Thou Shalt do no 'Potential or Actual Harm'- High 'NooN' Time for Gibraltar: Why the EU Clock isn't Ticking for this Jurisdiction's SAR

Introduction

If the Base Erosion and Profit Shifting Project were to create its own set of 10 Commandments, two of the commandments could be: 'thou shalt do no actual harm' and 'thou shalt do no potential harm'. Being classified as potentially harmful and or actually harmful is the third step to determine whether a tax regime is considered a 'harmful preferential regime' in accordance with the requirements laid out in the 'Harmful Tax Competition: An Emerging Global Issue' (the "**1998 Report**"). Once a regime is considered a 'harmful preferential regime' then it is normally pressured to modify its tax code by rolling back the harmful aspect(s). In the late 2010s, the substantial activities requirement ("**SAR**"), deriving from the 1998 Report, was extend to tax regimes which levied 'no or only nominal tax rates' ("**NooN(s)**") (technical term for a tax haven). The tax regimes which were considered harmful were name and shamed, such as BVI and Cayman. To avoid being grey or black listed, these jurisdictions took it upon themselves to introduce the SAR into their tax codes. Interestingly, Gibraltar, however, was not considered a NooN, and was not required to introduce the SAR into its tax code. This essay will explore why that is and argue that it has not been required to so for the very simple reason that it is not categorised as a 'harmful preferential regime'. This essay will first explore the backdrop that firstly brought about the SAR and also the extension of the rules to NooNs. After that, this essay will analyse the requirements to be considered a harmful preferential regime, before moving on to explore why and how the SAR were extended to NooNs. Thereafter, this essay will analyse why Gibraltar is not deemed a preferential harmful regime and therefore not subject to the SAR.

Background

In May 1996 at roughly the same time STS-77 was launched into orbit with its famous Coca-Cola fountain dispenser (spoiler! it required troubleshooting), the Ministers of the Organisation for Economic Co-operation and Development (the "**OECD**") called upon the OECD to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998"[1]. In 1998 report back they did. Over the two days' conference in April 1988, the OECD published its infamous 1998 Report. The 1998 Report, in part, looked at harmful preferential tax regimes with the fourth key factor as being identifying tax havens with 'no substantial activities'. The 1998 Report states "the absence of a requirement that the activity be substantial is important since it would suggest that a jurisdiction may be attempting to attract investment or transaction that are purely tax driven"[2]. At the same time, the OECD tasked the Forum on Harmful Tax Practices (the "**FHTP**") to analyse and observe the preferential tax regimes' tax practices.

Some time on, in 2015, the OECD published its 'Countering Harmful Tax Practices More Effectively - Taking into Account Transparency and Substance Action 5 Final Report' (the "**2015 Action 5 Report**"). The Action 5 Report committed the FHTP to: "Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the

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[1] OECD, Harmful Tax Competition: An Emerging Global Issue (1st edn, OECD 1998) 1
[2] OECD, Harmful Tax Competition: An Emerging Global Issue (1st edn, OECD 1998) 24

existing framework"[3]. Two years later, in October 2017, the OECD published its 'Harmful Tax Practices – 2017 Progress Report on Preferential Regimes' (the "**2017 Progress Report**"). The 2019 Progress Report published its review of 164 preferential regimes against compliance with BEPS Action 5.

With economic substance being back in the spotlight in regard to preferential regimes, the OECD decided to pick back where it had left off with the SAR laid out in the 1998 Report for NooNs. With that in mind, in in November 2018, the Inclusive Framework ("**IF**") on BEPS Action 5 published the 'Resumption of Application of Substantial Activities Factor to NooNs' (the "**2018 ESR Report**") and proclaimed that SAR as stated in the 1998 Report and laid out in Chapter 4 of the 2015 Action 5 Report would be extended to NooNs. Below, we will explore these requirements in greater detail, before moving on to analyse why and how the SAR were extended to NooNs.

The Gateway – Harmful Preferential Regimes

The 2015 Action 5 Report confirmed that the SAR "used to assess preferential regimes should be strengthened in order to realign taxation of profits with the substantial activities that generate them"[4].

However, Action 5 only applies the SAR to 'harmful preferential regimes'. To determine whether a jurisdiction is classed as a 'harmful preferential regime' the following three questions must be analysed:

(1) "Consideration of whether a regime is within the scope of the work of the FHTP and whether it is preferential;

(2) Consideration of the four key factors and eight other factors set out in the 1998 Report to determine whether a preferential regime is potentially harmful;

(3) Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful."[5]

The following requirements will now be explored in more detail.

(1) <u>Whether within the FHTP's scope - determining preferentiality</u>

<u>Scope</u>

First, for a jurisdiction to be in scope, the jurisdiction must first apply to income stemming from "geographically mobile activities, such as financial and other service activities, including the provision of intangibles".[6]

Secondly, "the regime must relate to the taxation of the relevant income from geographically mobile activities. Hence, the work is mainly concerned with business taxation"[7]…"while consumption taxes are excluded"[8].

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[3] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 11

[4] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 9

[5] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 19

[6] OECD, Harmful Tax Competition: An Emerging Global Issue (1st edn, OECD 1998) 9

[7] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 19

[8] OECD, Harmful Tax Competition: An Emerging Global Issue (1st edn, OECD 1998) 9

Preferentiality

For a tax to be considered preferential, it must be preferential by comparison to the same tax that would have been levied in the same jurisdiction. Preferentiality comes in many shades and may include “a reduction in the tax rate or tax base or preferential terms for the payment or repayment of taxes”[9]. The smallest amount of preferential treatment is enough to trigger this requirement. The key aspect is that the regime “must be preferential in comparison with the general principles of taxation in the relevant country and not in comparison with principles applied in other countries”[10]. The classic example that Action 5 gives is where “the rate of corporate tax applied to all income in a particular country is 10%, the taxation of income from mobile activities at 10% is not preferential”[11]. While the rate of 10% may not be Pillar 2-ETR compliant, the point is that 10% is levied on all profits equally and does not differentiate geographically mobile activities, and therefore, the 10% rate would not be deemed preferential even though the CT rate is significantly lower than another jurisdiction.[12]

(2) *Four key factors and eight other factors – ‘thou shalt do no potential harm’*

Four key and eight other factors are utilised in determining whether a ‘preferential regime’ (discussed above) is ‘harmful’. The Action 5 Report already notes that “a reference to substantial activity is already included in the eight other factors so this is not a new concept”[13]. Factor A. has to be satisfied + any other Factor between B. and L for the regime to be classed as ‘potentially harmful’, so **A + (B-L)**.

The four key factors

A. “The regime imposes *no or low effective tax rates on income* from geographically mobile financial and other service activities.
B. The regime is ring-fenced from the domestic economy.
C. The regime lacks transparency (for example, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).
D. There is no effective exchange of information with respect to the regime”[14].

The eight other factors

E. “An artificial definition of the tax base.
F. Failure to adhere to international TP principles.
G. Foreign source income exempt from residence country taxation.
H. Negotiable tax rate or tax base.
I. Existence of secrecy provisions.
J. Access to a wide network of tax treaties.
K. The regime is promoted as a tax minimisation vehicle.

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[9] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 19

[10] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 20

[11] Ibid.

[12] Ibid.

[13] Ibid.

[14] Ibid.

L. The regime encourages operations or arrangement that are purely tax-driven and in involve no substantial activities"[15].

For a jurisdiction to be deemed 'harmful' the first key factor is that the regime imposes 'no or low effective tax rates on income'. This is the first step and if not met, then the regime is not considered harmful.

Only if the regime satisfies the first key factor of 'no or low effective tax rates on income' then "an evaluation of whether that regime is potentially harmful should be based on an overall assessment of each of the other three 'key factors' and, where relevant, the 'other factors'. Where low or zero effective taxation and one or more of the remaining factors apply, a regime will be characterised as potentially harmful"[16].

(3) Determining whether 'potential harm' equates to 'actual harm' – thou shalt do no actual harm

Just like in competition law, where once the undertaking has been deemed 'dominant' then it must be proven that not only is it dominant, but it is 'abusing' its dominant position, so too, a tax regime can be classified as 'potentially harmful' but not be 'actually harmful' if "it does not appear to have created harmful economic effects"[17].

The Action 5 Report asks three questions which act as a guide when determining whether a 'potentially harmful' regime is 'actually harmful':

A. "Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?
B. Is the presence and level of activities in the host country commensurate with the amount of investment or income?
C. Is the preferential regime the primary motivation for the location of an activity"[18].

Once a thorough economic analysis has been undertaken to determine a regime's harmful economic effect, then it can be categorised as a 'harmful preferential regime'.

Action 5 Report notes that "where a preferential regime has been found to be actually harmful, the relevant country is given the opportunity to abolish the regime or remove the features that create the harmful effect. Other countries may take defensive measures to counter the effects of the harmful regime, while as the same time continuing to encourage the country applying the regime to modify or remove it"[19].

In summary, a regime can be potentially harmful as long as it is not actually harmful. Next this essay will briefly look at the SAR and why it was extended to NooNs.

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[15] Ibid.
[16] Ibid.
[17] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 21
[18] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 21 and OECD, Harmful Tax Competition: An Emerging Global Issue (1st edn, OECD 1998)
[19] Ibid.

Substantial Activities Requirement- extended to NooNs

In 2018, the SAR stemming from the 1998 Report, was extend to NooNs (the "**2018 ESR Report**"). It is understandable why the SAR was extended to NooNs because until the creation of the BEPS Action Plan, "which elevated the substantial activities requirement as it applied to preferential regimes…it left the analytical framework underlying the BEPS Action 5 work exposed to a potential incoherence: the substantial activities criterion has now been elevated as a key factor in one pillar of the work and is being applied, whereas it is not being applied in the pillar of the work despite having been included as a key factor in the 1998 Report"[20]. Therefore, the 2018 ESR Report clearly explains that "given the elevation of the substantial activities requirement in the work on preferential regimes as part of the BEPS Project, it was appropriate to resume the application of the substantial activities requirement set out in the 1998 Report for NooNs and provide guidance on the application of the requirement"[21]. By the SAR not being applied to NooNs it created a loophole whereby businesses with geographically mobile income could relocate to a NooN avoiding the SAR applied to preferential regimes.

Scope

The SAR applies to jurisdictions which do not levy a corporation tax or only levy a nominal rate. The reason nominal rate jurisdictions were included was to prevent a jurisdiction that did not levy a corporation tax changing its corporate tax levy to a nominal rate thereby bypassing the requirement of 'no tax being levied'.

The following types of activities were within the scope of the 1998 Report. These are "geographically mobile activities, such as financial and other service activities, including the provision of intangibles. The FHTP has typically identified these types of mobile activities as falling into the categories of headquarters, distribution centres, service centres, financing, leasing, fund management, banking, insurance, shipping, holding companies and the provision of intangibles"[22].

Where the above activities are in scope, then the SAR will apply to them. Generally speaking, substantial activities can be separated into two categories: earnings stemming from IP and non-IP activities. IP activities will not be explored in this essay.

Where earnings stem from non-IP income, the legislation then imposes the following requirements on an entity tax registered in a NooN engaging in an in-scope activity:

(1) *The Management Test*

This test requires that the entity be managed and directed in the jurisdiction where the in-scope activities are being carried out. Commonly this will include the board minutes being carried out in the NooN and importantly ensuring the meeting is quorate with the right people, and that the directors contribute and discuss the decisions that need to be made and do not just rubber stamp the resolutions.

(2) *Core Income Generating Activities Test*

[20] OECD, Resumption of Application of Substantial Activities Factor to No or only Nominal Tax Jurisdictions Inclusive Framework on BEPS: Action 5 (1st edn, OECD 2018) 10

[21] OECD, Resumption of Application of Substantial Activities Factor to No or only Nominal Tax Jurisdictions Inclusive Framework on BEPS: Action 5 (1st edn, OECD 2018) 9

[22] OECD, Resumption of Application of Substantial Activities Factor to No or only Nominal Tax Jurisdictions Inclusive Framework on BEPS: Action 5 (1st edn, OECD 2018) 11

The test requires that the entity demonstrates that the core income generating activities are carried out either by the entity itself or in the jurisdiction. They differ depending on the core income generating activity in question:

(a) *Headquarters regimes* – "could include taking relevant management decisions, incurring expenditures on behalf of group entities, and co-ordinating group activities"[23].
(b) *Distribution and service centre regimes* – "could include activities such as transporting and storing goods; managing the stocks and taking orders; and providing consulting or other administrative services"[24].
(c) *Financing and leasing regimes* – "could include agreeing funding terms; identifying and acquiring assets to be leased (in the case of leasing); setting the terms and duration of any financing or leasing; monitoring and revising any agreements; and managing any risks"[25].
(d) *Fund management regimes* – *"*could include taking decisions on the holding and selling of investments; calculating risks and reserves; taking decisions on currency or interest fluctuations and hedging positions; and preparing relevant regulatory or other reports for government authorities and investors*"*[26].
(e) *Banking and insurance regimes* – "could include predicting and calculating risk, insuring or re-insuring against risk, and providing client services"[27].
(f) *Shipping regimes* – "could include managing the crew (including hiring, paying, and overseeing crewmembers); hauling and maintaining ships; overseeing and tracking deliveries; determining what goods to order and when to deliver them; and organising and overseeing voyages"[28].
(g) *Holding company regimes* – "that the companies receiving benefits from such regimes respect all applicable corporate law filing requirements and have the substance necessary to engage in holding and managing equity participations (for example, by showing that they have both the people and the premises necessary for these activities)."[29].

(3) <u>Adequate Qualification Test</u>

This test requires that the entity have "an adequate number of full-time employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities"[30]. Adequacy will vary jurisdiction-to-jurisdiction.

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[23] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 39
[24] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 40
[25] Ibid.
[26] Ibid.
[27] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 41
[28] Ibid.
[29] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 42
[30] OECD, Resumption of Application of Substantial Activities Factor to No or only Nominal Tax Jurisdictions Inclusive Framework on BEPS: Action 5 (1st edn, OECD 2018) 12

Preferential regimes who have introduced SARs

Above, it was briefly mentioned that "where a preferential regime has been found to be actually harmful, the relevant country is given the opportunity to abolish the regime or remove the features that create the harmful effect"[31].

In 2017 the EU Code of Conduct Group analysed numerous low-tax jurisdictions' tax policies against substantial activities requirement. Thereafter, the Council of the European Union (the "Council"), on 5 December 2017, adopted the list of jurisdictions which were non-cooperative for tax purposes ("Non-Cooperative List")[32]. Due to the Non-Cooperative List, several of the NooNs ended up being grey or black-listed.

To avoid being blacklisted, the following NooNs modified their existing tax legislation introducing increased the SAR (in one form or another) into their tax codes: Seychelles, Mauritis, Cayman Islands, British Virgin Islands (BVI), Bermuda, Guernsey, Bahamas, Isle of Man, and Jersey.

However, Gibraltar was not required to introduce the SAR into its tax code. Why that is will be discussed in the following paragraphs.

Why Gibraltar is not a preferential regime and not subject to the SARs

Unlike the BVI, Cayman et al, quite simply, Gibraltar does not satisfy the gateway criterion to be categorised as a potentially harmful regime. The gateway criterion requires that "the generally applicable level (the benchmark) and the effective level resulting from a preferential business tax measure which deviates from the normal level of taxation"[33] This is the first step, and if not met, then the regime is not considered 'harmful'. On top of that, Gibraltar is not categorised as a NooN.

However, while Gibraltar does not satisfy the gateway criterion to be a 'potentially harmful regime, it has not always been scot-free. Gibraltar is classified as a 'traditional' tax regime and therefore while outside the remit of the Code of Conduct for Business Taxation, it has, however, been scrutinised on a couple of previous occasions where "the design of a corporate tax system was of a general nature, but where different types of income were effectively taxed at a significantly lower (and, in one case, a higher) rate than the standard corporate tax rate"[34]. This raised concerns within the Code of Conduct Group for Business Taxation whether jurisdictions, like Gibraltar, could effectively circumvent the harmful tax competition guidelines.

One such example, which was rolled back by Gibraltar after being classified as 'harmful' by the Code of Conduct Group for Business Taxation in 2012 was the 'tax exemption regime for passive income' (the "Regime"). Nouwen explains that the Regime is "a first example of a case where the design of a territorial corporate tax system was of a general nature, but where interest and royalty income in derogation from the mainstream 10% tax rate were automatically and fully exempted under an exemption regime for passive income…and that the Group[35] considered the non-taxation of passive

[31] OECD, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 Final Report (1st edn, OECD 2015) Action 5 Report 21 and OECD, Harmful Tax Competition: An Emerging Global Issue (1st edn, OECD 1998)

[32] Council of the European Union 15429/17 5 December 2017 {https://www.consilium.europa.eu/media/33082/council-conclusions-non-cooperative-jurisdictions-5-december-2017.pdf}

[33] Martijn Nouwen, Inside the EU Code of Conduct Group: 20 Years of Tackling Harmful Tax Competition (1st edn, IBFD 2021) 117

[34] Martijn Nouwen, Inside the EU Code of Conduct Group: 20 Years of Tackling Harmful Tax Competition (1st edn, IBFD 2021) 160

[35] Code of Conduct Group for Business Taxation

interest income under the Gibraltar tax system to be harmful, because economic impact date indicated that, in practice, the non-taxation of passive interest income benefitted transactions with non-residents disproportionately, leading to de facto ring-fending"[36].

Nouwen carries on that "the Commission agreed that a preferential tax regime which completely and automatically excludes foreign sourced passive income bears similarities to a tax regime that provided beneficial treatment for low or no substance offshore companies and that such tax regimes have consistently been found harmful by the Group…and the Group considered the non-taxation of foreign-source inter-company loan interest was a harmful feature of the Gibraltar tax system as it was de facto ring-fenced"[37]. While the Gibraltar tax authority explained that "according to Gibraltar none of the Code criteria applies as the passive income components not chargeable to tax concern residents and non-residents alike"[38], the data indicated that there was a large discrepancy between "income received by Gibraltar companies, approximating £1.3bn was derived from sources outside Gibraltar, of which £332m derived from sources in the EU"[39].

Nonetheless, with part of Gibraltar's traditional tax regime be labelled as harmful, Gibraltar swiftly agreed to abolish the exemption regime for passive interest income (which it did a year later). Once that was done, the Group "therefore concluded that Gibraltar's proposals were adequate to achieve rollback"[40]. Nowadays, tax is levied at the flat rate of 12.5% on intra-group interest whether sourced in Gibraltar or abroad, subject to a flat-exemption where the total amount is less than £100,000.

So, while the answer is simple, Gibraltar does not satisfy the gateway criterion to be considered a 'potentially harmful regime', that is because Gibraltar's approach is to ensure that its tax code is wholly compliant with all the OECD standards and guidelines, and where action needs to be taken, Gibraltar takes it to ensure it is compliant.

Conclusion

For people who have watched the film High Noon, there is suspense scene where the following quote is read out: "With every swing of the pendulum, with every second, a man's life ticked away, never have such few moments held such excitement". If I am allowed to butcher it, I would say "with every swing of the pendulum, with every second, preferential jurisdictions' advantages ticked away, never have such few moments held such excitement". This essay first explored the backdrop that brought about the substantial activities requirement and also the extension of the rules to NooNs. After that, this essay analysed the requirements for a regime to be considered a harmful preferential regime, before moving on and explored why and how the SAR were extended to NooNs. Thereafter, this essay analysed why Gibraltar is not deemed a preferential harmful regime and therefore not subject to the SAR.

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[36] Martijn Nouwen, Inside the EU Code of Conduct Group: 20 Years of Tackling Harmful Tax Competition (1st edn, IBFD 2021) 160
[37] Martijn Nouwen, Inside the EU Code of Conduct Group: 20 Years of Tackling Harmful Tax Competition (1st edn, IBFD 2021) 163
[38] Ibid.
[39] Ibid.
[40] Ibid.

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