



Collaborating firm of **ANDERSEN GLOBAL**



# Economic substance regulations Background on Non-IP Activities

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## BACKGROUND ON NON-IP ACTIVITIES



Action 5 of BEPS requires substantial activity not only for IP regimes but for all preferential regimes. The FHTP has therefore considered the application of the substantial activity requirement to other preferential regimes that have been identified and reviewed by the FHTP.

Because IP regimes are designed to encourage R&D activities and contribute to growth and employment, the principle underlying the substantial activity requirement in the context of IP regimes is only to permit taxpayers that did in fact engage in such activities and did incur actual expenditures on such activities to benefit from the regimes. In the context of other preferential regimes, the same principle can also be applied so that such regimes would only be found to meet the substantial activity requirement if they also granted benefits only to qualifying taxpayers to the extent those taxpayers undertook the core income generating activities required to produce the type of business income covered by the preferential regime.

A brief description of the type of activities that might be required for the different types of preferential regime is set out below.

### HEADQUARTER

#### *Business*

Headquarters activities grant preferential tax treatment to taxpayers that provide certain services such as managing, co-ordinating or controlling business activities for a group as a whole or for group members in a specific geographical area. These regimes may raise concerns about ring-fencing or because they provide for an artificial definition of the tax base where the profits of an entity are determined based on a "cost-plus" basis but certain costs are excluded from the basis or particular circumstances are not taken into account. These features could be addressed by the existing factors, but these activities raise concerns in respect of substance.

### DISTRIBUTION & SERVICE SECTOR

#### *Business*

Distribution centre activities provide preferential tax treatment to entities whose main or only activity is to purchase raw materials and finished products from other group members and re-sell them for a small percentage of profits. Service centre activities provide preferential tax treatment to entities whose main or only activity is to provide services to other entities of the same group. A concern with such activities is that they may have ring-fencing features. In addition, they may raise concerns that they permit an artificial definition of the tax base. Although these concerns may be addressed through the existing factors, concerns with respect to substance could remain.

### INFORMATION EXCHANGE

The international standard on information exchange upon request covers not only the exchange of information but also the availability of information, including ownership, banking, and account information. The work on monitoring this standard is carried out by the Global Forum on Transparency and Exchange of Information on Tax Purposes. Under its revised terms of reference, the Global Forum has incorporated the principles of the Financial Action Task Force (FATF) standard of beneficial ownership and as a result countries will be assessed on their ability to provide information on beneficial ownership where relevant and where this forms part of a request for exchange of information.

## BACKGROUND ON NON-IP ACTIVITIES



### **FINANCING/LEASING**

#### *Business*

Financing and leasing activities are activities which provide a preferential tax treatment to financing and leasing activities. The main concerns underlying these regimes include, among others, ring-fencing considerations and an artificial definition of the tax base.

### **FUND MANAGEMENT**

#### *Business*

Fund management activities grant preferential tax treatment to income earned by fund managers for the management of funds. In exchange for its services, the fund manager receives compensation that is computed on the basis of a pre-agreed formula. The focus is not the taxation of the income or gains of the fund itself or of the investors in a fund but the income earned by fund managers from the management of the fund. The remuneration of the fund manager and how and where this is taxed may raise issues of transparency and these could in part be dealt with by the compulsory spontaneous exchange of rulings.

### **BANKING & INSURANCE**

#### *Business*

Banking and insurance activities provide preferential tax treatment to banking and insurance activities. The main concern is linked to the benefits that they provide to income from foreign activities. If benefits are only provided to foreign income, then this could be addressed through the existing ring-fencing factor. In terms of substance, the regulatory environment, where applicable, should already ensure that a business is capable of bearing risk and undertaking its activity. However, in the context of insurance, it may be more difficult to easily identify those activities that raise concerns in respect of substance versus those that do not because of the possibility that risks may have been re-insured.

### **PREVENT TREATY ABUSE**

The result of this Action takes the form of new model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. The work done under this Action should address concerns about the use of holding companies to receive treaty benefits.

### **NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENT**

The result of this Action takes the form of new model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect of hybrid instruments and entities. The work done under this Action has led to a recommendation to deny a dividend exemption and other types of relief granted to relieve economic double taxation on deductible payments. This could again address some of the concern that “dividend” income can go untaxed.

# BACKGROUND ON NON-IP ACTIVITIES



## SHIPPING

### *Business*

Shipping activities provide a preferential tax treatment to shipping activities and are designed taking into considerations significant non-tax considerations. In addition to issues of ring-fencing and transparency, they may also raise concerns under the substantial activity analysis where they permit the separation of shipping income from the core activities that generate it.

## HOLDING COMPANY

### *Business*

Holding company activity can be broadly divided into two categories:

- those that provide benefits to companies that hold a variety of assets and earn different types of income (e.g. interest, rents, and royalties) and
- those that apply only to companies that hold equity participations and earn only dividends and capital gains.

In the context of (1) above, to the extent that holding company activity provide benefits to companies that earn income other than dividends and capital gains, the substantial activity requirement should require qualifying taxpayers to have engaged in the core activities associated with those types of income.

Holding companies that fall within category (2) above and that provide benefits only to dividends and capital gains, however, raise different policy considerations than other preferential regimes in that they primarily focus on alleviating economic double taxation. They therefore may not in fact require much substance in order to exercise their main activity of holding and managing equity participations. These regimes could, however, raise policy concerns that are not directly related to substance.

Concerns include whether holding companies enable the payer and payee to benefit from treaty benefits in circumstances that would not otherwise qualify for benefits and whether holding company regimes are ring-fenced. Some of these concerns may already be addressed in other work or under other existing factors. For instance:

## RING FENCING

If countries are concerned that equity holding companies are providing benefits to income only from foreign companies and that this income is not already taxed anywhere or the regime is otherwise targeting foreign investors, this concern is already addressed under the existing ring-fencing factor.

## OTHER MEASURES

Such as the work done under Action 3 of the BEPS Action Plan to strengthen controlled foreign company (CFC) rules.



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