

# OECD introduces minimum 'substance' requirements in low-tax jurisdictions

December 21, 2018

## In brief

The Organisation for Economic Co-operation and Development (OECD) Inclusive Framework (IF), in follow-up work related to BEPS Action 5, has released new global standards that apply to 'no or only nominal tax' jurisdictions and that require 'substantial activities' in order for the tax regime not to be considered a 'harmful tax practice.' The objective is to prevent such low-tax jurisdictions from attracting profits from certain mobile activities without corresponding economic activity. The types of mobile activities covered include headquarters, distribution centers, service centers, financing, leasing, fund management, banking, insurance, shipping, holding companies, and the provision of intangibles.

The standards are contained in a document entitled [Resumption of Application of Substantial Activities Factor to No or only Nominal Tax Jurisdictions](#). This document sets out the background, rationale, and detailed information around reinstating the substantial activities factor. As discussed below, Barbados, Bermuda, and Cayman Islands have announced new domestic laws intended to meet the substance requirements.

## In detail

### Substance requirement

For activities within scope earning non-intangible property (IP) income, an adequate number of full-time employees with necessary qualifications would be required, along with incurring an adequate amount of operating expenditures to undertake certain 'core income generating activities' (CIGA). Where activities involve the exploitation of IP assets, the substance requirement is adapted to

consider the employees / expenditure criteria on CIGA. This is referred to as the 'nexus approach'. For example, where the income is derived from:

- patents and similar assets: CIGA would include conducting research and development (rather than simply acquiring or outsourcing it)
- exploiting marketing IP assets such as trademarks: CIGA would include branding,

marketing, and distribution.

In 'exceptional cases,' the CIGA could include conducting the strategic decision making, managing and bearing the principal risks relating to the development and subsequent exploitation of the IP asset, or carrying on the underlying trading activities through which the asset is exploited.

**Observation:** The OECD substantial activities report is similar to guidance put

forward by the EU's inter-governmental Code of Conduct Group (Business Taxation) (CoCG) and endorsed by ECOFIN. For prior coverage regarding the CoCG's guidance for determining substance when considering whether a tax measure is harmful or 'fair,' see PwC's [Tax Policy Bulletin](#).

### Low-tax jurisdictions

Following pressure from the OECD in 2017, a number of low-tax jurisdictions with 'harmful tax practices' were placed on the EU Code of Conduct group's 'grey list.' Foreign jurisdictions on this list committed to introduce changes to domestic legislation in order to comply with EU criteria.

For example, Cayman Islands and Bermuda appeared on the grey list as jurisdictions with "*tax regimes that facilitate offshore structures which attract profits without real economic activity*" (the '2.2 jurisdictions'). Furthermore, Barbados, which was listed as a non-cooperative jurisdiction for tax purposes in December 2017 (the 'black-list'), was moved to the grey list in January 2018 after committing to implement recommendations requested by the EU Council in order to address concerns raised over its harmful preferential tax regime.

Barbados, Cayman Islands, and Bermuda have announced new domestic law to introduce substance requirements for businesses operating in their jurisdictions, expected to be effective on **January 1, 2019**.

Broadly, the substance requirements being announced by these jurisdictions are consistent with the OECD report, and call for an entity to be adequately managed and directed from within the jurisdiction and for certain 'core income-generating activities' to occur within the jurisdiction. Barbados and Cayman Islands permit those functions to be undertaken in another entity, provided the management and control of these functions occurs within Barbados and Cayman Islands, respectively. The current draft of Bermuda legislation does not include an equivalent provision.

**Observation:** Determining whether substance is sufficient will require consideration of local employees, board meetings and business premises. Note that each of the three jurisdictions appear to show slight variations on the requirements.

Taxpayers will be required to document substance in their tax returns. Failure to comply with substance requirements may result in

financial penalties, exchange of information around this lack of substance with other countries, and the potential for entities being struck off the list of registered business entities.

### The takeaway

Taxpayers should monitor how each relevant jurisdiction implements the new substance requirements (both law changes and future regulations), and be prepared to demonstrate that certain 'core income generating activities' are occurring within low-tax jurisdictions commensurate with the profits being reported in those jurisdictions.

Failure to satisfy the substantial activities requirements may result in other countries taking certain 'defensive measures' in response, which could include denying deductions, imposing withholding taxes on payments to companies in such jurisdictions, or applying controlled foreign corporation rules to subsidiaries in such jurisdictions.

While awaiting final legislation in Bermuda and guidance on key terms (in each of these jurisdictions), taxpayers should review the level of activity undertaken at key decision points in a transaction in order to comply with the new legislation.

## Let's talk

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

### International Tax Services

Alex Voloshko  
(202) 346-5218  
[alex.voloshko@pwc.com](mailto:alex.voloshko@pwc.com)

Maarten Maaskant  
(646) 471-0570  
[maarten.p.maaskant@pwc.com](mailto:maarten.p.maaskant@pwc.com)

### Transfer Pricing

David Ernick  
(202) 414-1491  
[david.ernick@pwc.com](mailto:david.ernick@pwc.com)

## Our insights. Your choices.

Select 'Tax services' as your *Services and solutions* of interest to receive more content like this.

[Set your preferences today](#)

© 2018 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see [www.pwc.com/structure](http://www.pwc.com/structure) for further details.

#### SOLICITATION

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

At PwC, our purpose is to build trust in society and solve important problems. PwC is a network of firms in 158 countries with more than 250,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at [www.pwc.com/US](http://www.pwc.com/US).