



# Legislative proposal for a controlled foreign companies regime in Poland from an international perspective

MAGDALENA MAŁGORZATA HYBKA, PhD\*

Preliminary communication\*\*

JEL: H25, H26

doi: 10.3326/fintp.38.4.4

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\* The author would like to thank three anonymous referees for their useful comments and suggestions.

\*\* Received: May 19, 2014

Accepted: October 13, 2014

A previous version of this paper was presented at the conference *Tax Reforms: Experiences and Perspectives* organized by the Institute of Public Finance, Faculty of Economics and Business, Zagreb and Faculty of Economics, Rijeka in Zagreb on June 20, 2014.

Magdalena Małgorzata Hybka

Poznan University of Economics, Department of Public Finance, Al. Niepodległości 10, 61-875 Poznań, Poland

e-mail: malgorzata.hybka@ue.poznan.pl

## Abstract

*Tackling corporate profit shifting requires appropriate anti-avoidance measures. This article reviews one of these measures, a controlled foreign companies (corporations) regime. It has been implemented in many countries, in some of them as early as the 1960s. The need for its introduction has also been expressed on many occasions by the Polish legislator. The article is composed of three sections. The first considers the reasons for the implementation of the analyzed regime. The second describes the controlled foreign corporation legislation in the USA and selected European Union member states. The last section is devoted to a bill on taxing controlled foreign companies in Poland.*

*Keywords: controlled foreign company, tax avoidance, Poland*

## 1 INTRODUCTION

Corporate income tax avoidance is a common phenomenon all over the world. It usually takes the form of profit shifting between companies operating in countries imposing relatively high corporate income tax rates and those located in tax havens, and brings about a substantial loss of tax revenue. With the spread of multinational companies, counteracting this phenomenon is more and more becoming a burning issue for the public administration of the former transition economies.

Amongst the anti-avoidance measures applied by different countries, controlled foreign company (corporation) legislation is one of the most popular and considered the most effective. The CFC regulations empower a country to impose taxation on income created by foreign entities controlled by resident taxpayers (usually corporations but in some countries also individuals). They are intended to counter tax avoidance by discouraging the migration of passive income<sup>1</sup> to non-resident companies. The adoption of such regulations was recommended by the OECD in its report *Harmful Tax Competition: An Emerging Global Issue* in 1998. The possibility is also included in the draft of the *Directive on a Common Consolidated Corporate Tax Base* proposed by the European Commission.

The controlled foreign companies regime, first applied in the United States, has been implemented in many OECD countries and in such European Union member states as France, Germany, Italy and the United Kingdom. From January 1, 2015 CFC rules will also be a part of Polish tax legislation. According to the new regulations taxpayers are obliged to declare in their yearly tax returns the income of the foreign companies controlled by them which are resident in certain tax havens or other statutorily defined territories. This income will be subject to personal income or corporate income taxation under certain conditions.

<sup>1</sup> Passive income refers to income that can be earned without active participation. It may include inter alia: interest, dividends, rents, royalties, amounts received from personal service contracts and income received as a beneficiary of an estate or trust. Such income is geographically mobile and usually more susceptible to international tax avoidance schemes. Each of the jurisdictions applying CFC rules may use a different catalogue of passive income items.

The basic aim of this article is to evaluate the legislative proposal for a CFC regime in Poland. To achieve this objective the article consists of three parts. It starts with an explanation of the motives for the introduction of CFC rules and arguments both in favour of and against their adoption, continues with an overview of CFC regulations already in place in the USA and selected European Union member states. The last part addresses the legislative proposal for CFC regulations in Poland.

## 2 RAISON D'ÊTRE OF CONTROLLED FOREIGN COMPANIES REGULATIONS

Preferential taxation offered by tax havens contributes to a significant decrease in public revenue in welfare states not engaged in harmful tax competition. This decrease of revenue is the result of tax avoidance schemes involving the shifting of profit between capital-related companies located in different tax jurisdictions. The shifting of profit is also accompanied by its retention in tax havens.

In spite of numerous attempts made to estimate the scale of this revenue loss it is not precisely known. Many of these estimations concern the tax avoidance strategies of American enterprises. One of the authors analysing the issue is J. G. Gravelle. In his publication he gives an insight into the potential magnitude of the revenue loss due to profit shifting and points out, for example, that eliminating this phenomenon would make it possible to lower the maximum rate of corporate income tax in the USA from 35% to 28% or would feed the American budget with an additional revenue of about 14 billion USD a year (2013:17).

The review of publications devoted to the problem of profit shifting to tax havens is included in the 2013 study of the OECD (2013:61-67). The study refers to analyses applying different methods and using different data sources in order to assess the scale of the phenomenon, including analyses taking into account the differences in effective tax rates imposed on international enterprises in particular jurisdictions or statistical data coming from tax returns. For example, the research conducted by the Citizens of Tax Justice in cooperation with the Institute on Taxation and Economic Policy in the USA in 280 large American enterprises chosen from the *Fortune 500* list shows that the effective tax rate for these enterprises in 2008-2010 was only 18.5%, while the statutory tax rate for corporations in the USA is 35% (McIntyre et al., 2011:3).

More insight into the scale of this phenomenon may come also from an analysis of foreign direct investment in tax havens and foreign direct investment placed by residents of tax havens. The aforementioned study of the OECD includes information that the share of foreign direct investment received by three jurisdictions regarded as tax havens – Barbados, Bermuda and the British Virgin Islands – in the total value of foreign direct investment in 2010 – was higher than the FDI in Germany or Japan. A similar situation was reported with respect to foreign direct in-

vestment coming from these jurisdictions. The British Virgin Islands were second in the ranking of the greatest investors in China, after Hong Kong and before the USA. Bermuda ranked third, as one of the largest investors in Chile and Mauritius ranked first – as the leading investor in India (OECD, 2013:17). Hence it appears interesting to ask if the phenomenon of profit shifting to tax havens also involves Polish enterprises and if it does – to what extent?

According to the data published by the Polish Ministry of the Economy, most foreign direct investment comes to Poland from member states of the European Union (---, 2014:12). These countries cumulatively represented nearly 87.7% of direct investment stock at the end of 2012. In the years 2008-2012 the Netherlands, Germany, France and Luxembourg were the four largest country sources of FDI (table 1). Together, these four economies alone accounted for nearly 52.4% of total FDI stock in Poland at the end of 2012.

Polish foreign direct investments were also located mostly in other EU member states (NBP, 2014:12). However the geographic structure of the location of Polish foreign direct investments is different (table 3). In 2012, Polish enterprises invested the most in the Netherlands, France and Cyprus (table 2). In 2009-2011, other popular investment locations for Polish enterprises were Switzerland, Luxembourg, UK, USA and Belgium. In 2012, however, much of the Polish capital was withdrawn from Switzerland, Luxembourg and Sweden. In the years 2010-2012 the highest outflow of Polish FDI was recorded in the case of Switzerland. This fact could be related to the declining attractiveness of Switzerland for European investors in this period. Due to the exponential rise of the franc against the euro and the dollar and weak growth in export markets, 2012 was the worst year for foreign direct investment in Switzerland since 2005. The attractiveness of Luxembourg for Polish investors could have been influenced by the amended Luxembourg-Poland double tax treaty in 2012. The amendments removed tax benefits previously available to Polish residents with respect to dividend income, widened the scope of information exchange between Luxembourg and Poland and introduced a new provision denying the benefits of the treaty in case of the existence of an artificial arrangement.

Despite investment outflow at the end of 2012, Luxembourg had the biggest share of Polish FDI abroad. It accounted for 21.8% of total Polish FDI outward stocks. Other significant countries for the location of Polish FDI stocks were Cyprus, UK, Netherlands and Switzerland. The data presented in table 3 indicate that low tax rate countries (Cyprus, Luxembourg, Netherlands and Switzerland) accounted for 46.7% of total Polish outward FDI stock in 2012. This share decreased in the years 2008-2012 by 6.4 percentage points but is still extremely high.

**TABLE 1**

*Foreign direct investment in Poland (inward stocks) in the period 2009–2012 (million EUR; top ten countries; as of 31/12 each year)*

No.	2008			2009			2010			2011			2012		
	Country	Total FDI inward stock	Country	Total FDI inward stock	Country	Total FDI inward stock	Country	Total FDI inward stock	Country	Total FDI inward stock	Country	Total FDI inward stock	Country	Total FDI inward stock	
1	Netherlands	22,048.3	Netherlands	22,908.0	Netherlands	29,242.8	Netherlands	23,889.0	Germany	26,897.6					
2	Germany	18,145.3	Germany	20,832.6	Germany	21,220.2	Germany	21,482.0	Netherlands	26,285.4					
3	France	12,463.1	France	14,315.9	France	19,374.9	France	18,676.3	France	21,938.4					
4	Luxembourg	10,019.8	Luxembourg	11,121.7	Luxembourg	13,435.8	Luxembourg	17,733.7	Luxembourg	18,222.8					
5	USA	7,100.0	USA	8,410.2	Italy	10,557.2	Sweden	9,203.4	Italy	9,982.9					
6	Sweden	5,276.4	Sweden	6,399.4	USA	9,450.6	Spain	8,814.1	Spain	9,703.8					
7	UK	4,408.6	Italy	5,210.4	Switzerland	6,797.9	Italy	8,207.9	Sweden	8,363.6					
8	Italy	4,308.9	Austria	4,719.5	UK	6,220.2	USA	7,148.6	USA	8,129.9					
9	Austria	4,116.5	UK	4,661.4	Sweden	6,193.0	UK	6,032.8	UK	7,540.9					
10	Belgium	3,784.6	Spain	4,160.1	Austria	5,085.7	Austria	5,279.1	Austria	6,070.3					
<b>11</b>	<b>Total world</b>	<b>115,708.9</b>	<b>Total world</b>	<b>128,834.3</b>	<b>Total world</b>	<b>161,377.7</b>	<b>Total world</b>	<b>157,151.1</b>	<b>Total world</b>	<b>178,256.7</b>					

Source: Own compilation based on: NBP (2009b:59–64;2010b:30–35; 2011b:4; 2012b:4; 2013b:4).

**TABLE 2**  
*Polish direct investment outflows abroad in the period 2009-2012 (million EUR; top five countries for outflows and withdrawals)*

No.	Capital outflows and withdrawals	2009		2010		2011		2012	
		Country	Total FDI outflow/ withdrawal	Country	Total FDI outflow/ withdrawal	Country	Total FDI outflow/ withdrawal	Country	Total FDI outflow/ withdrawal
1	Outflows	Luxembourg	927.1	UK	2,441.2	Luxembourg	2,909.9	Netherlands	574.2
2	Withdrawals	Belgium	800.2	Luxembourg	1,734.7	Cyprus	1,296.5	France	329.3
3	Outflows	Switzerland	757.2	USA	723.8	France	416.6	Cyprus	296.9
4	Withdrawals	Norway	309.7	Cyprus	717.9	Lithuania	266.0	Germany	223.7
5	Outflows	Germany	124.1	Belgium	544.6	USA	230.1	USA	221.7
1	Withdrawals	Croatia	-10.5	Switzerland	-1,329.9	Sweden	-156.8	Luxembourg	-715.7
2	Outflows	Romania	-8.8	Cayman Islands	-425.9	Vietnam	-52.8	Switzerland	-647.1
3	Withdrawals	Belarus	-8.2	Hong Kong	-169.4	Switzerland	-48.9	Sweden	-489.0
4	Outflows	Italy	-6.4	Russian Federation	-167.8	British Virgin Islands	-24.5	UK	-126.3
5	Withdrawals	Egypt	-5.7	Sweden	-95.4	Netherlands	-18.2	Czech Rep.	-86.6

Source: Own compilation based on: NBP (2010:4-7; 2011:2; 2012:2; 2013:2).

TABLE 3

Polish direct investment outward stocks in the period 2008-2012 (million EUR; top ten countries; as of 31/12 each year)

No.	2008			2009			2010			2011			2012		
	Country	Total FDI outward stock	Country	Total FDI outward stock	Country	Total FDI outward stock	Country	Total FDI outward stock	Country	Total FDI outward stock	Country	Total FDI outward stock	Country	Total FDI outward stock	
1	Switzerland	3,482.4	Switzerland	4,665.4	Luxembourg	6,758.2	Luxembourg	9,101.2	Luxembourg	9,101.2	Luxembourg	9,471.8	Luxembourg	9,471.8	
2	Luxembourg	3,360.7	Luxembourg	4,078.3	UK	4,191.6	UK	4,386.6	UK	4,386.6	Cyprus	4,450.2	Cyprus	4,450.2	
3	Netherlands	1,355.5	Netherlands	1,599.6	Netherlands	2,359.6	Netherlands	3,806.0	Switzerland	3,806.0	UK	4,396.8	UK	4,396.8	
4	Czech Rep.	972.1	Czech Rep.	1,054.8	Switzerland	2,285.8	Cyprus	3,324.8	Cyprus	3,324.8	Netherlands	3,224.3	Netherlands	3,224.3	
5	UK	802.6	UK	904.8	Czech Rep.	1,807.8	Netherlands	2,641.7	Netherlands	2,641.7	Switzerland	3,145.6	Switzerland	3,145.6	
6	Lithuania	731.0	Lithuania	856.0	Belgium	1,707.4	Belgium	2,121.1	Belgium	2,121.1	Belgium	2,283.2	Belgium	2,283.2	
7	Germany	591.4	Belgium	820.1	Lithuania	1,630.2	Lithuania	1,919.8	Lithuania	1,919.8	Czech Rep.	1,976.1	Czech Rep.	1,976.1	
8	Russian Federation	497.4	Norway	760.3	Germany	1,563.0	Czech Rep.	1,904.6	Czech Rep.	1,904.6	Germany	1,955.1	Germany	1,955.1	
9	Ukraine	462.9	Germany	741.1	USA	1,470.1	Germany	1,735.9	Germany	1,735.9	Lithuania	1,876.3	Lithuania	1,876.3	
10	Norway	384.9	Cyprus	573.0	Cyprus	1,428.9	USA	1,563.2	USA	1,563.2	USA	1,531.7	USA	1,531.7	
11	<b>Total world</b>	<b>15,983.0</b>	<b>Total world</b>	<b>17,030.3</b>	<b>Total world</b>	<b>33,264.0</b>	<b>Total world</b>	<b>40,887.6</b>	<b>Total world</b>	<b>40,887.6</b>	<b>Total world</b>	<b>43,492.2</b>	<b>Total world</b>	<b>43,492.2</b>	

Source: Own compilation based on: NBP (2009:59-62; 2010:28-31; 2011:4; 2012:4; 2013:4).

A significant part of the Polish capital invested in Luxemburg, Switzerland and Cyprus in the years 2008-2012 were cash flows (*Projekt z dnia 30 kwietnia 2013 r.*, 2013:13). Some large Polish enterprises operate within holdings, whose companies are registered in these countries. According to the Polish National Bank (NBP) in 2011 income from the capital of enterprises from their investments in Luxemburg, Switzerland and Cyprus equalled 300.3 million euro, 116.8 million euro and 410.5 million euro, respectively. In the case of Switzerland, Luxemburg, the Netherlands and Belgium, it is difficult to talk about Polish foreign investment in the traditional sense, i.e. involving, for example, takeovers of foreign enterprises or the purchase of a significant number of shares. Companies registered in these countries also invest resources in other jurisdictions but statistics are limited to the recording of the first transaction, ignoring the issues of the target location of the investment. The high position of Cyprus and Luxembourg in the ranking of countries most often chosen by Polish investors is due to the good conditions for businesses these countries offer to foreign investors, mostly in the form of preferential tax treatment. Foreign entities investing in Cyprus often locate their holding companies there.

The scale of the phenomenon of shifting profit to tax havens and retaining it there depends to some extent on the tax residence law of a given country and the methods applied for avoiding double taxation of the foreign income (the design of double tax treaties). In Poland, the Personal Income Tax Act and the Corporate Income Tax Act make legal distinctions between unlimited and limited tax liability (*Ustawa z dnia 26 lipca 1991 r.*; *Ustawa z dnia 15 lutego 1992 r.*). Pursuant to Article 3 of the first of these acts natural persons, if they are residents on Polish territory, are subject to tax liability on their total income regardless of the location of the source of this income. At the same time a resident on Polish territory is defined as a natural person (individual) meeting one of the following conditions:

- having the centre of his/her personal or economic interest (the centre of vital interests) on the territory of the Republic of Poland, or
- having been resident on the territory of the Republic of Poland for more than 183 days in a fiscal year.

At the same time natural persons who are not domiciled in Poland are subject to the tax liability only on income generated on Polish territory.

Relevant regulations concerning legal persons are included in Article 3 of the Act on Corporate Income Tax according to which taxpayers who have their location (seat) in the territory of Poland are subject to tax liability on the totality of their income, regardless of where it comes from. Taxpayers who do not have a location (seat) in the territory of Poland are liable to pay tax only on income generated in the territory of Poland. The Act on Corporate Income Tax does not contain a definition of location (seat) so according to the provisions of the Article 41 of the Civil Code (*Ustawa z dnia 23 kwietnia 1964 r.*) if no act or articles of association



based upon this act provide otherwise, the location of a legal person is the location of its managing body (Gajewski, 2009:28).

The income of a subsidiary located in a different country from that of its shareholder (whether a natural or a legal person) is taxed in the country of its location. The income of this subsidiary is usually taxed in the country of tax residence of the shareholder only if it is paid in the form of a dividend or comes from the sale of the subsidiary's assets due to its liquidation. This principle also applies to subsidiaries of Polish legal persons. The institution of a controlled foreign company makes it possible to tax income earned in tax havens, even when it is not distributed in the form of dividends. Therefore the CFC is an important instrument to limit the scale of tax avoidance. The proposal to introduce CFC rules in Poland is just one of many measures which over the last twenty years have been taken by the Ministry of Finance in order to restrain the erosion of the income tax base. Transfer pricing regulations play the primary role in counteracting profit shifting practices. In Poland, methods for the determination of the arm's length price have been regulated since 1st January 1997 by Article 25 of the Personal Income Tax Act and Article 11 of the Corporate Income Tax Act. The statutory requirements for transfer pricing documentation were introduced in 2001 and a formal Advance Pricing Agreement programme entered into force in 2006. Polish regulations in this regard are based on OECD guidelines and are especially concerned with transfer pricing methods.

Notwithstanding the existence of transfer pricing regulations it is still possible for profit to build up in sales and distribution subsidiaries located in countries offering preferential tax treatment (Prebble, 1987:22). As transfer pricing rules are not capable of tackling international tax avoidance, particularly of solving the problem of tax deferral, special anti-abuse provisions are necessary. In Poland, other anti-tax avoidance measures introduced cover inter alia: the modification of double taxation agreements (for example, the removal of the tax sparing clause in the agreements with Cyprus, Luxemburg, the Czech Republic, Malta, Singapore, Malaysia and the adjustment of agreements with Switzerland, Canada, and Austria to the current OECD standard). Moreover the Ministry of Finance is considering the introduction of a General Anti-Abuse Rule (GAAR) (from 1st January 2015).

The implementation of controlled foreign company regulations is likely to contribute to an increased public revenue through limiting the scale of tax avoidance. However it must be noted that the adoption of anti-avoidance provisions may have some negative consequences. Such provisions are, inter alia, taken into account by investors when assessing the investment climate of a country. CFC rules are one of the factors included whilst calculating tax attractiveness indices (Keller and Schanz, 2013:340). Hence these indices reflect the tax planning opportunities offered by a jurisdiction: countries with CFC rules are perceived to be less attractive than the countries without them. This means that the implementation of CFC regulations may lower the relative attractiveness of Poland for foreign investors.

Moreover CFC regulations are sometimes claimed to hinder the free movement of capital and severely affect foreign operations of MNEs. In addition, CFC rules may increase the compliance costs of multinational enterprises. In a survey conducted amongst US-based multinational enterprises, information reporting on foreign controlled corporations was the second most mentioned feature of the U.S. tax code contributing to the compliance costs of foreign operations (Blumenthal and Slemrod, 1995:46). The impact of these regulations on the investment activities of multinational enterprises has also been discussed in economic literature. P. Egger and G. Wamser found, for instance (using the data-set provided by the German Central Bank), that CFC rules in Germany are associated with an increase of the overall cost of capital for MNEs which leads to a significant decrease in their foreign real investment. The authors provide evidence that subsidiaries covered by CFC rules use significantly fewer fixed assets, so these regulations by policy makers may have an undesired impact on active investment (2011:18).

### 3 CONTROLLED FOREIGN COMPANY TAXATION: ANALYSIS OF LEGISLATION IN THE USA AND SELECTED EUROPEAN UNION MEMBER STATES

The institution of the controlled foreign company is very common. So far it has not been introduced in the EU by Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Ireland, Luxembourg, Poland, Romania and Slovakia (Deloitte, 2014:71). Some countries use not only CFC but also other instruments to counteract tax avoidance, and these also make it possible to impose taxes on some categories of income earned by companies related to domestic entities but located in tax havens. Amongst these countries there are: Austria, Latvia, Malta, the Netherlands and Slovenia.

In the countries which implemented the discussed instruments there are significant differences with respect to basic elements of its construction, including: the definition of control, the category of the income subject to taxation or tax exemptions. In most countries the income of a controlled foreign company is added only to the income of legal persons. In some, for example, Germany, Sweden or the USA, the income of CFCs is ascribed also to appropriate individuals and is taxed in their countries of residence.

In economic literature there are two CFC concepts, which take into account (Lang et al., 2004:137):

- 1) the category of income of the company, and
- 2) the scope of its activity.

In the case of the first, called the transactional approach, only passive sources of income are subject to taxation (for example dividends, interest on loans or license fees). In the other – the entity approach – the institution of the CFC refers to spe-

cific entities, usually pursuing economic activities of a nature as defined by the tax law.

In most countries the institution of the controlled foreign company refers to all entities and the tax is imposed on income regardless of its source. The exceptions include Hungary, Spain, Germany and the USA. In these countries tax is imposed on specified categories of a CFC's income.

A number of countries have developed lists of tax havens or countries using harmful tax competition and taxed the income of controlled foreign companies if they are residents in the listed jurisdictions – this approach is called the locational approach (Miller and Oats, 2009:277). As part of this concept, in some countries the institution of a controlled foreign company refers only to the shareholders of companies located in jurisdictions offering preferential tax conditions, which is called the designated-jurisdiction approach (Russo, 2007:213). In other countries the CFC rules apply only if the tax rate in a company's country of residence, imposed on the income of this company, is lower than the tax rate of an analogous company in the country of residence of the company's shareholder (effective-tax-rate approach). Most of the countries which implemented the institution of the controlled foreign company introduced the first of these solutions. The regulations existing in these countries usually specify what provisions of the tax law are regarded as preferential. Amongst the exceptions are Denmark, France, Spain, Germany and the USA, where the institution of CFC is applied regardless of the country of location of the controlled foreign company.

All these approaches have both advantages and disadvantages. In the transactional approach a list of categories of income either subject to tax or tax exempt should be included in the tax regulations. The purpose of this list is to draw the line between passive and active sources of income. In such a way the CFC rules better fulfil their purpose without discouraging foreign direct investment activities (as may be the case with the entity approach). However the major weakness of this approach is the complexity and relatively high administration costs. In addition, even with all the elaboration of passive and active income definitions that may be found in some countries using the transactional approach (e.g. USA), it is unlikely that the legislator will be able to include all the forms of income capable of being devised and used for the purpose of tax avoidance by tax planners. For this reason it is often necessary to provide enforcement authorities in these countries with wide discretionary powers that involve many subjective judgements (Prebble, 1987:24). In order to avoid double taxation of income by the entity approach the regulations should provide for a clause enabling the exclusion of the company from taxation if it carries out a genuine business activity. That may also lead to legal complexity and increase the number of court cases.

TABLE 4

*The dates of the introduction of CFC regulations in selected countries*

Country	Date of entry
United States	1962
Canada, Germany	1972
Japan	1978
France	1980
United Kingdom	1984
New Zealand	1988
Australia, Norway, Sweden	1990
Denmark, Finland, Indonesia, Portugal, Spain	1995
Hungary, Mexico, South Africa, South Korea	1997
Argentina	1999
Estonia, Italy, Israel, Lithuania	2000

*Source: Arnold and McIntyre (2002:89).*

The locational approach, with a list of countries included or excluded from taxation, reduces both the administrative burden and the compliance costs of multinational enterprises. Two problems, however, are likely to arise in connection to this approach. First it may contribute to the loss of revenue in respect of some passive income obtained by companies located in jurisdictions not included on a black list (or included on a white list). Secondly, if the company is grounded for tax-avoidance reasons it may be difficult to determine its residency. Such a company may have its place of incorporation, location of head office, place for conducting business and meeting place for board directors in different jurisdictions.

The institution of the controlled foreign corporation was first introduced by the United States (table 4). The relevant regulations are included in Subpart F (sections 951-965) of the *Internal Revenue Code* (online). A foreign company is regarded as controlled by American shareholders if the sum of their direct or indirect shares in the company's capital or voting rights, on any day of a fiscal year, exceeds 50%. When the sum of these shares is calculated, only those US shareholders whose direct or indirect share in the voting rights of the corporation is not less than 10% are taken into account. At the same time the share must exceed quoted thresholds for the period of a minimum of 30 days in a fiscal year. Statutorily specified categories of a CFC's income are added to the domestic income of the taxpayer and then taxed. These categories include:

- statutorily defined insurance income,
- foreign base company income, which covers: foreign personal holding company income (inter alia: interests, dividends, rents, royalties, gains and notional principal contract income); foreign base company sales income; foreign based company services income; foreign based company oil related income,

- income from countries subject to international boycotts,
- illegal bribes, kickbacks, or other payments unlawful under the *Foreign Corrupt Practices Act* (online),
- income from countries with which the U.S. has severed diplomatic relations.

The law envisages a number of exemptions from taxation. These concern, for example, foreign based company income or insurance income, if its amount is lower than 5% of the total income or than 1 million USD (*de minimis* rule). At the same time if this sum constitutes more than 70% of a CFC's income, the part of the total income of the corporation attributable to the shareholder must be declared and taxed in the USA (full-inclusion rule). Moreover the CFC income is exempt from taxation in the USA if the effective tax rate imposed in the country of residence of the CFC is more than 90% of the maximum corporate income tax rate in the USA. Some categories of income of a foreign personal holding company are also exempt from taxation.

Since CFC provisions are designed to prevent profit shifting to tax havens, they attract the attention of the European Union authorities from the viewpoint of the principles of the fundamental freedoms, especially the freedom of establishment and the freedom of movement of capital. In this respect the question arises as to whether CFC regulations infringe these principles. As a result the national CFC rules of the European Union member states may be influenced by rulings of the European Court of Justice.

In the so-called *Cadbury-Schweppes* decision, the European Court of Justice tried to impose restrictions on CFC rules for affiliates that operate within the EU/EEA and belong to multinationals that are headquartered in an EU/EEA country. The case concerned a UK parent corporation that set up two finance subsidiaries in Ireland. The Irish subsidiaries had no offices, phones or employees so the national tax administration assumed that they were set up to take advantage of the Irish low-tax regime. As a result the UK tax authorities sought to apply CFC rules on the income obtained by these subsidiaries (Harris and Oliver, 2010:309).

After the national tax authorities demanded corporation tax, *Cadbury-Schweppes* appealed. Finally the relevant UK court referred the case to the ECJ, which concluded that taking advantage of a low tax rate in a member state cannot in itself be defined as an abuse of Community law. It also held that the UK's CFC regulations were indeed in violation of the principles of free establishment within the community unless the legislation is limited to apply only to wholly artificial arrangements designed to avoid national taxation. Consequently the ECJ noted that even if the intention to obtain the tax advantage was the reason why the controlled subsidiaries were established in Ireland, these facts alone are not sufficient to conclude that there was a wholly artificial arrangement intended solely to avoid UK

tax. Summarizing, the decision of the ECJ is an attempt to draw a line between tax avoidance and tax planning and confirms that certain types of tax planning are acceptable in an internal market concept (O'Shea, 2007:20-21).

**TABLE 5**

*Main characteristics of CFC regimes in France, Germany, UK and USA*

Country	Approaches applied	Categories of shareholders subject to taxation	Categories of income subject to taxation	Definition of control	Nature of exemptions
France	Entity approach; effective tax rate approach	Legal entities	All types of CFCs' income	More than 50% of direct or indirect shares in the capital, voting rights or financial rights	Exemption for capital gains; exemption if shareholder proves that the CFC is not an artificial arrangement to circumvent French tax legislation
Germany	Transactional approach; effective tax rate approach	Individuals and corporations	Only passive income; law stipulates which categories of income are not subject to taxation	More than 50% of direct or indirect shares in the capital or voting rights; the threshold is reduced to 1% if CFC is engaged in the business of certain financial transactions	Exemption for EU-resident companies; exemption for real estate investment trusts
United Kingdom	Entity approach; effective tax rate approach	Companies	Only certain categories of income defined by gateway test	Direct or indirect share in CFC's capital or voting rights in the amount sufficient to manage the company's issues	Exempt period exemption; excluded territories exemption; low profits and low profit margin exemption; low level of tax exemption; finance company exemption
United States	Transactional approach; effective tax rate approach	Individuals and corporations	Only certain categories of income defined by tax law	The sum of the direct or indirect share of all shareholders in the corporation's capital or voting rights exceeds 50%; each American shareholder owning directly or indirectly at least 10% of the voting stock	<i>De minimis</i> exemption; low level of tax exemption; exemption for certain categories of income of a foreign personal holding company

Source: Own compilation based on Deloit (2014:20-23, 61-65).

In reaching this decision the ECJ examined the UK motive test and expressed doubt as to its adequacy. The decision of ECJ gave an impetus to legislative amendments to CFC rules in the United Kingdom. According to the provisions

currently in force the CFC institution is applied when companies resident in this country control a foreign company, i.e. own direct or indirect shares in its capital or voting rights of an amount sufficient to manage the company's affairs. The definition of control also includes 40% ownership if no other non-UK resident has a 55% interest in the corporation (Harris, 2013:119). Since 1st January 2013 the regulations for CFCs are contained in Part 9A, *Taxation (International and Other Provisions) Act 2010 (Controlled Foreign Companies)*, online). The changes implemented concern especially the scope of the taxable income of a CFC; it is determined with the use of the so-called "gateway test", which enables the determination as to if, and in relation to which income of a given CFC, profit shifting to another country for tax reasons has taken place. This test serves to exclude a proportion of entities from the scope of the CFC rules before taking into account the other exemptions. It is considered to be more precise and more objective than the motive test which it replaced.

The gateway test consists of two elements: "pre-gateway test" and "main gateway test". The first test enables companies to answer the question whether or not the specific parts of main gateway test require consideration. The second consists of five parts related to the following income categories:

- income attributable to UK significant people functions,
- non-trading finance income,
- trading finance income,
- income from captive insurance business,
- income that is within the scope of the CFC charge because the CFC is the subject of a solo consolidation waiver or because there are arrangements that have a broadly equivalent regulatory effect.

Taxation is imposed only on income falling into one of these categories. For each category of income defined by the law there is a qualitative set of questions to determine whether it passes through the gateway. For example non-trading finance income which consists of non-trading income taxable under the loan relationship rules (e.g. derivative contract income or interest), dividends or other distributions that are not tax exempt and non-trading income from relevant finance leases, may be excluded from CFC rules if it is considered incidental. If it is not incidental it will pass through the gateway and become chargeable if it is derived from: assets and risks in relation to which any relevant active decision making is carried out in UK, capital investment from the UK, specified arrangements in lieu of dividends (typically loans) with the UK or UK finance leases.

The legislator allowed for numerous exemptions (table 5). They apply mostly to controlled foreign companies located in some tax jurisdictions, if the profits of these CFCs do not exceed the amount of 500,000 GBP and the income from the activity other than commercial does not exceed the amount of 50,000 GBP and to CFCs meeting certain requirements and providing financial services within capital

groups or to newly founded CFCs in the period of 12 months from the date of their classification as CFCs. Moreover, the income of a CFC is exempt from tax provided that the tax it pays in its country of residence equals at least 75% of the tax it would have to pay if it was a resident of the United Kingdom.

The German CFC rules follow closely the US regulations (Peters, 2012:6). In Germany the provisions concerning controlled foreign companies are included in Articles 7-14 of the *Foreign Tax Act (Außensteuergesetz, online)*. Pursuant to the content of this Act, the implementation discussed is applicable in the following cases:

- taxpayers (natural and legal persons) subject to unlimited tax liability, having more than 50% of direct or indirect shares in the capital or voting rights of a foreign company, or
- taxpayers (natural or legal persons) subject to unlimited tax liability, having direct or indirect shares in the capital or voting rights of a foreign company in the amount of more than 1%, if the company runs a statutorily specified financial activity, including management of some assets.

The conditions are considered met also if the taxpayer is a partner in a partnership which is a partner in another partnership, if the latter owns shares in the capital or voting rights of a foreign company in the aforementioned amounts. Taxpayers owning shares in a controlled foreign corporation are obliged to pay tax on the passive income of the company, if in the company's country of residence this income is taxed by an effective tax rate lower than 25%. The *Foreign Tax Act* mentions ten categories of income which are regarded as active and these are not added to the income of a taxpayer. Amongst them are: income derived from agriculture and forestry, exploitation of natural resources, energy generation, manufacturing of goods, trading and services, banking, insurance, leasing of certain movable and immovable assets and licensing.

In France, the institution of the CFC is defined in Article 209 Bof the *General Tax Code (Code général des impôts, online)*. An enterprise is regarded as a CFC if an entity subject to corporate income tax owns directly or indirectly more than 50% shares in the capital or voting rights of this enterprise. An anti-abuse provision reduces this threshold to 5% for each direct or indirect French shareholder when more than 50% of the shares in the foreign entity are owned by other French entities or entities that are considered nominees of the French shareholder (Deloit, 2014:20). The income of a CFC is added to other income of this entity, if the effective income tax rate in the CFC's country of residence is at least 50% lower than the effective income tax rate in France. Moreover, these regulations are only applied if the income of a foreign company is not earned from industrial or commercial activity run in the jurisdiction where it is located. There are, however, exceptions to this rule. This exemption does not apply to companies which run an industrial or commercial activity in the jurisdiction where they are located, but –



at the same time – earn more than 20% of their income from financial activity or from the trading of intangible assets. If a company presents the tax authorities with evidence that it is not located on a foreign territory only for tax reasons its income may be exempt from tax in France.

Despite their weaknesses the US rules seem to be the most effective model of CFC legislation. They impose taxation on income derived from activities that are prone to profit shifting practices and are less likely to discourage active forms of investment than the regulations based on the entity approach. Moreover they provide for a wide range of persons subject to taxation, both individuals and corporations. However precision in defining the passive income sources comes at the expense of an increased complexity that leads to the relatively high administrative costs of the US model. Amongst the European Union member states the current British CFC provisions should be appreciated for the numerous exemptions and the application of a gateway test which will probably allow better targeting of artificial arrangements aimed at tax avoidance than the motive test.

Taking into account all the pros and cons of the applied provisions it has to be said that the best solution appears to be a hybrid of the transactional approach and the locational approach accompanied by a jurisdictional list of countries designed in the form of administrative documents. Such an approach will not be over-complex or cause extensive compliance costs and the jurisdictional list itself will be capable of easy amendment.

#### **4 TAXATION OF CONTROLLED FOREIGN COMPANIES IN POLAND: OVERVIEW OF THE BILL'S PROVISIONS**

Pursuant to the provisions of the bill sent to the lower chamber of the Polish Parliament (*Sejm*) on April 14th, 2014, a controlled foreign company is defined as a company with the seat or the management board either (*Projekt ustawy o zmianie ustawy, 2014*):

- on a territory or in a country applying harmful tax competition, or
- on the territory of any foreign country if Poland (or the European Union) has no international agreement with it (in particular, a double taxation agreement) on the basis of which it is possible to obtain tax information from this country.

A CFC is also any foreign company in which the following conditions are jointly met:

- for the period of minimum 30 days continually, the taxpayer owns, directly or indirectly, at least 25% of shares in the capital or 25% of the voting rights in the control or decision-making organs, or 25% of the shares involving the right to participate in profits,
- at least 50% of the company's revenue earned in a fiscal year comes from passive sources of revenue, i.e. dividends and other income from shares in

profits, from the sale of shares (stock), debts, interests and proceeds from loans, deposits and guarantees, as well as from copyrights, industrial property rights, including the sale of these rights and the execution of rights from financial instruments,

- at least one part of the company's passive income is subject to taxation in the country where the company has its seat or management board with the income tax rate lower than minimum 25% of the rate existing in Poland, or if the company is exempt or excluded from income tax in this country, unless the company's income is subject to exemption from tax in the country where the company has its seat or management board under the provisions of the *Directive on the Common Taxation System Applicable to Parent Companies and Subsidiaries of Different Member States*.

The legislator assumed that the taxable income is the income earned by a company proportionally attributable to the period in which the company has had CFC status, in such a share as corresponds with the shares owned by its Polish shareholder (the taxpayer) and involving the right to participate in profits, after deducting the dividend obtained by the taxpayer and the amounts earned from the sale of shares in the CFC. If the dividends obtained or the amounts earned from the sale of the shares are not deducted in the fiscal year in which they are obtained, they should be deducted from the taxpayer's income during five consecutive fiscal years. If it is impossible to determine the share of the taxpayer in the profits of a CFC in order to add the appropriate part of the company's income to the income of the taxpayer, the share in the capital or the voting rights should be taken into account.

The income of a CFC is defined as the surplus of the sum of revenues over the costs of obtaining them (business expenses). Most of this income is determined on the last day of the CFC's fiscal year. If the CFC has no specified fiscal year or the year exceeds the period of consecutive 12 months it is assumed that the fiscal year of the CFC is the same as the fiscal year of the taxpayer. Other than in the case of domestic entities a CFC is not allowed to deduct losses incurred in previous years from its income.

Special regulations are envisaged for a situation in which the share of the taxpayer in the controlled foreign company is indirect. In that case the share of the taxpayer in the CFC is reduced by the share owned in this CFC by a subsidiary, if the subsidiary added to the tax basis the income of this CFC based on the regulations of the CFC existing in the country in which the subsidiary is subject to taxation.

The bill includes also exemptions from the taxation of CFCs if any of the following conditions are met:

- the CFC runs a genuine business activity on the territory of a country which is not an EU member or does not belong to the European Economic Area in which it is subject to taxation on the entirety of its income and the income does not exceed 10% of the revenues earned from a genuine business activity. This exemption is to be applied only if there is a legal basis for obtaining tax information from the tax authorities of the country in which the foreign controlled company is subject to taxation on the entirety of its income, or
- the CFC is subject to taxation on the entirety of its income in an EU member state or a country belonging to the European Economic Area and runs a genuine business activity in this country, or
- in a fiscal year the revenues of the CFC do not exceed an amount equalling 250,000 euros, converted into Polish currency at the average exchange rate published by the National Bank of Poland, valid on the last day of the fiscal year preceding a given fiscal year.

The legislator also proposed conditions the meeting of which may be sufficient evidence that a company conducts a genuine business activity and should be entitled to the aforementioned exemption. These conditions include in particular:

- the performance of actual activities by the company in the jurisdiction in which it is resident for tax purposes (e.g. selling goods or providing services in this jurisdiction),
- the possession of equipped premises and qualified personnel in the country of incorporation,
- the non-creation of structures which are not justified from the business perspective,
- the proportionality between the scope of the company's activity and the premises, the premises and the personnel,
- the conclusion of agreements which correspond to economic reality are economically justified and not obviously in conflict with the general business interests of the company,
- the independent performance by the company of basic business functions using its own resources, including resident managers.

The income of a CFC is added to the income of the taxpayer and is taxed at an appropriate corporate or personal income tax rate. In the case of the first, the appropriate rate is 19%. In the case of personal income tax, current tax rates equal 18% and 32%.

In the light of the scheduled legal changes earning income from shares in controlled foreign companies will involve a number of record-keeping requirements. Taxpayers are obliged to keep a register of companies in which they own shares. The register is to include information enabling the determination of the income of a company. At the request of the tax authorities the taxpayer must provide them with insight into the register within 7 days of the date of receipt of the request.

Should the taxpayer fail to make the register available to the tax authorities, the authorities will independently estimate the amount of the company's income. By the end of the ninth month of the year falling after the CFC's fiscal year, taxpayers owning shares in the company are required to submit evidence of the amount of the company's income. By this time they should also pay the amount of the tax due.

## 5 CONCLUSION

The implementation of a CFC regime requires precise determination of the circumstances in which it is applied. As it is used in many countries the Polish legislator does not have to design national legislation following only the American example. However, it must be emphasized that it is the American institution of controlled foreign corporation that has the longest history and was the prototype on which other countries modelled and implemented their CFC regulations, including many countries of the European Union. The Polish legislator suggested the combination of the two existing approaches. The CFC regulations are to apply not only to shareholders of companies located in countries which use harmful tax competition, the list of which will be attached to the proposed act, but also to shareholders of companies which have their seat or management boards in the country in which at least one of the company's passive incomes is taxed at the income tax rate significantly lower than in the country of residence of the shareholder.

The institution of controlled foreign companies proposed by the Polish legislator is in many respects different from the regulations existing in such countries as the USA, Germany, France or Great Britain. The legislator envisaged a lower threshold for the level of control of the company by a Polish shareholder than it is the case in the aforementioned countries. Moreover, unlike, for example, the situation in the USA or Germany, all the income of the corporation is to be taxed – not only the passive component. Also the scope of exemption from tax for controlled foreign companies is clearly more limited than in the case of the USA and Great Britain.

The draft of the Polish bill has been subject to public consultation, which exposed some of its weaknesses. One of them is the shifting onto the taxpayer of the burden of proof with respect to the circumstances entitling exemption from tax. Moreover it has been emphasized that the act may significantly limit the freedom of running a business activity on an international scale. The provisions obliging the taxpayer to verify the share of passive income in the total income of a CFC and the analysis of the level of the tax rate imposed on each category of passive income earned by a CFC is regarded as too complicated a solution, which will result in an excessive compliance burden being imposed on the taxpayers.

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