EU insight on harmful tax measures includes new substance guidance

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In brief

The EU's inter-governmental Code of Conduct Group (Business Taxation) (CoCG) has put forward guidance for determining substance when considering whether a tax measure is harmful or 'fair'. The guidance includes elements of behaviour that Member States must meet and requirements that non-Member States must adopt in order to avoid being included on the so-called blacklist of non-cooperative non-EU, third countries. The guidance was formally endorsed without further discussion at the ECOFIN meeting on 22 June 2018.

The CoCG has also published the following items relating to its mandate on harmful tax matters:

- a summary of the status at 31 May 2018 of the 92 jurisdictions screened in 2017 which resulted in some being listed, others monitored and a few receiving comfort letters
- an overview of the preferential tax regimes it has examined since its creation in March 1998, and
- a work programme indicating areas where it will focus its attention for the foreseeable future.

In detail

The CoCG assesses harmful and 'fair' tax measures

The EU's Code of Conduct for Business Taxation was established at an ECOFIN meeting on 1 December 1997. The Code of Conduct is not a legally binding instrument but is a political commitment by Member States to:

- re-examine, amend or abolish existing tax measures that constitute harmful tax competition (rollback process), and
- refrain from introducing new measures that constitute harmful tax competition (standstill process).

The CoCG was set up within the framework of the by ECOFIN on 9 March 1998 to review measures that were agreed to constitute the Code.

The CoCG:

- agrees guidance notes for the ECOFIN to endorse (and regularly reviews implementation by Member States), and

- prepares ECOFIN conclusions for ECOFIN to adopt.

The avoidance or removal of harmful tax measures was, and remains, part of that Code. The potentially harmful nature of a country's tax measure is determined according to an overarching requirement that it provides for a significantly lower effective level of taxation than generally applies in that country (including zero taxation).

There are five specific criteria agreed by Member States as examples of harmful measures. They broadly cover:

- targeting non-residents
- ring-fencing from the national market
- non-alignment with substance
- transfer pricing/ group profit, and
- determination and lack of transparency.

The CoCG also now addresses tax havens, or more specifically the criteria for assessing whether a non-EU, third country is non-cooperative in relation to the so-called blacklist, against which a range of defensive actions is being agreed and enhanced. The criteria are split into categories covering:

- transparency
- fair taxation, and
- implementation of anti-BEPS measures.

ECOFIN has to decide the consequences for countries being on the blacklist. For such countries, it has already denied access to certain EU funding. It also has agreed that a hallmark for reporting an arrangement would be met if a deductible cross-border payment is made by an entity to an associated entity resident in a country on the list. ECOFIN is still considering other potential sanctions, such as applying withholding taxes and disapplying exemptions. In contrast, when a regime of an EU Member State is determined to be harmful, the roll back process and/ or standstill process may be applied.

Observations: The increased transparency requested of the CoCG has led to the publication and 'declassification' of various materials. Three of four items of significant use in determining how the CoCG works in considering harmfulness and substance are included in its most recent six-monthly report to ECOFIN but the fourth item is largely a standalone publication. Other declassified materials now available include the letters to Caribbean countries on which blacklisting decisions were deferred, but those letters all followed the previously published template. The Commission is making tax good governance an instrumental part of trade agreements with third countries and the work of the CoCG may significantly impact relations with these countries.

Status of 'potential' blacklist countries shows criteria commitments are met

The CoCG initially targeted 92 jurisdictions before they whittled that number down to the blacklist of non-cooperative countries and a so-called greylist of committed countries. The 92 jurisdictions each received a formal request to justify their frameworks for and effective applications of cooperative tax criteria following the CoCG's 'scoreboard of indicators'.

As a result of responses to the formal requests, and with further investigation, the CoCG determined that the countries fell into the following categories:

- 'listed' as non-cooperative (the blacklist)
- 'under monitoring' of their commitments to meet the criteria (the greylist), or
- 'comfort letter' countries (accepted as cooperative under the current criteria).

The cooperative tax criteria previously agreed by ECOFIN (as set out when the blacklist was published in 5 December 2017 ECOFIN conclusions) are:

1.1 Commitment to implement the automatic exchange of information, either by signing the Multilateral Competent Authority Agreement or through bilateral agreements

1.2 Membership in the Global Forum on transparency and exchange of information for tax purposes and satisfactory rating

1.3 Signatory and ratification of the OECD Multilateral Convention on Mutual Administrative Assistance or network of agreements covering all EU Member States

2.1 Existence of harmful tax regimes

2.2 Existence of tax regimes that facilitate offshore structures that attract profits without real economic activity

3. Membership in the Inclusive Framework on BEPS or implementation of BEPS minimum standards

The CoCG has now published - as Appendix 3 of the progress report - a status document on its reviews. However, much of the material had been made available in various places previously. The document indicates a country's status on listing and specifies a deadline for meeting their commitments of either 2018 or 2019, as determined by the CoCG. In addition, the document indicates the number of preferential tax regimes in a country that were assessed for harmfulness in relation to Item 2.1 and whether the CoCG is relying on the OECD's Forum on Harmful Tax Practices (FHTP) assessment or will carry out its own review of them (for more detail on preferential tax regimes see separate section below).

The CoCG has also indicated whether a country was regarded as a financial centre (FC) and also as a :

- LDC: Least Developed Country
- LMI: Low Middle Income Country, or
- UMI: Upper Middle Income Country.

A recent ECOFIN announcement confirmed that it has accepted the CoCG recommendation to cut the blacklist to seven countries, shown on the status report as: American Samoa, Guam, Namibia, Palau, Samoa, Trinidad and Tobago, and the US Virgin Islands.

***Observations*:** There is a broad spread of criteria that countries have not yet met across the six different Items. However, the elimination or adjustment of a particular tax regime to ensure it is not harmful is the most prevalent as 37 countries have committed to such a move. There are 31 countries that have not met the requirement to be part of the OECD's BEPS Inclusive Framework (or otherwise committed to the BEPS minimum standards), contributing to the fact that nearly as many regimes are being reviewed by the CoCG as the FHTP.

Substance guidance and 'scoping' breaks new ground

Scope of new interpretations

On fair taxation for the purposes of the blacklist, Item 2.1 covers the same basic substance issue in relation to a particular measure as the third criterion or Criterion 3 of the Code for EU Member States. The focus is on whether a measure in a Member State provides advantages even without any real economic activity and substantial economic presence within that State. In addition, blacklist Item 2.2 deals with a further requirement to not facilitate offshore structures or arrangements aimed at attracting profits that do not reflect real economic activity in the country.

The new guidance further develops the interpretation of Criterion 3 / Item 2.1 on real economic activity and substantial economic presence (Appendix 1 of the progress report). The material on Item 2.2 on alignment of profits and real economic activities is described as 'scoping' (Appendix 4 of the progress report).

On the guidance in Appendix 1, the CoCG's decision is final. The text is merely to help Member States and third countries identify regimes more easily: it neither provides a safe harbour nor is it prescriptive. Previous determinations of CoCG assessments, whether positive or negative, will not be affected.

However, regimes must be subject to normal tax audit procedures. Furthermore, a review may be reopened on the basis that once the CoCG has assessed a particular regime, a continued monitoring process kicks-in. Therefore, information must be supplied annually on numbers of taxpayers applying for and benefitting from the regime with income, employees and expenditures (but normally with respect to taxpayers that are members of multinational enterprise groups with annual revenues in the preceding year of at least EUR 750m).

Regarding the scoping in Appendix 4 for Item 2.2 for non-EU jurisdictions, the paper discusses:

- technical elements of commitments to be fulfilled by these jurisdictions on harmfulness and substance (the Criterion 3 issues, which are really Item 2.1 but described as relevant to Item 2.2)
- the core income-generating activities required in these jurisdictions (split between IP and non-IP) and implementation of commitments by these jurisdictions, with the burden of proof lying with the taxpayer
- review and monitoring of these jurisdictions - failure of an entity to meet requirements leading to rigorous, effective and dissuasive regulatory penalties and automatic exchange of that fact with the jurisdiction of residence of the legal or beneficial owner (or presumably head office); ultimately, where other sanctions produce no results, this should lead to the striking off the register of such an entity, and
- potential further transparency requirements: for spontaneous exchange on specific risk issues, beneficial ownership registers and mandatory disclosure rules.

Observations: The guidance may be particularly important with regard to:

- confirming that the practice of the five criteria being used as the sole determinants of whether a regime is harmful (and not just examples), assessed on a case-by-case basis, continues to apply
- elaborating on the distinction addressed at a particular measure granted without any real economic activity and substantial economic presence as in Criterion 3/ Item 2.1 and overall within the country facilitating a lack of alignment of profits with real economic activity there in Item 2.2, and
- enhancing some views that various third countries committed to changing their tax regimes without due consideration merely to avoid being on the blacklist, as their decisions were based on brief guidelines "for application by analogy", while the new guidance only now provides more concrete technical advice on what needs to be done.

The level of real economic activity required depends on mobility

The guidance notes that the extent of the requirements is likely to differ between:

- tangible or immobile activities where substance is not an issue (but nexus might be), like manufacturing, production or business property investment
- particular types of activity that need to be carefully reviewed, giving examples of financial services, intra-group captive insurance, holding companies (other than 'pure' equity ones) and coordination centres, and
- regimes that specify targeting, are designed to do so or otherwise allow it, thus requiring further reviews of substance.

Observations: The report recognises that pure equity holding companies should require reduced substantial activity thresholds. It also acknowledges that usual substance requirements cannot automatically be applied to collective

investment vehicles, noting that requirements in this regard can parallel EU legislation on investment funds, in particular directive 2011/61/EU on alternative investment fund managers.

Substantial economic presence considers input factors

The perceived requirements on presence focus on having an adequate number of employees with necessary qualifications and an adequate amount of operating expenditure with regard to the core income-generating activities (with some examples of the nature of what might be considered, including premises costs).

The report clarifies that the country requirements in Item 2.2 largely aim to mirror, by analogy, the FHTP requirements used in relation to assessing whether any particular preferential regime is harmful. Specifically they are to apply to the same geographically mobile activities and to each sector, with effect from 1 January 2019 at the latest (giving companies until 1 July 2019 to comply).

Non-EU countries were encouraged, via letters, to put in place appropriate accounting and tax recording/ reporting requirements in order to assess and share (with CoCG) the relevant information on substance. Those countries must also deploy appropriate resources to monitor the application of the requirements and that there are sanctions for non-compliance.

The overarching low or zero tax criterion is similar to the FHTP's gateway test according to the OECD's 2017 Progress Report on Preferential Regimes. The core income-generating activities then differ for non-IP and IP-based business.

Observations: The assessment does not wholly align with the FHTP requirements. Note that the guidance states only that "due consideration could also be given to assessments carried out by the FHTP of the regime in question, where appropriate". It also states that monitoring should be coordinated with the FHTP's parallel monitoring "to the extent that is relevant".

Non-IP regime core income-generating activities depend on type

Examples given by the FHTP requirement for core income-generating activities, reproduced from the BEPS Action 5 Report, refer to:

Headquarters regimes – taking relevant management decisions; incurring expenditures on behalf of group entities; and co-ordinating group activities.
Distribution and service centre regimes – transporting and storing goods; managing stocks and taking orders; and providing consulting or other administrative services.
Financing and leasing regimes – agreeing funding terms; identifying and acquiring assets to be leased (in the case of leasing); setting the terms and duration of any financing or leasing; monitoring and revising any agreements; and managing any risks.
Fund management regimes – taking decisions on the holding and selling of investments; calculating risks and reserves; taking decisions on currency or interest fluctuations and hedging positions; and preparing relevant regulatory or other reports for government authorities and investors.
Banking regimes – raising funds; managing risk including credit, currency and interest risk; taking hedging positions; providing loans, credit or other financial services to customers; managing regulatory capital; and preparing regulatory reports and returns.
Insurance regimes – predicting and calculating risk, insuring or re-insuring against risk, and providing client services.
Shipping regimes – managing the crew (including hiring, paying, and overseeing crewmembers); hauling and maintaining ships; overseeing and tracking deliveries; determining what goods to order and when to deliver them; and organising and overseeing voyages.
Holding company regimes with a variety of assets earning different types of income (e.g., interest, rents, and royalties), activities associated with the income that the holding companies earn.

Observations: Application of these requirements 'by analogy' leaves some doubt as to what adjustments, if any, are appropriate. In most categories, a direct read across seems fairly straightforward.

IP regime core income-generating activities focus on level of control

For IP regimes, the nexus approach on IP derived from local R&D activities could, in the context of non-cooperative third countries, prohibit genuine commercial activities by failing to recognise other intangible assets and different ways in which those assets can be created or otherwise exploited through core income-generating activities. So, the paper applies what it calls a 'strengthened general substantial activities approach'.

Periodic decisions of non-resident board members is unlikely to be sufficient. A company might sometimes be able to prove that it is undertaking core income-generating activities associated with intangible asset income other than research & development, marketing and branding. It may have the appropriate staff, premises and equipment to take strategic decisions and manage (as well as bear) the principal risks of developing/ acquiring and exploiting the intangible. Alternatively, it may carry on the underlying trading activities through which the intangibles are exploited and which lead to the generation of third-party revenue.

Where 'foreign' related parties are involved through acquisition, funding, licensing or monetisation, that is regarded as a high-risk scenario. In these circumstances, additional requirements would apply. Significant evidence would have to be given as to the level of control over development, exploitation, maintenance, protection and enhancement (DEMPE) functions. This information would also be shared with and reviewed by the entity's country of residence (or place of a PE's head office).

***Observations*:** The proposed rules seek to be 'effective and proportionate' whilst addressing the higher risk of artificial profit shifting posed by income derived from IP assets in certain scenarios. However, these concepts are nebulous and while the guidance provides a greater idea of the standards required relative to the risk, disagreements likely will continue to arise.

Potential future transparency requirements may be added

As noted above, where an entity fails the substance test, the CoCG requires enhanced spontaneous exchange of that information (e.g., to alert the tax administration that a party is making a deductible payment to such an entity). The CoCG suggests potentially adapting the means used to provide for exchange of tax rulings.

The CoCG also suggests that, since domestic beneficial ownership repositories will need to be in place, EU Member States should be able to query those sources directly (e.g., via an interconnected query platform).

Finally, the CoCG suggests such a third country could have to introduce a mandatory disclosure regime to require reporting of certain arrangements that the relevant Competent Authority would have to share with various other countries. The regime would, it states, have to be consistent with the EU's Directive on mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (DAC6) and the OECD work on financial account reporting (CRS) avoidance and opaque offshore structures.

Observations: As only a broad intention at this stage, detail of this future work is limited. However, some immediate and potentially significant questions arise. For example, presumably consistency with DAC6 would be limited to the financial account beneficial ownership hallmarks D, with which it notes these jurisdictions should be familiar; a question then arises as to whether the quoted OECD similarities would be limited to the CRS element and not include opaque offshore structures (though both could be intended, as being relevant to beneficial ownership). A further point arises as to reciprocity of reporting with other countries and with which countries' information would have to be shared (DAC6 broadly dealing with all EU Member States and the OECD with residence countries of users to which the information relates).

Almost half the preferential tax regimes reviewed by the CoCG were harmful

The CoCG published on 12 June 2018 a list of the different preferential tax regimes it has identified and assessed. The list includes a large number of regimes from EU Member States, assessed since the CoCG's inception in 1998. It also specifies the regimes more recently considered in relation to Item 2.1 of the blacklist criteria.

The present overview is organised in three parts:

The COCG has examined 632 preferential regimes (including 280 in 1998- 1999), 251 of which were deemed harmful and have been (or are being) rolled back, i.e., eliminated or amended.

Observations: This statement can be used in conjunction with the list of commitments by countries that puts them on the greylist rather than the blacklist. For example, the commitment list shows Uruguay having three preferential regimes under review. This statement identifies those regimes as 'free zones', 'shared service centres' and 'software industry incentives'. It also confirms that the FHTP is the lead assessor.

Work programme shows where the CoCG will focus in future

Within its existing mandate, the CoCG has set out in its 'New multiannual work package' (in Appendix 2 of the progress report) the priorities it agreed at its 31 May 2018 meeting:

Transparency of the CoCG - it will consider greater transparency of its work, in particular concerning the non-cooperative blacklist.
Monitoring of 'standstill' (no new benefits) and the implementation of 'rollback' (elimination or amendment) - focusing on patent boxes and notional interest deduction (NID) regimes, with potential guidance on NIDs.
Links with third countries - currently encompassing the 92 countries assessed in relation to the non-cooperative blacklist (and also it states action to combat tax avoidance/ evasion and measures potentially affecting the location of business activity). It could be expanded to more countries. The CoCG will consider revising the scope of Item 2.1 (harmful taxation) in relation to manufacturing regimes "taking into account its relevance for jurisdictions that are linked to the internal market".
Anti-abuse issues and defensive measures - the CoCG will turn its attention to outbound payments more generally as well as considering further defensive measures in relation to non-cooperative countries.
Transfer pricing issues - potentially revised guidance by the end of 2019 in various BEPS areas.
Implementation of CoCG guidance - the monitoring of previous guidance in various areas will be stepped-up including the most recent covering tax privileges related to Special Economic Zones (SEZ).

The CoCG also agreed to consider proposing a potential update to the 1997 mandate - including a review of the overarching low or zero tax criterion, mentioned above.

Observations: There are comments in the main body of the progress report which help shed further light on the new multiannual work package. While it is committed to greater transparency, confidentiality remains a concern to CoCG representatives. The CocG's work is intergovernmental in nature and is not subject to the scrutiny or supervision of the European Parliament (although the COCG agreed voluntarily to send a representative to appear before the TAXE3 committee in due course). NID regimes currently on standstill while questions/ criteria are finalised include those for Belgium, Cyprus, Italy, Malta and Portugal.

The takeaway

The CoCG is increasingly important in EU activity.

Member State regimes are increasingly criticised by the Commission and the Parliament, with pressure added to set high standards. Work on patent box regimes may almost be done, so attention is turning to notional interest deduction regimes. In addition, the CoCG may consider whether there is an effective way to review more generally low tax rates despite the sovereignty of Member States in this regard.

The work on non-EU countries likely will continue to expand. Defensive measures against countries not meeting the non-cooperative criteria may intensify. Monitoring will be enforced. There is already discussion of the criteria being further strengthened in future.

The CoCG's mandate may well be broadened, although greater transparency about its work is expected. Furthermore, the publication of more materials, like some of those now available, is likely.

Let's talk

For a deeper discussion of how these issues might affect your business, please call your usual PwC contact. If you don't have one or would otherwise prefer to speak to one of our global specialists, please contact one of the people below:

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