12 December 2019
Global Tax Alert

EU Code of Conduct Group issues update report, including new guidance

EY Tax News Update: Global Edition

EY's Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Also available is our EY Global Tax Alert Library on ey.com.

Executive summary

On 25 November 2019, the Council of the European Union (the Council) published a report from the Code of Conduct Group (COCG) (the report) that encompasses the work of the COCG in the second half of 2019 under the Finnish Presidency of the Council. Among other issues, the report includes a detailed state of play on the European Union (EU) list of non-cooperative jurisdictions for tax purposes. The report also includes new guidance, namely on notional interest deduction regimes, treatment of partnerships under criterion 2.2 (existence of tax regimes that facilitate offshore structures which attract profits without real economic activity) for screening jurisdictions, and on defensive measures towards non-cooperative jurisdictions. In addition, the report includes a list of new preferential regimes that the COCG has identified for review. This includes foreign source income exemption regimes that will be reviewed in 2020, based on the guidance issued in October 2019.

The report was endorsed during the Economic and Financial Affairs Council (ECOFIN) meeting of 5 December 2019.

Building a better working world

Detailed discussion

Background

On 1 December 1997, the Council and the representatives of the governments of the EU Member States adopted a resolution on a Code of Conduct for business taxation, with the objective of curbing harmful tax competition. As foreseen by the resolution, a COCG (Business Taxation) was set up within the framework of the Council by the ECOFIN on 9 March 1998 to assess tax measures that may fall within the scope of the Code of Conduct. The COCG is composed of high-level representatives of both Member States and the European Commission.

The COCG provides a six-month report to the Council on the main elements assessed and on the monitoring of (non-) compliance with agreed guidance. These reports are systematically made available to the public.

On 5 December 2017, the Council published a list of "uncooperative jurisdictions for tax purposes," comprising 17 jurisdictions which were deemed to have failed to meet relevant criteria established by the Commission.[1] The Council recommended Member States to consider applying one or more defensive measures, including both taxation and non-taxation measures, aimed at preventing the erosion of their tax bases. The suggested defensive measures in tax can be found in Annex III to the December 2017 Council conclusions. Member States have already agreed to apply at least one of the administrative measures in the tax area as listed in Annex III. On 21 March 2018, the Commission released a Communication which aimed to assist Implementing Partners in ensuring compliance with the new legal provisions while also providing broader recommendations on how to assess tax avoidance issues in conjunction with existing prohibitions on the use of non-cooperative jurisdictions and the publication of the EU list.[2]

On 25 November 2019, the Council published a report from the COCG that encompasses the work of the COCG in the second half of 2019 under the Finnish Presidency of the Council.

Overview of the report

The report is divided into five parts:

(i) Background

(ii) General aspects

(iii) Standstill and rollback review processes

(iv) COCG guidance notes

(v) The EU list of non-cooperative jurisdictions for tax purposes

The report also includes four annexes:

- Compliance of EU Member States with the COCG guidance on intermediate (financing, licensing) companies (Annex 1)
- Guidance on notional interest deduction regimes (Annex 2)
- Treatment of partnerships under criterion 2.2 (Annex 3)
- Guidance on defensive measures in the tax area towards non-cooperative jurisdictions (Annex 4)

According to the report, during the second semester of 2019, Belize and the Marshall Islands moved from annex I (the so-called black list) of the conclusions to annex II (the so-called gray list). Furthermore, Albania, Costa Rica, Mauritius, the Republic of North Macedonia, Serbia and Switzerland were removed entirely from annex II. As a result, eight jurisdictions today remain on the EU list of non-cooperative jurisdictions for tax purposes: American Samoa, Fiji, Guam, Oman, Samoa, Trinidad and Tobago, the US Virgin Islands and Vanuatu.

In addition, the report includes a list of new preferential regimes that the COCG has identified and that it will review. This includes foreign source income exemption regimes from 13 jurisdictions that the COCG will review in 2020 based on the guidance issued in October 2019. The guidance on foreign source income exemption provides direction for jurisdictions that have already taken a commitment to amend their foreign source income exemptions, due to harmful features identified by the COCG, and the guidance differentiates between passive and active income. For passive income, the COCG had found in 2017 that a tax system that fully excludes passive income with a foreign link from taxation, without any conditions, is harmful as it can result in ring-fencing and a lack of required substance. For active income, the COCG agreed that the assessment of foreign source income regimes should focus primarily on the exemption of passive income. However, it also agreed that it was essential to consider specific features of these regimes linked to active income – in particular, whether and how active income is taxed. Further, the guidance indicates that regimes that extend the exemption to active income from foreign operations should also be carefully considered, as this can trigger cases of double non-taxation. Jurisdictions with foreign source income exemption regimes that are considered harmful should either abolish the regimes in question or amend them to remove the harmful features.

Jurisdictions should introduce taxation of passive income, says the guidance or, if they exclude from taxation certain types of passive income, jurisdictions should:

(i) Implement adequate substance requirements to the entities concerned, in line with the EU's Code of Conduct (Business Taxation). Where jurisdictions are being assessed under Criterion 2.1 (Existence of harmful tax regimes), the substance requirements in the COCG guidance on the interpretation of the third criterion (Implementation of anti-BEPS measures) should apply.[3] Where jurisdictions are being assessed under Criterion 2.2, the substance requirements in the COCG scoping paper on criterion 2.2 should apply.[4]

(ii) Have robust anti-abuse rules in place.

(iii) Remove any administrative discretion in determining the income to be excluded from taxation.

Furthermore, jurisdictions should ensure the application of international principles in relation to the taxation of active income, notably with regard to the definition of permanent establishment provided by the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention and the consequent income allocation.

Monitoring of the implementation of agreed guidance

The report also mentions that the COCG has completed the monitoring of the implementation of the 2013 COCG guidance on intermediate (financing, licensing) companies, and concluded that all Member States are compliant. Annex 1 of the report provides an overview of the compliance of the said guidance in each Member State, and includes an explanation of the monitoring of Cyprus, Luxembourg, and Poland.

Moreover, during the second semester of 2019,[5] the COCG agreed on a questionnaire for monitoring the implementation of the 2016 guidelines on the conditions and rules for the issuance of tax rulings by Member States. The COCG will continue the monitoring of the implementation of the 2016 guidance during the incoming Croatian Presidency.[6]

Guidance on notional interest deduction regimes

The guidance on notional interest deduction (NID) regimes presents a non-exhaustive list of elements and characteristics which indicate that a NID regime may be harmful when assessed against the criteria of the Code of Conduct. The guidance aims to assist Member States and third countries more easily identify potentially harmful NID regimes. However, the guidance highlights that it can never provide a safe harbor for a particular regime. This means that a NID regime that requires particular attention under the guidance may be found not harmful by the COCG or vice versa.

The guidance provides that NID regimes should have certain limitations in scope and be properly constrained by appropriate anti-abuse measures and lists a number of limitations in scope and tax avoidance situations that together with a special or general anti-abuse provision are likely to make a regime less vulnerable to aggressive tax planning. Among others, the guidance lists the following limitations in scope:

- A NID regime should be limited, where applicable, to new equity created after the starting date of the regime.
- The application of the NID should neither create nor increase tax losses.
- A NID regime should exclude assets not necessary for conducting business to prevent benefits through NID on assets that do not generate taxable income.

Further, the guidance lists tax avoidance situations involving transactions between related parties under a NID regime, including:

- Cascading through intra-group loans and loans involving associated enterprises
- Transfer of participations
- The re-categorization of old capital as new capital via liquidations or the creation of start-ups
- Double-dipping structures combining interest deductibility and deductions under the NID

The guidance highlights the importance that special anti-abuse provisions place the burden of proof with the taxpayer and not with the tax administration and that special anti-abuse provisions should also work in cross-border situations. To this end, the guidance requires that each Member State with a NID regime inform any other concerned Member States which have a NID, if it has grounds for supposing that there is a tax loss in the other Member States or if a taxpayer received a reduction in tax which should not give rise to a second deduction in the other Member States.

Lastly, the guidance notes that it will be periodically reviewed by the COCG to ensure that they reflect future developments.

Treatment of partnerships under criterion 2.2

The COCG agreed on a set of questions to be sent to the relevant criterion 2.2 jurisdictions to clarify the nature of the different partnerships within each jurisdiction and help determine if and how they should be covered by the substance requirements. The questions are:

1. *Can a relevant activity[7] be carried out through a partnership?* If partnerships are not allowed to carry out any relevant activities and earn income in a particular jurisdiction, then those partnerships could be excluded from the substance requirements in that particular jurisdiction. However, if a partnership can in principle be used to carry out relevant activities, the below questions could narrow down the application of substance requirements.
2. *Can partnerships that carry out relevant activities have legal personality?* If the jurisdiction confirms that partnerships can have legal personality (either automatically or by opting to have one), then the partnerships are akin to companies, and should be in the scope of the substance requirements. However, if partnerships cannot have legal personality, the below question could narrow down the application of substance requirements.
3. *Can the partners or beneficial owners of a partnership carrying out a relevant activity without legal personality be nonresidents?* If the answer is negative, partnerships of the jurisdictions concerned could be left out of the substance requirements because nonresident partners or beneficial owners could not use them to shift profits. Conversely, if the answer is positive, the partnership should fall within the scope of substance requirements and substance would be checked at the level of the partnership. This would allow the authorities to easily assess the substance and apply sanctions where relevant and it would ease the exchange of information with relevant Member States.

Guidance on defensive measures

The objective of this guidance is to set out the principles of co-ordination of actions by Member States in this area, while providing further details as regards the proposed defensive measures of a legislative nature to be applied to listed non-cooperative jurisdictions. The guidance clarifies that the guidance is without prejudice of the competence of Member States to apply additional measures or to maintain lists of non-cooperative jurisdictions at the national level with a broader scope than the EU list of non-cooperative jurisdictions. Further, the defensive measures in the tax area included in this guidance should be specific measures that are different from the general administrative practices and tax rules in the Member States.

According to the guidance, Member States should apply at least one of the following legislative measures from 1 January 2021 at the latest:

- Non-deductibility of costs: to deny deduction of costs and payments that otherwise would be deductible for the taxpayer when these costs and payments are treated as directed to entities or persons in listed jurisdictions.
- Controlled Foreign Company (CFC) rules: to include in the tax base of the taxpayer the income of an entity resident or a permanent establishment situated in a listed jurisdiction. Member States could apply this measure in accordance with the Anti-Tax Avoidance Directive CFC rules.
- Withholding tax measures: to apply a withholding tax at a higher rate on payments such as interest, royalties, service fee or remuneration, when these payments are treated as received in listed jurisdictions.
- Limitation of the participation exemption on profit distribution: Member States which have rules that permit excluding or deducting dividends or other profits received from foreign subsidiaries, could deny or limit such participation exemptions if the dividends or other profits are treated as received from a listed jurisdiction.

The guidance states that, where applicable, Member States could also apply a reversal of the burden of proof and special documentation requirements to reinforce the effect of any of the defensive measures. Also, the guidance notes, Member States should regularly update the COCG on the state of play of defensive measures that they apply under the guidance.

Furthermore, the guidance indicates that the COCG will resume reviewing the work on legislative defensive measures in the tax area by July 2021 at the latest. By the end of 2021, an overview of defensive measures applied by Member States will take place, and as of 2022, the COCG will assess the need for further coordination of defensive measures in the tax area and the need to apply defensive measures in a more targeted manner.

Implications

Despite the fact that the COCG started outside of the EU legal infrastructure as a political peer pressure group among the Member States, and had no legally binding consequences, it continues to play an increasingly important role, and is widely accepted and supported by the European Commission.

Due to the increasing transparency of the group (forced by the European Parliament) and the assistance of the European Commission, the reports, the findings, guidance, recommendations and standard-setting work of the group should be closely monitored. In particular, businesses with operations in any of the jurisdictions remaining on the so-called black lists should consider what implications, if any, the application of defensive measures by EU Member States may have on their operations both now and in the future.

Endnotes

1. See EY Global Tax Alert, Council of the European Union publishes list of uncooperative jurisdictions for tax purposes, dated 6 December 2017.
2. See EY Global Tax Alert, European Commission adopts first counter-measures on listed non-cooperative tax jurisdictions, dated 22 March 2018.
3. http://data.consilium.europa.eu/doc/document/ST-10419-2018-INIT/en/pdf.
4. http://data.consilium.europa.eu/doc/document/ST-10421-2018-INIT/en/pdf.
5. The work of the European Commission is broken up into semesters, each of six months duration.
6. 1 January 2020 to 30 June 2020.
7. A relevant activity is defined by reference to the OECD Forum on Harmful Tax Practices' guidance on non-IP regimes as: headquarter business, distribution and services centers, financing and leasing, fund management, banking, insurance, shipping, holding activity (including pure equity holding).

For additional information with respect to this Alert, please contact the following:

Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft, Munich

- Klaus von Brocke klaus.von.brocke@de.ey.com

Ernst & Young LLP (United Kingdom), London

- Chris Sanger csanger@uk.ey.com

Ernst & Young Belastingadviseurs LLP, Rotterdam

- Marlies de Ruiter marlies.de.ruiter@nl.ey.com

Ernst & Young Belastingadviseurs LLP, Amsterdam

- David Corredor-Velásquez david.corredor.velasquez@nl.ey.com

Ernst & Young LLP (United States), Global Tax Desk Network, New York

- Jose A. (Jano) Bustos joseantonio.bustos@ey.com
- Konstantina Tsilimigka konstantina.tsilimigka1@ey.com

Ernst & Young LLP (United States), Washington, DC

- Rob Thomas rob.l.thomas1@ey.com