Countering Harmful Tax Practices - Considering Transparency and Substance

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Why the focus on HTP?

- Tax competition in the form of *harmful tax practices* can distort trade and investment patterns, erode national tax bases and shift part of the tax burden onto less mobile tax bases.
- Governments must intensify co-operation to curb harmful tax practices and avoid the race to the bottom - government deregulation of the business environment, or reduction in tax rates, in order to attract or retain economic activity in their jurisdictions.


INTERNATIONAL TAX SYSTEM
LETS GET TOUGH!!
LOW CORPORATION TAX

Background

- BEPS Action 5 on Harmful tax practices.

- Revamp the work on HTP by adopting and enhancing the 1998 OECD report on Harmful Tax Competition
- Enhancements include:
  - ✓ Increasing the membership from OECD members only to more jurisdictions
  - ✓ Strengthen the substantial activity requirement
  - ✓ Enhance the transparency requirement

- Concerned with geographically mobile activities
- The nature of these activities, globalization and innovation makes it easier to shift the from one country to another.

Current work on HTP

- Consideration of whether a regime is within the scope of work of the Forum on Harmful Tax Practices (FHTP) and whether it is preferential.
- Consideration of the 4 key factors and 8 additional factors set out in the 1998 report to determine whether a preferential regime is potentially Harmful.
- Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful.

Addresses:

- Geographically mobile activities
- Business taxation hence excludes consumption taxes

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

Assessment points:

1) Does it shift activity from one country to the country providing the preferential tax regime rather than generate significant new activity.
2) Is the presence and level of activity in the host country commensurate with the amount of investment?
3) Is the preferential regime the primary motivation for the location of an activity?

Acitivities within the FHTP Scope

- Headquarters
- Distribution centres
- Service centres
- Financing
- Leasing
- Fund management
- Banking
- Insurance
- Shipping
- Holding companies
- Provision of Intangibles

Preferential Regimes

- Regime must be preferential in comparison with the general principles of taxation in the relevant country and not in comparison with other countries.
- 4 underlying factors:
  1. Regime is ring fenced from the domestic economy
  2. Imposes low or no effective tax rates on income from geographically mobile and other service activities
  3. Regime lacks transparency i.e. details of the regime or its application of the regime are not apparent; inadequate regulatory supervision and inadequate financial disclosure
  4. No effective exchange of information mechanisms with respect to the regime.
- Harmful preferential regimes are designed to allow Taxpayers derive benefits from the regime while engaging in operations that are purely tax driven and involve no substantial activities.

8 additional Evaluation Factors for HTP Regimes

1. 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. Regime promoted as a tax minimisation vehicle
8. Regime encourages operation or arrangements that are purely tax driven and involve no substantial activities.

Discuss…

- ✓ Examples of Preferential Regimes in Kenya?
- ✓ Are they Harmful or Not?
- ✓ Impact of the Globe Proposal (Pillar 2)

Substantial Activity Requirement

- Profits are taxed where economic activities generating the profits are performed where value is created i.e. *Align taxation with value creation*.
- Grounded on the 12th factor – does it encourage purely tax driven operations or arrangements
- Elaborated in the context of BEPS-Aligning taxation with value creation
- Focuses less on ring fencing but more of corporate tax rate reductions on particular incomes

Consider this?

Is the presence and level of activities in the host country commensurate with the amount of investment or income?

Substantial activity requirement:

Identify:

1) Type of mobile activity being conducted
2) Relevant core income generating activities the entity has conducted
3) Amount and type of gross income
4) Amount and type of expenses and assets held
5) Number of full time, qualified employees and their roles

Mainly addressed 2 BEPs structures

a) IP Regimes
b) Cash boxes

Intellectual Property (IP) Regimes

- IP intensive industries are a key driver of growth and employment yet raise a lot of BEPS concerns.

To evaluate whether the income qualifies for benefit: Nexus approach

- Grant benefits only to income that arises from the IP where the actual Research and Development (R&D) activity was undertaken by the taxpayer itself.
- As long as there is a direct nexus between the income receiving the benefits and the <u>qualifying expenditure</u> contributing to that income benefits would be granted.
- This ensures that benefits are only granted to those entities that should benefit.
- Acquired IP – Only improvements after acquisition qualify

IP Regimes Continued:

Income Receiving benefit

$$= \frac{\text{Qualifying expenditure}}{\text{Total R\&D expenditure}} * \text{IP income}$$

Cash Boxes

Taxable Profits

HQ

Return

Cash Box

- ✓ **Financial contract**
- ✓ **License Contract**
- ✓ **Service contract**

- Dividends
- Royalties
- Interest

Activity

Outcomes: Dealing with Cash Boxes

Transfer Pricing

✓Accurate delineation of the transaction

✓Does cash box control the risks in relation to the tangible or intangible asset?

✓Does the cash box control financial risks in relation to the funding?

Risk free rate of return.

Cash Boxes Continued:

Alternative building blocks, e.g.

- Thresholds

CFC Income

i. Categorical analysis
ii. Substantive analysis
iii. Excess profit analysis

Under (i) and (ii) HQ may be subject to additional tax

Interest Deductibility:

- **Facilitate the convergence of national rules**
- Determine excessive interest:

interest over certain interest: income ratio

Cash Box Cont":..

Treaty Abuse

- ✓**Introduction of a minimum standard preventing treaty abuse**

Will Cash box be entitled to treaty benefits?

1. Limitation on Benefits & PPT; or
2. Principal Purpose Test Rule; or
3. LOB supplemented by anti conduit rule.

Overall Effect:

All measures combined

- Deterrent effect

- **Alignment taxation and value creation restored**

Improving Transparency through Compulsory Spontaneous Exchange of Information

- Lack of transparency makes it hard for the home country to take defensive measures.
- Spontaneous exchange on rulings related to preferential regimes is a requirement in dealing with HTP.

Ruling Defined:

"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 on"

Transparency Cont..

- Lack of transparency could be in 2 forms:

1. Design and administration of the regime –
   - ✓favourable application of laws and regulations:
   - ✓Negotiable tax provision
   - ✓Failure to make administrative practices widely available

2. Existence of provisions such as secrecy laws or inadequate ownership and other information requirements that would prevent effective exchange of information

Enabling laws for EOI:

1. Tax Treaties
2. Convention on Mutual Administrative Assistance in Tax Matters (MAC) – Multilateral instrument.

Current Status

- As at July 2019 – 255 regimes reviewed

Details	Number
Harmful	2
Potentially Harmful	5
Potentially Harmful but not actually harmful	6
Not operational	5
Under review	28
In the process of being eliminated/amended	14
Not harmful (amended)	47
Abolished	63
Out of scope (amended)	4
Out of scope	23
Disadvantaged areas	3
Not Harmful	55
Total	**255**

The End