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Tax Holidays in a BEPS-Perspective

Hilde Mæhlum Bjerkestuen & Hans Georg Wille*

1 INTRODUCTION

1.1 Topic and Purpose

A tax holiday is a time-limited exemption from taxation and one of the most commonly employed tax incentives in developing countries.[1] The main objective behind tax holidays is to attract foreign direct investment (FDI), as this is believed to stimulate economic growth and development.[2]

An exemption from taxation under a tax holiday could encourage investors to invest in developing countries. However, this requires the benefit under the tax holiday to actually accrue to the investor and not be consumed by taxation in the investor's residence country. The subject of this article is the interrelation between tax holidays offered by developing countries and rules in industrialized countries for the taxation of income earned by controlled foreign companies (CFCs).

Most countries recognize each company as a separate legal entity (distinct from its shareholders) and as a separate taxpayer. Hence, profits derived by a non-resident company would usually not be taxed to its resident shareholders until profits are remitted as dividends or shares are realized at a gain. This is often described as 'deferral of domestic tax', and involves a saving in terms of postponed taxation.

If the parent company is resident in a country that does not tax dividends or share gains resulting from foreign subsidiaries (e.g., under participation exemption rules or tax sparing credit) the investors would receive the full benefit of the tax holiday. This would lead to double non-taxation of the tax holiday income.

The question to be raised – in light of the Base erosion and profit shifting (BEPS) initiative – is whether such double non-taxation should be eliminated, or whether such tax benefits should be recognized as acceptable policy measures of developing countries.

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[1] Easson, Alex, *Tax Incentives for Foreign Direct Investment*, Kluwer Law International, The Hague 2004, pp. 111 and 134, UNCTAD *Tax Incentives and Foreign Direct Investment: A Global Survey,* ASIT Advisory Studies No. 16, United Nations 2000, p. 12.

[2] Tax Law, Design and Drafting, edited by Victor Thuronyi, Kluwer Law International, The Hague, 2000, p. 986. OECD (2001), *Corporate Tax Incentives for Foreign Direct Investment,* OECD Tax Policy Studies, No. 4, OECD publishing 2001 p. 25, UNCTAD (2000) pp. 12–13.

1.2 The BEPS Context

The BEPS project of the Organisation for Economic Co-operation and Development (OECD) suggests that Controlled Foreign Corporation (CFC) rules should be strengthened as one of several actions to end double non-taxation and curb tax base erosion and profit shifting.[3] While the application of CFC rules to low-taxed companies in classical tax havens generally would be regarded as justified, this is not so obvious when the low-taxed company benefits from a tax holiday in a developing country.

Tax holidays are not specifically dealt with by the OECD Action Plan on BEPS. Whether the OECD recommendations will suggest for CFC legislation to apply to all low-taxed CFCs or whether developing countries' tax holiday incentives should be protected is uncertain. The final recommendations regarding design of CFC rules are expected in September 2015.

We take this opportunity to analyse how CFC legislation *today* seem to deal with tax holiday incentives, and also to evaluate *arguments* that favour and oppose tax holiday benefits being captured by CFC rules.

1.3 Definitions of Basic Concepts and Terminology

In this article, the residence country of the parent company will be referred to as the *'residence country'*, while the country where the CFC is established and given a tax holiday (the developing country) will be referred to as the *'host country'* (of the investment).

'*Double non-taxation*' will be used with reference to the situation where income neither is taxed by the host country nor by the residence country at the time it is earned (i.e., no *current* taxation in either country).

'*Intended*' double non-taxation will denote situations where this is the result of the intended use of tax holidays from the host country's perspective. '*Unintended*' double non-taxation will denote situations where double non-taxation is the result of arrangements whereby profits are generated by the CFC beyond what is intended by the tax holiday, e.g., because they are shifted away from higher taxed jurisdictions where the MNE undertakes activities. Unintended double non-taxation could also be characterized as *abuse* of tax holidays.

1.4 Tax Holidays

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[3] OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing 2013 ('OECD (2013)a)') and OECD Action Plan on Base Erosion and Profit Shifting, OECD Publishing 2013 ('OECD (2013)b)') (especially action 3).

A tax holiday is a time-limited exemption from tax, or a reduced rate of tax, offered to qualifying companies or activities in order to enhance a specific behaviour or activity, normally FDI. The time limitation distinguishes a tax holiday from other tax exemptions and reduced tax rates in general. The exemption can be targeted at all kinds of taxes. This article will focus on tax holidays that offer an exemption from corporate income taxation (CIT).

Tax holidays can be prescribed by legislation and granted automatically when certain conditions are met. Alternatively, the entitlement can be left to the discretion of authorities. Discretionary tax holidays may be granted on application when certain conditions and requirements are met, but they could also form part of various concession agreements between the investor and the developing country.[4]

Tax holidays are usually targeted at types of investment which the developing country views as desirable. The incentive can target new investments in general, investments in specific sectors or industries, or investment in underdeveloped regions of the country. Tax holidays can also be offered to investors that carry out specific activities or at companies that meet certain criteria, e.g., in relation to the size or the nature and importance of the investment project.[5]

Tax holidays in developing countries are usually intended for attracting real investment in productive activities, and usually also for long-term investment involving substantial business operations.[6] Since tax holidays are time-limited tax incentives, the developing country would hope to gain significant tax revenues from such investments after the tax holiday period is over. During the tax holiday period, the developing country could also achieve higher tax revenues if the investment generates increased employment and increased income for residents of the developing country. Moreover, the developing country would hope to attract investment with positive spill-over effects on local companies e.g., in the form of transfer of managerial practices, production methods, marketing techniques, or any other know-how which could increase the country's productivity and international competitiveness. Furthermore, new investment could create a stronger industrial and economic base, improved infrastructure, and increased living standards, which again could lead to more investment.[7]

[4] Viherkenttä, Timo, *Tax Incentives in Developing Countries and International Taxation*, Kluwer Law and Taxation Publishers, Deventer 1991, p. 16.

[5] Viherkenttä (1991) p. 16, OECD (2001) pp. 25–26. UNCTAD (2000) pp. 11–18.

[6] Tax Law Design and Drafting (2000) p. 986, Easson (2004) pp. 4 and 105, Oman, Charles., Policy Competition for Foreign Direct Investment: A study of Competition among Governments to Attract FDI, Development Centre Studies, OECD Publishing, (2000) p. 17.

[7] OECD (2001) pp. 19–21.

Tax holidays would usually be intended to cover only income arising from income generated to realize the purpose of the tax holiday and not income generated beyond that or merely shifted to the company from other companies of the MNE. Income from passive investments in easily tradable assets would normally not be intended to benefit from the tax holiday.

1.5 The Basic Criticism against Tax Holidays

Even though tax holidays are regarded as an important policy measure for investment by many developing countries, they are criticized by many international bodies and theorists. Before discussing whether or not national legislators should include benefits obtained from tax holidays under their CFC rules, we will provide an overview of the basic criticisms raised against tax holidays.

The policy discussion of how CFC legislation should respond to tax holidays offered by developing countries is closely linked to the discussion of whether it is reasonable for developing countries to offer tax holidays at all. The conventional view among international bodies involved with tax matters (e.g., the OECD, the World Bank and the IMF) and many academics in the tax field is that providing tax incentives for obtaining investment is in general *not* recommended.[8] The main arguments are that tax incentives usually are both ineffective and inefficient, that they cause distortions (both intended and unintended), and that they lead to harmful tax competition.

The principal criticism against the use of tax incentives generally is that tax incentives are intended to cause distortions (of business decisions and competition). Tax incentives represent a deviation from the benchmark tax system and they may result in ineffective allocation of resources (e.g., by stimulating investment decisions that would not otherwise have been made).

Tax holidays are given with the specific purpose of influencing on investment decisions. However, the distortionary effects of tax holidays might be justified as compensation for various market imperfections in the investment environment. To invest in a developing country is often perceived by investors as involving other and higher risks compared to investment in industrialized countries. It could be argued that these additional risks require a balancing initiative by the developing country in the form of tax exemption during a select

[8] Easson (2004) p. 63 with further references to other studies and literature. Mascagni, Moore & McCluskey: *Tax Revenue Mobilisation In Developing Countries: Issues And Challenges*; Report to the European Parliament's Committee on Development, 2014 pp. 15–16.

number of years. Special tax incentives could also be viewed as necessary to offset additional cost from investing in such areas.[9]

Another objection to tax holidays is that they do not work – meaning that they are ineffective and inefficient. A tax incentive for investment would be considered effective if it actually resulted in investment (of the desired type) that would not have come in the absence of such incentive (incremental investment). And even if the incentive is effective in actually inducing such new investment, it would only be considered efficient (cost-effective) if the cost of granting such incentive is lower than the benefits obtained from granting the incentive.[10]

To assess whether tax holidays are effective can be very difficult, and several studies have been made without a consistent conclusion.[11] The answer may vary from country to country and between different types of tax holidays, depending on how they are designed, to whom they are offered, and the type of investment they are seeking to attract.

Tax incentives may presumably be a decisive factor for investors that have a choice of investing in a few similar locations where other factors influencing on investment performance are more or less equal. Only for those countries that have passed through the initial selection based on non-tax determinants will tax incentives become more important for the final investment decision. If the possible host countries that the investor can choose among are all developing countries, the tax incentive will only affect the allocation of investment among developing countries and will not affect the overall inflow of capital to the region. This, again, could lead to harmful tax competition between developing countries within the same region –'a race to the bottom' that benefits the foreign investors at the expense of the region as a whole. Regardless of the disputed effectiveness and efficiency of tax holidays, this is one of the main arguments against tax holidays. [12]

Even if a tax holiday incentive should be effective, it is not necessarily efficient. If the tax holiday is granted only to investors who would not have invested in the absence of such incentive and by amounts that are exactly necessary to attract the desired investment (not over-generous), there would be no revenue loss from the tax holiday. However, this is difficult to achieve. Tax holidays can result in 'windfall' gains to investors that would have

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[9] Viherkenttä (1991) p. 132, OECD *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing 1998 p. 15, Easson (2004) pp. 65–66.

[10] Easson (2004) pp. 66–78.

[11] See for example Alexander Klemm and Stefan Van Parys, *Empirical Evidence on the Effects of Tax Incentives,* IMF Working Paper WP/09/136 2009 p. 21, with additional references.

[12] The International Finance Corporation and the World Bank *Using tax incentives to compete for foreign investment - Are they worth the costs?* 2001 p. 92. Easson (2004) pp. 52–61.

come even without the incentive or at a less extensive incentive. This will result in revenue forgone for the developing country.[13] This revenue loss must be paid for, e.g., by an increase in other taxes, by reducing government spending (in e.g., education, health and infrastructure) or by having (still) to rely on aid from industrialized countries. Revenue loss resulting from tax holidays could otherwise be more effectively used for development purposes and used to improve the fundamental investment factors such as political and economic conditions. However, offering tax incentives is easier than changing more fundamental factors in a country and is often used as a 'quick-fix' to the more essential underlying challenges.[14]

To assess whether a tax holiday is efficient will be very difficult as it would require an estimate of the costs related to the offering of such tax incentive and the benefits derived from attracting investment. The cost of a tax holiday is not limited to revenue forgone but can also include costs of unintended distortions, administrative costs, compliance costs, and costs in the form of corruption and abuse of the incentives.[15]

Residence taxation by industrialized countries of income obtained under tax incentives in developing countries has been advocated on the grounds that this actually would benefit the developing countries; as such incentives are viewed as detrimental policy measures.

Trying to determine whether or not developing countries benefit from offering tax holidays call for more empirical research (although comprehensive empirical evidence on these questions can be difficult to collect). It is not the intention here to discuss whether or not tax holidays should be applied (lex ferenda). Nor will it be discussed whether the policy rationale behind tax holidays, i.e., to attract FDI into the country, is well-founded. The following discussion is based on the fact that tax holidays are used by developing countries today and that developing countries see this as a rational measure in their investment and development policy. The focus is on how the tax laws of capital exporting industrialized countries do and should interact with tax holidays offered by developing countries.

1.6 The Methodological Approach

The focus of the article is on CFC legislation. Due to its current taxation of tax holiday income, CFC legislation poses an immediate, negating effect to tax holiday benefits. Similar

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[13] Easson (2004) pp. 75–76, The International Finance Corporation and the World Bank (2001), p. 22.

[14] OECD *Tax Incentives for Investment – A Global Perspective: Experiences in MENA and non-MENA Countries* 2007.

[15] The International Finance Corporation and the World Bank (2001), especially pp. 21–26, Easson (2004) pp. 76–77. Discretionary tax incentives have been especially criticized for fostering corruption and rent-seeking behavior.

effects, although deferred, arise if *participation exemption* rules do not include share income from tax holiday companies, and also when dividends are taxed under a *credit regime* as the tax holiday income would not have borne any host country tax offsetting the residence country's tax on dividends (unless tax sparing arrangements are in place). However, these two instances would subject the tax holiday income to tax by the residence country upon *remittal* and thus provide for a deferral until the income is distributed to a resident taxpayer. This is less negative to the benefit conferred by the tax holiday than the current taxation imposed by CFC rules.

Even though tax holidays aimed at attracting investment can also be found in industrialized countries[16], tax holidays are much more widespread in developing countries.[17] Additionally, the interrelation between tax legislation in residence countries and tax holidays in developing countries is of particular interest because fundamental principles of international tax policy may perhaps have to be modified in consideration of special third-world implications.

In order to highlight issues relating to the applicability of CFC rules to subsidiaries benefitting from tax holidays in developing countries, we will assume that the developing country offering the tax holiday is not a low-tax jurisdiction per se, i.e., the tax rate otherwise applicable under the benchmark system in the developing country is relatively normal. Moreover, we will focus on tax holidays intended for active business operations.

The focus of this article is to identify and highlight trends and patterns in how domestic CFC rules interact with tax holiday regimes. For that purpose we will provide examples from certain countries' CFC legislation.[18]

1.7 Outline

In Chapter 2 of this article we will address the interrelation between existing CFC regimes and tax holidays. The main question here is how tax holidays are treated under various CFC-regimes and to what extent tax holidays can be vehicles for tax avoidance and profit-shifting from industrialized countries.

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[16] E.g., 'Patent Box' rules in countries such as the Netherlands and the UK.

[17] UNCTAD (2000) pp. 11–12.

[18] The description of various CFC regimes, as well as of domestic tax incentives, is based on the authors' knowledge of such rules and on available literature, e.g., Cahiers de droit international, *The Taxation of Foreign Passive Income for Groups of Companies,* International Fiscal Organisation (Volume 98a), Copenhagen 2013, ('IFA (2013)'), and Deloitte: *Guide to Controlled Foreign Company Regimes* 2014.

In Chapter 3 we will address arguments of how CFC legislation in residence countries could and should interact with tax holidays in developing countries, focusing mostly on situations where a tax holiday is used in line with its intention and purpose. The overall question addressed is whether double non-taxation should be eliminated or whether residence country taxation should allow investors to receive the benefit of a developing country's tax holiday incentive.

A summary will be provided in Chapter 4.

2 INTERRELATION BETWEEN CFC LEGISLATION AND TAX HOLIDAYS

2.1 *What is CFC Legislation?*

The essential feature of CFC regimes is that the residence country of the parent company is empowered to tax the resident parent company on its proportionate share of income derived by its non-resident subsidiary as this income *accrues* in the subsidiary, regardless of whether any distributions are made.

CFC regimes are usually limited to designated jurisdictions, i.e., 'target territories'. *The first question* addressed below is whether a developing country offering a tax holiday would be regarded as a 'target territory' under such CFC regimes. This question is particularly relevant when the developing country has relatively normal corporate tax rates under its benchmark system since 'target territory' definitions usually denote low-tax jurisdictions.

Even if the CFC regime generally is applicable to tax holiday companies established in a developing country, the application of CFC rules is often limited to specific categories of income. *The second question* is thus what types of income CFC regimes typically apply to. The type(s) of CFC income that is attributed to the shareholders under CFC-regimes is often referred to as 'attributable income' or 'tainted income', and these terms will be used in the following.

2.2 *Objectives of CFC Legislation*

The scope of various CFC regimes will usually be influenced by the policy objectives of the respective country. Before addressing the main questions regarding the applicability of CFC rules, we will provide a short overview of the main objectives behind such legislation.

CFC legislation today is primarily regarded as anti-avoidance legislation.[19] The objective is to protect domestic tax bases against profit shifting (typically of passive income) to low-tax jurisdictions.

A few countries also use CFC legislation to establish capital export neutrality (CEN), i.e., taxpayers are subject to the same amount of tax and timing regardless of where they invest. The original objective of the first CFC regime, the 'Subpart F' regime proposed in USA in 1961, was to obtain complete elimination of tax deferral. However, the final legislation adopted in 1962 constituted a compromise between elimination of deferral and prevention of offshore profit shifting.[20] Brazil and Indonesia seem to be the only countries today applying general and complete elimination of deferral.

Brazil's CFC rules are targeting both active and passive income. No minimum taxation threshold is stipulated; but amended rules from 2015 provide for certain deferral benefits in respect of affiliates subject to more than 20% taxation.[21]
Indonesia's CFC rules apply to active and passive income without stipulating a minimum taxation threshold. The requirement is for Indonesian resident taxpayers individually or collectively to control at least 50% of the equity of a foreign company.[22]
A policy of pure capital export neutrality was pursued under the previous CFC regime in New Zealand (up to 2009) which was intended to eliminate deferral with respect to all forms of foreign investment and applied to all income (passive and active) of CFCs wherever located (not restricted to low-tax jurisdictions) and whatever their business activities or motives of the establishment. The only limitation was a very short white list of high-tax countries to which the regime did not apply. From 2009 the regime was narrowed, and today mainly applies to passive CFC income (but still not limited to low-tax entities).[23]
Norway applies a CFC regime to passive as well as active income from low-tax jurisdictions in the absence of a double tax treaty.[24]

Even if economic arguments based on CEN could be used as basis for CFC legislation, the general justification for most CFC regimes is rather to protect the domestic corporate tax base and prevent tax avoidance (which usually implies requirements of control and low or no taxation, and usually only to certain specified types of income).

2.3 Various 'Target Territory' Definitions

2.3.1 Introduction

A distinction can roughly be made between CFC regimes that only apply to particular jurisdictions (the jurisdictional approach), typically low-tax jurisdictions, and CFC regimes that apply to CFCs regardless of where they reside as long as the CFC derives particular types

[19] IFA (2013) p. 26, OECD (1996) p. 11, Fundamentals of International Tax Planning, edited by Raffaele Russo, IBFD, Amsterdam 2007 p. 213.
[20] IFA (2013) pp. 783–784.
[21] IFA (2013) pp. 159–180 (especially s. 3).
[22] Jul Sevanta Tarigan, *Indonesia's CFC rules become stricter and broader,* International Tax Review, May 1, 2011, Deloitte (2014) p. 30.
[23] IFA (2013) pp. 532–537, OECD (1996) p. 25.
[24] Norwegian Tax Act § 10-63 and § 10-64.

of income. The first approach concentrates mainly on the location of the CFC while the latter concentrates on the nature of the income derived by the CFC (and could apply regardless of the foreign tax paid).

In its pure form, the jurisdictional approach would apply to all income of a CFC in a designated target territory. Under the pure income type approach, all designated income (typically passive income) would be attributed to the domestic shareholders (subjects of the regime) regardless of the residence country of the CFC. However, few countries operate either approach in its pure form and in practice each approach is modified to incorporate aspects of the other. For example, both the US and the UK apply the tainted income approach, but both regimes employ a comparative rate test to exempt certain CFCs.[25] Some countries apply CFC-regimes irrespective of the foreign tax levied, e.g., the CFC-regimes of Brazil, Canada, Denmark, Indonesia, and New Zealand.[26] Both approaches tend to reach similar results, largely through the exemption of certain locations within the tainted income approach (e.g., because of 'acceptable' tax rates), or the exemption of certain CFCs where the jurisdictional approach is used.

There are several alternatives for identifying a target territory, although two principal methods (with some variation) could be distinguished, namely the 'designated-jurisdiction approach' and the 'comparable tax approach'.[27]

In the next subchapters, the main 'target territory' definitions will be addressed with special focus on how these definitions affect the application of CFC rules on companies benefiting from tax holidays in developing countries.

2.3.2 The Designated Jurisdictions Approach

Under a pure 'designated jurisdiction' approach, the application of the CFC regime is restricted to identified jurisdictions. Under this approach, the target territories for the CFC regime will often be identified in lists of countries either excluded from the legislation because they have acceptable tax levels ('white list') or included under the legislation because they have unacceptable tax levels ('black list').

A CFC regime will rarely be based exclusively on a list of designated countries. Even if a country operates white lists and black lists, this is often used to supplement a 'comparable tax' approach or 'tainted income' approach. The lists would then be of a more administrative

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[25] IFA (2013) pp. 36–37.
[26] IFA (2013) pp. 172, 190, 269, 535.
[27] OECD (1996) pp. 40–45.

character and only provide a presumption as to the general status of the particular countries listed (i.e., 'grey' lists).

Under the Australian CFC regime, for example, a legislative white list of seven closely comparable tax countries is the only target territory definition used, so that all countries not on the list are potential targets for the CFC regime (if they derive 'tainted income'). However, even if a country is included in the white list, certain income of a CFC located in such country will be subject to Australian CFC taxation if the income benefits from a preferential tax regime. [28]

2.3.3 The Comparable Tax Approach

2.3.3.1 Various Alternatives Used for the Comparison

Under the 'comparable tax' approach, the application of a CFC regime will be based on a specifically stipulated threshold of what constitutes low taxation. The host country of the CFC in question would be regarded as a 'target territory' if the tax level applied by this host country fails to meet the threshold.

Whether such CFC regimes are applicable to a tax holiday subsidiary would mainly depend on whether or not specific incentives are taken into consideration under the comparison. The main focus here is on developing countries offering tax holidays while at the same time applying relatively normal tax rates under their benchmark system. The question is thus whether special tax incentives, such as tax holidays, are taken into account under the main variants of the comparable tax approach. A more pertinent issue in this regard is whether the developing country may affect the result by the way the tax holiday is designed and applied (possibly in collaboration with the investor).

Under the comparable tax approach, the CFC regime will apply to any country where the tax imposed on the CFC is less than a specified tax rate or less than a specified percentage of the tax hypothetically payable had the CFC been resident in the residence country of its controlling shareholder(s).

The tax rate chosen for the comparison generally takes one of three main forms: a) *nominal tax rates* (i.e., statutory), b) *effective average tax rates*, or c) *actual foreign tax paid*. The last choice of comparison is the most frequently used by countries applying a comparable tax approach, as this determines the exact benefit obtained by the foreign company from being located in a particular foreign country.[29]

2.3.3.2 Comparison Based on Nominal Tax Rates

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[28] IFA (2013) p. 108.

[29] OECD (1996) pp. 42–43. Fundamentals of International Tax Planning (2007) p. 213. IFA (2013) pp. 29 and 36.

If the comparable tax approach is based solely on *nominal tax rates,* the CFC regime will only apply to CFCs located in countries where the statutory tax rates are below a pre-stipulated threshold. A comparison based only on the statutory tax rates will make it relatively easy to determine whether or not the CFC rules are applicable. However, they will usually not be able to include CFCs offered a tax holiday by countries having high general tax rates.

The fact that some countries have high tax rates while several types of income are subject to low taxation was highlighted in the preparatory works to the Norwegian CFC rules as an argument against basing the comparison on statutory tax rates since this would make the rules ineffective. [30]

However, a comparison based on nominal tax rates does not necessarily have to refer only to the standard nominal corporate tax rates of the host country. The comparison could also include statutory tax concessions applied to the type of CFC in question. Under such prerequisites, a tax holiday company could also be subject to the CFC legislation. Nonetheless, this would usually require the eligibility criteria for tax holidays being specified in the legislation of the host country, and, additionally, that the tax holiday would be given automatically when the prescribed conditions are met. If the tax holiday is given discretionally, e.g., in a concession agreement between the investor and the host country, the application of the CFC regime could be avoided.

CFC regimes rarely use nominal rates as the sole basis for the comparison under the comparable tax approach.[31]

2.3.3.3Comparison Based on Effective Average Tax Rates

Another alternative under the comparable tax approach is to base the comparison on *average effective tax rates*. 'Average' in this context means the average level of effective taxation applied in the two countries (to companies in general or to companies comparable to the CFC, i.e., not to the particular CFC in question c.f. section 2.3.3.4).

Whether such CFC regimes will apply to CFCs granted a tax holiday will mainly depend on how average effective tax rates are calculated and the basis for comparison. This is due to one of the inherent characteristics of tax holidays, i.e., their targeting. Unlike general tax measures, tax holidays are selective in their application and only certain types of investment and/or specified investors are eligible to receive the preferential tax treatment.[32] Hence, even if some companies are granted a tax holiday, the average effective corporate income tax rate

[30] Ot.prp.nr.16 (1991–1992) pp. 78–80.
[31] OECD (1996) p. 42. IFA (2013).
[32] Easson (2004) p. 105.

in the country or for certain sectors, industries, etc. will not necessarily reflect this. Depending on the calculation of the average effective tax rate, the design and application of the tax holiday in the foreign country could impact on the application of the CFC regime.

If the assessment of the average effective tax rates under the low-tax definition is adapted to companies 'similar to' the CFC, the host country will be more likely to fall under the low-tax definition. If e.g., the calculation of average effective tax rates are based on companies operating in the same sector/industry/region as the CFC, or to companies that perform similar activities as the CFC, special tax incentives may be taken into account under the calculation, at least if the tax holiday is granted automatically to all companies that meet certain conditions.

Under a concession agreement, various requirements and conditions can be set for granting a tax holiday, and the design and application of the tax holiday can thus vary from one investor to another. The individual tax holiday company can be given a tax treatment quite distinct from similar types of companies, even when they operate in the same industry and region, and perform similar activities. Hence, even if the comparison under the CFC regime is based on the average effective tax rate that apply to companies *similar* to the tax holiday company, this may not reflect the beneficial tax treatment offered to the tax holiday company. Average effective tax rates may in these cases not be able to capture the low effective taxation of the specific tax holiday company.

This may indicate that discretionary applied tax holidays can more easily fall outside of the scope of CFC regimes when a comparable tax approach based on average effective tax rates is used. Of relevance here is also that low taxation may just be one of several issues negotiated in concession agreements between foreign investors and the host country. Low taxation could also be a trade-off for other aspects, e.g., in exchange for the undertaking of developing infrastructure, usage of local resources, or other performance requirements.

Norway is a country that bases its comparable tax approach on average effective tax rates.[33] 'Low-tax country' is defined as a country where the effective income tax levied on this type of company is less than two-thirds of the effective tax level applicable to this type of company in Norway. The low-tax country assessment thus takes into account both general rules and specific rules for this type of company.[34]

The preparatory works specify that it will not be decisive for the low-tax country assessment if this type of foreign company in a single year is subject to an effective tax of less

[33] IFA (2013).
[34] Ot.prp.nr.16 (1991–1992) p. 79.

than two-thirds of the Norwegian comparable effective tax rate. The comparison of the level of taxation should rather be based on an assessment of the average effective income tax rates over a period of more than a year.[35] Exactly how many years are not specified but a period of two to three years seems to be applied as a benchmark by the tax authorities.

The law does not specify what is meant by 'this *type* of company'. The prevailing thinking in Norway seems to be that, as a starting point, a company enjoying a tax holiday in a developing country falls under the CFC rules, in particular if the tax holiday is applied in a more general manner without additional requirements placed on the company. On the other hand, the principal approach of the rules clearly indicates that specific and individual circumstances not typical for the industry, etc. should be disregarded. As a consequence, there would also be scope for CFC taxation not to apply to tax holiday companies.

The question of whether the 'low-tax country' assessment should take specific tax incentives into consideration was considered by the Central Tax Office for Large Enterprises in decision 2009-082KV. In this case, the question was whether Egypt should be considered a 'low-tax country' because the company in question was offered a reduced tax rate in Egypt. Under this tax incentive, the company was offered a reduction in the tax rate (from 20 to 10%) for a five-year period. The tax administration concluded that this incentive should not be included in the basis for the comparison. Egypt was thus not considered a 'low-tax country' in this situation. There were several factors leading to this conclusion: The incentive was only granted by specific application and only given to a few companies. Furthermore, the tax reduction was only given for a short period of time (i.e., five years), and the eligibility was dependent on several strict requirements and conditions (e.g., the company had to build a new factory, significantly increase and develop the production capacity, hire several new employees, increase the share capital, and implement environmental protection measures). The Norwegian tax administration stated that the result would be different for 'normal' tax holidays in Egypt, i.e., tax reductions that applied more generally in certain economic zones/geographic areas (and where qualifying companies would not have to offer favours in return, such as an increase in production levels), and would normally apply to a larger group of companies or more types of business operations.

Thus, a CFC regime based on the comparable tax approach using average effective tax rates as a basis for comparison will not necessarily apply to tax holiday CFCs. This will depend on how the tax holiday is designed and applied and also on how the average effective tax level is to be determined by the CFC rule in question.

2.3.3.4 Comparison Based on the Actual Foreign Tax Paid

CFC regimes that apply the comparable tax approach usually base the comparison of domestic and foreign tax on *actual* tax paid by the particular CFC.[36] Under this method, focus is on a *particular* CFC and the benefit derived by it in the country of establishment.

[35] Ot.prp.nr.16 (1991–1992) pp. 79 and 154.
[36] IFA (2013) p. 36, OECD (1996) p. 42.

Under this approach, the country could either specify a minimum rate of foreign tax (as is done in Japan[37] and Germany[38] for example) or set a threshold based on a percentage of the domestic tax payable had the CFC been resident in the country applying the CFC rule (this is the method used by France[39] and Sweden[40] for example). The CFC regime would apply if the actual foreign tax paid on the income by the CFC is less than this prescribed percentage threshold.

Under this approach, it is wholly possible for the CFC regime to apply to a CFC in a high-tax jurisdiction (a country with a relatively high effective tax level) if the system of relief under a tax holiday results in a low effective tax rate for the specific CFC in question. A comparison based on the *actual* foreign tax paid is the most effective way of designing a CFC regime in order to include CFCs offered a tax holiday in a developing country with relatively normal standard tax rates compared to the residence country.

When the comparison under the comparable tax approach is based on the actual foreign tax paid, a company benefitting from a tax holiday will normally fall under this 'target territory' definition. However, the company may often be exempt for other reasons, such as the (active) nature of its business. This is further discussed in 2.5 below concerning 'tainted income'.

2.4 Entity Approach or 'Tainted Income Only' Approach

Some CFC regimes apply an all-or-nothing approach in attributing CFC income to its resident taxpayers. Once it is established that the foreign company meets the CFC requirements (e.g., based on target territory assessment), the CFC regime is applied to all of the profits of the CFC. The attribution is not restricted to tainted income alone, and the shareholder's share of the CFC's entire income is either taxed or not taxed. This is an all-or-nothing approach that is often referred to as an 'entity approach'. [41]

If the entity approach is used without exemptions, the application will be solely dependent on whether the host country of the CFC is regarded as a target territory. Hence, once it is established that the company is resident in a target territory, the entire CFC's income will be attributed (proportionately) to the shareholders. An entity approach without any exemptions is rarely used, however.

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[37] 20% – calculated by taking the amount of tax imposed in the fiscal year and dividing it by the amount of income in the fiscal year. IFA (2013) p. 429.

[38] The German CFC regime applies if the passive income of a CFC is subject to an effective tax burden of less than 25%. IFA (2013) p. 332.

[39] IFA (2013) pp. 299–319 (especially s. 4.4).

[40] IFA (2013) pp. 703–722.

[41] OECD (1996) s. 48.

Norway applies an entity approach without exemptions to CFCs resident in non-EEA countries with which Norway has not concluded a double tax treaty. (A double tax treaty with the host country has been considered preventing CFC taxation when the CFC 'mainly derives active business income'.) CFC taxation based on the entity approach will then be applied for as long as the non-treaty host country qualifies as a 'low-tax jurisdiction'. This means that many developing countries will see benefits from their tax holidays accruing to the Norwegian government rather than to the company investing in their jurisdiction. Although Norway has an extensive tax treaty network, far from all developing countries are covered.[42]

A few other countries (e.g., Brazil, Hungary and Indonesia) also attribute all income of foreign CFCs to domestic shareholders once it is established that the foreign company meets the requirement of being resident in a 'target country'. [43] As for Norway, the existence of a double tax treaty with the host country will normally prevent taxation by the residence country when the CFC has a substantial level of 'active business income'. [44]

Other countries applying the entity approach generally limit their CFC rules to CFCs that mainly derive tainted income – whether or not the host country is a tax treaty country. This is for example the case under the French and Japanese CFC regimes.

Under the French CFC regime, CFCs carrying out an 'effective industrial and commercial activity' in the territory where the CFC is established are exempted from CFC taxation.[45] The Japanese CFC regime exempts CFCs if four conditions are satisfied – an active business test, a substance test, a local management and control test, and an unrelated party transactions or local business test. [46]

Whether CFC rules will apply to a tax holiday company would then depend on how 'tainted income' is defined or applied, cf. 2.5 below.

Under the entity approach, CFC rules may apply to CFCs whose income *mainly* consists of tainted income. If 'mainly' means more than 50%, CFC taxation could apply to genuine business income representing up to 50% of total income. However, there would be clear incentives for MNEs to keep 'tainted income' below the threshold, and most tax holiday companies would probably make sure they have sufficient revenues from genuine business activities to avoid CFC taxation.

A CFC regime based on the entity approach could be prone to abuse. Its all-or-nothing approach could exempt tainted income up to the specified level. If CFC taxation would only apply to CFCs deriving e.g., more than 50% tainted income, MNEs could shift tainted income

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[42] See for example EY Worldwide Corporate Tax Guide: http://www.ey.com/GL/en/Services/Tax/Worldwide-Corporate-Tax-Guide---XMLQS?preview&XmlUrl=/ec1mages/taxguides/WCTG-2014/WCTG-NO.xml.

[43] See Deloitte (2014) pp. 7–8, 26–27, 30, IFA (2013) p. 127 and pp. 349–354. Brazil's rules have been revised effective from January 1, 2015, however they appear unchanged on the point of discussion here.

[44] Brazilian tax authorities take the view that existence of a double tax treaty does not prevent CFC taxation. This view has been disputed in Brazilian courts. For a description, see Alex Jorge, Leonardo Castro, and Matheus Piconez, *Do Treaties or the New CFC Rules Prevail in Brazil?,* Tax Notes International, Volume 76, Number 9, December 1, 2014, pp. 787-791.

[45] IFA (2013) pp. 308–312.

[46] IFA (2013) pp. 426–438.

to a tax holiday CFC by an amount representing 50% of its total income. As tax holidays often seem to specify beneficial tax rates for the *company as such,* the host country could subject the tainted income to the same reduced level of taxation as the tax holiday activities. The entity approach could then lead to double non-taxation of substantial levels of tainted income once the tax holiday requirements are fulfilled as a minimum.

2.5 Abuse of Tax Holidays

Before discussing what is meant by 'tainted income' and how this would impact on tax holiday incentives, we will provide some comments to what may be potential abuses of tax holidays.

In general, tax planning is an inherent part of the concept of tax holidays. The purpose of tax holidays is to influence investment decisions and behaviour and to attract investors who would not otherwise have invested in the country/sector/region. From the host country perspective such tax planning is obviously not considered abusive as long as the activities are performed in accordance with the host country's intentions with the tax holiday.

However, a question can be raised as to whether the tax benefit under a tax holiday can be extended (by the MNE) to also include income from activities not covered by the intentions of the tax holiday. From a *theoretical* perspective, abuse of tax holidays could involve tax planning strategies where MNEs shelter otherwise taxable income of high-taxed group companies in a tax holiday affiliate. Such arrangements would reduce the profits of high-taxed group companies but since the transactions are among members of the same MNE the total pre-tax income of the MNE remains the same – only the aggregate taxation is reduced.

When an MNE takes advantage of a tax holiday in a developing country for purposes for which the tax incentive was not intended by the developing country the result would be *unintended* double non-taxation – from the perspective of the residence country *as well as* the host country. The residence country of the parent company may view all double non-taxation of foreign subsidiaries as undesirable, but the essential feature here is that it is not intended from the host country perspective.

CFCs enjoying a tax holiday can in principle undertake activities beyond the purpose of the tax holiday (unless prevented by the tax holiday concession or local rules). An example could be a CFC given a tax holiday for the production of cement that decides to extend its business into shared services activities to group companies in other countries. Another example could be an extension into active management, development and supervision of a global portfolio of patents, etc., possibly carried out by expatriates deployed by the MNE in the developing

country. Yet another example could be an extension into merely passive ownership of a vessel that is leased on bare-boat terms to another group company. On a sliding scale, the passive lease of a vessel is probably considered more abusive than shared services activities, due to the differences in natural connection with the developing country (with patent management being somewhere in between). The abusive element is in any case closely linked to the objective of the tax holiday regime in question.

From a *practical* perspective, a question can be raised as to whether such abusive arrangements do in fact attract the interest of MNEs. One explanation to why such theoretical abuse may not necessarily be considered interesting by MNEs is the existence of high withholding taxes that many developing countries apply to dividends. In such case, before reaching the group parent, the beneficially taxed profits of the CFC will nonetheless have borne high local tax in the form of dividend withholding tax. Another explanation could be non-tax issues relating to high risks in the developing country, such as political instability, cash repatriation limitations, risk of currency devaluations, etc.

We have not seen comments in publications concerning such abuse, or strategies known to be typically adopted by MNEs in this respect. This indicates that such abuse may not represent a substantial problem; however we do by no means have a complete picture here.

2.6 Various 'Tainted Income' Definitions

Generally, CFC regimes taxing 'tainted income' usually aim at distinguishing 'passive' from 'active' income. Passive income such as interest, portfolio dividends, royalties, and rents received by the CFC would normally be in-scope of CFC rules. This is the most portable form of income and can easily be shifted cross-border to foreign entities (in order to defer or avoid domestic tax). However, the meaning of passive income varies from country to country.

Passive income may be defined directly by listing the typical types of income covered, which is done by the UK (through various 'gateway' provisions) and by the US (as Subpart F income), or indirectly by defining passive income in the negative as income other than a corporation's active business income, which is done by Germany (in a conclusive catalogue of activities considered to produce active income).[47]

Income derived by the tax holiday company under profit shifting arrangements would usually qualify as passive income. Under financing activities or when IP rights are transferred to the tax holiday CFC for example, the income shifted to the tax holiday CFC would

[47] IFA (2013) pp. 771–775, 795–798, 333–335 respectively.

normally be of a passive nature. This type of shifted profit would then usually be covered by tainted income definitions.

However, profits shifted to a tax holiday CFC can also sometimes qualify as active income. Management, development and supervision of a substantial portfolio of patents or of a large fleet of vessels or rigs on bare-boat charter may require substantial efforts by local personnel, and may thus be considered active income. Income would in these cases normally be sheltered from CFC taxation, unless the CFC regime applies to active as well as passive income. However, if the income derived by the CFC is disproportionate to the activity exercised by the CFC personnel, the income may still be subject to CFC taxation. (The use of artificial transfer prices could also be corrected by transfer pricing rules.)

The general observations above are often modified under domestic CFC legislations. Income which normally would be regarded as passive could be excluded from the tainted income definition under certain conditions. Similarly, income which normally would be regarded as active income could fall under the tainted income definitions in some situations.

The modifications in the general distinction between active and passive income relates to specific nuances in domestic CFC legislations. We will provide some observations in this regard.

One type of passive income which requires particular attention is the treatment of inter-affiliate payments of interest. In general, interest income is considered passive income and would usually be included in the definition of 'tainted income'. However, under some CFC regimes the arrangements where a CFC is used by the MNE to finance the activities of various companies in the group could be excluded from the application of CFC legislation if the financed companies conduct legitimate business activities. Under the Canadian CFC regime for example, interest received by a CFC from a related company is regarded as active business income of the CFC if the loan was used by the related company to earn active income.

An exemption from the Canadian tainted income definition ('FAPI') applies to interest income earned by an offshore financing affiliate of a Canadian corporation provided that the loan was used by the borrowing affiliate to earn active business income. In such circumstances the interest income earned by the financing affiliate is not included in the tainted income definition (FAPI income) and thus not subject to CFC taxation. Under some conditions, the interest income may also be repatriated to Canada without Canadian tax. This will thus result in double non-taxation. [48]

[48] IFA (2013) pp. 194–195. OECD (1996) pp. 50–51.

Similar effect could also be obtained under UK's CFC regime,[49] and also under the foreign personal holding company (FPHC) regime in the US if the lender and borrower are organized and operating in the same foreign country.[50]

Hence, under these domestic provisions profit shifting arrangements under inter-affiliate financing arrangements could be possible without the interference of CFC legislation. The essence of such exceptions is that the inter-affiliate payments (of in principle passive income) are regarded active income in some circumstances. This would typically be the case when the CFC has a physical presence in the host country and the payments are made from related companies carrying out genuine economic business activities.

Interest payments not covered by the tainted income definitions could enable the MNE to obtain a 'double dip'. One loan (from a bank to the parent company) could give rise to two interest deductions within the group: The parent company could claim deductions for the interest paid to the bank, and the financed subsidiary could claim deductions for the interest paid to the tax holiday CFC. At the same time, no tax would be paid on the intragroup transfer of funds since the payments received by the CFC are sheltered from tax under a tax holiday and the CFC regime of the parent company does not characterize the payments as passive income. This is not necessarily a problem with the CFC legislation as such, but could rather be a problem with any domestic rule that allows resident companies deduction of interest on loans used in intragroup financing. The effect under such arrangements could be reduced by implementing limitations on interest deductions, cf. OECD BEPS Action plans no. 2 and 4.

When a tax holiday company is used in a supply chain arrangement as a sales or distribution centre it would receive sales or services income. This type of income is usually regarded as active income. Under certain circumstances, however, such sales or services income could fall under tainted income definitions – often referred to as 'tainted base company income'.

Whether or not such income would be regarded as tainted depends on the circumstances under which the income is derived. A primary consideration is the geographic location of the transactions, i.e., in which market the CFC derives the income (the domestic jurisdiction where the controlling shareholder is resident, the local market of the country where the CFC is established or a third market). Another consideration is the relationship between the parties

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[49] IFA (2013) pp. 773–774, 776–777, HM Revenue & Customs (HMRC), draft guidance on UK Controlled Foreign Companies rules, Exemptions for profits from qualifying loan relationships: Ch. 9 (see especially pp 28–29). Available at: http://www.hmrc.gov.uk/drafts/cfc.htm.

[50] OECD (1996) pp. 50–51, IFA (2013) p. 795.

of the transaction, e.g., whether the base company income is derived from related or unrelated parties. When the transaction is between related parties a relevant consideration is often whether the income derived by the CFC is disproportionate in relation to the activities it undertakes.

In general, even if a CFC is not involved in related party transactions, related persons could provide substantial assistance to the CFC in earning its sales or services income. Where such assistance is provided, the income might be subject to CFC taxation, at least in circumstances where such income could not have been earned by the CFC without the assistance of the parent or a related company. The CFC legislation in the US, UK and Germany includes specific rules that treat income earned by a CFC as tainted income where the assistance provided by related parties to the CFC constitutes a significant factor in the earning of the income.[51]

3 Should CFC rules include tax holiday companies?

3.1 *Introduction*

As mentioned at the outset, the BEPS project does not address how the proposed strengthening of CFC legislation should interrelate with tax holiday regimes in developing countries. However, it is conceivable that deliberations concerning the strengthening of CFC rules could involve discussions of whether CFC rules should also apply to tax holiday companies.

In our opinion it would be important to reflect closely on how CFC legislation should relate to tax holidays in developing countries. Although applying CFC legislation to income under a tax holiday regime would prevent double non-taxation and effectively negate the tax benefit of the tax holiday incentive, this would also frustrate the economic policy of the developing country offering it.

Three *main* alternatives could broadly be distinguished when evaluating how CFC legislation should interact with developing countries' tax incentives.

Alternative one is to apply CFC taxation to income of all low-taxed foreign companies, regardless of the nature of the income derived and where the company is established. All the income derived by a tax holiday CFC would then be taxed on a current basis by the residence country of the MNE, and no categorization of the CFC income would be necessary. This

[51] IFA (2013) pp. 771–772, 797–798, OECD (1996) pp. 59–60.

alternative would require clarification of the limitations imposed by existing double tax treaties.

Alternative two is to exclude income from the intended use of tax holidays from the scope of CFC taxation. A sub-question would be whether the remaining 'tainted income' should include all income not accruing from the intended use of the tax holiday (including other income earned in the country giving the tax holiday) or be confined to income from profit shifting arrangements involving high-taxed affiliates in other countries.

Alternative three is to exclude low-taxed companies entirely as long as they benefit from a tax holiday in a developing country.

In the following, we will look into some main arguments in this discussion.

3.2 Economic Efficiency and Neutrality

The principle of economic efficiency implies that a tax system should be neutral so that tax legislation does not distort the optimal allocation of resources and the choices made by economic agents.

Investment decisions based on where the highest pre-tax return can be achieved is considered as the optimal choice under this principle. Rational investors will however make investment decisions based on what generates the maximum after-tax return to them. A neutral tax system would, ceteris paribus, ensure allocation of investment resources in the most (economically) efficient way.

The concept of neutrality is ambiguous however, depending on whether the focus is on CEN or on capital import neutrality (CIN).

A tax system based on CEN would imply that taxpayers are subject to the same amount of tax regardless of where they invest. When domestic taxpayers are offered a tax holiday in a foreign country, the incentive may stimulate the taxpayers to invest in the foreign country instead of in their residence country. CFC legislation could then be applied to achieve CEN since, in this situation a domestic taxpayer would be subject to the same amount of tax irrespective of where the investment is made.

According to CIN, all investors (both foreign and local) who carry out economic activities in a country are subject to the same tax rules, i.e., the tax rules of the host (source) country. In this way, investors compete on equal terms when investing in the same country. Such competitive neutrality has often been advocated by the business community.

Competitive neutrality is not just relevant for the host country. The residence country could also be interested in ensuring that its investors compete effectively internationally. When a

domestic investor carries out business in a foreign country offering tax holidays and the residence country of the investor subjects the income to taxation on an accrual basis under its CFC legislation, the domestic investor would have a competitive disadvantage compared to investors from other countries not being subject to CFC taxation.

While competitive neutrality could be an important argument for capital exporting countries as well as capital importing countries, arguments based on CEN and arguments based on CIN would usually not be compatible.

Which approach a country would choose depends on the tax policy of each country and the weight given to the various policy arguments. In the end, a choice would have to be made between mostly protecting the domestic tax base and focusing on anti-avoidance, or mostly enabling domestic investors to compete on equal terms internationally.

3.3 National Economic Sovereignty

When discussing international taxation in relation to tax holidays offered by developing countries arguments based on traditional concepts of effectiveness and neutrality would be inadequate alone. The principle of *national economic sovereignty* of each country could lead to modifications of the traditional argumentation, as well as the objective of encouraging investment into developing countries.

When a developing country abstains from fully exploiting its available tax base as an integral part of its economic policy, a simultaneous and corresponding increase in the tax take of the residence country could be seen as an unjustified interference with the economic sovereignty of the developing country.

The total tax burden on the investment will be unilaterally determined by the residence country if it applies CFC taxation to income earned by a developing country CFC having a tax holiday locally. Applying CFC legislation to such CFCs will frustrate the economic policy of developing countries in providing these incentives.

Tax incentives, such as tax holidays, are often one of few possibilities developing countries have to attract investment. For a developing country, granting tax incentives might be the only subsidy scheme available. While developed countries often can offer financial incentives such as grants, subsidized loans or loan guarantees, developing countries may have less possibility to provide capital upfront and may have to resort to fiscal incentives such as tax holidays.[52] The developing country would then reduce its downside risk if the investment is unsuccessful

[52] UNCTAD (2000) pp. 11–12.

and only incur a cost (of tax forgone) if the investment is a success. The policy options that developing countries otherwise would have and which they might regard as crucial for investments would be severely limited if tax incentives cannot be effectively employed. Hence, residence countries' CFC regimes can be claimed to unduly interfere with developing countries' economic sovereignty.[53]

It could be argued that the residence country should have the exclusive right to tax its residents. However, this argument is not as convincing when the residence country subjects *undistributed* profits of foreign subsidiaries to current taxation (i.e., CFC taxation). For CFCs, the host country is also the residence country, and it could be argued that the host country should have the primary right to decide the final tax impost on these companies. Of course, taxing parent companies on their 'share' of the foreign subsidiary's income (CFC taxation) is not inherently the same as subjecting these subsidiaries directly to tax in the residence country. Under CFC legislation the tax is levied on the parent company and not directly on the subsidiary. However, even if no tax is formally imposed on the CFC, from the point of view of the investing MNE CFC taxation would lead to economically similar results as if the tax was imposed directly on the CFC. Even though the tax subject is different, the taxable object is nevertheless the same.

3.4 Concluding Remarks

The tax base of the MNE's residence country is not eroded when a CFC's income stems from genuine economic business activities carried out by the CFC in a developing country. Absent the tax holiday, this income would have been the primary taxing right of the *developing* country and leaving only a secondary or top-up taxing right for the MNE's residence country. The effect of the CFC taxation would rather be to divert investments away from the developing country.

The argument in favour of CFC taxation is mainly that tax incentives do not work[54] and due to that effect residence countries should assist developing countries in curtailing this practice. In our view, this is a generalized and patronising position.

The question of how tax legislation in industrialized countries should interrelate with tax incentives in developing countries, and more specifically whether resident taxpayers should be permitted to enjoy the full benefit of tax incentives in developing countries, call for political discussions. Developing countries should participate in these discussions and have

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[53] Viherkenttä (1991) pp. 43–44.
[54] See i.a., Mascagni, Moore and McCluskey (2014) pp. 15–16.

the right to influence on the solutions since such rules and recommendations influence on their policy measures.

The main objective of CFC legislation is normally to protect domestic tax bases from profit shifting and preventing tax avoidance of passive income. The OECD Action Plan seems to support this, as it states that double non-taxation, per se*,* is not a concern, 'but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it'.[55]

To apply CFC taxation generally to tax holiday CFCs goes beyond this objective. Moreover, tax holidays compensating various disadvantages relating to investment in a developing country could also be a sound correction of *dis*incentives. It could be economically efficient from a global perspective not to apply residence taxation that would frustrate such incentives.

For example, tax incentives could presumably be a decisive factor for investors considering making a very costly capital investment in a developing country, e.g., a large factory. If the alternative is continuing long distance transportation of required input factors to support the existing business in the developing country, the local capital investment could save heavy and unnecessary transportation costs and environmental costs in the future. However, fear of exposing the large capital investment to political instability, currency devaluations, etc. may require a higher after-tax return to support the investment decision.

Accepting tax holidays could be justified in order to reduce imbalances in the global allocation of capital. CFC taxation of developing countries' tax incentives would then result in the opposite. Taxes waived by the developing country would simply increase the revenue of the residence country – often referred to as 'aid in reverse'.[56]

When the OECD prepares the final recommendations regarding the strengthening of CFC rules, consideration should be given to the special concerns of developing countries. Respect for the economical national sovereignty of third-world countries could imply that the intended use of tax holidays should be left untaxed – at least from current taxation – under the tax laws of industrialized countries.

We believe that as long as income exempted under tax holidays is generated in the host country and in line with the intended purpose of the tax holiday any resulting double non-taxation should be accepted. Arguably, developing countries should then abstain from taking undue advantage of such a situation.

[55] OECD (2013)b) p. 10.

[56] OECD (1996) pp. 16–17, Viherkenttä (1991) p. 2, UNCTAD (2000) p. 28, The International Finance Corporation and the World Bank (2001), p. 8.

CFC legislation should however play a role in relation to profit shifting arrangements to developing countries whereby taxable income is segregated from the activities generating it. A question to be considered in this context is how genuine business undertaken by the tax holiday company in the developing country *beyond* the intended scope of the tax holiday should be treated. As stated in 2.4 above, tax holidays are often given to a company *as such*. The CFC could then be seen as taking undue advantage of the tax holiday offered by the host country. If left untaxed, the result would in reality be that the tax holiday is informally extended. This may have local implications in the developing country, not only in terms of tax forgone but also potentially as regards corruption, etc. As long as the income is earned from genuine local business activities, however, such non-tax concerns do not seem to legitimate a taxing right of the tax authority of the residence country.

Profit shifting arrangements from residence countries can be avoided by designing CFC rules so that 'tainted income' becomes subject to CFC taxation. Work must then be done in properly defining what should constitute 'tainted income'. The 'tainted income approach' would have the benefit over an 'entity approach' (as described in 2.4 above) in that it will include tainted income also when it makes up parts of the CFC's income but not enough to bring it over the threshold. Monitoring the situation over a certain period of time – e.g., a few years – would seem administratively less burdensome on MNEs and tax administrations, yet still achieving the purpose.

4 SUMMARY

The OECD BEPS project suggests that CFC rules should be strengthened as one of several actions to end double non-taxation and curb tax base erosion and profit shifting. While the application of CFC rules to passive income of foreign companies established in classical tax havens generally would be regarded as justified, this is not the case in our view when a company carrying out genuine economic business activities benefits from low or no taxation for a certain period of time under a tax holiday offered by a developing country.

CFC taxation can be useful in curtailing profit shifting out of industrialized countries, however imposing CFC taxation on developing countries' tax holiday incentives would result in the opposite, i.e., a shift of tax revenue from the developing country to the industrialized country's treasury.

In preparing the final recommendations regarding the strengthening of CFC rules, OECD should consider the special concerns of developing countries. The authors' view is that non-taxation of tax holiday income should be acceptable as long as the exempted income is

generated by genuine economic business activities in the host country and in line with the intended purpose of the tax holiday.

Profit shifting arrangements segregating taxable income from the activities that generate it should on the other hand be subject to CFC taxation.