A PROPOSAL TO REFORM INCOME ANTI-TAX-DEFERRAL REGIMES

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This paper argues that despite the existence of CFC rules, their scope and effectiveness is limited and these limitations are likely to be further exacerbated by business that is conducted over electronic networks, like the Internet.

Two related problems exist with the scope and effectiveness of CFC rules. First, these rules are limited by their underlying design features, including that they only typically apply to foreign 'companies', and then only to those that are 'controlled' by residents. Even if these limitations are overcome, the rules usually only apply to 'tainted' income (passive income and sometimes foreign base company sales income) but not usually to active business income. This disparate treatment which applies among categories of income can lead to difficult characterisation issues and inevitable tax planning activities. Secondly, CFC rules may not be well-equipped to accommodate emerging challenges, including the increased use of hybrid entities, which can be used to avoid the operation of CFC rules. The onset of electronic commerce is likely to intensify these challenges.

The existence of these concerns suggests that a review of CFC rules is needed. It will be argued that ending deferral of income altogether may best address the expressed concerns and therefore represent the ideal solution to the problems with CFC rules. However, in the face of international competitiveness concerns, as well as political realities, it is recognised that this is an unlikely outcome. Therefore, if CFC rules are to remain effective, their scope needs to be extended, both in terms of the number of countries that should consider adopting such rules, and also in terms of extending the

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operation of these rules to ensure that harmful tax practices that may be carried on by preferential tax regimes are within the scope of the rules. Also, it is argued that for CFC rules to remain effective, they need to be strengthened through the adoption of supporting rules. Finally, and perhaps most significantly, it is argued that supplementary measures at the multilateral level are needed. There is currently no international tax body that can take this work forward in a truly multilateral way. One possibility might be to establish a World Tax Organisation to assume this responsibility. The role of such an organisation would not be to impose tax or to collect tax; rather such an organisation could represent a forum where emerging problems, such as electronic commerce and harmful tax competition, can be discussed in a coordinated and inclusive multilateral way that would extend beyond just OECD countries.

1. INTRODUCTION

The risk of many electronic commerce transactions escaping taxation by residence countries if highly mobile electronic commerce businesses shift their operations to tax havens is a growing concern among tax administrators.[1] Despite such concerns, it must be recognised that residence countries are not powerless against such actions and they may resort to countermeasures, such anti-tax-deferral rules (including controlled foreign company ('CFC') rules) to guard against the improper use of tax havens or low-tax jurisdictions as a base for such business operations.[2] This paper argues that despite the existence of CFC rules,[3] their scope and

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[1] See, eg, Arthur J Cockfield, 'Balancing National Interests in the Taxation of Electronic Commerce Business Profits' (1999) 74 *Tulane Law Review* 133.

[2] Other countermeasures that may be used by residence countries include transfer pricing rules, non-resident trust rules, foreign investment fund ('FIF') rules, and anti-treaty-shopping rules, though controlled foreign company ('CFC') rules are generally regarded as the most rigorous, targeted, and comprehensive countermeasures against the use of tax havens: see Brian J Arnold, 'Controlled Foreign Corporation Rules, Harmful Tax Competition, and International Taxation' in Canadian Tax Foundation (ed), *2000 World Tax Conference Report* (2000) 17:5.

[3] The discussion of CFC rules in this paper will be from an international or general perspective, rather than from the perspective of any particular country or jurisdiction. At the same time, references will be made to the rules of specific

effectiveness is limited and these limitations are likely to be further exacerbated by business that is conducted over electronic networks, like the Internet.

Specifically, two related problems exist with the scope and effectiveness of CFC rules. First, these rules are limited by their underlying design features, including that they only typically apply to foreign 'companies', and then only to those that are 'controlled' by residents. Even if these limitations are overcome, the rules usually only apply to 'tainted' income (passive income and sometimes foreign base company sales income) but not usually to active business income. This disparate treatment which applies among categories of income can lead to difficult characterisation issues and inevitable tax planning activities. Secondly, CFC rules may not be well-equipped to accommodate emerging challenges, including the increased use of hybrid entities,[4] which can be used to avoid the operation of CFC rules. The onset of electronic commerce is likely to intensify these challenges. Apart from administrative concerns regarding likely enforcement problems that tax authorities could face in trying to enforce CFC rules in an electronic commerce environment, it is likely that there will be substantive problems encountered with applying these rules in an electronic commerce setting. Electronic commerce may also present challenges to CFC rules as these rules look to *where* transactions or activities take place and the determination of the location of these activities may become more problematic for electronically-conducted transactions. Also, as the economy continues to shift from manufactured goods to services, this is likely to place further pressure on the already artificial process

countries where the context requires it. The discussion of CFC rules in this paper is intended to show how these rules attempt to deal with the use of tax havens from a policy perspective, particularly focussing on the limitations on the scope and effectiveness of these rules.

[4] 'Hybrid entities' are those that may be characterised one way by a foreign jurisdiction (eg, as a company) and a different way for by a domestic jurisdiction (eg, as a partnership).

of classifying income, which in turn, could affect how successfully CFC rules may operate. This is because CFC rules depend on how a payment may be classified, and characterising income as either active or passive is likely to become more problematic, artificial, and therefore manipulable, in an electronic commerce setting. In short, while electronic commerce may not necessarily create new problems for CFC rules, it is likely to make the application of existing rules more difficult, as well as increasing the ease with which structures that were not contemplated by such rules may be used.

The existence of these concerns suggests that a review of CFC rules is needed, for if it can be shown that these rules are limited in their scope and effectiveness, as well as by developments in electronic commerce, then any system of taxation based on residence could be severely undermined. Of the possible options for reform that will be analysed in this paper, it will be argued that ending deferral of income altogether may best address the expressed concerns and therefore represent the ideal solution to the problems with CFC rules. At the same time, however, and in the face of international competitiveness concerns, as well as political realities, it is recognised that this is an unlikely outcome. Therefore, the paper will proceed to argue that if CFC rules are to remain effective, their scope needs to be extended, both in terms of the number of countries that should consider adopting such rules, and also in terms of extending the operation of these rules to ensure that harmful tax practices that may be carried on by preferential tax regimes are within the scope of the rules. Also, it is argued that for CFC rules to remain effective, they need to be strengthened through the adoption of supporting rules (eg, foreign investment fund ('FIF') regimes). Finally, and perhaps most significantly, it is argued that supplementary measures at the multilateral level are needed. In this regard, two initiatives of the OECD, the 1998 *OECD Report on Harmful Tax Competition*[5] and the 2000 *OECD Towards Global Tax*

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[5] OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998), available at <http://www.oecd.org/daf/fa/harm_tax/harmfultax_eng.pdf>.

Co-operation report[6] both represent initiatives which seem to be the next logical step forward in this area. However, while the work undertaken by the OECD in this area is commendable, it is argued that the scope of this work needs to be broadened to become truly multilateral. There is currently no international tax body that can take this work forward in a truly multilateral way. One possibility might be to establish a World Tax Organisation to assume this responsibility. The role of such an organisation would not be to impose tax or to collect tax; rather such an organisation could represent a forum where emerging problems, such as electronic commerce and harmful tax competition, can be discussed in a coordinated and inclusive multilateral way that would extend beyond just OECD countries. This proposal therefore represents an important adjunct and continuation of the proposals to be put forward in this paper.

The structure of this paper is as follows. The next part of the paper will briefly examine the problem of deferral, as well as the impact of tax havens and preferential tax regimes, as this provides an important background to the need for CFC rules. Following this analysis, the specific limitations of CFC rules will be considered and finally alternatives to overcome these problems will be analysed before conclusions are drawn.

2. DEFERRAL, TAX HAVENS AND CFC RULES

2.1 The Problem of Deferral

The problem of deferral, which CFC rules are designed to overcome, is well-known. However, a brief mention of the problem is nevertheless warranted. As Arnold observes, most countries

[6] OECD, *Towards Global Tax Co-operation: Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs* (2000), available at <http://www.oecd.org/daf/fa/harm_tax/Report_En.pdf>.

impose their income tax on two jurisdictional bases – the taxpayer's personal connections to a country (the residence basis of taxation) and the geographical source of income (the source basis of taxation).[7] CFC rules are concerned with the jurisdiction to tax residents rather than the jurisdiction to tax income arising from sources within a country. Most countries that have an income tax seek to tax their residents on their worldwide income – that is, residents are taxed on their domestic and foreign income. However, the country in which such income is sourced also normally seeks to tax such income and this therefore raises the prospect of double taxation, which is usually relieved by the residence country providing a credit for foreign taxes on the foreign source income.[8]

While the taxation of residents of a country on their worldwide income with a credit for foreign taxes on foreign source income is often referred to as the 'international norm',[9] it is strictly only applicable to foreign source income that is earned *directly* by residents.[10] This norm does not apply to income that is earned *indirectly* by a resident company through a foreign subsidiary, for two reasons.[11] First, a foreign subsidiary is a separate taxable entity, and secondly, such a subsidiary would normally be regarded as a non-resident in the country where its controlling shareholders are resident. The effect of these two factors is that a residence country

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[7] See Arnold, above n 2, 17:1.

[8] See, eg, Article 23B of the OECD MC, which provides for the credit method of relief from double taxation. Some countries adopt the exemption method, where foreign-source income is exempt from residence-country taxation: see, eg, Article 23A of the OECD MC.

[9] See Arnold, above n 2, 17:2 (observing that 'what is often described as the international norm for the taxation of foreign source income–namely, the taxation of residents on their worldwide income with a credit for foreign taxes on foreign source income–does not apply to income earned indirectly through a foreign corporation.'). What follows on this point relies on this source.

[10] Such as dividends, interest, rent and royalties received by a resident.

[11] See Arnold, above n 2, 17:2 (also observing that most foreign source business income is earned indirectly by resident corporations through foreign subsidiaries, rather than branch structures, which are prevalent only in the financial and resource industries).

will be unable to tax the foreign source income that is earned by the subsidiary until the resident shareholders of the foreign company receive dividends or sell their shares in the foreign company. In this way, residence-country taxation on income earned indirectly through a foreign subsidiary may be deferred or postponed, which could be very beneficial from a tax viewpoint, especially if such income is sourced in a tax haven or low-tax jurisdiction.[12]

2.2 The Use of Tax Havens and Preferential Tax Regimes

In its 1998 report on harmful tax competition, the OECD observed that the use of tax havens was large, and expanding at an exponential rate.[13] This is supported by many others, including Arnold, who has recently observed that '[t]he increasing use of tax havens is one of the most important phenomena of the last half-century.[14] Tanzi and Zee also agree with these views, offering the following reasons for this growth:

> With the dismantling of trade barriers and exchange controls on the one hand and innovations in communication on the other, massive cross-country capital flows, in the form of both foreign direct investment (FDI) and portfolio investment (PI) - but especially the latter, can be brought about by investors with relative ease today in response to perceived differences in after-tax rates of return, where such differences could stem from any number of factors such as expected exchange and/or interest rate movements, and tax arbitrage considerations.[15]

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[12] It is beyond the scope of the paper to examine the benefits of deferral in detail, except to say that the tax benefits depend on firstly the time value of money, which is a function of the period that the residence-country tax is deferred, and secondly, the differential of tax rates between the residence country and foreign country where a subsidiary earns its income. For a detailed discussion of deferral, see Brian J Arnold, 'The Taxation of Controlled Foreign Corporations: An International Comparison' (Canadian Tax Paper No 78, Canadian Tax Foundation, 1986).
[13] See OECD, above n 5, 17.
[14] See Arnold, above n 2, 17:4.
[15] Vito Tanzi and Howell H Zee, 'Taxation in a Borderless World: The Role of Information Exchange' in Kluwer (ed), *International Studies in Taxation Law and*

Despite these qualitative observations, since tax havens and preferential tax regimes are non-transparent in many of their operations, it is difficult to accurately quantify the extent to which tax havens and low-tax jurisdictions are being used by taxpayers to avoid their tax obligations. Also, as such taxpayers obviously do not volunteer the extent of their non-compliance with domestic laws it becomes difficult to obtain more than anecdotal information with respect to such activities. Nevertheless, the anecdotal information reveals that the extent of such activity, and therefore the potential for evasion, is significant.[16] Similar anecdotal evidence can be found in relation to the possibilities of locating electronic commerce activities off-shore.[17]

Apart from the difficulties associated with trying to quantify the extent of activities with tax havens, there is no generally accepted definition of what a tax haven is, though the OECD has attempted to lay down key factors in identifying tax havens in its 1998 report on harmful tax practices,[18] and on the basis of these factors subsequently tentatively identified 35 countries as possible tax havens for the

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Economics (1999) 321. Other factors could include the adoption of flexible commercial regimes by tax havens, the strict bank secrecy and confidentiality requirements in tax havens and the aggressive marketing of tax havens: see Arnold, above n 2, 17:4.

[16] For example, the US Treasury Secretary, Paul O'Neill, in a statement before a Senate Committee investigation on 18 July 2001, noted that such activity could be 'significant'. He related the case involving a bank in the Cayman Islands run by John Mathewson (which held over $150 million in its accounts in which over 95 percent of the depositors in this bank were US citizens) to highlight the opportunities available to US taxpayers to evade their US tax obligations through the use of offshore bank accounts. The statement referred to is available at <http://www.treasury.gov/press/releases/po486.htm>.

[17] See, eg, *The Wall Street Journal*, which recently reported on the growing boom of dot-com companies in Bermuda, as companies set up shop in low-tax jurisdictions to enjoy tax advantages over their competitors: see 'Dot-Coms Go Offshore', available at <http://interactive.wsj.com/articles/SB978914055626662536.htm>.

[18] These factors include the imposition of no or nominal taxation; the lack of effective exchange of information mechanisms; lack of transparency; and the absence of a requirement for activities to be substantial: see OECD, above n 5, 23.

purposes of their harmful tax competition study.[19] However, this figure must be regarded as being a conservative one, as the 1998 OECD study only focused on 'geographically mobile activities, such as financial and other service activities, including the provision of intangibles,'[20] and not 'the tax treatment of interest on cross-border saving instruments, particularly bank deposits', which represents a large portion of tax haven business.[21]

Finally, a related and equally important development is the emergence of so-called preferential tax regimes, which may be offered by high-tax countries, to compete with low-tax countries and tax havens. Countries that operate such regimes normally offer tax incentives, including holding company regimes, which may be offered by a country to attract holding companies to a particular jurisdiction by offering exemptions, as well as administrative flexibility and other related incentives. For example, many developed countries (eg, Belgium, Netherlands) offer special tax regimes for holding companies in order to attract the headquarters of multinationals.[22] According to the 1998 OECD study, these regimes are normally differentiated from tax havens as such regimes are 'ring-fenced', meaning that such incentives are insulated from the domestic markets of the country providing the regime.[23]

Somewhat paradoxically, many countries that offer preferential tax regimes have adopted CFC rules. However, while this may seem contradictory, it may reflect a desire on the part of these countries to protect their tax base, while simultaneously competing for the tax base of other countries. The adoption of CFC rules by these regimes may also be claimed as defensive measures by countries in

[19] See OECD, above n 6, 17.
[20] See OECD, above n 5, 8.
[21] Ibid 10. See also the example in n 16 above and Arnold, above n 2, 17:23 (observing that private savings is a huge area of tax haven business).
[22] See OECD, above n 6, 12 (listing preferential taxation regimes under various headings including headquarters regimes).
[23] Ibid, 27. The OECD study identified 47 countries that qualify as potential harmful tax regimes in accordance with its criteria.

responding to other countries that offer similar regimes, but the OECD fears that such tax competition not only by tax havens, but also between preferential tax regimes, may ultimately lead to a 'race to the bottom' and an erosion of the worldwide tax base.[24] These fears have led the OECD to embark on its studies directed at dealing with what has been termed 'harmful tax competition', initially by identifying tax havens and potentially harmful tax regimes.[25]

2.3 Controlled Foreign Company ('CFC') Rules

The existence of CFC rules is designed to deal with the problem of deferral of income, and at a fundamental level, represents unilateral measures which may be used by countries who seek to tax their residents on their worldwide income. In broad terms, such rules are directed at the prevention of deferral of residence-country taxation of foreign companies that are controlled by residents. As discussed earlier, without such rules, deferral would be possible because such companies are separate taxable, non-resident entities.

Deferral is generally eliminated under CFC rules in relation to the 'tainted' income of certain companies by taxing such income to its resident shareholders when earned by the foreign company, not when distributed to its shareholders. In general terms, tainted income invariably includes passive, investment-type income, and sometimes also foreign base company sales income, but usually excludes active business income.[26] This is consistent with the policy of CFC rules, which is to prevent the deflection by residents of domestic income to CFCs, especially those CFCs resident in tax havens, and to prevent the accumulation of tainted income in such CFCs (ie, deferral). At

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[24] Ibid 20.

[25] See generally, OECD, above n 5; OECD above n 6. A detailed discussion of harmful tax competition is beyond the scope of this paper.

[26] No country, apart from New Zealand and Sweden, includes all business income (ie, active and passive) in tainted income: see Arnold, above n 2, 17:12. See also, OECD, *Studies in Taxation of Foreign Source Income: Controlled Foreign Company Legislation* (1996) ('OECD CFC Study') 25.

the same time, the policy of most CFC rules is not to create an obstacle for residents wishing to engage in legitimate offshore business activities carried on through foreign companies. This policy objective is usually achieved through the exemption for active business income, which is a feature of most CFC regimes.

3. EFFECTIVENESS OF CFC RULES

This part of the paper argues that the scope and effectiveness of CFC rules is limited, thereby suggesting that a review of CFC rules is needed. These limitations will be considered under two broad headings: underlying design feature limitations and challenges created by electronic commerce.

3.1 Underlying Design Feature Limitations

The first notable limitation relating to CFC rules is that they are unilateral measures that have only been adopted by some 22 countries (as of January 2000), since being first introduced by the United States in 1962.[27] This means that it has taken over 38 years for only 22 countries to adopt these rules and it must be remembered that there are still many countries, including many capital-exporting countries that have not adopted CFC rules.

Of the 22 countries that have adopted CFC rules, the large majority represent OECD countries, which are also major capital-exporting countries. Also of interest is the breakdown in numbers of countries that have adopted CFC rules over time – of the 22 countries mentioned above, only 1 country (the United States) adopted these rules between 1960 and 1969; only 4 more countries adopted CFC

[27] These countries include (in chronological order based on the year in which CFC rules were adopted): United States (1962); Canada and Germany (1972); Indonesia and Japan (1978); France (1980); United Kingdom (1984); New Zealand (1988); Australia and Sweden (1990); Norway (1992); Denmark, Finland, Portugal and Spain (1995); Hungary, Mexico, South Africa and South Korea (1997); Israel (proposed) and Italy (1999); and Estonia (2000). See Arnold, above n 2, 17:23-17:24; OECD CFC Study, above n 26.

rules between 1970 and 1979; and only another 3 countries added CFC rules between 1980 and 1989; while a staggering 13 countries added CFC rules between 1990 and 1999; and Estonia added its CFC rules in 2000. One interpretation of these figures is that the dramatic increase in adoption of CFC rules in the 1990s may indicate that countries believed that such rules were needed and represented a reasonably effective defensive measures to protect their tax bases at a time where access to, and use of, tax havens and preferential tax regimes, was also growing. At the same time, the increased use of tax havens during this period could have been attributable as much to personal tax planning as it might have been to business income.[28] Also, growth in the number of tax havens and preferential tax regimes may not necessarily indicate a failure on the part of CFC rules. Nevertheless, when taken together with the unilateral nature of such rules and the differences that exist between different CFC rules, it is contended that the statistical information does not support a conclusion that the rules have been particularly effective.

Moving to the underlying design feature limitations of CFC rules, the first such limitation is that the rules normally only apply to ‘companies’. This represents an important limitation of CFC rules and while countries that have introduced such rules normally have similar and separate rules in relation to non-resident trusts, existing CFC rules are not well-equipped to deal with foreign controlled branches (as opposed to subsidiaries), partnerships, or emerging hybrid entities that can be specifically used to overcome the operation of CFC rules.[29] Therefore, the first design feature limitation of CFC rules is an entity restriction, as the rules only extend to foreign-controlled companies.

The next limitation is that even if a foreign company is found to exist, CFC rules only apply where that foreign company is

[28] See, eg, Arnold, above n 2, 17:23 (n 8) (observing that private savings represent a substantial area of tax haven business).
[29] Hybrid entities will be discussed in more detail when the challenges that electronic commerce presents to CFC rules are discussed later in the paper.

'controlled' by residents. Control may be defined in many ways under CFC rules,[30] and while some countries (such as France) employ a substantial interest test to determine control, the basic policy reason for a control requirement is to try to achieve equity or fairness by excluding minority shareholders with small interests in foreign companies from the scope of the rules. While this may also desirable from a tax administration point of view, it constitutes a limitation of the rules, since deferral is not eliminated for all resident shareholders of all foreign companies in which they hold shares. It also leads to inevitable tax planning opportunities as resident shareholders rearrange their activities or fragment their ownership interests in foreign companies to avoid a conclusion that a foreign company is 'controlled' in a requisite sense.[31] An example of a common situation where control may not be satisfied is where shares in foreign mutual funds are widely owned – in this case, such funds may not be sufficiently controlled by resident shareholders so as to trigger the operation of CFC rules.

Even if a foreign company is controlled by resident shareholders, a further limitation of the rules is that most countries only apply their CFC rules if those shareholders own a significant interest (typically 10 per cent or more) of the shares of the foreign company. This requirement is sensible from a tax administration perspective, as it reduces compliance costs and administrative burdens associated with the rules. It is also a pragmatic limitation, as it recognises that minority shareholders may not have sufficient control over a foreign

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[30] For example, some countries use a *de jure* (or strict) control test under which residents must own more than 50 percent of the voting shares of the foreign corporation. Other countries use a 'votes-or-value test' under which residents are treated as controlling a foreign corporation if they own more than 50 percent of the voting shares or if they own shares representing more than 50 percent of the value of all shares of the corporation. Some countries (eg, Australia) supplement the *de jure* control test with a *de facto* control test under which ownership of less than 50 percent of the voting shares may actually represent control. See Arnold, above n 2, 17:24 (n 14).

[31] Although rules that aggregate the ownership of shares by related persons can work against such planning possibilities.

company that justifies them being taxed currently under CFC rules. For example, minority shareholders may not be able to secure the requisite information to accurately calculate their share of a CFC's income and the imposition of CFC rules in these situations could therefore be unfair.

At the same time, such a rule also constitutes a further design feature limitation of CFC rules, as it creates tax planning opportunities for resident shareholders to arrange their affairs so as to avoid threshold ownership requirements of CFC rules. Again, using the example of foreign mutual funds, if such funds are widely owned by resident shareholders that hold less than a significant interest in the foreign funds, then CFC rules may not be applicable. To counter these practices, Arnold notes that many countries have found it necessary to complement their CFC regimes by adopting foreign investment fund ('FIF') rules to support their CFC rules in situations where the CFC rules may not apply.[32] However, even this course of action may not be effective. For example, the OECD has recently observed that the adoption of FIF rules is not widespread among its Member countries, and the underlying policy of these rules for countries that have adopted such supplementary measures is not consistent – some have adopted them to supplement CFC rules, while others have used them in a wider context to eliminate the benefit of deferral for nearly all passive investments in foreign entities.[33]

Another limitation of CFC rules arises because of the so-called 'designated jurisdiction approach'. Most countries apply their CFC rules only to CFCs that are resident in designated jurisdictions, which are typically tax havens and other low-tax countries.[34] This is

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[32] See Arnold, above n 2, 17:8.
[33] See OECD, above n 5, 42.
[34] The exceptions are Canada and United States – in both of these regimes, the residence of a CFC is irrelevant for the purpose of the CFC rules. For further details regarding the application of the rules in the cases of Canada and the United States, see Arnold, above n 2, 17:9. See also, OECD CFC Study, above n 26, 21 and 23.

commonly referred to as the 'designated jurisdiction approach' and under such an approach, both the type of income earned by a CFC and the country in which it is located will be relevant factors in the application of CFC rules. While a detailed analysis of the designated jurisdiction approach is well beyond the scope of the paper, in broad terms, a CFC that is resident in a high-tax country is not normally be subject to the rules, even in relation to tainted income. However, if a CFC is resident in a tax haven or low-tax country, then its tainted income is usually subject to the CFC rules.

Countries that utilise the designated jurisdiction approach in applying their CFC rules normally have constructed lists of tax havens and other low-tax regimes and this also constitutes a limitation of CFC rules for countries that approach this approach. This is because there is a wide variation and little uniformity in the types of lists used by countries for their CFC rules:

> A list may be legislative or administrative; it may be binding or just presumptive. It may include tax havens (bad countries) or countries that are not considered to be tax havens (good countries).[35]

Apart from the wide variation in the types and uses of lists under the designated jurisdiction approach, there are many other problems with this approach. As Arnold notes:

> First, the criteria for designating countries either as tax havens or non-tax havens are not usually articulated beyond the obvious factor of tax rates. Second, countries have encountered political difficulties in listing some countries as tax havens. Third, the lists require periodic updating. Obviously, the more comprehensive a list, the greater the burden on the tax authorities to keep it current. Fourth, there are technical problems with respect to the test to connect a CFC

[35] See Arnold, above n 2, 17:10 (also observing that Australia and New Zealand have adopted the approach of designating non-tax haven countries in their lists and have a short list of seven non-tax-haven countries on their lists; CFCs established in any other countries are therefore subject to their CFC rules).

with a particular country and with CFCs established in high-tax countries carrying on branch operations in tax havens.[36]

The final design feature limitation of CFC rules arises because of the types of income to which CFC rules typically apply. With the exception of New Zealand and Sweden, which include all income derived by a CFC as tainted income, all other countries that have CFC rules broadly include only passive income, and (sometimes) foreign base company sales income as tainted income, leaving active income earned by the CFC outside the scope of CFC rules.

The underlying policy of the distinctions between active and passive income for CFC purposes is generally to try to ensure that such rules should not interfere with the ability of residents who engage in active business activities offshore. Therefore, in a broader context, the current treatment of active income under CFC rules can be reconciled with capital import neutrality (or international competitiveness considerations), while the current tax treatment of passive income can be reconciled with the principle of capital export neutrality.[37]

However, while the policy basis underlying these distinctions may be well-founded, inevitably planning opportunities and characterisation problems are likely to arise where different treatment is accorded to different categories of income, though this is not an issue necessarily unique to CFC rules. Also, many difficult issues in determining and calculating tainted income arise under CFC rules. An example of where such problems may be encountered arises because of the active income exemption that is a feature of most CFC rules. Tillinghast notes in this regard that an active business for the purpose of CFC rules is usually defined by referring to whether a CFC has 'produced' property, such that if it has, there is no current taxation, while the opposite holds if no production has

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[36] Ibid.

[37] This point will be elaborated later in the paper, when a proposal for reforming current CFC rules by eliminating deferral is analysed.

taken place.[38] This distinction may be clear enough in most cases, but is likely to become more problematic in cases of intangible content, including the sale of digitised information and computer software. In such cases, an ambiguity that may arise is what the relevant 'production' activity should be – is it the creation of the copy of the software or other digitised information that is delivered to a customer, or is it the creation of the program or other information? If it is the former, then this could be automated by a server that is located in a tax haven as no employees or other personnel may be needed to generate such copies. However, this would seem to be inconsistent with the active income exemption, and may lead to cases of abuse. A better analysis may therefore be to require that a foreign corporation must actually generate or produce the original computer program or other digitised information, rather than merely attend to the ministerial task of duplicating and distributing the program or information, which can be automated.

3.2 Challenges Created by Electronic Commerce

As mentioned earlier, it is feared that electronic commerce may allow for many electronic commerce transactions to escape residence-taxation as highly mobile electronic commerce businesses shift their operations to tax havens. Professor Doernberg, in a paper in 1998, refers to this as a potential problem of 'non-taxation' in the area of electronic commerce, which may arise if neither residence nor source countries are able to tax income produced directly or indirectly (eg, through a CFC) by a resident company.[39] According to Doernberg, the problem of non-taxation in the area of electronic commerce is primarily a function of two factors: 'the ease of moving productive assets used in electronic commerce compared with the relative burden of moving productive assets used in traditional

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[38] David R Tillinghast, 'Taxation of Electronic Commerce: Federal Income Tax Issues in the Establishment of a Software Operation in a Tax Haven' (1999) *Florida Tax Review* 341, 377. What follows on this point is adapted from this source.

[39] Richard L Doernberg, 'Electronic Commerce and International Tax Sharing' (1998) 16 *Tax Notes International* 1013.

commerce; and the presence of tax havens.'[40] Indeed, electronic commerce may increase the opportunities for companies to incorporate and do business from low-tax jurisdictions. At the same time, if a residence country has adopted CFC rules, then theoretically these rules should be able to overcome the fears of non-taxation of electronic commerce transactions. Implicit in this assertion, however, is the presumption that CFC rules can operate effectively in an electronic commerce environment. However, for reasons that follow, it is argued that such rules are not likely to be effective in an electronic commerce environment, thereby suggesting that these rules need to be reviewed.

While the onset of electronic commerce does not necessarily create new problems for CFC rules, it could make the application of existing rules more difficult. The effective application and enforcement of CFC rules depends on the ability of tax authorities to locate activities and gather information regarding the income of foreign companies. Even in a traditional context this task is difficult because of traditional barriers to international cooperation, including strict secrecy laws adopted by many tax havens, which can create significant administration and enforcement problems for residence countries. Electronic commerce can only be expected to exacerbate these problems and to that extent is likely to make the tax administrative concerns more problematic. These concerns have been well-expressed by the US Treasury:

> If CFCs can engage in extensive commerce in information and services through Web sites or computer networks located in a tax haven, it may become increasingly difficult to enforce Subpart F … because it may be difficult to verify the identity of the taxpayer to whom foreign base company sales income accrues and the amount of such income.[41]

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[40] Ibid.

[41] United States, Department of the Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce* (22 November 1996), available at <http://www.ustreas.gov/taxpolicy/internet.html> ('US Treasury Report') [7.3.5].

Apart from exacerbating tax administration concerns, electronic commerce could also affect the ease with which structures that are not contemplated by CFC rules can be used. One such technique is to exploit the corporate focus of CFC rules through the use of a hybrid entity, which may be defined as an entity that is classified differently for domestic tax purposes than it is classified for foreign tax purposes.[42] CFC rules are generally premised on the assumption that for commercial reasons, including limited liability, business will be carried on in the corporate form. This assumption may not be valid in light of the growing use of hybrid entities, where for example, an entity may be taxed as a company in a foreign jurisdiction, but may be regarded as a partnership or simply disregarded for domestic tax purposes. Such arrangements could therefore pose a threat to the way current CFC rules are structured as they can enable the circumvention of crucial provisions of these rules.

The location of the performance and usage of services are both relevant factors in the application of most current CFC rules. Electronic commerce may create challenges in this area also as it could create difficulties in locating where services are performed or used. Also, new services may be created in an electronic commerce environment. For example, the US Treasury notes that electronic commerce may make possible new services 'such as Internet access, and make easier the remote provision of other services, such as remote database access, videoconferencing and remote order processing.'[43] In relation to these services, it may become difficult to ascertain where they were performed, and in the case of digitised

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[42] For detailed information relating to hybrid entitles, see US Treasury, Office of Tax Policy, *The Deferral of Income Earned Through US Controlled Foreign Corporations* (2000) ('US CFC Report') 62 (observing that 'an entity taxed as a corporation in a foreign jurisdiction but treated as a partnership or disregarded entity for U.S. tax purposes is referred to as a "hybrid." An entity taxed as a partnership or other passthrough in a foreign jurisdiction but treated as a corporation for U.S. tax purposes is referred to as a "reverse hybrid."').

[43] Ibid 76.

products that may be downloaded (eg, computer software), it may be problematic to ascertain where such a product was used.

Also, as electronic commerce provides an increased opportunity for businesses to be incorporated in tax havens or low-tax jurisdictions, it opens up the possibility for products or services to be provided by a CFC, while employees or contractors that may be needed by the CFC can be located outside the jurisdiction where a CFC is resident. When these developments are taken together, they may enable a CFC to earn income that may not be subject to anti-deferral rules. For example, in the case of computer software, a foreign company that was in the business of software manufacturing and development could be incorporated in a tax haven. Specialised services that may be required by the CFC in the development of its software – for example, computer programming or debugging services – could be provided by so-called 'virtual migrants', who could be specialist computer programmers drawn from countries such as India or Russia.[44] In this way, it could be argued that the operations of the CFC constitute active business operations that would normally be outside the scope of most CFC rules.

Finally, electronic commerce may pose challenges to CFC rules to the extent that these rules treat different categories of income in a different way. These problems arise because of the underlying design feature of CFC rules, which depends on the making of distinctions between active and passive income. It was seen earlier that CFC rules normally apply to passive income and in some cases, foreign base company sales income, but generally do not apply to active income. These differences in classification can present problems where, for example, it may be unclear whether a digitised product

[44] See, eg, Allen R Myerson, 'Ideas & Trends: Virtual Migrants: Need Programmers? Surf Abroad' *The New York Times* (New York), 18 January 1998, available at <http://www.nytimes.com/> (noting that technology companies have created a new realm of international trade by exporting their work and hiring programmers overseas to do it).

represents payments for a good, right or service, and also whether the resultant income from acquiring such a product is active income (which may not be subject to CFC rules), or foreign base company sales income (which may be subject to CFC rules).

While such categorisation problems may not be new, they could be exacerbated in an electronic commerce environment. A prominent example in this regard deals with services, particularly in the financial services area. It was noted earlier that the world economy has seen a continued growth in services compared with goods, and CFC rules historically have been designed to deal with manufacturing industries rather than service industries.[45] Passive income such as dividends, rent, interest is easily deflected to low-tax jurisdictions, and accordingly is normally subject to CFC rules. However, an exception is sometimes provided in CFC rules for income that is derived in the active conduct of banking, financing, or similar business.[46] In this area, however, several problems have arisen with the application of CFC rules, and these problems are likely to worsen in an electronic commerce environment for several reasons.

First, the exception for financial services income is designed principally to apply to income that is intended to be passive, but this raises the problem of the active/passive distinction again. Secondly, financial services income is highly mobile, and in an electronic commerce environment it can be moved around from jurisdiction to jurisdiction easily. Finally, entities providing financial services may also be highly mobile and easily located in low-tax jurisdictions, completely unrelated to where the recipients of the services may be based. The result of these problems has led many, including recently the US Treasury, to conclude that 'the financial services rules do not

[45] See, eg, US CFC Report, above n 42, 70 (observing that 'Subpart F was designed principally to deal with manufacturing industries operating in high-tax, developed countries, rather than with service industries.')

[46] For example, in the United States, a financial services exception is covered in section 954(h) of the *Internal Revenue Code*.

sufficiently address the mobility of business enterprises or of income, nor do they adequately distinguish active from passive businesses.'[47] It should also be noted that even if changes were made to deal properly with services within the context of the structure of existing anti-deferral rules, the result would be more complexity, as more rules would be needed and this would add to the compliance and administrative costs associated with such regimes, thereby detracting from implementing such rules.

3.3 Summary

As noted earlier in this paper, the policy of CFC rules is directed at preventing the inappropriate deferral of residence-country tax on the foreign source income of foreign companies that are controlled by residents, as allowing deferral could cause inequities to arise, as well as allowing for tax base erosion. The preceding discussion has shown that despite the valid policy reasons that underlie CFC rules, they may no longer be operating effectively. This is as a result of a combination of problems with the underlying design features of CFC rules, as well as emerging challenges which include electronic commerce. Therefore, though the policies underlying CFC rules may be as important today as they were when the United States first-introduced such a regime in 1962, a combination of limitations with the design features of these rules, along with emerging developments are already challenging the effectiveness of these rules, and these challenges seem likely to increase in the future as electronic commerce develops.

This suggests that a review of the current CFC rules is necessary to analyse how these rules may best accommodate these challenges and this is undertaken in the next part of this paper.

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[47] See US CFC Report, above n 42, 75.

4. REFORMING CFC RULES: A PROPOSAL TO END DEFERRAL

4.1 Introduction

The preceding analysis has suggested that a review of CFC rules is needed to explore alternative ways of overcoming the underlying design limitations of CFC rules, as well as emerging challenges that are created by electronic commerce and related developments.[48] The need for review and possible reform of CFC rules is generally well accepted;[49] however, the literature relating to possible alternatives is not vast, with the United States being the only major developed country to conduct a substantial review of its anti-deferral rules in recent times. This at least in part probably reflects the fact that the United States was the first to adopt its Subpart F rules in 1962 and now that their rules are entering their fifth decade, they are showing signs of both age and inadequacy. As the United States' review is the only major recent literature in this area of recent times, it is instructive to make a brief reference to it.

The review conducted by the US Treasury was released in December 2000 and is documented in its report, *The Deferral of Income Earned Through US Controlled Foreign Corporations* ('US CFC Report').[50] Professor Avi-Yonah has observed that this report was originally expected to be issued in 1999 in response to a report published that year by the National Foreign Trade Council ('NFTC

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[48] These challenges include the use of hybrid entities that may be structured to avoid the operation of CFC rules.
[49] See, eg, US Treasury Report, above n 41, [7.3.5] ('It may be necessary to revise Subpart F or the regulations thereunder to take these new types of transactions into account.').
[50] See generally US CFC Report, above n 42. See also Reuven S Avi-Yonah, 'The US Treasury's Subpart F Report: *Plus Ça Change, Plus C'est la Même Chose*?' (2001) *International Bureau of Fiscal Documentation* 185.

Report')[51] which advocated significant changes to the Subpart F rules.[52]

The US CFC Report is a comprehensive document being over 200 pages long, and examines the historical background, challenges and possible reforms which may be necessary for the US Subpart F rules. The report considers three main alternative approaches to reforming the current Subpart F rules.[53] The first approach that is considered is to currently tax all income of a CFC. As this is the policy approach this will be advanced by the paper, a detailed analysis of it is deferred to the next part of the paper.

A second approach that the report considers is to currently tax all income of a CFC, but with active income being taxed at a lower rate.[54] The US Treasury claims that such an approach would have efficiency, equity and simplification advantages; however, these stated advantages need to be questioned. Apart from difficulties in determining what an appropriate rate would be to tax active income at, it is difficult to see how such an alternative promotes simplicity. This is because with a lower rate being applicable to active income, it is inevitable that tax planning could occur by taxpayers seeking to take advantage of the lower rate that would be applicable to such income. To overcome these possibilities, new rules would be needed to ensure that the integrity of the rules can be maintained and this

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[51] National Foreign Trade Council, *The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part I: A Reconsideration of Subpart F* (25 March 1999) ('NFTC Report'). For a review of this report, see Reuven S Avi-Yonah, 'Tax Competition and Multinational Competitiveness: The New Balance of Subpart F' (1999) 18 *Tax Notes International* 1575.

[52] See Avi-Yonah, above n 50, 185 (also observing that given the US CFC Report was delayed until the end of the Clinton Administration, it is likely to only have had (at best) persuasive force for the Bush Administration and Congress).

[53] Other approaches are also considered in this report but are beyond the scope of the paper. Three main alternative approaches are considered in the following report: see US CFC Report, above n 42, 82. What follows on this point is adapted from this source.

[54] Professor Avi-Yonah notes that similar proposals have been developed by others, including Stuart Leblang: see Avi-Yonah, above n 50, 187 (n 32).

would inevitably add a layer of complexity (not simplicity) to such an alternative.

The final approach considered in the report is a minimum effective tax rate option, under which CFCs would be taxed to the extent that their effective tax rate fell below a certain minimum percentage. This approach would require existing CFC rules to be revised and new rules to be added for the purpose of calculating a CFC's effective rate. Overall, therefore, this option would also seem to add to the complexity of the CFC rules and would accordingly not seem to be a viable alternative.

In summary, while the US CFC Report is commendable, it does not significantly advance the situation as no preferred model is put forward to overcome the identified problems and the report does not therefore endorse any changes to the existing anti-deferral rules.[55] This paper seeks to advance the debate in this area by proposing that the ideal option for reform may be to end deferral an currently tax all CFC income, and the reasons for this assertion are examined in the next part of this paper.

4.2 Ending Deferral

Of the possible alternative approaches that may be considered to reform CFC rules, this paper argues that ending deferral probably represents the ideal approach to confront the challenges that are presented by the design feature limitations and emerging challenges to these rules. In the context of present rules, this could be achieved in a number of ways, including extending existing CFC rules to

[55] Nonetheless, it does promote principles that should guide reforms in this area. These include the following: (1) Domestic and foreign income of US taxpayers should be evenly taxed, (2) Passive foreign income should remain currently taxable, (3) Rules that distinguish between income earned through corporate versus non-corporate entities should be avoided, and (4) Having regard to the increased mobility of business, future rules should not be based on the location of business activities: see US CFC Report, above n 42, 95.

cover all income (active or passive), or by treating CFCs as either branches or as domestic companies, thereby being able to currently tax all income of such companies. In a broader context, if the individual residence approach that has been advocated elsewhere in this paper is fully implemented, then deferral could be ended altogether (along with the need for CFC rules).[56]

Repealing deferral is a proposal that is likely to be confronted by much opposition, both political and ideological, but in many ways such a proposal does not represent anything really new. Indeed, when the first CFC regime was proposed by the United States, the Kennedy Administration in 1961, and several commentators since then, have all considered, and at various times proposed, to currently tax all income of a CFC.[57] However, despite the relative merits of these proposals, they have generally only been noted by most countries but not seriously considered.[58] It is argued that in the face of the identified problems and emerging challenges that are likely to confront CFC rules, the time to seriously re-consider this approach may have arrived for the reasons which follow.

It was seen earlier that under most countries' CFC rules, passive income is subject to the operation of CFC rules, while active income is usually exempt from the operation of these rules.[59] While there is a significant variation in the way active income may be defined under CFC rules, the basis policy is that passive income is easily diverted to tax havens and low-tax countries and accordingly should be

[56] This point is not developed further in this paper as it has been exhaustively treated in the paper that proposed the individual residence approach. The ensuing discussion therefore analyses other relevant aspects of implementing a proposal to end deferral.
[57] See, eg, Robert J Peroni, Clifton Fleming and Stephen Shay, 'Getting Serious about Curtailing Deferral of US Tax on Foreign Source Income', and Reuven S Avi-Yonah, 'Commentary', both in (1999) 52 *Southern Methodist University Law Review* 455, 531 respectively.
[58] Sweden and New Zealand being the exceptions, as all income of a CFC, whether passive or active, is attributed to shareholders under their respective CFC rules. See, eg, OECD CFC Study, above n 26, 25.
[59] The exceptions are New Zealand and Sweden - see above n 58.

subject to the rules, while at the same time, active income conducted from legitimate offshore business operations should be shielded from the rules. However, over time, the distinction between active and passive income has become more difficult to make, and electronic commerce can only be expected to exacerbate the situation, as it will allow for income recharacterisation to occur more easily.

Apart from the passive/active distinction becoming more difficult, the underlying design features of CFC rules which rely on a labyrinth of rules to determine whether income is tainted, makes compliance with the rules difficult and it also adds to the cost of administering and enforcing such regimes. These costs can only be expected to increase in the future, with electronic transmissions presenting further problems in identifying, locating and computing tainted income for the purposes of CFC rules.

Also, the current CFC rules encourage elaborate planning techniques to avoid the control tests of these rules, and the increased use of hybrid entities and branch structures are indicative of the continuing problems in this area, which are likely to become more complex, yet more accessible, under electronic commerce conditions. Electronic commerce exacerbates existing concerns and possibly creates new ones, but in addition, it was observed earlier that the increasing presence of services in the world economy is likely to place further pressure on the ability of current CFC rules to operate consistently with their underlying policy objectives.

If deferral was to be eliminated completely, it may provide for a considerable simplification of existing CFC rules compared to the present situation. For example, the need to distinguish between different types of foreign income (active/passive) would be dispensed with. There would also be simplification advantages for transfer pricing rules if consolidation of foreign operations were part of proposals to end deferral, as intra-group transactions could simply be ignored.

Ending deferral could also be seen as being consistent with neutrality as it could have the effect of eliminating tax considerations from decisions regarding the location of investments. Also, equity among domestic taxpayers may be promoted by providing no tax advantage for domestic businesses that operate through an incorporated foreign presence. Taken together, these factors could have the effect of promoting economic efficiency and welfare in the economy.

In a broader context, while most current CFC rules maintain a distinction between active/passive income, they take into account both capital export neutrality and capital import neutrality considerations.[60] This is because taxing passive income that is earned through a CFC currently is consistent with capital export neutrality, while excluding foreign active income that is earned through a CFC is consistent with capital import neutrality. A proposal to end deferral for both active and passive income could arguably be reconciled with capital export neutrality; however, the countervailing principle of capital import neutrality would suggest that the active income exemption should be retained. Therefore, a proposal to end deferral raises the issue of whether capital export neutrality should be preferred over capital import neutrality and this will be presently analysed.

4.2.1. Capital Export Neutrality

In analysing the relative merits of capital export neutrality versus capital import neutrality, the literature generally shows a preference

[60] According to Musgrave, 'export neutrality means that the investor should pay the same total (domestic plus foreign) tax, whether he receives a given investment income from foreign or from domestic sources … Import neutrality means that capital funds originating in various countries should compete at equal terms in the capital market of any country.': see Klaus Vogel, 'Worldwide vs Source Taxation of Income - A Review and Re-evaluation of Arguments (Part II)' (1988) 10 *Intertax* 310, 311 (citing Richard Musgrave, 'Criteria for Foreign Tax Credit' in *Taxation and Operations Abroad, Symposium* (1960) 84-85).

for capital export neutrality. For example, McLure argues that capital-export neutrality is necessary to achieve an efficient allocation of the world's investments, while capital-import neutrality, which is necessary for an efficient allocation of savings, is considered to be a less significant goal. [61] Professor Vogel argues similarly, referring to the following observations of Professor Musgrave in arguing for a priority of export over import neutrality:

> [I]t is generally correct as well to conceive of a tax neutrality with respect to all investors of one country, so that tax considerations will not influence their decisions to invest at home or abroad. Such capital-export neutrality will ensure that each national supply of capital available at that tax level will be allocated internationally in its most efficient manner.[62]

Finally, the US Treasury has also recently argued that whether global welfare or national welfare is seen as the goal, capital export neutrality remains the best policy option:

> [A] careful review of the literature reveals that capital export neutrality is probably the best policy when the goal is to provide the greatest global economic output … Similarly, with respect to national welfare, a careful review of the literature provides no convincing basis for rejecting the conclusions of the basis economic analysis that a country should tax income from outward foreign

[61] See Charles McLure Jr, 'Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm' (1992) 45 *National Tax Journal* 145, 146-7, 153 (n 13).

[62] Vogel, above n 60, 311. Vogel also refers to other commentators who have supported this view, including Richard Musgrave and Bernard Snoy, with Snoy stating that: 'in a world where capital markets are perfect and where the financing of corporate investment projects is not subjected to internal funds constraint, tax neutrality towards capital import is clearly not a prerequisite for efficient allocation of resources.': Ibid (citing Bernard Snoy, *Taxes on Direct Investment Income in the EEC, A Legal and Economic Analysis* (1975) 37); Ibid (noting that further support for capital export neutrality can be found in Sato and Bird, 'International aspects of the Taxation of Corporations and Shareholders' (1975) 22 *IMF Staff Papers* 408 ('only capital-export neutrality accords with the objective of world efficiency')).

investment at a rate that is at least as high as the tax rate imposed on income from domestic investment.[63]

If this preference is maintained, then it is arguable capital export neutrality is best achieved by ending deferral completely rather than restricting deferral to only passive income. Interestingly, when the US CFC rules were first proposed, the Kennedy administration proposal to end deferral completely for US-CFCs was primarily driven by capital export neutrality considerations. However, Congress ultimately rejected this proposal in enacting the Subpart F provisions of the *Internal Revenue Code* adding that 'attempting to force a strained interpretation of the legislation [Congress] did enact into an endorsement of capital export neutrality … flagrantly disregards the historical record.'[64]

This view has been challenged, chiefly by the US Treasury, which has argued that its regime was (and still is) compatible with capital export neutrality. However, it must be recognised that CFC rules that permit deferral of active but not passive income, can only be considered to be consistent with capital export neutrality if foreign countries have tax rates that are broadly compatible with domestic rates. That is, if active income is earned through a CFC that is located in a foreign country that has tax rates equal to the domestic country, permitting deferral on active income may not necessarily violate the principle of capital export neutrality. While this may have been the case historically with the enactment of the United States Subpart F rules in 1962,[65] it is contended that there is a wide variety of tax rates between countries today (especially when tax havens and preferential tax regimes are considered), with the result that allowing

[63] See US CFC Report, above n 42, 23.
[64] NFTC Report, above n 51, at 2-20 (as cited in Avi-Yonah, above n 50, 185).
[65] Professor Avi-Yonah notes that in 1962 when the US rules were introduced, 80% of outbound foreign direct investments were made into Canada and European countries, with tax rates that were as high or higher than the United States: see Reuven S Avi-Yonah, 'US Notice 98-11 and the Logic of Subpart F: A Comparative Perspective' (1998) 98 *Tax Notes International* 1797.

deferral of active income that is earned through foreign CFCs cannot be considered to be consistent with capital export neutrality in today's economy.

In summary, the above analysis suggests that if a preference for capital export neutrality is found to exist, then elimination of deferral of income for both passive and active income that is earned through CFCs best accords with this principle.

4.2.2. Capital Import Neutrality

While arguments based on capital export neutrality may support the repeal of deferral, unless such a policy was implemented on an international basis, it could lead to concerns of international competitiveness from domestic companies who may claim to be at a disadvantage compared with their foreign competitors in countries should domestic jurisdictions act unilaterally in eliminating deferral. Indeed, because of these concerns, currently very few countries have completely eliminated deferral, and this can also be reconciled with a desire on the part of residence countries to promote (or at least, not to impede) the international competitiveness of enterprises that operate legitimate business operations in foreign jurisdictions.

In terms of tax policy principles, the policy adopted by most countries of not interfering with the ability of residents to conduct active business operations offshore (even from tax havens) can be related back to the principle of capital import neutrality. And despite the earlier observations that capital export neutrality is generally preferred to capital import neutrality, it can (and has) been argued that capital export neutrality versus the capital import neutrality debate may be less significant and relevant in a globalising economy,[66] and several economists have therefore questioned the continuing validity of capital export neutrality as a guiding principle

[66] See, eg, Daniel J Frisch, 'The Economics of International Tax Policy: Some Old and New Approaches' (1990) 47 *Tax Notes* 581.

for international tax policy.[67] If this line of reasoning is accepted, then some argument may be made for the retention of the active/passive distinction that underlies most CFC rules and the current taxation of only passive income that is earned through CFCs.

By the same token, however, there is considerable doubt as to the plausibility of the assertion that CFC rules *per se* impede domestic enterprises from competing with their foreign-based counterparts. Retaining deferral of active income rests largely on this assertion and it was the central argument of the NFTC Report, which argued that 'the current structure of subpart F leans far too heavily in the direction of seeking to preserve an illusory neutrality, at the expense of imposing a real competitive disadvantage on US-based companies.'[68] However, contrary to this broad assertion, many, including the US Treasury have successfully retorted that such an argument is unsupported by an quantitative data: 'the available data simply does not provide a reliable basis for evaluating whether subpart F has affected multinational competitiveness to any significant extent.'[69] Professor Avi-Yonah has also observed that the issue of international competitiveness may also depend on which data and measure (eg, rank of company by worldwide sales or rank of company based on market value) is selected to determine competitiveness.[70] Also, competitiveness may be measured by many factors, only a part of that may relate to the tax burden imposed on a business. Taken together, these factors undermine the reliability of concerns regarding international competitiveness as a factor that suggests that deferral should not be completely repealed. Nevertheless, considerations of international competitiveness is

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[67] See, eg, Roseanne Altshuler, 'Recent Developments in the Debate on Deferral' (2000) 87 *Tax Notes International* 255; James Hines, 'The Case against Deferral: A Deferential Reconsideration' (1999) 52 *National Tax Journal* 385; Avi-Yonah, above n 50, 186.
[68] See NFTC Report, above n 51, x.
[69] See US CFC Report, above n 42, 57.
[70] See Avi-Yonah, above n 50, 186.

likely to be an important political consideration that may be raised to defeat suggestions that call for the complete elimination of deferral, as was evident when the Kennedy Administration suggested that deferral should be repealed when the inaugural anti-deferral regime was introduced in the United States in 1962.

4.3 Summary

On balance, and based on the preceding analysis, it is contended that ideally the problems confronting CFC rules are best addressed by ending deferral. The above analysis has argued that such an approach could provide considerable simplification as compared with current CFC rules, as well as promoting neutrality and equity. However, this ideal position needs to be tempered with the political reality that competitiveness concerns associated with ending deferral need to be considered when evaluating the likelihood of adopting such a policy approach. And although the effects of ending deferral on competitiveness are far from clear, the political reality is that unless proposed approaches take account of actual or perceived competitiveness implications, they are unlikely to gain political favour to enable them to be implemented by various countries.

5. CONCLUSION

In conclusion, while this paper has advanced that the ideal policy approach to overcome both the current and future challenges that CFC rules are likely to face is to end deferral, such a proposal may not be feasible in the face of political considerations, as well as international competitiveness concerns. Therefore, consistent with the views of the US Treasury, it is likely that '[a]n anti-deferral regime continues to be needed to prevent significant disparity between the rates of tax on [domestic] and foreign income, thereby promoting efficiency, preserving the tax base and promoting equity.'[71]

[71] See US CFC Report, above n 42, 99.

However, to ensure that these rules remain effective, it is argued that three related enhancements to existing rules are necessary. First, it is argued that the scope of the rules needs to be considerably extended, both in terms of the number of countries that have adopted such rules, and also in terms of ensuring that these rules can effectively apply not to tax havens, but also to preferential tax regimes. In this respect, it was observed that CFC rules are not applied by all countries and even for those countries that have such rules; they do not all cover harmful tax practices which may take place in preferential tax regimes. To implement this proposal, countries that do not have CFC rules could consider adopting them and countries that have CFC rules, could review their rules to ensure they are able to counter harmful tax practices that can occur in preferential tax regimes.

Secondly, existing CFC rules may need to be strengthened by supporting rules, such as FIF regimes, to ensure that the integrity of the underlying design features of CFC rules is not circumvented by planning arrangements designed to avoid the operation of these rules. Therefore, countries that do not have FIF regimes could consider adopting them and those that have these regimes could review them to ensure that they remain effective to counter harmful tax practices. As a further measure to strengthen existing rules, countries that currently relieve double taxation by the exemption method could consider not allowing relief under this method if foreign income has been derived from a preferential tax regime.[72]

Finally, and perhaps most importantly, it is contended that CFC rules need to be supplemented by measures at the multilateral level. Even if the scope of CFC rules is expanded and strengthened by supplementary measures such as FIF rules, CFC rules are inherently limited as they are unilateral measures which may prove to be less effective in the face of an increased use of tax havens and

[72] Such a recommendation has also been endorsed by the OECD in its 1998 report on harmful tax practices: see OECD, above n 5, 43.

preferential tax regimes in the future. In this regard, the initiatives of the OECD on harmful tax competition are logical steps forward, and indeed it could be argued that the renewed vigour with which such proposals are being pursued is indicative of growing concerns that CFC rules are increasingly becoming ineffective to deal with tax havens and preferential tax regimes. At the same time, it is argued that the scope of these initiatives needs to be broadened to become truly multilateral. As noted earlier, one possibility might be to establish a World Tax Organisation. The role of such an organisation would not be to impose tax or to collect tax, but to represent the forum where emerging problems that are caused by developments, such as electronic commerce and harmful tax competition, can be discussed in a coordinated and inclusive multilateral way that would extend beyond just OECD countries. This possibility could form the basis of further research in this area.