a CFC inclusion at the level of the non-Malta tax resident company results in taxable income exceeding its distributable profits, creating issues of impairment.

### *6. Concerning article 7(1)(b) of ATAD: the low-taxed test*

Article 7(1)(b) of ATAD (hereinafter the '**low-taxed test**') reads as follows: '[the low-taxed test is satisfied where] *the actual corporate tax paid on its profits by the entity or permanent establishment is lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment.*'[26]

This test requires a side-by-side of comparison of the actual tax paid in the state of the test entity with the tax that **would have been paid** in the Home State. This necessitates a computational exercise whereby the fictitious or hypothetical Home State tax liability is quantified, although the Directive provides little by way of guidance as to the manner in which this is to be done, or the key assumptions that ought to be made when doing so. The Speaker acknowledged that the ascertainment of an effective tax rate can prove challenging, particularly if the ruleset (tax base, rates, international tax rules) of the foreign jurisdiction varies considerably. The preamble to ATAD also permits the use of black, grey and/or white lists, although the compatibility of such lists need to be measured against the general ruleset.[27]

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[25] Vide para. 126 of the Final Report on BEPS Action 3, wherein the OECD stated that '*[a]dditional issues may arise when the income and profits arising in a CFC are taxed under the CFC rules operating in more than one jurisdiction, and this scenario may become more common in the future. If, for example, a subsidiary is treated as a CFC under the rules operating in multiple jurisdictions, then the subsidiary's income could potentially be taxed by the CFC jurisdiction and by any other jurisdiction that considers the subsidiary to be a CFC. Again, an indirect foreign tax credit could be applied in this situation but in order to provide such a credit countries may need to change their double taxation relief provisions in order for CFC tax paid in an intermediate country to qualify as a foreign tax eligible for relief. There should also be a hierarchy of rules to determine which countries should have priority, and this hierarchy could prioritise the CFC rules of the jurisdiction whose resident shareholder is closer to the CFC in the chain of ownership.*'

[26] Article 7(1)(b) of ATAD.

[27] *Vide* recital 12 of ATAD: '*It is important that tax administrations and taxpayers cooperate to gather the relevant facts and circumstances to determine whether the carve-out rule is to apply. It should be acceptable that, in transposing CFC rules into their national law, Member States use white, grey or black lists of third countries, which are compiled on the basis of certain criteria set out in this Directive and may include the corporate tax rate level, or use white lists of Member States compiled on that basis.*'



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A pressing question is the determination of which *income* (and tax thereon) should be considered when ascertaining the actual corporate tax paid in the state of the test entity. The Speaker outlined three possible approaches:

1. Entity approach: corporate tax on all of the income of the test entity; or
2. Transactional approach: corporate tax on all passive income; or
3. Transaction approach: corporate tax on each item of income.

As a point of departure, the Speaker stressed that the text of ATAD expressly states that a hypothetical tax test must be performed in relation to the test entity's *'profits'*. This rather broad language suggests a bias towards the entity approach, and is congruent with the assessment of the genuine nature of the activities performed by the test entity.[28] The relative rigidity of the various approaches is conditioned by the specific income profile of the test entity as well as the corporate tax system under review. A general rule cannot be inferred from the methodology employed.

Whether a test entity is low-taxed must be measured in relation to the Home State's effective tax rate: unsurprisingly the lack of an objective EU standard as to what constitutes a low-tax jurisdiction creates opportunities for CFC arbitrage. The Speaker used the following example to demonstrate the potentially distortive effect:

- EU MS A (Home State) with a CITR of 25%;
- EU MS B with a CITR of 12.5%; and
- State C with a CITR of 10%.

Consider a situation whereby ParentCo, a company tax resident in EU MS A, holds 100% of the shares in CFC, a company tax resident in State C. CFC derives passive income of 1000 that is taxed at 10%, resulting in actual corporate tax paid in State C of 100. The low-taxed test is satisfied when State C's ETR is measured against EU MS A's hypothetical ETR, however this outcome does not subsist when the comparator is substituted with EU MS B. According to the Speaker, this distinction introduces a competitive element amongst EU Member States and could incentivise the relocation of parent companies to low tax EU Member States.

### *7. Concerning article 7(2) of ATAD: the determination of tainted income at CFC level*

Article 7(2)(b) of ATAD classifies as tainted income '*the non-distributed income of the entity or permanent establishment arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.*'[29]
An initial discussion emerged in connection with the **carve-out to the tainted income rule**. The construction of the provision stipulates that income can only fall to be classified as tainted to the

[28] This is particularly so with respect to Option B.
[29] Article 7(2)(b) of ATAD.



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extent, *inter alia*, that such income is non-distributed.[30] Providing an escape route for distributed income aligns well with the primary motivation behind CFC rules: incentivising non-deferral.

Does the carve-out result in differential treatment depending on the nature of the CFC? The point of departure is that the ATAD CFC rule applies to both (i) low-taxed controlled entities as well as (ii) low-taxed permanent establishments ('**PEs**') of the controlling entity. A PE is not a separate juridical person, but a tax-specific fictional extension of the taxpayer's personality that is relevant in determining the extent of an enterprise's involvement in the economic life of a host state ('**PE State**'). In accordance with international standards, where a PE is deemed to exist[31], the profits attributable to that PE are the '*profits that the [PE] might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed through the [PE] and through other parts of the enterprise.*'[32] However, this hypothesis is merely relevant for ascertaining the appropriate quantum of profits that may be taxed by the PE State, and does not in any sense create a fund that is separate and distinct from the patrimony of the enterprise as a whole. A distribution by a PE to its head office, at least in the sense typically understood in terms of company law[33], is a legal impossibility, as such '*distribution*' does not entail a change of ownership, but rather refers to an intra-enterprise re-allocation of value. A member of the floor posited that, should the foregoing be correct, the carve-out rule is redundant insofar as PEs are concerned, in view of the incapacity of a PE to distribute profits to its head office.

Two viewpoints developed over the course of the debate.

The first group was of the opinion that the inherent nature of a PE, coupled with the language employed by regulation 7(2) of Legal Notice 411 of 2018, clearly circumscribes the application of the carve-out to the exclusion of PEs of Home State taxpayers. This position was challenged by the floor, wherein it was argued that adopting a restrictive and literal approach could establish an interpretation that creates differential treatment and distorts the choice between primary and secondary establishment. It was further questioned whether ATAD permits, or requires Member States to ensure parity between entity CFCs and PE CFCs. The outcome of this debate was inconclusive.

A second group, on the other hand, expressed the view that the provision was drafted with the 2010 OECD's Attribution of Profits to a Permanent Establishments Report in mind ('**AOA**').[34] Consequently, if the AOA endorses the hypothesization of a PE as a separate person with profits attributable thereto, then logical consistency requires a complementary possibility of a hypothetical distribution by the PE to its head office. Some members of the floor cited the existence of branch

[30] It should be noted that an equivalent carve-out is applicable vis-à-vis Option A.
[31] By way of domestic law, and preserved through the application of a double taxation agreement, where applicable.
[32] Commentaries to the OECD Model Convention, para. 15.
[33] See, for example, article 192 of the Companies Act, Chapter 386 of the Laws of Malta.
[34] OECD, 2010 Report on the Attribution of Profits to Permanent Establishments (OECD, 2010).



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profit tax regimes in support of this position.[35] Further debate ensued around the computation of the hypothetical distribution, during which a number of positions were considered.[36]

The floor then moved to the debate the mechanics of Option B as transposed into regulation 7(2) of Legal Notice 411 of 2018. According to the Speaker, the rationale of Option B is to supplement transfer pricing rules, and as a result should not find application to the extent that the CFC is allocated an appropriate remuneration in accordance with the arm length's principle. This position was challenged by some segments of the floor: the argument being that the object and purpose of ATAD indicates that the EU legislator intended to go a step further and include in the Home State's tax base any income that is artificially deflected to a low-tax jurisdiction where the CFC in question would not have been able to generate such income had it not been for control functions exercised at Home State level. Whilst both positions were discussed in some detail, the general consensus reached was that the effective application of transfer pricing rules to a low tax jurisdiction should disengage the CFC rule.

### *8. Concerning article 8 of ATAD: the computation of income to be included at the level of the controlling entity*

In line with the general rationale underpinning anti-deferral rules, the application of the ATAD CFC rule results in the tainted income of the CFC being included in the tax base of the controlling entity in proportion to its direct or indirect participation in the CFC.
Whilst the principle that tainted income should be picked up at the level of the controlling entity in proportion to its participation in the CFC is reasonable and undisputed, the manner in which this principle is executed in article 8(3) of ATAD leaves much to be desired. The rule in question stipulates that *[t]he income to be included in the tax base shall be calculated in proportion to the taxpayer's participation in the entity as defined in point (a) of Article 7(1).*'[37] However, article 7(1)(a) of ATAD provides for three alternative bases for establishing the degree of control of a test entity: share capital, votes and entitlement to profits. The proportionality rule pays no heed to this trichotomy, which creates confusion in those instances where a controlling entity may have different rights attaching to its holdings.

The Speaker speculated upon three alternative scenarios:

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[35] For example, § 884(a) of the US Inland Revenue Code provides that '*[…], there is hereby imposed on any foreign corporation a tax equal to 30 percent of the dividend equivalent amount for the taxable year.'* The dividend equivalent means the foreign corporation's effectively connected earnings and profits adjusted for changes in U.S. net equity.
[36] For example, one suggestion considered the use of a PE's balance sheet in order to assess which profits are required for the sustenance of the PE's operations and which are not. Any excess profits or surplus funds could then be deemed to be repatriated to the head office. A similar suggestion considered the example of a finance PE that would initially be allocated a certain amount of capital for its operations. A fact-based analysis could determine whether, as a result of its operations and its relationship with the head office (or other PEs), the PE is in possession of any surplus funds. The fact-based analysis would also determine whether such surplus funds ought to be retained at PE level or whether they ought to be reasonably repatriated to head office level.
[37] Article 8(3) of ATAD.



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1. According to the first approach, Member States are at liberty to choose any one of the three indicators, or any blend of the indicators, as ATAD does not prescribe to the contrary;
2. According to the second approach, the usage of the term '*participation*' in article 8(3) of ATAD suggests that the *pro rata* entitlement of the controlling entity should be determined by reference to its participation in the voting rights of the CFC. This is supported by the specific use of the term '*participation'* in connection with voting rights in article 7(1)(a) of ATAD;
3. According to the third approach, all three requirements ought to be taken into consideration.

The floor debated the merits of each approach, although it was generally considered that the income inclusion should be conditioned by reference to profit entitlement.

A further debate ensued in connection with the computation of the CFC income conclusion. The Speaker explained that in order for CFC rules to be effective, the income inclusion must be determined in accordance with the corporate tax rules of the Home State. However, CFC rules are, as a general rule, designed to attract positive items of income derived by CFCs.

This raises the question as to whether negative items of income (particularly active losses), should, on the grounds of coherency and fairness, also be allocated to the controlling entity. The Speaker noted that, especially under Option A, losses derived by CFCs should not be included in the tax base of the controlling entity.
The second paragraph of article 7(1) of ATAD stipulates that '*[f]or the purposes of [the low-taxed test], the permanent establishment of a controlled foreign company that is not subject to tax or is exempt from tax in the jurisdiction of the controlled foreign company shall not be taken into account.*'
This provision is curiously placed in view of the fact that the opening line of article 7(1) of ATAD does not appear to cater for the treatment of a PE of a CFC as a standalone CFC in its own right. The consequence of this (intentional?) oversight can be demonstrated by way of the following example.

Consider the following fact-pattern:

- EU MS (Home State) has a CITR of 30%;
- Country B has a CITR of 20%; and
- Country C has a CITR of 10%.

Parent is a company tax resident in EU MS. It holds, to the extent of 100%, the shares in CFC, a company tax resident in Country B. CFC carries on business through a PE situated in Country C, to which profits of 1000 are attributable. Suppose that Country B operates an exemption system. In terms of article 7(1) of ATAD, Parent, when performing the low-taxed test, would not take into consideration any profits that are exempt from tax in Country B. The rule, however, does not indicate whether, as a result, a parallel low-taxed test should be performed on the PE of the test entity in Country C. The Speaker acknowledged that the wording of ATAD expressly limits the use of the term PE by reference to the taxpayer located in the Home State.



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Two viewpoints were posited over the course of the discussion. According to one group of the floor, the lacuna created by the proviso could lead to absurdities and should therefore be construed as creating a parallel obligation to perform a low-taxed test on the PE of a test entity, as if it were a standalone CFC analysis. One member of the floor noted that, viewed in light of the object and purpose of the Directive, this approach would act as a back-stop in the event that Country B is not an EU MS that has an equivalent CFC rule for low-taxed PEs. On the other hand, the second group viewed this provision as a lacuna that should result in no CFC income inclusion for the low-taxed PE of the CFC in the hands of Parent.

The final major discussion point concerned measures against double taxation, with a particular focus on the relationship between double tax conventions and article 7 of ATAD. The main point of controversy was whether the ATAD CFC rule constitutes a form of treaty override.

Consider the following fact-pattern: a company tax resident in EU MS carries on business in low tax Country B through a PE situated therein. The double taxation convention in place between EU MS and Country B provides for an exemption from EU MS tax where income is attributable to the PE situated in Country B. Does article 23A of the double taxation convention restrict EU MS's ability to include the low-taxed PE's income in its tax base? Similar questions arose in connection with dividends derived by the controlling entity that may avail of a participation exemption regime, either under domestic law or by way of relief under a treaty.[38]

In the context of this debate, the Speaker made reference to the Commentary on Article 1 of the 2017 OECD Model Convention, which states that CFC rules preserving the right of a Contracting State to tax its own residents are '*not contrary to the provisions of this Convention.*'[39] The inclusion of a saving clause along the lines of article 1(3) of the 2017 OECD Model supports this position.[40] The Speaker expressed his disagreement with the veracity of this statement, noting that it cannot be applied abstractly as a general rule but is very much dependant on the manner in which the CFC legislation is drafted. Moreover, jurisdictional experience, such as the Conseil d'Etat's decision in *Schneider*[41], demonstrates that the compatibility of CFC regimes with double taxation conventions is not beyond dispute.

The Speaker considered the relevance of the *lex posterior* principle, which suggests that a later agreement by parties (i.e. in between EU Member States) should derogate any rule that may have been concluded in terms of prior treaties. However, the same cannot necessarily be stated for double taxation conventions concluded with third States – in such instances the Speaker suggested that

[38] Insofar as such treaty does not provide for a switch-over rule.
[39] Para. 81 of the Commentary on Article 1 of the 2017 OECD Model Convention.
[40] *ibid.*
[41] In Schneider, the Conseil d'Etat held that the provision of the France-Switzerland Double Taxation Convention modelled after article 7(1) of the OECD Model was an obstacle to applying France's CFC regulations.



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wording similar to article 9(5) of ATAD should be introduced for the sake of clarity. That being said, the Speaker also cited article 351 of the Treaty of the Functioning of the European Union ('**TFEU**'), which regulates the relationship between the TFEU and international agreements with third countries. In essence, if the international agreements concluded by an EU Member State and a third State are incompatible with the TFEU, then preference should be given to the agreement concluded with the third State. Nevertheless, the EU Member State is obliged to actively renegotiate the provisions of such agreement in order to ensure compatibility.

## Conclusions and reflections on the ATAD CFC rule

At the close of the session it was generally acknowledged that the ATAD CFC rule leaves much to be desired. Although the Directive strives to achieve a degree of harmonisation amongst Member States, the inclusion of options and minimum standards will ultimately result in divergences, underlaps and overlaps across the various regimes introduced across the bloc. Moreover considerable doubt was expressed across the floor as to whether the ATAD CFC rule is (i) effective, particularly in light of the myriad of arbitrage opportunities and (ii) proportionate, in view of the considerable administrative burden in exchange for marginal prospective increases in tax revenue.

The general consensus is that there are considerable shortcomings in the ATAD CFC framework, which shortcomings have been inherited by the Maltese ruleset in view of Legal Notice 411's faithful transposition of the Directive's text. Black letter law will inevitably need to be supplemented in order to fashion a pragmatic framework for facilitating administrative compliance.

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***This Master Class was held on 18 February 2019 at The Westin Dragonara Resortt.***
***The Rapporteur for the event was Dr Christopher Bergedahl.***



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