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Transcending Frontiers

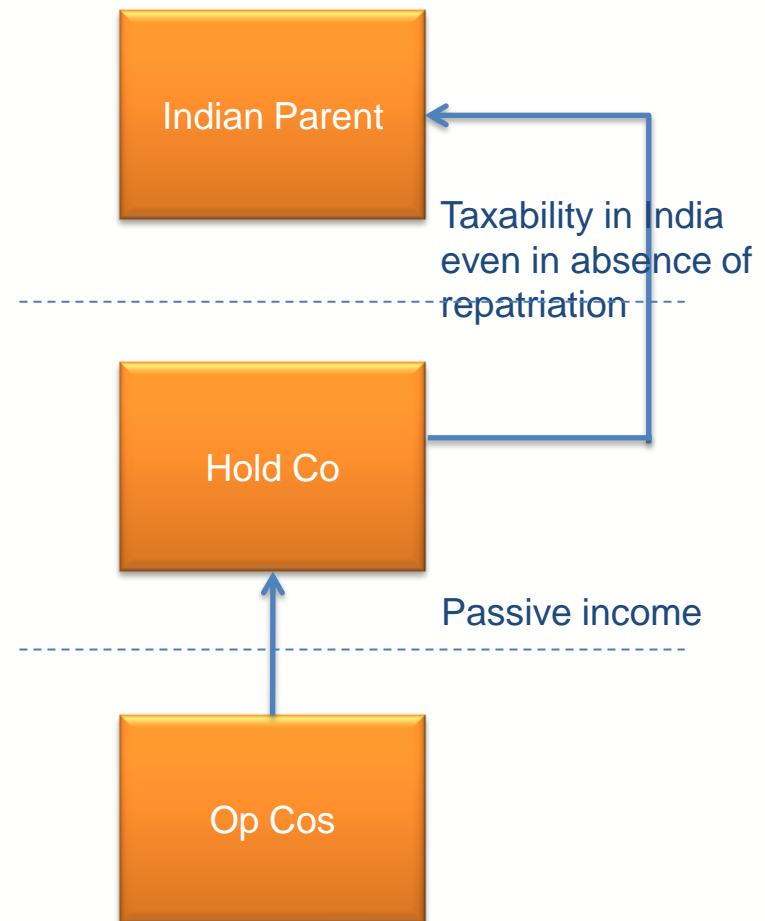
International Tax | Transfer Pricing | Regulatory Services



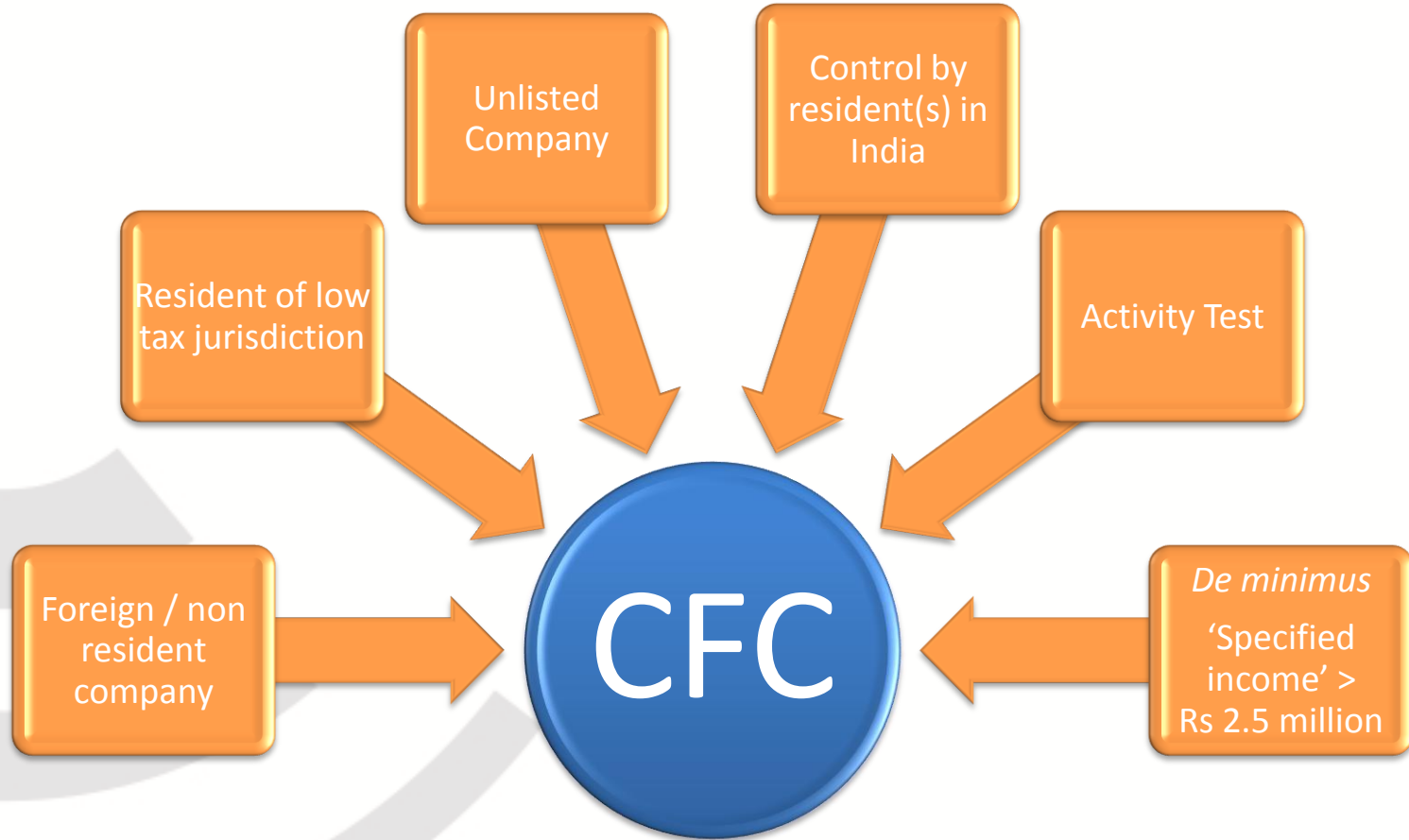
# Controlled Foreign Corporation ('CFC') Rules – *'Waiting in the Wings'*

# Concept

- Holding companies in low tax jurisdictions used as tax planning device by multinational companies
- Often serve no purpose other than deferral of taxes on passive income
- CFC regulations is an anti- avoidance measure restricting tax deferral
- Brings undistributed income of offshore subsidiaries within tax net on a deemed basis
- DTC Bill 2010 proposed introduction of CFC Rules in India with override on tax treaty
- Likely to be introduced in India under Budget 2012



# Applicability Conditions



# Target Jurisdiction

## Common approaches for identifying target jurisdictions

- 'Global approach' – target 'passive' income regardless of jurisdiction (whether high or low tax)
- 'Designated jurisdiction' approach – target specific/ designated low tax jurisdictions

## Proposed Indian CFC Rules

- Target 'low tax' jurisdictions
- 'Low tax' is a relative concept under proposed CFC Rules
- Tax paid in foreign country < 50% of tax payable by foreign company under DTC provisions [computed by deeming foreign company to be taxable in India]
- Amount of tax paid and not tax rate is relevant

***Proposed CFC Rules apply the 'designated jurisdiction' approach***

# 'Control' Test

## Types of 'Control' Test

- 'Legal Control' test - threshold percentage ( say of voting power or equity) to qualify as CFC
- 'De-facto' Control test - covers constructive and indirect ownership based on specific facts of each case

## Proposed Indian CFC Rules

- 'Control' may be exercised individually or collectively and directly or indirectly
- 'Control' test
  - 50% of the voting power/ capital/ secure income or assets of the company
  - Sufficient votes to exert a 'decisive influence' in shareholder meeting
  - 'Dominant influence' due to special contractual relationship

***Proposed CFC Rules apply a hybrid 'control' test – mix of 'legal' and 'de-facto' control***

# Active Trade or Business

CFC rules shall not apply to foreign company engaged in active trade or business

## Active trade or business (two-pronged test)

- Active participation in industrial, commercial or financial undertakings; **and**
- Less than 50% of income of the company is on account of:
  - dividend, interest, income from house property, capital gains, annuity payment, royalty, sale or licensing of intangible rights on industrial, literary or artistic property, income from management, holding or investment in securities, shareholdings, receivables or other financial assets
  - income from sale of goods/ supply of services to persons under common control or associated enterprise

***Failure of two-pronged test implies taxation of CFC's entire undistributed income from all sources - passive as well as active***

# Comparative View – Key Jurisdictions



US

- CFC results from ownership of 50% or more of voting rights or equity
- Global approach
- Active income test



UK

- CFC results from ownership of 50% or more of voting rights or equity / de-facto control test
- Designated jurisdiction approach
- Number of exemptions available (deminimis test/ distribution exemption/ genuine commercial operations/ motive test and public quotation test)



Canada

- CFC results from ownership of 50% or more of voting shares by resident(s)
- Global approach
- Active income test/ de minimis test



Australia

- CFC results from ownership of 50% or more of equity by Australian resident(s)
- Hybrid approach
- Active income test



# Legislative Lacunae

- Genuine businesses could fall within ambit of CFC rules?
  - Contract manufacturing operations
  - Captive operations (services and sale of goods)
- Control test - open ended and vague
  - 'Dominant influence' and 'Decisive influence' – not defined
  - Several other phrases such as 'direct' and 'indirect holding' and 'special contractual relationship' are open to interpretation
- Need for credit mechanism to account for taxes paid in overseas jurisdictions

# Points to Ponder

- Capital account convertibility still absent
- Outbound investment has just taken off
- Could CFC be a damper for outbound investment ?
- End of tax holiday, GAAR and now CFC – would it be too much for India Inc?
- Could CFC Rules (like Transfer Pricing regulations) end-up becoming a virtual levy?

# THANK – YOU

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