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CONTROLLED FOREIGN COMPANY TERMS DIVIDE EUROPEAN UNION

Countries within the E.U. are divided over the definition and application of controlled foreign company ("C.F.C.") rules within the E.U.[1] B.E.P.S. Action 3 suggests non-binding approaches when countries draft C.F.C. rules, and the European Commission ("E.C.") has proposed C.F.C. rules where tax is based on a minimum rate. However, countries with low tax rates, such as Ireland, are opposed to the legislation, as they believe it will inhibit foreign investment.

E.C. Proposal and Conflict

Under the E.C. proposal, a C.F.C. would be defined as follows:

- More than 50% of the company's shares, profits, or assets are controlled by a group.
- The company is based in a non-E.U. country with a statutory tax rate lower than 40% of the tax rate in the country of the parent company.
- More than 50% of the company's income comes from passive sources.[2]

The C.F.C. rules would not apply to companies listed on a public stock exchange, but it would apply to E.U. subsidiaries if the sole purpose of the subsidiary's existence was artificial.[3]

Many E.U. countries provide an exemption from tax for dividend and capital gain income realized from qualifying subsidiaries. These transactions are affected by the E.C.'s proposed "switch-over" clause.[4] Under the switch-over clause, dividend and capital gain income would be taxed if the subsidiaries were located in a jurisdiction whose tax rate was less than 40% of the rate in the parent jurisdiction.

Some countries are concerned that this would impact E.U. companies that serve as central holding companies for multinationals, as multinationals would choose to incorporate these entities elsewhere.

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1 European Commission, "Proposal for a Council Directive Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market," January 28, 2016.

2 *Id.*, art. 8, para. 1(a)-(c).

3 *Id.*, art. 8, para. 2.

4 *Id.*, art. 6.

The Dutch Proposal

As chairman of the E.U. Council, the Netherlands has recommended various amendments in an attempt to obtain agreement on the proposed C.F.C. rules before a self-imposed September deadline. The first amendment would add a statement that the proposed minimum tax rate is not an attempt to proscribe corporate tax rates in any E.U. country. Under the second, the C.F.C. rules would only apply to "artificial entities" and not every subsidiary in a group. Finally, the Netherlands has proposed the elimination of the switch-over clause. While these amendments may obtain agreement from some countries, larger European economies, such as Germany and France, may fight the amended proposals. Thus, despite hopes that the C.F.C. rules would be implemented quickly, they seem mired in negotiation gridlock for the foreseeable future.

GROUP CREATED TO SECURE PASSAGE OF E.U. "BLACKLIST"

A previous edition of *Insights* introduced the creation of a common E.U. blacklist, by noting that "under the European Commission's proposed country-by-country ('CbC') reporting requirements, any company with business activities in a country on the blacklist would be required to disclose profits earned and taxes paid in that jurisdiction."[5] The blacklist criteria include whether a country uses the common reporting standard on bank account transparency[6] and whether a country has adopted B.E.P.S. reforms.[7]

If a country is blacklisted, it may be exposed to "defensive measures" from the entire E.U.[8] These defensive measures may include the imposition of sanctions on the blacklisted country or a greater administrative burden on companies resident there. This may de-incenti*vize* companies from establishing residency in the blacklisted country.

The E.U. blacklist is expected to be finalized by the end of 2016, and E.U. ministers must formally adopt the list once it is finalized. However, the ministers cannot agree on the definition of a tax haven, and for several E.U. countries, their respective blacklists remain empty. To overcome this problem, the E.U. has created a "code of conduct group,"[9] which will determine the blacklist criteria based on O.E.C.D. and other standards, to be named later. Based on the C.F.C. negotiations mentioned above, it is unlikely that an agreement will be forthcoming.

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5 See in detail Christine Long and Beate Erwin, "U.S. on the Blacklist – Is Delaware a Tax Haven?," *Insights 5 (2016)*.

6 European Council, "Council Conclusions on an External Taxation Strategy and Measures Against Tax Treaty Abuse," May 25, 2016. para. 8.

7 *Id.*, para. 17.

8 *Id.*, para. 4.

9 European Commission, "Questions and Answers on the Action Plan for Fair and Efficient Corporation Taxation in the E.U.," news release, June 17, 2015.

PRACTITIONERS CRITIQUE "INEFFECTIVE" PROPOSED CODE §385 REGULATIONS

The previous edition of *Insights* discussed the proposed Code §385 regulations, noting that the "Treasury considered guidance to restrict strategies that avoid U.S. tax on U.S. operations by shifting or 'stripping' U.S.-source earnings to lower-tax jurisdictions through the use of intercompany debt."[10] In general, under the proposed regulations, the I.R.S. may disallow deductions made on certain loans by determining that a transaction is actually an equity investment, rather than a tax-deductible loan. The proposed regulations not only target corporate inversions but implicate non-inversion transactions as well.

Critics such as the legislative counsel for the Joint Committee on Taxation have indicated that the proposed regulations are not a long-term solution and the bigger problem is the U.S. system of worldwide taxation, which encourages base erosion. The Senate Finance Committee is discussing a possible response to the Treasury Department's controversial rules to stop companies from stripping U.S.-source income via loans to their subsidiaries. Other critics note that the regulations are so extensive that they require Congressional input and approval. The proposed regulations are unclear as to the treatment of long-standing debt instruments and whether the I.R.S. may, with hindsight, reclassify debt as equity even though the principal has been partially paid. Practitioners are seeking clarification on these issues before the proposed regulations are enacted.

"The French authorities believe that McDonald's had been using a Luxembourg-based entity to shift profits to lower-tax jurisdictions through fees for using the company brand and other services."

FRENCH AUTHORITIES RAID U.S. COMPANIES FOR TAX EVASION

French tax authorities have raided the French offices of Google, McDonald's, and Booking.com, respectively.

The French tax authorities believe Google owes the government €1.6 billion for failure to pay French tax. The assessment is based on the government's assertion that Google's Irish subsidiary maintains a permanent establishment ("P.E.") in France.[11] The French government claims that Google's French entity is a front and that it is in fact the Irish entity that produces the substantial activity in France resulting in revenue. Google asserts there is no P.E. in France, as all contracts are concluded in Ireland and, accordingly, all French sales income is correctly reported in Ireland. France's finance minister has dismissed a possible settlement with Google. If found guilty, Google may be subject to a penalty of €10 million or half of the value of the assessed amount.

Recently, the French authorities also raided the French headquarters of McDonald's in a tax probe. The French authorities believe that McDonald's had been

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10 Philip Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles," *Insights 5 (2016).*

11 "French Raid Google in Latest Probe into Tech's Tax Tactics," *The New York Times*, May 24, 2016.

using a Luxembourg-based entity, named McD Europe Franchising, to shift profits to lower-tax jurisdictions through fees for using the company brand and other services.

Finally, after a two-year investigation, French authorities are now seeking €365 million in unpaid taxes, penalties, and interest from Booking.com. Similar to the Google situation, the French authorities accuse Booking.com of maintaining a P.E. in France. Booking.com may challenge the assessment in French court.

The French government has claimed that, in 2015 alone, it collected €3.3 billion in back taxes and penalties from just five multinationals. These collection issues may become more prevalent as cash-strapped governments seek additional sources of revenue.

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