Quarterly
ISSN 1898–2255
Vol. 13, No. 3/2014
http://www.ekonomia.i.prawo.umk.pl

EKONOMIA I PRAWO
ECONOMICS AND LAW

Article details:
Received: 15.09.2013
Revised: 17.10.2014
Accepted: 03.11.2014

Hybka M.M., *Restraining harmful tax competition: an analysis of American CFC legislation*, „Ekonomia i Prawo. Economics and Law", Polszakiewicz B., Boehlke J. (ed.), Vol. 13, No. 3/2014, pp. 377-388. DOI: http://dx.doi.org/10.12775/EiP.2014.027.

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RESTRAINING HARMFUL TAX COMPETITION: AN ANALYSIS OF AMERICAN CFC LEGISLATION

SUMMARY

Capital and labor mobility facilitates cross-border activities of enterprises. In the era of globalization the optimal choice of investment location gives enterprises an opportunity to profit maximization. As a result the governments competing for foreign direct investment offer to enterprises preferential tax treatment.

In order to minimize the loss of tax revenue countries imposing high effective tax rates on enterprises implement diversified anti-tax-avoidance measures. One of these measures is controlled foreign corporation. The article examines the application of the controlled foreign corporation rules in the United States of America to combat harmful tax competition. It has to be underlined, that the American controlled foreign corporation legislation was a prototype for other countries that use this institution to prevent tax avoidance.

The aim of this article is to review the controlled foreign corporation legislation in the USA, analyze the structure of CFCs and the structure of their subpart F income in this country and evaluate the efficiency of this anti-tax-avoidance measure. The author describes inter alia, implications of harmful tax competition and the CFC rules. As the provisions of controlled foreign corporation are also planned to be introduced in Poland, the American legislation might be a good example of its successful implementation.

Keywords: harmful tax competition, tax avoidance, controlled foreign corporation, USA

JEL Classification: H25, H26, E62

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INTRODUCTION

Due to its negative consequences, the phenomenon of harmful tax competition has for many years been a subject of interest of both the European Union and OECD. Countries applying harmful tax competition – tax havens – benefit from their policy in a number of ways. Offering enterprises preferential tax treatment is for them often the only available method of attracting foreign direct investment. The existence of harmful tax competition contributes to a significant tax revenue loss in countries imposing relatively high effective income tax rates. Depending on the tax jurisdiction, the tax revenue loss due to harmful tax competition may amount to several dozen billion euros annually. Countries recording this loss implement various instruments aimed at limiting the scale of harmful tax competition.

One example of such instruments are the controlled foreign corporation (CFC) regulations. The application of this regulations involves assigning the income of a company located in a state different from the state of residence of its shareholders to the shareholders and then taxing the income in their state of residence, even if the shareholders are not paid the dividend. The institution of controlled foreign company is to be introduced in Poland on January 1st, 2014. According to the draft amendment to the corporate income tax law and the personal income tax law, the income of controlled foreign company is to be taxed, under certain conditions, with the same rate as the income of domestic entities[1].

The subject of research in this article involves controlled foreign corporations as an instrument of counteracting harmful tax competition in the USA. The article attempts to specify to what extent the American CFC regulations contribute to limiting harmful tax competition. Based on the statistical data for the USA, the author analyses the number and taxable subpart F income of American controlled corporations by countries.

[1] The Legislative Council of the Prime Minister, *The draft of 30th April 2013 on the amendment to the corporate income tax law and the personal income tax law*, *radalegislacyjna.gov.pl (11.08.2013). The draft includes provisions governing the taxation of income of the controlled foreign company located in the country that imposes income tax rate that is at least 25% lower than the corporate or individual income tax rate in Poland. According to these provisions a company is considered to be controlled by Polish shareholder (resident) only when he holds, for a period of minimum 30 days, directly or indirectly,* at least 25% of the share capital or the voting rights in this company. *A company will be regarded as CFC if 50% or more of its income is derived from passive sources (e. g. interest, dividends or royalties).*

1. HARMFUL TAX COMPETITION AND ITS IMPLICATIONS

The problem of harmful tax competition gained in importance after 1998 when OECD published a report on its causes and methods of elimination[2]. The report refers to two basic manifestations of the problem: the existence of tax havens and the preferential taxation of foreign entities (harmful tax practices)[3]. The report includes also the criteria which allow to describe the tax competition of a given state as harmful. According to the report, tax havens are countries where taxes are levied at a low rate or not at all and countries which do not participate in the exchange of tax information; they also apply tax regulations which are not transparent and enable foreign entities to acquire the status of a tax resident and profit from preferential tax treatment even if they are not engaging in a business activity locally. Foreign entities are preferentially taxed in a given country when:

– a zero or a relatively low effective tax rate is imposed on them;
– preferential tax solutions are not available for domestic entities;
– foreign entities taking advantage of preferential taxation are not entitled to conduct business activities locally;
– regulations concerning preferential taxation are not transparent;
– the country which implemented the regulations does not exchange tax information on the entities which take advantage of the regulations.

The OECD's actions were limited to encouraging countries applying harmful tax competition to exchange tax information. In the middle of 2000 a list of non-cooperative tax havens was released. The list included 35 tax jurisdictions[4]. A condition for removing a country from the list was starting to cooperate in tax information exchange. By 2008 the list shortened to only three countries: Andorra, Lichtenstein and Monaco, as the remaining tax havens decided to cooperate. These jurisdictions were removed from the black list only in 2009[5]. This year, three new lists of tax havens have been released – black, white and gray – which include countries which do not participate in the tax information exchange, participate in the tax information exchange and countries which promised to participate but have not been doing it so far respectively. The first list includes only four countries: the Philippines, Costa

[2] OECD, *Harmful Tax Competition: An Emerging Global Issue*, Paris 1998, p. 1-82.

[3] R. Eicke, *Tax Planning with Holding Companies – Repatriation of US Profits from Europe: Concepts, Strategies and Structures*, Kluwer Law International, Alphen aan den Rijn 2009, p. 111.

[4] R.S. Avi-Yonah, *The OECD Harmful Tax Competition Report: A Tenth Anniversary Retrospective*, „Brooklyn Journal of International Law", Vol. 34, No. 3/2009, p. 786.

[5] P. Harris, D. Oliver, *International Commercial Tax*, Cambridge University Press, Cambridge 2010, p. 106.

Rica, Labuan (a state in Malaysia) and Uruguay[6]. In April 2009 these countries promised to participate in the tax information exchange. By 18th May 2012, the gray list included only two countries – Guatemala and Nauru.

Also the European Union is concerned about the phenomenon of harmful tax competition. In the code of conduct prepared in 1997 for the EU member states it indicated to the necessity for gradual rolling back of the existing tax preferences which may be regarded as harmful tax competition and to refrain from introducing any such measures in the future[7]. The necessity to reduce harmful tax competition, including privileges offered to foreign entities by tax havens, and to develop a common strategy in this field for all the member states is also mentioned in the draft resolution of the European Parliament of May 3, 2013[8].

Tax privileges offered by tax havens enable foreign entities to avoid taxation. This often takes the form of transferring income to countries using harmful tax competition. Enterprises apply a number of tax planning instruments, including in particular[9]: civil law agreements (e.g. loan agreements), transfer pricing, production contracts, as well as hybrid instruments, hybrid transfers and hybrid entities. Tax avoidance enables enterprises to increase their profits and at the same time leads to significant reduction of the public tax revenue in countries from which the capital comes from; the scale of the public revenue loss is estimated by numerous institutions but it is not known exactly. The report prepared on the commission of the Congress of the United States says that as a result of transferring incomes to tax havens the USA loses annually as much as 57 to 90 billion $. American enterprises transfer their incomes to tax havens although they do not really conduct business activities in these countries. For example, in 2008 they declared that they generate 43% of their income in such countries as: Bermuda, the Netherlands, Ireland, Luxembourg, Switzerland, while their share in employing the local workforce remains at the level of 4% and the share in direct foreign investments of these countries – at the level of 7%. For the sake of comparison, let

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[6] OECD, *A progress report on the jurisdictions surveyed by the OECD global forum in implementing the internationally agreed tax standard*, http://www.oecd.org/ctp/42497950.pdf (10.08.2013).

[7] European Commission, *Harmful tax competition, Code of conduct for business taxation*, http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices (10.08.2013).

[8] European Parliament, *The draft of the European Parliament resolution of 21 May 2013 on Fight against Tax Fraud, Tax Evasion and Tax Havens (2013/2060(INI))*, http://www.europarl.europa.eu (10.08.2013).

[9] J.G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service, New York 2013, p. 9-12.

us see the indices for countries such as: Australia, Canada, Mexico, Germany and the United Kingdom – 14% of incomes, 40% of workforce and 34% of direct foreign investments[10].

2. CONTROLLED FOREIGN CORPORATION UNDER U.S. TAX LAW

The USA is especially vulnerable to losing their public tax revenue as a result of harmful tax competition. This is due to a significant level of internationalization of the activities of American enterprises. One of the reasons for the significant scale of the phenomenon of tax avoidance among American enterprises is the fact that, when specifying the tax residence of corporate persons, this country refers to the doctrine of the place in which a company was incorporated. A company becomes the resident of the USA if it was registered in this country[11]. At the same time, the place of residence of the company's shareholders, the seat of the management board or the territory in which the economic activities are conducted are irrelevant – the only fact which matters is the fact that the company was created or organized under the law of the United States, of any State of the USA or the District of Columbia[12].

At the beginning of the 1960s the phenomenon of income deferral to tax havens was noticed by the American tax administration. In 1962, American Internal Revenue Code (IRC) was amended with subpart F[13], which regulates the principles of taxation of controlled foreign corporations. The idea of CFC involves taxing incomes generated by enterprises with American capital located in tax havens, regardless whether this income was paid to the shareholders (stockholders) in the form of dividends. This taxation concerns only incomes which are not related to the business activities of such corporations involving offering goods and services to local entities not active in the international arena.

Section 957 of the IRC includes the definition of the term "controlled foreign corporation". A foreign corporation is considered to be controlled by American shareholders (stockholders) – both corporate and noncorporate –

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[10] M.P. Keightley, *An Analysis of Where American Companies Report Profits: Indications of Profit Shifting*, Congressional Research Service, Washington 2013, p. 4-5.

[11] H. Hamaekers et al., *Wprowadzenie do międzynarodowego prawa podatkowego*, Wydawnictwo Prawnicze LexisNexis, Warszawa 2006, p. 96.

[12] H.J. Ault, D.F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, [in:] A. Razin, J. Slemrod (ed.), *Taxation in the Global Economy*, University of Chicago Press, Chicago 1990, p. 12.

[13] Internal Revenu Code, *Internal Revenue Service*, http://www.irs.gov (10.08.2013).

if on any day during the taxable year of such foreign corporation they possessed direct or indirect share in the corporation's capital or voting power in the amount exceeding 50%. The calculation of this share takes into account shareholders (stockholders) if for the period of at least 30 days they own at least 10% share in the capital or voting power of the corporation. Hence, a foreign corporation in which in a given taxable year each of American shareholders (stockholders) owns shares not exceeding 5%, in the light of the American law, is not considered to be a controlled foreign corporation.

In the United States, the tax is imposed only on the CFC's from sources indicated in the IRC, the so-called passive income. Subpart F includes, among other, the following categories of this income[14]:

- insurance income (with exceptions);
- foreign personal holding company income (including income from dividends, interests, license charges, foreign exchange differences);
- foreign base company sales income, which includes inter alia income from specified activities in the field of intermediation in the sale of goods purchased from a related entity (a parent company, a subsidiary, American controlling entities, a branch of the controlled foreign corporation) or the sale of goods to this entity (there are exceptions, one of them is the intermediation in the sale of goods produced in the country of incorporation of a controlled foreign corporation or sold in this country for consumption purposes or for further domestic sale, or the intermediation in the sale of crops not produced in the USA);
- foreign base company services income, which includes income from providing services for or on behalf of a related entity, other than services provided locally in the country of incorporation of the controlled foreign corporation;
- foreign base company shipping income, which includes income from providing specified water or air transport services;
- foreign based income from processing, transporting, distribution and sale of oil.

[14] For details about certain categories of subpart F income see: E.T. Laity, *Defining Foreign Base Company Shipping Income and Oil Related Income*, „Virginia Tax Review", Vol. 20, No. 2/2000, p. 233; L. Lokken, *Foreign Base Company Sales Income under the New U.S. Regulations*, University of Florida, Levin College of Law, Florida 2009, p. 1-28; P.R. McDaniel, H.J. Ault, J.R. *Repetti, Introduction to United States International Taxation*, Kluwer Law International, The Hague 2005, p. 116.

In order to avoid double taxation of the income of a controlled foreign corporation the taxpayer is entitled to indirect foreign tax credit. The amount of the tax credit is calculated on the basis of the following formula:

$$\mathrm{FTC} = \frac{D}{I}\, xTP, \tag{1}$$

where:

FTC – foreign tax credit;

D – dividend (actual or constructive);

I – undistributed earnings;

TP – tax paid abroad.

The American legislator envisaged also the possibility to exclude from taxation some incomes of a controlled foreign corporation in a situation when certain conditions specified by law are met. For example, the income of the company may be exempt from taxation in the USA if the shareholder (stockholder) can prove to the tax authorities in the USA that the income has already been taxed abroad with a relatively high rate. This relatively high rate is such which exceeds the equivalent of 90% of the maximum rate with which to tax the income of a given shareholder under American tax law[15].

The institution of American controlled foreign corporation has a relatively long history[16]. Therefore, corporations conducting international business activities have developed methods to avoid the taxation of their foreign incomes. In order to do so, they use for example other American tax regulations, which give domestic and foreign entities an opportunity to choose their tax status; these *check-the-box regulations* make it possible to use "hybrid entity" tax strategies. Under the above-mentioned regulations, companies meeting specific criteria (concerning the number and status of their shareholders and business activities) may choose whether they want to pay the corporate income tax or whether their shareholders will pay the appropriate amount of income tax. The tax optimization scheme to avoid the taxation of income of a controlled foreign corporation is shown in graph 1.

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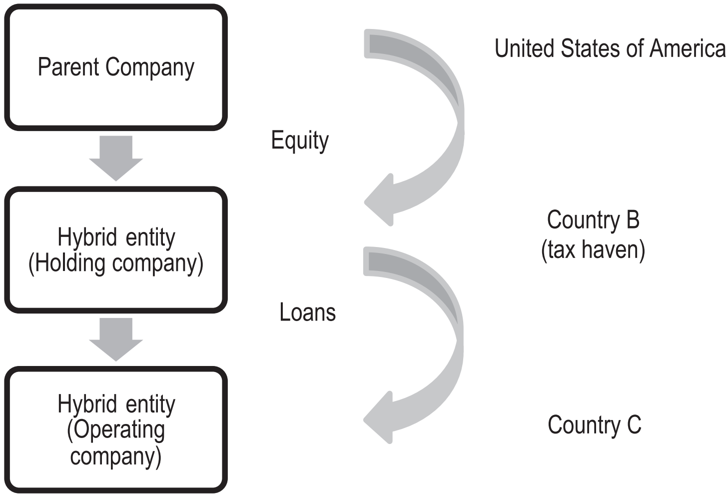
[15] E.P. Smith, P.J. Harmelink, J.R. Hasselback (red.), *Federal Taxation – Comprehensive Topics*, CCH a Wolters Kluwer business, Chicago 2009, p. 25495.

[16] M. Redmiles, J. Wenrich, *A History of Controlled Foreign Corporations and the Foreign Tax Credit*, Internal Revenue Service, Washington 2012, p. 129.

Graph 1. Tax avoidance scheme with the use of hybrid entities



Source: Russo R., *Fundamentals of International Tax Planning, International Bureau of Fiscal Documentation*, Amsterdam 2007, p. 147.

In the graph companies are using reverse hybrid models to avoid taxation. The reverse hybrid is an entity that is treated as corporate in the country of its shareholders but transparent in the country of location. The US parent company has direct shares in a holding company located in a tax haven (country B) and indirect shares in an operational company which is also a hybrid entity located in country C. For income tax purposes, the holding company chooses in the USA the status of corporate taxpayer and the operational company – the status of a branch. The holding company gives a loan to the operational one. The interest paid is deducted from the taxable income of the operational company in the country of its residence. The holding company does not pay any tax in country B. Although the holding company meets the conditions to be classified as a controlled foreign corporation, it does not pay in the USA the tax on interest it receives, because in the light of the American tax law, the loan was given to an entity which is only a branch of the company. Summarizing as a result of this tax avoidance scheme the low-taxed interest income does not fall within the application of US CFC legislation and the profits of an operating entity, reduced by the interest deduction, are taxable in its country of residence.

3. AMERICAN CONTROLLED FOREIGN CORPORATIONS

Controlled foreign corporations are an important group of taxpayers in the United States. In 2008 the number of foreign corporations controlled by corporations organized under US law was 83.6 thousand[17]. They are located in 188 countries and as many as 43% were incorporated in Europe. In the group of controlled foreign corporations located in Europe, most were incorporated in the EU countries and Switzerland. The most popular countries of location were: Great Britain, Canada, Mexico, China, Germany (table 1). About 35% of the analyzed corporations are located in these countries. Among the countries listed in table 1 the highest average passive incomes (subpart F incomes) per shareholder were declared by shareholders of American controlled corporations located in the Netherlands, Great Britain and Northern Ireland. The highest dividends per shareholder, on the other hand, were paid by American controlled foreign corporations in the Netherlands, Canada and Australia[18].

Table 1. American controlled foreign corporations in selected countries in 2008

Country of location	Number of CFC	Declared income (section F; thousand $)	Paid dividend (thousand $)
Great Britain and Northern Ireland	8707	9 702 236	4 820 662
Canada	6829	3 084 492	13 046 800
Mexico	4910	2 149 012	2 099 152
China	4546	253 424	1 598 572
Germany	4094	1 656 711	1 467 428
France	3522	1 940 024	1 366 567
Netherlands	3505	6 711 143	8 390 855
Australia	2802	1 936 790	2 831 545
Japan	2730	2 388 537	2 191 128
Hong Kong	2368	2 001 935	331 517
India	2094	180 305	537 476
Poland	847	192 439	721 145

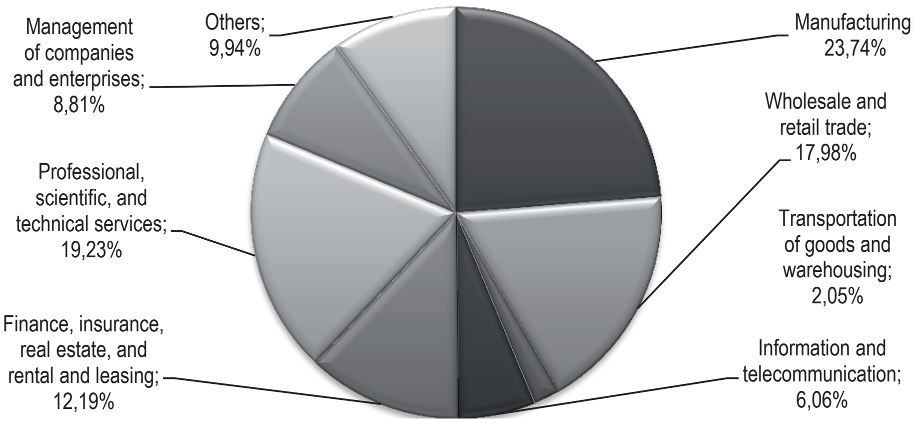
[17] L. Mahony, R. Miller, *Controlled Foreign Corporations – 2008*, Internal Revenue Service, Washington 2010, p. 170.

[18] Internal Revenue Service, *U.S. Corporations and Their CFC*, http://www.irs.gov (10.08.2013).

Country of location	Number of CFC	Declared income (section f; thousand $)	Paid dividend (thousand $)
Other countries	46 954	32 197 048	39 402 847
Total	83 642	80 355 541	96 741 710

Source: Internal Revenue Service, *U.S. Corporations and Their CFC*, http://www.irs.gov (10.08.2013).

Figure 1. American controlled foreign corporations according to the field of business activity in 2008



Source: Internal Revenue Service, *U.S. Corporations and Their CFC*, http://www.irs.gov (10.08.2013).

In 2008, most controlled foreign corporations engaged in manufacturing (19.9 thousand), professional, scientific and technical services (16.1 thousand) and trade (15.0 thousand). The least significant was the number of corporations engaged in the sector of information and telecommunication, as well as transportation of goods and warehousing (chart 1). The highest incomes were declared by controlled foreign corporations operating in mining and mineral extraction, and in the production and supply of energy, as these sectors recorded the highest rates of return on assets and gross profit rates. The rates of return on assets and gross profit rates were the lowest for controlled foreign corporations operating in the fields of agriculture, forestry and fishery. In the group of controlled foreign corporations which generated income from business activities, the effective tax rate on income tax paid abroad was 14.0%, whereas for all the controlled corporations it was 18.9%. For limited companies in the USA, this rate in 2008 was 23.2% (with tax credits) and 34.8% (without tax credits).

CONCLUSIONS

The efficiency of international measures taken so far in order to fight harmful tax competition has been insignificant. The measures have been limited to monitoring of tax preferences offered to enterprises located in tax havens and to ensuring the exchange of tax information between countries.

Also, national instruments are not fully efficient when it comes to counteracting harmful tax competition. This concerns also the institution of controlled foreign corporation. Since its implementation in the United States, international enterprises have developed a number of techniques to avoid the taxation of the incomes of such corporations. In order to do so, they use other American tax regulations, including mainly the right of companies to choose their tax status (check the box regulations). Therefore, the institution of controlled foreign corporation is often criticized as not fulfilling the aim for which it was introduced.

However, this criticism seems to be exaggerated. The institution of controlled foreign corporation contributes to tax revenue increase as passive income of controlled foreign corporations is added to the domestic income of parent companies and taxed in the USA. The limited efficiency of the discussed institution is the result of subsequent introduction into the American tax law other regulations which enable enterprises to avoid CFC rules.

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