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International tax alert
BEPS Action 5: Harmful tax practices

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On September 16, 2014, ahead of the G20 Finance Ministers' meeting on September 20-21, 2014, the OECD published seven papers as a first tranche of deliverables under the base erosion and profit shifting (BEPS) project, including a report on Action 5: Harmful tax practices. The OECD will be continuing its work on the remainder of the 15 BEPS Actions throughout 2015. The G20 and OECD member governments intend that the recommendations under each of the Actions will form a comprehensive and cohesive approach to the international tax framework, through domestic legislation and international principles under the model tax treaty and transfer pricing guidelines. As a result, the proposed solutions in the first seven papers, while agreed to, are not yet finalized and may be affected by decisions and future work on BEPS in 2015.

The OECD's work on harmful tax practices was documented in the OECD's 1998 report on "Harmful Tax Competition: An Emerging Global Issue". The 1998 report noted a set of factors to determine 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). As preferential regimes continue to be a pressure area, Action 5 of the BEPS Action Plan commits the FHTP to revamp its previous work on harmful tax practices.

Deloitte's comments

This interim report highlights work on two important issues: exchange of information between tax authorities and the need for "substantial activities".

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 will co-exist with other initiatives, such as a more global approach to transfer pricing documentation to ensure that tax authorities are able to access information that may not be in the possession of a local subsidiary. It will also serve as an early-warning system for tax authorities where incentives have the potential to erode their tax base. Companies should be aware that in the future, it is likely that rulings obtained in one country will be shared with other countries' tax authorities.

There is general agreement that the presence of "substantial activities" is an important factor in determining whether or not an incentive regime is harmful. However, there is as yet no agreement on its definition. This report looks at the definition only in relation to patent boxes, or intangibles regimes.

The nexus approach proposed to define substantial activities for intangibles regimes is predicated on there being a link between research and development (R&D) expenditure and the income arising from the patents developed. It Is not clear

whether such a link exists (the value associated with patents is arguably not related to the R&D expenditure incurred to develop them) nor, if there is a link, whether front end R&D expenditure is the most appropriate indicator of "back end" substantial commercialization activity. Further, and perhaps more importantly, there are significant practical challenges to this approach. These include the need to identify and track qualifying expenditure (potentially including historic expenditure) and the fact that some of the items falling within the definition of expenditure are outside the control of the taxpayer and, in some cases, its group. A question is raised whether the nexus approach might contravene European Union law.

The interim report

Under Action 5, the FHTP has been asked to provide outputs on: (1) a review of member country preferential regimes; (2) a strategy to expand participation to non-OECD member countries; and (3) consideration of revisions or additions to the existing framework (as noted in the 1998 report).

The interim report outlines the progress made on the delivery of the outputs asked of the FHTP. The report notes that the FHTP's focus has been on

- elaborating a methodology to define the substantial activity requirement in the context of intangibles regimes; and
- improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes.

Further updates and reports on the three outputs will be released as part of the 2015 work on Action 5.

Substantial activity requirement and intangibles regimes

The 1998 report identified four "key" factors and eight "other" factors to identify whether a regime is preferential. The four key factors were:

- no or low effective tax rate on geographically mobile income and other service activities;
- ring-fencing of the regime from the domestic economy;
- a lack of transparency around the regime; and
- no effective exchange of information.

The first factor – a no or low tax rate – acts as a gateway for the other factors.

Under the BEPS work, a lack of "substantial activity", one of the "other" factors in the 1998 report, has been elevated by the OECD to be a "key" factor and accordingly the FHTP is considering various approaches to applying the "substantial activity" factor.

Work to date has focused on what constitutes substantial activity in the context of intangibles regimes (other regimes will be also addressed in future work). Three different approaches have been considered: a "value creation approach", a "transfer pricing approach" and a "nexus approach". The interim report acknowledges that a few countries (thought to be the United Kingdom, Spain, The Netherlands and Luxembourg) prefer the transfer pricing approach and have concerns with whether the nexus approach complies with European Union law. However, while no decision has yet been made, as many countries expressed concerns with the transfer pricing approach, the interim report focuses on the nexus approach. .

The nexus approach looks to calculate the intellectual property (IP) income eligible for tax benefits by establishing a nexus between the qualifying expenditure incurred on developing IP assets (expressed as a proportion of overall expenditure on creating the IP assets) and the income received from those IP assets. It proposes

that IP assets should be limited to patents or functionally equivalent intangible assets, and goes into some detail on suggested definitions of “qualifying expenditure” (broadly, R&D expenditure incurred in the development but not the acquisition of IP assets, including expenditure incurred by unrelated parties on development activities outsourced to them by the taxpayer), “overall expenditure” (broadly, qualifying expenditure plus expenditure which would have been qualifying expenditure had it been incurred by the taxpayer, including expenditure to acquire IP assets from related or unrelated parties) and the “income received from IP assets” (broadly, royalties, gains from the sale of IP assets and embedded IP income from the sale of products directly related to the IP assets). It outlines an “additive” approach to calculate this expenditure, accumulating the expenditure incurred on creation and throughout the life of the asset, and confirms that in order to benefit from an IP regime, taxpayers would have to track the cumulative expenditure.

Compulsory spontaneous exchange on rulings

The FHTP has focused on developing a framework for compulsory spontaneous exchange of taxpayer specific rulings in respect of preferential regimes. Such exchanges will be “mechanical”, rather than discretionary for tax authorities.

The framework deals with four key design questions:

- When does the obligation to spontaneously exchange information on rulings arise?
- Who must information be exchanged with?
- What information must be exchanged?
- What is the legal basis for the spontaneous information exchange?

It should be noted that the rules include transfer pricing rulings. Specifically, unilateral advance pricing agreements (APAs), as well as multilateral APAs for countries that are affected by but not party to them, will be required to be exchanged.

The important issue of ensuring confidentiality of taxpayer information together with an implementation schedule and time limits for information exchange are being considered as part of the FHTP’s work.

Other matters

The interim report provides an update on the FHTP’s ongoing review of 30 OECD member and associated country preferential regimes.

Timetable and next steps

The FHTP will now commence work on the second output – engaging with other non-OECD member countries on the basis of the existing framework, with a deadline for delivery in September 2015.

Further work on substantial activity is required, including discussions on the approach to require substantial activity in intangibles regimes and once agreed, applied to a number of intangibles regimes. In addition to intangibles regimes, an approach must be agreed for assessing substantial activity in other preferential regimes.

The FHTP plans to start applying the framework for compulsory spontaneous exchange on rulings very shortly - in Autumn 2014. It will report on the status of the implementation in a 2015 progress report. The FHTP will also explore other ways in which transparency may be improved.

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