Council of the
European Union

Brussels, 2 June 2021
(OR. en)

9807/18
DCL 1

FISC 250

DECLASSIFICATION

of document:	9807/18 RESTREINT UE/UE RESTRICTED
dated:	6 June 2018
new status:	Public
Subject:	(5th draft) Scoping paper on criterion 2.2 of the EU listing exercise

Delegations will find attached the declassified version of the above document.

The text of this document is identical to the previous version.

Council of the
European Union

Brussels, 6 June 2018
(OR. en)

9807/18

RESTREINT UE/EU RESTRICTED

FISC 250

NOTE

From:	Bulgarian Presidency
To:	Delegations
Subject:	(5th draft) Scoping paper on criterion 2.2 of the EU listing exercise

Delegations will find attached a document in view of the meeting of the High Level Working Party (Taxation) of 6 June 2018.

ANNEX

(5th draft) SCOPING PAPER ON CRITERION 2.2

OF THE EU LISTING EXERCISE

I/ Technical elements of commitments to be fulfilled by the jurisdictions

Issue of lack of substance (Criterion 3 of the Code of Conduct test)

To address the issues that arise in connection with entities operating without any substance, the 2.2 jurisdictions have already been requested by the COCG to:

1) *give reassurances to EU Member States on this issue, in line with the Terms of Reference attached to this letter;* and

2) *discuss with the Code what further steps could better ensure that businesses have sufficient economic substance.*

The letters to these jurisdictions clarified that

"*a way to achieve this could be through the imposition of substance requirements, where appropriate. Moreover, this may require that you introduce additional accounting and tax reporting obligations such that an appropriate notification regime for entities that give rise to the risks and concerns underlying criterion 2.2 can ensure the collection and subsequent exchange of relevant information with Member States*."

In line with the Criterion 2.2 ToR and further discussions held in the context of the COCG, the dialogue with the jurisdictions has started on the basis of the below points:

1) The jurisdiction has provided concrete elements on the steps (including their timeline) envisaged to align their legal system with the ToR on criterion 2.2;

2) The jurisdiction shall guarantee that legal substance requirements will be introduced in the legislation for the incorporation and operation of entities making sure that in practice tax advantages (i.e. no or very low taxation) are not granted to entities without any real economic activity and substantial economic presence in the jurisdiction.

3) Taking into account the features of each specific industry or sector, the jurisdiction should be asked to introduce requirements concerning an adequate level of (qualified) employees, adequate level of annual expenditure to be incurred, physical offices and premises, investments or relevant types of activities to be undertaken.

4) The jurisdiction shall also ensure that the activities are actually directed and managed in the jurisdiction and that core income-generating activities are performed in the jurisdiction. The jurisdiction shall in addition provide a guarantee that appropriate resources are deployed by governmental authorities, including tax authorities, to check the application of these requirements and that sanctions are envisaged in case of non-compliance.

5) The jurisdiction shall introduce appropriate notification regimes whereby all information needed to assess the actual amount of profits booked in the jurisdictions could be made available to the relevant jurisdictions having in place CIT system for the purpose of calculating the tax liability of their taxpayers. The jurisdiction has to ensure that information are collected, accessed and automatically exchanged with relevant EU Member States.

II/ The core income generating activities in 2.2 jurisdictions

According to Criterion 2.2: "*The jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction*". The jurisdictions which raised concerns were asked to address these through the imposition of substance requirements, where appropriate. It is considered that those substance requirements should mirror those used in the FHTP in the context of specified preferential regimes.

A taxpayer should not be able to avoid the substantial activity requirements and still benefit from a low or no tax rate simply by moving to a 2.2 jurisdiction which at present is not subject to the substance requirements; rather, the same test for carrying out the core income generating activities in a jurisdiction should apply equally whether these are carried out in a preferential regime or in a 2.2 jurisdiction In fact, the need for this approach has been underlined by some members of the Inclusive Framework which are now adding substantial activity requirements to their preferential regimes, and have expressed concern that they may be at a competitive disadvantage if taxpayers relocate to a zero tax jurisdiction rather than comply with the new requirements. Thus, there is a strong level playing field argument that points in this direction.

In the context of FHTP assessments, the substantial activities criterion requires that jurisdictions ensure that core activities relevant to the regime type are undertaken by the taxpayer wishing to benefit from the regime (or are undertaken in the jurisdiction). The FHTP guidance on substantial activities further notes that core income generating activities presuppose having an adequate number of full-time employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities. Finally, it requires the jurisdiction to have a transparent mechanism to ensure taxpayer compliance and to deny benefits if these core income generating activities are not undertaken by the taxpayer or do not occur within the jurisdiction. For IP regimes, specific substance requirements apply, namely the nexus approach.

a. Non-IP Substantial Activities Test

For companies dealing with assets other than IP, the substance requirements would apply to the same types of geographically mobile activities which have typically been the focus of the preferential regimes. 2.2 Jurisdictions would be required to meet the same substantial activities test for each sector, demonstrating that the core income generating activities are undertaken by the entity (or in the jurisdiction), involving an adequate number of employees and expenditure, supported by effective enforcement mechanisms. Annex 2 of this paper contains the 2017 FHTP Guidance on non-IP regimes which will have to be considered as the guidance for this exercise to be applied by analogy.

This would include fund managers as this is a mobile activity within the scope. However, collective investment funds (CIVs) are of a different nature, except in rare circumstances where the manager and the CIV form one legal entity. Therefore, the usual substance requirements cannot automatically be applied to CIVs. Thus, and in part similar to pure equity holding companies, reduced substantial activities requirements adapted to CIVs should apply ~~(in particular proper authorisation procedures and valuation rules, competent authorities should be able to effectively enforce compliance of CIVs through regulatory supervision, on site audits, the designated depositary in the jurisdiction and other similar requirements)~~.[1] ~~-~~**Requirements in this regard can be paralleled with EU legislation on investment funds, in particular Directive 2011/61/EU on Alternative Investment Fund Managers.**

b. Substance requirements for IP income

Income derived from IP assets can pose a higher risk of artificial profit shifting than non-IP assets. This is reflected in international standards in the field of taxation, which require that income deriving from IP assets must be subject to specific substantial activity requirements. For example, the FHTP's approach to income deriving from IP assets in the context of preferential regimes requires that the tax benefits a company can derive are conditional on the extent of substantial R&D activities of taxpayers receiving benefits income deriving from IP assets. This approach uses expenditures as a proxy for substantial activities to calculate the proportion of income that may enjoy the tax benefit ('The Nexus approach').

In the context of 2.2 jurisdictions, the absence of a preferential regime poses significant challenges to applying the Nexus approach. The overall aim in this context is not to calculate the portion of a company's intangible asset income that can take advantage of a preferential tax rate, but rather to determine whether a company generating income from intangible assets can incorporate or operate within a 2.2 jurisdiction. Therefore, while the focus of the Nexus approach on intellectual property derived from local R&D activities is acceptable as a standard for preferential IP regimes, it could in this context prohibit genuine commercial activities by failing to recognise other intangible assets and different ways in which those assets can be created or otherwise exploited through core income generating activities.

[1] ~~Requirements in this regard can be paralleled with EU legislation on investment funds, in particular Directive 2011/61/EU.~~

Any approach to substance requirements for IP income must therefore be effective, proportionate and both: (i) adequately address the higher risk of artificial profit shifting posed by income derived from IP assets in certain scenarios; and (ii) not inadvertently prohibit activities that constitute real economic activity

Strengthened general substantial activities approach

The approach that meets these requirements:

1) applies a targeted version of the general substantial activities approach to income derived from intangible assets in low risk scenarios;

2) includes a rebuttable presumption that the test is failed in these situations absent local R&D activities (for IP assets) or local marketing and branding activities (for non-IP intangible assets);

3) Makes the rebuttal of that presumption contingent on a taxpayer being able to evidence that it undertakes the substantive activities supporting intangible asset income, and makes it subject to enhanced reporting and monitoring requirements regardless of the decision taken by the 2.2 jurisdiction on the appropriateness of this substance;

4) ~~Further increases the burden of the proof on the taxpayer to rebut~~ **presumes** the non-compliance ~~presumption in high risk scenarios thus making sure that this test would never be satisfied by a company~~ **of companies** that merely passively hold~~s~~ and generate~~s~~ income from intangible assets **within higher risk scenarios**.

b.1. Core Income generating activities for income deriving from IP assets

For intellectual property assets such as patents it is expected that core income generating activities include R&D activities.

For non-trade intangible assets such as brand, trademark and customer data it is expected that the core income generating activities include marketing, branding and distribution activities.

However the core income generating activities associated with an intangible asset will ultimately depend on the nature of the asset e.g. whether it's a patent, technical know-how, a trademark, customer lists or brand/goodwill.

They will also depend on how that asset is being used to generate income for the company e.g. whether it is being licenced or used to generate income from trading activities, such as the provision of services to third-party customers.

In certain situations therefore, a company might be given the possibility to prove that it is undertaking other core income generating activities associated with intangible asset income without specifically undertaking R&D, marketing and branding. Those activities might include:

- Taking the strategic decisions and managing (as well as bearing) the principal risks relating to the development and subsequent exploitation of the intangible asset; or

- Taking the strategic decisions and managing (as well as bearing) the principal risks relating to the third-party acquisition and subsequent exploitation of the intangible asset; or

- Carrying on the underlying trading activities through which the intangible assets are exploited and which lead to the generation of revenue from third-parties.

These activities, as well as R&D, branding and distribution activities which remain the main core activities to be looked at, **would require the necessary staff, premises and equipment. Therefore, it** would require more than local staff passively holding intangible assets whose creation and exploitation is a function of decisions made and activities performed outside of the jurisdiction.

They equally wouldn't be satisfied by the periodic decisions of non-resident board members, with the need instead for local, permanent and qualified staff making active and ongoing decisions in relation to the generation of income **in the 2.2 jurisdiction**.

b.2. Higher-risk scenarios – involvement of foreign related parties

The risks of artificial profit shifting are likely to be greater where a company

(a) owns an intangible asset that has been acquired from related parties or obtained through the funding of overseas R&D activities e.g. under a cost-sharing agreement; and

(b) is licenced to foreign related parties or monetised through activities performed by foreign related parties (e.g. foreign-related parties are paid to develop and sell a product in which the intangible asset is embedded).

To mitigate this greater risk, there should be a rebuttable presumption that the core income generating activities test is not satisfied in these scenarios, even if there are local activities that would, under a transfer pricing analysis, entitle the company to some allocation of taxable profits.

Companies could be given the ability to challenge this default presumption, and evidence how the income being generated in these higher risk situations is directly linked and justified by activities undertaken in the local jurisdiction rather than overseas.

This would need to be a high evidential threshold. Companies would, for example, need to evidence that, in addition or alternatively to R&D, branding and distribution activities, a high degree of control over the development, exploitation, maintenance, enhancement and protection of the intangible asset is, and historically has been, exercised by full time highly skilled employees that permanently reside and perform their core activities within the 2.2. jurisdiction. They must be able to support these evidences through the provision of additional information including:

- Detailed business plans which allow to clearly ascertain the commercial rationale of holding IP assets in the jurisdiction,

- employee information including level of experience, type of contracts, qualifications, duration of employment,

- concrete evidence that decision making is taking place within the jurisdiction.

This information would have to prove that in the jurisdiction there is more than local staff passively holding intangible assets whose creation and exploitation is a function of decisions made and activities performed outside of the jurisdiction.

This test will not be satisfied by mere periodic decisions of non-resident board members, with the need instead for local, permanent and qualified staff making active and regular decisions in relation to all the activities linked to the generation of IP income.

In order to further mitigate the higher level of risk that these scenarios pose, even where a taxpayer is able to rebut the presumption (i.e. it can demonstrate that it undertakes the substantive activities supporting intangible asset income) the 2.2 jurisdiction would be required to disclose the full evidence to the competent authority in the country of residence/relevant jurisdiction. (This may require that legislation be put in place that requires enhanced reporting from companies that fall into this category). This would allow Member States to review whether the testing being implemented by 2.2 jurisdictions' competent authorities in higher risk scenarios adequately mitigated tax risks.

The effectiveness and proportionality of the new legislation reflecting this approach will be subject to review after 1 year of application by the relevant jurisdictions. Since the new legislation is requested to be in place as of 1 January 2019 and will be immediately applicable to new companies (as well as to new activities and new IP assets), while existing companies (or existing activities and existing IP assets) will be given 6 months to adapt (i.e. by 1 July 2019 at the latest), the COCG will review this approach in July 2020 (1 year after the new legislation has been applicable to all companies) with a view to considering possible amendments.

III/ Implementation by 2.2 jurisdictions and consequences for non-compliance

A 2.2 jurisdiction would implement the substantial activities requirement in three key steps:

(1) identify the relevant activities in their jurisdiction;

(2) impose substance requirements;

(3) ensure there are enforcement provisions in place.

The first obligation for the 2.2 jurisdictions is to identify the relevant categories of activities in the jurisdiction in respect of which substance requirements would apply, including at least banking, insurance, fund management, financing, leasing, headquarters, and shipping. The 2.2 jurisdictions may be able to identify these categories of activity through existing or newly introduced regulatory requirements or by obtaining other information from reporting requirements or service providers. Alternatively, if it is administratively easier, a jurisdiction could apply the substance requirements to all businesses but then reduce requirements / carve out those entities that are not in scope. A jurisdiction may also decide to exempt local businesses that are not in scope of the work on harmful

tax practices, such as hotels and retail, or alternatively have them covered as presumably such entities would have no difficulty in meeting the requirements.

Second, for each set of activities, the 2.2 jurisdiction would need to impose substance requirements to ensure consistency with the COCG and FHTP guidance. This may require legislative changes, as is the case for many of the other Inclusive Framework members, and which many of the 2.2 jurisdictions have already indicated their willingness to do.

Third, the 2.2 jurisdiction would need to implement adequate enforcement and sanction mechanisms to ensure compliance by the relevant individual entities with substance requirements. This would need to include mechanisms to identify which entities are conducting the relevant categories of activities, and to detect and enforce the substantial activities requirements for entities which purport to have substantial activities but in fact do not meet the requirements. To be able to do so, a 2.2 jurisdiction would need to require each entity in scope to prepare and file information on at least business type (to identify the type of mobile activity); amount and type (e.g. rents, royalties, dividends, sales, services) of gross income; amount and type of expenses and assets; premises, and number of employees, specifying the number of full time employees. In addition, each entity must be required to prepare and file information showing that it has conducted relevant core income generating activities such as R&D, marketing, branding and exploitation within the 2.2 jurisdiction.

Ordinarily in the context of a preferential regime, where a taxpayer has failed to meet the substantial activity requirements the result should be that the tax benefits of the regime are denied. This would not apply in the 2.2 context, but there would need to be an equivalent level of enforcement. The consequences where an entity fails the substance requirements should include rigorous, effective and dissuasive regulatory penalties and enhanced spontaneous exchange with jurisdictions of residence (e.g. of a party making a deductible payment to such a company) and ultimately, where other sanctions produce no results, **this should lead** ~~consideration should be given~~ to striking off the register such an entity. This should be complemented by a commitment by the 2.2 jurisdiction to continue enforcement efforts and remedy any shortcomings in the enforcement process.

IV/ Review and monitoring of the 2.2 jurisdictions' implementation of the substance requirements

Drawing on the process and practice of the Code of Conduct Group and FHTP, there are two parts to the review to ensure a 2.2 jurisdiction had implemented the substance requirements: a review of the legal and administrative framework and monitoring of effectiveness in practice.

The first part in the assessment of the 2.2 jurisdiction would involve a review of the legal and administrative framework (whether regulatory, commercial tax, or other legislation) and other information provided by the jurisdiction to determine whether the substance requirements are met. This includes whether the legislation requires substance, and whether there are adequate enforcement and sanction provisions, as well as information on the mechanism for overseeing these provisions (such as which agency will enforce the requirements, how this will be done and with which resources).

The second part is an ongoing annual monitoring process to ensure that the legislative and enforcement provisions were being adequately administered by the 2.2 jurisdiction at a systemic level. This includes collecting information on the core income generating activities for the activity,

requirements for an adequate number of full-time employees with necessary qualifications and for an adequate amount of operating expenditures to undertake core income generating activities, enforcement mechanisms and statistics such as the aggregate numbers of entities, aggregate amount of income, employees and expenditure in that type of activity, and information on the number of entities which have been found to not meet the requirements. This information is used as a high level indicator as to whether the law or enforcement mechanisms are deficient and need to be remedied by the jurisdiction. Moreover, given the fact that the Global Forum initiated a close cooperation on the 2.2. issue, on site assessments on the adherence of the above standards by this forum could be an option.

The existing review documents (i.e. the self-review template and monitoring questionnaire) could be used, with slight adjustments to accommodate the analytical approach.

V. Further transparency requirements

Three requirements are set out below to enhance transparency. These draw on existing transparency initiatives related to both the EU and the OECD. Those requirements are not mutually exclusive and could be applied simultaneously by the 2.2 jurisdictions.

1 – Spontaneous exchange on specific risk issues

Spontaneous exchange of information has long been a part of the EU work and the FHTP framework for addressing harmful tax practices to better equip other countries to enforce their own tax laws and identify BEPS concerns. For example, in the FHTP context, specific requirements have been agreed for spontaneous exchange of information on tax rulings (including rulings related to preferential regimes), on certain features of IP regimes, and on downward adjustments.

In this vein, specific transparency requirements must be devised as a backstop to the substance requirements for 2.2 jurisdictions. The information filed by entities that are in scope (see Section "*Implementation by 2.2 jurisdictions and consequences for non-compliance*", fourth paragraph) must be spontaneously exchanged with EU members where either the legal or beneficial owner is tax resident, which then links also to the availability of legal and beneficial ownership information discussed below. The burden of proof whether substance criteria are met is on the taxpayer.

In these cases, it could be possible to use the FHTP transparency framework for spontaneous exchange of information on tax rulings. For example, the transparency framework sets out with which jurisdictions information must be exchanged, such as country of residence of related party which is on the other side of a relevant transaction, and the immediate parent and ultimate parent company. It would also be possible to design a standardised format for such exchanges, using a similar template and XML Schema as is used for the exchange on rulings and which was developed in cooperation with the EU).

2 – Beneficial ownership

The need for accurate and accessible beneficial ownership information is part of the international tax and anti-money laundering standards. EU Member States have been ambitious on this agenda, most recently in December 2017 by reaching political agreement on the Fifth Anti-Money Laundering Directive, which will ensure the creation of beneficial ownership registers in all EU Member States, as well as their interconnectivity and their access to the public under certain circumstances. This is the latest step in the wider strategy to achieve greater efficiency in access to ownership information, including through the Fourth Anti-Money Laundering Directive, the DAC 5, the regulation on the interconnection of corporate registers and initial scoping efforts at OECD's Working Party 10 with respect to the standardisation of the structuring of ownership information held in central repositories in electronically searchable form.

To further drive forward this agenda, a 2.2 jurisdiction could be required to ensure that every company or other body corporate created under its laws would be subject to enhanced transparency requirements that ensure that ownership information is available and accessible in a timely, accurate and electronically searchable manner. This could be done, for instance, by creating more efficient exchange of information on beneficial ownership through efficient access to registries being made accessible to designated authorities from participating jurisdictions.

As such, 2.2 jurisdictions would need to ensure that legal and beneficial ownership information in relation to bodies corporate is kept up to date and can be readily queried in an electronic manner, therewith allowing relevant international authorities to ascertain the ownership of an entity in a real-time or close to real time manner.

This would allow each 2.2 jurisdiction to keep its own, domestic repositories in place, while enabling the instantaneous query of ownership information across jurisdictions through, for instance, a single interconnected query platform.

In this context, 2.2 jurisdictions would be expected to have fully accurate legal ownership information in relation to their bodies corporate available in all instances, as well as to require that up-to-date beneficial ownership information be made available and kept up to date by bodies corporate, to the extent obtainable under domestic law and taking into account the circumstances of publically traded entities. In light of the experience in the EU of implementing enhanced access to beneficial ownership information, the implementation of the enhanced transparency requirements in 2.2 jurisdictions could be introduced in a staged manner to ensure the greatest quality and usability of the data, effectiveness of access agreements and so on.

More broadly, the efforts made at the EU level and with the 2.2 jurisdictions could be supported and expanded internationally including through ongoing work within through the OECD's WP10.

3 – Mandatory disclosure rules

The relevance of mandatory disclosure rules in the offshore tax avoidance and evasion field is now heightened, with the EU directive ("DAC6") and the approval of rules by Working Party 10 and Working Party 11 on mandatory disclosure rules for CRS Avoidance Arrangement and Opaque Offshore Structures. Building on this work, a third option for enhanced transparency would be to require 2.2 jurisdictions to introduce mandatory disclosure rules consistent with DAC6 and the OECD work. Given that many of the 2.2 jurisdictions were actively involved in the discussions in WP10 and WP11, they are already very familiar with these rules (and thus the equivalent hallmark D in DAC6).

These rules would require such promoters and service providers to disclose information on the arrangement or structure to the competent authority (which is identified in accordance with a test set out in domestic law on the basis of the one set out in DAC6).

Information on those schemes (including the identity of any user or beneficial owner) would then be exchanged with the tax authorities of jurisdiction in which the users and/or beneficial owners are resident in accordance with the requirements of the applicable information exchange agreement.