CFC Rules - An Indian Perspective

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The revised discussion paper on Direct tax code (Revised DTC) proposes to introduce the “Controlled Foreign Corporation Rules” (CFC Rules) in the case where the companies are incorporated outside India and are controlled by a tax resident of India. The draft revised discussion paper only speaks about the introduction of CFC rules, but does not provide such draft rule. Through this article an attempt has been made to understand the meaning of “Controlled Foreign Corporations” (CFCs) and the CFC rules adopted in various countries with CFC regulations.

**Meaning of Controlled Foreign Corporations** (CFCs)

With the globalization of economies and scale of operations, the tax payers in various tax jurisdiction have resorted to various tax deferral method to avoid the tax incidence in the home country tax jurisdiction with higher tax rate. One of the popular methods of tax deferral is transfer of passive or investment income (such as interest, dividend and capital gains) by establishing an entity in a low tax jurisdiction or a tax havens. The Mechanism of tax deferrals starts by establishing an entity in a low tax jurisdiction. Such entity, since controlled by parent company, is called a “Controlled Foreign Corporation” in the home country of parent company. For example a 100% subsidiary of an Indian company in Bermuda is a CFC in India. The passive income of such CFCs is then not distributed to the shares holders of CFC to avoid levy of taxes in the parent company home country tax jurisdiction for a long time, thus deferring the incidence of tax on such Income.

**Meaning of Controlled Foreign Corporations Rules** (CFC Rules)

This artificial deferral of taxes through the holding structure in low tax or preferred tax regimes has been seen as injurious to revenue collection targets in various countries specially the developed economies. Several countries have adopted measures aimed at preventing this artificial deferral of passive or investment income through CFC’s. The CFC rules is one of the such measures to curb the practice of artificial deferral of income.
CFC rules generally deeming in nature and are applied to apportion income of a CFCs to the parent entity and to subject it to taxation in the parent entity’s home country. Under CFC rules any undistributed income of an CFC is deemed to be distributed to the parent company / shareholders, thus taxed in their hand in the home country tax jurisdiction.

**The tax Jurisdiction with CFC rules**

The practice of deferral of taxes through CFC mechanism is more prevalent in the developed countries where the generation of capital has reached at its peak or nearing peak, thus left with the excess capital or wandering capital. The profit earning capacity of such capital is reduced if employed in the home country jurisdiction due to saturation of income generation opportunities and high rate of taxes. So far several countries in the world have adopted the CFC rules, out of which few are developing economies and the rest of them are Developed Countries. USA was first to introduce the CFC rules followed by Germany, Canada, Japan, France, UK, New Zealand, Sweden, Australia, Norway, Finland, Spain, Indonesia, Portugal, Denmark, Korea, Hungry, Mexico, South Africa, Argentina, Venezuela, Italy, Israel and Lithuania.

**Circumstances for applicability of CFC Rules**

The tax jurisdiction with the CFC rules have drafted comprehensive conditions for invoking the CFC rules. In most of the above named tax jurisdictions with CFC rules, for invoking the tax CFC rules, following circumstances should exits -

1. The tax resident shareholders either alone or together with others own more than 50% / substantial share or voting power of the foreign company.
2. Such CFC has earned the passive income (such as interest, dividend and capital gains)
3. The CFC’s income has suffered a “low tax” or “Nil Tax” in the foreign tax jurisdiction as compared to parent country tax rate.
4. The CFC has not distributed such income to the parent company for a long time.

In case the above conditions are met, the passive undistributed income of the CFC is deemed to be distributed to the shareholders and is taxed in the hands of such shareholders in the country tax residence of such shareholder in proportion of their shareholdings.

**Safeguards before invoking the CFC rules**

The Countries with CFC regulations not only have introduced the rules for invoking the CFC rules but have also provided the exemption and safeguards from the rigors of the such rules. Like certain countries with CFC rules in European Union (EU) provide exemptions for EU entities (CFC). Certain countries do not apply the rules blindly to any jurisdiction CFCs but provide for application of such rules to only “black listed” low tax jurisdiction or tax havens. On the other hand the certain countries have list of tax jurisdictions which are exempt from the CFC rules. Following are the exemptions provided from the applicability of CFC rules in various tax jurisdiction with CFC rules -

1. Excluded countries list i.e. the foreign company is resident in a non-tax haven country.
2. Motive test - whether the tax avoidance is the main motive for the existence of the foreign company.
3. Acceptable distribution range of profits i.e. Some % of net profits are distributed within certain period of earning. For example if CFC distributes 80% of income with in two years no CFC rule shall apply in such cases.
4. Exemption to Publicly quoted companies from CFC rules.
5) Nature of primary activity exemption – No CFC rules for trading companies.
6) Minimum Income threshold limits for invoking CFC rules.
7) Tax Suffered by CFC in other tax jurisdiction is less than ¼ the tax paid by them in home country on corresponding income. For example if a CFC pays tax in any tax jurisdiction @ 30%, the tax rate in low tax jurisdiction should be less than 22.5% to attract CFC rules.
8) EU exemption - CFC rules are not applicable to EU entities in various countries in EU unless the tax administration can demonstrate that they are part of an artificial arrangement aimed at circumventing the tax legislation.
9) Safe harbor clause: CFC rules are not applicable to entities deriving income from commercial or industrial operations effectively carried out within the territory of the country where they are established / incorporated.
10) CFC rules not to apply if the passive income is < certain percentage of CFC total revenue. For example if the passive income is < 20% of total revenues of the CFC, then CFC rule shall not apply.
11) CFC rules not to apply unless the gross revenue of CFC is > certain percentage (say > 50%) from services provided to group companies.
12) Credit of taxes paid in foreign jurisdiction is allowed in the home country of the parent entity and taxes paid by parent on consolidated profits worldwide.

Indian perspective

The CFC rules are introduced in a country to provide the capital export neutrality as the tax cost of earnings remain same in both the situations whether the money is invested in home country or in a foreign country. In Indian perspective the introduction of the CFC rules is a little premature as India being a developing country, needs import of technology at sustainable cost, customer base for inorganic growth and capital building. The Indian Industries / entrepreneur have just started to venture out on the hunt of technology and customer base. The various Indian industries such as automobile, automobile ancillary, Information technology, Steel, Telecommunication, Mineral & ore etc. have, in the recent past, made significant progress in this direction. The companies have acquired corporations outside the Indian tax jurisdictions and have brought the low cost machinery and technology to India with exiting customer base. Such entrepreneur spirit need to be supported for a while.

The history of introduction of CFC rules world over has been that the capital export (outbound investment) took place from the developed countries to undeveloped countries or to developing countries. In Indian context Outward Direct Investment (ODI) should not be seen a capital export as the need of the hour is to acquire the capital assets and the technology at a lower cost for the nation building. In the context of the above following suggestion are desirable in Indian context -

1- Introduction of CFC rules at this stage may adversely affect the Indian growth story, thus the introduction of such rules be deferred to a suitable time in future.
2- If the introduction of CFC rules is inevitable, then the rules should be brought with the enough safe harbor provisions. Few of such safe harbor are as following -

a. The CFC rules should not be made applicable to a foreign tax jurisdiction which is not a low tax jurisdiction or not a tax haven.
b. A Mechanism should be introduced in the law to test the intention behind the existence of the foreign company structure whether this is a tax avoidance of some other economic and strategic benefit.

c. The companies listed in a recognised stock exchange in India Should not be subject to CFC rules.

d. There should be a provisions for a minimum of threshold limit of possible tax deferral for invoking CFC rules.

e. CFC rules Should not be made applicable to entities deriving income from commercial or industrial operations effectively carried out within the territory of the country where they are established / incorporated.

f. Taxation of consolidated entity in India be brought and the Credit of taxes paid in foreign jurisdiction is allowed in India to avoid any double taxation of the income.

g. The sanctity of bilateral Double taxation avoidance agreement should be maintained and the provisions of treaty override should not be brought to the statute books.

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