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Global Tax Alert

OECD releases update on peer review of preferential tax regimes and no or only nominal tax jurisdictions

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Executive summary

On 23 July 2019, the Organisation for Economic Co-operation and Development (OECD) released an update on the results of the peer reviews of jurisdictions' domestic laws under Action 5 (harmful tax practices) of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project. The results were approved on 19 July 2019 during a meeting of the Inclusive Framework on BEPS.

The updated results cover 56 regimes, bringing the number of regimes that have been reviewed, or are under review, to 287. The assessments were undertaken by the OECD Forum on Harmful Tax Practices (FHTP). The update is an indication of the extent of the ongoing work aimed at ending harmful tax practices, through the requirement that all preferential regimes require adequate levels of substance. The peer review results will continue to be updated from time to time, as approved by the Inclusive Framework on BEPS.

Additionally, the OECD released the results of the review of the substantial activities factor for no or only nominal tax jurisdictions in connection with the domestic laws of the 12 jurisdictions that have been identified by the FHTP as being a no-or-only-nominal-tax jurisdiction.

Building a better working world

Detailed discussion

Background

In an effort to realign the taxation of profits with the substantial activities that generate them, and to improve transparency, the OECD started work on addressing harmful tax competition in the late 1990s, resulting in a 1998 report, Harmful Tax Competition: An Emerging Global Issue. Under this initiative, the OECD also created the FHTP to take the work forward. Following its creation, the FHTP has been one of the key groups with the mandate to monitor and review tax practices of jurisdictions, focusing on the features of preferential tax regimes. The Code of Conduct group in the European Commission performs a similar role.

On 5 October 2015, the OECD released its final report on Action 5, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance* (the Action 5 Report) under its BEPS Action Plan.[1] The Action 5 Report covers two main areas: (i) applying the "substantial activity" criterion when determining whether tax regimes are harmful; and (ii) improving transparency. Besides this, the Report contains a strategy to expand the review of preferential regimes to third countries beyond the OECD/G20 countries. This expansion is executed through the Inclusive Framework on BEPS, which currently has 131 member jurisdictions. Each of the member jurisdictions has committed to fulfilling the BEPS minimum standards, including the minimum standard on Action 5. This means that for each of these members their preferential regimes have been, are being or will be reviewed based on the Action 5 criteria, including the new criteria on substance and transparency.

Since the publication of the 2017 Progress Report in October 2017,[2] the FHTP has further continued its work on the review of preferential regimes within the scope of BEPS Action 5:

- During May 2018, the OECD released updates to the results of the reviews of 11 preferential tax regimes
- On 15 November 2018, the OECD released updated results covering the assessment of 53 preferential tax regimes. On the same date, the OECD also released guidance on the application of the substantial activities requirement for "no or only nominal tax" jurisdictions[3]
- On 29 January 2019, the OECD released the 2018 Progress Report, for which the FHTP has reviewed 255 regimes in total since the start of the BEPS project[4]

On 23 July 2019, the OECD released an update to the results of the reviews for 56 preferential tax regimes.

Updated conclusions of the preferential tax regimes review

According to the updated results, 13 additional regimes have been identified as having been abolished as a result of the jurisdictions delivering on their commitments to make the relevant legislative changes. These include:

- Malaysia: International currency business unit
- Monserrat: International business companies
- Morocco: Banks and holding companies in offshore zones
- Switzerland: Commissionaire ruling regime
- Other regimes in Cabo Verde, Mongolia and Thailand

Additionally, three regimes have been amended to remove the potentially harmful features, and four new regimes have been classified as "not harmful" as they were specifically designed to meet the Action 5 minimum standard:

- Malaysia: Principal hub (amended – not harmful)
- Malta: Patent box deduction rules (not harmful)
- Poland: intellectual property (IP) box (not harmful)
- Other regimes in Cabo Verde, Mauritius and Thailand

The updated results include new commitments to make legislative changes in four regimes:

- Aruba: Investment promotion
- Greece: Tax patent incentives
- Kazakhstan: Astana international financial center and special economic zones

In addition, two regimes have been found to be potentially harmful but not actually harmful (Aruba – Imputation payment company and Vietnam – Software production) and one regime is not operational (Paraguay – Investment of capital from abroad IP). The updated results indicate one regime has been determined to be actually harmful (Jordan – Development zone).

Finally, eight regimes in Cabo Verde, Nigeria, Paraguay and Vietnam were found to be out of scope, and 21 additional regimes in Cook Islands, Dominica, Dominican Republic, Jamaica, Morocco, North Macedonia, and Qatar have now been placed under review.

Substantial activities requirement for "no or only nominal tax" jurisdictions

On 15 November 2018, the OECD released a standard on substantial activities that would apply to jurisdictions that do not impose a corporate income tax. It would also apply to jurisdictions that are considered to impose only nominal corporate income tax to avoid such requirements. Jurisdictions that have been reviewed on the basis of the preferential regimes they offer are out of the scope of the substantial activities standard, unless they subsequently undertook significant reforms which abolished or substantially abolished their corporate income tax altogether.

After agreeing on the substantial activities standard, the FHTP identified 12 "no or only nominal tax jurisdictions" that introduced the necessary domestic legal framework to meet the standard, namely Anguilla, the Bahamas, Bahrain, Barbados, Bermuda, British Virgin Islands, Cayman Islands, Guernsey, Isle of Man, Jersey, Turks and Caicos Islands and the United Arab Emirates.

Based on the FHTP's review, the domestic legal framework of 11 of these jurisdictions (Anguilla, the Bahamas, Bahrain, Barbados, Bermuda, British Virgin Islands, Cayman Islands, Guernsey, Isle of Man, Jersey, Turks and Caicos Islands) are in line with the substantial activities standard and therefore are "not harmful." Regarding the remaining jurisdiction reviewed by the FHTP (the United Arab Emirates), the FHTP concluded that the legal framework was generally in line with the standard, with one technical point outstanding. In this respect, the United Arab Emirates committed to make further legislative changes and the law is now "in the process of being amended."

Next steps

The FHTP has now reviewed 287 regimes. These reviews have led to extensive amendments to preferential regimes worldwide. Following the reviews and taking into account the amendments which have already been finalized, 4 of these regimes are currently harmful, 7 regimes are potentially harmful but not actually harmful, 109 regimes are not harmful, 15 regimes are in the process of being eliminated or amended, 3 regimes are not operational, and 76 regimes have been abolished. Additionally, 35 regimes have been found to be out of scope, and 35 regimes are still under review. The remaining three regimes relate to disadvantaged areas.

The FHTP will continue its reviews in December 2019, and will continue to monitor the implementation of the new laws in practice in 2020. Also, from 2020, the FHTP will start an annual monitoring process with respect to the effectiveness of jurisdictions' mechanisms to ensure compliance with the substantial activities standard in practice.

Implications

The updated results of the review of the preferential tax regimes underscore that swift and geographically comprehensive progress is being made on the implementation of BEPS Action 5 on harmful tax practices. They further affirm the actions of Inclusive Framework on BEPS members in making significant commitments to change their tax rules. The release of the updated results also provides information to taxpayers on the status of preferential regimes in jurisdictions in which they may operate.

The FHTP will continue its work, including the monitoring and review of preferential tax regimes that are being amended to conform to the Action 5 minimum standard. Taxpayers should monitor the work of the FHTP on the regimes that are found to be harmful and that may be in the process of being amended or eliminated, especially given that some countries include in their domestic laws special rules with respect to payments to preferential regimes. Therefore, for example, inclusion in the OECD list may lead to non-deductibility of payments.

Finally, the release of the first results of the review of the substantial activities standard for "no or only nominal tax" jurisdictions illustrates the OECD's efforts in ensuring that substantial activities are performed in respect of the same types of mobile business activities, both with respect to a preferential regime and a "no or only nominal tax" jurisdiction.

Endnotes

1. See EY Global Tax Alert, *OECD releases final report on countering harmful tax practices under Action 5*, dated 8 October 2015.
2. See EY Global Tax Alert, *OECD releases progress report on preferential regimes under BEPS Action 5*, dated 18 October 2017.
3. See EY Global Tax Alert, *OECD releases updated results on scrutiny of preferential tax regimes and substantial activity requirements for no or only nominal tax jurisdictions*, dated 20 November 2018.
4. See EY Global Tax Alert, *OECD releases 2018 Progress Report on Preferential Regimes under BEPS Action 5*, dated 30 January 2019.

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

Ernst & Young LLP (United Kingdom), London

- Chris Sanger csanger@uk.ey.com

Ernst & Young Belastingadviseurs LLP, Rotterdam

- Ronald van den Brekel ronald.van.den.brekel@nl.ey.com
- 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

- Barbara M. Angus barbara.angus@ey.com
- Rob Thomas rob.l.thomas1@ey.com

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