ACTION ITEM 5:
COUNTERING HARMFUL TAX PRACTICES MORE EFFECTIVELY

Authors
Stanley C. Ruchelman
Rusudan Shervashidze

Tags
B.E.P.S.
Compulsory Spontaneous Exchange of Information
F.H.T.P.
Harmful Tax Competition
Harmful Tax Practices
Nexus Test
Qualified Expenditures
Transparency and Substance

The Organization for Economic Co-operation and Development ("O.E.C.D.") worked together with G20 countries[33] to develop a 15-point action plan to deal with Base Erosion and Profit Shifting ("B.E.P.S."). The goal of the B.E.P.S. Action Plan is to develop a single global standard for automatic exchange of information and stop corporations from shifting profits to jurisdictions with little or no tax in order to ensure taxation in the jurisdiction where profit-generating economic activities are performed and where value is created.

B.E.P.S. occurs in situations where different tax laws interact in a way that creates extremely low global tax rates or results in double non-taxation. This kind of planning gives a competitive advantage to multinational entities that have substantial budgets to engage high-powered tax advisers and to implement their plans.

The O.E.C.D. published deliverables that intend to eliminate double non-taxation resulting from B.E.P.S. The final measures will be completed in 2015 and will be implemented either through domestic law or the existing network of bilateral tax treaties.[34]

ACTION ITEM 5: HARMFUL TAX PRACTICE

Harmful Tax Competition: An Emerging Global Issue

In 1998, the O.E.C.D. published the report *Harmful Tax Competition: An Emerging Global Issue*[35] ("the 1998 Report") with the intention of developing methods to prevent harmful tax practices with respect to geographically mobile activities. These methods have been adopted in the Forum on Harmful Tax Practice ("F.H.T.P.") with some modifications. Significant attention is given to:

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33 The G20 countries are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.

34 O.E.C.D. Action 5: 2014 Deliverable.

35 O.E.C.D. (1998), Harmful Tax Competition: An Emerging Global Issue, O.E.C.D. Publishing. http://dx.doi.org/10.1787/9789264162945-en.

"In order for a regime to be considered preferential it must offer some form of tax preference in comparison with the general principles of taxation in the relevant country.

- Elaborating on a methodology to define a substantial activity requirement in the context of intangible regimes; and

- Improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes.

<u>*Forum on Harmful Tax Practice*</u>

The 1998 Report describes three stages to determining whether a regime is harmful or provides preferential treatment:

- Consideration of whether a regime is within the scope of work of the F.H.T.P. and, if so, whether it is preferential;

- 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; and

- Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful in practice.

In order for a regime to be considered preferential it must offer some form of tax preference in comparison with the general principles of taxation in the relevant country. The preferential regime may take a wide variety of forms, and even a small amount of preference is sufficient for the regime to be considered preferential.

To determine whether a preferential regime is potentially harmful, the F.H.T.P. uses four Key Factors and eight Other Factors set out by the 1998 Report.

Key Factors:

4. The regime imposes no or low effective tax rates on income from geographically mobile financial and service activities.

5. The regime is ring-fenced from the domestic economy.

6. 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).

7. There is no effective exchange of information with respect to the regime.[36]

Other Factors:

8. An artificial definition of the tax base;

9. Failure to adhere to international transfer pricing principles;

10. Foreign source income exempt from taxation in the country of residence;

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[36] O.E.C.D. Action 5: 2014 Deliverable.

11. A negotiable tax rate or tax base;

12. The existence of secrecy provisions;

13. Access to a wide network of tax treaties;

14. The promotion of the regime as a tax minimization vehicle; and

15. The regime encourages operations or arrangements that are purely tax-driven and involve no substantial business activities.[37]

The presence of first factor is established once it is determined that the regime has a "no or low effective tax rate." This is a gateway criterion. It is evaluated based on the combined effective tax rate for both national and subnational taxes. Once this first criterion is met the regime will be considered *potentially harmful* based on an overall assessment of the other three Key Factors and, where relevant, the eight Other Factors. As the presence or absence of any one factor is not controlling, a tax regime may be characterized as potentially harmful if at least one of the Key Factors or Other Factors is met. By its nature, if a tax regime provides a preferential rate and is an attractive *entrepôt* in the context of a cross border transaction, it almost certainly will be viewed as potentially harmful.

Once the regime is considered *potentially harmful* it may still not be viewed as *actually harmful*. The following three questions are identified as helpful in assessing whether or not the regime is actually harmful:

- Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?

- Is the presence and level of activities in the host country commensurate with the amount of investment or income?

- Is the preferential regime the primary motivation for the location of an activity?

Once the preferential regime is found to be actually harmful, the relevant country is given an opportunity to abolish the regime or remove the features that create the harmful effect.

Action Item 5: Substantial Activity

Action Item 5 requires the F.H.T.P. to revamp the existing standard to concentrate on the existence or absence of substantial activity and improve transparency through mechanisms such as compulsory spontaneous exchanges on rulings related to preferential tax regimes. The framework for the substantial activity test was established by the 12 factors outlined in the 1998 Report. Its importance is now elevated.

The substantial activity test looks at whether a regime encourages purely tax-driven operations or arrangements. Action Item 5 observes that many harmful preferential

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[37] O.E.C.D. Action 5: 2014 Deliverable.

tax regimes are designed to allow the taxpayers to derive benefits from those regimes while engaging in operations which are purely tax-driven and involve no substantial activities. The 1998 Report contains limited guidance on how to apply this factor.[38]

Substantial Activity Requirement

“The nexus approach focuses on the relationship between R&D activities actually carried out in a jurisdiction and preferential tax treatment …If the nexus test is met, both front-end and back-end tax regimes that incentivize innovative activities will not be categorized as actually harmful.”

There is no clear definition of a “substantial activity requirement,” but there is general agreement among the O.E.C.D. countries that it is an important factor in determining if a regime is potentially harmful. The substantial activity factor from the 1998 Report has been elevated under the Action Item 5 and is now considered with the four Key Factors in determining if a regime is potentially harmful.

The F.H.T.P., for the first time, focuses on regimes which provide preferential treatment for income arising from intellectual property (“I.P.”). It is understood that I.P.-intensive industries are beneficial to a country, and therefore governments are free to grant incentives for research and development (“R&D”) activities, but such incentives should be created within the scope of the principles agreed upon under the F.H.T.P. All intangible regimes in member countries are being reviewed simultaneously.

Application of Substantial Activity in the Context of Intangibles

Three different approaches were considered to define substantial activity in an I.P. regime. These approaches address value creation, transfer pricing, and nexus. Action Item 5 eliminates the first two approaches and concentrates solely on nexus. The nexus approach focuses on the relationship between R&D activities actually carried out in a jurisdiction and preferential tax treatment. This approach is designed to encourage R&D by only allowing tax benefit for taxpayers who are actually engaged in R&D activity. If a taxpayer outsources its R&D to an unrelated party, the taxpayer will continue to be entitled to the benefit of an I.P. regime. However, if R&D activity is assigned to a *related* party, the taxpayer will not be entitled to the benefit from an I.P. regime even if it funds the entire activity with its own capital.

If the nexus test is met, both front-end and back-end tax regimes that incentivize innovative activities will not be categorized as actually harmful. A front-end regime provides benefits when and as I.P. is created or developed. An example would be an allowance of more than 100% of development costs as funds are expended. A back-end regime would provide a preferential tax rate when and as developed I.P. is exploited. An example would be a preferential rate on royalty income.

Under the approach approved in Action Item 5, the portion of I.P. income that may benefit from an I.P. regime is based on the portion that qualified expenditures by the taxpayer bear to the overall expenditure for R&D activity. As a result, capital contributions or expenditures for substantial R&D activity by parties other than the taxpayer will disallow subsequent income from the benefits of an I.P. regime.

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38 O.E.C.D. (1998), Harmful Tax Competition: An Emerging Global Issue, O.E.C.D. Publishing. http://dx.doi.org/10.1787/9789264162945-en.

This approach becomes complex when several entities bear a share of substantial R&D. Where that occurs, the ratio of qualifying expenditures of each entity to the total amount of expenditures is applied to the qualifying I.P. income generated from the R&D at the level of each entity. The formula is as follows:

$$\frac{\textbf{Qualifying expenditures incurred to develop I.P. asset}}{\textbf{Overall expenditures incurred to develop I.P. asset}} \times \textbf{Overall income from I.P. asset} = \textbf{Income receiving tax benefits}$$

Action Item 5 suggests that this calculation should be treated as a rebuttable presumption. The taxpayer can demonstrate that more income should receive a benefit than in the presumed calculation by showing a direct link between income that would benefit from the I.P. regime and qualifying expenditures. This may require a greater degree of recordkeeping on the part of the taxpayer. The circumstances under which the taxpayer can rebut the presumption are not yet defined, but further guidance is being developed.

Where the amount of income receiving benefits under an I.P. regime does not exceed the amount determined by the nexus approach, the regime has met the substantial activities requirement. Note that this analysis is conducted on a country-by-country basis and is applied to entities that are taxpayers in the jurisdiction providing the benefits. Consequently, a permanent establishment ("P.E.") maintained in a foreign jurisdiction cannot be taken into account by the head office of an entity unless the I.P. income of the P.E. is subject to tax in the jurisdiction of the head office. Also, expenditures of a P.E. that ceases to exist cannot be taken into account at the time I.P. revenue is generated.

Definitions

An exact definition of the term "qualified expenditures" is not provided under Action Item 5. Instead, each jurisdiction will provide its own definition, which must meet certain requirements to be deemed acceptable. The definition must be limited to actual R&D activity and would exclude interest payments, building costs, acquisition costs, and other assets that do not have a direct connection to the I.P. assets. Suggested qualified expenditures include salary and wages, direct costs, overhead costs, cost of supplies, and, in some circumstances, depreciation.[39]

The term "overall expenditures" will be defined in such a way that if the qualifying taxpayer incurs all relevant expenditures itself, the ratio will allow 100% of the income from the I.P. asset to benefit from the preferential regime. This means that the taxpayer's overall expenditures must equal the sum of all qualifying expenditures. Any expenditure that would not be included as a qualifying expenditure, if incurred by the taxpayer, cannot be included in overall expenditures. This general rule is subject to several exceptions. I.P. acquisition costs, for example, are included in the overall expenditures, even though they are not considered qualifying expenditures at the level of the entity. Additionally,

[39] O.E.C.D. Action 5: 2004 Deliverable.

comparable treatment is given to acquisition costs and outsourcing costs. In each of these cases, the rationale is that benefits under an I.P. regime should relate to all of the taxpayer's qualifying expenditures.

The term "overall income" will be defined by each jurisdiction according to its domestic laws. However, the definition must meet a standard under which income benefitting from a preferential regime is not disproportionately high in relation to the percentage of qualifying expenditures claimed by qualifying taxpayers. Under this standard, overall income means overall net income.

The goal is to exclude capital contributions or expenditures for substantial R&D activity by parties other than the taxpayer from the definition of a "qualified expenditure."

Outsourcing

Action Item 5 presumes that outsourcing to unrelated parties is not a significant problem. Thus, the nexus approach allows all qualifying expenditures for activities undertaken by unrelated parties to qualify even if the activities of the unrelated party were not carried out within the jurisdiction. Individual countries may further limit the definition of an unrelated party to universities, hospitals, R&D centers, and nonprofit entities.

Tracking Income and Expenditures

The nexus approach mandates that an I.P. regime must require taxpayers to track expenditures, I.P. assets, and income to ensure that only income related to R&D expenditures benefit from the preferential regime. While tracking may be relatively simple for a taxpayer that has only one I.P. asset, the task becomes more complex when more than one I.P. asset is owned. Action Item 5 cautions against manipulation of revenue streams to artificially provide benefits to income that is not overall income, in substance.

Grandfathering

Grandfathering of a harmful preferential regime will be permitted so long as the regime in question meets the following conditions:

- No new entrants are permitted;
- A definite date for complete abolition of the regime has been announced; and
- The regime is transparent and has effective procedures for exchange of information.

Presumably, the grandfathering provision found in Action Item 5 will apply to the winding down of so-called "double Irish" arrangements. Residency rules terminating these arrangements will take effect on January 1, 2015 with regard to new Irish companies. Existing companies will enjoy a grandfathering period until the end of 2020.

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Transparency through Compulsory Spontaneous Exchange

Lack of transparency is one of the key issues addressed under Action Item 5. Lack of transparency may arise as a consequence of the way in which a regime is deigned and administered. It may also arise from the existence of secrecy laws or other impediments regarding the effective exchange of information. To combat the lack of transparency, the F.H.T.P. is authorized to focus on developing a framework for the compulsory spontaneous exchange of information regarding rulings related to preferential regimes. This will introduce an obligation for an individual country to spontaneously exchange information that could be relevant to another country, even when the information has not been requested by the second country. In addition, the F.H.T.P. is authorized to prepare a report on preferential regimes for public dissemination – *viz.*, name and shame.

Application of Filters

The framework developed for compulsory spontaneous exchanges addresses four key design questions:

16. When does the obligation to spontaneously exchange information arise?

17. With whom must information be exchanged?

18. What information must be exchanged?

19. What is the legal basis for the spontaneous information exchange?

Other issues involve time limits, relevance of reciprocity, confidentiality, and feedback from the receiving country.

The framework for the compulsory spontaneous exchange of information contemplates the use of a mechanical filter methodology to reduce the level of discretion for spontaneous exchange. This means that a ruling would apply certain tests in which the answer is either yes or no. Only rulings that pass though the filter with all "yes" answers will be subject to compulsory spontaneous information exchange. Please see the annexed flow chart provided at the end of the article for spontaneous information exchange on rulings related to preferential regimes.

The tests in the mechanical filter ask the following questions:

20. Is the regime within the scope of the F.H.T.P.'s work?

21. Is the regime a preferential regime?

22. Does the regime meet the "no and low effective tax rate" factor?

If the answer to all three questions is "yes," and the ruling is specific to a taxpayer or group of taxpayers, a spontaneous exchange of information is required if a taxpayer is entitled to rely on the ruling. Examples include an Advance Tax Ruling ("A.T.R.") and an Advance Pricing Agreement ("A.P.A.").

Procedures for the Exchange of Information

A two-step procedure is contemplated in Action Item 5. The first step involves a disclosure generated by the country granting the preferential tax ruling. The second step is a follow-up by the country receiving the information.

The automatic exchange in the first step will contain the following information:

- Identification of the taxpayers and the entities involved in the cross-border transaction;

- Details of the transaction and the period covered by the transaction; and

- If the ruling is in the form of an A.P.A., the transfer pricing methodology that was applied and the price that was agreed upon.

For rulings other than an A.P.A., an additional filter is created so as not to overly burden either country taking part. Non-A.P.A. rulings are divided into three categories:

- Inbound investment into the county in which the taxpayer has obtained the ruling;

- Outbound investment from that country; or

- Transactions or situations involving other countries.

The sending country will have discretion regarding how much information to share with the receiving country. The minimum that the sending country should provide is:

- The identity of the taxpayers and the accounting period covered by the ruling;

- A summary of the issues and income covered, preferably in English or any other language bilaterally agreed; and

- The tax administration's response and reasoning.[40]

Once the ruling is granted, it should be exchanged with all affected countries as soon as possible and not later than three months from the date the ruling became available. An appropriate system must be in place to provide the ruling to the appropriate authorities. Presumably, the taxpayer requesting the ruling will identify the affected countries.

Under the second step for compulsory spontaneous exchanges, the receiving country may request additional information related to the transaction. It is expected that feedback will improve spontaneous exchange of information procedures and may facilitate the identification of potential tax adjustments in the sending country.

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[40] Action 5.

Whether the country initiating the exchange will make the adjustment is an open question. Presumably, an adjustment will be made only if the facts provided by the taxpayer are not accurate and complete.

Confidentiality of the Information

Action Item 5 contemplates the necessity of legal protections for the information being exchanged. Countries that do not have appropriate domestic laws in place to protect the confidential tax information received will be expected to develop a legal framework for the protection of such information. All treaties and exchange of information instruments contain provisions for confidentiality and address the obligation to protect that information. International exchange of information instruments will prevail when the domestic law provides for a broader use of the exchanged information. It is contemplated that through continuous monitoring of exchanged information transparency procedures will continue to develop and improve.

In 2010, each member country of the F.H.T.P. was asked to respond to a survey of its preferential regimes. The self-evaluation was followed by extensive analysis and peer review. The F.H.T.P.'s work on preferential regimes in member and associate countries is an ongoing process that will continue beyond September 2014.

CONCLUSION

At this point, Action Item 5 is a work in progress – one clearly directed toward countries currently in the news, such as Luxembourg and Ireland. Eventually, countries that utilize double structures and substance officers will discover acceptable ways to comply with the O.E.C.D. system while only providing limited information in spontaneous exchanges. Alternatively, published guidance accompanied by proper caveats may also be considered, as well as a unification of tax rates and the elimination of withholding taxes in specified circumstances. At the same time, the F.H.T.P. will continue evaluating tax systems.

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Flow Chart: Spontaneous Information Exchange on Rulings Related to Preferential Treatments