Introduction of the CFC rules in Slovakia

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Abstract

As from 1 st January 2022 the CFC rules as a measure to combat tax avoidance and tax evasion should be introduced also for individuals in Slovakia. The essence of this paper is to present the new rules to be introduced as of next year and to analyse critically the legal and tax consequences and the questions arising from such a measure. As a result it should be shown if such a measure can fullfil the ambition of the legislator to combat efficiently with the tax erosion and profit shifting on the level of natural persons in Slovakia.

Key words

CFC rules, tax avoidance, tax evasion, profit shifting

JEL Classification

H21, H26

Introduction

The new paradigm in the tax policy in Slovakia is determined by no exact and predictable plans of tax reforms that should be performed in near future. The only "reform" we have seen in recent months could be subsumed under the heading – "how to get more taxes from aggressive oligarchs". This applies very much to the introduction of the CFC rules ("controlled foreign corporation rules – further only "CFC rules") which have been introduced as an amendment to the Slovak Income Tax Act by the Slovak Parliament on 2nd December 2020[1] and will become effective as of 1st January 2022. The proclaimed official aim of the amendment was to "take measures mainly against aggressive oligarchs hiding behind shell companies in various controversial jurisdictions willing to cover corruption schemes and make them do business through Slovak legal entities, ideally through Slovak holdings" (Blahová, 2021).

The aim of this paper is to analyse critically the essence and impact of this substantial change in the Slovak income tax law and give clear evidence that the legislative piece of work

[1] The Amendment of the Income Tax Act was published under no. 416/2020 Coll.

has been prepared in a very fast mode with indicating the real impact on the Slovak entrepreneurship and companies. This piece of legislation shows very substantial deficits which will be explained further in the paper.

1 CFC rules – purpose, objectives and current status

CFC rules have not been a topic in the Slovak tax law for years. With a stronger internationalization of the business and trade and with Slovak companies having its subsidiaries also abroad, it is apparent that this topic becomes more important. The purpose and objectives of the CFC rules is to implement anti-avoidance and anti-evasion measures to tax the income which might be shifted to jurisdictions with lower or no corporate taxation under the "tax jurisdiction" of the parent companies or even of the tax residency of the ultimate beneficial owner of the entire group.

Therefor at this stage it is necessary to point out that we distinguish between the CFC rules for legal persons (corporations) and CFC rules for individuals. In order to prevent businesses and individuals from lowering their tax burdens by making advantage from lower or no tax rates in tax heavens and elsewhere the international tax community (more likely mainly the member states of the OECD countries) have decided to take measures to eliminate the creature of non-genuine tax structures which minimize the tax liability in the countries of the residency (of the legal person or of the UBO). When preparing the BEPS actions by OECD the Action 3 was meant to introduce the guidance how to implement the CFC rules on corporations. The idea was to cut the revenues of the subsidiaries with non-genuine business reason from the offshore jurisdictions and shift them to the country of the holding company (OECD, 2015).The final report on Action 3 named "Designing Effective Controlled Foreign Company Rules" gives very detailed guidance and recommendations for the countries concerning the rules how to define a CFC, how to determine the CFC exemptions and thresholds, how to define the CFC income, how to set rules for computing and attributing income and finally how to prevent and eliminate double taxation in relation to the CFC rules.

The result of the OECD work is on one hand the initiative of the EU concerning the approval of the ATAD Directive (Anti-Tax Avoidance Directive, 2016), particularly Article 7 and 8, on the other hand the introduction of the set of CFC rules in many OECD and non-OECD countries. The effectivity of this measure is a subject-matter of dozens of papers (Clifford, 2018; Haufler, Mardan, 2017).

The Anti-Tax Avoidance Directive (ATAD), implemented since 1st January 2019, has provided all Member States with a set of robust anti-abuse rules, including interest limitation rules and CFC rules to deter profit shifting to low/no-tax jurisdictions. However it is apparent that the ATAD rules are not sufficient to put an end to the pertinent tax avoidance (European Commission, 2021). In the field of the CFC rules, the European Council has announced in its communication that "a common scheme consists of first transferring ownership of intangible assets such as intellectual property to the CFC and then shifting royalty payments. CFC rules reattribute the income of a low-taxed controlled foreign subsidiary to its - usually more highly taxed - parent company" (European Council, 2016).

According to the literature the main effect of the CFC rule is that they change the behaviour of the multinationals (Weyzig, 2017).

Picture no. 1 as well as the Table no. 1 show the introduction of the CFC rules in the European countries. The overview is related to the CFC rules on legal persons in line with the ATAD. It is clear that the approach in the particular countries has been rather different, as some of the countries have chosen the taxation of the entire income of the CFCs abroad (e.g. Poland), some of them have chosen the taxation of the entire income however only associated to the non-genuine income (e.g. Slovakia), some of the tax only passive income of the CFCs (e.g. Czech Republic) and some of the have not implemented the CFC rules at all (e.g. Switzerland as a non-EU country).

In essence the Slovak CFC legislation for legal persons (transposition of the Article 7 and 8 of the ATAD) reflects in greater part the wording of the ATAD in the Art. 17h of the Slovak Income Tax Act. A CFC is defined as an entity or any other legal arrangement without own legal personality but owning or managing assets (e.g. trust) where:

a) the Slovak corporate tax resident by itself, or together with its related parties (as defined under Slovak law) holds a direct or indirect participation of more than 50 percent of the voting rights, or owns directly or indirectly more than 50 percent of capital or is entitled to receive more than 50 percent of the profits of that entity or legal arrangement; and
b) the actual corporate income tax paid on its profits by this entity or legal arrangement is lower than the difference between the corporate tax that would have been charged on the entity or legal settlement under the applicable corporate tax system in the Slovak Republic (as computed according to the rules applicable in Slovakia) and the actual corporate tax paid on its profits by the

entity or legal arrangement (Kačaljak, Koroncziová, 2020). However only the income of the CFC from non-genuine activities would be included in the corporate income tax declaration of the parent company under the Art. 17h para. 4 of the Slovak Income Tax Act. Of course, it is often not easy to determine what is the income from non-genuine activities, in this case we have ECJ cases (e.g. Cadbury Schweppes – C-196/04) where we could find some hints (Alvarez, 2020).

The introduction of the CFC rules for individuals goes in our point of view a level further. Observing the current situation there are only few countries with CFC rules for individuals in Europe and this is also with very different approach. We can conclude from our analysis that if there are any CFC rules for individuals, the threshold for a qualified holding is normally more than 50% (e.g. Belgium, Ireland, Germany, Italy), more than 25% (e.g. Finland, Latvia, Poland, Portugal) or more than 10% (e.g. France and Slovakia). It is apparent that Slovakia has chosen the strictest way to consider a certain stake as having control over the subsidiary. This is even more strange in case of an indirect holding in the CFC. We will demonstrate this as result of our research.

Table no 1: Controlled Foreign Corporation (CFC) Rules in European OECD Countries, as of 2021

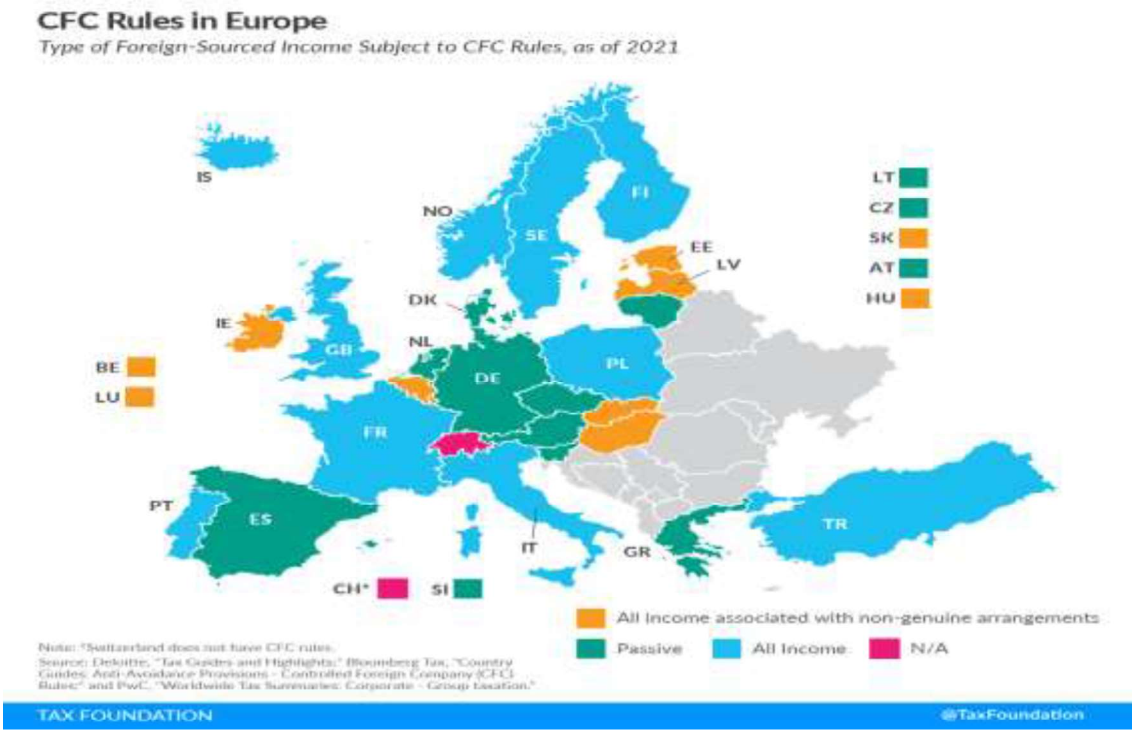
Country	Covered Type(s) of Income	CFC Rule Exemptions
Austria (AT)	Passive	CFC with substantive economic activities exempted
Belgium (BE)	All income associated with non-genuine arrangements	None
Czech Republic (CZ)	Passive	CFC with substantive economic activities exempted
Denmark (DK)	Passive	Foreign subsidiaries are exempt if less than 1/3 of their income is passive income
Estonia (EE)	All income associated with non-genuine arrangements	CFC exempt if profits below €750,000 or passive income below €75,000; CFC located in countries that are Estonian Tax Treaty Partners

Finland (FI)	All Income	CFC exempt if i) located in EU or EEA and not an artificial arrangement; ii) industrial, manufacturing, and shipping business; or iii) Finland has a double-tax treaty with the foreign country (excluding tax treaty countries mentioned in a "blacklist")
France (FR)	All Income	CFC exempt if located in EU and not an artificial arrangement, or if CFC carries out trading or manufacturing activity
Germany (DE)	Passive	CFC exempt if located in EU or EEA and not an artificial arrangement
Greece (GR)	Passive	CFC exempt if located in EU or EEA country with exchange of information agreement and not an artificial arrangement; CFC shares traded on a regulated market
Hungary (HU)	All income associated with non-genuine arrangements	CFC exempt if i) real economic activity; ii) below certain profit threshold and ratio; or iii) located in country with treaty allowing for an exemption
Iceland (IS)	All Income	CFC exempt if located in EEA countries or has a double-tax treaty with Iceland and not an artificial arrangement
Ireland (IE)	All income associated with non-genuine arrangements	CFC exempt if i) below certain profit and income thresholds; ii) transfer pricing rules apply; or iii) passes the essential purpose test
Italy (IT)	All Income	CFC with substantive economic activities exempted
Latvia (LV)	All income associated with non-genuine arrangements	CFC exempt if profits below €750,000 or passive income below €75,000 and CFC is not based or incorporated in a tax haven
Lithuania (LT)	Passive	CFC exempt if country included in white list and not receiving special tax treatment
Luxembourg (LU)	All income associated with non-genuine arrangements	CFC exempt if i) not an artificial arrangement or ii) accounting profits below €750,000 or less than 10% of operating costs
Netherlands (NL)	Passive	CFC exempt if not an artificial arrangement

Norway (NO)	All Income	CFC exempt if located in EEA country and not an artificial arrangement or located in tax treaty country and not mainly passive income
Poland (PL)	All Income	CFC exempt if not an artificial arrangement
Portugal (PT)	All Income	CFC exempt if located in EU and EEA countries and not an artificial arrangement; other exemptions can apply
Slovak Republic (SK)	All income associated with non-genuine arrangements	Substantive activities exemption
Slovenia (SI)	Passive	Substantial economic activities exemption
Spain (ES)	Passive	CFC exempt if located in EU and not an artificial arrangement
Sweden (SE)	All Income	CFC exempt if located in EEA and not an artificial arrangement or located in white list countries
Switzerland (CH)*	N/A	N/A
Turkey (TR)	All Income	CFCs with gross revenue less than TRY 100,000 are exempt
United Kingdom (GB)	All Income	Various exemptions can apply

Note: *Switzerland does not apply CFC rules
Source: Compilation according to Deloitte (https://www.dits.deloitte.com/#TaxGuides)
Bloomberg Tax,
https://www.bloomberglaw.com/product/tax/bbna/chart/3/10077/347a743114754ceca09f7ec4b7015426)
PwC, (https://www.taxsummaries.pwc.com/australia/corporate/group-taxation)

Picture no. 1: CFC Rules in Europe



Source: Tax Foundation
(https://files.taxfoundation.org/20210707150305/Controlled-Foreign-Corporation-CFC-Rules-in-Europe-base-erosion-and-profit-shifting-2021.png)

2 Design, methodology, research hypothesis and result of the research

The object of our research is the amendment of the Income Tax Act stipulating the rules for CFC of Slovak individuals. The methodology was the analysis of the approved text of the law amendment and our findings demonstrate unclear and possibly problematic application of the new amendment by the Slovak taxpayers.

Our research hypothesis is that due to the huge deficiencies of the amendment in question the applicability of the new law is very low, very close to non-applicability. The aim of the paper is to show the main problems and challenges in connection with the new amendment as well as to give proposal for proper "corrections" of the respective law.

Our results can be subsumed as follows: The main deficiencies of the approved amendment are in the conformity with the Slovak Constitution and the jurisprudence of the European Court of Justice (Kačaljak, 2021).

From the constant jurisprudence of the ECJ we can take that CFC rules also for individual persons are a legitimate means for EU countries to tackle the tax avoidance however also in cases of non-genuine structures or in cases where there is no Treaty on the Exchange of Tax

Information with the third country (C-135/17 X GmbH, 2019). However, the Slovak Income Tax Act as valid as from 1st January 2020 stipulates that non-cooperating country is also a country where the tax rate is zero or there is no corporate income tax, even in cases when Slovakia has a Double Tax Treaty or Treaty on Exchange of Information with the respective country. As a result, for these countries the wording of the provisions of the CFC rules for individuals as from 2022 would mean, that any income (regardless if genuine or non-genuine) from a third country with zero tax or no tax would have to be taxed in Slovakia. This approach will be in contradiction with the jurisprudence of the ECJ case law and in contradiction with the freedom of establishment. In addition this might be also in contradiction with Slovak Constitution, mainly with legal certainty of natural and legal persons (Galandová, 2021). Therefore, the impression that with the new provisions only non-genuine structures are hit is not correct (Blahová, 2021). It is necessary to point out, that by disregarding the foreign legal entity's separate existence without a fundamental reason, full inclusion CFC rules conspire against the exercise of fiscal sovereignty by third counties under general international law (Teijeiro, 2015).

The other important deficit of the new provisions is the very strict control concept, where already a holding of share in the size of 10% is regarded as controlling and therefore subsumed under the CFC provisions. This is very problematic, as a shareholder with 10 % in reality does not have any control over the company – he cannot decide whether e.g. dividends will be distributed or not. This is even more problematic with indirect shareholding (Galandová, 2021).

We can also find deficiencies in the definition of sanctions and in their size. A sanction of 100 % is from our point of view not proportionate and can be seen again as in contradiction with the Slovak Constitution and the ECJ jurisprudence. One of the most problematic issues is the ignorance of any losses which the company in a third country might incur. The CFC rules will apply if the effective tax rate in the CFC country jurisdiction is less than 10%. No losses that might have incurred in previous years and now are deducted are not taken into account. This is a clear misunderstanding of the common tax law rules as applies in civilized world (Galandová, 2021).

But there are also other inconsistencies in the approved amendment, such as no real definition of the personal and material substance and fixed assets of the subsidiary for the purpose to decide whether the subsidiary performs a genuine activity and therefore no CFC rules should apply (this is the case only for so-called "cooperating countries"). Normally states are trying to give guidance to taxpayers how the substance requirements should be interpreted. This is something that lacks in Slovakia.

There is also no clear guidance how the taxpayer should proceed if the foreign company has only income which is normally in Slovakia exempt from the corporate income tax. We do not have any clue how the CFC rules should apply to transparent entities.

We also do not know which tax credit is more important – that one according to the Double Tax Treaty or the tax credit that was paid due to the application of the existing tax rules on CFC for natural persons.

Conclusion

Our analysis has shown that there are very huge deficiencies even in basic concepts of the new CFC rules for individuals in Slovakia. The main are the constitutional non-conformity and the non-conformity with EU law. In addition there are huge sanctions which might again be not in line with the constitutional jurisprudence. What is really very surprising is the very low threshold for the consideration of a holding as substantial (more than 10 %) which might result that the entire income of the CFC abroad (not only the non-genuine income) will be regarded as CFC income and will be taxed either with 25 % or 35 %.

Our proposals for the amendment of the law would be threefold. First, the threshold for the control concept should be increased to more than 50 %. Second, efforts should be taken to recognize the existing double tax treaties and avoid the double-taxed income and allow for deduction of tax losses. Third, only non-genuine income and not the entire income from the CFC jurisdictions should be taxed in the future.

Dedication

This paper is a result of the VEGA project no. 1/0007/19 "*Allocation of assets in the environment of low interest rates in financial and non-financial businesses in Slovakia*".

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