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Final report on BEPS Action 5: Countering harmful tax practices more effectively, taking into account transparency and substance

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On October 5, 2015, ahead of the G20 Finance Ministers' meeting in Lima on October 8, the Organisation for Economic Co-operation and Development (OECD) Secretariat **published** thirteen papers and an Explanatory Statement outlining consensus Actions under the base erosion and profit shifting (BEPS) project. The output is intended to form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the OECD Model Treaty and transfer pricing guidelines. They are broadly classified as "minimum standard", "best practices" or "recommendations" for governments to adopt. The OECD will be continuing its work on some specific follow-up areas in future years.

As part of the 2015 output, the OECD has published a final report on Action 5, *Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance*. The report establishes minimum standards with regard to both determining whether preferential regimes take sufficient account of the need to reward only substantial activities, and ensuring that there is transparency in relation to rulings. It also sets out minimum standards for domestic law provisions in respect of intellectual property (IP) regimes, such as patent box regimes.

The OECD's work on harmful tax practices originally was documented in the OECD's 1998 Report *Harmful Tax Competition: An Emerging Global Issue* (1998 report). The 1998 report agreed to a set of factors for determining whether a regime is preferential and, if so, whether the preferential regime is potentially and actually harmful. It also created the Forum on Harmful Tax Practices (FHTP).

The September 2014 interim report on Action 5 (interim report) outlined the progress made on the delivery of the outputs asked of the FHTP. It focused on (i) elaborating on a methodology to define the substantial activity requirement in the context of intangibles regimes; and (ii) improving transparency through compulsory spontaneous exchange of rulings related to preferential regimes.

The 1998 report identified four "key" factors and eight "other" factors used to identify whether a regime is preferential. The first factor—a low or zero tax rate— acts as a gateway for the other factors. The interim report proposed, and the final report confirms, that a lack of "substantial activity", previously one of the other factors, now is a key factor.

Several approaches were considered to determine a lack of substantial activity. The OECD has achieved consensus on the "nexus approach", which uses expenditure as a proxy for activity, and this principle can be applied to all types of preferential regimes. Such regimes may grant preferential benefits to a taxpayer only to the extent the taxpayer undertook the core income-generating activities required to produce the type of income covered by the preferential regime.

Preferential IP regimes

The interim report developed the nexus approach in the context of IP regimes, establishing that the core income-generating activity for such regimes is research and development (R&D), allowing a taxpayer to benefit from an IP regime only to the extent the *taxpayer itself* incurred qualifying R&D expenditures that gave rise to the IP income. For companies within the European Union, the R&D must be conducted within the company making the claim, which can include R&D conducted in a foreign permanent establishment (PE) of that company. Non-EU countries can apply a "jurisdictional test" if they wish.

Subsequent to the publication of the interim report, Germany and the United Kingdom proposed a "modified nexus" approach, which was then endorsed and adopted by the OECD. The final report includes additional detail on the application of the modified nexus approach.

$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{Overall income from IP asset} = \text{Income receiving tax benefits}$$

The nexus approach was designed to require a link between expenditures, IP assets and IP income, and taxpayers must track expenditures and income to IP assets where they can. However, where such tracking would be unrealistic and require arbitrary judgements, jurisdictions may choose to allow tracking to take place at the product level.

IP assets that could qualify for tax benefits under an IP regime are patents and 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. IP assets that are functionally equivalent to patents include plant breeder rights, copyrighted software and, for small entities, certain other IP assets that are non-obvious, useful and novel.

There are various categories of expenditures that comprise qualifying and overall expenditures; the nexus ratio, therefore, also can be expressed as:

$$\frac{a+b}{a+b+c+d}$$

Where: *a* represents R&D expenditures incurred by the taxpayer itself, *b* represents expenditures for unrelated party outsourcing, *c* represents acquisition costs and *d* represents expenditures for related party outsourcing. All expenditure and costs will be included in the nexus calculation at the time they are incurred, regardless of their treatment for accounting or other tax purposes.

Expenditures for general and speculative R&D that cannot be tied to a specific IP asset or product can be divided *pro rata* across several IP assets or products. When calculating qualifying expenditures, jurisdictions may permit taxpayers to apply a 30% "up-lift" to expenditures that are included in qualifying expenditures. This up-lift may increase qualifying expenditures but only to the extent that the taxpayer has non-qualifying expenditures.

Overall expenditures must include the sum of all expenditures that would count as qualifying expenditures if they were undertaken by the taxpayer itself. Overall expenditures, therefore, only include two things *not* included within qualifying expenditures: expenditures for related party outsourcing and the cost of acquired IP.

Jurisdictions will define "overall income" consistent with their domestic law definitions of income, after application of the transfer pricing rules. The definition they choose should be proportionate to the qualifying expenditures incurred by companies, and should be limited to IP income.

Transitional measures and grandfathering provisions for IP regimes

The nexus approach was designed to apply a cumulative ratio of qualifying expenditures and overall expenditures. However, as a transitional measure, jurisdictions could allow taxpayers to apply a ratio where qualifying expenditures and overall expenditures are calculated based on a three or five year rolling average at a company level. This allows for the fact that there has been no requirement for a taxpayer to have tracked and traced expenditures in this way before the introduction of nexus. Taxpayers then will be required to transition from using the average to using cumulative ratios for the IP assets or products.

No "new entrants" will be permitted in any existing IP regime that is inconsistent with the nexus approach after June 30, 2016. For the purposes of grandfathering, "new entrants" include both new taxpayers not previously benefiting from the regime and new IP assets owned by taxpayers already benefiting from the existing IP regime. *All existing regimes must be closed by June 30, 2021*.

To mitigate the risk that new entrants will seek to avail themselves of existing regimes with a view to benefiting from grandfathering, jurisdictions are required to implement safeguarding measures. The first of these is enhanced transparency for new entrants entering the regime after February 6, 2015, requiring spontaneous exchange of information on the identity of new entrants benefiting from a grandfathered regime. IP assets acquired directly or indirectly from related parties currently not benefiting from a preferential IP regime after January 1, 2016 should be excluded from grandfathering (but only from December 31, 2016, allowing a period of grace while countries enact nexus compliant legislation).

Other preferential regimes

The final report considers the application of the substantial activity requirement to other preferential regimes that have been identified by the FHTP since the 1998 report. The determination of what constitutes the core income-generating activities is dependent on the type of regime, and will be considered on a case-by-case basis.

The final report gives some guidance regarding the type of activities that would be considered "core activities" for the various non-intangibles regimes, including headquarters, distribution service centre, financing or leasing, fund management, banking and insurance, shipping and holding company regimes.

The final report also outlines the primary concerns of the OECD and FHTP with each type of regime, which include: ring-fencing (where a regime excludes resident taxpayers from taking advantage of benefits, or where the entity benefiting from the regime is prohibited from operating in the domestic market); lack of substance; and artificial definition of the tax base.

Transparency in relation to rulings

As part of its commitment to improve transparency, the FHTP has developed a framework for compulsory spontaneous information exchange between governments in respect of taxpayer-specific rulings. The final report states that the compulsory spontaneous information exchange should apply to all instances where the absence of an exchange of a ruling may give rise to BEPS concerns.

The framework details the six types of ruling that will be subject to compulsory spontaneous exchange. 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 categories of rulings are: (1) rulings related to “preferential regimes” (broadly, those concerning geographically mobile income such as IP and financing); (2) unilateral advance pricing agreements (APAs) or other unilateral cross-border rulings in respect of transfer pricing; (3) cross-border rulings providing for a downward adjustment of taxable profits; (4) PE rulings (including whether or not a PE exists and the amount of profits attributable to the PE); (5) related party conduit rulings (which include rulings on income that flows through a country, including where two domestic entities are subject to different tax treatments); and (6) a catch-all category for any other type of ruling agreed by the FHTP in the future as giving rise to BEPS concerns in the absence of spontaneous information exchange.

For most rulings, the information will be automatically exchanged with: (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” (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 (2) 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% (to be kept under review) based on direct or indirect voting rights or equity interests.

Information on rulings issued on or after January 1, 2010 that were still in force at January 1, 2014 will be subject to exchange by the end of 2016. Information on future rulings (defined as those issued on or after April 1, 2016) must be exchanged as quickly as possible, (and, broadly, within three months). The information to be exchanged automatically includes, as a first step, a summary and basic information prepared on the basis of a common template. The receiving tax authority can request the ruling itself as a second step.

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. The information exchanged must be used only for tax purposes, and if domestic law provides for the information to be used more widely, this will be overridden by the international provisions restricting its use.

Deloitte's comments

The final report builds on the concepts set out in the interim report. Accordingly, much of the content of the final report will be familiar, although there are also new elements. The G20 leaders are expected to give final approval to the content of the final report.

For countries with existing IP regimes, the pace of change will be swift; the legislative process to update non-nexus-compliant regimes (essentially all regimes) must commence in 2015, with new compliant regimes in place by July 1, 2016.

A significant issue for claimant companies will be the requirement that the claimant itself must both incur qualifying expenditures and earn the related income; many groups will 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.

"Tracking and tracing" historic expenditures also will be a challenge for some entities, particularly in industries such as the pharmaceutical sector, which are characterized by very long lead times between R&D activities taking place and income being generated. The proposal for a rolling three or five year average before transition to full accumulation is welcome, as is the recognition that if claimants cannot track expenditures to individual IP assets, a less granular approach will be permitted on a case-by-case basis.

Compulsory spontaneous exchanges of information in respect of rulings are a key part of the G20/OECD's drive under BEPS to improve transparency in relation to tax and to ensure that tax authorities are able to access information that may not be in the possession of a local subsidiary. It also will serve as an early warning system for tax authorities where incentives have the potential to erode their tax base. *Companies must be aware that rulings obtained in one country will be shared with other tax authorities.*

In addition, the EU Council of Finance Ministers has agreed on a proposal for an EU directive on mandatory automatic exchange of tax information, specifically focused on cross-border corporate tax rulings. "Advance cross-border ruling" is defined broadly and will include rulings that relate to cross-border transactions and those on the presence (or absence) of a PE. The directive is expected to be in place in EU member states' national law by January 1, 2017. It will require member states to exchange detailed information on valid (currently applicable) rulings from 2012 to 2017, as well as information on rulings obtained after January 1, 2014 that are now invalid. Exchange of information on rulings for small and medium sized entities will apply only to rulings obtained after April 1, 2016. This will involve wider sharing than anticipated by the G20/OECD under Action 5, as the EU requirements are for the information to be shared with *all* EU member states (rather than just the countries of those entities that are party to the ruling, along with the immediate and ultimate parent companies, as set out by the OECD/G20).

Canada does not currently have a patent regime. In our pre-Budget 2015 submission to the Department of Finance, Deloitte **recommended** that Canada consider adopting a patent regime in order to ensure that the country remains competitive in attracting investment in R&D.

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 the information exchange, a monitoring and review mechanism will be put in place to ensure countries' compliance with the obligation to exchange information at the start of 2017. The FHTP also will 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.

The FHTP has identified two areas that would benefit from further consideration, once they have been able to identify the impacts of other areas; these areas are the artificial definition of the tax base and ring-fencing.

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