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Subject: Code of Conduct (Business Taxation)
– Guidance on the interpretation of the third criterion

Delegations will find in Annex the Guidance on the interpretation of the third criterion of the Code of Conduct (Business Taxation), as endorsed by the Council at its meeting held on 22 June 2018 (see doc. 10373/18).

Guidance on the interpretation of the third criterion of the Code of Conduct for business taxation

1. Purpose of the Guidance

The guidance set out below is based on past decisions of the Code of Conduct Group and is intended to improve the transparency of the Code of Conduct Group's work. It is also intended to help Member States as well as third countries identify more easily potentially harmful tax measures.

The guidance neither replaces the principles and criteria of the Code of Conduct nor prejudices the harmfulness of any particular regime. The guidance presents a non-exhaustive list of elements and characteristics which indicate that a tax measure may be harmful when fully assessed against the criteria in the Code of Conduct. Every assessment will continue to be based on the five criteria of the Code of Conduct on a case-by-case approach.

The purpose of the text is to provide guidance on the application of the criteria in the Code of Conduct but it does not go beyond those criteria nor does it limit them. The guidance can never provide a safe harbour for a particular regime. A tax measure that is the object of particular scrutiny or that requires particular attention under the guidance may be found non-harmful by the Code of Conduct Group; likewise a measure that is not the object of particular scrutiny or that does not require particular attention under the guidance may be found to be harmful when assessed by the Group.

The purpose of the guidance is not to confine the Group to applying pre-determined general criteria; rather it should continue to subject each particular regime to a case-by-case examination against the Code of Conduct criteria in the light of the Group's guiding principles set out in document 16410/08 FISC 174.

2. Relationship with past assessments

Past assessments, and regimes for which the Group has agreed in the past that there was no need to assess, will not be affected by the guidance. Regimes that have not been considered by the Group can be reviewed on the basis of this guidance. The current procedure for reopening past assessments remains in place.

3. Review of the Guidance

The countering of harmful tax measures is an ongoing process; therefore the guidance notes could be periodically reviewed by the Code Group to ensure that they reflect future developments.

4. Guidance

1. Real economic activity

When

- a regime grants tax benefits to activities such as manufacturing or production,
- the qualifying activities necessary to benefit from the regime do not include any highly mobile activities, or
- the benefits of the regime are directly linked to investment in tangible assets¹,

the regime does a priori not raise concerns under criterion 3 of the Code of Conduct. It would not need to be assessed regarding a substantial economic presence. It would however still need to be subject to an analysis under the nexus requirement.

When

- a regime does not specify a requirement that activities need to be considered as real economic activities in order to qualify for tax benefits,
- there is an express obligation in a regime that business should be conducted outside the state or territory or there is a de jure or de facto obstacle to conduct such business inside,
- a regime can be considered to be designed to attract highly mobile capital, or
- a regime allows an activity that may under certain circumstances be considered not to constitute a real economic activity

the regime may a priori not be regarded as requiring real economic activity and needs to be further analysed concerning the requirements of the regime for substantial economic presence which should be relevant to the regime type.

¹ The investments qualifying for the incentive are long-term investments in the fixed assets (buildings, constructions, technical equipment and facilities) that are used for the performance of economic activities of the company.

In particular, certain types of activities are likely to need such further analysis. These activities could for instance be the following:

- Certain financial services, including intra-group financial services²;
- Intra-group captive insurance³;
- Intra-group holding activities^{4 5}, excluding pure equity holding companies⁶ which only hold equity participations and earn only dividends and capital gains or incidental income; or
- Co-ordination centres⁷.

This list is neither absolute nor exhaustive. Every assessment against the third criterion of the Code of Conduct will continue to be based on a case-by-case approach, taking into account the specific nature of the regime.

2. Substantial economic presence

If the analysis under 1 raises doubts as to whether the activities that are covered by a regime constitute real economic activities, an analysis of the requirements for substantial economic presence should be performed.

² The income generating activity could cover agreeing on funding terms, monitoring and revising agreements and managing risks.

³ The income generating activity could cover predicting and calculating risk, insuring or re-insuring against risk and providing client service.

⁴ The income generating activity could be such that is associated with income from for instance interest, rents and royalties

⁵ In the 1999 "Code of Conduct Group report" the following is stated in paragraph 48: "*The Group noted that there can be commercial reasons why a multi-national enterprise may have a particular holding company within its corporate structure. But the Group also noted that many holding companies are set up wholly or mainly for tax planning reasons. In particular, holding companies may be used as a tax efficient holding point for profits or as a tax efficient conduit. Holding companies that are tax-driven normally have little or no economic substance, and may be no more than brass plate companies. They are therefore potentially highly mobile, and business taxation measures can have a significant effect on their location in the Community.*"

⁶ Pure equity holding companies must respect all applicable corporate law filing requirements in order to meet the substantial activities requirement and it is suggested that they should have the people and the premises for holding and managing equity participations. Since such regimes are provided to avoid double taxation, there should be no expectation of a correlation between income-generating activities and benefits.

⁷ The income generating activity could cover taking relevant management decisions, incurring expenditure on behalf of group entities and co-ordinating group activities.

The main elements of this analysis to be carried out by the Code of Conduct Group are requirements for an adequate number of employees with necessary qualifications and an adequate amount of operating expenditure with regard to the core income generating activities (see for example footnotes 2-4 and 6-7).

The analysis of the two above-mentioned requirements can where appropriate take into account one or more of the following factors that may be present in the national regime:

- a statistical analysis of the average number of employees, where account would also need to be taken of the nature of the activities, e.g. whether it is a capital or labour-intensive industry;
- an analysis of whether the requirement of the regime is for full-time or part time jobs;
- an analysis of whether the regime requires that the qualifications of employees are related or adapted to the nature of the activity benefiting from the regime;
- an analysis of quantitative and qualitative aspects of the management and the administration of the entity;
- an analysis of the character of premises for the activity at issue and whether they are adequate for such activity (for instance investments made to carry out the activity concerned, the organizational structure including a management of resources consistent with the nature of the activity).

The list of factors above should not be seen as exhaustive.

Since every regime has different features, consideration of how the economic presence requirement applies must take place in the context of the regime being considered. As such, the degree of substantial economic presence that may be appropriate for one regime will not necessarily be adequate in the context of another regime. Due consideration could also be given to assessments carried out by the FHTP of the regime in question, where appropriate.

3. Nexus requirement

There should be an adequate de jure and de facto link between real economic activity carried on by entities covered by the tax privilege at issue and the profits for which that benefit is granted.

5. Audit requirements

Taking into account the potential risks, there should be tax audits verifying that the activities of the entities benefitting from the regime at issue meet the requirements of this Guidance.

These audits should be carried out regularly on a similar basis as that generally applied in the Member State in question.

6. Monitoring of regimes

Regimes that have been subject to an assessment based on this guidance will be monitored on their substance requirements. Regimes for which the Group has agreed before this guidance enters into force that there was no need to assess them or that have been assessed not harmful, will not be affected by the monitoring.

Such monitoring will consist for Member States as well as third countries of providing each year to the Code of Conduct Group data that shows how in practice regimes are implemented and that the core income generating activities are undertaken by the taxpayer. On the basis of the data provided, or its absence, the Code of Conduct Group may decide whether it is appropriate to reopen a review of the regime concerned.

The following data should be provided⁸:

- the number of taxpayers applying for the regime,
- the number of taxpayers benefiting from the regime,
- the type of core activities undertaken by taxpayers benefiting from the regime,
- the quantity of core activities undertaken by taxpayers benefiting from the regime (as measured by the number of full-time employees⁹ with necessary qualifications and the amount of operating expenditures associated with these activities),
- the aggregate amount of net income benefiting from the regime (as discussed above, for regimes which do not have income reporting because they implement a non-income based tax in place of income tax or where such data is not collected as part of the tax return or is not otherwise easily obtainable, accounting profits or other similar statistics can be reported instead), and
- the number of taxpayers, if any, that no longer qualify for benefits in whole or in part under the regime.

As a case-by-case approach is the basis of the Code of Conduct Group's work, the data that needs to be provided each year shall be adapted to the individual regimes concerned. The Code of Conduct Group may specify the type of data to be communicated before the end of the assessment of the regime concerned. Such data requirements may also be modified on request by the Code of Conduct Group at any time during the monitoring procedure.

⁸ The monitoring provided in the following bullet points would be carried out for fiscal years commencing in 2019. For earlier years, countries would be asked to report data points that they have available, which would be collected together with other data points on monitoring.

⁹ The number of full-time employees could include the part-time employees, whose aggregated working hours is divided by full-time work hours.

In order to reduce administrative burden and avoid double work, monitoring should be coordinated with the parallel monitoring by the OECD Forum on Harmful Tax Practices to the extent that is relevant.

In order to reduce the administrative burden of collecting the required information, monitoring would be required only with respect to taxpayers that are members of multinational enterprise groups with annual revenues in the preceding year of EUR 750 million or more, unless decided otherwise by the Code of Conduct Group with a view to particular risks. Moreover, monitoring will not be required if the small number of taxpayers benefitting from a regime means that provision of the above information would have the effect of disclosing the identity of the taxpayer, and jurisdictions could establish de minimis exceptions to the monitoring requirement to prevent such disclosure. Finally, pure equity holding companies would not be subject to this type of monitoring for the reasons discussed above.
