

OECD/G20 Base Erosion and Profit Shifting Project

**Countering Harmful Tax Practices More Effectively,
Taking into Account
Transparency and Substance**

ACTION 5: 2014 Deliverable



**Countering Harmful
Tax Practices
More Effectively,
Taking into Account
Transparency
and Substance**

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

Please cite this publication as:

OECD (2014), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.
<http://dx.doi.org/10.1787/9789264218970-en>

ISBN 978-92-64-21885-7 (print)
ISBN 978-92-64-21897-0 (PDF)

Series: OECD/G20 Base Erosion and Profit Shifting Project
ISSN 2313-2604 (print)
ISSN 2313-2612 (online)

Photo credits: Cover © archerix / Fotolia.

Corrigenda to OECD publications may be found on line at: www.oecd.org/about/publishing/corrigenda.htm.

© OECD 2014

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of the source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d'exploitation du droit de copie (CFC) at contact@cfcopies.com.

Foreword

Addressing base erosion and profit shifting (BEPS) is a key priority of governments around the globe. In 2013, OECD and G20 countries, working together on an equal footing, adopted a 15-point Action Plan to address BEPS. The Action Plan aims to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. It was agreed that addressing BEPS is critical for countries and must be done in a timely manner, not least to prevent the existing consensus-based international tax framework from unravelling, which would increase uncertainty for businesses at a time when cross-border investments are more necessary than ever. As a result, the Action Plan provides for 15 actions to be delivered by 2015, with a number of actions to be delivered in 2014.

The OECD Committee on Fiscal Affairs (CFA), bringing together 44 countries on an equal footing (all OECD members, OECD accession countries, and G20 countries), has adopted a first set of seven deliverables described in the Action Plan and due in 2014. This report is part of these deliverables and is an output of Action 5.

Developing countries and other non-OECD/non-G20 economies have been extensively consulted through regional and global fora meetings and their input has been fed into the work. Business representatives, trade unions, civil society organisations and academics have also been very involved through opportunities to comment on discussion drafts. These have generated more than 3 500 pages of comments and were discussed at five public consultation meetings and via three webcasts that attracted more than 10 000 viewers.

The first set of reports and recommendations, delivered in 2014, addresses seven of the actions in the BEPS Action Plan published in July 2013. Given the Action Plan's aim of providing comprehensive and coherent solutions to BEPS, the proposed measures, while agreed, are not yet formally finalised. They may be affected by some of the decisions to be taken with respect to the 2015 deliverables with which the 2014 deliverable will interact. They do reflect consensus, as of July 2014, on a number of solutions to put an end to BEPS.

The adoption of this first set of deliverables and the implementation of the relevant measures by national governments mean that: hybrid mismatches will be neutralised; treaty shopping and other forms of treaty abuse will be addressed; abuse of transfer pricing rules in the key area of intangibles will be greatly minimised; and country-by-country reporting will provide governments with information on the global allocation of the profits, economic activity and taxes of MNEs. Equally, OECD and G20 countries have agreed upon a report concluding that it is feasible to implement BEPS measures through a multilateral instrument. They have also advanced the work to fight harmful tax practices, in particular in the area of IP regimes and tax rulings. Finally, they have reached a common understanding of the challenges raised by the digital economy, which will now allow them to deepen their work in this area, one in which BEPS is exacerbated.

By its nature, BEPS requires co-ordinated responses. This is why countries are investing time and resources in developing shared solutions to common problems. At the same time, countries retain their sovereignty over tax matters and measures may be implemented in different countries in different ways, as long as they do not conflict with countries' international legal commitments.

Table of contents

Abbreviations and acronyms	7
Executive summary.....	9
Chapter 1. Introduction and background	13
Chapter 2. Overview of the OECD’s work on harmful tax practices	15
Chapter 3. Framework under the 1998 Report for determining whether a regime is a harmful preferential regime	19
Chapter 4. Revamp of the work on harmful tax practices.....	27
A. Substantial activity requirement.....	27
B. Improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes.....	35
Chapter 5. Review of member and associate country regimes	50
A. Introduction	55
B. Conclusions on sub-national regimes and when they are in scope.....	56
C. Conclusions reached on regimes reviewed.....	57
Chapter 6. Next steps.....	62
Annex A. Spontaneous information exchange on rulings related to preferential regimes – flow chart	65
 Tables	
Table 5.1. Regimes other than intangible regimes	58
Table 5.2. Intangible regimes	59
Table 5.3. Rulings related to preferential regimes and ruling regimes.....	60

Abbreviations and acronyms

AOA	Authorised OECD approach
APA	Advance pricing agreements
ATR	Advance tax rulings
BEPS	Base erosion and profit shifting
CAN	Consolidated application note (2004)
CFA	Committee on Fiscal Affairs
CFC	Controlled foreign company
EOI	Exchange of information
FHTP	Forum on Harmful Tax Practices
IP	Intellectual property
MAC	Convention on Mutual Administrative Assistance in Tax Matters
OECD	Organisation for Economic Co-operation and Development
PE	Permanent establishment
R&D	Research and development
TP	Transfer pricing

Executive summary

More than 15 years have passed since the publication of the OECD's 1998 Report *Harmful Tax Competition: An Emerging Global Issue* but the underlying policy concerns expressed in the 1998 Report as regards the “race to the bottom” on the mobile tax base have not lost their relevance. In certain areas, current concerns may be less about traditional ring-fencing but instead relate to across the board corporate tax rate reductions on particular types of income. The fact that preferential regimes continue to be a pressure area is highlighted by their inclusion in *Addressing Base Erosion and Profit Shifting* (BEPS Report) and *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan).

To counter harmful tax practices more effectively, taking into account transparency and substance, Action Item 5 of the BEPS Action Plan commits the Forum on Harmful Tax Practices (FHTP) to:

“Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and 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.”

Under Action Item 5, the FHTP is to deliver three outputs: first, finalisation of the review of member country preferential regimes; second, a strategy to expand participation to non-OECD member countries; and, third, consideration of revisions or additions to the existing framework.

This report outlines the progress made on the delivery of these outputs under Action 5. It shows progress made and identifies the next steps towards completion of this work, in particular on the first output. As regards the review of the existing preferential regimes, the emphasis has been put on (i) elaborating a methodology to define a substantial activity requirement in the context of intangible regimes and (ii) improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes.

Finally, it provides a progress report on the review of the regimes of OECD member and associate countries in the OECD/G20 Project on BEPS (associate countries)¹.

Countries have agreed on the need to strengthen the substantial activity requirement and several approaches have been explored with the common goal of realigning taxation of profits with substantial activities. Discussions are continuing to agree an approach, and once the approach has been agreed, the preferential regimes identified in this report will be assessed. As regards transparency, a detailed framework has been developed and agreed and is set out in the report. The agreed framework will be applied to the preferential regimes identified in this report and to other preferential regimes. Finally, the FHTP has started reviewing regimes of member and associate countries. The review of associate country regimes takes place on an equal footing with the review of member country regimes, but more time is being allowed for the completion of the review for associate country regimes.

This report contains six chapters. Chapter 1 introduces Action Item 5 of the BEPS Action Plan and covers background on the 1998 Report. Chapter 2 gives an overview of the OECD's work on harmful tax practices. Chapter 3 sets out the framework under the 1998 Report for determining whether a regime is a harmful preferential regime. Chapter 4 describes progress by the FHTP on the requirements of Action Item 5 to revamp the work on harmful tax practices by requiring substantial activity for any preferential regime. It also contains the agreed framework for improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes. Chapter 5 presents the status of the review of member country regimes and the progress made on the review of preferential regimes of associate countries. Finally, Chapter 6 deals with next steps.

Note

1. The following are associate countries in the OECD/G20 Project on BEPS: Argentina, Brazil, China, Colombia, India, Indonesia, Latvia, Russia, Saudi Arabia and South Africa.

Chapter 1

Introduction and background

At its June 2013 meeting, the Committee on Fiscal Affairs (CFA) approved the BEPS Action Plan (OECD, 2013a) which was subsequently endorsed by the G20 Finance Ministers at their July 2013 meeting and by the G20 Leaders at their September 2013 meeting. In response to the call in the BEPS Report (OECD, 2013b) to develop “solutions to counter harmful regimes more effectively, taking into account factors such as transparency and substance”¹ Action Item 5 of the BEPS Action Plan commits the FHTP to the following²:

“Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and 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.”

As is clear from Action Item 5, work in this area is not new. In 1998, the OECD published the report *Harmful Tax Competition: An Emerging Global Issue* (OECD, 1998). This report laid the foundations for the OECD’s work in the area of harmful tax practices and created the FHTP to take forward this work. It was published in response to a request by Ministers to develop measures to counter harmful tax practices with respect to geographically mobile activities, such as financial and other service activities, including the provision of intangibles. The nature of those types of activities makes it very easy to shift them from one country to another. Globalisation and technological innovation have further enhanced that mobility. The goal of the OECD’s work in the area of harmful tax practices is to secure the integrity of tax systems by addressing the issues raised by regimes that apply to mobile activities and that unfairly erode the tax bases of other countries, potentially distorting the location of capital and services. Such practices can also cause undesired shifts of part of the tax burden to less mobile tax bases,

such as labour, property, and consumption, and increase administrative costs and compliance burdens on tax authorities and taxpayers.

The work on harmful tax practices is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates. Rather, the work is about reducing the distortionary influence of taxation on the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place. This is essential in moving towards a “level playing field” and a continued expansion of global economic growth. Countries have long recognised that a “race to the bottom” would ultimately drive applicable tax rates on certain sources of income to zero for all countries, whether or not this is the tax policy a country wishes to pursue and combating harmful tax practices is an interest common to OECD and non-OECD member countries alike. There are obvious limitations to the effectiveness of unilateral actions against such practices. By agreeing a set of common criteria and promoting a co-operative framework, the work not only supports the effective fiscal sovereignty of countries over the design of their tax systems but it also enhances the ability of countries to react against the harmful tax practices of others.

More than 15 years have passed since the publication of the 1998 Report but the underlying policy concerns expressed in the 1998 Report have not lost their relevance. In certain areas, current concerns may be less about traditional ring-fencing but instead relate to across the board corporate tax rate reductions on particular types of income (such as income from financial activities or from the provision of intangibles). The fact that preferential regimes continue to be a pressure area is highlighted by their inclusion in the BEPS Report³ and Action Item 5 of the BEPS Action Plan⁴.

Under Action Item 5, the FHTP is to deliver the following three outputs:

- First, finalisation of the review of member country preferential regimes;
- Second, a strategy to expand participation to non-OECD member countries;
- Third, consideration of revisions or additions to the existing framework.

Notes

1. See Chapter 5 of the BEPS Report - Addressing concerns related to base erosion and profit shifting, p. 53.
2. See Action 5 of the BEPS Action Plan - Counter harmful tax practices more effectively, taking into account transparency and substance, p. 18.
3. See Chapter 5 of the BEPS Report - Addressing concerns related to base erosion and profit shifting, p. 48.
4. See Action 5 of the BEPS Action Plan - Counter harmful tax practices more effectively, taking into account transparency and substance, p. 17.

Bibliography

OECD (2013a), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing.

<http://dx.doi.org/10.1787/9789264202719-en>

OECD (2013b), *Addressing Base Erosion and Profit Shifting*, OECD Publishing.

<http://dx.doi.org/10.1787/9789264192744-en>

OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing.

<http://dx.doi.org/10.1787/9789264162945-en>

Chapter 2

Overview of the OECD's work on harmful tax practices

The 1998 Report (OECD, 1998) divided the work on harmful tax practices into three areas: (a) preferential regimes in OECD member countries, (b) tax havens and (c) non-OECD economies. The 1998 Report set out four key factors and eight other factors to determine whether a preferential regime is potentially harmful¹ and four key factors used to define “tax havens”². The 1998 Report was followed by four progress reports:

1. The first report, issued in June (OECD, 2000), outlined the progress made and, among other things, identified 47 potentially harmful regimes within OECD member countries as well as 35 jurisdictions found to have met the tax haven criteria (in addition to the 6 jurisdictions meeting the criteria that had made advance commitments to eliminate harmful tax practices).
2. A second progress report was released in 2001 (OECD, 2001). It made several important modifications to the tax haven aspect of the work. Most importantly, it provided that in determining which jurisdictions would be considered as uncooperative tax havens, commitments would be sought only with respect to the principles of effective exchange of information and transparency.
3. Between 2000 and 2004, generic guidance, or “application”, notes were developed to assist member countries in reviewing existing or future preferential regimes and in assessing whether any of the factors in the 1998 Report are present. Application notes were developed on transparency and exchange of information, ring-fencing, transfer pricing, rulings, holding companies, fund management, and shipping. The separate application notes were combined into a single Consolidated Application Note (CAN, OECD, 2004a).
4. In early 2004, the OECD issued another report (OECD, 2004b) which focused mainly on the progress made with respect to

eliminating harmful aspects of preferential regimes in OECD member countries. In addition to the 47 regimes identified in 2000, the report included determinations on holding companies and similar preferential regimes. A number of regimes that had been introduced since the initial identification of potentially harmful regimes in 2000 were also considered but none of these regimes were found to be harmful within the meaning of the 1998 Report.

5. Finally, a report on member country preferential regimes was issued in September 2006 (OECD, 2006). Of the 47 regimes initially identified as potentially harmful in the 2000 Report, 46 were abolished, amended or found not to be harmful following further analysis. Only one preferential regime was found to be actually harmful and legislation was subsequently enacted by the relevant country to abolish this regime.

Over time, the work relating to the tax haven aspects was increasingly carried out through the Global Forum on Taxation (Global Forum), which was created in the early 2000s to engage in a dialogue with non-OECD member countries on tax issues. The jurisdictions that had committed to the principles of effective exchange of information on request and transparency were invited to participate in the Global Forum, along with OECD member countries, to further articulate the principles of effective exchange of information on request and transparency and to ensure their implementation. In 2002, the Global Forum developed the *Agreement on Exchange of Information in Tax Matters* (OECD, 2002), and in 2005 it agreed standards on transparency relating to availability and reliability of information. Since 2006, the Global Forum has published annual assessments of progress in implementing the standards³.

In September 2009, the Global Forum was renamed the Global Forum on Transparency and Exchange of Information for Tax Purposes, and was restructured to expand its membership and its mandate and to improve its governance⁴. Subsequently, the CFA decided to restructure the bodies responsible for Exchange of Information (EOI) by creating Working Party No. 10 on Exchange of Information and Tax Compliance to take over the responsibilities of Working Party No. 8 on Tax Avoidance and Evasion, as well as the EOI matters previously addressed by the FHTP. Going forward, the work of the FHTP therefore focused on preferential tax regimes and on defensive measures in respect of such regimes (other than any such measures related to a lack of EOI or transparency⁵).

Notes

1. Those factors and the process for determining whether a regime is a harmful preferential regime under the framework of the 1998 Report are described below under Chapter 3, Section B.
2. The four key factors to define a “tax haven” were: 1) no or nominal tax on the relevant income; 2) lack of effective exchange of information; 3) lack of transparency; 4) no substantial activities. No or nominal tax is not sufficient in itself to classify a jurisdiction as a tax haven.
3. The relevant reports can be accessed on the following webpage: www.oecd.org/tax/transparency/keypublications.htm.
4. Information on the Global Forum on Transparency and Exchange of Information for Tax Purposes and its work is available at: www.oecd.org/tax/transparency.
5. Defensive measures related to a lack of exchange of information or transparency fall within the mandate of Working Party No. 10.

Bibliography

- OECD (2006), *The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries*, OECD, Paris.
www.oecd.org/ctp/harmful/37446434.pdf
- OECD (2004a), *Consolidated Application Note: Guidance in Applying the 1998 Report to Preferential Tax Regimes*, OECD, Paris.
www.oecd.org/ctp/harmful/30901132.pdf
- OECD (2004b), *Harmful Tax Practices: The 2004 Progress Report*, OECD, Paris.
www.oecd.org/ctp/harmful/30901115.pdf
- OECD (2002), *Agreement on Exchange of Information in Tax Matters*, OECD Publishing.
<http://dx.doi.org/10.1787/9789264034853-en>
- OECD (2001), *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report*, OECD, Paris.
www.oecd.org/ctp/harmful/2664438.pdf
- OECD (2001), *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices*, OECD Publishing.
<http://dx.doi.org/10.1787/9789264184541-en>
- OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing.
<http://dx.doi.org/10.1787/9789264162945-en>

Chapter 3

Framework under the 1998 Report for determining whether a regime is a harmful preferential regime

This Chapter describes the framework under the 1998 Report (OECD, 1998) for determining whether a regime is a harmful preferential regime. This involves three stages:

- a) Consideration of whether a regime is within the scope of work of the FHTP and whether it is preferential;
- b) Consideration of the four key factors and eight other factors set out in the 1998 Report to determine whether a preferential regime is potentially harmful; and
- c) Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful.

a) Consideration of whether a regime is within the scope of work of the FHTP and whether it is preferential

Scope of work of the FHTP

To be within the scope of the 1998 Report, the regime must, firstly, apply to income from geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Preferential regimes designed to attract investment in plant, building and equipment are outside the scope of the 1998 Report¹.

Secondly, the regime must relate to the taxation of the relevant income from geographically mobile activities. Hence, the work is mainly concerned with business taxation. Consumption taxes are explicitly excluded². Business taxes may be levied at national, federal or central government level (“national taxes”) and/or at sub-national, sub-federal or decentralised level (“sub-national taxes”). Sub-national taxes include taxes levied at state, regional, provincial or local level. In the course of the current review, the

question arose as to whether regimes offering tax benefits at sub-national level alone (sub-national regimes) are within the scope of the FHTP's work. This is discussed under Chapter 5, Section B. below.

Preferential tax treatment

In order for a regime to be considered preferential, it must offer some form of tax preference in comparison with the general principles of taxation in the relevant country. A preference offered by a regime may take a wide range of forms, including a reduction in the tax rate or tax base or preferential terms for the payment or repayment of taxes. Even a small amount of preference is sufficient for the regime to be considered preferential. The key point is that the regime must be preferential *in comparison with the general principles of taxation in the relevant country*, and not in comparison with principles applied in other countries. For example, where the rate of corporate tax applied to all income in a particular country is 10%, the taxation of income from mobile activities at 10% is not preferential, even though it may be lower than the rate applied in other countries.

b) Consideration of the four key factors and eight other factors set out in the 1998 Report to determine whether a preferential regime is potentially harmful

Four key factors and eight other factors are used to determine whether a preferential regime within the scope of the FHTP's work is potentially harmful³. A reference to substantial activity is already included in the eight other factors so this is not a new concept. The eight other factors generally help to spell out, in more detail, some of the key principles and assumptions that should be considered in applying the key factors themselves.

The four key factors are:

1. The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.
2. The regime is ring-fenced from the domestic economy.
3. The regime lacks transparency (for example, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).
4. There is no effective exchange of information with respect to the regime⁴.

The eight other factors are:

1. An artificial definition of the tax base.

2. Failure to adhere to international transfer pricing principles.
3. Foreign source income exempt from residence country taxation.
4. Negotiable tax rate or tax base.
5. Existence of secrecy provisions.
6. Access to a wide network of tax treaties.
7. The regime is promoted as a tax minimisation vehicle.
8. The regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities.

In order for a regime to be considered potentially harmful, the first key factor, ‘no or low effective tax rate’, must apply. This is a gateway criterion. Where a regime offers tax benefits at both national and sub-national level, the question of whether the regime meets the low or no effective tax rate factor is, generally, determined based on the combined effective tax rate for both the national and sub-national levels. The reduction in national taxes alone may, in some cases, be considered sufficient to determine that entities benefiting from the regime are subject to a low or no effective tax rate. The application of the no or low effective tax rate factor to regimes offering tax benefits at sub-national level alone is discussed under Chapter 5, Section B below.

Where a regime meets the no or low effective tax rate factor, an evaluation of whether that regime is potentially harmful should be based on an overall assessment of each of the other three ‘key factors’ and, where relevant, the eight ‘other factors’. Where low or zero effective taxation and one or more of the remaining factors apply, a regime will be characterised as potentially harmful.

c) Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful

A regime that has been identified as being potentially harmful based on the above factor analysis may be considered not to be actually harmful if it does not appear to have created harmful economic effects.

The following three questions can be helpful in making this assessment:

- Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?
- Is the presence and level of activities in the host country commensurate with the amount of investment or income?

- Is the preferential regime the primary motivation for the location of an activity⁵?

Following consideration of its economic effects, a regime that has created harmful effects will be categorised as a harmful preferential regime.

Where a preferential regime has been found to be actually harmful, the relevant country is given the opportunity to abolish the regime or remove the features that create the harmful effect. Other countries may take defensive measures to counter the effects of the harmful regime, while at the same time continuing to encourage the country applying the regime to modify or remove it⁶. It is recognised that countries' defensive measures may also apply in situations which do not involve harmful preferential regimes as defined in the 1998 Report. The 1998 Report does not affect countries' right to use such measures in such situations⁷.

Notes

1. See paragraph 6 of 1998 Report, p. 8.
2. See paragraph 7 of 1998 Report, p. 8.
3. See paragraphs 59-79 of 1998 Report, pp. 25-34.
4. Note that in assessing transparency and effective exchange of information factors, the FHTP looks specifically at how a particular regime measures up against those factors. It does not attempt to revisit the work of the Global Forum, which has a broader and more general focus on transparency and effective exchange of information more generally. However, to the extent that the work of the Global Forum highlights certain issues with respect to a particular regime, these are taken into account in the FHTP's evaluations.
5. See paragraphs 80-84 of 1998 Report for more details on each of those questions, pp. 34-35.
6. See paragraph 96 of 1998 Report, p. 40.
7. See paragraph 98 of 1998 Report which states this principle with respect to CFC rules specifically, p. 41.

Bibliography

OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*,
OECD Publishing.
<http://dx.doi.org/10.1787/9789264162945-en>

Chapter 4

Revamp of the work on harmful tax practices

To counter harmful regimes more effectively, Action Item 5 of the BEPS Action Plan (OECD, 2013a) requires the FHTP to revamp the work on harmful tax practices, with a priority and renewed focus on requiring substantial activity for any preferential regime and on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes. This Chapter describes the work carried out by the FHTP in these two priority areas.

A. Substantial activity requirement

1. Introduction

Action Item 5 specifically requires substantial activity for any preferential regime. Seen in the wider context of the work on BEPS, this requirement contributes to the second pillar of the Base Erosion and Profit Shifting (BEPS) project, which is to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created. The framework set out in the 1998 Report (OECD, 1998) already contains a substantial activity requirement. This requirement is grounded in particular in the twelfth factor (i.e. the eighth other factor) set out in the 1998 Report. This factor looks at whether a regime “encourages purely tax-driven operations or arrangements” and states that “many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities”. The 1998 Report contains limited guidance on how to apply this factor.

The substantial activity factor has been elevated in importance under Action Item 5, which mandates that this factor be elaborated in the context of BEPS. This factor will then be considered along with the four key factors when determining whether a preferential regime within the scope of the

FHTP's work is potentially harmful. The FHTP is therefore considering various approaches to applying the "substantial activity" factor for the purposes of its work. The FHTP's work on substantial activity has focused in the first instance on what this would require in the context of regimes which provide a preferential tax treatment for certain income arising from qualifying Intellectual Property ("intangible regimes" or "IP regimes"). There is a clear link between this work and statements in the BEPS Action Plan that current concerns in the area of harmful tax practices may be less about traditional ring-fencing and instead relate to corporate tax rate reductions on particular types of income, such as income from the provision of intangibles¹. All intangible regimes in member countries are being reviewed at the same time as part of the current review and none of these regimes had been reviewed as part of the earlier work. The elaborated substantial activity requirement can therefore be applied without needing to re-assess intangible regimes previously reviewed. Under Action Item 5, the substantial activity requirement applies to all preferential regimes within scope, including preferential regimes other than IP regimes, and the FHTP will also consider this aspect.

2. Substantial activity requirement in the context of intangible regimes

Regimes that provide for a tax preference on income relating to intangible property raise the base-eroding concerns that are the focus of the FHTP's work. At the same time, it is recognised that IP-intensive industries are a key driver of growth and employment and that countries are free to provide tax incentives for Research and Development (R&D) activities, provided that they are granted according to the principles agreed by the FHTP.

The FHTP considered three different approaches to requiring substantial activities in an IP regime. Discussions about the specific approach to choose are ongoing with much progress having been made already. The continuing discussions are focused on reaching consensus on an approach to requiring substantial activities as soon as possible. The first approach was a value creation approach that required taxpayers to undertake a set number of significant development activities. This approach did not have any support over the other two. The second approach was a transfer pricing approach that would allow a regime to provide benefits to all the income generated by the IP if the taxpayer had located a set level of important functions in the jurisdiction providing the regime, if the taxpayer is the legal owner of the assets giving rise to the tax benefits and uses the assets giving rise to the tax benefits, and if the taxpayer bears the economic risks of the assets giving rise to the tax benefits. A few countries supported the transfer pricing

approach, suggesting that it was consistent with international tax principles, and they expressed concerns with the nexus approach, including questions about its compatibility with European Union law etc. Many countries raised a number of concerns with the transfer pricing approach, which is why the work of the FHTP did not focus further on this approach. The third approach was the nexus approach.

This approach looks to whether an IP regime makes its benefits conditional on the extent of R&D activities of taxpayers receiving benefits. The approach seeks to build on the basic principle underlying R&D credits and similar “front-end” tax regimes that apply to expenditures incurred in the creation of IP. Under these front-end regimes, the expenditures and benefits are directly linked because the expenditures are used to calculate the tax benefit. The nexus approach extends this principle to apply to “back-end” tax regimes that apply to the income earned after the creation and exploitation of the IP. Thus, rather than limiting jurisdictions to IP regimes that only provide benefits directly to the expenditures incurred to create the IP, the nexus approach also permits jurisdictions to provide benefits to the income arising out of that IP – so long as there is a direct nexus between the income receiving benefits and the expenditures contributing to that income. This focus on expenditures aligns with the underlying purpose of IP regimes by ensuring that the regimes that are intended to encourage R&D activity only provide benefits to taxpayers that in fact engage in such activity.

Expenditures therefore act as a proxy for substantial activities. It is not the *amount* of expenditures that acts as a direct proxy for the amount of activities. It is instead the *proportion* of expenditures directly related to development activities that demonstrates real value added by the taxpayer and acts as a proxy for how much substantial activity the taxpayer undertook. The nexus approach applies a proportionate analysis to income, under which the proportion of income that may benefit from an IP regime is the same proportion as that between qualifying expenditures and overall expenditures. In other words, the nexus approach allows a regime to provide for a preferential rate on IP-related income to the extent it was generated by qualifying expenditures. The purpose of the nexus approach is to grant benefits only to income that arises from IP where the actual R&D activity was undertaken by the taxpayer itself. This goal is achieved by defining “qualifying expenditures” in such a way that they effectively prevent mere capital contribution or expenditures for substantial R&D activity by parties other than the taxpayer from qualifying the subsequent income for benefits under an IP regime.

If a company only had one IP asset and had itself incurred all of the expenditures to develop that asset, the nexus approach would simply allow

all of the income from that IP asset to qualify for benefits. Once a company's business model becomes more complicated, however, the nexus approach also by necessity becomes more complicated, because the approach must determine a nexus between multiple strands of income and expenditure, only some of which may be qualifying expenditures. In order to address this complexity, the nexus approach apportions income according to a ratio of expenditures. The nexus approach determines what income may receive tax benefits by applying the following calculation:

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

Jurisdictions could treat this calculation as a rebuttable presumption. In the absence of other information from a taxpayer, a jurisdiction would determine the income receiving tax benefits based on the calculation above. Taxpayers would, however, have the ability to prove, in certain circumstances to be defined in further guidance being developed by the FHTP, that more income should be permitted to benefit from the IP regime if they could show a direct link between that income and qualifying expenditures to develop the IP asset. This version of the nexus approach may require greater record-keeping on the part of taxpayers, and jurisdictions may need to establish notification and monitoring procedures. Difficulties may arise around how to establish the direct linkage between expenditures and income, but it could ensure that taxpayers that engaged in greater value creating activity than is reflected in the calculation above would be permitted to have more income benefit from the IP regime. Jurisdictions that did decide to adopt this version would still use the calculation above to establish the presumed amount of income that could qualify for tax benefits.

Where the amount of income receiving benefits under an IP regime does not exceed the amount determined by the nexus approach, the regime has met the substantial activities requirement. The remainder of this section provides further guidance on the application of the nexus approach and the above calculation.

A. Qualifying taxpayers

Qualifying taxpayers would include resident companies, domestic Permanent Establishments (PE) of foreign companies, and foreign PEs of

resident companies that are subject to tax in the jurisdiction providing benefits. The expenditures incurred by a PE cannot qualify income earned by the head office as qualifying income if the PE is not operating at the time that income is earned².

B. IP assets

Under the nexus approach as contemplated, the only 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, where such processes are relevant. The nexus approach focuses on establishing a nexus between expenditures, these IP assets, and income³. Under the nexus approach, marketing-related IP assets such as trademarks cannot qualify for tax benefits under an IP regime.

C. Qualifying expenditures

Qualifying expenditures must have been incurred by a qualifying taxpayer, and they must be directly connected to the IP asset. Jurisdictions will provide their own definitions of qualifying expenditures, and such definitions must ensure that qualifying expenditures only include expenditures that are necessary for actual R&D activities. They would include the types of expenditures currently granted R&D credits under the tax laws of multiple jurisdictions⁴. They would not include interest payments, building costs, acquisition costs, or any costs that could not be directly linked to a specific IP asset⁵.

D. Overall expenditures

Overall expenditures should be defined in such a way that, if the qualifying taxpayer incurred all relevant expenditures itself, the ratio would allow 100% of the income from the IP asset to benefit from the preferential regime. This means that overall expenditures must be the sum of all expenditures that would count as qualifying expenditures if they were undertaken by the taxpayer itself. This in turn means that anything that would not be included in qualifying expenditures even if incurred by the taxpayer itself (e.g., interest payments, building costs, acquisition costs, and other costs that do not represent actual R&D activities) cannot be included in overall expenditures and hence does not affect the amount of income that may benefit from an IP regime. IP acquisition costs are an exception, since they are included in overall expenditures and not in qualifying expenditures. Their exclusion is consistent with the principle of what is included in overall expenditures, however, because they are a proxy for expenditures incurred by a non-qualifying taxpayer. Overall expenditures therefore include all

qualifying expenditures, acquisition costs, and expenditures for outsourcing that do not count as qualifying expenditures.

Often, overall expenditures will be incurred prior to the production of income that could qualify for benefits under the IP regime. The nexus approach is an additive approach, and the calculation requires both that “qualifying expenditures” include all qualifying expenditures incurred by the taxpayer over the life of the IP asset and that “overall expenditures” include all overall expenditures incurred over the life of the IP asset. These numbers will therefore increase every time a taxpayer incurs an expenditure that would qualify for either category. The proportion of the cumulative numbers will then determine the percentage to be applied to overall income earned each year.

E. Overall income

Jurisdictions will define “overall income” consistent with their domestic laws on income definition. The definition that they choose should comply with the following principles:

Overall income should be limited to IP income: Overall income should only include income that is derived from the IP asset. This may include royalties, capital gains and other income from the sale of an IP asset, and embedded IP income from the sale of products directly related to the IP asset.

Income benefiting from the regime should be proportionate: Overall income should be defined in such a way that the income that benefits from the regime is not disproportionately high given the percentage of qualifying expenditures undertaken by qualifying taxpayers. This means that overall income should not be defined as the gross income from the IP asset, since such a definition could allow 100% of the net income of qualifying taxpayers to benefit even when those taxpayers had not incurred 100% of qualifying expenditures. Overall income should instead be adjusted by subtracting IP expenditures allocable to IP income and incurred in the year from gross IP income earned in the year⁶.

F. Outsourcing⁷

The nexus approach is intended to ensure that, in order for a significant proportion of IP income to qualify for benefits, a significant proportion of the actual R&D activities must have been undertaken by the qualifying taxpayer itself. The nexus approach would allow all qualifying expenditures for activities undertaken by unrelated parties – whether or not they were within the jurisdiction – to qualify, while all expenditures for activities

undertaken by related parties – again, whether or not they were within the jurisdiction – would not count as qualifying expenditures⁸.

As a matter of business practice, unlimited outsourcing to unrelated parties should not provide many opportunities for taxpayers to receive benefits without themselves engaging in substantial activities because, while a company may outsource the full spectrum of R&D activities to a related party, the same is typically not true of an unrelated party. Since the vast majority of the value of an IP asset rests in both the R&D undertaken to create it and the information necessary to undertake such R&D, it is unlikely that a company will outsource the fundamental value-creating activities to an unrelated party, regardless of where that unrelated party is located⁹. Allowing only expenditures incurred by unrelated parties to be treated as qualifying expenditures thus achieves the goal of the nexus approach to only grant tax benefits to income arising from the substantive R&D activities in which the taxpayer itself engaged that contributed to the income. Jurisdictions could narrow the definition of unrelated parties to include only universities, hospitals, R&D centres and non-profit entities that were unrelated to the qualifying taxpayer. Where a payment is made through a related party to an unrelated party without any margin, the payment will be included in qualifying expenditures.

Jurisdictions could also only permit unrelated outsourcing up to a certain percentage or proportion (while still excluding outsourcing to related parties from the definition of qualifying expenditures). As explained above, business realities typically mean that a company will not outsource more than an insubstantial amount of R&D activities to an unrelated party, so both a prohibition on outsourcing to any related parties and that same prohibition combined with a cap that prohibits outsourcing to unrelated parties beyond an insubstantial amount should have the equivalent effect of limiting qualifying expenditures to those expenditures incurred to support fundamental R&D activities by the taxpayer.

G. Treatment of acquired IP

The basic principle underlying the treatment of acquired IP by the nexus approach is that only the expenditures incurred for improving the IP asset after it was acquired should be treated as qualifying expenditures. In order to achieve this, the nexus approach would exclude acquisition costs from the definition of qualifying expenditures, as mentioned above, and only allow expenditures incurred after acquisition to be treated as qualifying expenditures. Acquisition costs would, however, be included in overall expenditures. Acquisition costs (or, in the case of licensing, royalties or license fees) are a proxy for overall expenditures incurred prior to acquisition. Therefore, no expenditures incurred by any party prior to

acquisition will be included in either qualifying expenditures or overall expenditures.

H. Tracking of income and expenditures

Since the nexus approach depends on there being a nexus between expenditures and income, it requires jurisdictions wishing to introduce an IP regime to mandate that taxpayers that want to benefit from an IP regime must track expenditures, IP assets, and income to ensure that the income receiving benefits did in fact arise from the expenditures that qualified for those benefits. If a taxpayer has only one IP asset that it has fully self-developed and that provides all of its income, this tracking should be fairly simple, since all qualifying expenditures incurred by that company will determine the benefits to be granted to all the IP income earned by that company. Once a company has more than one IP asset or engages in any degree of outsourcing or acquisition, however, tracking becomes essential. Tracking must also ensure that taxpayers have not manipulated the amount of overall expenditures to inflate the amount of income that may benefit from the regime.

This means that taxpayers will need to be able to track the link between expenditures and income and provide evidence of this to their tax administrations. Jurisdictions will therefore need to establish a reasonable tracking method based on consistent criteria capable of objective measurement. This could take the form of, for example, research codes identifying the purpose of individual research expenditures or descriptions of research expenditures. Not engaging in such tracking will not prevent taxpayers from earning IP income in a jurisdiction, but it will prevent them from benefiting from a preferential IP regime.

The main complexity associated with tracking arises from the fact that a preferential rate is applied to certain IP income, which is a function of the regime rather than the nexus approach, and existing IP regimes suggest that taxpayers are willing to comply with certain often complex requirements when an optional tax benefit is made conditional on such requirements. Because the nexus approach will standardise the requirements of IP regimes across jurisdictions, it may in the long term reduce the overall complexity that taxpayers that are benefiting from multiple IP regimes currently face. Financial accounting often already requires tracking of IP income and expenditures on a project-by-project basis. It is recognised that the existing systems may not fully support the requirements of the nexus approach and that it may take time to set up systems that do support these requirements. The FHTP recognises that discussions with business would be necessary.

I. Grandfathering

Consistent with the work so far in the area of harmful tax practices, the FHTP will draft further guidance on grandfathering, building in particular on paragraph 12 of the 2004 Report (OECD, 2004b), where it says “the Committee decided that where a regime is in the process of being eliminated it shall be treated as abolished in the above table if (1) no new entrants are permitted into the regime, (2) a definite date for complete abolition of the regime has been announced, and (3) the regime is transparent and has effective exchange of information”.

B. Improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes

1. Introduction

The second priority under Action Item 5 for revamping the work on harmful tax practices is to improve transparency, including compulsory spontaneous exchange on rulings related to preferential regimes. Seen in the wider context of the work on BEPS, this requirement contributes to the third pillar of the BEPS project, which is to ensure transparency while promoting increased certainty and predictability. The work on this requirement is intended to allow the FHTP to start applying the agreed transparency framework according to the schedule set out under the heading “i) Application and implementation of the framework” below and then report on the status of the implementation and the time frame to complete it in a FHTP 2015 progress report.

The lack of transparency in the operation of a regime, which is the third key factor, will make it harder for the home country to take defensive measures. Lack of transparency may arise in two broad contexts: (1) in the way in which a regime is designed and administered, including favourable application of laws and regulations, negotiable tax provisions, and a failure to make administrative practices widely available; and (2) the existence of provisions such as secrecy laws or inadequate ownership and other information requirements that prevent (or would prevent) effective exchange of information¹⁰. Issues around transparency often link into concerns around exchange of information¹¹.

There is extensive guidance in the CAN (OECD, 2004a) on transparency. As the 1998 Report and the CAN make clear, transparency is often relevant in connection with rulings, including unilateral Advance Pricing Agreements (APAs) and administrative practices more widely, where spontaneous notification may be required. This is brought out most clearly in Chapter V of the CAN which deals with rulings¹². Amongst “the features which are likely to result in a lack of transparency”, the CAN refers

to the situation “where the tax authority does not notify other tax authorities on a timely and spontaneous basis of the existence of a ruling where the tax authority is aware that it affects residents in the other country (e.g. an advance tax ruling or unilateral APA that provides for a downward adjustment that would not be directly reflected in the company's financial accounts)”¹³.

Action Item 5 requires a renewed focus on transparency and explicitly refers to “compulsory spontaneous exchange of information on rulings related to preferential regimes”. The word “compulsory” is understood to introduce an obligation to spontaneously exchange information wherever the relevant conditions are met. The term “spontaneous exchange of information” refers to a situation in which one country is aware of information that could be of relevance to another country, but the information has not been requested by the second country.

The FHTP has decided to take forward the work on improving transparency in two steps:

1. The first step has focused on developing a framework for compulsory spontaneous information exchange on rulings. This will enable other countries to check whether a ruling has any implications for the tax treatment of taxpayers in their country. This framework is covered in more detail below.

The framework is intended to be dynamic and flexible and will be further developed taking into account the second step of the FHTP’s work on transparency (see below), the FHTP’s work on the elaborated substantial activity requirement and the consideration by the FHTP of possible revisions of, or additions to, the existing framework under the third output of Action Item 5.

2. In the second step of the work, the FHTP will focus on the application of the framework set out in this report to member and associate countries’ preferential regimes. In the first instance, the FHTP will develop practical guidance (with examples) on how the framework is intended to operate and to aid implementation of the framework. The intention is for the FHTP to start applying the framework following the FHTP’s autumn meeting and to report on this in a FHTP 2015 progress report.

As part of the second step of the work on transparency, the FHTP will review ruling regimes in member and associate countries. In this context, a ruling “regime” could be any legislative or administrative process under which a ruling, on which a taxpayer is entitled to rely, is granted. This work is intended to serve a dual

purpose, i.e. (i) to identify ruling regimes that are themselves harmful preferential regimes within the meaning of the 1998 Report and (ii) to identify what ruling regimes trigger the obligation to spontaneously exchange information.

On (i), ruling regimes have been an area of focus since the start of the OECD's work on harmful tax practices. Chapter V of the CAN recognises that although rulings can be a useful tool for both tax administrations and taxpayers, ruling regimes can also be used to attract internationally mobile capital to a jurisdiction and they have the potential to do this in a manner that contributes to, or constitutes a harmful tax practice, as defined according to the factors in the 1998 Report¹⁴. The FHTP's work on ruling regimes will therefore consist of reviewing countries' ruling regimes (whether they provide general and/or taxpayer-specific rulings) against the factors in the 1998 Report, including the substantial activity requirement and transparency factor as elaborated under Action Item 5. This may result in ruling regimes themselves being found to be potentially and, as the case may be, actually harmful¹⁵.

On (ii), ruling regimes that are found to be in themselves preferential and that meet the filters set out in the framework below will trigger the obligation to spontaneously exchange information like any other preferential regime. The relevant regime will not have to have been found to be potentially or actually harmful within the meaning of the 1998 Report for that obligation to arise. The FHTP will report on the review of countries' ruling regimes in a FHTP 2015 Progress Report.

As part of the second step, the FHTP will explore whether there are other ways in which transparency may be improved.

The work that will be carried out under the second step will also consider the interaction with other BEPS Action Items in relation to transparency to avoid unnecessary overlaps and creating an additional administrative burden on countries.

The framework, as currently contemplated, only requires spontaneous information exchange on taxpayer-specific rulings related to preferential regimes, i.e. rulings that are specific to an individual taxpayer and on which that taxpayer is entitled to rely. There is at present no such requirement for general rulings, i.e. rulings that apply to groups or types of taxpayers or may be given in relation to a defined set of circumstances or activities¹⁶.

One reason for not currently requiring spontaneous information exchange of general rulings is that in the absence of a link between the

ruling and a specific taxpayer to which the ruling applies, it would be very difficult to determine with which country or countries information should be exchanged. Spontaneous information exchange of general rulings with each country with whom a relevant tax administration has an information exchange relationship would impose a disproportionate administrative burden and is unlikely to be very effective. In addition, general rulings appear to pose less of a risk since they are often published and their conditions of applicability will therefore be available. As general rulings are not suitable for spontaneous exchange of information, the FHTP will consider them separately under the second step of the work on transparency which will consider the actual ruling regimes of member countries and associate countries against the factors in the 1998 Report. This work will also consider whether countries' general ruling regimes are transparent and will seek to establish best practices to ensure they are indeed available to other countries.

2. Framework for compulsory spontaneous exchange on taxpayer-specific rulings related to preferential regimes

This section describes the framework developed by the FHTP for compulsory spontaneous exchange on taxpayer-specific rulings related to preferential regimes¹⁷. The framework seeks to find a balance between ensuring that the information exchanged is relevant to other tax administrations and that it does not impose an unnecessary administrative burden on either the country exchanging the information or the country receiving it.

The framework builds on the guidance contained in the CAN and also takes into account the Convention on Mutual Administrative Assistance in Tax Matters (MAC)¹⁸ and the European Union's Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation (including its work on spontaneous information exchange in the context of transfer pricing and on cross-border rulings). These sources all have a common goal in that they seek to encourage spontaneous information exchange in circumstances where it is assumed that information obtained by one country will be of interest to another country. This framework, whilst seeking to achieve a similar outcome, is, however, focussed on the factors in the 1998 Report.

The framework deals with the following 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?

The following issues are also dealt with: time limits for compulsory spontaneous information exchange, relevance of reciprocity, confidentiality of the information exchanged, when feedback from the receiving country is appropriate and application and implementation of the framework.

a) When does the obligation to spontaneously exchange information arise?

To ensure that the obligation to spontaneously exchange information is sufficiently targeted, the framework applies a filter approach to determine when such an obligation arises. The filter approach seeks to reduce the level of discretion that would otherwise have to be used by a tax administration to make that determination and instead uses more mechanical filters. The flowchart contained in Annex A. visualises how these filters are intended to work.

The first three filters limit the obligation to spontaneously exchange information to rulings related to (i) preferential regimes that (ii) are within the scope of work of the FHTP and that (iii) meet the no or low effective tax rate factor. These are the normal filters that apply to identify those situations in which an analysis of the other key factors and the other factors in the 1998 Report is necessary.¹⁹ If a ruling passes all of these three filters, additional filters apply to further target the obligation to spontaneously exchange information on rulings that are likely to be relevant to other jurisdictions. Under the filter approach, as currently contemplated, only a ruling that passes through all of the filters will be subject to compulsory spontaneous information exchange.

The obligation to spontaneously exchange arises for rulings related to *any* preferential regime. That is, a regime does not need to have been reviewed or to have been found to be potentially or actually harmful within the meaning of the 1998 Report for the obligation to arise. Therefore, the obligation will also apply to any ruling (as defined) in connection with preferential regimes that have not yet been reviewed or that have been reviewed but that have not been found to be potentially or actually harmful and that have therefore been cleared. As mentioned before, ruling regimes that are in themselves preferential and that meet the filters set out in the framework will trigger the obligation to spontaneously exchange information like any other preferential regime.

Countries that have preferential regimes that have not yet been reviewed by the FHTP will need to self-assess whether the first three filters (and the other filters) are satisfied. Where this is the case, the obligation to spontaneously exchange information arises immediately, without the FHTP first needing to formally review the relevant regime. The relevant country will be expected to take a view on whether the first three filters (and the other filters) are satisfied. In case of doubt as to the applicability of the filters, it is recommended that the relevant country spontaneously exchange information. The expectation is that a country that has a preferential regime which has not yet been reviewed by the FHTP will in the meantime self-refer this regime for review by the FHTP. Regimes that have been reviewed by the FHTP and that have been found to meet the first three filters will be added to a compilation to be occasionally updated by the FHTP. The creation of the compilation will be undertaken as part of step two of the FHTP's work on transparency.

Filter 1: Is the regime within the scope of the FHTP's work?

This filter limits the requirement to spontaneously exchange information to rulings relating to preferential regimes that are within the scope of the 1998 Report. To be within the scope of the 1998 Report, the regime must, firstly, apply to income from geographically mobile activities, such as financial and other service activities, including the provision of intangibles²⁰. Secondly, the regime must relate to the taxation of the relevant income from geographically mobile activities²¹.

Filter 2: Is the regime a preferential regime?

As stated in Action Item 5, the obligation to spontaneously exchange information applies to rulings related to a preferential regime. Chapter 3(a) above describes when a regime is considered to be preferential. The words "related to" make clear that this obligation not only covers rulings on a preferential regime itself or certain aspects of it but also, and more broadly, rulings that concern matters that have an impact on the application of a preferential regime.

Filter 3: Does the regime meet the no or low effective tax rate factor?

This filter limits the obligation to spontaneously exchange information to regimes meeting the no or low effective tax rate factor. A no or low effective tax rate may arise because the tax rate itself is very low or because of the way in which a country defines the tax base to which the rate is applied²².

Filter 4: Is there a taxpayer-specific ruling related to a regime that meets the first three filters?

The obligation to spontaneously exchange information as mandated by Action Item 5 applies to “rulings related to preferential regimes”. Chapter V of the CAN deals specifically with rulings and defines them as:

“any advice, information or undertaking provided by a tax authority to a specific taxpayer or group of taxpayers concerning their tax situation and on which they are entitled to rely”²³.

Whilst the terms of a ruling may be relied upon by the taxpayer, this is typically subject to the condition that the facts on which the ruling is based have been accurately presented and that the taxpayer abides by the terms of the ruling. This definition is wide and would include both general rulings and taxpayer-specific rulings. However, the framework, as currently contemplated, only requires spontaneous information exchange on taxpayer-specific rulings related to preferential regimes. The paragraphs below explain in general terms what is understood by “general rulings” and “taxpayer-specific rulings” and gives examples of taxpayer-specific rulings.

General rulings apply to groups or types of taxpayers or may be given in relation to a defined set of circumstances or activities, rather than applying to a specific taxpayer. They typically provide guidance on the position of the tax authority on such matters as the interpretation of law and administrative practice²⁴ and on their application to taxpayers generally, to a specified group of taxpayers or to specified activities. This guidance typically applies to all taxpayers that engage in activities or undertake transactions that fall within the scope of the ruling. Such rulings are often published and can be applied by taxpayers to their relevant activities or transactions without them needing to make an application for a specific ruling.

Taxpayer-specific rulings are rulings that apply to a specific taxpayer and on which that taxpayer is entitled to rely. Such rulings can be given both pre- and post-transaction. Examples of taxpayer-specific rulings include Advance Tax Rulings or clearances (ATRs) and APAs.

Advance Tax Rulings are specific to an individual taxpayer and provide a determination of the tax consequences of a proposed transaction on which the particular taxpayer is entitled to rely. Advance tax rulings may come in a variety of forms and may include rulings or clearances that are given as part of a statutory process or an administrative practice, including rulings that are given informally. They frequently determine whether, and in some cases, how, particular law and administrative practice will be applicable to a proposed transaction undertaken by a specific taxpayer. Such rulings may

also provide a determination of whether or how a general ruling applies to the facts and circumstances of a particular taxpayer. Typically, the taxpayer concerned will make an application for a ruling before undertaking the transaction concerned, although some regimes provide guidance to taxpayers after a transaction has been carried out and these post transaction rulings will also be covered. The ruling will provide a determination of the tax consequences of the relevant transaction on which the taxpayer is entitled to rely, assuming that the facts are as described in the advance tax ruling request. Such rulings are tailor-made for the taxpayer concerned as they take into account the factual situation of the taxpayer and are thus not directly applicable to other taxpayers. (Although, when published in anonymised or redacted form, such rulings may provide guidance to taxpayers with similar facts and circumstances²⁵.) This category of ruling could include for example rulings on transfer pricing matters that fall short of an advance pricing arrangement. It may also include a view or determination of the future tax treatment of the taxpayer on which they are entitled to rely.

Advance Pricing Arrangements. An APA is defined in the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TP Guidelines, (OECD, 2010)) as "an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of time"²⁶. They provide taxpayers with certainty about how transfer pricing rules apply to future transactions within the scope of the APA. They normally do this by determining an appropriate set of criteria (e.g., method, comparables and appropriate adjustments thereto and critical assumptions as to future events) for the determination of the transfer pricing²⁷. The TP Guidelines distinguish APAs from other rulings procedures, such as advance tax rulings, in the following way:

*"The APA differs from the classic ruling procedure, in that it requires the detailed review and to the extent appropriate, verification of the factual assumptions on which the determination of legal consequences is based, before any such determinations can be made. Further the APA provides for a continual monitoring of whether the factual assumptions remain valid throughout the course of the APA period"*²⁸.

APAs may be unilateral, bilateral or multilateral. Bilateral and multilateral APAs are concluded between two or more tax authorities under the mutual agreement procedure of the applicable tax treaties. Typically, the associated enterprises applying for an APA provide documentation to the tax authorities concerning the industry, markets and countries to be covered by

the agreement, together with details of their proposed methodology, any transactions that may serve as comparables, and a functional analysis of the contribution of each of the relevant enterprises. Because APAs govern the methodology for the determination of transfer prices for future years, they necessitate assumptions or predictions about future events.

Filter 5: Is the taxpayer-specific ruling a ruling in the area of transfer pricing or another ruling?

To further target the obligation to spontaneously exchange information on rulings, an additional filter distinguishes between rulings in the area of transfer pricing and other rulings.

Filter 5(a): For transfer pricing rulings only – Is the ruling a unilateral transfer pricing ruling or a bilateral or multilateral APA?

This filter applies to rulings in the area of transfer pricing only. Transfer pricing rulings include APAs (whether unilateral, bilateral or multilateral) and ATRs on transfer pricing issues other than APAs. Such rulings generally either determine transfer pricing issues between associated enterprises engaging in cross-border transactions or the allocation of profits between a head office in one country and a PE in another country. They are therefore likely to have a direct effect on the tax base of associated enterprises, or of the head office or PE, as the case may be, in other countries. In some countries, unilateral APAs can also be obtained for domestic transactions. Where this is the case, the obligation to spontaneously exchange information would not arise in the absence of an affected country to spontaneously exchange information with.

Without details of the relevant transfer pricing rulings, other affected jurisdictions (see “b) Who must information be exchanged with?”) will not be in a position to verify that those rulings are in accordance with international transfer pricing principles and take any necessary steps to protect their own tax base. Absent information exchange, details of transfer pricing rulings will not normally be available to affected countries in the case of:

- Unilateral APAs, i.e. APAs established between a tax administration of one country and a taxpayer in its country;
- Bilateral and multilateral APAs but only in the case of any affected country that has not been involved in the agreement of the APA; and
- ATRs (other than APAs) on transfer pricing issues.

It is therefore important that the obligation to spontaneously exchange information covers these types of rulings where they also meet the first four filters. The first three filters require the transfer pricing ruling to relate to a preferential regime that is within the scope of the FHTP's work and meets the no or low effective tax rate factor. The legislative or administrative process under which a transfer pricing ruling on which a taxpayer is entitled to rely is granted can under certain circumstances in itself be a preferential regime. The work in the second step of the work on transparency is intended to identify whether this is the case for any of the ruling regimes in place in member countries and associate countries. The obligation to spontaneously exchange information does not apply to bilateral or multilateral APAs in respect of any country that has been involved in the agreement of the APA. This is because the relevant tax administration should already be in possession of the relevant information.

The practical guidance which will be developed by the FHTP in the second step of its work on transparency will include examples on how filter 5(a) is intended to operate.

Filter 5(b): For rulings other than transfer pricing rulings only – Does the ruling cover (i) inbound investment into the country in which the taxpayer has obtained the ruling, (ii) outbound investment from that country or (iii) transactions or a situation involving other countries?

The cross-border nature of transfer pricing rulings and their likely direct effect on the tax base of other countries, in and of themselves, should work as an adequate filter for targeting rulings that are likely to be of relevance to other countries. For rulings other than transfer pricing rulings, a further filter is considered necessary to make sure that the information exchanged is relevant and that the obligation to spontaneously exchange information on rulings does not impose an unnecessary administrative burden on either the country exchanging the information or the country receiving it.

As relevant cross-border transfer pricing rulings are covered by filter 5(a), filter 5(b) applies to other rulings that could have a cross-border aspect, i.e. rulings that cover (i) inbound investment into the country in which the taxpayer has obtained the ruling, (ii) outbound investment from that country or (iii) transactions or a situation involving other countries. The practical guidance which will be developed by the FHTP in the second step of its work on transparency will include examples on how this filter is intended to operate.

b) Who must information be exchanged with?

Compulsory spontaneous exchange on rulings related to preferential regimes must take place with any affected country. This is closely linked to the operation of filters 5(a) and (b). This could therefore include:

1. The source country;
2. The country of residence of the immediate parent company;
3. The country of residence of the beneficial owner, which in most cases will be the ultimate parent company;
4. In the case of transfer pricing rulings:
 - The country in which an associated enterprise engaged in a cross-border transaction covered by the ruling is tax resident or carries on a business through a PE;
 - In the case of a ruling allocating profits between the head office and a foreign PE, the country in which the head office is tax resident or the country in which the PE is located, depending on which country granted the ruling.
5. In the case of rulings other than transfer pricing rules:
 - In the case of an inbound investment into the country in which the taxpayer has obtained the ruling: the country in which the party making the investment is resident or in which it carries on a business through a PE;
 - In the case of an outbound investment from the country in which the taxpayer has obtained the ruling: the country in which the party on the receiving end of the investment is resident or carries on a business through a PE;
 - In the case of transactions or a situation involving other countries: the country in which the other party or parties to those transactions is or are resident or carries or carry on a business through a PE.

c) What information must be exchanged?

The information that must be exchanged spontaneously will depend on whether or not the relevant ruling is a transfer pricing ruling.

If the ruling is not a transfer pricing ruling, it will be up to the sending country to determine which information, for example the full text of the ruling in the original language or any other material, would be considered

useful. However, as a minimum, a short summary, preferably in English or any other language bilaterally agreed, should be provided and should include at least:

- Information necessary to identify the taxpayer(s) and the accounting periods covered by the ruling;
- A summary of the issue(s), transactions and income covered by the ruling; and
- The tax administration's response and reasoning. The name of the responsible tax officials will not be disclosed.

In the second step of the work on transparency, the FHTP will explore what further information should be contained in a sending country's summary.

If the ruling is a transfer pricing ruling, there will be a two-stage process. The first stage will involve the sending country spontaneously exchanging sufficiently detailed information about the ruling so as to enable the receiving country to decide whether a request for additional information under the second stage is appropriate. To this end, the initial spontaneous exchange should include at least:

- Information necessary to identify the taxpayer(s) and the entities involved in the cross border transaction covered by the ruling;
- Detail of the transaction(s)/business activity/situation and the period covered by the transfer pricing ruling; and
- The transfer pricing methodology applied and the price/margin agreed.

In the second step of the work on transparency, the FHTP will explore what further information should be contained in the sending country's initial spontaneous exchange.

Both in the case of transfer pricing rulings and rulings other than transfer pricing rulings, the sending country should provide all further relevant information if there is a further request from the receiving country under the relevant information exchange provisions.

The sending country will, however, need to consider provisions in the relevant information exchange instrument on disclosure of any trade, business, commercial or other secrets and the expectation that information exchanged under the framework remains confidential (see “h) Confidentiality of the information exchanged”).

d) What is the legal basis for information exchange?

Information exchange between tax authorities requires a framework legally enabling the sending country to exchange the information and the recipient country to receive it. Some form of enabling legal instrument is therefore needed. There are a number of international legal instruments on the basis of which spontaneous information exchange for tax purposes may take place, including:

- The relevant bilateral information exchange instruments;
- International instruments designed specifically for administrative assistance purposes in tax matters, such as the MAC; and,
- Within the European Union, Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation.

Domestic law provisions may also provide the relevant legal basis in some countries.

Countries that currently do not have the necessary legal framework in place for spontaneous information exchange will need to consider ways of putting such a framework in place to comply with their obligation under Action Item 5. This may involve signing the MAC. The framework described above is supported by the breadth of Article 7 of the MAC. Countries may also consider revising existing bilateral information exchange instruments (such as bilateral tax conventions or tax information exchange instruments). Entering into a competent authority agreement under the relevant information exchange instrument may also assist.

e) Time limits for compulsory information exchange

The effectiveness of information exchange very much depends on the timeliness of the information exchanged. For that reason, a country that has provided a ruling that is subject to the obligation to spontaneously exchange information under Action Item 5 must exchange the relevant information on that ruling with any affected country as quickly as possible and no later than 3 months after that in which the ruling becomes available to the competent authority of the country that has granted the ruling. The recommendation is that the relevant authorities within the country that has granted the ruling transmit that ruling to their competent authority without undue delay. Countries need to ensure they have an appropriate system in place to ensure they are in a position to do so.

f) Feedback

Regular, timely and comprehensive feedback on the usefulness of the information spontaneously exchanged enables improvements to be made for future spontaneous information exchanges²⁹. From the perspective of the sending country, feedback can also be useful as it may result in a tax adjustment for the sending country³⁰. Therefore, if the sending country has requested feedback from the receiving country, the competent authority of the receiving country should request feedback from the relevant authorities in its country on the usefulness of the information spontaneously exchanged and forward this information to the competent authority that spontaneously provided the information.

g) Reciprocity

There are a number of benefits associated with a reciprocal approach to exchange of information. However, the benefits of reciprocity do not appear to have any relevance where the legal system or administrative practice of only one country provides for a specific procedure. Accordingly, a country that has granted a ruling that is caught by the obligation to spontaneously exchange information cannot invoke the lack of reciprocity as an argument for not spontaneously exchanging information with an affected country, where the affected country does not grant, and therefore cannot exchange, rulings which could potentially trigger the obligation to spontaneously exchange information³¹. This assumes of course that the affected country is committed to applying the framework and to spontaneously exchanging information if it were to grant rulings which trigger the obligation to spontaneously exchange information.

h) Confidentiality of the information exchanged

Both the country exchanging information and its taxpayers have a legal right to expect that information exchanged pursuant to the framework remains confidential. The receiving country must therefore have the legal framework necessary to protect information exchanged.

All treaties and exchange of information instruments contain provisions regarding tax confidentiality and the obligation to keep information exchanged confidential. Under those provisions, information may only be used for certain specified purposes and disclosed to certain specified persons. Information exchange partners may suspend or limit the scope of the exchange of information if appropriate safeguards are not in place or if there has been a breach in confidentiality and they are not satisfied that the situation has been appropriately resolved.

Domestic laws must be in place in the receiving country to protect confidentiality of tax information, including information exchanged. Effective penalties must apply for unauthorised disclosures of confidential information exchanged.

Information exchanged pursuant to this framework may be used only for tax purposes or other purposes permitted by the relevant information exchange instrument. If domestic law allows for a broader use of the information than the applicable information exchange instrument, it is expected that international provisions and instruments will prevail over provisions of domestic law.

i) Application and implementation of the framework

The intention is for the FHTP to start applying the framework following the FHTP's autumn meeting and to report on the status of the implementation and the time frame to achieve it in a FHTP 2015 Progress Report. Countries that do not (yet) have the necessary legal framework in place to spontaneously exchange information as required by Action Item 5 will be given an adjustment period following which the continued lack of the necessary legal framework will result in the elaborated transparency factor being triggered. Recognising differences in countries' legislative and parliamentary processes and that the introduction of a legal framework may take some time, member and associate countries will be given until the end of 2014 to initiate steps to put in place that legal framework to be able to spontaneously exchange information.

An ongoing monitoring and review mechanism will be put in place to ensure countries' compliance with the obligation to spontaneously exchange information under Action Item 5. This will involve an annual review by the FHTP. To that end and once a year, countries that provide taxpayer-specific rulings that fall within the framework will be expected to provide statistical information. As a minimum, this will include (a) the total number of spontaneous exchanges sent under the framework; (b) the number of spontaneous exchanges sent on non-transfer pricing rulings; (c) the number of spontaneous exchanges sent on transfer pricing rulings; and (d) for each exchange, which country or countries information was exchanged with.

In the second step of the work on improving transparency, which commences following the publication of this report, the FHTP will identify what further information may assist countries in assessing whether a country has complied with its obligation under the framework. This information could include the total number of taxpayer-specific rulings related to preferential regimes they have granted (this number would include rulings that have not been spontaneously exchanged under the framework) and an

estimate of taxes involved. Further work will be done on how this should be measured and reported.

Notes

1. See p. 17 of the BEPS Action Plan. See also Chapter 1 above.
2. Jurisdictions with IP regimes should ensure that the same IP asset is not allocated to both the head office and the foreign PE (e.g., because they apply the Authorised OECD Approach (AOA)).
3. Jurisdictions may also choose to modify the nexus approach slightly so that the nexus is between expenditures, products arising from IP assets, and income. Such an approach would require taxpayers to adjust the ratio to include all qualifying expenditures from all IP assets that contributed to the product in “qualifying expenditures” and to include all overall expenditures from all IP assets that contributed to the product in “overall expenditures”. This aggregate ratio would then be applied to overall income from the product that was directly linked to all the underlying IP assets. This approach would be consistent with the nexus approach and may reduce compliance costs for certain taxpayers with multiple patents that contribute to one product, but jurisdictions must ensure that this product-based approach requires the same level of tracking as a patent-based approach and that benefits expire at a fair and reasonable time (e.g., the average life of all patents). The FHTP will develop further guidance on this approach.
4. Qualifying expenditures could therefore include salary and wages, direct costs, overhead costs, cost of supplies, and depreciation (not including depreciation or amortization of acquisition costs) 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.
5. This means that general and speculative R&D can be included in qualifying expenditures so long as taxpayers can show that there is a direct link between the R&D and the IP asset that was produced. It also means that building costs or other non-separable capital costs would not

be included because it would be impossible to establish a direct link between the cost of an entire building and different IP assets created in that building.

6. IP expenditures will be calculated by applying the ordinary domestic tax law provisions (i.e., not using specific provisions in IP regimes).
7. Spain and the UK maintained a reservation with regards to Section F.
8. Jurisdictions that are not member states of the European Union could modify this limitation to include all qualifying expenditures for activities undertaken by both unrelated parties and resident related parties in the definition of qualifying expenditures.
9. Outsourcing is different from the buying in of components from a party that owns the IP to those components, and this reference to the likelihood of outsourcing to unrelated parties does not refer to the likelihood of buying components from unrelated parties.
10. See Box II and paragraph 63 of 1998 Report and paragraph 18 of the CAN.
11. See, for example, paragraph 66 of 1998 Report which states that: *“Exchange of information may be a constraint in situations where a non-transparent regime allows the tax administration to give a prior determination to an individual taxpayer and where that tax authority does not inform the foreign tax authority affected by such a decision. This failure to notify the foreign tax authority may curtail the ability of that tax authority to enforce effectively its rules”*.
12. For the purposes of Chapter V of the CAN, a ruling is defined to be *“any advice, information or undertaking provided by a tax authority to a specific taxpayer or group of taxpayers concerning their tax situation and on which they are entitled to rely”* (see paragraph 161 of the CAN). The definition is wide and includes general rulings, advance tax rulings and advance pricing arrangement. However, the chapter applies only to rulings covering activities within the scope of the 1998 Report i.e., geographically mobile activities, such as financial and other service activities, including the provision of intangibles.
13. See the Box on p. 53 of the CAN (which is in the section containing general guidance on ruling regimes). See also the Box on p. 58 (which is in the section containing guidance on ATRs specifically) and the Box on p. 60 of the CAN (which is in the section containing guidance on APAs specifically).
14. See paragraph 168 of the CAN.

15. As explained earlier, where a preferential regime has been found to be actually harmful, the relevant country is given the opportunity to abolish the regime or remove the features that create the harmful effect. Other countries may take defensive measures to counter the effects of the harmful regime, while at the same time continuing to encourage the country applying the regime to modify or remove it.
16. General rulings can in the meantime of course continue to be exchanged under the relevant information exchange provisions.
17. For the avoidance of doubt, other spontaneous information exchanges and other forms of information exchange are unaffected by the framework and can of course continue to take place under the relevant information exchange provisions.
18. For information on the MAC, see: www.oecd.org/tax/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm.
19. The three-stage process for determining whether a regime is harmful is explained in Chapter 3.
20. See Chapter 3(a).
21. See Chapter 3(b) for a brief explanation of what taxation the FHTP's work is concerned with and Chapter 5, Section B for a further explanation of when sub-national taxes are within the scope of the FHTP's work.
22. See paragraph 61 of the 1998 Report.
23. See paragraph 161 of the CAN for the definition of "ruling".
24. Law and administrative practice includes statutory law (including relevant treaty provisions), case law, regulations, administrative instructions and practice.
25. In their anonymised or redacted form, such rulings fall within the category of "general rulings", unless they are in fact written in response to a taxpayer-specific ruling request. Of course, in their non-anonymised, non-redacted form, such rulings fall within the category of "taxpayer-specific rulings".
26. APAs may determine the attribution of profit in accordance with Article 7 of the OECD Model Tax Convention as well as transfer pricing between associated enterprises. Such APAs would also fall within the scope of the definition of "ruling" for the purposes of the obligation to spontaneously exchange on rulings.

27. See the definition of APA in the first sentence of paragraph 4.123 of the TP Guidelines.
28. See paragraph 3 of the Annex to the TP Guidelines.
29. See paragraph 5 of the *Manual on Exchange of Information*, Module 2 - Spontaneous Information Exchange (OECD, 2006).
30. See paragraph 18 of the *Manual on Exchange of Information*, General Module - General and Legal Aspects of Exchange of Information.
31. See paragraph 15.1 of the *2014 Update to the OECD Model Tax Convention* (OECD, 2014) which sets out the principle in the context of information exchange on request.

Bibliography

- OECD (2014), *2014 Update to the OECD Model Tax Convention*, OECD, Paris.
www.oecd.org/tax/treaties/2014-update-model-tax-convention.pdf
- OECD (2013a), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing.
<http://dx.doi.org/10.1787/9789264202719-en>
- OECD (2010), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, OECD Publishing.
<http://dx.doi.org/10.1787/tpg-2010-en>
- OECD (2006), *Manual on the Implementation of Exchange of Information Provisions for Tax Purposes: Module 2 on Spontaneous Exchange of Information*, OECD, Paris.
www.oecd.org/ctp/exchange-of-tax-information/36647914.pdf
- OECD (2004a), *Consolidated Application Note: Guidance in Applying the 1998 Report to Preferential Tax Regimes*, OECD, Paris.
www.oecd.org/ctp/harmful/30901132.pdf
- OECD (2004b), *Harmful Tax Practices: The 2004 Progress Report*, OECD, Paris.
www.oecd.org/ctp/harmful/30901115.pdf
- OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing.
<http://dx.doi.org/10.1787/9789264162945-en>

Chapter 5

Review of member and associate country regimes

A. Introduction

The current review of member country regimes commenced in late 2010 with the preparation of a preliminary survey of preferential tax regimes in member countries, based on publicly available information and without any judgment as to the potential harmfulness of any of the regimes included. Further regimes were subsequently added to the review process based on member countries' self-referrals and referrals by other member countries.

Each member country was requested to provide a description of its regimes, along with a self-review using a standard template. The self-reviews were followed by extensive analysis and peer reviews. The reviews were based on the principles and factors set out in the 1998 Report (OECD, 1998) and, where necessary, relevant economic considerations. As the current review commenced before the publication of the BEPS Action Plan (OECD, 2013), all of the regimes (with the exception of intangible regimes) have been assessed against the factors as previously applied so that there is a consistent approach applied to similar types of regimes such as those for holding companies.

As all the intangible regimes of member countries are being considered together, they are being considered not only in light of the factors as previously applied but also in light of the elaborated substantial activity factor. As intangible regimes are just a subset of preferential regimes, the FHTP will also need to discuss and subsequently apply the substantial activity requirement to other preferential regimes; this could include preferential regimes already reviewed provided that they are still in force and not abolished.

Action Item 5 also requires the FHTP, as a priority, to improve transparency. Therefore regimes, including the intangible regimes, may also subsequently need to be reconsidered in the light of the analysis in this respect.

The review of preferential regimes of associate countries commenced in late 2013. The review followed the same process, and was carried out on the same basis, as that for the review of member country regimes. The review of the preferential regimes of Colombia and Latvia has been started but not finalised. The finalisation of the review of preferential regimes of other associate countries is part of the FHTP's next steps (see Chapter 6 below).

The FHTP's work on preferential regimes in member and associate countries is an ongoing process which will continue beyond September 2014. This process permits any member and associate country to request at any time a review of any existing preferential tax regime to the extent it considers that the nature of the regime, its economic effects or the extent and manner of its use have changed in ways that may make it harmful within the meaning of the 1998 Report. Regimes will also be subject to review under the elaborated substantial activity and transparency factors.

B. Conclusions on sub-national regimes and when they are in scope

In the course of the current review, the question arose as to whether sub-national regimes offering tax benefits at sub-national level alone are within the scope of the FHTP's work. Given that the no or low effective tax rate gateway factor looks at the combined effective tax rate for both the national and sub-national levels, a sub-national regime will fall outside the scope of the FHTP's work where the tax rate at the national level or the sub-national level fails to meet the no or low effective tax factor on its own.

The 1998 Report does not, however, preclude sub-national regimes from the FHTP's scope of work as a matter of principle, and there is nothing in the history of the FHTP's work precluding sub-national regimes from the scope of its work. In addition, it would be inconsistent with the 1998 Report's broader objective of establishing a "level playing field"¹ to exclude regimes offering tax benefits at the sub-national level alone from the scope of the FHTP's work, particularly where the tax rate at sub-national level represents (or could represent, in the case of a discretionary tax rate) a significant portion of the combined effective tax rate. Bearing this in mind, the FHTP agreed to include sub-national regimes within the scope of its work where both of the following two criteria are satisfied:

- i. The national government is ultimately responsible for the general design of the relevant regime and leaves limited discretion to the sub-national government as to whether or not to introduce the regime and/or as to the key features of the regime. The rationale is that in such a case, there is no fundamental difference between the relevant regime and regimes enacted and administered at national level; and,

- ii. The tax rate at sub-national level represents (or could represent, in the case of a discretionary tax rate) a significant portion of the combined tax rate and the combined effective tax rate for both the national and sub-national levels meets the no or low effective tax factor.

C. Conclusions reached on regimes reviewed

The review process of the FHTP includes the following 30 preferential regimes. The tables below identify the country and the name of the regime and provide the conclusion reached on certain regimes that the FHTP has agreed are not harmful².

Table 5.1. Regimes other than intangible regimes

	Country	Regime	Conclusion
1.	Australia	Conduit foreign income regime	Not harmful
2.	Canada	Life insurance business regime	Potentially harmful but not actually harmful
3.	Colombia	Foreign portfolio investment regime	Not harmful ³
4.	Greece	Offshore engineering and construction	Under review
5.	Japan	Special zones for international competitiveness development	Not harmful ⁴
6.	Japan	Measures for the promotion of research and development	Not harmful
7.	Latvia	Shipping taxation regime	Not harmful
8.	Latvia	Special economic zone regime	Under review ⁵
9.	Luxembourg	Private asset management company (<i>Société de gestion de patrimoine familial</i>)	Not harmful
10.	Luxembourg	Investment Company in Risk Capital (<i>Société d'investissement en capital à risque</i>) regime	Not harmful ⁶
11.	Switzerland – Cantonal level	Auxiliary company regime (previously referred to as domiciliary company regime)	Under review ⁷
12.	Switzerland – Cantonal level	Mixed company regime	Under review
13.	Switzerland – Cantonal level	Holding company regime	Under review
14.	Switzerland – Federal level	Commissionaire ruling regime	Under review
15.	Turkey	Shipping regime	Not harmful

Table 5.2. Intangible regimes

	Country	Regime	Conclusion
16.	Belgium	Patent income deduction	See the paragraph following this table.
17.	Colombia	Software regime	
18.	France	Reduced rate for long term capital gains and profits from the licensing of IP rights	
19.	Hungary	IP regime for royalties and capital gains	
20.	Israel	Preferential company ⁸	
21.	Luxembourg	Partial exemption for income/gains derived from certain IP rights	
22.	Portugal	Partial exemption for income from certain intangible property	
23.	Netherlands	Innovation box	
24.	Spain	Partial exemption for income from certain intangible assets	
25.	Spain – Basque Country	Partial exemption for income from certain intangible assets	
26.	Spain – Navarra	Partial exemption for income from certain intangible assets	
27.	Switzerland	Relief for newly established or re-designed enterprises ⁹	
28.	Switzerland – Canton of Nidwalden	Licence box	
29.	Turkey	Technology development zones	
30.	United Kingdom	Patent box	

The IP regimes listed in Table 5.2 were all considered under the criteria in the 1998 Report and are still only under review with respect to the elaborated substantial activity factor.

Table 5.3. Rulings related to preferential regimes and ruling regimes

	Country	Regime	Conclusion
			<p>The FHTP plans to start applying the framework for compulsory spontaneous exchange on rulings related to preferential regimes following the FHTP's autumn meeting and then report on the status of the implementation and the time frame to achieve it in a FHTP 2015 progress report. All preferential regimes will need to be considered in the light of the elaborated transparency factor which includes the framework. The conclusions on regimes assessed under the elaborated transparency factor will then be included in this table.</p>

Notes

1. See paragraph 8 of the 1998 Report.
2. A finding that a preferential regime was not harmful does not preclude a future re-assessment of the regime under the factors as elaborated under Action Item 5. Any such re-assessment would occur as part of the future work outlined in Chapter 6.
3. This conclusion was reached by the FHTP without reaching any conclusion that Colombia's regime was within the scope of the work of the FHTP.
4. This regime was considered prior to the approval of the BEPS Action Plan.
5. The FHTP has not yet reached a conclusion as to whether the regime is within the scope of the work of the FHTP.
6. This conclusion was reached by the FHTP without reaching any conclusion that Luxembourg's regime was within the scope of the work of the FHTP.
7. Switzerland has announced its intention to abolish this regime (as well as the following three regimes) as part of its Third Corporate Tax Reform.
8. Israel's preferred company regime was only included in the review to the extent that it offers a preferential treatment for certain income from qualifying intangible property.
9. Switzerland's relief for newly established or re-designed enterprises was only included in the review to the extent that it offers a preferential treatment for certain income from qualifying intangible property.

Bibliography

OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing.

<http://dx.doi.org/10.1787/9789264202719-en>

OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing.

<http://dx.doi.org/10.1787/9789264162945-en>

Chapter 6

Next steps

Going forward, the FHTP will complete the work under the first output of Action Item 5 and commence work on the second output, i.e. engaging with other non-OECD member countries on the basis of the existing framework. The deadline for the delivery of the second output is September 2015 and the goal is to achieve a level playing field and avoid the risk of the work on harmful tax practices displacing regimes from OECD member and associate countries to other countries, giving them an unwarranted competitive advantage and limiting the effectiveness of the whole exercise.

The completion of the work under the first output under Action Item 5 will consist of the following:

1) Further work on substantial activity

The work on substantial activity can be seen as occurring in three stages. Firstly, discussions on the approach to require substantial activity in IP regimes are continuing. Secondly, once an approach is agreed, it will be applied to the IP regimes listed in Table 5.2 above, as well as other associate country IP regimes. Lastly, Action Item 5 requires there to be substantial activity in “any preferential regime” and therefore any agreed approach needs to extend beyond IP regimes. While the ongoing discussions on substantial activity in the context of intangible regimes may inform this work, the requirement may need to be articulated differently in the context of different preferential regimes since any substantial activity requirement must reflect the nature of the preferential regime being assessed. Regimes which have already been assessed may need to be re-assessed once the articulation of the requirement has been agreed.

2) Further work on improving transparency

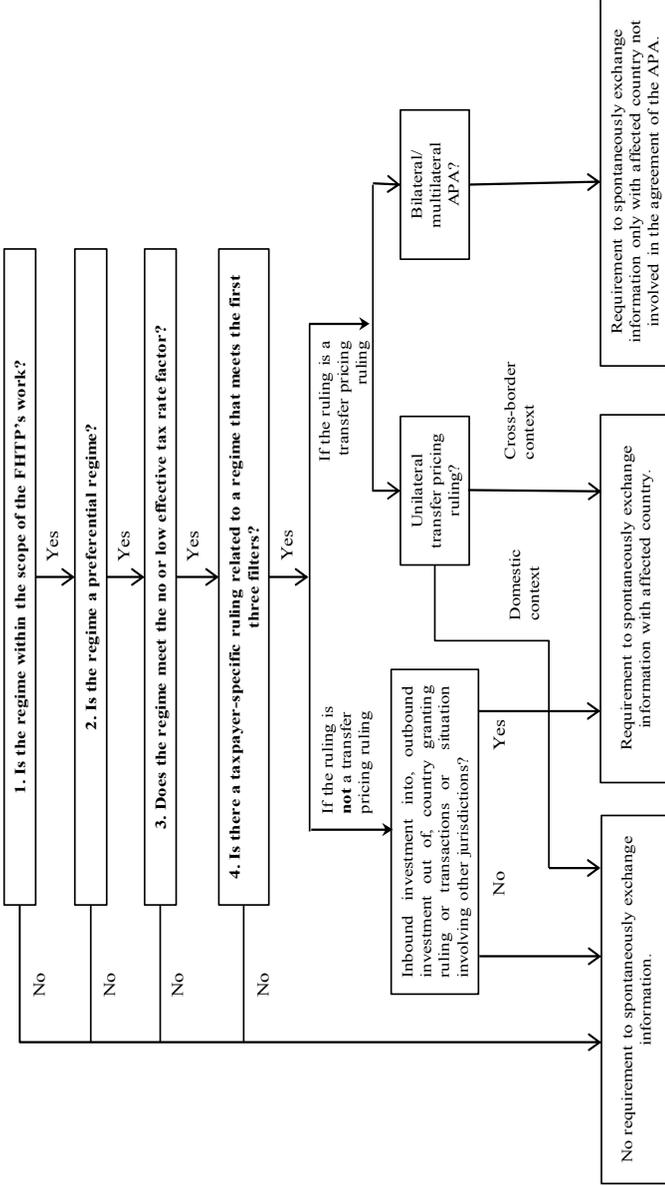
The FHTP will continue work on the application of the framework for compulsory spontaneous information exchange on rulings to member and associate countries’ preferential regimes, with a view to starting to apply the

framework following the FHTP’s autumn meeting and to reporting on this in a FHTP 2015 Progress Report. The FHTP will also explore in what other ways transparency may be improved.

3) Further work on the review of preferential regimes of associate countries

The review of preferential regimes of associate countries will continue.

Annex A. Spontaneous information exchange on rulings related to preferential regimes – flow chart



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Union takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

OECD/G20 Base Erosion and Profit Shifting Project

Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

Addressing base erosion and profit shifting is a key priority of governments around the globe. In 2013, OECD and G20 countries, working together on an equal footing, adopted a 15-point Action Plan to address BEPS. This report is an output of Action 5.

Beyond securing revenues by realigning taxation with economic activities and value creation, the OECD/G20 BEPS Project aims to create a single set of consensus-based international tax rules to address BEPS, and hence to protect tax bases while offering increased certainty and predictability to taxpayers. A key focus of this work is to eliminate double non-taxation. However in doing so, new rules should not result in double taxation, unwarranted compliance burdens or restrictions to legitimate cross-border activity.

Contents

Executive summary

Chapter 1. Introduction and background

Chapter 2. Overview of the OECD's work on harmful tax practices

Chapter 3. Framework under the 1998 Report for determining whether a regime is a harmful preferential regime

Chapter 4. Revamp of the work on harmful tax practices

Chapter 5. Review of member and associate country regimes

Chapter 6. Next steps

Annex A. Spontaneous information exchange on rulings related to preferential regimes – flow chart

www.oecd.org/tax/beps.htm

Consult this publication on line at <http://dx.doi.org/10.1787/9789264218970-en>.

This work is published on the OECD iLibrary, which gathers all OECD books, periodicals and statistical databases.

Visit www.oecd-ilibrary.org for more information.

