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From:	General Secretariat of the Council
To:	Delegations
Subject:	The EU list of non-cooperative jurisdictions for tax purposes • Guidance on foreign source income exemption regimes

Delegations will find in the annex the guidance on foreign source income exemption regimes, endorsed by the Council at its meeting held on 10 October 2019.

ANNEX

Guidance on foreign source income exemption regimes

On 20 May 2019, the Code of Conduct Group (COCG) agreed on an approach to assess foreign sourced income exemption regimes. Based on this approach, these guidelines should provide direction for jurisdictions that have already taken a commitment to amend their foreign source income exemptions, due to harmful features identified by the COCG. The guidelines will also serve as a basis for the screening of other jurisdictions with similar regimes before the end of 2019.

Foreign source income exemption regimes, or regimes that charge corporate tax on a territorial basis are not, in themselves, problematic. In fact, exempting foreign profits is acceptable and even recommendable, in certain cases, to prevent double taxation. However, problems arise when such regimes not only prevent double taxation, but also create situations of double-non taxation. This is particularly the case for regimes that have (i) an overly broad definition of the income excluded from taxation, notably foreign source passive income without any conditions or safeguards, and/or (ii) a nexus definition that is non-compliant with the definition of a permanent establishment in the OECD Model Tax Convention.

The COCG has assessed such regimes in the past and has drawn on COCG precedents as the basis of this guidance. Past assessments will not be affected by this guidance. Regimes that have not been reviewed by the COCG can be reviewed on the basis of this guidance and the criteria of the Code of Conduct. The current procedure for reopening past assessments remains valid.

Passive Income

In 2017, the COCG found that a tax system that fully excludes passive income with a foreign link from taxation, without any conditions, is harmful. This is the case even if the profits are determined using internationally established principles, as the end effect is the same as a regime providing beneficial treatment. for low/no substance offshore companies.

Foreign source exemption regimes that are broad enough to include passive income, without any conditions, can result in ring-fencing and a lack of substance. Ring-fencing arises because the receipt of passive income generally requires a transaction with a non-resident. Passive income is generally not coupled with economic substance requirements. The COCG has found that the exemption of passive income without clear conditions (e.g. explicit link to some real activity in the jurisdiction) contravenes the principles of the Code.

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.

In particular, 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.

The analysis will therefore focus on the definition of the income deemed to have its source in the jurisdiction, as this will determine whether or not the business income is taxed according to international principles. This analysis will look at whether the jurisdiction applied a definition of Permanent Establishment in line with that of the OECD Model Tax Convention. This is the internationally agreed principle to assess the economic presence of an entity in another jurisdiction, to determine the allocation of the right to tax.

Options for remedying harmful foreign income exemption regimes

Jurisdictions with foreign source income exemptions regimes that are considered harmful should either abolish the regimes in question or amend them to remove the harmful features.

Jurisdictions should either:

- Introduce taxation of passive income; or
- if they exclude from taxation certain types of passive income:
  - implement adequate substance requirements to the entities concerned, in line with the EU's Code of Conduct (Business Taxation)[1];
  - have robust anti-abuse rules in place; and
  - 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 OECD Model Convention on Double Tax Treaties (including by amending the definition of permanent establishment in a DTA in place already that does not respect international principles) and the consequent income allocation.

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[1] Where jurisdictions are being assessed under Criterion 2.1, the substance requirements in the COCG guidance on the interpretation of the third criterion (doc. 10419/18) should apply. Where jurisdictions are being assessed under Criterion 2.2, the substance requirements in the COCG scoping paper on criterion 2.2 (doc. 10421/18) should apply.

As each of these regimes has its own specificities, the COCG agreed that the Commission services should work with the jurisdictions in question to clarify the areas of concern. Solutions should be developed based on the guidelines above, to address the specific issues identified by the COCG for each regime. Accordingly, this Guidance should not be treated as a stand-alone document and should be accompanied by technical advice and interaction with the jurisdictions under review.

Review

The countering of harmful tax measures is an ongoing process. This guidance note will therefore be periodically reviewed by the COCG to ensure that it reflects future developments.