
The authors of this note discuss the interplay between the OECD’s BEPS Action 5, which addresses the detection and coordinated countering of harmful tax practices through a renewed focus on both transparency and substance requirements, and work being undertaken at the EU level to build on the results of the BEPS project.

1. Introduction

One of the main objectives of the 15-point Action Plan on Base Erosion and Profit Shifting (BEPS), adopted by the OECD in 2013, is to establish a greater coherence in respect of the present-day scheme of international corporate income taxation. And one of the most troublesome issues that arises as a result of uncoordinated tax regimes is the prevalence of what are being considered “harmful tax practices”. Such practices (notably, the existence of tax havens, the creation of various preferential tax regimes and the issuance of highly favourable and seemingly “aggressive” tax rulings) are characterized by their propensity to erode the tax bases of some countries to the benefit of others where there are lower effective taxes. And that, in turn, leads to an undesirable “race-to-the-bottom”. Action 5 of the OECD’s Action Plan on BEPS was, therefore, dedicated to addressing the detection and coordinated countering of such harmful tax practices, with a renewed focus on both transparency and substance requirements.

At the EU level, and separate and apart from the efforts of the European Commission’s Competition authorities to combat “aggressive” tax structuring via the State aid rules (which is not the topic of this note), the legislative in which the Commission stated that the European Union can (read “should” or “will”) build on the results of the BEPS project at the EU level. Furthermore, the EU Ministers of Finance reached an agreement in October 2015 for a Directive amending Directive 2011/16/EU as regards the mandatory, automatic exchange of tax rulings. As indicated in the accompanying press release, this amendment is fully in line with the OECD’s work on BEPS.

2. Background

In 1998, the OECD Committee on Fiscal Affairs published a report on Harmful Tax Competition (the “1998 Report”), with the goal of developing a better understanding of harmful tax practices around the world. In total, 12 factors were set out in order to determine whether a preferential tax regime could be harmful. The creation of a “box” and other tax-advantageous IP regimes, has not, as yet, been fully developed.

But matters are moving apace. The EU’s Code of Conduct Group has made specific reference to the ongoing work at the OECD level and, more in particular, to BEPS Action 5. It is, therefore, fully expected that the OECD’s lead will be followed by the European Union. This was confirmed in a Communication from the European Commission (the “Commission’) on a “Fair and Efficient Corporate Tax System in the European Union” (the “Communication”), in which the Commission stated that the European Union (read “should” or “will”) build on the results of the BEPS project at the EU level. Furthermore, the EU Ministers of Finance reached an agreement in October 2015 for a Directive amending Directive 2011/16/EU as regards the mandatory, automatic exchange of tax rulings. As indicated in the accompanying press release, this amendment is fully in line with the OECD’s work on BEPS.

4. See also the conclusion on page 15 of the Communication, supra n. 3. “This Action Plan will be the basis for Commission work on corporate tax policy over the next years. Work will evolve to take account of the input of the European Parliament, contributions of other EU institutions and stakeholders, and outcomes of the OECD BEPS initiative. The Commission will keep progress under review.”
7. The four key factors are: (1) no or low effective tax rates on movable sources of income; (2) “ring-fencing” from the domestic economy; (3) a lack of transparency; and (4) no effective exchange of information. Eight other, indicative factors are: (1) an artificial definition of the tax base; (2)
Forum on Harmful Tax Practices (the "Forum"), operating under the auspices of the Committee on Fiscal Affairs, was first proposed in this 1998 Report. To this day, this platform plays an important coordination and knowledge-gathering role within the OECD with regard to countering preferential tax regimes.

The 1998 Report was followed by publications describing the progress that had been made and the next steps that had to be taken. In this way, potentially harmful regimes within OECD Member States were, first, to be detected and then commitments with tax havens were sought with regard to effective exchanges of information and transparency. The tax haven aspect of the work was soon taken over by the Global Forum on Taxation (later renamed the Global Forum on Transparency and Exchange of Information for Tax Purposes), however, in order to allow non-OECD member countries to more easily enter into a dialogue with and become engaged in the process and actually take up commitments. This, in turn, afforded the Forum the opportunity to fully concentrate its own efforts on the countering of preferential tax systems.

3. BEPS Action 5

3.1. Introductory remarks

After around 2005, progress in combating "harmful tax practices" slowed down, and it was not until the wake-up call of the 15-point BEPS Action Plan in 2013 that the Forum picked the thread up again. Action 5 of this Action Plan quite straightforwardly commits the Forum to:

Revamp the work on harmful tax practices with a priority on (i) improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and (ii) on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework. (numbering and emphasis added)

The Forum was expected to deliver results in three stages as described in the subsections below. To that end, interim results were first presented in 2014 (the "2014 Deliverables") and final results in October 2015.

3.2. Review of member and associate countries

In the final report on BEPS Action 5 (the "Final Report"), the Forum presented a review of preferential regimes in both OECD member and associate countries. The criteria from the 1998 Report were applied, as well as the newly-developed "substantial activity" factor with regard to intangible regimes (see section 3.4.1.).

With regard to the IP tax regimes that were reviewed (for example, in Belgium, Luxembourg, the Netherlands and the United Kingdom), the Final Report states the following:

148. The IP regimes listed in Table 6.1 were all considered under the criteria in the 1998 Report as well as the elaborated substantial activity factor. Those regimes are inconsistent, either in whole or in part, with the nexus approach as described in this report. This reflects the fact that, unlike other aspects of the work on harmful tax practices, the details of this approach were only finalized in this report while the regimes had been designed at an earlier point in time. Countries with such regimes will now proceed with a review of possible amendments of the relevant features of their regimes. Where no amendments are made, the FFHP will proceed to the next steps in its review process. (emphasis added)

3.3. Strategy to involve non-OECD member/associate countries

In order to avoid non-OECD member or non-associated countries from benefiting from a competitive advantage, the goal is for such other countries to also be involved and take up commitments in connection with the guidelines being recommended under BEPS Action Plan 5. The outcomes of the efforts undertaken by the Forum to achieve this global, level-playing field were published in the Final Report.

3.4. Revision of existing criteria

Much progress has already been made with regard to the revision of the 1998 criteria on harmful tax practices and the development of a new framework to detect and combat such practices. The Final BEPS Report places the emphasis on (1) requiring 'substantial activity' in order for a taxpayer to benefit from a preferential tax regime; and (2) making taxpayer specific rulings more transparent.

3.4.1. Substantial activity requirement in IP regimes – OECD level/EU level

3.4.1.1. OECD level

To date, the "substantial activity" requirement has only been addressed in the context of special IP or "patent box" tax regimes. The primary goal is to align taxation (and tax benefits) with 'substance'. That, of course, makes it critical to determine how to define this concept of 'substantial activity'. The Forum considers the "Nexus Approach" as the most appropriate methodology for doing so. Specifically, tax benefits or advantages should only accrue in respect of income generated from IP rights to the extent the taxpayer in question has actually incurred the expenditures to develop those IP rights. Via the "Nexus Approach", the amount of income that may qualify for any tax benefit (presumably accorded via a preferential regime) is to be determined by applying the following calculation:

11. Id., at p. 25.
Expenditures, therefore, act as a proxy for substantial activities. In other words, the amount of “qualified expenditures” incurred by the taxpayer in relation to the “overall expenditures” incurred is considered to represent “substantial activity” and may then be used to calculate the tax benefit.

“Qualifying expenditures” must have been incurred by the taxpayer and must be directly connected to the IP asset. Indeed, the Final Report states that:12

Jurisdictions will provide their own definitions of qualifying expenditures, and such definitions must ensure that qualifying expenditures only include expenditures that are incurred for the purpose of actual R&D activities. They would include the types of expenditures that currently qualify for R&D credits under the tax laws of multiple jurisdictions […] Qualifying expenditures could therefore include salary and wages, direct costs, overhead costs directly associated with R&D facilities, and cost of supplies so long as all of these costs arise out of activities undertaken to advance the understanding of scientific relations or technologies, address known scientific or technological obstacles, or otherwise increase knowledge or develop new applications.

In order to determine the “overall expenditures,” only two items may be added to the “qualifying expenditures”: (1) expenditures for related-party outsourcing and (2) acquisition costs. Expenditures for activities undertaken by unrelated parties will already qualify as “qualifying expenditures.”

The “Nexus Approach” also allows jurisdictions to permit taxpayers to apply a 30% “up-lift” to costs incurred by related parties or for the acquisition of IP rights. The purpose of the “up-lift” is to ensure that the “Nexus Approach” does not unfairly penalize taxpayers for acquiring IP or outsourcing R&D activities to related parties. But the upper limit to the “up-lift” still ensures that taxpayers will only receive benefits if they themselves undertook significant R&D activities, while it acknowledges that taxpayers that have acquired IP or outsourced a portion of the R&D to a related party may still be responsible for much of the value creation that has contributed to the IP income in the first place.

3.4.1.2. EU level

The legislative process with regard to countering “harmful tax practices” is in process. In the Communication from the Commission on a “Fair and Efficient Corporate Tax System in the European Union”,13 one of the stated objectives driving the new approach to corporate taxation in the European Union is to ensure that Member States can correctly value corporate activity in their jurisdiction. In other words, profits should be taxed in the place where the actual activities take place. In particular, with respect to preferential tax regimes, the Communication states that:14

Certain preferential tax regimes are perceived to facilitate tax avoidance rather than genuinely encouraging the economic activities for which the tax benefit is offered. For example, a company may locate its intellectual property in a different country to its real R&D activities, in order to avail of the preferential tax treatment, in particular patent boxes. In 2014 the Code of Conduct for Business Taxation Group agreed that, in order to address this problem, preferential regimes, such as patent boxes, should be based on the “modified nexus approach.” This means that there must be a direct link between the tax benefits and the underlying research and development activities. The Commission will continue to provide guidance to Member States on how to implement patent box regimes in line with the new approach so as to ensure that they are not harmful, and will carefully monitor this implementation.

Thus, the European Union is also stressing the need to link tax benefits (for example, a patent box regime) and the underlying activities (for example, R&D). It is not clear whether the Commission will impose more stringent rules than the OECD recommends in this respect, but it is clearly intended that taxpayers only benefit from preferential tax regimes to the extent that there is a determinable and definable link to where the value is created, i.e. the place of the actual economic activity. Oddly, although that link is stated many times in the various texts, the actual text of the OECD’s Nexus Approach – which refers only to “qualifying expenditures” by a taxpayer – is not entirely limited to the expenditures in the jurisdiction of the taxpayer, as various exceptions are allowed (or it is foreseen that exceptions may be made by various countries) for expenditures made or paid outside the jurisdiction.

3.4.2. Improving transparency through compulsory spontaneous exchange – OECD level/EU level

3.4.2.1. OECD level

As a result of the commitment to improve transparency, the Final Report provides an extensive framework for compulsory spontaneous information exchange between countries of taxpayer-specific rulings. Indeed, it is expressly stated that such information exchanges should always apply when the absence of such an exchange results in BEPS concerns.

Firstly, six types of rulings are identified for which a spontaneous exchange is to be effected.15 And several criteria are developed, some of which are identical to the criteria used to detect preferential regimes in general.

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12. Id. at p. 27.
14. Id., 2.3. “Linking preferential regimes to where value is generated”.
15. These six categories are (1) rulings relating to preferential regimes; (2) unilateral APAs or other cross-border unilateral rulings in respect of transfer pricing; (3) cross-border rulings providing for a downward adjustment of taxable profits; (4) permanent establishment (PE) rulings; (5) related party conduit rulings; and (6) any other type of ruling agreed by the FHTP (Forum on Harmful Tax Practices) that in the absence of spontaneous information exchange gives rise to BEPS concerns. Final Report, supra n. 10, para. 91, at p. 46.
Secondly, the Final Report indicates with which countries the information is to be exchanged. In short, for most rulings, two categories of countries are relevant: (1) 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 benefiting from preferential treatment; and (2) the residence country or countries of both the ultimate parent company and the immediate parent company.

Thirdly, the Final Report provides more general guidance on how to apply the overall framework. The obligation to spontaneously exchange rulings applies not only to future rulings but also to rulings that have already been issued. Thus, where a country has provided a ruling that is subject to spontaneous exchange, it must exchange the relevant information on that ruling with any affected country as quickly as possible, and in any event, no later than three months after the date on which the ruling becomes available to the competent authority of the country that granted it. Future rulings should start to be exchanged as from 1 April 2016. The deadline provided for past rulings is the end of 2016.

Finally, it is set out that each country that receives such information must ensure that it is adequately protected, including as to its confidentiality. All such information can only be used for tax purposes.

3.4.2.2. EU level

As alluded to above, the EU Finance Ministers reached an agreement on 6 October 2015, to amend the Mutual Assistance Directive [on administrative cooperation in the field of taxation] (2011/16). The amendment now requires the Member States to automatically exchange a basic set of information on advance (cross-border) tax rulings and advance pricing arrangements (“APAs”). Such information must be shared with all EU Member States, rather than only amongst those Member States where the entities that are party to the ruling are located (as is otherwise required under BEPS Action 5).

These new EU rules are to be applied as from 1 January 2017. For rulings and APAs issued before 1 January 2017, a look- back period will apply.

4. Next Steps

The next steps in the work of the Forum fall into three broad categories. The first is its ongoing work, including the monitoring of preferential regimes and the application of the agreed transparency framework. Specifically, the Final Report indicates that countries should update the Forum on legislative progress in respect of changing their existing laws. In particular, existing IP regimes must be amended in order to comply with the Nexus Approach. Future monitoring will take into account any such amendments and, where no amendments are made to existing IP regimes, the Forum will then automatically move to the next stage of the review process. With regard to the transparency framework, the Final Report also foresees the establishment of a monitoring and review mechanism with the responsibility for ensuring that all countries spontaneously exchange the information covered by the framework.

The other two categories are (1) further development of a strategy to expand participation in the Forum’s activities to third countries; and (2) considering further revisions or additions to the existing Forum criteria.

5. Conclusion

In sum, the international (and certainly the EU) tax landscape has dramatically changed over the past two years and has been indelibly altered. This progress has been made much more quickly than most observers – and especially most taxpayers – ever foresaw. Substance has always been a “buzzword” in international tax planning, but now it will become ever more a reality to be dealt with. That being said, the “devil is always in the details”. So taxpayers and their advisors must now await the panoply of actual implementing legislation worldwide before they can really assess how high the bar of “substance” will be set.


18. As an example of the impact that BEPS Action 5 has already generated, even prior to its effective date, on 13 October 2015 (after a public consultation commenced in January 2015), Ireland introduced new legislation to bring its “Knowledge Development Box” in line with BEPS Action 5 and the Nexus Approach. Effective 1 January 2016, Ireland imposes a special tax rate of 6.25% – one-half of the normal Irish rate of 12.5% for active or trading income – to profits from certain IP where qualifying R&D is carried out in Ireland. An uplift in the amount of qualifying expenditure is available, being the lower of (1) 30% of the amount of qualifying expenditure and (2) the aggregate of acquisition costs and group outsourcing costs.