EU starts to review foreign source income exemption regimes and recommends EU blacklist defensive measures

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In brief

The EU (via the Economic and Financial Affairs Council or ECOFIN) invited the Code of Conduct Group (CoCG) on December 5, to start reviewing foreign source income exemption regimes and endorsed its recommendations related to defensive measures against uncooperative tax jurisdictions. Nine jurisdictions' exemption regimes initially will be considered for harmful elements. There are currently eight other jurisdictions on the blacklist of uncooperative jurisdictions, although the list will be reviewed in light of commitments by additional jurisdictions to make changes by December 31, 2019. The main deadline the COCG recommends for EU Member States to introduce at least one of the recommended defensive measures is January 1, 2021. A number of the measures have features similar to some of the proposals put forward under Pillar 2 of the digitalisation/globalisation project being considered by the G20/OECD Inclusive Framework.

In detail

Foreign source income exemption regimes

The CoCG provided guidance in October 2019, for those jurisdictions that provide an exemption for foreign source income, in relation to the interpretation of the criteria previously established for determining harmful tax regimes. Some jurisdictions already had committed to various incentives as part of broader substance requirements to avoid being on the EU blacklist; these jurisdictions have been, or currently are being reviewed. Note that the blacklist criteria were considered in our Tax Policy Bulletin of July 26, 2018, while an indication of regimes that have already been considered for harmfulness was set out in Annex 1 to the list of agreed CoCG guidance 1998-2018 and guidance on notional interest deduction regimes was added in Annex 2 to the Council Secretariat note of 25 November 2019. Other incentives have since been identified by the CoCG as foreign source income exemptions that potentially could be harmful.

The order of reviewing newly identified regimes, as identified in the November 25, 2019 Report published on December 5 alongside the press release and outcome of the ECOFIN Meeting on that date, is set out below (the number after each jurisdiction identifies the particular regime, and also the number of previous incentive regimes the CoCG has considered for that jurisdiction):

- the CoCG will initially focus on the nine jurisdictions with such incentives that are either developed countries or developing countries with a financial centre - Costa Rica (CR003), Hong Kong (HK009), Malaysia (MY015), Nauru (NR001), Panama (PA008), Qatar (QA004), Singapore (SG013), Uruguay (UY008) and Samoa (WS002).
- the foreign source income exemptions that have been identified in four developing countries that do not have a financial centre first will be discussed with the jurisdictions concerned and assessed in a second stage - Botswana (BW002), Maldives (MV002), Namibia (NA003) and Eswatini (SZ002).

The guidance is in Annex 2 to the Council Secretariat note of October 4, 2019 published on October 10, 2019 alongside the press release and outcome of the ECOFIN Meeting on that date. The focus for what is particularly harmful is on regimes that have:

- an overly broad definition of the income excluded from taxation, notably foreign source passive income without any conditions or safeguards, and/or
- a nexus definition [active income] that is non-compliant with the definition of a permanent establishment in the OECD Model Tax Convention.

If jurisdictions exclude from taxation certain types of passive income, the guidance suggests that they should:

- implement adequate substance requirements to the entities concerned, in line with the CoCG's guidance in that regard
- have robust anti-abuse rules in place, and
- remove any administrative discretion in determining the income to be excluded from taxation.

Observation: Jurisdictions whose foreign source income exemptions are being reviewed or will be reviewed should begin to assess their compliance with the criteria identified. If they want to keep a regime of that type and ensure it is not identified as being harmful, they could consider relevant modifications. A jurisdiction could be elevated to the blacklist if it has just one regime which is regarded as harmful.

Blacklist defensive measures

The CoCG has been discussing defensive measures that Member States could take against jurisdictions on the blacklist ever since the list was started and initial thoughts on countermeasures were considered (see Council conclusions of December 5, 2017). At that time the following administrative measures were stipulated:

- reinforced monitoring of certain transactions
- increased audit risks for taxpayers benefiting from the regimes at stake, and
- increased audit risks for taxpayers using structures or arrangements involving these jurisdictions.

A reversed burden of proof was then described as a measure that could be considered along with a list of other possibilities.

Some measures apply more broadly to blacklist jurisdictions as a result of non-tax regulations on topics such as the European Fund for Sustainable Development, the general framework for securitisation and the European Fund for Strategic Investments.

The tax Directive on mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (DAC6) also has stricter reporting obligations for a deductible cross-border payment made to an associated enterprise resident in a blacklist jurisdiction - there is no tax main benefit requirement compared to, say, a similar payment to a resident in another jurisdiction that has a zero or low tax rate.

The new guidance on defensive measures is in Appendix 4 of the November 25 note, as discussed above. There is an overriding requirement to apply an appropriate mix of minimum level legislative - not administrative or burden of proof - measures. Those should ensure meeting the objectives of “encouraging a positive change leading to the removal of jurisdictions from the list (and preventing using the legislation, policies and administrative practices of listed jurisdictions for aggressive tax planning, evasion or abuse).” The legislative measures set out are:

- non-deductibility of costs - including "for example interests, royalties and other concessions on intellectual property (IP) assets and service fees"
- Controlled Foreign Company (CFC) rules - including adjusting [as necessary, including where ATAD compliant] to ensure the rule has the required effect above, potentially depending on the regime "for example, not applying exemptions based on ATAD Article 7(3) or (4) when these are applied to non-listed jurisdictions, including all income of the controlled foreign company in a listed jurisdiction instead of applying ATAD Article 7(2)(a) or (b), applying a lower ownership threshold or a higher effective tax rate test than the one applied for non-listed jurisdictions"
- withholding tax measures - at a higher rate for example on payments such as interest, royalties, service fee or remuneration or alternatively or in combination with this measure Member States could consider applying specific targeted withholding tax on such payments, and
- limitation of participation exemption on profit distribution - more stringent towards taxpayers as compared to the rules otherwise applicable (e.g., under the Parent-Subsidiary Directive).

The deadline for Member States to introduce at least one of the legislative defensive measures is generally 1 January 2021. However, the CoCG took note that some Member States, due to the nature and content of defensive measures and the national rules on enactment of laws, might face genuine institutional or constitutional issues in legislating that quickly. In that case, it recommends consideration of a July 1, 2021 deadline.

The eight jurisdictions currently on the blacklist are: American Samoa, Fiji, Guam, Oman, Samoa, Trinidad and Tobago, the US Virgin Islands and Vanuatu.

Observation: Jurisdictions that are on the blacklist will want to assess the impact of any defensive measures being adopted and follow closely the intentions of EU Member States in adopting any of the measures. Those jurisdictions currently on the greylist of jurisdictions that have made commitments to change their tax systems will also want to take note, the critical timing being if and when the EU were to move them from the greylist to the blacklist for failure to meet their commitments. There is some duplication but also an increased risk of double taxation when comparing these measures with proposals being discussed by the G20/OECD Inclusive Framework under Pillar 2 of the digitalisation/ globalisation project. At least some of the income inclusion, undertaxed payment, treaty subject to tax and exemption/credit switch-over options of those Global Anti-Base Erosion (‘GloBE’) proposals are likely to be agreed in 2020 for implementation from 2021 (see further our Tax Policy Alert of November 8, 2019 and the PwC response to the OECD on those proposals).

Commitments to be fulfilled by December 31, 2019

The November 25 Council note, discussed above, also provides the latest formal update to the CoCG assessments of jurisdictions’ commitments. This includes the scheduled due dates for those commitments. The most immediate deadlines are for December 31, 2019, although the CoCG may need additional time to assess the situation and recommend whether a jurisdiction should be given additional time or be put on the blacklist.

The jurisdictions with commitments to be met by December 31, 2019 are, according to the Council Secretariat note of October 4 above:

Criterion (broadly)	Jurisdictions
1.1 Automatic exchange of information (EOI)	Palau and Turkey

1.2 Membership of the Global Forum (on tax and transparency) and a satisfactory rating for EOI on request	Jordan, Palau, Turkey and Vietnam (Anguilla, Marshall Islands and Curaçao had earlier commitments but the Global Forum has not yet rated them)
1.3 Agreement to share tax information - multilaterally or bilaterally with all EU Member States	Armenia, Bosnia and Herzegovina, Botswana, Cabo Verde, Eswatini, Jordan, Maldives, Mongolia, Montenegro, Namibia, Republic of North Macedonia, Palau, Thailand and Vietnam
2.1 Existence of specified harmful tax regimes	Antigua and Barbuda, Australia, Cook Islands, Curaçao, Maldives, Morocco, Namibia, Saint Kitts and Nevis, Saint Lucia and Seychelles
2.2 Substance requirements	Bahamas, Barbados, Bermuda, British Virgin Islands and Cayman Islands
3.1 Member of the OECD's Inclusive Framework on BEPS	Jordan and Montenegro

Observations: Some of the commitments made and the potential consequences of not meeting those commitments have not been very high profile. This has been exacerbated by the cross-over between certain regimes being reviewed by the OECD-led Forum on Harmful Tax Practices (FHTP) assessing the regime rather than the CoGC, e.g., Australia's 'Offshore banking unit' and Jordan's 'Development Zone.' Where a jurisdiction has been in active discussions with the EU CoCG (or the FHTP) there is a greater likelihood that additional time may be granted beyond the December 31, 2019 deadline.

The takeaway

The CoCG and its subgroup on external issues (non-Member States), meet regularly before submitting recommendations for ECOFIN endorsement and subsequent adoption by Member States.

They have agreed guidance in recent months on interpretation of how to address the harmful nature of foreign source income exemptions. This will be of great interest to non-EU jurisdictions already being assessed on such regimes and those now identified for future review. They may need to consider justification of their existing rules or the need for changes in order to continue with a regime of that nature without EU sanctions.

Non-EU jurisdictions that have committed to reforms in order to stay off the EU's blacklist of uncooperative tax jurisdictions will need to discuss whether they have met December 31, 2019 deadlines. Jurisdictions already on the blacklist (or likely to be added to it), will need to assess the impact of, and monitor, EU Member States' adoption of recommended defensive measures.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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