

OECD releases updated results on scrutiny of preferential tax regimes and substantial activity requirements for no or only nominal tax jurisdictions

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Executive summary

On 15 November 2018, the Organisation for Economic Co-operation and Development (OECD) [released an update](#) to the [2017 Progress report on Preferential Tax Regimes](#) conducted in connection with Action 5 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project.

The updated results cover 53 regimes, bringing the number of regimes reviewed, or under review, to 246. The assessments were undertaken by the Forum on Harmful Tax Practices (FHTP), comprised of the 123-member jurisdictions of the Inclusive Framework on BEPS (IF on BEPS). The updated results indicate the extent of continuing work to end harmful tax practices, under which all preferential regimes will require adequate levels substance. The results will be updated from time to time as approved by the IF on BEPS.

Additionally, on the same date, the IF on BEPS released a Substantial Activities Requirement for "no or only nominal tax" jurisdictions (the [Standard](#)). The document sets out the background and rationale for the resumption of the substantial activities requirement, a requirement first set out in an OECD 1998 report (see below). It also sets out the technical guidance governing the application of that requirement.

An update on other aspects of this work will be included in the next progress report on BEPS Action 5.

Detailed discussion

Background

Recognizing the need to realign the taxation of profits with the substantial activities that generate them, and to improve transparency, 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](#). Under this initiative, the OECD also created the FHTP to take the work forward. Following its creation, the FHTP has been one of the key groups with the mandate to monitor and review tax practices of jurisdictions, focusing on the features of preferential tax regimes. The Code of Conduct group in the European Commission performs a similar role.

On 5 October 2015, the OECD released its final report on Action 5, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance* (the Action 5 Report) under its BEPS Action Plan.¹ The Action 5 Report covers two main areas: (i) the definition of a “substantial activity” criterion to be applied when determining whether tax regimes are harmful; and (ii) improving transparency.

In October 2017, the OECD released the *Harmful Tax Practices - 2017 Progress Report on Preferential Regimes*,² which includes results of the review of 164 regimes that had been identified by the FHTP over the course of five meetings held between November 2016 and September 2017, and it reflected results as of October 2017.

In May 2018, the IF on BEPS released updates to the results of the reviews of 11 preferential tax regimes. On 15 November 2018, the OECD released the latest results on preferential tax regimes covering the assessment of 53 regimes.

Additionally, the 1998 Report sets out a framework for approaching the problem of how certain “no or only nominal tax” jurisdictions (tax havens) and harmful preferential tax regimes “affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems.”

Given the elevation of the substantial activities requirement in the work on preferential regimes as part of the BEPS Project, the OECD believed it was appropriate to resume the application of the substantial activities requirement set out in the 1998 Report for “no or only nominal tax” jurisdictions, as well as to provide guidance on the application of the

requirement. For that reason, the IF on BEPS has decided to apply the Substantial Activities Requirement for “no or only nominal tax” jurisdictions and on 15 November 2018 released a document with technical guidance on the application therein.

Updated conclusions of the preferential tax regimes review

According to the updated results, 18 additional regimes have been identified as being in the process of being abolished or amended, as the jurisdictions have delivered on their commitment to make the relevant legislative changes. This includes:

- ▶ Andorra: holding company regime
- ▶ Curacao: export facility regime
- ▶ Spain: partial exemption for income from certain intangible assets (Federal regime)
- ▶ Other regimes from Andorra, Curaçao, Hong Kong (China), Mauritius, and San Marino

Additionally, new or replacement regimes in four regimes have been specifically designed to meet the Action 5 standard:

- ▶ Lithuania: intellectual property regime
- ▶ Mauritius: partial exemption system regime and banks holding a banking license under the Banking Act 2004 regime
- ▶ San Marino: intellectual property regime

The updated results include new commitments to make legislative changes to amend or abolish another 10 regimes, including:

- ▶ Aruba: exempt company regime
- ▶ Maldives: reduced tax rates on profits sourced outside Maldives regime
- ▶ Mongolia: free trade zone regime
- ▶ Other regimes from Aruba, Australia, Montserrat, the Philippines and Saint Lucia

An additional 17 regimes have been brought into the FHTP review process. These include:

- ▶ Gabon: special economic zone regime
- ▶ Greece: tax patent incentives regime
- ▶ Unites States: foreign derived intangible income (FDII) regime
- ▶ Other regimes from Aruba, Brunei Darussalam, Curaçao, Jordan, Kazakhstan, Malaysia, Panama, Paraguay, and Saint Kitts and Nevis

Finally, the update includes four other regimes that have been found to be out of scope, not yet operational or which have already been abolished or do not possess harmful features, namely:

- ▶ Aruba: shipping and aviation regime and San Nicolas regime
- ▶ Kenya: special economic zone regime
- ▶ Paraguay: free zone regime

Next steps

The FHTP will meet next in January 2019, to assess continuing reviews on the remaining regimes for which commitments to amend or abolish were made in 2017. Further discussion on all other regimes will take place through the FHTP review process during 2019.

Having completed this latest set of reviews, the total number of regimes reviewed stands at 246. The overall conclusions of the Action 5 regime review process brings the total number of harmful regimes to 3 and the number of non-harmful regimes to 53. Also, three regimes are identified as being potentially harmful and five other regimes as potentially harmful but not actually harmful.

Out of the 246 regimes, 78 regimes are in the process of being eliminated or amended, while 46 regimes have already been amended or abolished. Additionally, 23 regimes have been found to be out of scope, 2 regimes have been identified as not operational, and a further 3 regimes are in disadvantaged areas. The remaining 30 regimes are still under review.

Substantial Activities requirement to “no or only nominal tax” jurisdictions

The IF on BEPS has decided to apply the Substantial Activities requirement, as set forth in chapter 4 of the final report on Action 5, for the first time to “no or only nominal tax” jurisdictions. Broadly, the Substantial Activities Requirement looks at whether a regime encourages purely tax-driven operations or arrangements, as many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities. Following Action 5, the Substantial Activities requirement is considered one of the main factors when determining whether a regime is potentially harmful. The rationale behind this approach is that as all preferential regimes for geographically mobile income must now meet the Substantial Activities requirement. It is essential, the OECD notes, to ensure that business activities do not simply

relocate to a zero-tax jurisdiction in order to avoid the substance requirements, as this would tilt the playing field against those that have now amended their preferential regimes to comply with the Standard and, in the OECD’s view, jeopardize the progress made in Action 5 to date.

According to the Standard, the substantial activities requirement to no or only nominal tax jurisdictions would apply to jurisdictions which do not impose a corporate income tax. It would also apply to jurisdictions which are deemed to impose only nominal corporate income tax to avoid the requirements. Jurisdictions which have been reviewed on the basis of the preferential regimes they offer are out of the scope of the Standard, unless they subsequently significantly undertook reforms which abolished or substantially abolished their corporate income tax altogether.

In respect of the type of activities covered, the Substantial Activities requirement will apply to geographically mobile activities, such as financial and other service activities, including the provision of intangibles. The FHTP has typically identified these types of mobile activities as falling into the categories of headquarters, distribution centers, service centers, financing, leasing, fund management, banking, insurance, shipping, holding companies and the provision of intangibles.

Based on the FHTP’s guidance on substantial activities, there are two basic categories of activities: (i) activities earning non-Intangible Property (IP) income (which is set out in Annex D of the 2017 Progress Report); and (ii) activities for the exploitation of IP assets (which is the nexus approach set out in the Action 5 Report).

1. For activities within scope that earn non-IP income, this would mean that the “no or only nominal” tax jurisdiction would be required to meet the same substantial activities criterion applicable for IP-regimes, meaning that it would need to introduce laws to: (i) define the core income generating activities for each relevant business sector; (ii) ensure that core income generating activities relevant to the type of activity are undertaken by the entity (or are undertaken in the jurisdiction); (iii) require the entity to have an adequate number of fulltime employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities; and (iv) have a transparent mechanism to ensure compliance and provide an effective enforcement mechanism if these core income generating activities are not undertaken by the entity or do not occur within the jurisdiction.

2. Where the business activities are the exploitation of IP assets, the substance requirements used by the FHTP are the “nexus approach” which consists of two parts: (i) a first part which sets out a formula to determine the amount of eligible income which can benefit from a lower tax rate; and (ii) a second part which is a consequence for the non-eligible income which is then taxed at the normal (i.e., higher) tax rate. For a “no or only nominal tax” jurisdiction, the challenge is that even though the formula could be applied (the result of which might be that there is zero eligible income), it is unclear how to apply the second part. In order to apply the principle underlying the nexus approach to “no or only nominal tax” jurisdictions, the Standard states that the best way forward is to apply a similar concept as applies for non-IP income, which is the core income generating activities guidance. The Standard further provides guidance on how the substantial activities requirements will apply to “no or only nominal tax” jurisdictions for more specific cases generating IP income, i.e., patents and similar assets, marketing intangibles and other exceptional cases.

The Standard also highlights the importance of ensuring compliance via a common and effective approach. In this regard, there should first be a mechanism to identify the entities conducting the relevant categories of mobile activities and to detect whether the core income generating activities were being carried out. Second, there should be a mechanism to take action in the event an entity failed to meet the Substantial Activities requirement. Thirdly, there should also be enhanced spontaneous exchange of information.

During 2019, the FHTP will work on the next steps for assessing compliance with the global standard for no or only nominal tax jurisdictions, and continue to report results to the IF on BEPS.

Implications

The updated results of the review of the preferential tax regimes demonstrate the swift and geographically comprehensive progress being made on the implementation of BEPS Action 5. They further affirm the actions of IF on BEPS members that have made significant commitments to change their tax rules. The release of the updated results also provides clarity to taxpayers on the status of preferential regimes in jurisdictions in which they may operate.

The FHTP will continue its work, including the monitoring and review of preferential tax regimes which are being amended to conform to the Action 5 standard. Taxpayers should monitor the work of the FHTP on the regimes that are found to be harmful and which may be in the process of being amended or eliminated, especially given that some countries include in their domestic laws reference to payments to preferential regimes. Therefore, inclusion in the OECD list may lead to non-deductibility of payments.

Finally, the release of the Substantial Activities requirement on “no or only nominal tax” jurisdictions will contribute the OECD says, to ensuring that substantial activities must be performed in respect of the same types of mobile business activities, regardless of whether they take place in a preferential regime or in a “no or only nominal tax” jurisdiction.

It should also be noted that similar assessments are made at European level by the Council through the list of non-cooperative jurisdictions for tax purposes. MNEs with any form of structure or transaction involving these regimes and jurisdictions should continue to monitor developments closely, as well as to assess alternative plans.

Endnotes

1. See EY Global Tax Alert, [OECD releases final report on countering harmful tax practices under Action 5](#), dated 8 October 2015.
2. See EY Global Tax Alert, [OECD releases progress report on preferential regimes under BEPS Action 5](#), dated 18 October 2017.

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