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cutting through complexity

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Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance

Introduction

Pursuant to the release of the report addressing Base Erosion and Profit Shifting (BEPS) in February 2013, the Organisation for Economic Co-operation and Development (OECD) and the G20 countries adopted a 15-point Action Plan to address BEPS in September 2013. After two years of work, the 15 actions have now been completed. On 5 October 2015, OECD released its final reports on all the 15 actions and the way forward to tackle the issue globally, together with a plan for follow-up work and a timeline for implementation. All the different outputs, including those delivered in an interim form in 2014, have been consolidated into a comprehensive package.

The continued importance of the work on harmful tax practices was highlighted by the inclusion of this work in the Action Plan on (BEPS Action Plan, OECD, 2013), whose Action 5 committed the Forum on Harmful Tax Practices (FHTP) to revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes and on requiring substantial activity for any preferential regime.

The goal of Action 5 is to identify and counter harmful tax practices, taking into account transparency and substance. To counter harmful regimes more effectively, Action 5 elevates the requirement of a substantial activity for any preferential regime and also focuses on improving transparency. In doing so, it touches on a wide variety of topics, including substance requirements for Intellectual Property (IP) and other regimes, determination of which IP regimes are allowable and which need to be phased out, what constitutes a harmful preferential regime, which ruling information is to be mandatorily exchanged and to whom, what qualifies as a 'ruling' and the best practices for cross-border rulings (the process for granting rulings, terms and publication).

Background

The OECD started work on addressing harmful tax competition in the late 1990s, resulting in a 1998 report, Harmful Tax Competition: An Emerging Global Issue (the 1998 Report). The goal of OECD's work in the area of harmful tax practices is to secure the integrity of tax systems by addressing the issues raised by the regimes that apply to mobile activities and that unfairly erode the tax bases of other countries, potentially distorting the location of capital and services.

Taking forward the work laid down in the 1998 report, OECD released an interim report in September 2014 titled 'Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance' (the Report), which reflects the importance of having appropriate 'substantial activity' requirements in preferential regimes and on the need for increased transparency. Several approaches were considered to determine a lack or otherwise of substantial activity, and the consensus was finally achieved on the 'nexus approach', which uses expenditure as a proxy for an activity, and this principle can be applied to all types of preferential regimes.

Framework agreed under the 1998 Report for determining whether a regime is a harmful preferential regime

The framework under the 1998 Report suggested the following three stages for determining whether a regime is a harmful preferential regime or not:

Stage 1 - Consideration of whether a regime is within the scope of work of the FHTP and whether it is preferential

To be within the scope of this framework, the regime must first apply to the income from geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Preferential regimes designed to attract investment in plant, building and equipment fall outside the scope of the framework. Secondly, the regime must relate to the taxation of relevant income from geographically mobile activities. Hence, the work is mainly concerned with business taxation. Consumption taxes are explicitly excluded.

Further, to determine whether the regime is preferential or not, it must offer some form of tax preference in comparison to the general tax rules in the relevant country.

Stage 2 - Consideration of the four key factors and eight other factors set out in the 1998 Report to determine whether a preferential regime is potentially harmful

Once a regime has been identified as 'preferential', four key factors and eight other factors are used to determine whether the preferential regime is potentially harmful. The four key factors are:

- The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.
- The regime is ring-fenced from the domestic economy.
- The regime lacks transparency (e.g. the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).
- There is no effective exchange of information with respect to the regime.

The eight other factors which need to be considered are:

- Artificial definition of the tax base
- Failure to adhere to international transfer pricing principles
- Foreign sourced income exempt from residence country taxation
- Negotiable tax rate or tax base
- Existence of secrecy provisions
- Access to a wide network of tax treaties
- Promotion of the regime as a tax minimisation vehicle
- Encouragement of operations or arrangements that are purely tax-driven and involve no substantial activities

The first factor (no or low effective tax rate) is a gateway criterion: if this criterion is not met, the regime will not be considered harmful. If the criterion is met with, the other three key factors and, where relevant, the eight other factors need to be evaluated.

Stage 3 - Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful

In this stage, it is determined whether the potentially harmful regime is actually harmful. The regime which was initially considered as a harmful may not actually be harmful if it does not create an actual harmful effect.

The following three questions can be useful in assessing whether the regime is economically harmful or not:

- Whether the regime results in a shift of taxes from one country to the country providing the regime rather than generating new activities
- Whether the activities in the host country are commensurate with the amount of investment or income
- Whether the preferential regime is a primary motivation for the location of an activity

Where a regime is found to be harmful, the relevant country is given the opportunity to abolish the regime or remove the features that create the harmful effect.

Revamping measures on harmful tax practices under Action Plan 5

To counter harmful regimes more effectively, Action 5 of the BEPS Action Plan requires FHTP to revamp the work on harmful tax practices, with priority and renewed focus on the following aspects:

i. Elevating substantial activity requirements
ii. Focussing on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes

i. <u>Elevation of substantial activity requirements in Action 5</u>

Substantial activity was already considered as one of the 'other factors' in the 1998 framework. It states that if the encouragement of operations or arrangements are purely tax-driven and involve no substantial activities, then it can be considered as one of the factors in determining whether a regime is preferential or not. However, in **Action 5 the 'substantial activity requirement' was given immense importance.** Going forward it will be considered alongside the four key factors when determining whether a regime is potentially harmful or not. The various aspects under substantial activity requirements are discussed below:

How to determine whether substantial activity requirements have been satisfied

The FHTP considered the following three different approaches for requiring substantial activities in an IP regime:

- The first approach was a value creation approach that required taxpayers to undertake a set number of significant development activities. This approach did not have any support over the other two.
- The second approach was a transfer pricing approach that would allow a regime to provide benefits to all the income generated by the IP on fulfillment of the following conditions:
  - If the taxpayer had located important functions in the jurisdiction providing the regime;
  - The taxpayer is the legal owner of the assets giving rise to the tax benefits and uses the assets giving rise to the tax benefits; and
  - If the taxpayer bears the economic risks of the assets giving rise to the tax benefits.

    A few countries supported the transfer pricing approach, but many countries raised a number of concerns with it, which is why the work of the FHTP did not focus further on this approach.
- The third approach was the nexus approach, which has been agreed upon by the FHTP and endorsed by the G20.

The nexus approach for IP regimes has been identified as a method to determine whether the substantial activity requirement has been satisfied or not. As per nexus approach, the core income-generating activity for IP regimes is Research and Development (R&D) and thus allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying R&D expenditure that gave rise to the IP income. Under the nexus approach, benefits would only be granted in respect of income arising from IP where the actual R&D activity was undertaken by the taxpayer itself.

Mere capital contributions or expenditures for substantial R&D activity by parties other than the taxpayer are not qualifying IP expenditures, except where such activities are undertaken by unrelated parties. A substantial activity is not only required for IP regimes but for all the other preferential regimes as well. When applied to other regimes, the nexus approach also should establish a link between the income qualifying for benefits and the core activities necessary to earn the income. The core activities at issue in non-IP regimes are geographically mobile financial and other service activities.

Computation mechanism under the nexus approach

The proportion of income that may benefit from an IP regime ('the nexus ratio') is the same proportion as that of qualifying expenditures compared to the overall expenditures. This is summarised in the following formula given in the Final Report:

$$\frac{\textit{Qualifying expenditure}}{\textit{Overall expenditure}} \times \textit{Overall income from the IP asset}$$

Qualifying expenditure means

- R&D expenditure incurred by the taxpayer itself
- R&D expenditure incurred for outsourcing to an unrelated party

When calculating qualifying expenditure, the jurisdictions may permit taxpayers to apply a 30 per cent 'up-lift' to expenditure that is included in qualifying expenditure. This up-lift may increase the qualifying expenditure, but it cannot exceed the taxpayer's overall expenditure.

Overall expenditure means

- All qualifying expenditure
- IP Acquisition costs
- R&D expenditure for outsourcing to a related party

It has been further clarified that the overall expenditure will exclude cost not to be included in the qualifying expenditure but incurred by the taxpayers such as interest payments, building costs, and other costs that do not represent actual R&D activities.

IP asset:

- Patents itself
- Other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes, where such processes are relevant. They are (i) patents defined broadly, (ii) copyrighted software, and (iii) in certain circumstances other IP assets that are non-obvious, useful, and novel.

  The taxpayers qualifying for the above third category would be only those who have no more than EUR50 million in global group-wide turnover and their turnover no more than EUR7.5 million per year in gross revenues from all IP assets. This third category of IP assets will be reviewed by 2020.

Tracking of expenditures and income

As the nexus approach depends on there being a nexus between expenditures and income, the report requires the jurisdiction wishing to introduce an IP regime to mandate taxpayers that want to benefit from this regime to track expenditures, IP assets and income. This is to ensure that income receiving the benefits did arise from the expenditures that qualified for those benefits.

However, where such tracking would be unrealistic and require arbitrary judgements, countries may also allow a product-based approach wherein a nexus can be built between expenditures, products arising from IP assets and income. Under this approach, qualifying and overall expenditure would not be tracked in relation to specific IP assets but in relation to specific products to which IP assets contribute. The taxpayer that uses a product-based approach must provide documentation that the taxpayer was engaged in a sufficiently complex IP-related business that tracking to individual IP assets would be unrealistic and based on arbitrary judgements.

As a transitional measure, jurisdictions could allow taxpayers to apply a ratio where qualifying expenditure and overall expenditure are calculated based on a three or five-year rolling average at a company level. This is due to the fact that there has been no requirement for a taxpayer to have tracked and traced expenditure in this way before the introduction of a nexus.

Transitional measures and grandfathering provisions for IP regimes

No new entrants will be permitted in any existing IP regime that is inconsistent with the nexus approach after 30 June 2016. For the purposes of grandfathering, 'new entrants' include both new taxpayers not previously benefitting from the regime and new IP assets owned by the taxpayers already benefitting from the existing IP regime. All existing regimes must be closed by 30 June 2021. The legislative processes to implement a new IP regime must begin in 2015.

To mitigate the risk that new entrants will seek to avail themselves of the existing regimes with a view to benefitting from grandfathering, jurisdictions are required to implement the following safeguarding measures:

- Enhanced transparency for new entrants entering the regime after 6 February 2015, requiring the spontaneous exchange of information on the identity of new entrants benefitting from a grandfathered regime.
- IP assets acquired directly or indirectly from related parties currently not benefitting from a preferential IP regime after 1 January 2016 should be excluded from grandfathering (but only from 31 December 2016, allowing a period of grace while countries enact nexus compliant legislation).

ii) ***Focus on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes***

Transparency is the second most important thing in the agenda of OECD under Action Plan 5. The FHTP decided to take forward the work on improving transparency in three steps:

- The first step focussed on developing a framework for compulsory spontaneous information exchange in respect of rulings related to preferential regimes. This framework was set out in the FHTP's 2014 Progress Report (OECD, 2014a) and has been modified, and is now superseded by the guidance in this report.
- In the second step of the work, the FHTP has considered whether transparency can be further improved and has considered the ruling regimes in OECD and its associate countries. This approach builds on the fact that Action 5 is not limited to exchanging information on rulings related to preferential regimes but allows for broader transparency.
- In the third step, the FHTP developed a general best practices framework for the design and operation of ruling regimes.

To improve transparency, the framework has listed six types of a ruling that will be subject to compulsory spontaneous exchange of information between respective countries. A ruling is defined widely as 'any advice, information or undertaking' that a tax authority gives to a specific company or group on which reliance can be placed. The six types of rulings are:

- Rulings related to preferential regimes - A filter approach is used for such rulings so that there is an obligation to spontaneously exchange information on cross-border taxpayer-specific rulings related to regimes that (i) are within the scope of the work of the FHTP (i.e. a ruling concerning geographically mobile activities, such as financial and other service activities, including intangibles); (ii) are preferential; and (iii) meet the low or no effective tax rate factor. Where rulings are given in respect of these regimes, there will be an obligation to spontaneously exchange information.

  Countries that have preferential regimes that have not yet been reviewed by the FHTP will need to self-assess and take a view on whether the filters are satisfied. Where this is the case, the obligation to spontaneously exchange information arises immediately, without the FHTP first needing to formally review the relevant regime. In the case of doubt as to the applicability of the filters, it is recommended that the relevant country spontaneously exchange information.

- Unilateral Advance Pricing Agreements (APAs) or other cross-border unilateral rulings in respect of transfer pricing (i.e. unilateral tax rulings covering transfer pricing or the application of transfer pricing methods, falling short of an APA).
- Cross-border rulings are providing for a unilateral downward adjustment of taxable profits that is not directly reflected in the taxpayer's financial/commercial accounts. The Final Report gives the example of excess profit rulings, informal capital rulings and similar rulings that recognise the contribution of capital or an asset and provide for an adjustment that reduces taxable profits (e.g. through a deemed interest deduction on an interest-free loan). An agreement was reached that information on cases of informal capital contribution, or excess profit regimes will be exchanged even if a country does not require a ruling to benefit from the regime.
- Permanent Establishment (PE) rulings: Rulings that (i) explicitly determine or decide on the existence or absence of a PE (either inside or outside of the country giving the ruling) or (ii) provide for how much profit will be attributed to a PE.
- Related party conduit rulings: These cover arrangements involving cross-border flows of funds or income through an entity in the country giving the ruling, whether those funds or income flow to another country directly or indirectly (i.e. through another domestic entity first).
- In addition, information exchange would apply to any other type of ruling agreed upon by the FHTP that in the absence of spontaneous exchange of information gives rise to BEPS concerns. This category gives the FHTP flexibility to extend the obligation to exchange information to additional categories of rulings in the future.

For most rulings, the information will be automatically exchanged with:

- the countries of residence of all related parties with which a company enters into a transaction for which a ruling is granted, or which gives rise to income from related parties benefitting from a 'preferential treatment' (broadly, more beneficial than the country's normal tax regime) and for PE cases, this includes the residence country of the head office and/or the country of the PE; and
- the residence country of the ultimate parent company and the immediate parent company.
- conduit rulings will be exchanged more widely.

The related party threshold for this purpose is 25 per cent (to be kept under review) based on direct or indirect voting rights or equity interests.

The Final Report provides for new key dates as under:

- Information on rulings issued on or after 1 April 2016 will have to be exchanged at the latest within three months after the ruling has become available to the competent authority of the country granting the ruling.
- The obligation to exchange information also applies to rulings that were issued on or after 1 January 2010 and were still in effect as from 1 January 2014, including rulings modified in this period. The process to exchange information on these rulings should be completed by the end of 2016.

The country receiving the information must have the legal framework necessary to protect the information being exchanged, including its confidentiality. Exchange with a country may be suspended if appropriate safeguards are not in place or if there is a breach in confidentiality.

Review of OECD and associate country regime

In 2010, the FHTP started a review process of preferential tax regimes in member countries and associated countries, which covers 43 regimes, which comprised of 16 IP regimes and 27 non-IP regimes. As the review commenced in 2010, i.e. before the BEPS Action Plan, the review is generally based on the factors set out in the 1998 Report, under which a 'substantial activity' was not yet a key factor. This was done to ensure consistency in the approach. Only IP regimes were considered in light of the substantial activity requirement. The FHTP concluded all 16 IP regimes as inconsistent with the nexus approach. Of the remaining 27 non IP regimes, 19 were considered as not harmful. Out of balance eight, four regimes were under review, and the remaining four were in the process of being eliminated.

Further work of the FHTP

The FHTP intends to monitor both preferential IP and non-IP regimes. Countries will be required to update the FHTP of any changes they make to their preferential regimes to apply the nexus approach. Where no amendments are made, the FHTP will move to the next stage of the review process. In respect of information exchange, a monitoring and review mechanism needs to be put in place to help ensure countries' compliance with the obligation to exchange information at the start of 2017.

The FHTP will also consider how the administrative burden of sharing information should balance with the need to identify BEPS risks and will consider ways in which participation in information exchange can be extended to third countries. Further, the FHTP will continue its work in reviewing preferential regimes. Currently, FHTP has identified 43 regimes of which 16 are IP regimes.

Action 5 of the BEPS Action Plan (OECD, 2013) explicitly recognised the need to involve third countries and requested the FHTP to develop a strategy to engage non-OECD/non-G20 countries into the work on harmful tax practices. The FHTP agreed on the following elements of an engagement strategy with third countries:

- The strategy should be to include third countries that have preferential regimes, as well as other countries having a stake in the work.
- The FHTP will communicate the purpose and objectives of its work, also setting out the level of involvement and participation of third countries.
- Additional work will be carried out to implement the strategy in 2016 in the context of the wider objective of designing a more inclusive framework to support and monitor the implementation of the BEPS measures.

Our comments

A significant issue for claimant companies may be the requirement that the claimant itself must both incur the qualifying expenditure and earn the related income. Many groups may be obliged to restructure their commercial and R&D operations to bring the two into the same legal entity if they wish to continue to benefit.

In so far as India is concerned, there are no IP regimes as on date which could potentially get attracted under BEPS. However, it would be worthwhile to examine the existing IP structures of the group which are located in the preferential regime to evaluate whether they are in line with the recommendations proposed in this report.

As regards to Indian non-IP regimes, the report evaluated four such regimes (viz. certain income of offshore banking units and international financial service centres, newly established units in a Special Economic Zone, a special provision for taxation of shipping companies and taxation of insurance businesses) and concluded that none of these regimes were considered as harmful from a BEPS perspective.

Application of the 'nexus approach' for substantial activity test is interesting from the Indian perspective and development to watch out for, as India has been one of the preferred destinations for carrying out outsourcing activities by the multinational groups.

Compulsory spontaneous exchange of information in respect of rulings form a key part of the G20/OECD's drive under BEPS to improve transparency in relation to tax and to help ensure that tax authorities are able to access information that may not be in the possession of a local subsidiary. Companies need to be aware that rulings obtained in one country are likely to be shared with other tax authorities.

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