

BEPS Action 5: Harmful tax practices

On 16 September 2014, ahead of the G20 Finance Ministers' meeting on 20-21 September, the OECD published seven papers as a first tranche of deliverables under the Base Erosion and Profit Shifting ('BEPS') Project. The OECD will be continuing its work on the remainder of the 15 Actions on BEPS throughout 2015. It is clear that the G20 and OECD governments intend that recommendations under each of the BEPS Actions will form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations 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, are not yet finalised and may be affected by decisions and future work on BEPS in 2015.

The OECD's work on harmful tax practices was notably documented in the OECD's 1998 Report on 'Harmful Tax Competition: An Emerging Global Issue' ('1998 Report'). The 1998 Report agreed 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). Preferential regimes continue to be a pressure area and therefore Action 5 of the BEPS Action Plan commits the FHTP to revamp its previous work on harmful tax practices.

Deloitte Comments and Issues

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 areas 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 need to be aware that, in future, it is likely that rulings obtained in one country will be shared with other 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 something of an unknown quantity: it has never been tested in practice. Conceptually, it is predicated on there being a link between 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 commercialisation activity. Perhaps more pertinently, there are significant practical issues. 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. There is a question (referred to in the Interim Report) whether the nexus approach might contravene European Union law.

The groundswell of international opinion appears to be growing behind the nexus approach to intangibles regimes and therefore businesses contemplating the UK patent box regime will need to monitor closely developments and Treasury announcements in this area.

Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance ('Interim Report')

The Interim Report is part of the OECD's work in relation to Action 5 ('Harmful Tax Practices') of the BEPS Action Plan. 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 agreed within the 1998 Report).

The Interim Report outlines the progress made on the delivery of the outputs asked of the FHTP. Its focus has been 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 on rulings related to preferential regimes.

There will be further updates and reports in respect of all three outputs as part of the 2015 work on Action 15.

Substantial activity requirement and intangibles regimes

The 1998 Report identified four 'key' factors and eight 'other' factors used to identify whether a regime is preferential. The four key factors are:

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

The first factor – a low or zero tax rate – acts as a gateway for the other factors.

Under the BEPS work, a lack of 'substantial activity', previously one of the 'other' factors, 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 considered as part of the 2015 BEPS 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 UK, Spain, The Netherlands and Luxembourg) prefer the transfer pricing approach and have concerns with whether the nexus approach is consistent with EU law. However, many countries raised concerns with the transfer pricing approach and so the Interim Report focuses on the nexus approach, although no decision has yet been made.

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

It proposes that *IP assets* should be limited to patents or functionally equivalent intangible assets, and goes into some detail on its suggested definitions of *qualifying expenditure* (broadly, R&D expenditure incurred by the taxpayer in the development but not 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 asset). It outlines an 'additive' approach to calculate this expenditure, cumulating 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 tax-payer specific rulings in respect of preferential regimes. Such exchanges will be 'mechanical' based on the rules being considered by the OECD, rather than discretionary for tax authorities.

The framework deals with four key design questions: (1) When does the obligation to spontaneously exchange information on rulings arise? (2) Who must information be exchanged with? (3) What information must be exchanged? (4) What is the legal basis for the spontaneous information exchange?

When they meet the hurdles for spontaneous exchange, such as being in relation to a potentially harmful regime on geographically mobile income or other service activities, the rules include transfer pricing rulings. Specifically, unilateral Advance Pricing Agreements (APAs), and also multilateral APAs for countries that are affected by but not party to them, will need to be exchanged. The important issue of ensuring confidentiality of taxpayer information together with time limits and implementation 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, including the UK patent box. In addition to intangibles regimes, an approach needs to 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, and 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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