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Bumps in the level playing field

Alex Postma · Tuesday, May 5th, 2020

The OECD recently issued a paper called: "Resumption of application of substantial activities for no or nominal tax jurisdictions", which is a quite elaborate way of saying that the OECD going forward will require substance in low or no tax jurisdictions. Their stated reason is "leveling the playing field" between low or no tax jurisdictions and countries with preferential regimes. The question arises however whether this objective is met.

From the early 1998 beginnings of the Forum for Harmful Tax Practices (FHTP), an OECD specialist group that determines whether tax practices can be harmful to the tax base of other jurisdictions, focused only on tax rates, transparency and exchange of information to assess a country as "uncooperative", leaving the element of substance out of the equation. The Global Forum on Transparency and Exchange of Information for Tax Purposes, another OECD team, then assumed the quest for transparency and exchange of information and the FHTP started focusing on tax regimes rather than tax systems. As a result, the requirement of substance was enforced only on high tax rate countries with preferential regimes and not on countries whose tax rate were nominal or absent in the first place. This – in the view of the OECD – provides an unfair advantage to countries with no or nominal profits tax. The "resumption" paper now seeks to address this incoherence and the resulting lack of "level playing field". It tries to achieve this goal by first distinguishing between income from intangible property (IP income) and non-IP income. For non-IP income it requires that no or low tax countries introduce laws that:

- Define the core income generating activities (CIGA)
- Ensure that the CIGAs are relevant to the entity and are undertaken in the jurisdiction
- Require the entity to have an adequate number of full-time employees with the necessary qualifications and incurring an adequate number of operating expenditures to undertake such activities and
- Effective and transparent enforcement if the CIGAs are not undertaken by the entity or do not happen within the jurisdiction.

Then, with respect to IP income, the OECD refers to its "nexus approach". The nexus approach only allows preferential rates to tax payers that have actually developed the IP in question. So far this nexus approach has been applied only in respect of high tax countries with a preferential IP regime. IP income that doesn't meet the nexus rule must be taxed at the full rate of that country. The OECD acknowledges that this system does not work for a no-tax regime. To deal with this, it lays out that, going forward, no or low-income jurisdictions must require entities holding IP to meet the abovementioned core income generating activities guidance. What does that mean?

- For IP income that relates to patents this – in the view of the OECD – would mean that conducting research and development (rather than acquisition or outsourcing R&D) would be required by the entity. In their view this emulates the nexus approach that is required for regime countries.
- In a surprise turn, the OECD also proposes to apply the core income generating activities guidance for other intangible assets such as marketing intangibles. This type of IP is not allowed under the nexus approach and high tax countries cannot include it in their preferential regimes. It would require entities holding such marketing intangibles to perform branding, marketing and distribution activities in their country of residence.
- Finally, the OECD allows an exception to the CIGA rules for both IP and non-IP income if the entity can demonstrate – even if the research and development or the branding, marketing and distribution are not all performed by the entity – that substantial activities in respect of the IP are conducted by the entity with an adequate number of qualified full-time employees. These substantial activities could include strategic decision making, managing and bearing the principal risks relating to the development and exploitation of the intangibles, or carrying on the underlying trading activities through which the asset is exploited.
- For entities that merely passively hold IP assets that have been created and are effectively managed outside the jurisdiction the requirements would not be met.

It is, of course, commendable that the OECD addresses the discrepancy that existed between the substance requirements for preferential regimes on the one hand and low or no tax jurisdictions on the other hand. However, this paper **–** by prescribing the rules of engagement and approval for marketing intangibles to be held by low or no tax jurisdictions while not allowing high tax countries to apply their IP regimes to marketing intangibles **–** seems to widen the gap rather than close it. If the OECD is serious about creating a level playing field, then creating rules that addresses all IP in all countries would be a step forward.

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The views expressed are those of the author and do not necessarily represent the views of any members of the global EY organization.

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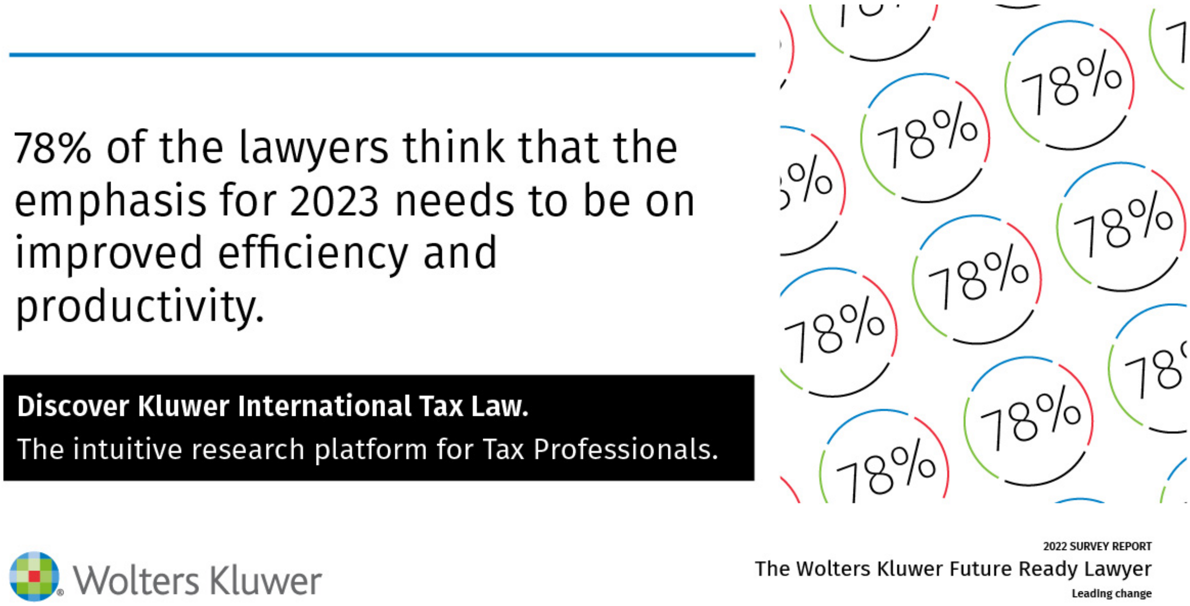

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