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Can the Arm's Length Principle in the OECD Transfer Pricing Guidelines Fulfil the Minimum Requirements of the Transaction Approach in the Controlled Foreign Company Rules under Anti-Tax Avoidance Directive?

by

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Contents

Abbreviation List

ALP	Arm's Length Principle
ATAD	Anti-Tax Avoidance Directive
BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Company
ECJ	European Court of Justice
MNE	Multinational Enterprise
MS	Member State
MTC	Model Tax Convention
OECD	Organisation for Economic Cooperation and Development
PE	Permanent Establishment
SGI	Société de Gestion Industrielle
TP	Transfer Pricing
US	United States

1 Introduction

1.1 Background

Presently, aggressive tax planning carried out by multinational enterprises (MNE) has brought about massive public protests and government concerns.[1] In order to maintain the fair and sustainable international competitive environments for companies, the Organisation for Economic Cooperation and Development (OECD) and the European Union (EU) have issued various documents such as Transfer Pricing (TP) Guidelines[2], Base Erosion and Profit Shifting (BEPS) project[3] and Anti-Tax Avoidance Directive (ATAD)[4], both of which contain Controlled Foreign Company (CFC) rules, to hamper artificial tax avoidance.

Since 1 January 2019, with the newly adopted ATAD in the EU[5], CFC rules have been forced to be implemented into the domestic legislation of every EU Member State (MS). Some Member States[6], including the Netherlands, had been reluctant to include the CFC legislation as a part of their national law due to the fact that it would affect their competitive edge or even hinder them from being favourable jurisdictions for foreign investment.[7] The Dutch State Secretary of Finance is of the opinion that the Netherlands has already applied CFC regulations under the form of the arm's length principle (ALP).[8] The Government of the Netherlands states in its policy letter on tackling tax avoidance and tax evasion that: "I have opted for model A[9]… Under model B the income is determined on the basis of the arm's length principle. This means that non-arm's length

[1] G. Van Hulle, *Current challenges for EU controlled foreign company rules?* 71 Bull. Intl. Taxn. 12 (2017) 719.

[2] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017).

[3] Developed in the context of the OECD/G20 BEPS Project, the 15 actions equip governments with domestic and international instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created. <https://www.oecd.org/tax/beps/beps-actions.htm> (accessed on 28 May 2019).

[4] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14.

[5] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 11-14, article 11.

[6] Listed in alphabetic order: Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Italy, Lithuania, Poland, Portugal, Spain, Sweden and the United Kingdom were the Member States with CFC regimes before ATAD. It is to note that the Netherlands had a CFC-type regime but it does not have a real CFC regime within the technical context as the rest of the EU Member States.

[7] G. Van Hulle, *Current challenges for EU controlled foreign company rules?*, 71 Bull. Intl. Taxn. 12 (2017) 722.

[8] See EY Global Tax Alert: *Netherlands enacts new CFC legislation: Impact on multinational enterprises* (2019). <https://www.ey.com/gl/en/services/tax/international-tax/alert--netherlands-enacts-new-cfc-legislation---impact-on-multinational-enterprises> (accessed on 28 May 2019).

[9] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14, art.7(2)(a).

transactions within a group are adjusted as if they were transactions between independent parties. Because the Netherlands already applies the arm's length principle, further amendment of Dutch legislation is not strictly necessary for the Netherlands to fulfil its obligation for implementation in this regard."[10]

Starting with this official letter that the Dutch Government released, the key point there lies in the CFC income computation of model B which is stipulated in Article 8(2) of ATAD: " Where point (b) of Article 7(2)[11] applies, the income to be included in the tax base of the taxpayer shall be limited to amounts generated through assets and risks which are linked to significant people functions carried out by the controlling company. The attribution of controlled foreign company income shall be calculated in accordance with the arm's length principle."[12] Through the wording, it seems that model B automatically includes the arm's length principle and the arm's length principle functions as the basis and essence of model B. This makes the Dutch Government stated that the adoption and application of the ALP in the Netherlands has already met the requirement of model B – the alleged "transaction approach"[13] – of the CFC rules in ATAD. Therefore, choosing model B to implement CFC measure seems unnecessary.[14] This triggers the question on if the ALP in the Netherlands makes the model B of CFC rules required in ATAD redundant.

Generally, the ALP in TP regulations is widely applied in order to prevent price manipulation which will cause tax avoidance.[15] And CFC regulations have usually been regarded as a "backstop"[16] of TP regulations in terms of combating tax avoidance.[17] While CFC regulations aim at achieving this goal in a divergent way of re-attributing the

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[10] Government of the Netherlands, Policy letter on tackling tax avoidance and tax evasion, Policy Note (27 02 2018) 6. <https://www.government.nl/documents/policy-notes/2018/02/27/policy-letter-on-tackling-tax-avoidance-and-tax-evasion> (accessed on 28 May 2019).

[11] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14, art.7(2)(b), the alleged "transaction approach".

[12] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14, art.8(2).

[13] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14, art.7(2)(b).

[14] Government of the Netherlands, Policy letter on tackling tax avoidance and tax evasion, Policy Note (27 02 2018) 6.

[15] F. Majdowski & K. Bronzewska, *Revolutionary Changes to the Arm's Length Principle under the OECD BEPS Project: Have CFC Rules Become Redundant?* 46 Intertax, Issue 3 (2018) 211.

[16] J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 Emory L.J. (2009) 105; J. Fleming, R. Peroni & S. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework*, 93(3) N.C. L. Rev. (2015) 684; HMRC, *Tackling Aggressive Tax Planning in the Global Economy: UK Priorities for the G20-OECD Project for Countering Base Erosion and Profit Shifting* (2014) Point 3.7.

[17] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft, OECD Publishing (2015) para. 21.

undistributed income back to the parent state.[18] Thus, although CFC regulations are applicable in a narrower scope[19], it cannot be concluded categorically that CFC regulations are needless provided TP regulations are in use.

Hence, the effort of this thesis paper will be devoted to the analysis of the interrelation between the ALP in TP regulations and model B of CFC regulations under ATAD, the fundamental discrepancies substantially rooted in them, and the consequences these disparities will make accordingly when these two regimes are separately applied to deter the profit shifting. The emphasis will also be placed on the tests of the concurrent application of both regimes under different scenarios. The focal point will end in answering the primary question: whether CFC regulations are truly a "backstop" of TP regulations and whether the TP regulations are capable of altering the CFC regulations under ATAD transaction approach as they may lead to the same result?

1.2 Aim

The aims of this thesis are:

First, introduce the ALP and CFC rules respectively, including their functional mechanisms and final purposes, in order to fully understand the rationales behind them.

Second, analyse the interaction and relations between TP regulations and CFC rules in general such as similarities and differences, in order to grasp a rough idea of their fundamental incoherent manners and answer whether CFC regulations are truly a "backstop" of TP regulations.

Third, illustrate specific scenarios under the after-BEPS TP regulations and CFC rules in ATAD, in order to figure out whether the ALP is sufficient to 'alter' CFC regulations as they may lead to the same result.

1.3 Method and Material

To achieve the aim of this thesis, the legal doctrine method[20] will be applied, supplemented by specific examples for illustration. The main objects and research materials are international tax legislation and the EU tax legislation as well as the specific provisions stipulated therein, including Article 9 of the OECD Model Tax Convention on the original provision of the ALP, BEPS Action Plan 8-10 regarding the amended

[18] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14. Preamble para. 12.
[19] P.K. Schmidt, *Taxation of Controlled Foreign Companies in Context of the OECD/G20 Project on Base Erosion and Profit Shifting as well as the EU Proposal for the Anti-Tax Avoidance Directive–An Interim Nordic Assessment*, 2 Nordic Tax J. (2016) 98.
[20] S. Douma, *Legal Research in International and EU Tax Law*, Kluwer Wolters (2014) 18-19.

ALP, the OECD BEPS Action Plan 3 concerning the general characteristics of CFC rules and the interaction between CFC rules and TP rules, and Article 7 and 8 of Anti-Tax Avoidance Directive regarding CFC rules in the EU. Also, ECJ case law, relevant sources of written and unwritten international and EU tax laws, concepts, doctrines, literature, academic materials and government reports will be exploited in this thesis paper.

1.4 Delimitation

The demarcation of this paper is limited within the OECD context and the EU context regarding the legislation on TP regulations, the ALP and CFC regulations.

With regards to the TP regulations, the ALP in UN MTC or other tax treaties will not be included in this paper.

In the context of CFC regulations, only the transactional approach[21] of CFC regulations in ATAD will be further analysed in the examples while the entity approach[22] will be omitted. In addition, only the Netherlands domestic CFC rules will be taken into account owing to fact that the issue originally arose there, whereas other domestic CFC rules of the Member States will fall out of the scope of this paper. The references regarding the US, Australia and Germany in chapter 3 are concerned with the common features CFC rules have.

In addition, the competitiveness concern between fundamental freedoms and CFC regulations brought by *Cadbury Schweppes*[23] and subsequent cases will not be elaborated in this paper, since in these cases, the ECJ justified the applied CFC rules because it "specifically targeted wholly artificial arrangements which do not reflect economic reality and whose only purpose would be to obtain a tax advantage".[24] The transactional approach of CFC rules in ATAD defines the CFC income should accruing to "non-genuine" activities in which no significant people preform functions, which means the activities do not contain economic substance. Hence, the application of transaction approach which will be analysed at details in this paper theoretically will not raise the EU's concern in terms of fundamental freedoms. Therefore, the contradiction between four freedoms and CFC rules will not be covered in this thesis paper.

[21] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14, article 7(2)(b).
[22] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14, article 7(2)(a).
[23] Judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, ECLI:EU:C:2006:544, para. 45.
[24] Judgment of 10 February 2011, Haribo Lakritzen Hans Riegel BetriebsgmbH and Österreichische Salinen AG v. Finanzamt Linz, Joined Cases C-436/08 and C-437/08, ECLI:EU:C:2011:61, para. 165.

1.5 Outline

This thesis has been divided into five sections to analyse the topic. Chapter 2 will focus on what is the arm's length principle about in the OECD Article 9, how the ALP works and what is the purpose and the new features of the ALP in OECD BEPS Action 8-10. Chapter 3 will analyse the mechanism and the purpose of CFC legislation in general by reference to the OECD BEPS Action 3, the minimum standards of the CFC rules in ATAD in particular regarding the computation approach. Chapter 4 will firstly discuss the similarities and differences between TP regulations and CFC regulations. Secondly, several examples under different scenarios will be carried out to illustrate the current interrelation between these two regimes in a clear manner, in the context of the ALP in the BEPS Action 8-10 and CFC rules in ATAD. Finally, chapter 5 will provide the final conclusions of this paper.

2 Arm's Length Principle

The authoritative statement[25] of the ALP was stipulated in Article 9 of the OECD Model Tax Convention (MTC)[26]. This provision has never been changed since it was stipulated in the first draft version in 1963[27]. The ALP is defined as the standard and central[28] of TP regulations in the OECD Transfer Pricing Guidelines[29] and is elaborated there in a much more detailed manner, whereas the TP regulations have been evolved and amended periodically.[30] Hence, the context of the ALP has changed over time although the wording of Article 9 has remained the same[31], which means that it is of significance to thoroughly analyse TP regulations in order to grasp the current meaning of the immutable

[25] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 35, para. 1.6.

[26] OECD, Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing (2017), Article 9(1): "Where a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

[27] J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law*. Vol. 35. Kluwer Law International BV, 2010.

[28] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 1 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 15.

[29] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 33, para. 1.1.

[30] A. Rugman & E. Lorraine, *Multinationals and Transfer Pricing*, Routledge (2017) 6-10.

[31] R. Collier, *The Arm's Length Principle – Is It A Principle And Is It Arm's Length?*, Saïd Business School, Oxford University Press (2017).

ALP provision behind the surface. Moreover, the OECD's recent amendments on the ALP and TP regulations in the BEPS project have brought new dimensions of the ALP to recognise the corresponding income in the cross-border transactions.[32] Therefore, it is worth looking into the general and the strengthened features of the ALP and the different impacts it will have on the functional analysis in transactions. The purpose of price adjustments is to align the transfer price with the market price, which will consequently eliminate the possibility of price manipulation and the motivation of profit shifting that will lead to tax avoidance.[33]

2.1 What is the Arm's Length Principle?

Article 9(1) of the OECD MTC introduces the need for "a comparison between conditions made or imposed between associated enterprises and those which would be made between independent enterprises"[34] and the need for "a determination of the profits which would have accrued at arm's length".[35]

To understand the needs required here, it is of importance to know beforehand that the commercial and financial relations between independent enterprises are determined by "market forces" – a consequence of "the supply and demand of a certain good or service".[36] The market forces normally result in a price that is acceptable to both independent enterprises[37] and will also be accepted by the tax authorities they belong to.[38] The ALP is built on the theory of market force and determined by it.[39] Therefore, the arm's length price that needs to be obtained between related parties is actually the market price set between independent parties.[40]

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[32] F. Majdowski & K. Bronzewska, *Revolutionary Changes to the Arm's Length Principle under the OECD BEPS Project: Have CFC Rules Become Redundant?* 46 Intertax, Issue 3 (2018) 210.
[33] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 33, para. 1.2.
[34] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 35, para. 1.7.
[35] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 35, para. 1.7.
[36] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 22.
[37] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 22.
[38] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 34, para. 1.3.
[39] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 22.
[40] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 34, para. 1.3.

Determining the profits at arm's length implies relying on the pricing that would be adopted by independent enterprises in comparable situations.[41] Therefore, the ALP is the foundation [42] for this comparison which is between independent and controlled transactions under comparable situations.[43] This is the rationale of the ALP.[44]

In order to compare the controlled and uncontrolled transactions that are actually comparable, the key is to treat the associated enterprises as separate parties.[45] Because the separate party approach treats the associated enterprises as if they were independent enterprises, the focus would be placed on whether the conditions in this controlled transaction are different from the condition that would be obtained in uncontrolled transactions, which is referred to as a "comparable analysis"[46], is at the heart of the ALP.[47] In order to treat the associated enterprise as separate ones, the core is to apply what is called as a "functional analysis"[48] to the controlled transaction between the associated enterprises.[49] Base on the outcome of the functional analysis, transfer prices between associated enterprise are "determined as part of a comparability analysis".[50]

The comparability analysis is contained in the OECD Transfer Pricing Guidelines described in two steps: the first step is "to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated" [51]; the second step is "to compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of

[41] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 21.
[42] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 35, para. 1.7.
[43] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 21.
[44] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 21.
[45] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 21.
[46] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 43, para. 1.33.
[47] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 35, para. 1.6.
[48] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 51.
[49] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 21.
[50] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 21.
[51] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 43, para. 1.33.

comparable transactions between independent enterprises."[52] In a brief wording, the first step refers to the "functional analysis" performed within the associated enterprises in order to accurately delineate them as separate and independent enterprises[53]; the second step refers to the "comparability analysis" applied between the controlled transaction and uncontrolled transaction in order to determine the transfer prices of that controlled transaction.[54]

In order to set transfer prices between associated enterprises at arm's length, it is of significance to understand the role of each party plays in the transaction in the first place[55], in other words, how important they separately are to this controlled transaction – the more important role this party plays, the more profits or losses it should undertake.[56] To measure how important this "role" is, three main elements are provided in the OECD Transfer Pricing Guidelines - the functions performed, the risks assumed, and the assets used of each party.[57] Each party should be investigated with these three factors in order to understand the contribution each party makes to the economic outcome of this controlled transaction,[58] which is known as the "functional analysis".

However, the functional analysis is not sufficient to determine the transfer prices that should be set. It needs to be supplemented by the comparability analysis in order to fully compare the controlled transaction with the uncontrolled one.[59] The OECD Transfer Pricing Guidelines recommend taking into account for another four comparability factors: contractual terms of the transaction, characteristics of the property, economic circumstances, and business strategy,[60] in addition to performing the functional analysis.[61] After assessing all the above-mentioned comparability factors, it is possible

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[52] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 43, para. 1.33.
[53] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 43, para. 1.33.
[54] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 43, para. 1.33.
[55] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 21.
[56] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 21-22.
[57] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 45, para. 1.37. "The extent to which any one of the characteristics categorised above is economically relevant in a particular transaction depends on the extent to which it would be taken into account by independent enterprises when evaluating the terms of the same transaction were it to occur between them."
[58] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 22.
[59] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 23.
[60] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 45.
[61] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 25-26.

to estimate whether the controlled transactions are actually comparable to the uncontrolled transaction[62] and whether the "reasonable accurate adjustments can be made to eliminate the effect of any such differences".[63] The comparability adjustments are influenced by the transfer pricing methods applied to the controlled transaction.[64] However, as long as the controlled transaction is within the "arm's length range"[65], it is comparable with the uncontrolled transaction.[66]

Above all, to put it simple, the arm's length principle refers to the comparison of transfer prices and income and expense distribution between controlled transactions (related parties) and uncontrolled transactions (non-related parties) under comparable circumstances, by ensuring the economic outcome of the cross-border controlled transaction is in proportion to the function related parties perform, the risks they assume, and the assets they use respectively for the purpose of the transaction, and make corrections accordingly if the distribution is not proportionate.[67]

For instance, country A is a high tax jurisdiction, while country B is a low tax jurisdiction. The manufacturer is located in the country A and the distributor in the country B. The manufacturer and the distributor are associated parties. The manufacturer should have sold its products to the related distributor at the same price that it sells to other independent and non-related distributors. But the producer in the country A sells its products at a price which is lower than the market price (arm's length price). It is worth noting that the sale price set for the products in the controlled transaction from country A to country B may not be in line either with the market value or the economic consideration, but for the consideration of obtaining tax advantages.[68] Since they are associated parties, the price manipulation can act as one measure to optimize the profit within the group.[69]

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[62] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 28.

[63] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 162, para. 3.47.

[64] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 26-28.

[65] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 163, para. 3.55. "In some cases it will be possible to apply the arm's length principle to arrive at a single figure that is the most reliable to establish whether the conditions of a transaction are arm's length. However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable."

[66] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 25.

[67] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 22.

[68] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation* [2006] ECR I-2107, Opinion of AG Geelhoed, paras. 62-69.

[69] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 33, para. 1.2.

Therefore, the manufacturer in country A has the strong intention to transfer the profits to the country B – a low-tax jurisdiction, since the profits in the high-tax jurisdiction decrease due to the excessive low sale price, which leads to the profits lower than the market profits. As a result, the tax levied in the high-tax jurisdiction will be reduced, because most of the profits are shifted to country B and taxed at a low rate. Under this circumstance, if the country A adopts the ALP, it will force the manufacturer established in its state to adjust the transfer price in accordance with the market price which is the transfer price between unrelated independent parties.[70] Otherwise, the tax authority in country A is entitled to readjust the price and to include in its profits those have not attributed to the taxpayer.[71]

From the example above, it can be concluded that the purpose of applying the ALP effectively is to eliminate the profit shifting from the host country to a country where another associated entity is located and protects against the erosion of the tax base in the host country.[72]

2.2 The Arm's Length Principle in the BEPS 8-10

The new ALP in BEPS 8-10 has been amended to deter tax avoidance of artificially transferred risks and profits[73] in order to establish a more complete risk and function analysis guideline.[74]

The ALP in the BEPS combines pricing and substance-over-form standards.[75] The latter constitutes the new dimension of the ALP. The substance-over-form entails that a contractual risk allocation must conform to the actual conduct of the parties, which must be determined based on the control over risk[76] and the financial capacity to bear the

[70] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 34, para. 1.3.
[71] A. Bullen, *Arm's Length Transaction Structures. Recognizing and restructuring controlled transactions in transfer pricing*, Volume 20 in IBFD Doctoral Series (2011) 27, 28, 31, 34.
[72] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 7.
[73] S. Goutam, *Critical Account of the OECD's Action Plan on Base Erosion and Profit Shifting*, 8 Madras Law Journal 9, Vol. 287 (2015) 7. Action 9 - [Risk and Capital] BEPS action plan suggest that "ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense deductions and other financial payments."
[74] J. Wittendorff, *BEPS Actions 8–10: Birth of a New Arm's Length Principle*, Tax Notes International 87 (2016) 336.
[75] J. Wittendorff, *BEPS Actions 8–10: Birth of a New Arm's Length Principle*, Tax Notes International 87 (2016) 336.
[76] J. Wittendorff, *BEPS Actions 8–10: Birth of a New Arm's Length Principle*, Tax Notes International 87 (2016) 340.

risk.[77] For instance, only a risk-adjusted return or a risk-free return can be captured if there are no significant people functions.[78]

Since the contractual arrangements between associated parties may not always be consistent with the actual conducts,[79] the actual transactions between affiliated entities are determined and defined by investigating whether the contractual relationship between the two parties complies with their actual implementation.[80] For example, if the contract information is incomplete or inconsistent with the actual behaviours, supplementary evidences can be provided according to the actual behaviours of affiliated enterprises or the corresponding contracts can be substituted.[81] [82]

3 Controlled Foreign Company Rules

3.1 What is the Controlled Foreign Company?

In order to thoroughly understand the system of the CFC rules, the first and foremost is to know that corporate income tax law systems of most countries do not tax the profits of a subsidiary of a company within its jurisdiction[83] until the income is distributed by the subsidiary to the parent company as a dividend, which can be referred to as "tax deferral".[84]

Taking such mechanism into account, companies in particular companies established or operating in high-tax jurisdictions start setting up subsidiaries in other low-tax countries and transfer mobile activities[85] to those low-tax jurisdictions or tax havens which do not impose many requirements for attributing income to that country, with the purpose to avoid or defer paying corporate income tax in high-tax jurisdictions. As a result, income from these mobile activities such as dividends, interest, royalties is shifted to low-tax jurisdictions. This means that companies are effectively avoiding corporate income tax

[77] J. Wittendorff, *BEPS Actions 8–10: Birth of a New Arm's Length Principle*, 87 Tax Notes Intl. (2016) 358.
[78] OECD, BEPS Actions 8-10: Financial transactions, Public Discussion Draft, OECD Publishing (2018) 11, para. 1.
[79] OECD, BEPS Actions 8 – 10: Financial transactions, Public Discussion Draft (2018) 8, para. 22.
[80] OECD, BEPS Actions 8 – 10: Financial transactions, Public Discussion Draft (2018) 8, para. 22.
[81] J. Wittendorff, *BEPS Actions 8–10: Birth of a New Arm's Length Principle*, Tax Notes International 87 (2016) 332, section B.
[82] OECD, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing (2015) 14.
[83] Judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, ECLI:EU:C:2006:544, para. 4.
[84] L. D. Broe, *International tax planning and prevention of abuse: A study under domestic tax law, tax treaties, and EC law in relation to conduit and base companies*, Vol. 13. IBFD (2008) para. s56.
[85] "Mobile activities" generally refers to corporate activities that have very limited (if any) connections with a particular country and can thus be carried on anywhere in the world.

until the subsidiaries pay a dividend to the parent company.[86] To counter such practices, many large countries with a big internal market introduced CFC regimes. It was first introduced in the US in 1962 in Subpart F rules with the purpose of neutralizing movable passive income earned through the US controlled CFCs in the means of taxing the income of the CFC.[87] After that, from the 1970s to 1990s, Canada, West Germany, Japan, and Nordic counties also established their own CFC legislations.[88] In 1996, the OECD adopted a recommendation on CFC rules for all the OECD countries to implement.[89] In 2015, the OECD strengthened the CFC rules and made recommendations through Action 3 of the BEPS Project[90] to "respond to the challenges faced by existing CFC rules which have often not kept pace with changes in the international business environment, and many of them have design features that do not tackle BEPS effectively".[91] Since "all CFC rules share some general policy considerations, including how they complement transfer pricing rules"[92], the recommendations in BEPS 3 are "designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries".[93] In 2016, CFC rules are included in Anti-Tax Avoidance Directive[94] which required every MS to implement such rules.[95]

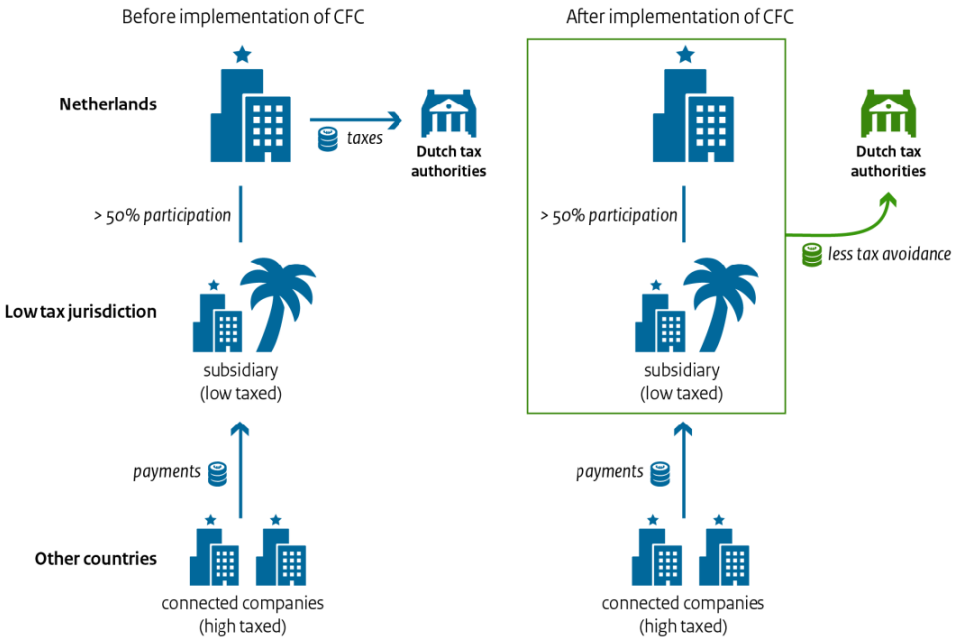
Under CFC regimes, countries attempt to prevent erosion of the domestic tax bases of parent companies and to discourage companies from shifting income to low-tax jurisdictions by triggering current taxation[96] at the parent company level when income is

[86] Government of the Netherlands, Policy letter on tackling tax avoidance and tax evasion, Policy Note (2018) 5.
[87] L. Kauder, *Taxation of Domestically Controlled Foreign Corporations: A Comparative Study of Subpart F and Section 482*, 14(2) Villanova L. Rev. (1969).
[88] P.K. Schmidt, *Taxation of Controlled Foreign Companies in Context of the OECD/G20 Project on Base Erosion and Profit Shifting as well as the EU Proposal for the Anti-Tax Avoidance Directive–An Interim Nordic Assessment*, 2 Nordic Tax J. (2016) 89.
[89] OECD, Controlled Foreign Company Legislation (1996).
[90] J. Hail, *Base Erosion and Profit Shifting (BEPS) – Are You Ready?* Wolters Kluwer (2015).
[91] OECD (2015), Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, executive summary.
[92] OECD (2015), Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, paras. 5-6.
[93] OECD (2015), Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, executive summary.
[94] A. Rigaut, *Anti-Tax Avoidance Directive (2016 / 1164): New EU Policy Horizons*, 503–4.
[95] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14.
[96] OECD, Glossary of Statistical Terms, "Most current taxes on income, wealth, etc consist of taxes on the incomes of households or profits of corporations and taxes on wealth that are payable regularly every tax period (as distinct from capital taxes levied infrequently)." <https://stats.oecd.org/glossary/detail.asp?ID=513> (accessed on 28 May 2019)

realized at the subsidiaries in low-tax jurisdictions regardless of whether it is distributed back to the taxpayer in the States.[97]

See the figure below to know how the CFC regime in the Netherlands works[98]:

Figure 1:



Typically, CFC taxation is only triggered or CFC is recognized when three cumulative requirements are fulfilled: the subsidiary is controlled by the parent company at a certain level; the subsidiary is located in a low-tax jurisdiction or tax haven; the subsidiary generates passive income without performing genuine activities.[99] Provided that these three requirements are met, the parent company has to define, compute and attribute proportionally the income accruing at the CFC level into its own tax base.[100]

Fundamentally, CFC regimes differ from country to country, but all seek to deter income deferred or profits shifted to no-tax or low-tax jurisdictions where the controlled entities generate passive income through in particular mobile activities or the controlled entity

[97] G. Van Hulle, *Current challenges for EU controlled foreign company rules?* 71 Bull. Intl. Taxn. 12 (2017) 719.
[98] Government of the Netherlands, Policy letter on tackling tax avoidance and tax evasion, Policy Note (2018) 6.
[99] P.K. Schmidt, *Taxation of Controlled Foreign Companies in Context of the OECD/G20 Project on Base Erosion and Profit Shifting as well as the EU Proposal for the Anti-Tax Avoidance Directive–An Interim Nordic Assessment*, 2 Nordic Tax J. (2016) 88.
[100] P.K. Schmidt, *Taxation of Controlled Foreign Companies in Context of the OECD/G20 Project on Base Erosion and Profit Shifting as well as the EU Proposal for the Anti-Tax Avoidance Directive–An Interim Nordic Assessment*, 2 Nordic Tax J. (2016) 88.

does not have genuine economic activities,[101] in order to safeguard the domestic tax base.[102]

3.2 CFC Regulations in Anti-Tax Avoidance Directive

Because of the concern and conflict stemming from the Netherlands Statements written in the beginning, this thesis paper will devote most effort regarding CFC regulations into ATAD and only focus on the model B "transaction/substance approach" of CFC rules provided in the Article 7(2)(b) in ATAD, while omitting model A, the alleged "entity approach" regarding specific income categories[103].

3.2.1 Introduction to the Anti-Tax Avoidance Directive

Anti-Tax Avoidance Directive is a hard law which shall be implemented into the domestic legislation of all the Member States with a purpose of countering tax avoidance by providing a level playing field across the European Union.[104] As is stated in paragraph 16 of the preamble of ATAD that a key objective of ATAD is "to improve the resilience of the internal market as a whole against cross-border tax avoidance practices[105], this cannot be sufficiently achieved by the Member States acting individually"[106], it is of great significance that all the Member States should move forward in the same direction in terms of fighting against the tax avoidance issues by setting a minimum level of protection for the internal market and materializing the objective of the minimum degree of coordination.[107]

ATAD is a demand for the tax base protection at a minimum level.[108] All the Member States are entitled to establish stricter rules beyond the wording of the ATAD in order to safeguard the domestic corporate income tax bases.[109] Therefore, CFC rules which are

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[101] M. Dahlberg & B. Wiman, *General Report, in The Taxation of Foreign Passive Income for Groups of Companies* vol. 98a (2013) 27.
[102] OECD, Controlled Foreign Company Legislation, OECD Publishing (1996).
[103] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14, art.7(2)(a).
[104] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, 1–14, paras. 2-6.
[105] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, preamble para. 16.
[106] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, preamble para. 16.
[107] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, preamble para. 16.
[108] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14, preamble para. 3.
[109] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14, art. 3.

the quite important component part of the ATAD, as stipulated in the article 7 and 8, are the minimum requirements that the EU makes all the Member States implement,[110] in particular, the 14 Member States, including the Netherlands, that had not adopted CFC legislation in their domestic laws.[111]

The main purpose of applying CFC rules is to reduce the distortion effect that such CFC rules may have on competitiveness. "Active" income referring to income received from performing a service is usually excluded from the scope of these rules, making sure that only shifting of income purely for tax reasons is targeted, which means that Member States should limit the CFC income artificially diverted to the subsidiary.[112]

3.2.2 The Minimum Requirements for Determination

3.2.2.1 Determination for a CFC

The definition of a CFC under the ATAD is based on four criteria which are (i) involving a foreign subsidiary, (ii) the control from the parent entity over the subsidiary at a certain level, (iii) the subsidiary established in the low-tax or no-tax jurisdiction, and (iv) passive profits arise from non-genuine arrangements at the subsidiary level.[113]

Specifically, under Article 7 paragraph 1 of ATAD, a CFC is "an entity or a PE of which the profits are not subject to tax or are exempt from tax in that MS"[114], which indicates that this entity or PE is foreign-based in the very first place.

Secondly, through the wording "the taxpayer by itself, or together with its associated enterprises holds a direct or indirect participation of over 50% of the voting rights, or over 50% capital, or is entitled to receive over 50% of the profits"[115], the control from the parent company over the CFC required here is at least 50%.

Thirdly, the entity or PE establishment will qualify as a CFC if its "actual corporate tax paid on its profits is lower than the difference between the corporate tax that would have been charged on the entity or PE"[116]. In other words, the actual corporate tax rate that

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[110] Ibid., para. 12.
[111] A. Rigaut, *Anti-Tax Avoidance Directive (2016/1164): New EU Policy Horizons*, 56(11) Eur. Taxation (2016) 497-505.
[112] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, para. 12.
[113] Government of the Netherlands, Policy letter on tackling tax avoidance and tax evasion, Policy Note (2018) 6.
[114] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(1)(a).
[115] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(1)(a).
[116] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(1)(b).

the subsidiary subject is lower than 50% of the corporate tax rate in the jurisdiction of the parent company, which will be defined as low-taxed.

In a nutshell, as a fundamental condition for the application of the CFC rules, the parent company or with its associated parties will have to have more than 50% control over the subsidiary in the form of an entity or a PE located in another jurisdiction where the corporate tax rate is lower than 50% of that in the taxpayer's jurisdiction. In addition, there must be alleged undistributed passive income such as dividends, interest, royalties from in particular mobile activities [117] or the income accruing to non-genuine activities[118], which is stipulated in the second paragraph of Article 7.

3.2.2.2 Determination for CFC income

(1) Entity Approach

The first approach is the entity approach which is also known as the category approach as it regards the non-distributed passive income [119] from certain categories such as interests, royalties, dividends of the CFC as one part of the tax base of the parent company, without considering the activities taken by the taxpayer.[120] It is worth noting that only the passive income derived from the CFC without carrying on substantive activities can be taken into account.[121] In addition, the threshold for passive income is set at one third[122] which means that if the passive income generated by the subsidiary is less than one-third of the total income it earns, the subsidiary can fall out if the scope of a CFC.[123] In this approach, the taxable income should be calculated complying with the rules of the MS where the controlling company is located.[124]

(2) Transactional approach

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[117] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(2)(a).
[118] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(2)(b).
[119] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(2)(a). "This point shall not apply where the controlled foreign company carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant fact and circumstances."
[120] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(2)(a).
[121] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(2)(a).
[122] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(3).
[123] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(3).
[124] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.8(1).

The second approach is the transactional approach which is not selected by the Netherlands as it is based on the functioning of the ALP, no further legislation amendments are needed to "fulfil the obligation for implementation"[125] of ATAD. This approach requires that only the non-distributed profits of an entity or PE stemming from artificial "non-genuine" arrangements that have been generated "for the essential purpose of obtaining a tax advantage"[126] are taxable as the attributable CFC income.

An arrangement is defined as "non-genuine" to the extent that the CFC "would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income."[127] That means the income is derived from the activities where no significant people perform functions, undertake risks or own assets. Therefore, the targeted income of the CFC in the transactional approach is generated only or mainly out of the tax consideration rather than the commercial consideration.

In the meantime, two de minimis exemption with regards to accounting profits may be applicable. The first provision allows the EU MS to abandon the application of the CFC rules to the entity or PE "with accounting profits of no more than EUR 750,000 and non-trading income of no more than EUR 75,000",[128] and the second one offers the same treatment in terms of "an entity or PE of which the accounting profits amount to no more than 10% of its operating cost (excluding cost of goods sold) for the relevant tax period",[129] which means that even these subsidiaries meet the basic four requirements for being CFCs, the income derived from these CFCs may not be regarded as attributable CFC income.

3.2.2.3 Computation of CFC Income

If the transactional approach is applied, the tax base in the taxpayer's jurisdiction is limited to the income "generated through assets and risks which are linked to significant people functions carried out by the controlling company".[130] This forms the basis for taxation of the attributable CFC income. The attributable CFC income from alleged

[125] Government of the Netherlands, Policy letter on tackling tax avoidance and tax evasion, Policy Note (2018) 6.
[126] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(2)(b).
[127] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(2)(b).
[128] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(4)(a).
[129] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.7(4)(b).
[130] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.8(2).

"non-genuine arrangements"[131] shall be computed consistent with the TP rules based on the ALP,[132] which means that the CFC income that needs to be distributed back bears no functions, assets or risks at the CFC. Here requires that the attributable CFC income should be calculated with the application of the ALP to the functions performed, the risks assumed and the assets used by the controlling entity as if it is an independent and non-related entity under comparable situations,[133] which reflects that the ALP functions as the methodology to determine the value of CFC income.[134] However, the prerequisite is the existence and application of the CFC regime. Only under and within the scope of the transactional approach of the CFC rules under ATAD, the ALP is the foundation and core of the CFC regulation to make the provision to be effective.

Thus, Article 8(2) of ATAD is the intersection of CFC regulations and the ALP and where the issue arises. However, to be noted, without the application of the CFC regime as a prerequisite, the same result cannot be achieved since CFC regulations function differently in various aspects from the ALP and "generally do not complement TP rules in a coherent manner".[135]

4 Interaction Between TP Rules and CFC Rules

4.1 Similarities Between TP and CFC Regulations

It might seem that the concept of TP regulations and CFC regulation are not that interrelated and even distant. The mechanism of TP regulations is based on the ALP which sets transfer prices between associated parties in controlled transactions by treating associated parties as unrelated and independent parties under comparable situations. However, the mechanism of CFC regulations is to trigger current taxation at the parent company level when income is realized at the subsidiaries in low-tax jurisdictions regardless of whether it is distributed back to the taxpayer in the States. Although the mechanisms of TP regulations and CFC regulations are different, both share the same final purpose to deter profit shifting to associated entities, counter deferral and avoidance of taxation, and protect against the erosion of the tax base[136].

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[131] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.8(3).
[132] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, p. 1–14, art.8(2).
[133] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 22.
[134] F. Majdowski & K. Bronzewska, *Revolutionary Changes to the Arm's Length Principle under the OECD BEPS Project: Have CFC Rules Become Redundant?* 46 Intertax, Issue 3 (2018) 210.
[135] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para. 21.
[136] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.28.

4.2 Key Differences Between CFC and TP Regulations

Although CFC regulations and TP regulations seem to address the same income in the context of cross-border transactions[137] and both of them are applied to test the price of the controlled transactions without manipulating and minimize instances of the eroded tax base,[138] this might not always be the case and they are not interchangeable.[139] The OECD states that either CFC regulations or TP regulations do not "eliminate the need for the other set of rules".[140] Hence, this section will analyse the major and fundamental differences enshrined in CFC and TP regulations.

4.2.1 Mechanism

CFC regulations aim to counteract attribution of passive profit to low level of taxation by taxing CFC income at parent company level even without distribution[141], whereas the mechanism of TP regulations is to amend the price of related parties consistent with the price between unrelated ones in order to avoid price manipulation so that it can reflect the normal market price.[142] CFC regulations accept the amount of profit shifted, while TP regulations may correct the price itself in accordance with the ALP.[143]

4.2.2 Methodology

CFC regulations focus on profits generated "by a controlled party from transactions with a variety of counterparties"[144] which means that CFC regulations consider all the controlled foreign entities and neglect the separate identity of each entity. TP regulations work on the basis of the ALP and "focus on the individual transactions between related parties"[145] by applying the functional analysis of related foreign entities as separate and

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[137] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.22.
[138] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing (2015), para. 8.
[139] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.22.
[140] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing (2015), para. 8.
[141] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016), preamble para. 12.
[142] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing (2017) 33, para. 1.2.
[143] M. Kane, *Milking Versus Parking: Transfer Pricing and CFC Rules Under the Internal Revenue Code*, 66(2) Tax L. Rev. (2013) 494.
[144] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.28.
[145] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para. 28.

independent entities.[146] In this regard, CFC rules stand opposite to the rationale of the ALP which requires separate functional analysis.

4.2.3 Scope

Obviously, the subjective scope of TP regulations is wider than that of the CFC regulations. TP rules are applied to the transaction between associated parties which do not necessarily fall within the definition of controlling entity and controlled entity in CFC regulations.[147] The requirement of associated stipulated as "an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State"[148] is not as strict or specific as that of the controlled foreign company. Therefore, TP regulations can be applied to those companies that are related but do not have control over each other such as sibling companies[149], while the CFC regulations are only limited to companies with control. Consequently, some transactions are at arm's length without falling within the scope of CFC regulations.

For example, If the related subsidiaries are in the same group, even if they are not controlled by each other, CFC regulations can still work because all the transferred profits will be taxed in the parent jurisdiction as CFC income. Therefore, theoretically, CFC can cover the profit shifting between intra-group sibling companies.[150] However, if the arbitrage transaction or the profit shifting is happening between related parties without control that are not in the same control group, CFC regulations alone cannot capture the income between these associated parties,[151] since ATAD art.7(1)(b) stipulates: "For the purpose of point (b) of the first paragraph, the permanent establishment of a controlled foreign company that is not subject to tax or is exempt from tax in the jurisdiction of the controlled foreign company shall not be taken into account."[152] Therefore, in this regard, CFC rules will not be applied.

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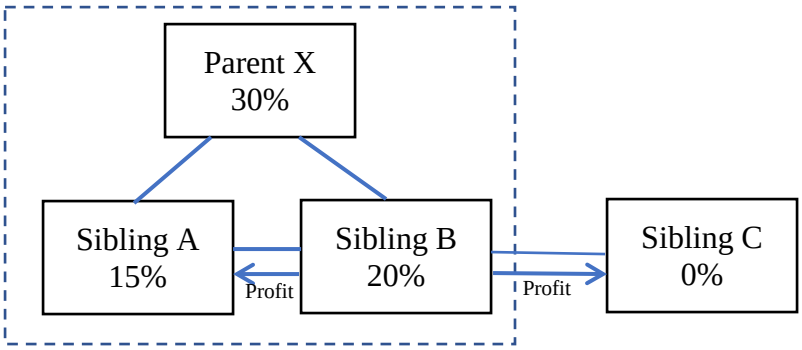
[146] L. Burns, *Rethinking the Design of Australia's CFC Rules in the Global Economy*, 59(7) Bull. International Taxation 278 (2005); S. Picciotto, *International Taxation and Economic Substance*, 70 (12) Bull. International Taxation 2 (2016).
[147] Kauder, *Taxation of Domestically Controlled Foreign Corporations: A Comparative Study of Subpart F and Section*, 14(2) Villanova L. Rev. 267 (1969) 482.
[148] OECD, Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing (2017), article 9.
[149] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.23.
[150] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) p. 1–14, preamble para. 23.
[151] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) p. 1–14, preamble para. 24.
[152] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) p. 1–14, art.7(1)(b).

Example 1: Profit Shifting between Sibling Companies



Provided company A, B, C are sibling companies which are related but not controlled by each other. Company A and B belong to the same parent company X, while company C is not one part of the group. All these four companies X, A, B, C located in different jurisdictions applying different tax rates. CFC rules are established in the state of company X. If company B shifts profits to company A, the profits will still be taxed at the parent company level at the rate of 30%, because CFC legislation will take effect. However, if company B shifts profits to company C, the profits will apply the tax rate at the jurisdiction of company C, which is 0.

In this regard, aggressive tax planning is established, thus TP regulations are needed in order to combat tax avoidance as such.

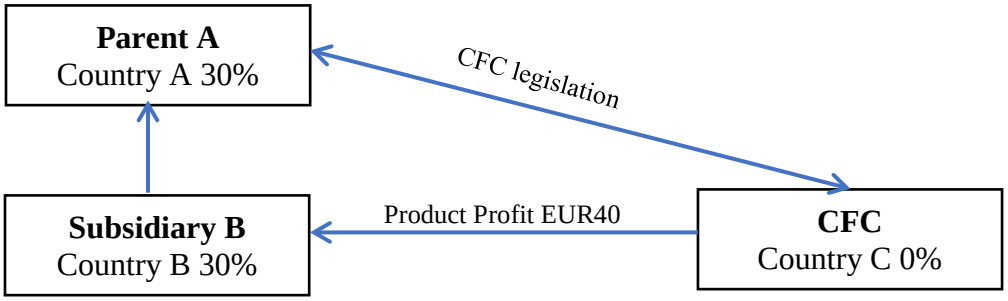
4.2.4 Tax Base

The CFC regulations aim to neutralize the income shifted to the low tax state by redistributing it back to the state where the controlling entity resides in or tax it without shifting it back.[153] Considering this, the CFC regulations actually function in favour of the controlling entity and protect the tax base in the controlling country.[154] But the jurisdiction of controlling company is not necessarily the state where the tax base is eroded.[155] However, the TP regulations directly grant taxation rights to the state where the income is derived from.[156] In a nutshell, CFC regulations protect the tax base of the residence state[157], while TP regulations protect the tax base of the states which suffer the profit shifting.[158] As a result, if merely CFC regulations are in effect, not all the jurisdictions involved in can be protected from losing their taxation rights, regardless of

[153] G. Van Hulle, *Current challenges for EU controlled foreign company rules?* 71 Bull. Intl. Taxn. 12 (2017) 719.
[154] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.23.
[155] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.23.
[156] OECD, Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing (2017), Commentary on Article 1, para. 81.
[157] E. Burkadze, *Interaction of Transfer Pricing Rules and CFC Provisions*, International Transfer Pricing Journal, (2016) 374.
[158] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.23.

the tax base of that CFC state or a third country in a foreign-to-foreign base erosion case.[159]

Example 2: Foreign-to-Foreign Stripping



Provided that Company A is a parent company established in Country A. It has two subsidiaries in two separate countries, Subsidiary B in Country B and a CFC in Country C. Country A and Country B both apply a corporate tax rate at 30%, while Country C is a tax haven with 0% tax rate. Country A has a CFC legislation which entitles it to tax the CFC profits.

*Now CFC sells a product at a price of EUR100 and the cost of which is EUR60 to Subsidiary B in Country B. Assume that the profit obtained there falls within the scope of the CFC legislation of Country A. Therefore, the company would have to pay the tax of the profit of the product on EUR12 ((100-60) *30%) in Country A. Hence, although the profit is shifted from CFC to Subsidiary B in Country B, the profit is only taxed in Country A where the parent company is.*

In this regard, CFC regulations alone can only restore the tax base of the parent company and are a complementary instrument of TP regulation only under the circumstance that the controlling person is a resident taxpayer in that state where the tax base is eroded due to the profit shifting.[160] Hence, TP regulations are needed in order to protect the taxation rights of all the parties.

4.2.5 Change of Tax Residence

The tax residence of the controlling entity can be restructured to another state without CFC legislation or with low tax rates,[161] which may give rise to the avoidance of applying CFC regulations but the obligation to obey TP regulations maintains.[162] Under

[159] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.23.`
[160] E. Burkadze, *Interaction of Transfer Pricing Rules and CFC Provisions*, 23(5) Int'l Transfer Pricing J. (2016) 9.
[161] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.23.
[162] M. Kane, *Milking Versus Parking: Transfer Pricing and CFC Rules Under the Internal Revenue Code*, 66(2) Tax L. Rev. (2013) 491.

this circumstance, CFC regulations are not applicable to the transactions made by the controlling entity with its foreign shareholder. Therefore, TP regulations are needed in order to be applied by all countries where economic activities occur to protect their own tax bases.[163]

4.2.6 Profit Shifting Direction

Effective CFC regulations discourage the parent company from shifting profits into low-tax jurisdictions or tax havens which do not recognise the tax liability of companies established in its territory.[164] While TP regulations do not intend to address the issue of profit shifting into low-tax jurisdictions or income that is not subject to tax.[165] In this regard, CFC regulations can act as a complementary role to TP regulations.[166]

4.2.7 Specificity

CFC regulations are more specific and targeted, providing certain concrete requirements to determine whether the entity meets the criteria.[167] To the contrary, TP regulations are not an exact science[168] - "detailed rules without concrete concept",[169] and difficult to apply because there are no such content requirements for the ALP.[170] The previous experience of different states confirms that verification of the arm's length level of taxpayer transactions with foreign entities is very difficult and often ineffective.[171]Consequently, TP regulations need CFC regulations to determine certain categories of income to be automatically attributed back to the parent state.[172]

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[163] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.23.
[164] G. Van Hulle, *Current challenges for EU controlled foreign company rules?* 71 Bull. Intl. Taxn. 12 (2017) 719.
[165] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.28.
[166] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para.28.
[167] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing (2015) para. 9.
[168] L. Lokken, *Foreign Base Company Sales and Services Income: An Overreaching Anachronism or an Essential Element of the Controlled Foreign Corporations Regime?*, 3(1) J. Taxation Global Transactions (2003) 44; L. Burns, *Reform of Australia's CFC Rules*, 21(1) Austl. Tax F. 189 (2006); D. Hay, *Controlled Foreign Companies Reform: How the Proposed New Rules Interact with Transfer Pricing Legislation*, 17(4) International Transfer Pricing J. (2010) 312.
[169] J. Monsenego, *The Key to Understanding Transfer Pricing – The Arm's Length Principle*, Chapter 3 in *Introduction to Transfer Pricing*, Wolters Kluwer (2015) 32.
[170] J. Monsenego, *The substance requirement in the OECD transfer pricing Guidelines: what is the substance of the substance requirement?* 21(1) Int'l Transfer Pricing J. (2014) 22.
[171] D. Sandler, *Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries* 9 (2d ed., Kluwer Law International (1998).
[172] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing (2015) para. 9.

4.2.8 Summary

As analysed above, TP and CFC regulations differ widely in various dimensions with different targets. Therefore, they are neither interchangeable nor precluding the need for the application of each other. If only one set of rules exits, "CFC rules may capture some income that is not captured by TP rules and vice versa, however, neither set of rules fully captures the income that the other set of rules intends to capture."[173] Moreover, the application of CFC rules cannot deter the effectiveness of the ALP[174], the question thus needs to be solved next is whether CFC regulations can be regarded as complementary to TP regulations?

4.3 Are CFC Rules A Backstop to TP Regulations

CFC rules are usually referred to be a "backstop" to TP rules.[175] It is worth noting that the "backstop" that is frequently used could be quite misleading in that CFC regulations generally do not complement TP regulations in a coherent manner[176] as is illustrated in 4.2.

If merely CFC regulations are applicable, firstly, the targeted scope would be limited to the entities within the definition of control at a certain level, rather than the "related entities" that TP regulations are able to cover. For example, related entities without control would be fall out the scope of the application of CFC rules. As a result, it can be manipulated to shift income to these entities. Secondly, only the tax base of the parent company can be restored, while other states would still face losing tax rights in their own jurisdictions. Thirdly, once the tax residence is restructured to the state where CFC legislations are not in use or the corporate tax rate is at a low level, CFC rules will no longer work to tackle tax avoidance. Therefore, TP regulations must be in force.

However, TP regulations alone also cannot fully fulfil the purpose of combating tax avoidance. Since TP regulations are not specifically designed to solve the problem of profit shifting to low-tax or no-tax jurisdictions, but CFC regulation target at this issue. In addition, TP regulations are difficult to determine and apply because they have never

[173] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing (2015) para. 8.
[174] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) p. 1–14, preamble para. 14.
[175] A. Dourado, *The Role of CFC Rules in the BEPS Initiative and in the EU*, 2015(3) British Tax Review (2015) 340-363; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 Emory L.J. 79 (2009).
[176] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft (2015), para. 21.

been an exact science, while CFC rules are mechanical and targeted[177], which can complement the deficiency of TP regulations. CFC regulations thus could reduce or avoid excessive pressure on TP regulations by supporting them to a significant extent.[178]

For all these reasons, it has been assumed in the literature that either of the two regulations serves as a remedy to the problems these regulations have created. Although not in a comprehensive manner, they can serve as an effective solution to the core problem of the second regime.[179]

Additionally, TP regulations apply in a much wider manner, CFC rules only act as an auxiliary role in terms of their same goal of combating tax avoidance. This constitutes the reason for CFC regulations being a backstop of TP regulations. The adequately high rate of tax that CFC regulations apply may discourage companies to use TP regulations as TP outcomes show scarcely benefit of engaging in the pricing manipulation.[180] It is thus not that the rationale behind CFC regulations is to restore the income from transfer pricing manipulation but that certain CFC provisions may lead to the same result as TP regulations do.[181] Hence, CFC regulations indeed function as a backstop to TP regulations to deter tax avoidance and to safeguard tax bases, albeit in a discrepant manner.

4.4 The Tests Between the ALP and Transaction Approach

Now that CFC regulations are only a backstop to fulfil the goal of anti-tax avoidance, which gives rise to the question whether in most cases TP regulations alone can produce the same result as CFC rules apply. Taking the Netherlands statement into consideration, the examples below will be limited within the transaction approach – model B – of the CFC regulations under ATAD. In addition, to eliminate the effect of passive income required in model A, all the examples below will be based on the assumption of passive income.

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[177] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing (2015) para. 9.

[178] F. Majdowski & K. Bronzewska, *Revolutionary Changes to the Arm's Length Principle under the OECD BEPS Project: Have CFC Rules Become Redundant?* 46 Intertax, Issue 3 (2018) 223.

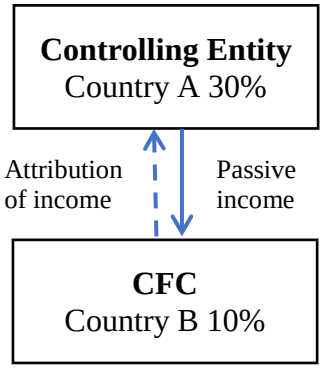
[179] M. Kane, *Milking Versus Parking: Transfer Pricing and CFC Rules Under the Internal Revenue Code*, 66(2) Tax L. Rev. (2013) 488.

[180] M. Kane, *Milking Versus Parking: Transfer Pricing and CFC Rules Under the Internal Revenue Code*, 66(2) Tax L. Rev. (2013) 488.

[181] OECD, BEPS Action 3: Strengthening CFC Rules, Public Discussion Draft, OECD Publishing (2015), para. 21.

4.4.1 Transferring Passive Income

Example 3: Transferring Passive Income to a CFC



Provided that the controlling entity is located in country A which is a high-tax jurisdiction applying the corporate tax rate at 30%, while CFC is established in country B levying 10% corporate income tax.

The controlling entity transfers passive income in a transaction to the CFC where neither significant value is added nor significant people functions are related to the transaction. The transfer price may not be in accordance with the market price as comparable independent parties have. TP regulations of the state of controlling person would prevent such pricing manipulation between the controlling entity and the CFC by applying the functional analysis of the ALP.

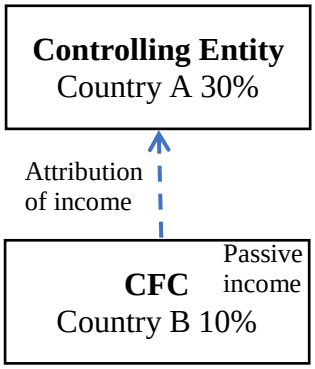
Under model B of CFC rules in ATAD, where "non-genuine" criterion is required, such transfer of income without assets owned or risks undertaken in the CFC will be subject to CFC rules in the state of the controlling entity. As a result, the income will be attributed back to the controlling entity by using the ALP and taxed at the rate of 30%.

In this case, TP regulations and CFC regulations are alternatives, because the income is transferred from the controlling entity instead of generating in the CFC, TP regulations will identify such transaction which is inconsistent with the market value and correct the transfer price accordingly with the ALP applied. CFC rules will also be activated as long as all the requirements are met and the income will be calculated in accordance with the ALP[182] and taxed at the controlling entity's level. Thus , the ALP in TP regulations fulfil the minimum requirements of the transactional approach of CFC regulations under ATAD.

[182] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (2016) 1–14, article 8(2).

4.4.2 Generating Passive Income at a CFC

Example 4: Generating Passive Income at a CFC



Provided that the controlling entity is located in country A which is a high-tax jurisdiction applying the corporate tax rate at 30%, while CFC is established in country B levying 10% corporate income tax.

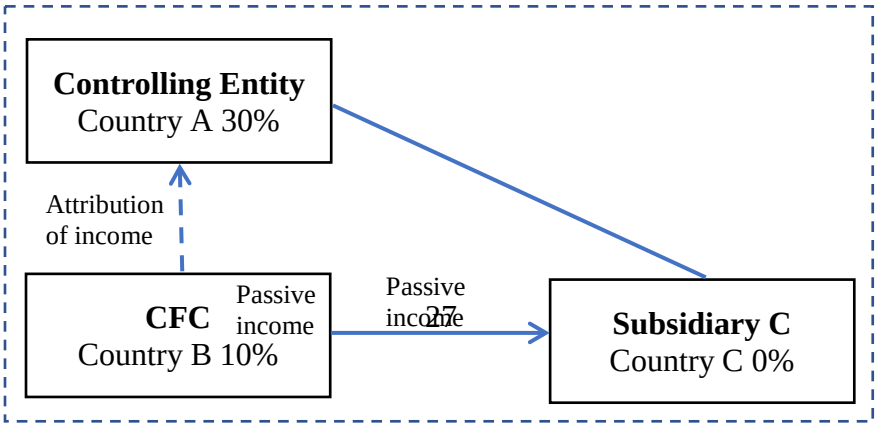
The CFC generates its passive income in its own jurisdiction arising from arrangements without assets or risks. The CFC will not distribute the income back to the parent company since the corporate tax rate in country B is lower than that in country A. TP regulations will not be in effect due to the lack of income distribution or profit shifting.

The CFC rules of ATAD will be applicable. The income will be computed in accordance with the ALP with functions, risks, assets are taken into account and attributed back to the controlling entity where the actual functions are carried out.

In this case, the ALP acts as a tool inbuilt in CFC rules to assist CFC rules to complete income attribution due to the fact that only after applying the CFC rules to determine the CFC, can the ALP be applied. The ALP alone will become obsolete owing to no profit shifting. Therefore, although the ALP here serves as the decisive element of the transaction approach, it cannot be concluded that the ALP can fully meet the requirements of CFC rules.

4.4.3 Transferring Passive Income Generated at a CFC

Example 5: To a Subsidiary of the Controlling Entity within the Group



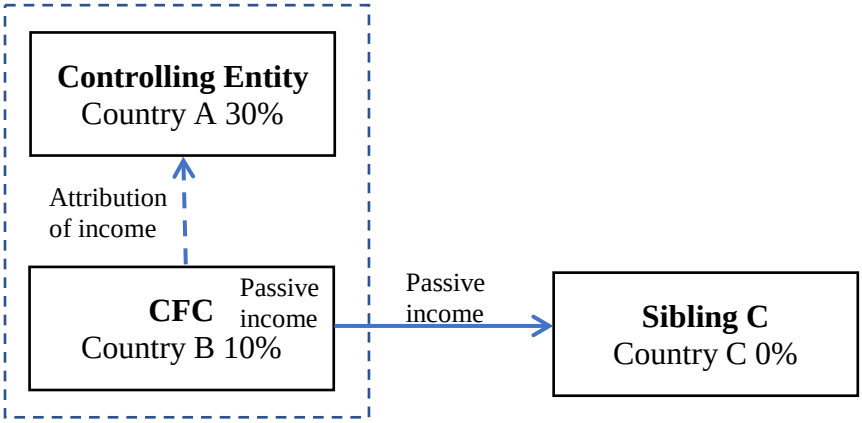
Provided that the controlling entity is located in country A which is a high-tax jurisdiction applying the corporate tax rate at 30%, while the CFC is established in country B levying 10% corporate income tax. Subsidiary C is a related entity of the CFC and a subsidiary of the controlling entity in country C where the corporate tax is 0, and it is in the same control group.

The CFC generates its passive income in its own jurisdiction arising from arrangements without assets or risks and transfers the income to sibling C. TP regulations will be applicable to ensure that the income transferred to comply with the ALP to show the significant people functions of the controlling entity.

CFC rules under ATAD will trigger the income transferred to the subsidiary C to be taxed at the controlling entity's level in country A instead of country C. The attributable income will be calculated on the basis of the ALP as required in model B of ATAD CFC rules which will analyse the assets, risks, functions of controlling entity accordingly.

In this case, the situation is similar to Example 3. Both regimes are interchangeable because the results of applying them are both determined by analysing the functions performed, risks assumed and assets used at the controlling entity's level. Hence, the ALP can meet the demands required by CFC rules.

Example 6: To a Related Entity without Control out of the Group



Provided that the controlling entity is located in country A which is a high-tax jurisdiction applying the corporate tax rate at 30%, while the CFC is established in country B levying 10% corporate income tax. Sibling C is a related entity of the CFC in country C where the corporate tax is 0, and it is not in the same control group.

The CFC generates its passive income in its own jurisdiction arising from arrangements without assets or risks and transfers the income to sibling C. TP regulations will be applicable to ensure that the income transferred to comply with the ALP.

However, CFC regulations will not work in country C because sibling C is neither controlled by CFC nor in the same control group of controlling entity and CFC. The income transferred there will not be taxed in any country.

In this case, TP regulations are applied to the transaction between CFC and sibling C, since the amended ALP requires actual transactions depending on the risk analysis, the functions should be ascended back to the controlling entity, and thus protect the tax base of country A. Whereas CFC can only be applied to the transaction within the control group, the sibling C falls out the scope of the group, which means the income shifted there will not be attributed back to country A. Therefore, merely TP regulations are effective in this case. The ALP can meet the demands required by CFC rules.

4.4.4 Summary

To sum up, the substitutability of CFC regulations by TP regulations is limited.

First, from Example 3, under the circumstance that the income is shifted from the controlling entity to the CFC, the ALP of TP regulations will take effect owing to the income transfer, the ALP required in CFC transactional approach will also work because of the existence of the CFC. Hence, TP regulations and CFC regulations are triggered at the same time based on the same criteria – the arm's length principle – in the state of the controlling entity. Therefore, the ALP can meet the minimum requirements of the transactional approach of CFC rules under ATAD.

Second, from Example 4, under the circumstance that the income is generated at the CFC itself without inward or outward transfer. The ALP will only be applicable when CFC rules are already applied. Thus, the ALP alone is not able to fulfil the requirements of the CFC rules.

Third, from example 5 and 6, under the circumstance that the income is derived from the CFC and transferred to a third party located in a third state as is shown in Example 5. If the third party is one part of the control group, the income shifted from the CFC to it will be ultimately taxed at the state of the controlling entity. The ALP in CFC rules will be used to analyse the significant people functions at the controlling entity in accordance with the ALP. In addition, the income is transferred from the CFC to the third party, thus the ALP of TP regulation will be applied to reflect the market value that the transfer should have, but the function analysis will be held at the controlling entity since the CFC income bears no risks, functions or assets at the CFC. Therefore, the functional analysis of both regimes will take place at the controlling entity level, which lead to the analogous result as Example 3 has. In this regard, the ALP in TP regulations can meet the minimum demands of the CFC rules.

In addition, Example 6 illustrates another situation in which the CFC income is shifted to a sibling entity out of the control group. The TP regulation will work as the income transfer exists, which will analyse all the function in the controlling entity. However, the CFC rules, in this case, are not effective. The income transferred to the sibling entity cannot be attributed back to the controlling entity. Therefore, TP regulations here function as an alternative of CFC rules in case of the absence of it.

5 Conclusion

This thesis is aimed at answering whether CFC regulations are a backstop of TP regulations and whether TP regulations are capable of altering CFC regulations under ATAD as they may lead to the same result.

With regards to the first question, the "backstop" role that CFC regulations are often referred to needs to be unscrambled. This word means that the CFC regulations and TP regulation share the same purpose – deter tax avoidance – and the application of either regime can achieve the aim. In addition, from the word, TP regulations should be regarded as the primary measure to achieve this goal but may not be effective all the time. Thus, as the other set of rules to tackle the problem, CFC rules function as supplementary means to complement the loophole.

From the analyses in section 4.2 and 4.3, neither set of rules can eliminate the needs of the other if taxes need to be fully captured. Although widely applicable, TP regulations alone cannot fully fulfil the purpose of combating tax avoidance. Since TP regulations are not specifically designed to solve the problem of profit shifting to low-tax jurisdictions or tax havens, but CFC regulations target this issue. In addition, TP regulations are not built on concrete concepts and difficult to determine and apply because they have never been an exact science, while CFC rules are mechanical and targeted. CFC regulations thus could reduce or avoid excessive pressure on TP regulations by supporting them to a great extent.

Therefore, CFC regulations indeed function as a backstop to TP regulations to obtain the same result – to deter tax avoidance and to safeguard tax bases, albeit in a discrepant manner. Now that in some circumstances TP regulations and CFC regulations are able to lead to the same result, whether TP regulations can alter CFC regulations provided that the transaction computation approach of CFC rules is applied?

From the examples given in section 4.4, when merely CFC regulations are effective, the ALP entailed in the transactional approach under ATAD cannot fully meet the demands required in CFC rules, because in this case the ALP is based on the application of CFC rules and only acting as a computation measure to attribute CFC income. Nevertheless,

in other scenarios regardless of both regimes are applicable or merely TP regulations are applicable, the conclusion is in line with the Netherlands – the ALP is sufficient enough to alter CFC regulations.

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