United Nations Handbook

on Selected Issues in

Protecting the Tax Base

of Developing Countries

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United Nations
New York, 2015

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Preface

The year 2015 is a pivotal time for global action in fostering sustainable development. In September of this year, the United Nations will adopt an ambitious, people-centred and transformative post-2015 development agenda, with a view to promoting sustained and inclusive economic growth, social progress and environmental protection. A new set of Sustainable Development Goals, which are action-oriented, global in nature and universally applicable, will seek to complete the unfinished business of the Millennium Development Goals and address new challenges in an integrated manner, taking into account national realities, capacities and levels of development.

The success of this global endeavour is predicated upon the provision of equally ambitious and credible means of implementation. There is a need for significant mobilization of adequate financial resources from a variety of sources, in order to promote sustainable development in all its dimensions. The outcome of the third International Conference on Financing for Development (Addis Ababa, Ethiopia, 13-16 July 2015) will provide a comprehensive financing framework with policy commitments and concrete deliverables on the mobilization and effective use of resources for sustainable development.

The United Nations General Assembly recognized that the mobilization of national and international resources and an enabling national and international environment were key drivers of sustainable development. It called for enhancing and strengthening domestic resource mobilization and fiscal space, including, where appropriate, through modernized tax systems, more efficient tax collection, the broadening of the tax base and the effective combating of tax evasion and capital flight. While each country is responsible for its tax system, it is important to support national efforts in these areas by strengthening technical assistance and enhancing international cooperation and participation in addressing international tax matters.

Taxation is one of the most important ways in which developing countries can mobilize resources for investment in sustainable development. Yet, public revenue remains insufficient to meet sustainable development needs, and gaps persist between the capacity of developed and developing countries to raise public financial resources.

In recent years, international attention has been attracted to the issues of tax base erosion and profit shifting (BEPS), which derives from aggressive exploitation of legal arbitrage and tax planning opportunities by multinational enterprises and results in diminished tax revenue for Governments. Major work in this area has been done by the Organisation for Economic Co-operation and Development (OECD). Its focus, however, is naturally on the priorities of member States of the OECD, and such priorities do not always reflect issues that are of particular relevance to developing countries. To fill this gap, the United Nations — through its Committee of Experts on International Cooperation in Tax Matters — initiated a study on the perspectives of developing countries, with a view to facilitating input of their experiences and views into the ongoing international activities on BEPS.

It is evident that BEPS negatively affects domestic resource mobilization in developing countries, resulting in forgone tax revenue and a higher cost of tax collection. Strengthening the capacity of developing countries to protect and broaden their tax base is crucial. To this end, the Financing for Development Office of the United Nations Department of Economic and Social Affairs launched a capacity development project focusing on the development of practical materials which address selected issues to promote the protection of the tax base of developing countries. These materials, which form the basis of this publication, were prepared through the collaborative efforts of international tax scholars and practitioners and numerous experts from the national tax authorities and the ministries of finance of developing countries.

We see this *Handbook* as a tangible deliverable towards the objectives of the Addis Ababa Conference on Financing for Development and hope that it will serve as a useful, relevant and practical tool in the daily work of tax professionals in developing countries, which is of crucial importance for assuring the success of national efforts to foster sustainable development.

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Acknowledgements

We would like to express our appreciation and thanks to all of the people and organizations involved in the development of this publication.

We wish to thank the authors of the chapters, namely: Mr. Brian J. Arnold, Mr. Hugh J. Ault, Mr. Peter A. Barnes, Mr. Graeme S. Cooper, Mr. Wei Cui, Mr. Peter A. Harris, Ms. Jinyan Li, Mr. Adolfo Martín Jiménez, Ms. Diane M. Ring and Mr. Eric M. Zolt. Most of all, we are grateful to Mr. Arnold and Mr. Ault, who, in addition to drafting two chapters, assisted us in securing commitments from the other authors and provided invaluable technical advice in the development of the overall content of this publication.

We also wish to acknowledge the contribution of experts from national tax authorities and ministries of finance of developing countries who contributed their views and provided inputs to the draft chapters, namely: Mr. Carlos Protto (Argentina); Mr. Syed Mohammad Abu Daud (Bangladesh); Mr. Flávio A. G. M. Araújo (Brazil); Mr. Roland Atanga Fongue (Cameroon); Ms. Ana Yesenia Rodríguez (Costa Rica); Mr. Edgar O. Morales (Dominican Republic); Mr. Galo Maldonado López (Ecuador); Ms. Rosma Sinaga (Indonesia); Mr. Muhammad T. Hidayatulloh (Indonesia); Ms. Mathabo Mokoko (Lesotho); Mr. Mansor Hassan (Malaysia); Ms. Laila Benchekroun (Morocco); Mr. Adesoji Bodunde Omoyele (Nigeria); Ms. Kim Jacinto-Henares (Philippines); Ms. Charadine S. Bandon (Philippines); Mr. Baye Moussa Ndoye (Senegal); Mr. Dejan Dabetic (Serbia); Ms. Phensuk Sangasubana (Thailand); Ms. Patience E. Rubagumya (Uganda); Mr. Alvaro C. Romano (Uruguay); Ms. Thi Thanh Binh Tran (Viet Nam); Ms. Thi Minh Tho Tran (Viet Nam); Mr. Berlin Msiska (Zambia); Mr. Max Mugari (Zimbabwe).

We also acknowledge with gratitude the important role of current members of the United Nations Committee of Experts on International Cooperation in Tax Matters who contributed their advice and expertise either as members of the Advisory Group on Capacity Development or through participation in meetings organized to review the content of this publication, namely: Mr. Ulvi Yusifov (Azerbaijan); Ms. Bernadette Butler (Bahamas); Ms. Lise-Lott Kana

(Chile); Mr. Wolfgang Lasars (Germany); Mr. Eric Nii Yarboi Mensah (Ghana); Mr. Armando Lara Yaffar (Mexico); Ms. Carmel Peters (New Zealand); Mr. Stig Sollund (Norway); Mr. Cezary Krysiak (Poland); Mr. El Hadji Ibrahima Diop (Senegal); Mr. Henry John Louie (United States of America); Mr. Ignatius K. Mvula (Zambia).

We are also grateful to the heads and representatives of international and regional organizations, who supported and/or participated in activities related to the development of this publication, including: Mr. Lincoln Marais, Mr. Thulani Shongwe and Ms. Nara Monkam of the African Tax Administration Forum (ATAF); Mr. Márcio Verdi, Mr. Socorro Velazquez and Mr. Miguel Pecho of the Inter-American Center of Tax Administrations (CIAT); Mr. Ricardo Martner and Mr. Michael Hanni of the Economic Commission for Latin America (ECLAC); Ms. Heidi Wagner of the International Tax Compact (ITC). Most of all, we would like to thank Mr. Pascal Saint-Amans, Ms. Marlies De Ruiter, Mr. Jacques Sasseville, Mr. David Partington and Ms. Renata Fontana of the Organisation for Economic Co-operation and Development (OECD), for contributing their expertise and resources, including on the occasion of jointly organized workshops aimed at discussing the content of this publication.

We would also like to thank the Canadian Tax Foundation and the Canadian Branch of the International Fiscal Association (IFA) for their financial support, which has contributed to making the development of selected chapters of this publication possible.

Finally, we also wish to acknowledge the valuable assistance of other staff in the Financing for Development Office, namely, Ms. Irving Ojeda Alvarez, Ms. Leah McDavid, Ms. Suzette Limchoc, Ms. Mary Nolan and Ms. June Chesney, in compiling and editing this publication.

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30 June 2015

Introduction

Within the United Nations, the Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee) has, over the years, been addressing issues in international tax cooperation, giving special attention to developing countries. Its deliberations have included issues relevant to protecting and broadening the tax base of developing countries, as well as the effective combating of tax evasion and tax avoidance.

In recent years, there has been strong political momentum among developed countries to curtail base erosion and profit shifting (BEPS) by multinational enterprises engaged in a wide range of cross-border tax planning techniques that allow them to pay little or no tax anywhere in the world. At the request of the G20 Finance Ministers, the Organisation for Economic Co-operation and Development (OECD) released, in February 2013, a report outlining BEPS issues and, in July of the same year, followed up with an action plan designed to address these issues in a coordinated and comprehensive manner. Specifically, the OECD Action Plan on BEPS was to provide countries with domestic and international instruments that would better align rights to tax with economic activities. The Action Plan was organized around 15 actions, to be implemented by specified deadlines during 2014-2015.

The OECD Action Plan recognized that developing countries also face issues related to BEPS, although these issues may have a different impact on them given the specificities of their legal and administrative systems. The Action Plan also called for a prominent role for the United Nations in providing the perspective of developing countries. In response, the UN Tax Committee, at its ninth session (Geneva, 21-25 October 2013), set up the Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries (Subcommittee on BEPS) and mandated it to draw upon its own experience and engage with other relevant entities, particularly the OECD, with a view to monitoring developments on BEPS, communicating on such issues with officials in developing countries and facilitating the input of the views and experiences of these countries into the relevant ongoing work of the United Nations and the OECD.

In follow-up, the Subcommittee on BEPS prepared a paper with a view to providing information and seeking the views of developing countries on the issue (available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/BEPS_note.pdf) and, in parallel, circulated a questionnaire asking for feedback on the relevant experiences of developing countries (available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/BEPS_questionnaire.pdf). Overall, the feedback received from developing countries confirmed the importance of the United Nations efforts to reach out to them, and it was recognized that BEPS had an impact on their domestic resource mobilization, resulting in forgone tax revenue and higher costs of tax collection. Moreover, they identified several issues among those that fell within the scope of the OECD Action Plan on BEPS that were most relevant to them, and outlined additional areas of concern regarding BEPS that were not covered under the Action Plan, including the taxation of capital gains of non-residents and income from services, as well as tax incentives (full country responses are available at http://www.un.org/esa/ffd/tax-committee/tc-beps.html).

In parallel, at the request of the G20 Development Working Group (DWG), the OECD prepared a two-part report on the impact of BEPS in low-income countries, based on its dialogue and consultations with those countries. The report listed a number of priority issues faced by developing countries, largely consistent with the issues indicated in the responses to the questionnaire circulated by the UN Subcommittee on BEPS. In addition, the report outlined several recommendations on how the DWG could assist developing countries in meeting the relevant challenges, including through the promotion and endorsement of relevant capacity development initiatives to be carried out by international and regional organizations, within their respective mandates and resources.

Against this background, the Financing for Development Office (FfDO) of the United Nations Department of Economic and Social Affairs launched, in early 2014, a project aimed at strengthening the capacity of developing countries to increase their potential for domestic revenue mobilization through enhancing their ability to effectively protect and broaden their tax base. This project has drawn upon and contributed to the work done in this area by the UN Tax Committee and its Subcommittee on BEPS, as well as the work of the OECD project on BEPS, as appropriate, with a view to complementing that work from a capacity development perspective for the benefit of developing countries.

The work of the project focused on a number of topics — which developing countries reported to be of particular interest and relevance to them during the above-mentioned consultations — with a view to enhancing the capacity of these countries in three important areas: a) engagement and effective participation in relevant international decision-making processes; b) assessment of relevance and viability of potential options to protect and broaden their tax base; and c) effective and sustained implementation of the most suitable options from which they would benefit.

The core modality for carrying out this project was the development of practical papers intended to simplify, summarize and systematize relevant information and materials, including those produced by the UN Tax Committee, as well as within the OECD project on BEPS. In doing so, such papers aimed at providing information geared towards the needs of developing countries, including through the provision of practical examples tailored to the realities of these countries.

Special efforts were made throughout the project to seek inputs and feedback from developing countries, members of the UN Tax Committee, as well as relevant international and regional organizations. To this end, two designated workshops were held with the participation of these stakeholders (New York, 4 June 2014; and Paris, 23 September 2015), with a view to ensuring that major concerns of developing countries in these area were taken into account and addressed in the papers.

Subsequently, the papers were finalized, edited and compiled in this publication. The *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* will be launched during the third International Conference on Financing for Development (Addis Ababa, Ethiopia, 13-16 July 2015).

The e-version of this publication is available at http://www.un.org/esa/ffd/publications/handbook-tb.html.

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Chapter I

Protecting the tax base of developing countries: an overview

Hugh J. Ault* and Brian J. Arnold**

1. Introduction

1.1 General background

One of the most significant policy challenges facing developing countries is establishing and maintaining a sustainable source of revenues to fund domestic expenditures. While this problem has many facets, one of the most important is protecting the domestic tax base. In recent years, increasing attention has been paid to the fact that many multinational enterprises (MNEs) appear to have been able to pay effective tax rates well below what one would expect from the headline rates in the countries in which they operate. Several widely publicized cases of well-known companies paying low or no taxes have highlighted these issues and brought the questions of tax avoidance and evasion into the public political debate. In response to these developments, the Organisation for Economic Co-operation and Development (OECD) began analytical work to try to determine exactly the techniques that corporations were able to use to dramatically reduce their effective tax rates. This work was supported by the G20 and the G8 at their recent meetings, where the particular problems facing developing countries were mentioned. The results of this work were the OECD Report "Addressing Base Erosion and Profit Shifting"[1] (OECD Report on Addressing BEPS), the subsequent "Action Plan on Base Erosion

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[1] Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/tax/beps-reports.htm.

and Profit Shifting"[2] (OECD Action Plan on BEPS) and, ultimately, the OECD Secretary-General Report to the G20 Leaders in November 2014,[3] all of which are discussed below in more detail.

1.2 History of the OECD work on BEPS

1.2.1 OECD Report on Addressing BEPS

Initially, the G20 requested the OECD to prepare a report setting forth a "diagnosis" of the extent and causes of profit shifting and the accompanying base erosion. The OECD Report on Addressing BEPS was presented to the G20 Finance Ministers and Central Bank Governors at their meeting in Moscow in February 2013, where it received a positive reception.[4]

The OECD Report on Addressing BEPS identified several "key pressure points" that were central in the spread of base erosion and profit shifting:

- International mismatches in entity and instrument characterization, so-called hybrid arrangements, which take advantage of differences in domestic law to create income that escapes taxation altogether or is taxed at an artificially low rate;
- The use of treaty concepts limiting taxing jurisdiction to prevent the taxation of digital goods and services;
- The use of debt financing and other intra-group financial structures;
- Various aspects of transfer pricing dealing with risk, intangibles, and the splitting of ownership within a group, which allow

[2] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf.

[3] OECD, Secretary-General Report to G20 Leaders (Brisbane, Australia, November 2014) (Leaders' Report), available at https://g20.org/wp-content/uploads/2014/12/OECD_secretary-generals_report_tax_matters.pdf.

[4] Meeting of G20 Finance Ministers and Central Bank Governors, Moscow, February 2013, Communiqué, paragraph 20, available at https://g20.org/wp-content/uploads/2014/12/Final_Communique_of_FM_and_CBG_Meeting_Moscow.pdf.

income to be taxed in a country other than the country in which the value from economic activities is created;

- The lack of effective anti-avoidance measures such as General Anti-Avoidance Rules (GAAR), Controlled Foreign Corporation (CFC) regimes, thin capitalization rules and anti-treaty shopping rules; and
- The availability of harmful preferential regimes.

The OECD Report on Addressing BEPS went on to examine the techniques that multinational corporations use to exploit these "pressure points" to achieve base erosion and profit shifting.

As a result of this "diagnosis," the OECD Report on Addressing BEPS concluded that what was needed was a comprehensive "global action plan" to deal with the many interrelated strands that lead to base erosion and profit shifting. Accordingly, the OECD developed a comprehensive plan that was presented to the G20 leaders at their meeting in July 2013, where it was fully endorsed.[5]

1.2.2 OECD Action Plan on BEPS

The OECD Action Plan on BEPS sets out 15 Actions to carry out the mandate of the G20:

(1) Address the tax challenges of the digital economy;

(2) Neutralize the effects of hybrid mismatch arrangements;

(3) Strengthen the controlled foreign company (CFC) rules;

(4) Limit base erosion via interest deductions and other financial payments;

(5) Counter harmful tax practices more effectively, taking into account transparency and substance;

(6) Prevent treaty abuse;

(7) Prevent the artificial avoidance of permanent establishment (PE) status;

[5] G20 Leaders' Declaration, (St. Petersburg, 6 September 2013), paragraph 20, available at https://g20.org/wp-content/uploads/2014/12/Saint_Petersburg_Declaration_ENG_0.pdf.

(8), (9) and (10) Assure that transfer pricing outcomes are in line with value creation with respect to intangibles, risks and capital, and other high-risk transactions;

(11) Establish methodologies to collect and analyse data on BEPS and the actions to address it;

(12) Require taxpayers to disclose their aggressive tax planning arrangements;

(13) Re-examine transfer pricing documentation;

(14) Make dispute resolution mechanisms more effective;

(15) Develop a multilateral instrument to enable interested countries to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.

The items listed in the OECD Action Plan on BEPS that are most relevant to developing countries will be discussed in detail in the following sections of this chapter. However, some preliminary observations can be made at this point. The substantive items in the OECD Action Plan on BEPS can be grouped into two basic categories. The first category includes transactions and arrangements where the interaction of domestic tax rules of two or more countries create the possibility of double non-taxation or taxation at a low rate. These situations are described as resulting from the lack of "coherence" of existing international tax rules. The OECD Action Plan on BEPS observes that much attention has been paid in the development of international tax standards to measures intended to avoid double taxation. However, the interaction of rules that allow income to escape tax altogether or to be taxed at a low rate have been for the most part ignored, which has generated a number of techniques that allow for base erosion and profit shifting. These typically involve situations where a country allows a deduction for a payment with the expectation that the payment will be taxed in another jurisdiction but where this is in fact not the case. A similar problem arises where countries treat an entity differently, one viewing it as transparent and taxing the participants and the other viewing it as a taxable entity. Again, there is a lack of coherence between the two national tax systems.

A separate set of issues can arise where there is a disconnect between the actual economic activities of a company and the jurisdiction to which current rules may assign taxing rights over the income that those activities generate. For example, the interposition of an intermediate or conduit company between a parent company and its operating subsidiary may result in income being attributed to an intermediate company that has no real substance. Similarly, current rules may allow a company to have a substantial economic presence in a jurisdiction without that jurisdiction having a recognized taxing right. This situation may arise as a result of the increased importance of technological and communications advances that make physical presence in a jurisdiction less necessary or no longer necessary at all. Or it may arise because of the technical requirements of existing rules in domestic tax law or tax treaties that relate to taxing jurisdiction.

In addition to the importance of reassessing the applicable substantive rules, the OECD Action Plan on BEPS stresses the need for transparency and sharing of information among jurisdictions. Thus, one of the action items calls for the development of better mechanisms for information sharing to implement the substantive rules.

The basic focus in the OECD Action Plan on BEPS calls for adjustments to current international tax rules that would reduce the ability of companies to generate non-taxed or low-taxed income by modifying existing rules. However, the Plan states that: "[w]hile actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income."[6]

Subsequent to the publication of the OECD Action Plan on BEPS, the OECD issued a number of Discussion Drafts and Reports on various Action Plan items, which culminated in seven Reports and Recommendations published in 2014.[7] These materials were presented to the G20 Leaders' Meeting in November 2014 and were welcomed

[6] See OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 2, at 11.

[7] OECD, OECD/G20 Base Erosion and Profit Shifting Project, *Explanatory Statement, 2014 Deliverable* (Paris: OECD, 2014), available at www.oecd.org/tax/beps-2014-deliverables-explanatory-statement.pdf.

in the Communiqué resulting from that meeting.[8] An additional set of reports and recommendations on the remaining action items are expected to be issued by December 2015.

1.3 Developing country perspectives

While the work of the OECD is important, and substantial efforts were made to take the viewpoints of developing countries into account in formulating its analysis, it was clear from the beginning that some kind of independent examination of the problems of tax avoidance and the resulting profit shifting and base erosion from the perspective of developing countries was required. This is true for a number of reasons. First, most developing countries are primarily (though not exclusively) concerned with the reduction in source-based taxation, rather than the shifting of domestic income of locally owned companies to low- or no-tax jurisdictions. Second, the corporate tax on inward investment typically accounts for a greater share of total revenue in developing countries than in countries with more developed tax systems. In addition, the potential responses to base erosion and profit shifting are limited to some extent by the administrative capacity of developing countries.

Protecting the domestic tax base against base erosion and profit shifting is necessary if developing countries are to attain revenue sustainability. Capacity development in this area is essential to move toward that goal. The OECD work has much to offer to developing countries in terms of identifying issues and suggesting possible techniques to deal with the problem of base erosion and profit shifting, but it is important to keep in mind the special needs and perspectives of developing countries regarding these issues: among others, the state of development of the tax system, the administrative resources available to deal with these matters, the nature of the trade and commercial relations with trading partners, and regional considerations. Each country must evaluate its own situation to identify its particular issues and determine the most appropriate techniques to insure a sound tax base.

[8] G20, Leaders' Declaration, supra note 5, at 20.

1.4 United Nations response

In light of the importance of the issue of base erosion and profit shifting for developing countries and the necessity for further study and examination, the United Nations Committee of Experts on International Cooperation in Tax Matters (United Nations Committee of Experts) established the Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries, which was mandated with informing developing country tax officials on these issues and facilitating the input of developing country views and experience into the work of both the United Nations Committee of Experts and the wider work of the OECD Action Plan on BEPS. In addition, the Financing for Development Office (FfDO) of the United Nations Department of Economic and Social Affairs undertook a project to supplement and complement this work from a capacity development perspective. This project focused on a number of issues of particular interest to developing countries and which include, but are not limited to, the matters covered by the OECD.

In particular, the FfDO project has decided to focus its efforts on the following topics:[9]

- Neutralizing the effects of hybrid mismatch arrangements;
- Limiting the deduction of interest and other financing expenses;
- Preventing the avoidance of permanent establishment status;
- Protecting the tax base in the digital economy;
- Transparency and disclosure;
- Preventing tax treaty abuse;
- Preserving the taxation of capital gains by source countries;
- Taxation of services;
- Tax incentives.

[9] This project does not deal with the base erosion and profit shifting aspects of transfer pricing as those matters are being considered by the Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing, as part of its work on the revision of the *United Nations Practical Manual on Transfer Pricing for Developing Countries.*

On an initial examination, these issues seemed to be of most importance to developing countries. Countries can, of course, deal with some of these issues unilaterally and a number have already begun to do so. In order to respond effectively to some of the challenges that base erosion and profit shifting pose, however, it is essential that actions be taken forward in a coordinated manner. Countries should be more aware both of how their tax systems affect other countries' systems and how their domestic system is impacted by another country's tax rules. These results can be achieved only through increased international dialogue and cooperation.

The basic goal of the FfDO project is to complement and supplement the work of the OECD project on BEPS and the United Nations Committee of Experts by providing additional insight into the issues identified in the OECD project on BEPS when viewed from the perspective of developing countries. It will also supplement the OECD work by considering issues involving tax base protection, which are of particular importance to developing countries but are not included within the OECD focus. In addition, the OECD work has quite short deadlines for its initial assessments and recommendations. It will clearly be a longer-term matter for these insights to be evaluated and implemented.

The final outcome of the FfDO project is the present publication on the selected topics listed above. The chapters have been developed by individual authors, informed by the OECD work on the topics and a review of the existing literature. Most importantly, the work reflects the input of developing countries both through various activities of the United Nations Committee of Experts and through workshops held specifically to catalogue the experience and concerns of developing countries with the overall problem of base erosion and profit shifting.

2. Neutralizing the effects of hybrid transactions

2.1 What are hybrid transactions?

In many cases, the same cross-border transaction may be treated differently in two jurisdictions. Domestic tax rules are typically developed without significant consideration of how the transaction may be treated in another jurisdiction where a foreign party is involved.

This "hybrid" nature of the transaction may result in income escaping taxation in both jurisdictions. It may arise in a number of ways, with respect to the overall treatment of the transaction or just of some particular elements. For example, one country may view a payment as having taken place, whereas the other country may not find a payment, or there may be a difference of view as to which taxpayers have made or received a payment. Similarly, an entity may be treated as transparent in one jurisdiction and as a separate entity in the other jurisdiction. As a result, the overall tax revenues that the two countries were expecting from a transaction may be reduced. The transaction may have resulted in "stateless" income that is not taxed in any jurisdiction. In addition, situations can arise in which the same amount is deducted twice, due to the differing treatment of a legal entity or disagreement as to who is the owner of an asset, with both countries granting a depreciation deduction for the same asset. These "hybrid" results can come about because of differences in domestic law or differences in the application of tax treaties.

2.2 Hybrid situations

One of the most common forms of hybrid transaction involves an instrument that is treated differently in two jurisdictions with respect to the payments on the instrument. Typically, the country of the issuer of the instrument treats the instrument as debt and payments on the debt as deductible interest, while the country of the investor treats the instrument as equity and the payments as dividends that qualify for some kind of participation exemption.

> Example: Company B, resident in Country B, issues an instrument to Company A, resident in Country A. Under the laws of Country B the instrument is treated as debt and the payments on the instrument are deductible by Company B. Under the laws of Country A the instrument is treated as a share of stock of Company B and the payments are treated as dividends. Under Country A's tax system, dividends are given a participation exemption.

The result may be the same where the instrument itself has the same character in the two jurisdictions but certain features are treated differently. For example, a debt instrument may be convertible into a stock investment, and one country views the conversion privilege separately from the debt aspects of the instrument while the other does not.

In other situations, double non-taxation is the result of differing approaches to determining ownership for tax purposes.

> Example: Company A, resident in Country A, transfers shares to Company B, resident in Country B, under an arrangement in which Company A agrees to repurchase the shares at some point in the future for a fixed price (so called stock "repo"). Under Country A's tax law, the formal sale is treated as a secured loan and the difference in the two prices is treated as interest that is deductible by Company A. Country B follows the legal form of the transaction and treats Company B as the purchaser of the shares and the payments received on the shares by Company B as dividends. When the shares are repurchased by Company A, Company B may realize a gain. Both the dividends and the gain on the sale of the shares may qualify for the participation exemption under Country B's tax system.

2.3 Possible responses and developing country perspectives

As a response to differing treatment of a payment, it would be possible for a developing country to deny a deduction for any payments that are not taxed in the hands of the foreign recipient. A similar approach could be taken in the case of differing classification of legal entities. To the extent that any response depends on information about the treatment of the payment or entity in the other jurisdiction, there are administrative problems for developing countries. More broadly, from the perspective of the developing country from which the payment is made, it would be possible to protect its tax base to some extent by applying a broad-based withholding tax on all outbound payments. Alternatively, there could be rules limiting the availability of deductions generally, through an overall earnings stripping rule, or more specifically by focusing on the connection between the deduction and the generation of domestic source income. Deduction and withholding rules could be coordinated to make sure that no payments are deductible if they are not subject to withholding tax. However, where responses to hybrid transactions are not coordinated, double taxation may result if the two countries involved take divergent approaches.

2.4 OECD Action 2 — 2014 Deliverable

The scope of the OECD Action 2 — 2014 Deliverable[10] on neutralizing the effects of hybrid mismatch arrangements is more limited than the approaches discussed above, dealing only with specifically defined "hybrid instruments" and "hybrid entities." Its basic approach with respect to instruments is to have as a primary domestic rule the denial of the deduction of a hybrid payment that is not taxed in the other jurisdiction. This of course requires the payer country to have adequate information with respect to the treatment of the payment in the recipient country. In cases where the payer country does not have domestic legislation denying the deduction, it is recommended that the recipient country deny an otherwise applicable exemption regime. Similar principles are suggested in the case of other hybrid transactions.

3. Limiting the deduction of interest and other financing expenses

3.1 General

The use of borrowing (leverage) was identified in both the OECD Report on Addressing BEPS and Action 4 in the OECD Action Plan on BEPS as a technique that facilitated base erosion and profit shifting. The issue comes up because most jurisdictions recognize interest expense on borrowing (the "rental" cost of money) as a deductible expense. When applied to corporations, this basic rule encourages the use of debt financing rather than equity financing for corporate structures, as interest deductions reduce the tax base while distributions of corporate profits in the form of dividends do not. In addition, it gives an incentive to "load" debt into companies operating in high-tax countries and arrange for the interest payments to be received by an entity in a low- or no-tax jurisdiction. This problem is especially troublesome where the loan is provided by a related shareholder or a related finance company organized in a low-tax jurisdiction. Furthermore, not only can the amount of the loan

[10] OECD/G20 Base Erosion and Profit Shifting Project: *Neutralising the Effects of Hybrid Mismatch Arrangements — Action 2: 2014 Deliverable* (Paris: OECD, 2014), available at http://www.oecd.org/tax/beps-2014-deliverables.htm.

be excessive, but there is also an incentive to have an excessively high interest rate on the loan. From the point of view of developing countries, where inward investment is financed through debt, this can result in serious problems of base erosion and profit shifting.

> Example A: Company P has no external debt. It has provided capital to Company F, organized in a tax haven, which functions as a financing vehicle to all of Company P's operating subsidiaries, including Company DC, which is resident in Country DC, a developing country. Company DC has paid in capital of 250 and is able to borrow 1,000 from Company F, deducting 100 of interest expense at 10 per cent in Country DC, which entirely eliminates the profits of 100 of Company DC.

As this example shows, there are a number of connected issues involved in determining the appropriate treatment of cross-border interest. First, because there is no external debt anywhere in the Company P group, the only effect of allowing the interest deduction is to shift profits from Company DC to Company F — that is to say, the combination of the deduction in Country DC and the exemption from tax of the interest in the country of the recipient has resulted in part of the profits of Company DC and the Company P group not being taxed anywhere. If Company P had instead financed the investment in Country DC through a direct equity investment, Company DC would have been taxed on the profits, which would be transferred to Company P as a dividend and which might be subject to withholding tax by Country DC. It is worth noting here that, from an economic perspective, money is fungible — apart from tax consequences, Company P is generally indifferent to whether the internally derived funds are represented by a loan or an equity investment.

Issues with respect to the interest deduction can also arise even where the borrowing does not involve a related party. Although the borrowing is from an unrelated party, there will still be an incentive to locate the borrowing where it will be most advantageous from a tax point of view, which can have a base-eroding aspect.

> Example B: Company P, resident in Country P, pays tax at a rate of 20 per cent in Country P and wishes to make an investment in Country DC, which has a tax rate of 40 per cent. It has determined that it will need to finance this investment by

external financing. It can structure the investment in Country DC so that all of the financing expense falls in Country DC and is deducted there while the interest receipts are taxed in Country P or in a third country.

3.2 Possible responses

3.2.1 Recharacterization of debt as equity

If the financing instrument takes the legal form of a loan, it would be nonetheless possible for tax purposes to treat the instrument as an equity investment and disallow the deduction of the purported interest expense. This might be the approach if the debt is subordinated to other debt or if the "interest" payments are dependent on profits, giving the financing the economic character of equity despite its formal legal status as debt.

3.2.2 Thin capitalization rules

A number of countries have so-called thin capitalization rules that deny the interest deduction where the amount of debt in relation to equity capital exceeds certain ratios. Thus, in Example A above, where the borrowing was four times the amount of the equity capital, all or part of the interest deduction in Country DC could be disallowed if it has thin capitalization rules that deny the deduction of interest on a corporation's debt to the extent that it exceeds, say, two or three times its equity. In some cases, only related-party debt is included, but in other situations all loans are taken into account in determining whether the interest expense is deductible.

3.2.3 Earnings stripping rules

Instead of focusing on the amount of debt relative to equity, it is also possible to restrict the amount of the interest deduction by focusing on the amount of the interest expense relative to the company's income. Thus, in Example A above, where the profits of 100 were completely eliminated by the interest deduction of 100, it would be possible to limit the interest deduction to, say, 30 per cent of the before-tax earnings; as a result, 70 of the interest deduction would be disallowed. It might be possible to allow the disallowed interest expense to be "carried forward" to subsequent years in which the taxpayer has additional profits and less interest expense. Again, it might be possible to limit the "earnings stripping rules" to related-party interest or to apply them to all interest on all borrowings.

3.2.4 Transfer pricing aspects

In some cases, the interest deduction can be limited by applying "arm's length" transfer pricing principles. For example, the interest deduction might be disallowed if the taxpayer cannot establish that a third-party lender (for example, a bank) would have made the loan in similar conditions and on similar terms. Similarly, the loan could be respected as such, but the amount of deductible interest could be limited to what an "arm's length" rate of interest would have been.

3.2.5 Allocation of worldwide interest expense

From an economic point of view, money is fungible, that is to say, borrowing for one purpose or in one country means that the taxpayer can continue holding other assets or investments in other countries. Suppose, for example, that the taxpayer holds asset A and wishes to acquire asset B. To make this acquisition, the taxpayer could either borrow funds to finance the purchase or could "disinvest" in asset A (that is to say, sell asset A and use the proceeds) to purchase asset B. Viewed from this perspective, if the taxpayer borrows to acquire asset B, the interest expense can be viewed as related to both asset A and asset B. In the same way, in example B above, the borrowing in Country DC to finance the acquisition there could also be seen to be related to the assets that Company P holds in Country P. If this approach is taken, the proper allocation of the interest among the countries involved would require some kind of allocation based on the assets, income or activities of the taxpayer in each country.

3.2.6 Withholding tax on interest

It would be possible to offset in part the tax base reductions caused by interest expense by subjecting the interest to withholding tax. This tax is unlikely to completely offset the corporate tax forgone as a result of the interest deduction because corporate tax is usually imposed at a higher rate than the rate of gross withholding tax. The rate of withholding tax might vary depending on the nature of the loan and the status of the recipient (for example, the parent company, a group finance company or an unrelated bank). Determining the appropriate rate of tax and the economic incidence of the tax are challenges in designing a withholding tax system.

3.3 Developing country perspective

The variety of responses discussed above to base-eroding interest payments raise a number of questions for developing countries. In establishing rules to prevent inappropriate interest deductions, developing countries must balance the need to attract investment against the necessity of protecting the tax base. In addition, considerations of practical implementation should be taken into account. For example, an approach based on worldwide apportionment would require substantial information from other jurisdictions to be available. In contrast, a focus on only related-party loans in the context of thin capitalization rules would present fewer administrative challenges, although it could be subject to taxpayer manipulation that would undercut its effectiveness. Rules that broadly deny the interest deduction, while easily administered and appealing to developing countries, run the risk of discouraging commercially appropriate financial structures. Similarly, use of withholding taxes on outbound interest payments, especially to unrelated lenders, may raise borrowing costs for local borrowers.

3.4 OECD Deliverables on limiting the deduction for interest

The OECD Action Plan on BEPS foresees its Deliverables with respect to limiting the deduction for interest being published by September 2015.[11]

[11] OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 2, Annex A.

4. Base protection issues involving permanent establishments

4.1 General considerations

Under the laws of many countries, and under both the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention)[12] and the OECD Model Tax Convention on Income and on Capital[13] (OECD Model Convention), the concept of "permanent establishment" (PE) plays a key role in determining the taxing jurisdiction and hence the tax base of the country. With respect to business activities, the existence of a permanent establishment is necessary to allow the source country to tax the business income derived by a resident of the other country, and may also require the residence country to exempt the income. Thus, the exact content of the definition of permanent establishment is of crucial importance. The various definitions of permanent establishment differ substantially both in domestic laws and in the United Nations and OECD Model Conventions. For example, under Article 5 (5) (b) of the United Nations Model Convention an agent who holds a stock of goods from which he regularly fills orders can constitute a permanent establishment even in the absence of the power to conclude contracts in the name of the principal. Under the OECD Model Convention, Article 5 (5), authority to conclude contracts is necessary for the actions of an agent to constitute a permanent establishment for the principal. Similarly, under Article 5 (3) (b) of the United Nations Model Convention, the furnishing of services for a certain period of time in connection with the same or connected projects may constitute a permanent establishment, even in the absence of a fixed place of business. Under the OECD Model Convention, a fixed place of business is required.

The broad question of which activities should constitute a permanent establishment as a fundamental rule in determining taxing

[12] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[13] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

jurisdiction must be distinguished from the narrower question of how to deal with structures that are "artificially" set up to avoid permanent establishment status while at the same time giving the taxpayer substantial economic presence in the taxing jurisdiction. Action 7 in the OECD Action Plan on BEPS is clearly focused on the latter issue; its mandate is to develop changes to the definition of PE to "prevent the artificial avoidance of PE status."[14]

Developing countries are of course concerned with the "artificial" avoidance of PE status and with establishing mechanisms to deal with such avoidance. However, they are also concerned with the appropriateness of the PE definition generally and the extent to which it unduly restricts source-based taxation of activities that involve substantial economic activity in the domestic jurisdiction. The issue arises most importantly in the context of the taxation of the digital economy and the taxation of services, and is discussed subsequently in sections 5 and 9 below. The focus here is principally on dealing with structures that can be viewed as "artificial" regardless of the basic PE definition.[15]

4.2 Commissionaire arrangements

In recent years, a number of companies have reorganized their international structures by centralizing a number of functions dealing with intangibles, product promotion, inventory management and the like in individual companies, often located in low-tax jurisdictions, and converting sales subsidiaries that had previously handled all aspects of the purchase and sale of goods in the source country into so-called "low risk" distributors. In many cases, these business restructurings had the effect of reducing substantially the amount of revenue attributed to the source jurisdiction. Under the prior structure where the "full-fledged" distribution subsidiary bought the goods from a related

[14] OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 2, at 19.

[15] The two issues discussed here are related. A broader definition of PE would eliminate the possibility of "artificially" avoiding the narrower definition. Thus, a PE definition that treated the maintenance of a stock of goods for delivery as a PE would respond to some of the issues raised by commissionaire arrangements.

party and sold them in the source jurisdiction, the full amount of the sales profit would be taxed in the source country. However, where the operations are rearranged with the local company acting only as a sales agent, it is possible to argue that only a small sales commission would be taxable in the source State. This position relies on Article 5 (5) (a) of the United Nations Model Convention and Article 5 (5) of the OECD Model Convention, which require that for a PE to be present in these circumstances, the agent must have "authority to conclude contracts" in the name of the related person supplying the goods. This requirement has been interpreted to require that the agent must have the legal authority to bind the supplier — that is to say, at the end of the contract negotiations, the agent must have the legal authority to create binding obligations on the supplier in order for a PE to exist, regardless of the extent of the agent's activity in the market jurisdiction.

Under the laws of many countries, the agency relationship can be structured as a so-called commissionaire arrangement, under which an agent concludes contracts that are binding only on the agent itself and do not create any obligations on the part of the supplier, even though it is clear that the supplier will be supplying the goods on the terms agreed to by the agent. In such a case, the only amount taxable in the country of sale would be the "low risk" sales commission and not the real profit on the sale of the goods, which would be attributed to the supplier, who in these circumstances would not technically have a PE in the country of sale.

4.2.1 Possible responses

One relatively straightforward response to the commissionaire problem would be to modify the agency PE rule in the treaty to make explicit that the negotiation of contracts on behalf of the principal dealing with goods that the principal was to furnish would be sufficient to establish a permanent establishment. Thus, it would no longer be required for an agent to have authority to bind in order to establish taxing jurisdiction. It may be possible under the general and specific tax avoidance doctrines of some countries to find a permanent establishment in the appropriate factual circumstances or by applying some kind of "economic substance" analysis, but in most countries the courts have rejected the application of this anti-avoidance approach.

4.3 Preparatory and auxiliary services

Article 5 (4) of the United Nations Model Convention, like the OECD Model Convention, lists a number of activities that are described in the Commentary as being "preparatory or auxiliary" and that do not result in the creation of a PE. The basic idea is that a taxpayer resident in one country should be able to establish itself in the territory of the other country and carry on activities that are not central to the earning of its profits without any taxation in the other country. This is the case even if many or all of the enumerated activities are carried on over a long period of time. Concern has been expressed that by manipulating and combining various functions, taxpayers can establish a substantial presence in the market jurisdiction that contributes to the profitability of the enterprise without those activities constituting a PE under the existing rules.

4.3.1 Possible responses

A re-examination of the activities enumerated in the various paragraphs of Article 5 would allow a more nuanced treatment of situations where activities are combined. In addition, as indicated above, in some countries courts have adopted an interpretive approach to the concept of permanent establishment that focuses more directly on the level of economic penetration in the jurisdiction and less on the formal legal technicalities of the nature of the relationships involved. There are pros and cons to such an approach, which can create substantial legal uncertainty.

4.4 OECD Action 7 — 2015 Deliverable

Action 7 in the OECD Action Plan on BEPS expressly requires attention to the issues of "commissionaire arrangements" and the exemptions for preparatory and auxiliary activities. The final recommendation on this item will be made in September 2015.

5. Protecting the tax base in the digital economy

5.1 General

Information and communications technology (ICT) have significantly changed the ways that companies can do business globally. ICT raises a number of related problems with respect to base erosion and profit shifting. First, through technological advances, it has become possible to have significant market penetration in a country without creating a taxable presence in the form of a PE. As a result, countries are deprived of revenues from the traditional sale of goods that they would historically have been entitled to tax under existing rules regarding jurisdiction to tax. Second, new forms of income have been created from the business models using ICT. For example, it is possible to collect data about consumer preferences and other information from the market jurisdiction through the monitoring of digital traffic, which can then be sold to third parties to aid them in their marketing strategies. In addition, the ability to deliver goods and services using ICT raises questions concerning the nature of income resulting from the provision of the goods/services. For example, payments might be considered to be royalties subject to tax on a withholding basis or might be treated as business profits taxable only in the presence of a PE. Finally, the flexibility provided by ICT allows multinational enterprises to centralize their functions in certain jurisdictions, often tax havens, which then provide a vehicle for base-eroding payments from the market jurisdiction. Action 1 in the OECD Action Plan on BEPS undertakes to identify the issues involved in the taxation of the digital economy, including the application of indirect taxes to such activities. These issues are of particular importance to developing countries, where there has been a significant expansion of access to digital services and the attendant possibility of the use of ICT to exploit the local market. The possible erosion of the corporate tax base is important for developing countries because that tax is typically a major source of revenue.

5.2 Avoiding taxable presence

ICT makes it possible to avoid a traditional taxable presence in the jurisdiction. In the simplest case, a distribution structure using a local sales office can be replaced by a website selling the product for direct delivery, thus eliminating all the sales income from the domestic tax base. Similarly, a local presence, such as an office, might be maintained but through ICT many of the functions formerly performed by the local presence can be transformed into functions performed offshore. This development might be referred to as “base cyberization”: part of the tax base that was previously captured by traditional jurisdictional concepts has now been converted to "cyber" transactions that are not taxed.

5.2.1 Possible solutions and developing country perspectives

In these circumstances, it might be possible to re-evaluate the traditional presence tests in light of new technological developments. This is part of the broader discussion of the relevance of the permanent establishment concept discussed in section 4.1 above. For example, the types of activities that traditionally have not constituted a PE might be treated differently where the sales in a jurisdiction are made online. Thus the existence of a warehouse, which often does not constitute a PE (see, however, United Nations Model Convention, Article 5 (4) (a)) might be evaluated differently in this context. Similarly, activities in the jurisdiction that would not normally lead to the existence of a dependent agent PE might need to be evaluated differently where the sales take place online. In a more far-reaching modification of existing rules, ICT activities in a jurisdiction might be considered to be a "virtual PE" based on the existence of "significant digital presence." It might also be possible to evaluate the business activities of a taxpayer in the jurisdiction by taking into account both the physical presence and the digital presence in the jurisdiction to determine if there was "significant business presence." Similarly, the collection of information through a fixed place has traditionally been viewed as not constituting in itself a PE. But where the extensive ability to collect and utilize digital information is the primary revenue source of the business, a different result may be required to adequately protect the tax base of the source country. These issues are also examined in connection with avoidance of permanent establishment status in section 4 above and income from services in section 9 below.

5.3 Income characterization

Apart from the issue of taxable presence, the existence of ICT has raised issues as to the appropriate characterization of particular items of income that result from digital access to the goods or services involved. Thus, the traditional sale of goods can be transformed into a licence for downloading a digital file or a manufacturing activity can be carried out digitally through "3D printing." Utilization of "cloud" transactions raises similar questions of characterization. In some cases, it might be possible to treat such situations as involving royalties or rentals, thus typically giving taxing jurisdiction to those countries that follow the United Nations Model Convention's approach to royalties.

5.4 OECD Action 1 — 2014 Deliverable

The OECD issued a report in 2014 entitled "Addressing the Tax Challenges of the Digital Economy."[16] The report discusses many of the issues raised in the previous sections but makes no specific recommendations.

6. Transparency and disclosure

6.1 General

In order to assess the extent of possible base erosion and profit shifting, it is essential that tax authorities in developing countries have access to information about the nature and structure of the activities of taxpayers carrying on business or investing in their jurisdiction. This requires both transparency with respect to the way in which taxpayers' activities are structured and disclosure of the necessary information. The information involved may be detailed information as to particular transactions (for example, the determination of transfer pricing) or more general, higher-level information that allows the tax authorities to view the overall structure of the taxpayer's global business and, in particular, the use made of tax haven vehicles as part of a tax avoidance scheme. These matters primarily concern MNEs doing business and investing in the country. The primary function of transparency and disclosure in this context is to help jurisdictions to assess and collect the appropriate amount of tax on inward investment. The underlying tax issues concerned arise principally in the context of transfer pricing and base-eroding payments. The OECD Action Plan on BEPS is primarily focused on these matters.

[16] OECD/G20 Base Erosion and Profit Shifting Project: *Addressing the Tax Challenges of the Digital Economy — Action 1: 2014 Deliverable* (Paris: OECD, 2014), available at http://www.oecd.org/tax/beps-2014-deliverables.htm.

In addition, in order to assess tax on its resident companies and individuals, a jurisdiction needs to have access to information concerning the foreign assets and activities of its resident taxpayers. For developing countries, these issues primarily concern the taxation of resident individuals, and there have been a number of important international developments moving in the direction of automatic exchange of information (AEOI). The work has been carried out by the OECD in cooperation with the G20[17] and foresees being implemented through a multilateral competent authority agreement[18] which builds on the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.[19]

6.2 Transfer pricing documentation

Both the United Nations Practical Manual on Transfer Pricing for Developing Countries[20] and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[21] contain substantial guidance on the structure and application of transfer pricing documentation rules. Such documentation would ideally allow tax administrations to carry out transfer pricing risk assessment, to assure that the taxpayer has applied the appropriate transfer pricing methodology and to assist in the audit of transfer pricing cases. However, currently it is very difficult for countries, developing countries in particular, to obtain information about the global activities of MNEs operating in their jurisdiction, where their profits are reported and where and how much tax they pay. This information would allow tax

[17] OECD, Secretary-General Report to G20 Leaders, supra note 3.

[18] OECD, *Multilateral Competent Authority Agreement,* available at http://www.oecd.org/tax/exchange-of-tax-information/multilateral-competent-authority-agreement.htm.

[19] OECD-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, available at http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf.

[20] United Nations, Department of Economic and Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New-York: United Nations, 2013).

[21] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris: OECD, 1995).

administrations to assess whether the income reported and the taxes paid in their jurisdiction were appropriate in the light of the global activities of the MNE. For example, it would allow tax authorities to identify where base-eroding payments are received or to determine whether the "low risk" return shown by a local distributor was appropriate in light of the residual profit being reported elsewhere.

6.2.1 Country-by-country reporting

Action 13 in the OECD Action Plan on BEPS proposes a requirement that MNEs provide country-by-country (CbC) information in the context of transfer pricing documentation. However, it is clear that the importance of CbC reporting goes well beyond transfer pricing issues because CbC reporting provides insight into the relations between the various parts of the MNE. It can assist the countries involved in determining whether the income and tax allocations of the group seem to make sense in general terms. CbC information can also be useful as a risk assessment tool to help a tax administration make decisions about the allocation of its auditing and investigative resources. This aspect is particularly important for developing country tax administrations, given their lack of resources.

6.2.2 Technical issues in country-by-country ("CbC") reporting

As the purpose of CbC reporting is to give a broad overall view of the activities of an MNE, income and tax position, the necessary information should be at a fairly high level. Action 13 recommends the development of a "master file" containing information about the overall group organizational structure, lines of business and financial and tax position. In addition, the taxpayer would be required to prepare a "country-by-country template" showing revenue, profit before tax, cash taxes and accrued taxes in the current year, stated capital and retained earnings, number of employees and tangible property. Finally, a "local file" is required with more detailed information about local taxpayers (for example, subsidiaries and branches) and their transactions with related parties, the financial aspects of those transactions and a description of the transfer pricing method used.

6.2.3 Developing country perspective

From the perspective of developing countries, the information that would become available from the increased reporting requirements would certainly be useful in properly assessing MNEs doing business in their jurisdictions. However, there are a number of important policy issues to be considered. First, the country must have the appropriate domestic legislation for it to gather the required information from its taxpayers. In addition, to the extent that foreign multinationals prepare master files and CbC templates under the guidance of the home office, there must be some mechanism for other countries, in particular developing countries, to obtain the information contained in master files and CbC templates. There are also issues of confidentiality regarding certain information that must be taken into account. More broadly, there is the issue of balancing the compliance burden of information reporting on taxpayers against the usefulness of the information for tax administrations. The OECD Report on Addressing BEPS to the G20 Leaders indicated that there was substantial disagreement among the countries involved in the OECD project on BEPS as to exactly how this balance should be struck.[22]

Another important policy issue on which there is disagreement is the extent to which the information developed under the CbC rules should be restricted to tax administrations, to governments more generally, or available to the general public.

6.3 Automatic exchange of information

In addition to the work on transparency and disclosure undertaken in connection with the OECD project on BEPS, the G20 and the Global Forum on Transparency and Exchange of Information for Tax Purposes have been active in developing a new international standard for automatic exchange of information (AEOI). The basic structure of this project is that participating countries would require local banks and financial institutions to obtain information on financial accounts, which they would make available to the local tax authorities; they, in turn, would provide that information on an automatic

[22] OECD, *Addressing Base Erosion and Profit Shifting,* supra note 1, at 27.

basis to other countries (that is to say, without the need for a specific request). Under a mandate from the G20, the OECD has developed a Common Reporting Standard (CRS) establishing the information to be reported and a Model Competent Authority Agreement (CAA) outlining the mechanism for implementing the exchange. The CRS identifies the entities that are required to report, the type of information to be reported and collected and the kinds of accounts on which reporting is necessary. It is accompanied by a Commentary, which sets out the information technology modalities allowing the information to be transmitted automatically. Under the CAA, participating countries would agree to pass the necessary domestic legislation in order to obtain the required information and to have appropriate safeguards to ensure the confidentiality of taxpayer information.

6.4 Developing country perspective

While the automatic exchange of information can enhance the revenue-raising capacity of a developing country, there are some important technical and policy issues that must be faced. The current CAA model for exchange of information is structured on the basis of reciprocity — that is to say, both jurisdictions must be able to obtain and exchange the required information. However, developing countries may lack the legal and administrative capacity to obtain information from their local financial institutions. They would not be in a position to obtain information to exchange, but would be very interested in receiving information from an exchange partner (for example, from a financial centre). It might be possible to develop some form of "phased in" implementation so that developing countries could benefit from obtaining information from other countries while developing their own capacity to provide information. A second problem is that many developing countries have a limited network of tax treaties or tax information exchange agreements, which are a condition for and the mechanism for exchanges of information. One possibility for extending the range of automatic exchange would be to take advantage of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. A number of countries have taken advantage of the mechanism, though it remains to be seen exactly how effective it will be.

7. Preventing treaty abuse

7.1 General

Tax treaties offer a number of advantages to taxpayers, particularly with regard to the reduction of source-based taxation. While the treaty rules providing for the elimination or reduction of source country tax are important in carrying out a basic purpose of tax treaties, namely, to encourage cross-border investment, there are situations where those rules can be used to create advantages that were not intended by the treaty partners. These situations can be characterized as "improper use of tax treaties," and countries are concerned with limiting such "treaty abuse" and denying treaty benefits in those cases. Action 6 in the OECD Action Plan on BEPS recognizes the importance of preventing the granting of treaty benefits in inappropriate circumstances.

On the other hand, to deny treaty benefits in cases where they are appropriate undercuts the basic purpose of entering into a tax treaty in the first place and creates uncertainty for taxpayers. Thus, the determination of "treaty abuse" in a particular situation depends on balancing a number of factors. In determining in specific situations whether there is an abuse or improper use of a treaty, the Commentary to the United Nations Model Convention endorses the following "guiding principle":

> A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable tax treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.[23]

There are a number of techniques to deal with treaty abuse, including:

- Specific and general anti-abuse rules in domestic law;
- Judicial anti-abuse doctrines;

[23] Paragraph 23 of the Commentary on Article 1 of the United Nations Model Convention, quoting paragraph 9.5 of the Commentary on Article 1 of the OECD Model Convention.

- Specific anti-abuse rules in treaties;
- General anti-abuse rules (GAAR) and "Limitation on Benefits" (LOB) articles in treaties;
- Purposive interpretation of tax treaty provisions.

Which technique or combination of techniques is most appropriate will depend on the basic legal structure of the country involved and the nature of the transaction. The following material examines various techniques for dealing with treaty abuse and then discusses how they might be applied to some common situations.

7.2 Specific and general anti-abuse rules in domestic legislation and their relation to treaties

Where a domestic anti-abuse rule appears to limit the applicability of a treaty benefit, several results are possible depending on the circumstances. In some situations, a closer examination of the treaty may indicate that the status of the domestic rule has already been taken into account and is made explicitly applicable in the treaty context. In other situations, a domestic rule may apply to determine or re-characterize the facts on which the domestic tax liability is based. In this situation, according to the Commentaries to the United Nations and OECD Model Conventions, there is no conflict between the treaty and domestic law and domestic law can apply without any limitation by the treaty. Depending on the situation in the country, domestic judicial doctrines such as business purpose, substance-over-form and sham transaction may also be factors in determining the facts on which tax liability is based and do not present a conflict with the treaty. Nonetheless, in some limited circumstances, treaty rules may prevail over certain domestic anti-avoidance principles where there is a conflict between them. When this result occurs, under the general principle that tax treaties prevail over domestic law in the event of a conflict, it will usually be necessary to rely on other techniques — for example, as discussed below, a specific anti-avoidance rule included in the treaty.

7.3 Treaty-based rules

7.3.1 Specific anti-avoidance rules in treaties

Existing treaties contain a number of specific rules that are aimed at denying treaty benefits in particular situations that have been identified as abusive. The use of "beneficial ownership" rules can restrict treaty benefits where the recipient of the income is not the "true owner" of the income and is only functioning as an agent, conduit or nominee. The "special relationship" provisions of the interest and royalties articles allow the tax authorities to reclassify certain payments that are not made at arm's length. Special provisions are often used that are aimed at personal services companies used by entertainers and athletes to avoid source-country tax.[24] Similarly, special provisions in Article 13 of both the United Nations and OECD Model Conventions allow countries to tax gains from the sale of shares of real estate holding companies to prevent the use of such companies to avoid taxation on gains on the underlying real estate.[25]

7.3.2 General anti-avoidance rules in treaties

Some treaties deal with the problem of treaty abuse by having an explicit general anti-abuse rule (GAAR) in the treaty. Paragraph 36 of the Commentary on Article 1 of the United Nations Model Convention suggests one possible version:

> Benefits provided for by this Convention shall not be available where it may reasonably be considered that a main purpose for entering into transactions or arrangements has been to obtain these benefits and obtaining the benefits in these circumstances would be contrary to the object and purpose of the relevant provisions of this Convention.

While a treaty GAAR can be a useful tool, too broad an application of a GAAR can in some circumstances create undesirable legal uncertainty and impede investment. In addition, the existence of a

[24] See Article 17 (2) of the United Nations and OECD Model Conventions.

[25] See Article 13 (4) of the United Nations and OECD Model Conventions.

GAAR in some treaties, but not others, can make the application of other techniques in treaties lacking a GAAR more difficult.

7.3.3 Limitation on benefits rules

A number of existing treaties contain a so-called Limitation on Benefits (LOB) article, which restricts treaty benefits where the person claiming the treaty benefit is technically a treaty resident but lacks substantial connections with the residence jurisdiction. The structure of these articles varies greatly, and a number of tests are used to determine if there is an appropriate connection with the treaty partner. Some of the tests turn on the share ownership of the resident entity and the extent to which the otherwise taxable income of the entity is reduced by base-eroding payments. Thus, for instance, if a closely held corporation resident in State B is owned by residents of State C and paid out most of its income to State C residents in the form of deductible payments, the corporation would be denied the benefits of the treaty between State A and State B on income arising in State A. In other cases, the focus is on the nature of the business operations in the two countries. Still other rules focus on whether the shares of the resident entity (or its parent in the case of subsidiaries) are publicly traded, since in those circumstances it is viewed as unlikely that the resident entity was set up primarily to obtain treaty benefits.

7.4 Limiting treaty abuse through treaty interpretation

Artificial arrangements that have been structured to attempt to take advantage of treaty benefits can sometimes be dealt with through an appropriate approach to treaty interpretation. Under Article 31 of the Vienna Convention on the Law of Treaties,[26] treaties are to be interpreted in good faith and in the light of the object and purpose of the treaty. Viewed from this perspective, structures without a business purpose or lacking in substance can be ignored in applying the treaty even where the treaty does not have a GAAR. The effectiveness of this approach depends on the general approach of the courts in the relevant country to statutory and treaty interpretation.

[26] Convention on the Law of Treaties, Vienna, 23 May 1969.

7.5 Example of possible inappropriate use of treaties: "treaty shopping"

One common form of improper treaty use involves so-called treaty shopping. In these situations, the taxpayer interposes an intermediary company (I) between the source country (S) and the residence country (R) to take advantage of the treaty benefits of the treaty between the intermediary country and the source country. The taxpayer "shops" to find a treaty between the source country and the intermediary country that has the lowest tax "price" in terms of treaty benefits.

> Example: Company R, organized in Country R, is entitled to receive royalties from Company S, a company organized in Country S. Under the R-S treaty, royalty payments from Company S to Company R are subject to withholding tax. To avoid this result, the taxpayer forms Company I in Country I and transfers its right to receive the royalties to Company I. The I-S treaty reduces or eliminates the Country S withholding tax. In Country I, Company I may not be subject to tax on the income it receives (though still qualifying as a treaty "resident"). Payments by Company I to Company R would not be subject to Country I tax because the I-R treaty has eliminated the Country I withholding tax. As a result of the treaty shopping structure, income originating in Country S has ended up in Country R without the imposition of any Country S tax.

Various techniques could be used to prevent the inappropriate use of the I-S treaty in this case. If Country S had a domestic GAAR applicable to this case, it might be possible to ignore the existence of Company I and treat the transaction as if the royalty had been paid directly to Company R. The same result could be reached if the I-S treaty had a GAAR applicable in this case, because a main purpose of the structure is clearly tax avoidance. Treaty benefits could also be denied under a limitation on benefits article in the treaty, which denies benefits where there is foreign ownership of the entity claiming treaty benefits and that entity has no substantial business operations in its country of residence.

7.6 OECD Action 6 — 2014 Deliverable

The OECD Action 6 — 2014 Deliverable,[27] focuses on the need to have a "minimum level of protection" against treaty abuse. This minimum standard can be met by including:

(a) A GAAR in the treaty based on a "one of the principal purposes" test — that is to say, one of the principal purposes of the relevant transaction is to obtain treaty benefits and in the circumstances granting those benefits would be contrary to the object, spirit and purpose of the treaty; or

(b) Both an LOB clause, along the lines described above, combined with a GAAR or, if the treaty does not contain a GAAR, domestic anti-conduit financing rules.

The original version of the OECD report recommended both an LOB and a GAAR as necessary, but opposition from some countries to the use of a GAAR led to the inclusion of the reference to adequate domestic law measures taking its place. It is therefore clear that countries must have flexibility with respect to implementing measures aimed at restricting treaty abuse. The OECD Action 6 — 2014 Deliverable also indicates that the preamble of the treaty should include a clear statement that the treaty is not intended to be used to generate "double non-taxation" or facilitate treaty shopping. Also, it makes explicit that domestic anti-abuse rules generally are applicable and are not displaced by restrictions on taxing rights in the treaty. Finally, it sets out some of the considerations that a country must take into account in selecting treaty partners, stressing the need to be very careful in entering into treaties with countries with no or low taxation, where the benefits of the treaty are unlikely to outweigh its costs.

7.7 Developing country perspective

A detailed LOB clause such as that set out in the OECD Action 6 — 2014 Deliverable would be difficult for many developing country

[27] OECD/G20 Base Erosion and Profit Shifting Project: *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances — Action 6: 2014 Deliverable* (Paris: OECD, 2014), available at http://www.oecd.org/tax/beps-2014-deliverables.htm, paragraphs 12-14.

tax administrations to deal with. The LOB rules are complex and are intended to cover a number of sophisticated financing transactions that typically would not be an issue in the case of a developing country. Nonetheless, some kind of simplified LOB focusing on a limited number of objective criteria to ensure that the taxpayer, in addition to technically being a resident, also had substantial contacts to the jurisdiction might be a possibility. Whether or not specific treaty anti-avoidance rules are necessary would depend on a variety of factors, including the general approach of the courts to avoidance transactions. A GAAR along the lines of the one proposed in the United Nations Model Convention could also be considered. In that connection, it would be important to keep in mind the guidance given in the Commentary on Article 1 of the United Nations Model Convention that the application of such a rule should be based on objective facts and circumstances.[28]

8. Preserving the taxation of capital gains by source countries

8.1 General

Foreign direct investment in developing countries can be structured as a locally organized subsidiary or as a branch of a foreign corporation. In both cases the shares of the corporation may be held by an offshore holding company. If the operating assets in the country are sold, whether they are owned by the foreign corporation or a local subsidiary, the country will typically have the right to tax any capital gain on the assets, both under its domestic law and under a tax treaty. Similarly, if dividends are paid by a domestic corporation, withholding tax would generally be applicable to the dividends. However, if instead of selling the assets directly, the foreign investor sells the shares of the domestic subsidiary or the shares of the foreign subsidiary with the branch operation in the country, source-country tax may be avoided. A similar result would apply if the shares of the domestic corporation were held by a holding company and the shares of the holding

[28] Paragraph 27 of the Commentary on Article 1 of the United Nations Model Convention.

company were sold. Thus, the accrued gain attributable to the underlying assets which has accrued in the source country would escape taxation by the source country on the transfer. This gain may represent appreciation in the underlying assets or retained earnings that would have been taxed to the shareholder had they been distributed to the shareholder as a dividend. These elements of gain will escape taxation by the source country if the shares are sold unless the domestic law of the source country has a special provision to reach such gains. Even if the domestic law has the appropriate provisions, tax treaty provisions may in some circumstances prevent taxation of the gain.

8.2 Domestic law provisions

8.2.1 Shares in domestic companies

The structure of the capital gains provisions as they apply to the sale of shares of domestic companies differs substantially from country to country. Some do not apply to any sales of domestic shares by non-residents, some tax the sale if the corporation holds certain assets (for example, real or immovable property located in the country) and others may assert a source-based claim if the non-resident owns a specified percentage of shares in the domestic corporation regardless of the composition of its assets. Additionally, some countries tax the sale of shares only if the transaction is viewed as a matter of tax avoidance; if, for example, property the sale of which would be taxable is transferred to a corporation, then followed closely in time by the sale of the shares of the corporation. There is no clear pattern in the rules of domestic law applicable in this area. The basic decision of how far to extend source-based taxation to the sale of shares of domestic corporations involves a balancing of the desire to attract foreign investment and the importance of the taxation of the gains for the domestic tax base.

8.2.2 Administrative issues

If the decision is made to tax the sale of shares in domestic corporations by non-residents in some cases, there are a number of administrative issues to consider. There are several ways to enforce the tax. The seller may be required to report the gain and pay the tax in the same way as if the gain had arisen with respect to assets located directly in the country. This approach may be difficult to enforce, especially if there is no requirement under local law for the sale of shares to be reported by the domestic corporation. In addition, tax might be collected by a withholding tax obligation on the purchaser to withhold and remit the appropriate amount of tax. However, in the case of a sale between two non-residents, this obligation is difficult to enforce in practice. Additional administrative issues are involved if the decision is made only to tax the sale of the shares in cases where there is a tax avoidance element.

8.3 Multiple taxation of the same economic gain

An additional structural issue is the impact the sale of the shares should have on the tax status of the underlying assets of the corporation. If the sale of the shares is taxable but no adjustment is made in the tax cost of the underlying assets, a second tax would be due on the same economic gain when the assets are sold. Whether or not this pattern of taxation is appropriate will depend on the general structure of corporate-shareholder taxation in the country.

8.4 Shares of a foreign corporation

Assuming the decision is made to tax the sale of shares of domestic corporations in certain circumstances, a separate question is how to treat the sale of shares of a foreign corporation that has a domestic permanent establishment or owns the shares of a domestic corporation. There are significant administrative difficulties in implementing a tax on such transfers as a general matter, both in terms of obtaining the necessary information to assess the tax and implementing effective methods for collection. Regardless of how the issue of the taxability in general of such transactions is resolved, it may be desirable to have a provision that imposes tax where the transaction can be viewed as involving tax avoidance — for example, where the transfer of the shares of the domestic corporation to a foreign corporation is followed by the immediate sale of the foreign shares, or in situations where the foreign corporation is merely a shell corporation.

8.5 Treaty aspects

If the decision is made to tax capital gains on the sale of shares in domestic or foreign corporations (as well as interests in partnerships and other entities), it is important to consider the extent to which that right should be preserved in tax treaties. Many treaties limit the right of the source country to tax gains on the sale of shares to shares in companies the value of whose assets consists principally of real or immovable property located in the source country. Article 13 (5) of the United Nations Model Convention provides for source State taxing rights where the percentage ownership of shares in a domestic corporation exceeds a certain amount, regardless of the nature of the underlying assets. In addition, as discussed in section 7.3 above, treaty anti-abuse rules may be applicable to protect a source country's right to tax gains from the sale of shares of either domestic or foreign corporations.

9. Services

9.1 General

The use of services payments to erode the tax base of developing countries is a serious issue that involves several types of services and the provisions of both domestic law and tax treaties. The provisions of the domestic law of developing countries dealing with income from services vary enormously. Some countries impose tax on virtually all business services provided by non-residents in the country or to residents of the country; others impose tax only if a non-resident has a PE or fixed base in the country. Some countries impose tax on income from services by way of a final gross-based withholding tax, while other countries tax income from services on a net basis.

It is relatively easy for multinational enterprises operating in a developing country through a subsidiary resident in the country to reduce the tax payable to that country through payments for services rendered to that subsidiary by other non-resident group companies. The payments will generally be deductible in computing the income of the company resident in the source country, but may not be taxable by the developing country in the hands of the non-resident service provider. Even if payments for services performed by the non-resident company are taxable under the domestic tax law of the developing country, an applicable tax treaty along the lines of the United Nations or OECD Model Conventions would in many circumstances prevent the country from taxing such payments unless the non-resident has a PE or fixed base in the country.

The United Nations Model Convention contains several provisions dealing with various types of services. Some types of services — for example, insurance, government service, pensions, and services of directors and top-level managerial officials — do not provide serious opportunities for the erosion of the tax base of developing countries. These services are not dealt with in this overview. As discussed below, the United Nations Committee of Experts has decided to include a new article dealing with income from certain "technical services" in the United Nations Model Convention.

9.2 Employment income

In general, under both domestic law and the provisions of both the United Nations and OECD Model Conventions, employment income derived by non-residents is taxable by a country only if the employment services are performed or exercised in the country. Under Article 15 of the United Nations Model Convention, a source country is prevented from taxing a non-resident on income from employment exercised in the source country if the non-resident is employed by a non-resident employer that does not have a PE or fixed base in the source country; or, if it has a PE or fixed base, the employee's remuneration is not deductible in computing the profits attributable to the PE or fixed base, and the non-resident employee is not present in the source country for 183 days or more in any 12-month period. The same result applies under Article 15 of the OECD Model Convention except that the concept of a fixed base has been deleted from it.

The broad scope of source country taxation of income from employment earned by non-resident employees suggests that opportunities for avoidance of source country tax are limited. Where a non-resident employee's remuneration for employment services (performed in the source country) is deductible by the employer in computing income subject to tax by the source country, the non-resident employee is usually subject to tax on that remuneration by the source country. The employee's remuneration will usually be deductible if the employer is a resident or a non-resident carrying on business in the source country through a PE or a fixed base located in the source country. In these circumstances, the employer is usually required to withhold the tax on behalf of the employee from the remuneration.

Nevertheless, a developing country's tax base may be eroded if a non-resident employer avoids having a PE or fixed base in the source country or if a non-resident individual can alter his or her legal status from employment to independent contractor. A non-resident employee of a non-resident employer without a PE or fixed base in the source country is taxable only if the non-resident employee is present in the source country for more than 183 days in any 12-month period. If a non-resident is an independent contractor, Article 7 or 14 of the United Nations Model Convention (Article 7 of the OECD Model Convention) will limit the source country's right to tax to situations where the non-resident has a PE or a fixed base in the source country and the income is attributable to the PE or fixed base, or where the non-resident stays in the source country for 183 days or more in any 12-month period. In contrast, a non-resident employee of a resident employer or a non-resident employer with a PE or fixed base in the source country is taxable on any income from employment exercised in the source country.

9.3 Entertainment and athletic services

Some entertainers and athletes can make large sums of money in a short period of time. Developing countries that wish to tax income derived by non-resident entertainers and athletes must ensure that the provisions of their domestic law and tax treaties allow them to tax such income irrespective of the legal structure of the arrangements. Article 17 of the United Nations Model Convention allows the country in which entertainment or sports activities take place to tax the income from those activities. Countries must also have provisions in place to deal with techniques used by non-resident entertainers and athletes to avoid source-country tax. Common avoidance schemes in this regard involve the assignment of income by a non-resident entertainer or athlete to another person, usually related to the taxpayer, or the use of an entity of which the non-resident entertainer or athlete is a shareholder and employee. Article 17 of the United Nations and OECD Model Conventions allows the imposition of tax in these circumstances.

9.4 Business services

Under the provisions of Articles 7 and 14 of the United Nations Model Convention (Article 7 of the OECD Model Convention), residents of one State are taxable on their income from services by the other State only if the residents carry on business through a PE or fixed base in the other State. Under Article 5 (3) (b) of the United Nations Model Convention, a non-resident is deemed to have a PE if it provides services in the other State for 183 days or more in any 12-month period. In addition, a non-resident is subject to tax on income from professional or independent services under Article 14 of the United Nations Model Convention if the non-resident stays in the other State for more than 183 days in any 12-month period. The rules in Articles 7 and 14 do not apply to special types of income from services such as international shipping and air transportation, entertainment and athletic activities and employment.

The tax base of developing countries can be eroded through the performance of services by non-residents in two major ways. First, if a non-resident service provider does not have any PE or fixed base in the developing country, any income from services may not be taxable by the developing country under its domestic law or under the provisions of an applicable tax treaty. Moreover, even if the non-resident service provider has a PE or fixed base in the developing country, that country cannot tax income from services that is not attributable to the PE or fixed base. Second, if the services are provided outside the developing country but are deductible in computing the payer's income for purposes of the developing country's tax, the developing country may be unable to tax the income under its domestic law or under the provisions of an applicable tax treaty. If the non-resident service provider has a PE or fixed base in the developing country, the income attributable to the PE or fixed base under the provisions of Article 7 or 14 of the United Nations Model Convention may include foreign source income if, for example, the remuneration of the employees performing the services is deductible in computing the profits of the PE or fixed base. Nevertheless, unless the domestic law of the developing country imposes tax on such foreign source income of a non-resident, the fact that an applicable tax treaty allows the country to tax will have no effect.

As discussed in section 4 above, there are several ways in which taxpayers can structure their affairs to avoid having a PE or fixed base in a country. In some situations, non-resident service providers can provide services in a developing country at various locations in the country without any one place being used for more than six months; similarly, a non-resident service provider may attempt to avoid having a PE or fixed base by using the fixed place of business of a client or a related enterprise. Although the Commentary on Article 5 of both the United Nations and OECD Model Conventions indicates that a PE may exist in this situation,[29] the tax administration of the developing country may not have the necessary information-gathering resources to discover the facts required to show that there is a PE or fixed base. In other situations, a non-resident can avoid having a PE or fixed base by fragmenting its activities among related enterprises, or by using related non-resident enterprises to carry out connected projects. Under Article 5 (3) (b) of the United Nations Model Convention, any services performed for the same or a connected project are aggregated for purposes of counting the number of days on which services are provided in the source country. There is no rule, however, to take into account services provided by related enterprises with respect to the same or connected projects. The same concern applies to construction projects under Article 5 (3) (a) of the United Nations Model Convention. Specific anti-avoidance rules in domestic law or tax treaties might be useful in this regard, although the application of such rules requires effective information-gathering by the tax authorities of the developing country.

A multinational enterprise with a group company carrying on business in a developing country may use another group company

[29] Paragraph 3 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 4 of the Commentary on Article 5 of the OECD Model Convention.

resident in a low-tax country to provide various services to the company in the developing country. These services, which often include legal, accounting, management and technical services,[30] may not require employees of the non-resident service provider to be present in the developing country for long periods of time. It is difficult for developing countries to counteract this type of tax planning even with effective anti-avoidance rules in place. Some countries have insisted on a shorter period than 183 days in order to minimize this limitation on their ability to tax.

9.5 Technical services

Some developing countries have special rules in their domestic law and tax treaties for income from technical services. Under these rules, such services are subject to a final gross-based withholding tax at a flat rate and the resident payer for the services is required to withhold tax from the payments to the non-resident service provider. The types of services to which the rules apply often include managerial, technical and consulting services, but these are not defined precisely.

Neither the current United Nations nor the OECD Model Convention contain any specific provisions dealing with income from technical services. As noted above, in general, income from business services is covered by Article 7 or 14 of the United Nations Model Convention and is taxable only if the non-resident has a PE or a fixed base or spends a significant amount of time in the source country. The high threshold for the imposition of source-country tax on income from business services means that it is relatively easy for non-residents to provide technical services to customers in a source country without becoming subject to source-country tax. As the payments for the services are usually deductible by the payers (either residents of the source country or non-residents with a PE or fixed base in the source country), fees for technical services present a serious problem of base erosion for source countries.

The erosion of the source country's tax base by payments for technical services and the inability of the source country to tax such

[30] The treatment of technical services is discussed in more detail in section 9.5 below.

payments led some countries to add specific provisions to their domestic laws and their tax treaties to allow them to tax payments for technical services on a gross basis.[31] A 2011 survey by the International Bureau of Fiscal Documentation (IBFD) found that 134 of the 1,586 tax treaties concluded between 1997 and 2011 contained a separate article dealing with fees for technical services.[32] Several other treaties extended the provisions of Article 12 dealing with royalties to include certain technical services. Under the separate articles, income from technical services is treated like royalties. Source country tax is allowed on a gross basis at a fixed rate but is limited to fees for technical services "arising" in the source country, which usually means that the services must be performed in the source country. As noted above, typically these separate articles dealing with fees for technical services refer to "managerial, technical or consultancy services" without defining that expression.

The United Nations Committee of Experts has been working since 2008 on the provisions of the United Nations Model Convention dealing with the taxation of income from services. In 2013, the Committee decided that a new article should be added to the United Nations Model Convention allowing source countries to tax fees for technical services on a basis similar to the taxation of royalties (that is to say, on a gross basis at a limited rate without any threshold requirement, even if the services are provided outside the source country). If a new article with these features is added to the United Nations Model Convention and developing countries are successful in negotiating the inclusion of it in their tax treaties, such countries will be able to protect their domestic tax base from erosion through payments to nonresidents for technical services.

[31] In some cases, the definition of royalties is amended to include technical fees; in other cases, a separate article dealing with technical fees is added to a tax treaty. See S. B. Law, "Technical Services Fees in Recent Treaties," (2010) Vol. 64, No.5 *Bulletin for International Taxation,* 250-52.

[32] See W. Wijnen, J. de Goede and A. Alessi, "The Treatment of Services in Tax Treaties," (2012) Vol. 66, No. 1 *Bulletin for International Taxation.*

10. Tax incentives

10.1 General

Tax incentives are widely used by both developing and developed countries to attract foreign investment. Although it seems likely that multinational enterprises use tax incentives to erode the tax base of both developing and developed countries, developing countries may be more susceptible to such base erosion because of a greater need for foreign investment and less capacity for the effective administration of tax incentives.

Tax incentives for foreign investment can be divided into two major categories:

(a) Incentives that directly reduce the cost to a non-resident of an investment in the source country (for example, a tax holiday or reduced tax rates); and

(b) Incentives that indirectly reduce the cost to a non-resident of an investment in the source country (for example, the lax enforcement of thin capitalization or transfer pricing rules by the source country).

The key issue for developing countries is how to design and administer tax incentives for foreign investment in order to maximize their effectiveness.

10.2 Cost/benefit analysis of tax incentives

The ostensible benefit of granting tax incentives for foreign investment is increased foreign investment and the consequential economic benefits for the source country. Often these benefits are simply assumed to occur and rarely are attempts made to quantify them prior to the granting of the incentive. The benefits of tax incentives must be weighed against their costs, which include:

- forgone tax revenues;
- the costs of administration and enforcement;
- possible misallocation of economic resources;
- opportunities for corruption.

The costs of tax incentives can be minimized if developing countries follow best practices in designing, implementing, administering and evaluating their tax incentive programmes.

10.3 The role of tax sparing

If a company resident in a developed country makes a direct investment in a developing country (that is to say, not through a domestic subsidiary) that qualifies for a tax incentive in the form of a tax holiday, the tax given up by the developing country will be replaced by the tax imposed by the developed country (assuming that it taxes the worldwide income of its residents). As a result, the developing country's tax holiday is ineffective because it provides no benefit to the non-resident investor. Instead of paying tax to the developing country and claiming a credit for that tax against the tax payable to the developed country, the investor pays tax only to the developed country. To avoid this result, many developing countries insist on "tax sparing" provisions in their tax treaties with developed countries. Under these tax sparing provisions, the developed country (the country in which the investor is resident) generally agrees to provide a credit for the tax that would have been paid to the developing country (that is to say, the tax that was spared) in the absence of the tax incentive.

The importance of tax sparing is sometimes exaggerated. In general, tax sparing is a problem only where a non-resident invests in a developing country directly in the form of a branch. If the investment is made through a subsidiary established in the developing country, the residence country does not generally impose tax when profits are earned by the subsidiary, and many developed countries exempt dividends from foreign subsidiaries. Even if the investment is made in branch form, tax sparing is not a problem with respect to several developed countries that exempt profits earned through a foreign branch.

Tax sparing provisions in bilateral tax treaties are often subject to abuse and may result in an unanticipated increase in the cost of a developing country's tax incentives without any increase in foreign investment.

10.4 Possible effects of the OECD project on BEPS on tax incentives

It is impossible to predict the effect of the OECD project on BEPS on tax incentives offered by developing countries. One possibility is that it will make doing business in developed countries more expensive because of increased tax burdens resulting from the reduction or elimination of base erosion and profit shifting. If so, the tax incentives offered by developing countries may become more attractive for multinational enterprises. This assumes, of course, that multinational enterprises cannot easily strip profits out of developing countries. If they can do so, the tax incentives offered by developing countries will be less important. Another more likely possibility is that several of the BEPS action points may provide developing countries, as well as developed countries, with additional tools to improve the administration and enforcement of their tax incentives.

11. Conclusion

Tax base protection is an essential element in establishing domestic revenue sustainability. The identification of the features of the tax system that facilitate base erosion and profit shifting will allow countries to assess the impact that such provisions have and to develop the appropriate measures to take in response. Once the diagnosis of the problem has been made, the next step is the implementation and administration of those solutions that are best suited to the particular circumstances of each country. Although there is no one answer to the issues of base erosion and profit shifting, a careful choice among the possible approaches can lead to substantial improvements in the revenue-raising capacity of the tax systems of developing countries.

Chapter II

Taxation of income from services

Brian J. Arnold*

1. Introduction

With the support of the G20 nations, in 2012 the Organisation for Economic Co-operation and Development (OECD) launched an ambitious project to deal with base erosion and profit shifting (BEPS) by multinational enterprises.[1] In July 2013, the OECD issued an Action Plan on Base Erosion and Profit Shifting (OECD Action Plan on BEPS), involving 15 actions to be taken to prevent base erosion and profit shifting.[2] These actions range from the completion of ongoing work by the OECD dealing with hybrid mismatch arrangements and transfer pricing to an examination of the effects of the digital economy on base erosion and profit shifting and the possibility of a multilateral treaty as a means of implementing tax treaty measures intended to prevent base erosion and profit shifting. A tight timeframe was set for the implementation of the OECD project on BEPS, with many of the actions to be completed by September 2014, others by September 2015 and the balance by the end of 2015.

The OECD has been careful to involve developing countries in the BEPS initiative and, not surprisingly, these countries have indicated their enthusiastic support. Obviously, their tax bases are equally, if not

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[1] Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/tax/beps-reports.htm.

[2] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf.

more, susceptible to base erosion and profit shifting as the tax bases of developed countries. Moreover, many developing countries have less capacity in terms of administrative resources and expertise to deal with base erosion by multinational enterprises than developed countries.

Although base erosion and profit shifting are equally important for both developed and developing countries, they affect them in different ways. The OECD Action Plan on BEPS does not identify the provision of services as a means of eroding the tax base of countries that requires action. Some of its action points, such as the digital economy and the artificial avoidance of permanent establishment status, may touch on the provision of services. In contrast, developing countries have become increasingly concerned about the erosion of their domestic tax bases by multinational enterprises through payments by residents for management, consulting and technical services provided by related non-resident companies. The United Nations Committee of Experts on International Cooperation in Tax Matters (United Nations Committee of Experts) has been considering the taxation of services for several years and in 2012 endorsed the addition of a new article to the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention)[3] dealing with fees for technical services.[4] Therefore, because of the importance of services for developing countries, the present chapter examines the taxation of income from services in the context of the BEPS initiative from their perspective.

As noted above, it is relatively easy for multinational enterprises to reduce the tax payable to a source country in respect of a group company resident and doing business in that country through payments for services rendered to that company by other non-resident group companies. The payments will generally be deductible in computing the income of the company resident in the source country but may

[3] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[4] United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, Report on the eighth session (15 – 19 October 2012), chapter III, section D, available at http://www.un.org/ga/search/view_doc.asp?symbol=E/2012/45&Lang=E.

not be taxable by the source country in the hands of the non-resident service provider. For example, even if payments for services performed by the non-resident company are taxable under the domestic tax law of the source country, an applicable tax treaty along the lines of the United Nations Model Convention would prevent the source country from taxing such payments unless the non-resident has a permanent establishment (PE) or fixed base in the source country. The same type of base erosion may occur with respect to developed countries; however, if the flow of services is relatively equal between the two countries, the erosion of the tax base of the source country may not be a serious concern because that country's tax revenues are increased in its capacity as the country of residence.

The present chapter begins with a brief discussion of the taxation of income from services performed by non-residents under the domestic law of developing countries. It emphasizes that protecting the tax base of developing countries involves both the provisions of domestic law and tax treaties. The chapter then provides an overview of the provisions of the United Nations Model Convention dealing with income from services. This overview is intended to provide the necessary background to determine which provisions of the United Nations Model Convention may be problematic in terms of base erosion through the provision of services. These overviews of the provisions of the United Nations Model Convention and domestic law dealing with income from services are followed by a detailed discussion of the opportunities for base erosion through the performance of services by non-residents and the possible responses to prevent such base erosion. It is organized on the basis of various types of services including the treatment of fees for technical services. This chapter does not deal with digital services, which are the subject of a separate chapter.[5] The potential responses of developing countries to the problem of base erosion include changes to tax treaties and domestic law and some type of coordinated international action. This chapter does not make any recommendations for action by developing countries to protect their tax bases against base erosion; it simply identifies possible actions and provides some brief comments on their advantages and disadvantages.

[5] See chapter VIII, Protecting the tax base in the digital economy, by Jinyan Li.

It also contains a discussion of the possible constraints on the taxation of income from services imposed by the provisions of the General Agreement on Trade in Services[6] (GATS) and Article 24 of the United Nations Model Convention on Non-discrimination. The chapter ends with a brief conclusion.

2. Domestic law with respect to the taxation of income from services

2.1 Introduction

It is not surprising that the treatment of income from services under the domestic laws of developing countries varies considerably.[7] The following discussion is not intended to comprehensively identify all of the different rules in the various developing countries. Instead, it is intended to describe the most common patterns for the domestic taxation of services and the major factors affecting such taxation.

At the outset, it should be noted that this chapter is primarily concerned with the treatment of income from services derived by non-residents of developing countries. Income derived by residents of developing countries from services performed outside their country of residence or services performed for non-residents (that is to say, foreign source income) is dealt with only briefly here because such services do not provide opportunities for base erosion and profit shifting for most developing countries as serious as those provided by inbound services.[8] For countries that tax on a territorial basis, income derived from services performed outside the country is not taxable. Therefore,

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[6] General Agreement on Trade in Services, 15 April 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, available at http://www.wto.org/english/docs_e/legal_e/26-gats.pdf.

[7] See, generally, Ariane Pickering, "General Report," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international* (The Hague, The Netherlands: Sdu Uitgevers, 2012), Vol. 97a, 17 – 60, at 23 – 35.

[8] It is notable that the OECD Action Plan on BEPS did not identify the performance of services as an area of concern.

in these countries there is a structural incentive for residents to earn foreign source income in low-tax countries. The significance of this incentive depends on the extent to which residents of a territorial country earn foreign source income from services and on the extent to which the services are geographically mobile. Countries that tax on a territorial basis could eliminate some of these problems by moving to a worldwide system or by extending the concept of domestic source income to include at least some services rendered outside the country.

For countries that tax on a worldwide basis (that is to say, residents are taxable on both their domestic and foreign source income), income derived by residents from services performed abroad is ordinarily taxed like any other business income on a net basis at the generally applicable rate. The residence country ordinarily allows a credit against residence country tax payable for any tax paid to the foreign country in which the services are performed in order to eliminate double taxation. Thus, under a worldwide system income from foreign services is taxable at the higher of the tax rate in the country of residence or the tax rate in the source country (that is the country in which the services are performed or used); as a result, there appear to be limited opportunities for the avoidance of residence country tax. However, residents of a country that taxes on a worldwide basis can establish controlled foreign corporations (CFCs) to provide services outside that country. Since a foreign corporation is generally considered to be a taxable entity separate from the person(s) who own(s) the shares of the corporation, a CFC is not subject to tax on its income in the country in which the controlling shareholders are resident, unless the income earned by the CFC is sourced in that country.[9] Many developed countries (and some developing countries)[10] have rules, referred to as controlled foreign corporation (CFC) rules, to limit the use of

[9] If a treaty applies with terms similar to those of Article 7, Business profits, and Article 14, Independent personal services, of the United Nations Model Convention, the CFC would be subject to tax in that country only if the income was attributable to a permanent establishment or a fixed base in that country or if the CFC performed services in that country for more than 183 days in any 12-month period.

[10] Developing countries with CFC rules include, for instance, the Bolivarian Republic of Venezuela, Brazil, China, Egypt, Estonia, Hungary, Indonesia, and South Africa.

CFCs to defer or avoid residence country tax.[11] Some countries apply their CFC rules to income from services provided to residents of the country in which the controlling shareholders of the CFC are resident, to related parties or to persons resident outside the country in which the CFC is resident.[12] The use of CFCs to avoid or defer residence country tax especially with respect to passive investment-type income but also with respect to certain types of business income, including income from services, is relatively easy and inexpensive. Developing countries need to consider carefully whether it is appropriate or necessary for them to adopt CFC rules and whether such rules should apply to income from services.

2.2 A framework of analysis

The taxation of business profits, including income from services derived by non-residents under a country's domestic laws and under tax treaties, can be usefully examined in terms of the following framework of analysis:[13]

(1) There must be some connection or nexus between a non-resident's service activities or income and a country before the country can tax the non-resident.[14] This initial question of jurisdiction to tax or nexus is a question of domestic law and is probably determined primarily on the basis of the

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[11] See, generally, Brian J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* (Toronto: Canadian Tax Foundation, 1986); Brian J. Arnold, "A Comparative Perspective on the U.S. Controlled Foreign Corporation Rules," (2012) Vol. 65, No. 3 *Tax Law Review*, 473 – 504.

[12] Such income is generally referred to as base company services income.

[13] The framework set out in the text is adopted from the framework for the taxation of business profits in Brian J. Arnold, "Threshold Requirements for Taxing Business Profits Under Tax Treaties," in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties* (Toronto: Canadian Tax Foundation, 2004).

[14] Any type of connection would appear to be sufficient for this purpose: services performed in the country, services rendered to residents of the country, or services utilized or consumed in the country. See, generally, the sources listed in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7.

practical ability of a country to enforce any taxes imposed on non-residents as much as some theoretical justification for taxing them.

(2) For many countries, the type of services involved must be determined because different rules apply to different types of services. For this purpose, the major types of services are employment, professional services, technical services, international transportation services, entertainment, insurance, construction and other business services.

(3) A country must decide whether it wants to tax any and all income from services performed by non-residents in the country or whether it will tax such income only if the non-resident's activities in or with the country meet or exceed a minimum threshold. The most common threshold requirement is a permanent establishment (PE) or fixed base. Several developing countries use the PE concept, not as a threshold requirement, but to determine whether a non-resident is taxable on a net or gross basis.

(4) Once it has been established that any minimum threshold for taxation has been met or that no threshold is appropriate, rules are necessary to determine what income from services derived by a non-resident is attributable to and taxable by the source country.[15] These rules (often referred to as geographical source rules) are necessary for both revenue and expenses and their function is to allocate the income between the residence and source countries.

(5) The next stage involves the rules that apply for the purpose of computing the income from services derived by a non-resident from a country that is subject to tax by that country. These rules are the detailed computational rules for determining the non-resident's net income. Generally, they will be the same for resident and non-resident taxpayers, although some special rules may be appropriate to

[15] See Brian J. Arnold and Jacques Sasseville, "Source Rules for Taxing Business Profits under Tax Treaties," in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties*, supra note 13.

reflect the different circumstances of residents and non-residents.[16] These computational rules are different from, but closely related to, source rules.[17] Tax treaties generally rely on domestic law to provide the detailed computational rules, subject only to broad principles of non-discrimination, separate accounting, and the arm's length standard.[18] If a country taxes income from services derived by non-residents through a withholding tax imposed on the gross amount of the payments, detailed rules for the computation of a non-resident's net income are unnecessary.

(6) Finally, a country must have rules to determine the tax payable and to collect the tax.[19] These rules may be different for residents and non-residents to reflect the greater difficulty in collecting tax from non-residents.

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[16] For example, non-residents are typically not entitled to the personal deductions or credits available to residents. Also, as discussed below, several developing countries have rules that prescribe the amount of a non-resident's income (so-called presumptive taxation).

[17] The computational rules deal with what amounts are included in income, what amounts are deductible in computing income, and the timing of such inclusions and deductions. In general, these types of provisions apply irrespective of the geographic source of the income or expenses. For example, the deduction of entertainment expenses may be prohibited even if they are incurred inside the country. Source rules, on the other hand, are used to determine the revenue and expenses to be taken into account in calculating the income from a particular country. For example, payments for services might be considered to be derived from a country if the services are performed in the country; and interest expenses might be considered to be sourced in a country if the borrowed funds are used in that country.

[18] The only detailed rules for the computation of the income of a PE in the United Nations Model Convention are in Article 7 (3) and (5). Article 7 (3) requires a source country to allow deductions for expenses incurred for the purposes of a PE wherever the expenses are incurred and denies the deduction of notional expenses. Article 7 (5) requires the same method of computing the business profits of a PE to be used consistently from year to year.

[19] See Robert Couzin, "Imposing and Collecting Tax," in *The Taxation of Business Profits Under Tax Treaties,* supra note 13.

The six stages in this framework of analysis are intimately connected. For example, a threshold requirement, such as a PE or fixed base, or gross basis taxation through a withholding tax, may be adopted because it makes the collection of tax more effective. Not all of the stages may be involved with respect to all types of income from services taxable by a particular country under its domestic law. For example, a final gross basis withholding tax usually eliminates the need for source and computational rules. Similarly, a threshold requirement may obviate the need for the application of source and computational rules for those non-residents who do not meet the threshold. Nevertheless, it is useful to think about each stage separately as part of the framework of analysis even though not all stages apply in all circumstances. First, in some circumstances all of the stages will apply. This is the case where income from services derived by a non-resident enterprise is derived through a PE in the source country and is dealt with under Article 7 of an applicable tax treaty.[20] Second, where one or more of the stages is not applicable, that will usually be the result of a conscious policy decision by the particular country. For example, if a country imposes a final gross basis withholding tax on certain income from services, as noted above, the necessity for source and computational rules is effectively eliminated for payments by residents to non-residents that are subject to withholding tax. But not all such payments may be subject to withholding tax. Payments for services subject to withholding tax may be limited to certain types of services — for example, independent personal services — and to payments by residents or non-residents with a PE or a fixed base in the source country. Other services may be subject to net-basis taxation only if the services are performed in or used in the source country. In effect, the decisions about the source of income from services and the basis of taxation are embedded in the decisions about what types of services are subject to withholding tax.

[20] In these situations, the jurisdictional nexus is the performance of services in the source country by the non-resident; source country taxation applies only to income from services that are derived from a business; the requirement for a PE is the threshold for source country tax; the source rule is that any income attributable to the PE is subject to source country tax; the computational rules are usually the general rules that apply to determine income from a business under domestic law; and the tax is assessed on a net basis.

2.3 An overview of the domestic laws of developing countries with respect to the taxation of income from services derived by non-residents

In this section, the domestic laws of developing countries with respect to the taxation of income from services by non-residents are examined in terms of the framework of analysis described above. The discussion does not focus on the treatment of income from services in any particular country or countries, although occasional references to the rules in particular countries are made by way of example.

First, the jurisdictional basis for taxing non-residents on income from services is simply a manifestation of the scope of a particular country's domestic tax rules. Although there are no effective limitations on domestic taxation of non-residents under international law, there are practical constraints on the ability of a country to enforce taxes imposed on non-residents in the absence of some connection with the country.

Second, in several countries the rules vary depending on the type of services involved. Some countries treat income from services derived by non-residents in the same way as other business income derived by them, although even these countries often have special rules for certain types of specialized services, such as international shipping and transportation, insurance, construction and entertainment. Surprisingly, even for countries that treat income from services differently from other business income, few of them have any statutory definition of services.[21] Some South American countries have judicial or administrative pronouncements concerning the meaning of services. In general, the meaning is quite broad and includes a wide range

[21] Similarly, the GATS does not define the term "services." The Russian Federation's tax code contains a statutory definition of services as actions with intangible results consumed in the course of the actions that confer benefits to the customer. The definition excludes actions with tangible results provided to the customer, financial rental, licences of intellectual property and assignment of rights. Despite the definition, there is considerable uncertainty about the meaning of services. See Dzhangar Dzhaichinov and Petr Popov, "Russia," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, 579 – 91.

of activities performed by one person for the benefit of another person in consideration for a fee.[22]

Where countries have special rules for particular types of services, there are often definitions for those types of services. For example, several countries treat income from professional and other independent services differently from other services. Article 14 (2) of the United Nations Model Convention provides a definition of professional services to include "independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants."

Under the domestic laws and tax treaties of some countries, it is often necessary to distinguish between payments for services and other types of payments, such as royalties, payments for leasing of industrial, commercial or scientific equipment and payments for know-how.[23] Distinguishing between these types of payments is especially difficult where services and other transfers are made under so-called mixed contracts and where services are provided as an ancillary and subsidiary aspect of a transfer of intellectual property, lease of equipment or supply of know-how. In some situations, intangible property such as know-how may be transferred to a related entity in a low-tax country through the provision of services or the secondment of highly skilled employees.[24]

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[22] See, for example, Sergio André Rocha, "Brazil," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, 155-167, at 158; Sandra Benedetto and Liselott Kana, "Chile," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, 191 – 208, at 195; Rodrigo Castillo Cottin and Ronald Evans Márquez, "Venezuela," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, 747 – 59, at 749.

[23] For example, only certain payments, such as royalties, may be subject to withholding tax.

[24] See Ariane Pickering, "General Report," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 28 – 29. Countries usually deal with this issue through the application of their transfer pricing rules.

Countries take different positions with respect to whether income from automated activities, such as the provision of access to a database, online gaming or gambling and communications, are treated as services, royalties or other income.[25] Some countries take the position that services must involve activities performed by individuals while other countries do not consider intervention by individuals to be necessary.

Several countries, particularly in Europe, provide a threshold requirement for the taxation of income from certain services derived by non-residents.[26] Typically, the threshold is similar to the PE and fixed base requirements in the United Nations Model Convention, although the domestic concepts are often broader than the treaty concepts. Alternatively, some countries (for example, Mexico) use a simple time threshold. The threshold requirement may apply only to certain types of services.

In Spain and several South American countries, the concept of a PE is used not as a minimum threshold requirement for the taxation of non-residents, but as a means of determining whether income from services is taxable on a net or gross basis.[27] In general, if a non-resident

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[25] See Tracy Gutuza, "South Africa," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 660.

[26] See, for example, Kolozs Borbála and Kőszegi Annamária, "Hungary," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 341; Luis Felipe Muñoz and Ricardo Quibrera Saldaña, "Mexico," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 482; Dzhangar Dzhaichinov and Petr Popov, "Russia," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 583 – 84; Pavlo Khodakovsky and Anna Pogrebna, "Ukraine," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 687.

[27] See Alejandro Almarza, "Argentina," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 65 – 66; Yishian Lin, "Chinese Taipei," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 193 – 94; Esperanza Buitrago and Mauricio Marin, "Colombia," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal*

earns income from services attributable to a PE in the source country, the income is taxable on a net basis in accordance with the same rules applicable to residents; otherwise, it is subject to a gross withholding tax. In some countries, any income derived by non-residents from those countries is subject to tax without any minimum threshold requirement except as provided pursuant to an applicable tax treaty.[28]

There is considerable variation in the rules used by developing countries to determine the geographical source of income from services. Some countries have detailed statutory rules, while other countries have only judicial or administrative rules that are vague and uncertain. All countries treat income from services that are physically performed in the country as domestic source income. However, several countries also subject income from services derived by a non-resident to domestic tax where the services are performed outside the country, in the following circumstances:

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international, supra note 7, at 231 – 2 and 238; Lenka Fialkova, "Czech Republic," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 254 – 55; Saurav Bhattacharya and Dhaval Sanghavi, "India," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 353; Marcial Garcia Schreck, "Peru," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 547; Tracy Gutuza, "South Africa," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 601; Jose M. Calderón, "Spain," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 628; Luis Aisenberg and Alejandro Horjales, "Uruguay," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 735 and 750; and Rodrigo Castillo Cottin and Ronald Evans Márquez, "Venezuela," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 748 and 751.

[28] See, for example, Sergio André Rocha, "Brazil," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 156 – 57; Tracy Gutuza, "South Africa," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 595; Shivaji Felix, "Sri Lanka," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 647.

- the services are performed in connection with or through a PE in the country;
- the services are used or consumed in the country;[29] and
- payments for services are deductible by residents of that country or by non-residents with a PE in that country.[30]

These rules under which income from services performed outside the country is subject to domestic tax often apply only to certain services, such as professional services, remuneration of directors and top-level officials of resident corporations and technical services. In addition, special source rules apply to international transportation services and insurance. Income from international transportation services and insurance premiums are generally subject to domestic tax if cargo or passengers are taken on board in the country or if the insured risk is located in the country, respectively.

Peru has a special deeming rule that applies to apportion the gross income derived by a non-resident between Peruvian and foreign sources where services are performed partly inside and partly outside Peru.[31] For example, 1 per cent of gross income from transportation activities beginning or ending in Peru is deemed to be derived from Peru and is subject to a 30 per cent withholding tax.

With respect to the rules for the computation of income from services derived by non-residents that is subject to tax by source countries, the critical issue is whether the source country tax is imposed on a gross or net basis. If the tax is imposed by way of a final withholding tax on the gross payments to non-residents, no computational rules are necessary. The withholding tax is generally imposed at the time the

[29] For instance, in the Bolivarian Republic of Venezuela, Colombia, India, Peru, Ukraine and Uruguay. In Peru, income from technical assistance and digital services are sourced in Peru if they are "economically utilized" there, which is the case if the recipient of the services deducts the payment for the services in computing its income subject to Peruvian tax.

[30] For example, in Brazil, Chile, Colombia, the Czech Republic, India and Peru.

[31] See Marcial Garcia Schreck, "Peru," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 548.

amount is paid (or shortly thereafter) on the full amount paid without the deduction of any expenses incurred in earning the income. If the tax is imposed on the net income earned by non-residents, generally the same computational rules (amounts deductible, timing, etc.) apply that apply to business income earned by residents of that country. However, several South American countries as well as India impose a withholding tax on a presumptive amount of income derived by non-residents.[32] The presumed amount is a percentage of the amount of gross payment to the non-resident. The justification for this presumptive tax base is to provide some standard relief for the expenses that might typically be incurred by non-residents in providing the services. The presumptive tax base eliminates the need for taxpayers to keep track of their actual expenses and for the tax authorities to verify those expenses. The same result can be achieved — although not as transparently — by reducing the rate of withholding tax so that the tax imposed approximates the tax that would be payable if a non-resident's actual net income were taxable at the ordinarily applicable rates.

Although many developed countries provide an election for non-residents to pay tax on a net basis with respect to certain income from services, developing countries do not generally do so due to inadequate administrative resources.[33] Similarly, few developing countries

[32] Argentina and Uruguay use this presumptive income approach extensively. See Alejandro Almarza, "Argentina," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 74 – 76; and Luis Aisenberg and Alejandro Horjales, "Uruguay," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 739. The approach is also used in several other countries (including the Bolivarian Republic of Venezuela, India and Peru) although it is applied to a narrower range of payments for services. For example, in India non-residents providing construction, air transportation, shipping, prospecting or extraction of oil services are, respectively, taxable on 10, 5, 7.5 and 10 per cent of the amounts receivable for such services. See Saurav Bhattacharya and Dhaval Sanghavi, "India," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 359 – 60.

[33] Uruguay provides an election for corporations earning income from transportation, films and television and international news. See Luis Aisenberg and Alejandro Horjales, "Uruguay," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 739.

use a non-final withholding tax as a collection device for taxes on income from services derived by non-residents, although India is an exception in this regard.[34] Such a non-final withholding tax is creditable against the tax payable by the non-residents on a net basis when they file their tax returns and any excess withholding tax is refundable at that time. Non-final withholding taxes impose compliance burdens on taxpayers to file returns and resident payers to withhold, as well as administrative burdens on tax officials to assess tax returns and refund any amounts withheld in excess of the tax payable.

In some countries the withholding tax is used as a means of policing the deduction of payments to non-residents for services. Such payments may not be deductible unless tax is withheld or the payer provides the tax authorities with prescribed information concerning the non-resident and the payment.[35]

Final gross basis withholding taxes on payments for services are often restricted to certain types of services, such as entertainment, international transportation, insurance, professional services and technical services.

The rates of final withholding taxes on income from services vary considerably from country to country depending on the type of services. Rates are generally low (5 – 10 per cent) on payments for international transportation but can be as high as 35 per cent in some South American countries. The most common rate appears to be 15 per cent.[36] As noted above, in some countries a relatively high rate of

[34] See Saurav Bhattacharya and Dhaval Sanghavi, "India," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 362 – 63.

[35] See Ariane Pickering, "General Report," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 35.

[36] See, for technical services, Sergio André Rocha, "Brazil," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 157; and Sandra Benedetto and Liselott Kana, "Chile," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 194; see also, in general, Lenka Fialkova, "Czech Republic," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 259.

withholding tax is applied to a percentage of the relevant payment for services. For example, in the Bolivarian Republic of Venezuela only one-half of the gross amount of payments for technical services is subject to tax at the rate of 34 per cent, resulting in an effective tax rate of 17 per cent.[37] Argentina uses this presumptive approach for most types of income subject to the nominal rate of withholding tax of 35 per cent. Since varying percentages of income are subject to tax, the effective tax rates range from 12.5 per cent to 31.5 per cent.[38]

India applies a general withholding tax rate of 10 per cent although the rate increases to 20 per cent if the non-resident service provider does not have a taxpayer identification number. Brazil and the Bolivarian Republic of Venezuela apply an increased rate of withholding tax on payments for services made to residents of listed low-tax jurisdictions.

3. An overview of the provisions of the United Nations Model Convention dealing with income from services

3.1 Introduction

This section contains a brief description of all of the provisions of the United Nations Model Convention that deal with income from services.[39] The purpose of this overview is to provide sufficient background information about the provisions to allow the identification of those of them that potentially permit the erosion of the tax base of developing countries. The identification of the provisions that are problematic in this regard is essential in order to properly target

[37] See Rodrigo Castillo Cottin and Ronald Evans Márquez, "Venezuela," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 753.

[38] See Alejandro Almarza, "Argentina," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 74 – 76.

[39] The material in this section is based on Brian J. Arnold, "The Taxation of Income from Services under Tax Treaties: Cleaning Up the Mess — Expanded Version," (2011) Vol. 65, No. 2 *Bulletin for International Taxation* (online version).

any possible responses to the problems. The potential application of Article 24 of the United Nations Model Convention to prevent the discriminatory treatment of non-residents earning income from services is discussed subsequently.

3.2 Business profits derived from services provided by enterprises

Under Article 7 of the United Nations Model Convention, income from services provided in a contracting State (the source country) by an enterprise resident in the other contracting State may be taxed in the source country only if the enterprise carries on business in the source country through a PE situated therein. If the enterprise carries on business through a PE in the source country, that country is entitled to tax the profits that are attributable to the PE and also certain other profits that are attributable to activities similar to those carried on through the PE. This limited force of attraction rule allows the source country also to tax profits derived from sales of goods and merchandise and from other business activities similar to those made or carried on through the PE if the sales or activities take place in the source country. At present, this limited force of attraction rule is included in only about 10 per cent of all bilateral tax treaties. It is intended to function as an anti-avoidance rule.

Under Article 7 (2), the determination of the profits attributable to a PE is premised on two important legal fictions, namely:

- The PE is a separate entity engaged in the same activities under the same conditions as the enterprise; and
- The PE deals independently with the other parts of the enterprise of which it is a part.

These legal fictions effectively ensure that the profits attributable to a PE are determined in accordance with the arm's length principle that applies under Article 9 of the United Nations Model Convention to transactions between related or associated enterprises. Article 7 (3) of the United Nations Model Convention allows that any expenses incurred by an enterprise for the purposes of the PE are deductible in computing the profits of the PE irrespective of whether the expenses are incurred in the PE State or exclusively for the purposes of the PE.

However, Article 7 (3) clarifies explicitly that notional expenses or internal charges for royalties, interest or fees for services made between a PE and the head office or other parts of the enterprise are not deductible or includible in computing the profits attributable to the PE. In summary, the profits attributable to a PE under Article 7 of the United Nations Model Convention are the net profits computed in accordance with the arm's length principle as if the PE were a separate entity.

In general terms, a PE is defined in Article 5 (1) of the United Nations Model Convention to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on. The general practice of countries is that a place of business is not considered to be "fixed" in a temporal sense unless it lasts for a minimum of six months.[40] Accordingly, income derived by a non-resident enterprise from services performed in the source country are generally taxable by that country only if the non-resident has a fixed place of business in the source country at its disposal for a minimum of six months and the services are provided through that fixed place of business. Under Article 5 (5) (a), a non-resident enterprise is also considered to have a PE if the enterprise has a dependent agent that has and habitually exercises an authority to conclude contracts on its behalf. The dependent agent PE rule is unlikely to have much significance for service businesses because an agent must habitually conclude contracts binding on the enterprise, not just perform services on its behalf.

3.3 Construction services

Under Article 5 (3) (a) of the United Nations Model Convention, a building site, construction, assembly or installation project or supervisory activities in connection with such a site or project constitutes a PE if the site, project or activities last more than six months. It is unclear whether Article 5 (3) (a) is a deeming provision or whether construction sites and projects must also meet the requirements of a fixed place of business under Article 5 (1).[41] However, the preferred view is that

[40] See paragraph 3 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 6 of the Commentary on Article 5 of the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital (OECD Model Convention).

[41] If Article 5 (3) (a) is a deeming provision, construction activities taking

construction and other related activities must be conducted through a fixed place of business to be a PE.[42]

3.4 Services in general

Under Article 5 (3) (b) of the United Nations Model Convention, the furnishing of services by a non-resident is deemed to be a PE if the activities continue in the source country for 183 days or more in any 12-month period and take place with respect to the same or a connected project. For this purpose only days during which services are performed in the source country by the enterprise through employees or other personnel ("working days") are taken into account. Days during which employees or other personnel are merely present in the source country but are not working are not counted. Projects are considered to be connected if they have commercial coherence, which is a question of fact. If, however, projects are carried out pursuant to contracts concluded with the same person or related persons and involve the same type of work, they will ordinarily be considered to be connected especially if the same individuals perform the services under the various projects.

3.5 Insurance

Under Article 5 (6) of the United Nations Model Convention, a PE is deemed to exist where a non-resident enterprise collects insurance premiums or insures risks in the source country, unless such activities are conducted by independent agents. Article 5 (6) does not require the activities to occur through a fixed place of business in the source

place in different geographical locations would be aggregated for the purpose of the six-month time threshold if they are part of the same project. However, if construction activities must meet the requirements of Article 5 (1), it would be necessary to consider each place where construction activities occur separately. Article 5 (3) of the OECD Model Convention is clearly an additional condition not a deeming rule.

[42] This conclusion raises the issue of whether or not Article 5 (3) (b) of the United Nations Model Convention is a deeming provision. In the author's view, Article 5 (3) (b) is clearly a deeming provision, although there is an argument that both Article 5 (3) (a) and (b) must be construed in the same manner. If, therefore, Article 5 (3) (a) is not a deeming provision, it can be argued that Article 5 (3) (b) should also not be considered to be a deeming provision.

country or for any minimum period of time. It is sufficient if the specified activities — collecting premiums — take place in the source country or if the risks that are insured are in the source country.

3.6 Income from shipping, inland waterways transportation and air transportation

Under Article 8 of the United Nations Model Convention, profits derived by an enterprise from international shipping and air transportation and inland waterways transportation are taxable exclusively by the country in which the enterprise has its place of effective management. Alternative B of Article 8 provides that profits from international shipping activities taking place in a country may be taxed in that country if the activities are more than casual. The phrase "more than casual" means scheduled stops in a country to take on cargo or passengers. For this purpose, the profits taxable by the source country are determined by allocating the enterprise's total net profits from shipping and the rate of tax on those profits is to be established through bilateral negotiations.

3.7 Income from independent personal services

Under Article 14 of the United Nations Model Convention, income from professional services or other independent activities derived by an individual resident of one State is subject to tax by the other State (the source country) if:

- The individual has a fixed base in the source country that is regularly available for the purpose of performing the services; or
- The individual is present in the source country for 183 days or more in the aggregate in any 12-month period.

In the first case, only the income attributable to the fixed base is taxable by the source country. Such income may include income from services performed outside the source country. In the second case, however, only income from activities performed in the source country is taxable by the source country.

Article 14 applies to professional and other independent services. Professional services are defined in Article 14 (2) to include "independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants."

In general, a fixed base for purposes of Article 14 has the same meaning as a fixed place of business under Article 5 (1) although some countries consider the two expressions to have different meanings. The computation of the profits attributable to independent personal services performed through a fixed base under Article 14 is generally considered to be subject to the same principles as the computation of profits attributable to a PE under Article 7.[43] However, Article 14 and its Commentary do not contain detailed rules concerning the attribution of profits to a fixed base similar to the rules in Article 7 and its Commentary. If Article 14 is subject to the same principles as Article 7, the source country would be entitled to tax only the net profits derived from independent services by an individual resident of the other contracting State.

Article 14 of the OECD Model Tax Convention on Income and on Capital was deleted in 2000 with the result that income from services generally (that is to say, other than such income dealt with in specific articles) is dealt with exclusively under Article 7. The deletion of Article 14 with several consequential changes (the most important of which is the inclusion of a provision in Article 5 equivalent to Article 14 (1) (b)) is provided as an alternative in the Commentary on Article 5 of the United Nations Model Convention.[44]

3.8 Income from employment

Under Article 15 (Dependent personal services) of the United Nations Model Convention, income from employment derived by an individual resident of one State from employment exercised in the other State may be taxed in that other State (the source country) in any one of the following three situations:

[43] As noted in paragraphs 10 and 11 of the Commentary on Article 14 of the United Nations Model Convention, some countries take the position that Article 14 permits taxation of independent services on a gross basis. This argument is based in part on the fact that Article 24 (3) is expressly applicable only to a PE, not to a fixed base.

[44] See paragraphs 15.1 – 15.26 of the Commentary on Article 5 of the United Nations Model Convention.

- The employee is present in the source country for 183 days or more in any 12-month period; or
- The employee's remuneration is paid by an employer resident in the source country; or
- The employee's remuneration is borne by a PE or fixed base that a non-resident employer has in the source country.

Thus, if the remuneration paid to the employee is deductible by the employer in computing income for purposes of the source country's tax base (either because the employer is a resident of the source country or because the employer is a non-resident with a PE or a fixed base in the source country), the remuneration derived by the employee is taxable by the source country even if the employee is present in the source country for only a very short period. In these situations, the only condition for source country tax is that the employment activities must be exercised in the source country; in other words, the employee must be present and perform the duties of employment in the source country. If the employee's remuneration is not paid by a resident employer or borne by a PE or a fixed base of a non-resident employer in the source country, the source country is entitled to tax employment income derived by an individual resident in the other country only if the individual is present in the source country for more than 183 days in any 12-month period.

There are no limitations under Article 15 on the amount subject to tax, the rate of tax or the method of taxation imposed by the source country on the income from employment activities exercised in that country. Thus, a source country is entitled to tax a non-resident individual's income from employment by imposing a withholding tax on the gross amount of the non-resident's remuneration.

3.9 Directors' fees and the remuneration of top-level managerial officials

Under Article 16 of the United Nations Model Convention, fees derived by non-resident directors and remuneration derived by non-resident top-level managers of a company resident in the source country may be taxed by the source country. The only condition for source country tax under Article 16 is that the company paying the fees or remuneration must be a resident of the source country in accordance with Article 4.

It is not necessary for the services to be performed by the directors or managers in the source country. Similar to Article 15, there are no limitations on source country tax under Article 16.

3.10 Entertainers and athletes

Under Article 17 of the United Nations Model Convention, income derived by a resident of one contracting State from personal activities as an entertainer or sportsperson exercised in the other contracting State (the source country) may be taxed by the source country. The only condition for source country tax under Article 17 is that the entertainment or athletic activities must take place in the source country. Similar to Articles 15 and 16, there are no limitations on the amount of income subject to tax, the rate of tax or the method of tax imposed by the source country. The source country's right to tax under Article 17 also applies to any income from entertainment or athletic activities that accrues to a person other than the individual entertainer or athlete (for example, a company owned by that individual). Entertainment activities are limited to performance artists such as actors and musicians and do not include visual artists or behind-the-camera personnel such as directors. Athletic activities include traditional sports but also car racing, billiards and chess.

3.11 Pensions and social security payments

Under Article 18 of the United Nations Model Convention, social security payments (that is to say, public pensions) are taxable exclusively by the country making the payments.[45] Private pensions are taxable exclusively by the country in which the recipient is resident under Article 18 (alternative A) or alternatively under Article 18 (alternative B) by both the country in which the recipient is resident and the country in which the payer of the pension is resident or has a PE. Alternative B reflects the fact that contributions to the pension plan by both the employer and the employee may have been deductible in computing the income subject to tax by the source country (in the case of a PE, only if the contributions were effectively connected with the PE). Since that country's

[45] Article 18 (2) (alternative A) and Article 18 (3) (alternative B) of the United Nations Model Convention.

tax base is reduced by the deductions for the pension contributions, it seems reasonable to allow that country to tax the recipient of the pension payments to offset the prior deductions. The country in which the employment services that resulted in the pension were rendered is irrelevant for purposes of both versions of Article 18.

3.12 Income from government services

Under Article 19 of the United Nations Model Convention, the right to tax salary, wages and other remuneration and pensions in respect of employment services provided by an individual to the government of a country is ordinarily allocated exclusively to the country paying the remuneration. However, if a government employee is a resident and a national of the other contracting State and the services are provided in that State, the remuneration is taxable exclusively by that State. Similarly, pension payments made by a contracting State are taxable exclusively by the other State if the recipient individual is a resident and a national of the other State.[46] Article 19 does not apply to salaries and pensions paid by a contracting State in connection with a business carried on by it.[47]

3.13 Other income

Under Article 21 of the United Nations Model Convention, income not dealt with in any other article is taxable exclusively by the residence country subject to a throwback rule if the taxpayer carries on business through a PE or a fixed base in the source country.[48] However, under Article 21 (3), a source country is entitled to tax items of income derived by a resident of the other State if those items of income are not dealt with in another article of the treaty and arise (that is to say, have their source) in the source country. Consequently, the only condition for

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[46] See Article 19 (2) of both the United Nations and OECD Model Conventions.

[47] See Article 19 (3) of both the United Nations and OECD Model Conventions.

[48] See Article 21 (2) of both the United Nations and OECD Model Conventions. The right or property in respect of which the income is paid must be effectively connected with the PE or fixed base.

source country taxation of other income under Article 21 (3) is that the income must have its source in that country. No rules are provided in Article 21 or in the Commentary for determining the source of income.

Article 21 (3) is potentially applicable to income from services although that should not frequently happen because such income will usually be dealt with in another article. In some circumstances, the scope of application of the other provisions depends on the domestic laws of the source country.[49]

4. Problem areas: opportunities for the erosion of the tax base of developing countries through the provision of services by non-residents and possible responses

4.1 Introduction

In conceptual terms, the protection of a country's tax base requires coordination between the provisions of its domestic law and the provisions of its tax treaties. It may also require coordination between the treatment of the income under the domestic tax laws of the residence and source countries. The provisions of a country's domestic tax law should ensure that tax is levied effectively on any income from services derived by non-residents that the country wants to tax and that the tax so levied can be collected effectively. For this purpose, a country should also consider the deductibility of amounts paid by residents (and non-residents) to non-residents for services in computing income

[49] For example, Article 7 applies only if a taxpayer is carrying on a business and, as a partially defined term, the meaning of "business" must be determined under domestic law unless the context requires otherwise. Until recently, the Brazilian tax authorities took the position that payments to non-residents for services and technical assistance were not business profits covered by Article 7 and were, therefore, within the scope of Article 21. See Brazil, Internal Revenue Service, Ruling No. 1/2000. This position was changed on 20 June 2014 in Internal Revenue Service, Ruling No. 5/2014. According to the latter ruling, income from services and technical assistance is considered to be dealt with in the royalties article, the independent services article or, if neither of these applies, the business profits article. Such income will no longer be considered to be subject to the other income article.

subject to domestic tax. To the extent that such amounts are deductible, they reduce or erode the domestic tax base. If the payments are subject to source country tax in the hands of the non-resident recipients of the payment, the domestic tax base will be eroded only to the extent of the difference, if any, between the reduction in tax as a result of the deduction and the tax imposed on the non-resident service provider. For example, in principle, there will be no erosion of the domestic tax base if non-residents are subject to tax on their net income at the same rates applicable to resident taxpayers.[50] However, the domestic tax base may be eroded if non-resident service providers are subject to a final gross-basis withholding tax that is levied at a rate less than the ordinary rate applicable to resident taxpayers. For example, if the ordinary tax rate is 35 per cent and the rate of withholding tax on services is 15 per cent, the domestic tax base will be eroded to the extent of 20 per cent of the gross amounts paid to non-residents for services. The erosion of the domestic tax base is greatest where the amounts paid to non-residents for services are deductible but the non-resident service providers are not subject to any domestic tax for some reason.

In addition, the treatment of non-resident service providers in their countries of residence must be taken into account. A non-resident enterprise may perform services in another country through a branch or PE there, through a subsidiary corporation established in that country or directly (that is to say, not through a branch, PE or subsidiary) to residents of that country. Ordinarily, the source country will impose tax on any income from services derived by a resident subsidiary or on income earned by the non-resident through a branch or PE, but may not impose tax on other income from services derived by a non-resident service provider. The country in which the enterprise is resident may tax any income derived by the enterprise from services, including services provided outside the country, unless that country taxes on a territorial basis or is a tax haven or provides an exemption for foreign source business income earned through a PE. If the country of residence taxes the income, it will usually provide a credit for any

[50] This analysis does not take into account the amount of tax actually paid by the non-resident. For example, the source country's tax base will be eroded to the extent that the non-resident's income from services is reduced by expenses.

source country tax on the income. The country of residence will not generally tax the income from services earned by a foreign subsidiary of a resident enterprise except if the CFC rules apply.

Even if income from services performed by non-residents is subject to comprehensive taxation under a source country's domestic law, the provisions of that country's tax treaties may limit that domestic tax. To the extent that there is a conflict between the provisions of domestic law and the provisions of a tax treaty, the provisions of the tax treaty will generally prevail. Based on the overviews of the provisions of the domestic law of developing countries dealing with the taxation of income from services derived by non-residents and the provisions of the United Nations Model Convention dealing with income from services, certain types of income from services, such as income from entertainment and athletic activities, directors' fees and remuneration of top-level managerial officials, insurance and certain employment income, do not raise serious concerns about base erosion or profit shifting. However, under the United Nations Model Convention business profits from services and income from independent services, including income from technical, management and consulting services, are taxable by the source country only if the income is earned through a PE or fixed base and it is attributable to that PE or fixed base, or if the individual service provider is present in the source country for 183 days or more in the aggregate in any 12-month period and the services are performed in that country.

In the remaining part of the present chapter, various types of services are examined to determine whether they provide serious opportunities for erosion of the tax base of developing countries and what actions these countries might take in their domestic law or in their tax treaties to protect their tax base.

4.2 Employment income

Most countries, both developed and developing, tax employment income derived by non-residents if the employment services are performed in the country. Employment services (including government service) performed by a non-resident outside a country are not subject to tax by that country even if the non-resident is an employee of a resident enterprise or the employment services are consumed or used by residents of the country. This general practice reflects a consensus that the source of employment income is the country in which the employee is present and performing the duties of employment. The practice is clearly justified because the income from employment exercised in a country is closely connected with that country.

The taxation of non-residents on income from employment exercised in a source country usually applies irrespective of whether the employer is a resident or non-resident of the source country (or if the employer is a non-resident, irrespective of whether the non-resident has a PE or fixed base in the source country to which the employment is connected), irrespective of the duration of the employment in the source country or the amount of income derived and irrespective of whether the non-resident employee's remuneration is deductible by the employer against the source country's tax base.[51] In summary, under Article 15 of the United Nations Model Convention a source country is prevented from taxing a non-resident on employment income only if the non-resident is employed by a non-resident employer that does not have a PE or fixed base in the source country, or if it has a PE or fixed base, the employee's remuneration is not deductible in computing the profits attributable to the PE or fixed base and the non-resident employee is not present in the source country for 183 days or more in any 12-month period.

The broad scope of source country taxation of income from employment earned by non-resident employees suggests that opportunities for tax avoidance of source country tax are limited, as discussed below. It also suggests that the enforcement of source country tax on the employment income of non-residents may be problematic in certain circumstances. Typically, income from employment is taxed on a gross basis or a quasi gross basis, with standard deductions allowed, and the tax is collected by means of a withholding obligation imposed on employers. This collection mechanism is effective and efficient (although it places the compliance burden on the employer). However, the withholding obligation on the employer can be effectively enforced only if the employer is a resident or a non-resident with a PE or fixed base in the source country. Where the employee is employed by a

[51] These conclusions are based on Article 15 of the United Nations Model Convention.

non-resident employer without a PE or fixed base in the source country, it is difficult for the source country to enforce its tax on the non-resident employee, especially if the employee is present in the source country for a short period of time.

Perhaps the most serious concern in terms of protecting the source country's tax base is where a non-resident employee's remuneration for employment services (performed in the source country) is deductible by the employer in computing income subject to source country tax. The employee's remuneration will usually be deductible if the employer is a resident or a non-resident carrying on business in the source country through a PE or a fixed base located in the source country. In these circumstances, the non-resident employee's income from employment should be subject to tax and the employer is usually required to withhold the tax from the remuneration. Some countries make the employer's deduction conditional on the employer withholding tax from the employee's remuneration.

There are several ways in which a source country's tax base in respect of income from employment may be eroded. Some involve the provisions of domestic law alone; some involve the provisions of tax treaties; and some involve the provisions of both domestic law and tax treaties.

First, the source country's tax base may be eroded where a non-resident is employed by a resident employer to perform services outside the source country. Assuming that the source country taxes on a worldwide basis, the non-resident employee's remuneration will be deductible in computing the employer's worldwide income subject to tax, but the employee's remuneration will not be taxable by the source country because the employment is not exercised in the source country.[52] An important exception under Article 16 of the United Nations Model Convention may apply where directors and top-level managerial officials are involved.

Second, the tax base may be eroded where non-resident employees perform services in the source country on behalf of a non-resident

[52] If the employee is a resident of the source country and that country taxes on a worldwide basis, the employee's remuneration will be subject to source country tax.

employer that avoids having a PE or fixed base in the source country. In this situation Article 15 (2) of the United Nations Model Convention would prevent the source country from taxing the non-resident's employment income unless the employee is present in the source country for more than 183 days in any 12-month period. If, however, the non-resident employer has a PE or fixed base in the source country, the source country would be entitled to tax not only the profits attributable to the employer's PE or fixed base, but also the employee's remuneration borne by the PE or fixed base. There are several ways, including the use of artificial structures, in which non-residents can avoid having a PE or fixed base in the source country.[53]

Third, a source country's tax on the employment income of a non-resident can be avoided by altering the legal status of the non-resident from employment to independent contractor. If a non-resident is employed by a resident enterprise or a non-resident enterprise with a PE or a fixed base, under Article 15 of the United Nations Model Convention the source country is entitled to tax income from employment exercised by the non-resident employee in the source country. The source country's right to tax applies irrespective of the length of time spent in the source country or the amount of income earned. On the other hand, if the non-resident is an independent enterprise, Articles 7 and 14 of the United Nations Model Convention limit the source country's right to tax to situations in which the non-resident has a PE or a fixed base in the source country and the income is attributable to that PE or fixed base. If a non-resident individual does not have a fixed base in the source country, the source country's tax is limited to situations in which the individual stays in the source country for 183 days or more in any 12-month period and the income is derived from activities performed in the source country.[54] The time period in Article 5 (3) (b) and Article 14 (1) (b) for independent contractors is similar to or longer than the time period in Article 15 (2) (a) for employees.[55] Therefore, the real difference between the treatment

[53] See chapter VII, Preventing avoidance of permanent establishment status, by Adolfo Martín Jiménez.

[54] Article 14 (1) (b) of the United Nations Model Convention.

[55] Under Article 5 (3) (b) of the United Nations Model Convention, an enterprise must perform services in the source country for more than

of non-resident employees and non-resident independent contractors is that the latter may carry on activities in the source country for up to six months without becoming subject to source country tax, whereas employees of resident employers or non-resident employers with a PE or fixed base are taxable by the source country irrespective of how long they spend in the source country. The same distinction may exist under some countries' domestic law.

Thus, even if a non-resident service provider is taxable under the domestic law of the source country, any tax treaties entered into by the source country that are based on the United Nations or OECD Model Conventions will limit the source country's tax more severely for employees than for independent contractors. Non-resident service providers have an incentive to structure their relationships to avoid employment status.

Neither the United Nations nor the OECD Model Convention provides a definition of employment or independent services. Article 14 (2) of the United Nations Model Convention provides an inclusive definition of professional services, but that definition simply refers to "independent" activities without defining what the term "independent" means. Under Article 3 (2), the terms "employment" and "activities of an independent character" in the case of Article 14 or "business" in the case of Article 7, have the meanings for purposes of the treaty that they have under the domestic law of the source country unless the context requires otherwise.[56] Most countries distinguish between employment and independent services for various legal purposes, including tax.

Where a country's domestic law allows the formal contractual arrangement to be ignored and the nature of the services to be determined based on the substance of the relationship between the service provider and the customer, the provisions of the treaty will respect the application of domestic law in this regard.[57] However, the decision

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183 days and only working days (not all days of presence) are counted for this purpose.

[56] In this situation, the source country is the country applying the treaty.

[57] See paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 8.5 – 8.7 of the Commentary on Article 15 of the OECD Model Convention.

to disregard the formal contractual arrangements must be based on objective criteria and the Commentary on the United Nations Model Convention provides important guidance and examples in this regard.[58] Even if the formal contractual relationship is adhered to under domestic law, a contracting State may deny the benefits of the exemption in Article 15 (2) in abusive cases in accordance with the Commentary on Article 1 dealing with the improper use of tax treaties.[59]

A related difficulty with the legal meaning of employment for purposes of tax treaties is the international hiring-out of labour.[60] Under this practice, international human resource agencies hire out individuals to enterprises resident in other countries. The individuals purport to be employees of the agency and the agency purports to provide services to the enterprise resident in the source country, but does not have a PE in the source country. The Commentary on Article 15 contains a provision that countries might consider including in their tax treaties to deny the exemption in Article 15 (2) where the individual renders services to a person, other than the formal employer, who supervises or controls the manner in which the services are performed and the services are an integral part of the business carried on by that person.[61]

The provisions of Article 15 of the United Nations Model Convention dealing with employment income do not apply if the provisions of Articles 16, 17, 18 or 19 apply. With the possible exception

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[58] See paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 8.11 – 8.28 of the Commentary on Article 15 of the OECD Model Convention. Important factors for this purpose are whether the services provided by the individual constitute an integral part of the employer's business and who bears responsibility for the results of the individual's work.

[59] See paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 8.8 – 8.9 of the Commentary on Article 15 of the OECD Model Convention.

[60] See paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 8.1 – 8.3 of the Commentary on Article 15 of the OECD Model Convention.

[61] See paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraph 8.3 of the Commentary on Article 15 of the OECD Model Convention.

of Article 17 dealing with entertainment and athletic services, which is analysed separately below, these Articles do not raise any serious concerns about base erosion or profit shifting.

4.3 Government service

Under Article 19 of the United Nations Model Convention, income from government services, including pensions, is generally taxable by the country that pays the remuneration, so there is no erosion of that country's tax base assuming that the country actually taxes the income. Article 19 applies only to non-resident individuals employed by the government of the source country; it does not apply to non-residents providing independent services to the government. Accordingly, the same issues with respect to the distinction between employment and independent or business services also applies to non-residents providing services to the government. However, since the legal relationship is with the government, the opportunities for tax avoidance are limited. The only circumstance in which the government paying the employee or former employee is not entitled to tax the income is if the employee is a resident and national of the other country and the services are performed in that country. Therefore, with respect to income from government service, the source country simply has to ensure that such payments are taxable under its domestic law in order to protect its domestic tax base.

4.4 Directors' fees and remuneration of top-level managerial officials

With respect to the remuneration of directors and top-level managerial officials, under Article 16 of the United Nations Model Convention, the country in which the company paying the remuneration is resident is entitled to tax the remuneration. It is irrelevant whether the services are provided inside or outside the source country. In terms of base erosion, any remuneration paid by a resident company to its non-resident directors and senior managers will likely be deductible in computing its income. Although the remuneration is deductible in computing the company's income, that deduction may be offset by the tax on the director or top-level managerial official (assuming, of course, that the non-resident director or official is taxable on the remuneration under domestic law). Therefore, countries that wish to tax non-resident directors and senior managers of resident companies on their remuneration, irrespective of where the services are performed, must ensure that the provisions of their domestic law impose tax in these circumstances and that any tax treaties that they enter into contain a provision comparable to Article 16 of the United Nations Model Convention. However, such countries must recognize that, in the absence of a tax treaty, the imposition of tax on the remuneration of non-resident directors and senior managers of resident companies from services performed outside the country may result in double taxation.[62] They should also recognize that, where a tax treaty applies, they give up the first right to tax directors and senior managers of companies resident in the other contracting State on their remuneration from services performed in the source countries.

4.5 Pensions

Pensions paid to non-residents may reduce a source country's tax base because the non-resident recipients are not subject to tax and the payers of the pensions claim deductions for such payments (or for prior contributions to the pension plan) in computing their income for source country tax purposes. Source countries that are concerned about the potential base erosion with respect to pensions should ensure that pensions paid to non-residents by resident employers, by non-resident employers with a PE or fixed base in the source country, and by the government are subject to domestic tax. Moreover, they must ensure that any tax treaties they enter into do not limit their ability to tax such pensions (that is to say, the treaties should contain Article 18 (alternative B) of the United Nations Model Convention).[63]

The extent of any base erosion with respect to pensions relates to the amount of pension income derived by non-residents from prior

[62] Usually tax will also be imposed by the country in which the directors and managers are resident and may also be imposed by the country in which the services are performed.

[63] Article 18 of the OECD Model Convention and Article 18 (alternative A) of the United Nations Model Convention provide that pensions (other than social security payments and pensions paid by the government under Article 18 (2) (alternative A) of the United Nations Model Convention) are taxable exclusively by the country in which the recipient of the pension is resident.

employment services performed in a source country and must be balanced against the amount of pension income received by residents of the source country from prior employment services performed in another country. Pensions do not appear to involve any serious base erosion or tax avoidance issues.

4.6 Entertainment and athletic services

Some entertainers and athletes can make large sums of money in a short period. They may be self-employed independent contractors, employees of an entity such as a team, orchestra or other enterprise, or employees of an entity that they control or are associated with. Because Article 17 of the United Nations Model Convention applies to both employees, independent contractors and enterprises, income derived by non-residents from entertainment and athletic activities are discussed separately from employment income and business profits from services.

Developing countries that wish to tax income derived by non-resident entertainers and athletes must ensure that the provisions of their domestic law and tax treaties allow them to tax such income irrespective of the legal structure of the arrangements. It is generally accepted that a country in which entertainment and athletic activities are performed has the first right to tax such income. This right to tax is justified by practical considerations rather than concern about the protection of the tax base. Often the source of the income is generated from ticket sales to consumers, which will not be deductible in computing the source country's tax base. Nevertheless, the source country supplies the market for the entertainment or athletic event and the income-earning activities are performed there.

Despite the general acknowledgement that the country in which entertainment and sports activities take place has the first right to tax the income from such activities, developing countries face serious challenges to tax such income effectively. First, domestic law must impose tax on income derived by non-resident entertainers and athletes from activities performed in the country irrespective of how long the activities continue. For this purpose, the source country tax is generally imposed on the gross amount paid to the non-resident entertainer or athlete and collected by way of a withholding obligation imposed on the promoter of the event. Some countries may allow the non-resident to file a return and pay tax on the net income; however, this requires a commitment of administrative resources to assess returns and make refunds of excessive tax paid if appropriate. Countries should give careful consideration to the type of entertainment and athletic activities that are subject to tax; for example, it may be appropriate to exempt entertainment and athletic activities of a cultural nature or activities that do not generate much income. Countries should also carefully consider the rate of withholding tax, especially if a final withholding tax is used. Second, they should have an information-gathering mechanism to identify when and where entertainment and sporting events are taking place in their country. Third, they should have an effective tax collection mechanism to enforce the tax liability on non-resident entertainers and athletes.

Countries should also have provisions in place to deal with techniques used by non-resident entertainers and athletes to avoid source country tax. Common avoidance schemes in this regard involve the assignment of income by a non-resident entertainer or athlete to another person, usually related to the taxpayer, or the use of an entity of which the non-resident entertainer or athlete is a shareholder and employee. An example of the latter scheme might operate as follows:

- The entertainer or athlete owns all or a majority of the shares of a corporation that enters into contractual arrangements with the promoter of an event;
- The contractual arrangements require the corporation to provide the services of the entertainer or athlete;
- The entertainer or athlete has an employment contract with the corporation under which the employee's salary is modest, a small percentage of the total gross revenue derived by the corporation from the event.

In the absence of special domestic rules, the tax consequences of such an arrangement would be that the salary derived by the non-resident entertainer or athlete would be subject to source country tax because the employment is exercised in the source country. If the source country has entered into tax treaties based on the United Nations or the OECD Model Convention, Article 17 of those treaties would not limit the source country's ability to tax if the entertainment or sports activities are performed in the source country. However, the source country might not be able to tax the income derived by the corporate employer of the entertainer or athlete under the provisions of domestic law or under any applicable tax treaties because the employer does not have a PE in the source country. Therefore, the source country must have rules in its domestic law to allow the taxation of any income derived from employment or athletic activities performed in the country irrespective of whether the income is derived by the entertainer or athlete or by some other person such as a related entity. The source country must also ensure that its tax treaties contain a provision comparable to Article 17 (2) of the United Nations Model Convention.

4.7 Business, professional and other independent services

This section deals with income from business services, including professional and other independent services, with the exception of entertainment and athletic services, which are discussed above. The section begins with a discussion of business services in general followed by a discussion of several specific types of services, namely: construction, international shipping and air transportation, insurance and technical services.

As noted above, under their domestic laws, developing countries generally tax business, professional and other independent services provided by non-residents if the services are physically performed in the country. Some countries tax income derived by a non-resident from such services only if they are performed through a PE or fixed base in the country. These countries have generally aligned the provisions of their domestic law with the provisions of their tax treaties.

However, for many other developing countries, the taxation of income from business, professional and other independent services derived by non-residents under domestic law is significantly different from the taxation of such income allowed under the provisions of the United Nations Model Convention. Many of these countries also tax income from such services under their domestic law if the services are consumed or used in the source country or the payments for the services are deductible against the country's tax base by a resident payer or a non-resident payer with a PE or fixed base in the country. Moreover, several countries tax income from such services on a gross basis unless the non-resident service provider has a PE or fixed base in the country. Under the provisions of Articles 7 and 14 of the United Nations Model Convention, non-resident service providers are taxable exclusively by the country in which they are resident, unless the services are provided through a PE or fixed base in the source country or, in the case of professional and other independent services provided by an individual, the individual stays in the source country for at least 183 days in any 12-month period. If the source country is entitled to tax income from services derived by a non-resident service provider under Article 7 or Article 14 (1) (a), it is entitled to tax any income "attributable" to the PE or fixed base. Such income may include income earned outside the source country (foreign source income) as long as it is attributable to the PE or fixed base.[64] However, the consumption or use of services in the source country and the deduction against the source country's tax base of the payments for services to non-residents are insufficient to justify taxation by the source country under the provisions of the United Nations Model Convention. In effect, the source country's entitlement to tax under Article 7 or Article 14 is subordinated to the residence country's right to tax unless a substantial minimum threshold requirement (PE, fixed base or 183 days of presence) is met. Moreover, even if the conditions of Article 7 or Article 14 for taxation by a source country are met, the source country must impose tax on a net basis.[65] As a result, if a country taxes non-resident service providers on a gross basis, it is required under any applicable tax treaties to allow non-residents to file tax returns, claim deductions for any expenses incurred in earning the income and pay tax only on their net income.

Therefore, developing countries that tax income from services derived by non-residents significantly differently from the provisions of Articles 7 and 14 of the United Nations Model Convention should consider whether they wish to limit their taxing rights by entering into tax treaties.

[64] In the case of Article 14 (1) (b) of the United Nations Model Convention, where an individual service provider stays in the source country for at least 183 days, only income from services performed therein is taxable by the source country.

[65] Not all countries agree that net-basis taxation is required under Article 14.

The tax base of developing countries can be eroded through the performance of services by non-residents in two major ways. First, if a non-resident service provider does not have any PE or fixed base in the developing country, any income from services may not be taxable by the developing country under its domestic law or under the provisions of an applicable tax treaty. Moreover, even if the non-resident service provider has a PE or fixed base in the developing country, that country may be unable to tax income from services that is not attributable to the PE or fixed base. Second, if the services are provided outside the developing country but are deductible in computing the payer's income for purposes of the developing country's tax, the developing country may be unable to tax the income under its domestic law or under the provisions of an applicable tax treaty. If the non-resident service provider has a PE or fixed base in the developing country, the income attributable to the PE or fixed base under the provisions of Article 7 or 14 of the United Nations Model Convention may include foreign source income if, for example, the remuneration of the employees performing the services is deductible in computing the profits of the PE or fixed base. Nevertheless, unless the domestic law of the developing country includes such foreign source income in the income of a non-resident, the fact that an applicable tax treaty allows the country to tax may be of no effect.

There are several ways in which taxpayers can structure their affairs to avoid having a PE or fixed base in a country.[66] In some situations, non-resident service providers can provide services in a developing country at various locations in the country without any one place being used for more than six months. Or a non-resident service provider may attempt to avoid having a PE or fixed base by using the fixed place of business of a client or a related enterprise. Although the Commentary on Article 5 of the United Nations Model Convention indicates that a PE may exist in this situation,[67] it is necessary for the tax administration of the developing country to have the necessary information-gathering resources to discover the facts required to assess tax. In other situations,

[66] See chapter VII, Preventing avoidance of permanent establishment status, by Adolfo Martín Jiménez.

[67] See paragraph 3 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 4 of the Commentary on Article 5 of the OECD Model Convention.

a non-resident can avoid having a PE or fixed base by fragmenting its activities among related enterprises. Some of these situations can be dealt with by anti-avoidance rules in domestic law or by the inclusion of specific anti-avoidance rules in tax treaties.

To avoid having a PE under Article 5 (3) (b) of the United Nations Model Convention, a non-resident service provider may simply limit its service activities in the source country to a period or periods of less than 183 days in any 12-month period. Thus, a multinational enterprise with a group company carrying on business in a developing country may use another group company resident in a low-tax country to provide various services to the company in the developing country. These services, which often include legal, accounting, management and technical services,[68] may not require employees of the non-resident service provider to be present in the developing country for long periods of time. It is difficult for developing countries to counteract this type of tax planning even with effective anti-avoidance rules in place. Some countries have insisted on a shorter period than 183 days to minimize the limitation on their ability to tax. A non-resident can also avoid having a PE under Article 5 (3) (b) by using related non-resident enterprises to carry out connected projects. Under Article 5 (3) (b) any services performed for the same or a connected project are aggregated for purposes of counting the number of days on which services are provided in the source country. There is no rule, however, to take into account services provided by related enterprises with respect to the same or connected projects. Specific anti-avoidance rules in domestic law or tax treaties might be useful in this regard,[69] although the application of such rules requires effective information-gathering by the tax administration of the developing country.

4.8 Construction

Under the domestic law of most developing countries, construction activities conducted by non-residents in the developing country are usually subject to tax by that country, although in some countries

[68] The treatment of technical services is discussed in more detail below.

[69] See paragraph 11 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 18 of the Commentary on Article 5 of the OECD Model Convention.

they may be taxable only if they last for a minimum period of time. Under Article 5 (3) (a) of the United Nations Model Convention, a source country is entitled to tax income from construction activities in the source country only if they last for six months or more and are related to a single project. Thus, non-resident construction companies can avoid having a PE in a developing country by fragmenting a project into multiple projects that last less than six months or by having the projects carried out by different related entities. Some developing countries have negotiated a shorter time threshold for construction projects in their tax treaties. Anti-avoidance rules in domestic law or tax treaties might be useful in counteracting other strategies for avoiding PE status.[70]

4.9 Insurance

Insurance services provided by non-resident insurance companies do not provide serious opportunities for the erosion of the tax base of developing countries. Under Article 5 (6) of the United Nations Model Convention, if a non-resident enterprise collects insurance premiums or insures risks in the source country, a PE is deemed to exist unless such activities are conducted by independent agents. Therefore, assuming that a developing country has provisions in its domestic law imposing tax on non-resident insurance companies that collect premiums or insure risks in the source country and that any tax treaties it enters into contain a provision similar to Article 5 (6) of the United Nations Model Convention, the potential for base erosion will be quite limited.

4.10 International shipping and air transportation

In general, profits from international shipping and air transportation are earned outside any particular country's territory. As a result, the imposition of tax on such profits is difficult for any country other than the country in which the enterprise is resident or is effectively managed. For this reason, under Article 8 of both of the United Nations and OECD Model Conventions the exclusive right to tax such income

[70] See chapter VII, Preventing avoidance of permanent establishment status, by Adolfo Martín Jiménez.

is given to the country in which the enterprise has its place of effective management. Article 8 (2) (alternative B) of the United Nations Model Convention allows a country to tax shipping activities (not air transportation) within the country if those activities are more than casual. The tax must be levied on a net basis.

International shipping and air transportation services present problems of base erosion for developing countries where the profits derived by non-residents from such activities are not subject to tax by developing countries and where the payments made for such services are deductible against the developing country's tax base. Some developing countries impose a low-rate, gross-based withholding tax on income from international shipping and air transportation derived by non-residents from goods or passengers taken on board in the developing country. Developing countries that wish to tax such income must carefully consider whether to include in their tax treaties a provision similar to Article 8 (alternative A) of the United Nations Model Convention, because that provision will preclude source country tax completely, or Article 8 (alternative B), because that provision limits source country tax to shipping activities in the source country that are more than casual and requires net basis taxation.

4.11 Fees for technical services

4.11.1 Introduction

The United Nations Committee of Experts has been working since 2008 on the provisions of the United Nations Model Convention dealing with the taxation of income from services, including income from technical, managerial, consulting and other similar services (referred to here for convenience as "technical services").[71] A Subcommittee on Tax Treatment of Services (Subcommittee) with Ms. Liselott Kana

[71] See "Secretariat Note — Recent Work of the Committee on Tax Treatment of Services," 11 October 2013, presented at the ninth session of the United Nations Committee of Experts (21 – 25 October 2013), E/C.18/2013/CRP.17, available at http://www.un.org/esa/ffd/wp-content/uploads/2014/09/9STM_CRP17_Services.pdf.

of Chile as coordinator was established in 2009. Over the course of the next few years, the Committee and the Subcommittee continued to discuss the taxation of services. They also examined a study by the International Bureau of Fiscal Documentation (IBFD) on the provisions of recent tax treaties dealing with income from services[72] and papers by the author of the present chapter analysing the provisions of the United Nations Model Convention dealing with services and identifying options for change.[73] In 2011, at its seventh session, the Committee decided to work on the taxation of fees for technical services as a matter of priority. In 2012, at its eighth session, the Committee examined and debated a wide-ranging list of options to deal with income from technical services and decided to proceed with work on a new article covering such income to be added to the United Nations Model Convention. In 2013, at its ninth session, the Committee discussed three options concerning the scope of a new article dealing with income from technical services, as follows:

- Option 1: a broad provision applicable to services performed inside and outside the source country, with no threshold for source country taxation and taxation on a gross basis;
- Option 2: a provision applicable only to services rendered in the source country, with no threshold and taxation on a gross basis at a limited rate;

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[72] See W. Wijnen, J. de Goede and A. Alessi, "The Treatment of Services in Tax Treaties," (2012) Vol. 66, No. 1 *Bulletin for International Taxation*.

[73] See "Note on the Taxation of Services under the United Nations Model Tax Convention," 11 October 2010, presented at the sixth session of the United Nations Committee of Experts (18 – 22 October 2010), E/C.18/2010/CRP.7, available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/6STM_NoteTaxationOfServices.pdf; "Additional Note on the Taxation of Services under the United Nations Model Tax Convention," 13 October 2010, presented at the sixth session of the United Nations Committee of Experts (18 – 22 October 2010), E/C.18/2010/CRP.7/Add.1, available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/6STM_CRP7_Add1.pdf; and "Note on the Taxation of Fees for Technical and Other Services under the United Nations Model Convention," 2 August 2012, presented at the eighth session of the United Nations Committee of Experts (15 – 19 October 2012), E/C.18/2012/4, available at http://www.un.org/ga/search/view_doc.asp?symbol=E/C.18/2012/4&Lang=E.

- Option 3: a narrow provision restricted to services performed in the source country, with a time threshold for source country tax and taxation on a net basis.[74]

A majority of the Committee decided to proceed with the drafting of the wording for a new article and Commentary along the lines of Option 1.[75]

4.11.2 The treatment of technical services under domestic law

As discussed above, some developing countries have special rules in their domestic law and tax treaties for income from technical services derived by non-residents. One basic difficulty with these rules is that the types of services to which the rules apply are often not defined precisely. Some countries distinguish between technical assistance, which generally involves a transfer of know-how or technical expertise (analogous to the transfer of the right to use intellectual property), and technical services, which involve the application of specialized knowledge or skills.

The definition of technical services is similarly problematic under the provisions of tax treaties. According to an IBFD study carried out in 2011,[76] 134 out of 1,586 bilateral tax treaties concluded in the period 1997 – 2011 contained a special provision dealing with "managerial, technical and consulting services" without defining such services. Some countries, such as India, extend Article 12 dealing with royalties to include payments for services that are ancillary or subsidiary to the application of intellectual property or that make available

[74] See "Note on a New Article of the United Nations Model Convention Dealing with the Taxation of Fees for Technical and Other Services," 11 October 2013, presented at the ninth session of the United Nations Committee of Experts (21 – 25 October 2013), E/C.18/2013/CRP.5, available at http://www.un.org/esa/ffd/wp-content/uploads/2014/09/9STM_CRP5_Services.pdf.

[75] United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, Report on the ninth session (21-25 October 2013), chapter III, section K, available at http://www.un.org/ga/search/view_doc.asp?symbol=E/2013/45&Lang=E.

[76] See W. Wijnen, J. de Goede and A. Alessi, "The Treatment of Services in Tax Treaties," supra note 71.

technical knowledge, skill, know-how or processes, or that involve the development of a technical plan or design.

The distinction between technical services and professional and business services that involve technical expertise is unclear. For example, engineering services would often be considered technical services; however, the independent activities of engineers are included in the definition of "professional services" for purposes of Article 14 of the United Nations Model Convention.[77] Thus, income from engineering services, at least those performed by individuals, would be taxable by a source country only if the engineer has a fixed base in that country or stays in that country for 183 days or more in any 12-month period.

4.11.3 The taxation of income from technical services under the provisions of the United Nations Model Convention and bilateral tax treaties

Even if the provisions of a developing country's domestic law impose tax on income from technical services earned by a non-resident, the provisions of an applicable tax treaty may limit that tax. This section provides a brief review of the provisions of the United Nations Model Convention potentially applicable to income from technical services and an overview of the provisions dealing with income from technical services that some developing countries have included in some of their tax treaties.

The current United Nations Model Convention does not contain any specific provisions dealing with income from technical services provided by a resident of one State in the other contracting State or to customers in the other contracting State. In general, income from business services is covered by Article 7 or 14. Under Article 7 (1), a country is entitled to tax a non-resident's business profits only if the non-resident carries on business in the country through a PE. A PE is defined in Article 5 to be a fixed place of business which lasts for a minimum period (generally, six months) and under Article 5 (3) (b) a non-resident is deemed to have a PE in the source country if it furnishes services in the source country for more than 183 days in any 12-month

[77] See Article 14 (2) of the United Nations Model Convention.

period in respect of the same or connected projects. The fixed place of business rule is easily avoided by some non-resident service providers by moving from place to place before the threshold is met. Under Article 14 of the United Nations Model Convention, income derived by a non-resident from professional or other independent services performed in the source country is taxable by the other State only if the income is attributable to a fixed base in that country that is regularly available to the non-resident or if the non-resident is present in the source country for 183 days or more in any 12-month period. It is generally accepted that the source country must tax income under Article 7 or 14 on a net basis.

Article 12 of the United Nations Model Convention dealing with royalties does not apply to fees for technical services because the definition of royalties in Article 12 (3) is limited to payments for the use of, or the right to use, intellectual property, equipment or information. However, according to the Commentary, Article 12 could apply to services under a mixed contract if the services are "of an ancillary and largely unimportant character."[78]

Finally, income from technical services may be taxable under Article 21 (Other income) of the United Nations Model Convention if the income is not considered to be income from carrying on business or from professional or independent personal services under domestic law. As a result, such income is other income that is taxable by a source country if it arises in the source country in accordance with Article 21 (3) of the United Nations Model Convention. There is no limit on source country taxation of other income under this provision, so that such tax may be imposed as a flat rate withholding tax on the gross amount of the payment. Further, there is no threshold requirement for source country taxation of other income under Article 21 (3), unlike income covered by Article 7 or 14. All that is necessary is that the income arises (has its source) in the source country.[79]

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[78] See paragraph 12 of the Commentary on Article 12 of the United Nations Model Convention, quoting paragraph 11 of the Commentary on Article 12 of the OECD Model Convention.

[79] No rules are provided in Article 21 for determining the source of income so that it would likely be necessary to have recourse to domestic law

This overview of the provisions of the United Nations Model Convention that are potentially applicable to income from technical services shows that it is relatively easy for a non-resident enterprise to avoid source country tax on such income especially where the services are provided to a related enterprise resident in the source country. As long as the non-resident service provider does not have a PE or fixed base in the source country or stay in the source country for more than 183 days, the income is not taxable by the source country under Article 7 or 14. The income could be covered by Article 21 if it is not considered to be dealt with by Article 7 or 14; however, in most situations income from technical services would be considered to be business profits or income from professional or independent services so that Article 21 would not apply.[80]

This result is problematic from the perspective of base erosion because the payments for the technical services are ordinarily deductible in computing the income of the person to whom the services are provided (that is to say, either a resident of the source country or a non-resident with a PE or a fixed base in the source country). Although the payments erode the source country's tax base, they are not taxable by the source country in the hands of the non-resident service provider. As a result, multinational enterprises can use technical services to strip the profits of subsidiaries resident in developing countries. Often the group company providing the technical services will be resident in a low-tax country so that the tax savings from the deduction of the payments in the source country will significantly exceed the tax on the payments to the non-resident service provider.

The erosion of the source country's tax base by payments for technical services and the inability of the source country to tax such payments has led some countries to add specific provisions to their domestic laws and tax treaties to allow them to tax payments for technical services

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for this purpose. Although the general source rule for income from services under the United Nations and OECD Model Conventions is the place where the services are performed, some countries consider income from services to be sourced where the services are used or where the payer is resident.

[80] See supra note 49 with respect to the recent change in Brazil's position concerning the application of Article 21 to income from technical services.

on a gross basis.[81] As noted above, the 2011 study by the IBFD found that 134 of 1,586 tax treaties concluded between 1997 and 2011 contained a separate article dealing with fees for technical services.[82] Several other treaties extended the provisions of Article 12 dealing with royalties to include certain technical services. Under the separate articles, income from technical services is treated like royalties. Source country tax is allowed on a gross basis at a fixed rate that varies; sometimes the rate is higher than the rate on royalties and sometimes lower. Typically, source country tax is limited to fees for technical services "arising" in the source country, which usually means that the services must be performed therein. As noted above, typically these separate articles dealing with fees for technical services refer to "managerial, technical or consultancy services" without defining that expression.

In general, business profits and income from professional and independent services are taxable under the provisions of the United Nations Model Convention only if the non-resident service provider has a PE or fixed base in the source country and is taxable on a net basis. Notwithstanding this general pattern, there seems to be widespread recognition that source countries should be entitled to tax interest, royalties and fees for technical services that constitute business profits, even in the absence of a PE or a fixed base, probably because these payments reduce the source country's tax base. This recognition is reflected in the decision of the United Nations Committee of Experts to work on a new article to allow source countries to tax income from technical services on a basis similar to the taxation of royalties (that is to say, on a gross basis at a limited rate without any threshold requirement, even if the services are provided outside the source country). If a new article with these features is added to the United Nations Model Convention and developing countries are successful in negotiating the inclusion of the new article in their tax treaties, such countries will be able to tax income from technical services earned by non-residents and protect their domestic tax base from

[81] In some cases, the definition of royalties is amended to include technical fees; in other cases, a separate article dealing with technical fees is added to a tax treaty. See S. B. Law, "Technical Services Fees in Recent Tax Treaties," (2010) Vol. 64, No. 5 *Bulletin for International Taxation*, at 250 – 52.

[82] See W. Wijnen, J. de Goede and A. Alessi, "The Treatment of Services in Tax Treaties," supra note 72.

erosion through payments for technical services. Although payments for technical services to non-residents by residents of a developing country or non-residents with a PE or a fixed base in the developing country will be deductible against its tax base, that country will be entitled to tax such payments. Practically, however, there are several obstacles for developing countries to overcome in order to effectively tax income from technical services derived by non-residents:

- The provisions of domestic law must allow the taxation of income from technical services derived by non-resident service providers;
- Developing countries must successfully negotiate the inclusion of a new technical services article in their tax treaties, which may be difficult since developed countries may be reluctant to agree to the inclusion of the new article without significant concessions on other issues;
- The rate of tax may be excessive and discourage investment;
- Taxation on services provided outside the source country may result in unrelieved multiple taxation, since the countries in which the services are performed and in which the service provider is resident may also tax the income; and
- An efficient withholding system should be adopted to ensure that the tax imposed on non-resident service providers can be collected effectively.

5. Constraints on the taxation by developing countries of income from services derived by non-residents

5.1 Introduction

In considering possible responses to base erosion through services performed by non-residents, developing countries should ensure that they do not adopt measures in their domestic law that contravene the provisions of the General Agreement on Trade in Services[83] (GATS) or

[83] General Agreement on Trade in Services, 15 April 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, supra note 6.

the non-discrimination article in their tax treaties. In general, neither the GATS nor non-discrimination articles based on Article 24 of the United Nations Model Convention impose serious constraints on the taxation of income from services derived by non-residents. The following discussion provides an overview of the provisions of the GATS and Article 24 of the United Nations Model Convention potentially applicable to income from services.

5.2 The General Agreement on Trade in Services

For countries that are members of the World Trade Organization (WTO), any measures of domestic law must comply with the provisions of the General Agreement on Trade in Services (GATS).[84] For purposes of the GATS, the term "services" is not defined except to include "any service in any sector" and to exclude services performed by governments.[85] However, "services" would appear to have a broad meaning for purposes of the GATS as illustrated by the "Services Sectoral Classification List" used during the negotiation of the GATS.[86] In general, the GATS applies to measures by member countries "affecting trade in services"[87] and "trade in services" is defined to mean the supply of a service in any of the following four modes:

- From the territory of one member country into another;
- In the territory of a member country to a consumer of any member country;
- By a service supplier of one member country through commercial presence in another member country;

[84] See, in general, Catherine Brown, "Tax Discrimination and Trade in Services: Should the Non-discrimination Article in the OECD Model Treaty Provide the Missing Link between Tax and Trade Agreements?" in Arthur J. Cockfield, ed., *Globalization and Its Discontents: Tax Policy and International Investment*, (Toronto: University of Toronto Press, 2010), at 257 – 79.

[85] See Article I (3) (b) of the GATS.

[86] See World Trade Organization, "Services Sectoral Classification List," 10 July 1991, MTN.GNS/W/120, available at http://www.wto.org/english/tratop_e/serv_e/serv_sectors_e.htm.

[87] See Article I (1) of the GATS.

- By a service supplier of one member country through natural persons in another member country.[88]

Therefore, although it is not completely clear because the GATS uses different language than the language used for tax purposes, the provisions of the GATS apply to direct tax measures imposed by a country on income from the following types of services:

- Services supplied in the country;
- Services supplied outside the country but consumed in the country;
- Services supplied by a non-resident through a commercial presence[89] in the country, whether the services are consumed inside or outside that country; and
- Services supplied by a non-resident through individuals (for example, employees) in the country, whether the services are consumed inside or outside that country.

The GATS requires most-favoured-nation (MFN) treatment with respect to services and service suppliers of member countries.[90] Most-favoured-nation treatment means that services and service suppliers of one country must be treated no less favourably than services and service suppliers of any other country.

The requirement to provide most-favoured-nation treatment for services and service suppliers of other countries does not appear to cause any problems for most countries with respect to the taxation of non-residents on income from services under domestic law. As long as a country taxes all non-resident service suppliers in the same manner, the country has complied with its most-favoured-nation treatment obligations under the GATS. Thus, a country is entitled to impose

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[88] There is considerable overlap among these provisions.

[89] Article XXVIII (d) of the GATS defines the term "commercial presence" to mean "any type of business or professional establishment," including through a legal entity, branch or representative office. This definition is broader than the concepts of a PE and a fixed base for tax purposes, except that the GATS definition might not include some of the deeming provisions applicable under Article 5 of the United Nations Model Convention.

[90] See Article II (1) of the GATS.

a gross-basis withholding tax on all non-resident service providers receiving payments for technical services provided to residents of the country. However, if a country provides benefits, such as reduced rates of withholding, to the residents of countries with which it negotiates tax treaties, those benefits would violate the most-favoured-nation treatment required by the GATS, except for a specific exception in the GATS. Article XIV (e) carves out from a country's most-favoured-nation obligations any difference in treatment that "is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement." Thus, if a country provides a reduced rate of withholding tax on payments for technical services or other treaty benefits for income from services, there can be no violation of the country's most-favoured-nation obligations under the GATS.[91]

Most-favoured-nation treatment does not require a country to tax non-resident service suppliers the same as (that is to say, no less favourably than) its own resident service suppliers. However, Article XVII of the GATS requires national treatment of trade in services with respect to services in sectors specified by a member country in its Schedule to the GATS, subject to any conditions in that Schedule (generally referred to as a country's commitments under the GATS).

Even if national treatment is required by Article XVII, Article XIV provides several exceptions. These exceptions do not apply to measures that are administered in a manner that constitutes a disguised restriction on trade in services or arbitrary or unjustifiable discrimination between countries where like conditions apply. The most relevant exception is included in Article XIV (d) and provides that nothing in the GATS prevents a country from adopting or enforcing a measure inconsistent with national treatment that is "aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members." According to the footnote to Article XIV (d), measures to impose or collect taxes equitably or effectively include measures which:

- Apply to non-resident service suppliers in respect of taxable income sourced or located in a country;

[91] See Article XIV (e) of the GATS.

- Apply to non-residents to ensure the collection of taxes in a country's territory or to prevent avoidance or evasion;
- Apply to consumers of services supplied in a country or from another country to ensure the collection of taxes on consumers from sources in the country;
- Distinguish between service suppliers subject to worldwide taxation and other service suppliers in recognition of their different tax base;
- Apply for the purposes of determining income, profit, gain, loss, deduction and credit of residents or branches of non-residents (including transfer pricing rules).

The footnote prescribes that the terms used therein should be interpreted in accordance with the meaning that they have under the domestic law of the country imposing the tax measure. Although this footnote poses many interpretive issues, it seems reasonably clear that a country is entitled to tax non-resident service suppliers differently from resident service suppliers with respect to income sourced in the country. Therefore, a developing country that imposes a gross withholding tax on non-residents providing services in the country would not be in violation of its obligations under the GATS.

However, it is less clear whether a developing country that imposes a gross withholding tax on non-resident service suppliers providing services outside that country would be in violation of its obligations to provide national treatment under the GATS. First, Article XIV (d) applies only with respect to "direct taxes" and, in the absence of a clear domestic law meaning of the term "direct taxes," it is unclear whether a tax levied by a country on services provided abroad and generally shifted to domestic consumers constitutes an indirect tax.[92] Second, the footnote to Article XIV (d) indicates that whether taxable items are "sourced or located" in a country for purposes of its tax law is determined under that country's domestic law. Therefore, in those

[92] The uncertainty is reflected in the Schedules containing the countries' commitments to the GATS. Some countries appear to have excluded certain taxes (for example, excise taxes on insurance premiums applicable exclusively to payments to non-resident insurers that ensure domestic risks) on the basis that they might violate the GATS.

countries that consider income derived from services consumed or used by residents of that country or non-residents with a PE or fixed base in that country to be sourced in that country, there should be no violation of the GATS. If, however, a developing country imposes tax on fees for services performed outside the country by non-residents even where the fees are considered to be sourced in another country, under that developing country's domestic law, the tax would violate the national treatment under the GATS unless it is necessary to ensure the imposition or collection of tax in the country or to prevent tax avoidance or evasion. It is unclear what "the imposition or collection of taxes in the Member's territory" in the footnote is intended to mean. Since all of a country's taxes would appear to be imposed and collected in its territory, the reference to taxes in a country seems to be meaningless. The exception for measures to prevent tax avoidance and evasion is potentially broad and a gross withholding tax imposed on fees for services performed outside a country could be justified on that basis.

In conclusion, although developing countries should carefully consider the provisions of the GATS, in particular the requirement to provide national treatment to non-resident services providers and the exception in Article XIV (d), it seems that there are reasonable arguments that a gross withholding tax on payments for services performed outside the country but consumed or used in the country would not violate the GATS.

5.3 Article 24 of the United Nations Model Convention (Non-discrimination)

Article 24 of the United Nations Model Convention provides three types of protection against discrimination relevant to income from services.

First, Article 24 (3) prevents a contracting State from taxing a PE of an enterprise of the other contracting State less favourably than it taxes its own enterprises carrying on the same activities. This provision prevents a country from taxing non-resident service providers that are carrying on business through a PE in the country less favourably than resident service providers. Thus, if resident service providers are subject to tax on their net profits, non-resident service providers (that are resident in treaty countries) must be taxable on the same basis.[93] However, Article 24 (3) does not apply to "connected requirements" such as information reporting and enforcement measures. Therefore, payments for services to a non-resident may be subject to withholding at source even though resident service providers are not subject to withholding.[94] However, pursuant to Article 24 (3) non-resident service providers must be entitled to file returns, pay tax on their net profits attributable to the PE and claim a refund to the extent that the amount withheld exceeds the tax.

Article 24 (3) does not apply to income from independent personal services dealt with under Article 14 of the United Nations Model Convention. As a result, non-residents earning income from such services may be taxed less favourably than residents earning the same type of income. In fact, most countries do not discriminate against non-residents earning income from independent personal services, although some countries take the position that Article 14 does not require taxation on a net basis.

Second, Article 24 (4) requires a contracting State to allow the deduction of interest, royalties and "other disbursements" paid by its resident enterprises to residents of the other contracting State under the same conditions as if the amounts were paid to its own residents. The term "other disbursements" is sufficiently broad to include payments by residents of a country to non-residents for services. Thus, a country cannot deal with base erosion by denying the deduction of payments to non-residents for services if it allows the deduction of such payments to residents. Some countries disallow the deduction of

[93] Article 24 (3) of the United Nations Model Convention does not prevent a country from taxing both resident and non-resident service providers by means of a withholding tax on the gross amount of the payments received by them.

[94] Arguably, paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 65 of the Commentary on Article 24 of the OECD Model Convention, contains a statement that may contradict this conclusion: "permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely." However, this statement relates to the taxation of the profits of a permanent establishment and not to connected requirements.

payments for certain services to residents of tax havens. Such a measure would not be effective if the country enters into a tax treaty with a tax haven that contains a provision similar to Article 24 (4) of the United Nations Model Convention. However, Article 24 would not prevent a country from denying a deduction of amounts paid by a resident to a non-resident where the resident does not withhold tax properly in accordance with the law.

Third, Article 24 (5) prohibits a contracting State from taxing a resident enterprise that is owned or controlled, directly or indirectly, by residents of the other contracting State differently (that is to say, through other or more burdensome taxation) from other resident enterprises. This provision applies to both taxation and connected requirements, such as information reporting and enforcement measures. Thus, if an enterprise resident in one contracting State establishes a company in the other State to provide services, that company must be treated in the same manner for tax purposes as other similar companies resident in that State.

From this overview of the provisions of Article 24 relevant to income from services, it is apparent that Article 24 does not prevent developing countries from adopting measures to protect their domestic tax base. For example, as noted above, several countries tax income derived by non-residents on a net basis if the services are provided through a PE, but otherwise on a gross withholding tax basis. This method of taxation of income from services complies with Article 24 (3) with respect to income earned through a PE, assuming that the domestic definition of a PE is the same or narrower than the definition in Article 5 of the United Nations Model Convention. Further, Article 24 (3) does not impose any constraints on a country's ability to tax income from services earned by a non-resident other than through a PE. Therefore, if a developing country adopts a gross-based withholding tax on fees for technical services, that tax would violate Article 24 (3) to the extent that it applies to income from technical services earned through a PE in the country.

For those countries that have a specific article in their treaties dealing with fees for technical services, taxation of such fees in accordance with that article cannot be discriminatory in violation of

Article 24.[95] A similar result would apply if the United Nations Model Convention is amended to add a new article dealing with fees for technical services and a country imposes tax in accordance with such an article included in its tax treaties.

6. Conclusion

In broad general terms, situations that present base erosion or profit shifting problems for developing countries with respect to services involve the following:

(1) Payments to non-residents by residents of a developing country or by non-residents with a PE or fixed base in that country that are deductible in computing income subject to source country tax but are not taxable by the developing countries in the hands of the non-residents;

(2) Income from services derived by non-residents that should be subject to tax by developing countries, but because of deficiencies in domestic law or the provisions of an applicable tax treaty are not subject to tax; and

(3) Income from services derived by a resident of a developing country that is diverted or shifted to a non-resident entity controlled by or associated with the resident.

The first situation is obviously the most serious because not only is the income derived by the non-resident not taxable by developing countries, but also the payments for the services reduce their tax base. In general, this situation can be dealt with by developing countries if they tax the non-residents on the income from services or if they deny a deduction for the payments for such services.

Denying a deduction for payments for services to non-residents by residents and non-residents with a PE or fixed base is a draconian

[95] Paragraph 1 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 4 of the Commentary on Article 24 of the OECD Model Convention provides that: "measures that are mandated or expressly authorized by the provisions of these [other] Articles [of the Convention] cannot be considered to violate the provisions of the Article [24] even if they only apply, for example, as regards payments to non-residents."

solution because it penalizes payers with respect to legitimate income-earning expenses. However, in certain situations in which it is difficult or impossible for developing countries to impose tax effectively on non-resident service providers, the denial of deductions might be justified as the only effective way to protect the tax base. This might be the case, for example, where the non-resident service provider is resident in a tax haven.

It should be emphasized that in these three situations base erosion and profit shifting are acceptable if they result from deliberate tax policy choices made by developing countries. If a developing country decides not to tax certain income from services derived by non-residents as a deliberate tax policy decision or enters into a tax treaty with another country or countries in which it gives up its right to tax such income under domestic law, there can be no issue of inappropriate base erosion or profit shifting.

Base erosion and profit shifting are especially problematic with respect to services rendered by a non-resident company to a company resident in a developing country where both companies are members of a multinational group. In such situations, the payments for services are usually deductible in computing the resident company's income subject to tax by the developing country; however, the income earned by the non-resident service provider may not be subject to tax by the developing country. If, as may be the case, the group company providing the services is resident in a low-tax country, the payment for the services is deductible against the developing country's tax base at relatively high rates but is taxed at relatively low rates, so that the tax savings from the deduction substantially exceed any tax on the income. Moreover, multinational companies have considerable flexibility to structure their affairs in a tax-efficient manner by manipulating the character of intragroup payments. In these situations, intragroup payments may be characterized as payments for services or royalties, whichever yields the best tax result. Fees from technical, management and consulting services are especially problematic.

In sum, the problems of base erosion and profit shifting with respect to income from services are complex and multifaceted. Many different types of services are involved and the legal form (for example, employment or independent services) in which they are provided varies.

The provisions of a developing country's domestic law and its tax treaties with respect to the taxation of income from services are both important. Moreover, the taxation of income from services should not be viewed exclusively from the perspective of base erosion and profit shifting, or, more generally, through the lens of tax avoidance; it should be viewed in the broader context of a developing country's entire tax system and its economy as a whole. Developing countries need foreign investment and they must be cautious about adopting tax policies that discourage such investment. On the other hand, developing countries also need tax revenues to fund public expenditures and this goal requires them to protect their domestic tax bases. These two goals — the need to attract or at least not to discourage foreign investment and the protection of the domestic tax base — must be carefully balanced. Simplistic solutions should probably be avoided. For example, it might be possible for a developing country to protect against base erosion and profit shifting by taxing non-residents on all their income from services performed in the country or consumed or used in the country, or by denying the deduction of payments for services to non-residents and by not entering into tax treaties that limit the country's right to tax income from services. Such a country might discover, however, that these tax policies are not in accordance with international practice and that they may discourage non-resident service providers from performing services in that country or for residents of that country that are necessary for the country's economy.

This chapter has not made any recommendations for developing countries to adopt to protect their tax bases against base erosion and profit shifting with respect to income from services. Instead, it has attempted to identify in a reasonably comprehensive fashion the ways in which the tax base of developing countries can be eroded with respect to income from services and the possible responses that developing countries might adopt in their domestic laws and their tax treaties to protect their tax base. As a final point, it is worth noting that in an increasingly globalized and integrated economy, the necessity for developed and developing countries to take coordinated action to deal with international tax problems is becoming more important.

Chapter III

Taxation of non-residents' capital gains

Wei Cui*

1. Introduction

Designing and enforcing a legal regime for taxing non-residents on capital gains realized from domestic sources is a topic of vital importance for developing countries. The reason is that non-capital-gain income that may be derived from a given country can generally be crystalized in the form of capital gains on the disposition of the income-generating asset.[1] This is true of most important types of income, be it rent, interest, royalty, dividend or business profit. Taxing capital gains, therefore, is invariably needed to ensure that income from assets in the source country is properly subject to tax. In this sense, capital gains taxation of non-residents is inherently a measure for protecting that country's tax base from erosion.

This perspective, however, cannot be said to be clearly reflected in the prevailing international tax regime. There is a well-known principle that if the non-capital-gain income from an asset is taxable in a source country (for example, because the asset is properly viewed as being located in that country), then the capital gains from the disposition of that asset should be taxable in the same country.[2] This principle,

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[1] The intrinsic connection between income derived from an asset and capital gains realized on the disposition of the asset is grounded in a basic tenet of modern finance theory, namely, that the value of an asset simply is the present discounted value of future income that the asset can be expected to generate.

[2] "It is normal to give the right to tax capital gains on a property of a given kind to the State which under the Convention is entitled to tax both the property and the income derived therefrom." See paragraph 4 of the Commentary on Article 13 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations

clearly based on the intrinsic connection between the income derived from an asset and any capital gains realized on the disposition of the asset, is commonly used to justify taxing capital gains realized by non-residents on the disposition of immovable property and assets used in a permanent establishment (PE) situated in the taxing country. Nonetheless, it has not been consistently applied to other types of capital gains realized by non-residents. The United Nations Model Double Taxation Convention between Developed and Developing Countries[3] (United Nations Model Convention), for example, provides for source-country taxation of interest, dividends, royalties and other income, in addition to the taxation of income from immovable property and business profits attributed to a PE. However, in Article 13 (Capital gains), the United Nations Model Convention follows the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital[4] (OECD Model Convention) in giving prominence to taxing capital gains realized on the disposition of immovable property and business assets used in a PE, but takes a weaker stance on the taxation of gains realized on the disposition of company shares, and allows other capital gains realized by non-residents to go untaxed.[5]

Model Convention), quoting paragraph 4 of the Commentary on Article 13 of the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital (OECD Model Convention). The rule that "gains from the alienation of immovable property may be taxed in the State in which it is situated … corresponds to the provisions of Article 6 and of Article 22 (1)." See paragraph 5 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraph 22 of the Commentary on Article 13 of the OECD Model Convention. The taxation of gains on the business assets of a permanent establishment (PE) or fixed base "corresponds to the rules for business profits [and for income from independent personal services] (Article[s] 7 [and 14])." See paragraph 6 of the Commentary on Article 13 of the United Nations Model Convention, quoting and supplementing paragraph 24 of the Commentary on Article 13 of the OECD Model Convention.

[3] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[4] Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

[5] See section 5 below.

The reason for this inconsistency is not well articulated. Adding to this, there are substantive disagreements — often between developing and developed countries — about what types of non-capital-gain income should be taxable in a country other than the resident country of the recipient of the income.[6] Both of these factors — divergent views about where non-capital-gain income should be taxed, and inconsistencies in observing the equivalence between income and gain (and therefore between the sources of income and gain) — have led to widely divergent practices in the capital gains taxation of non-residents.

The first challenge facing developing countries in designing policies in this area, therefore, may be the apparent absence of an "international norm," or confusing accounts of what such a norm consists of. The present chapter will offer some basic insights into understanding the divergent practices. It argues that there are sound conceptual justifications for taxing non-residents on capital gains in general, and that there are no compelling reasons for assuming that such taxation should be limited to immovable property.[7] Instead, the legitimacy of such a tax may depend more on its specific design — for example, its treatment of losses, and its ability to avoid arbitrary and multiple taxation of the same economic gain — than on the basic idea of its imposition.[8]

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[6] This could be a debate either about whether a source country should have a taxing right, or about what the source of the income is in the first place.

[7] In this respect, the arguments of the present chapter go beyond some recent discussions of the taxation of capital gains that are intended to emphasize the interests of developing countries. See United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, "Article 13 (Capital Gains): the practical implications of paragraph 4," (2014), available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/10STM_CRP13_CapitalGains.pdf (hereinafter "Committee of Experts Paper"); International Monetary Fund (IMF), "Spillovers in International Corporate Taxation," (2014) *Policy Paper*, available at http://www.imf.org/external/np/pp/eng/2014/050914.pdf (hereinafter "IMF Spillovers Report"); and Richard Krever, "Tax Treaties and the Taxation of Non-Residents' Capital Gains," in Arthur J. Cockfield, ed., *Globalization and its Tax Discontents: Tax Policy and International Investments* (Toronto: University of Toronto Press, 2010), 212-238.

[8] Unfortunately, both the United Nations and OECD Model Conventions (and many existing discussions purporting to give guidance to developing countries) tend to be brief, or even silent, on these design issues.

A second, more important challenge for taxing non-residents on capital gains lies elsewhere: namely, the tax can be difficult to enforce, and the dynamics of engagement between tax administrators and taxpayers in collecting the tax can be quite different from normal tax administration. These difficulties may provoke questions about whether the likely revenue payoff from the tax justifies the resources needed for its enforcement. The difficulty of enforcing the capital gains tax on non-residents may sound clichéd; however some of the more familiar descriptions of the administrative difficulties may not be accurate. For example, it is unclear whether developing countries are more likely to be at a disadvantage in administering the tax. The present chapter analyses the pros and cons of the various mechanisms for administering the capital gains tax for non-residents and argues that buyer withholding is a more effective enforcement mechanism than tactics that focus on the transferred assets. Moreover, ways in which voluntary compliance in this area may be improved are considered.

Tax avoidance poses the third challenge for taxing non-residents on capital gains. The typical strategies for legally avoiding a tax on capital gains imposed by a source country are neither complex nor difficult to identify. They include treaty shopping and the use of offshore holding companies. However, the incentives for taxpayers to adopt such strategies may vary as a function of the severity of the first two challenges. If there are basic inconsistencies in the rules adopted by domestic law and by tax treaties towards capital gains taxation, and if the enforcement of such tax rules is inadequate, taxpayers may have greater incentives to engage in avoidance. Moreover, the feasibility of avoidance behaviour could also depend to a substantial extent on non-tax characteristics of the business and the legal environment for investing in a country: some countries witness the use of extensive offshore markets through which investments are channelled into those countries, while others do not experience such practices. The present chapter will discuss both specific and general anti-avoidance rules for maintaining the integrity of a tax on capital gains earned by foreigners, as well as how to choose among these rules in light of the circumstances that generate tax avoidance.

Section 2 of the present chapter examines the general principles for taxing non-residents on capital gains realized on the disposition of domestic assets. It considers the relationship between capital gains and other forms of income from an asset, as well as the question why immovable property has been regarded as a special asset class for source-based taxation of capital gains. Section 3 analyses specific legal design issues for taxing capital gains, including whether to assimilate such taxation to gross- or net-income-based taxation, and issues arising from the taxation of shares of companies. Section 4 considers the fundamental administrative issues in taxing non-residents on capital gains. Whereas the issues described in sections 2–4 below normally need to be addressed under domestic legislation, section 5 briefly reviews Article 13 of the United Nations Model Convention — highlighting some shortcomings of the Article from the source-country perspective — as well as treaty practices among developing countries with respect to taxing capital gains. Section 6 turns to tax planning commonly adopted to avoid the tax on capital gains. It pays particular attention to policies recently adopted by a number of developing countries aimed at taxing indirect transfers of the shares of resident companies. Section 7 briefly examines the issue of departure taxes for individuals. Section 8 concludes by offering some reflections on how to view the pursuit by developing countries of capital gains taxation of non-residents.

2. General principles for taxing non-residents on capital gains

2.1 The economic substance of capital gains

In thinking about taxing non-residents on gains realized on the disposition of domestic assets, it is useful to keep in mind what assets tend to generate capital gains in the first place and why. For instance, mass-produced durable assets (for example, machines, computers, household appliances, vehicles, ships and aircraft) generally see their values depreciate over their useful lives because of wear and tear and newer, better products becoming available on the market. Even the value of buildings as physical structures — if the value of the land they sit on is disregarded — generally declines instead of increases. By contrast, the value of the ownership (for example, through company shares) of businesses may increase, if the businesses are successful, as may the value of land in locations that experience economic growth. Other than land, assets that are unique in some ways — for example, depletable resources and, importantly, monopoly rights (such as rights to operate in restricted industrial sectors, for instance, mining, telecommunications) — may also increase in value. Finally, modern financial markets create possibilities of speculation and arbitrage that can give rise to substantial gains (and losses). Many developing countries, for example, have become acquainted with "vulture funds" that buy up non-performing business loans or sovereign debts with high risks of default and realize substantial returns from them.

Reflecting on the types of assets that are likely to give rise to capital gains is important for two reasons. First, it helps a source country to determine for which categories of assets it is important to reserve rights in terms of taxing capital gains. This issue will be discussed further in section 4 below,[9] but it is already immediately clear that immovable property, even if defined to include mining and mineral rights, is not the only type of asset that can yield substantial gain. In fact, from all that is known, it may not even be the most important class of assets.[10] Second, it enables an appreciation of the economic nature of capital gains. Essentially, in a competitive asset market, assets experience gain because of an increased expectation of the streams of income that they will generate. In effect, between the time the owner acquires the asset and the time he or she sells it, the market (that is to say, potential buyers) has come to expect the asset to generate more future income in present value terms. This increased expectation could be due to greater certainty in the future flow of income, an acceleration of the timing of the return, an increase in the absolute value of the future return or its value relative to other assets available for investment. Indeed, gain could arise due to the lack of competition as well: an initial buyer with special access or bargaining power may be able to obtain an asset cheaply and "flip" it to other buyers.

[9] This issue is particularly pertinent to the interpretation of Article 13 (2) and (3) of the United Nations Model Convention.

[10] In the global private equity industry, for example, where capital gains tend to be the driver of profits, funds deployed in the real estate and infrastructure sectors have been consistently and significantly smaller in comparison with funds deployed in other sectors (such as buyouts). See Bain and Company, *Global Private Equity Report 2014*, at 6.

From the perspective of economic efficiency, it is in fact attractive to tax many of the types of gain described above. Increases in the value of non-reproducible assets — land, natural resources and collectibles — tend to reflect what economists call "pure rent" or "economic profit": taxing pure rent is efficient because it does not distort economic behaviour. Taxing gains that arise because of imperfect competition is also often efficient. Finally, gains in operating businesses and speculative gains on financial markets may represent a mixture of rent, return to risk-taking and return to managerial skills. Although taxing the latter two types of return may distort economic behaviour, the magnitude of the distortions may be limited — for instance, where the managerial skills are relatively location-specific, for example, involving specific language, culture and/or political skills.

Capital gains that arise in the ways just described can be contrasted with some other forms of gains. One kind of nominal capital gain results from inflation: in an inflationary context, even depreciating equipment can sell for a greater nominal amount of cash than the purchase price. Another kind of gain is income that has already been earned on the asset but that has been added to or reinvested in (capitalized into) the original asset. For example, if a corporation has retained earnings and does not distribute such earnings to shareholders, the price of its shares will go up simply because the shareholders have deferred the realization of their income, not because the corporation's business has better prospects than before.[11] If a shareholder sells his or her shares, the gain realized may simply be the income that he or she could have realized as dividend if the corporation had made a distribution.

In general, the design of an income tax may need to provide special treatment for these latter forms of nominal capital gain. In the case of inflation, its presence should ideally be taken into account in determining whether the taxpayer has any taxable gain. In the case of accrued earnings realized through a sale of the asset, it may be

[11] Similarly, if a zero-coupon bond with a $100 face amount is issued for two years in an environment where the market interest rate is stable at 5 per cent, no one will buy the bond initially if it is issued for more than $90.703. After a year (with the bondholder being one year closer to maturity) the bond will be worth $95.24, but the increase from $90.703 merely represents an accrual of interest, and not a change in the expectation of the bond's yield.

important to treat the gain from the sale similarly to other ways of realizing already-accrued earnings (for example, dividends).[12] However, it is crucial to recognize that capital gains often come about not because income has already accrued, but because of a changed expectation of what income will accrue.

To appreciate the point of this conceptual discussion, a common scepticism about the wisdom of taxing foreigners on capital gains needs to be considered. Because transfers of domestic assets by foreigners may be difficult to detect, and a tax on such transfers may be difficult to enforce, it is sometimes asked why the source country should attempt to do so. The asset itself is still located in the source country, and most of the income it generates — in the form of rent, dividends and other periodic payments — can be more easily subjected to tax (for instance through withholding). What does the source country lose by not taxing the gains non-residents derive by transferring ownership of the asset? Why tax upon transfer of ownership of an asset, and not just when income is received by the owner?[13]

It is important to remember that there is an answer to this scepticism. As already explained, generally, the value of an asset is determined by the stream of income it is expected to generate. If such income is going to be taxed at known rates, then the value of the asset should also reflect the tax. For example, if an asset generates $10 of income in each period, and a 20 per cent tax is imposed on the $10 of income no matter who owns it, then the after-tax income generated by the asset will be $8 per period. The value of the asset to a private owner will then be determined by the $8 return, and not the $10 return.[14] If, despite the lower

[12] In the bond example in note 11 above, if the interest rate stays the same, the increases in the value of the bond in year one and year two should both be treated as interest.

[13] Notably, the recent IMF Spillovers Report expresses this scepticism: "Conceptually, there are arguments as to whether or not it is appropriate to tax [capital] gains at all: they presumably reflect accumulated and expected earnings, so it may not be necessary or appropriate to tax them if those earnings have been, or will be, adequately taxed in other ways." See IMF Spillovers Report, at 29.

[14] This reflects the idea that a tax on the income generated by an asset may be "capitalized" into the value of the asset. Economists have offered

price, buyers are willing to pay in view of the expected tax on income, then the seller still realizes a gain and the seller's ownership of the asset has generated a form of income for him or her that is not captured by the tax imposed on future income. Indeed, in this example, since the burden (economic incidence) of the tax on dividends has already shifted onto the seller by being capitalized into asset value, it is clear that only a tax on capital gains can reach the additional income realized by the seller in the form of gain. Thus insofar as gains arise as a result of changes in expectations, there is a unique role for the tax on capital gains — one that cannot be played by the tax on investment income such as dividends.[15]

2.2 Why do source countries tax non-residents so little on capital gains?

If capital gains taxation is not redundant, and if, moreover, capital gains may arise not only in connection with immovable property, then it is striking how little source countries are expected to tax non-residents on capital gains under prevailing international norms. Most importantly, many developed countries do not tax capital gains realized by non-residents on the disposition of shares of domestic (that is to say, resident) companies, with the exception of companies that hold domestic real estate. There are a number of independent reasons for the adoption of this policy, most of which are not necessarily persuasive in the context of developing countries. For example, developed countries generally prefer residence-based taxation, vis-à-vis themselves and developing countries.[16] In the European Union, there has even been a coordinated move towards residence-based taxation, removing the tax

many empirical confirmations of the capitalization of different types of taxes into the value of different types of assets, for example, real estate and company shares.

[15] To put it differently, a tax on dividends will tax a given amount of dividend the same way, no matter how the shares yielding the dividends are acquired. For income tax purposes, however, how the shares are acquired — with how many previously taxed funds — does matter.

[16] If investment flows between two developed countries are roughly equal, it makes sense for them to forgo source-country taxation; thereby they will save administrative costs without losing revenue overall.

on dividends, interest and royalties derived from related companies.[17] Independently, there has also been a desire to align the treatment of shareholder capital gains with the policy of exempting dividends paid both to residents and non-residents, a policy that developed countries may already have adopted.[18] For developing countries that are capital importers and that have decided to maintain the classic corporate income tax, the above reasons generally have been considered — and frequently found to be outweighed by other considerations.

Two practices of developed countries are, however, relevant. First, some of them have historically eschewed capital gains taxation of non-residents because of its perceived administrative burden. The United States of America, for example, originally abandoned taxing non-residents on capital gains realized on the sale of United States securities in 1936 for administrative reasons.[19] Canada narrowed its range of capital gains taxation for foreigners recently, in 2010, partly for the same reason.[20] This shows that enforcing the tax may be challenging for developed and developing countries alike. Second, even in countries where the alienation of shares of domestic companies by non-residents generally goes untaxed, special exceptions have been made — in Australia, Canada, Japan and the United States, for

[17] See Harry Huizinga, "Taxing Corporate Income — Commentary," in Stuart Adams and others, eds., *Dimensions of Tax Design [The Mirrlees Review]* (Oxford: Oxford University Press, 2010), 894–903. In connection with the OECD Action Plan on Base Erosion and Profit Shifting initiative, some scholars have advocated for a reversal of this trend. See, for example, Katharina Finke, Clemens Fuest, Hannah Nusser and Christoph Spengel, "Extending Taxation of Interest and Royalty Income at Source — An Option to Limit Base Erosion and Profit Shifting?" (2014), ZEW — Centre for European Economic Research Discussion Paper No. 14-073.

[18] See Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2010), Part IV, Chapter C, Section 3.

[19] See Stanford G. Ross, "United States taxation of aliens and foreign corporations: the Foreign Investors Tax Act of 1966 and related developments," (1967) Vol. 22, *Tax Law Review*, 279, 293–5.

[20] See Jinyan Li, Arthur J. Cockfield and J. Scott Wilkie, *International Taxation in Canada: Principles and Practices* (Toronto: LexisNexis Canada, 2011), at 184.

example — for companies that hold domestic real estate. In other words, taxing real estate gain is felt to be sufficiently important, from both a revenue and (perhaps more importantly) a political perspective, that the administrative costs of enforcing a tax on the transfers of shares of some resident companies are worth incurring.

It is useful to reflect on this last trade-off between the importance of taxing a particular category of capital gains and its administrative costs. An often-repeated justification for taxing the gain from the dispositions of real property holding companies is that if such dispositions are not taxed, it would be too easy to avoid a tax on the capital gains realized on the disposition of the real estate itself by selling the shares of holding companies. This justification seems obvious. But it should be equally obvious that tax avoidance concerns arise not just in connection with real estate. Take, for example, an operating business the value of which has increased due to its improved prospects. It is undisputed that the disposition of a business run through a permanent establishment (PE) of a non-resident should be taxable in the country of the PE (paralleling the taxability of the business profits attributable to the PE). However, if a business is operated through the form of a domestic subsidiary and is sold through a share deal, the tax on the disposition of the business would be avoided, if share sales are not taxed. That this concern has not generally motivated a policy of taxing share sales — despite the effort in a number of countries (for example, in Canada and the United States) to equate the tax treatment of branches and subsidiaries, for instance, through the branch profits tax — appears to be an obvious case of inconsistency.

One possible explanation for this inconsistency is the following. The administrative cost of taxing share transfers should be equal between a company that holds domestic real estate and a company that holds a domestic operating business. The need to tax share transfers to prevent avoidance of a tax on direct asset transfers also arises equally for immovable property and for assets of operating businesses.[21] Finally,

[21] This rationale extends to the disposition of interest in other entities that are treated as legal persons. See David A. Weisbach, "The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax," (2007) Vol. 60, *Tax Law Review*, at 215; Wei Cui, "Taxing Indirect

as discussed above, there is no clear difference between immovable property and business assets in their ability to generate capital gains. What is different is that foreign ownership of domestic immovable property has traditionally been politically more sensitive than foreign ownership of other domestic assets. It may be this political significance — rather than anything to do with revenue potential, the ease of tax administration or the need to rationalize tax systems — that has elevated immovable property to the status of an "especially taxable" asset class in the international tax arena.[22] Although this source of political legitimacy for the taxation of non-residents on capital gains may still be relevant, tax systems in the twenty-first century typically rely on a wider range of justifications, having to do with budgetary needs, efficiency, fairness and administrative requirements. These justifications may well point to the taxation of a wider range of capital gains realized by non-residents.

3. Non-administrative design issues in taxing non-residents on capital gains

3.1 Gross-income versus net-income approaches

Under their domestic laws, countries may tax income earned from sources within them by non-residents on either a net- or a gross-income basis. Under net-income-based taxation, non-resident taxpayers are treated in many ways like residents: they file income tax returns on a periodic basis; report income from different sources and of different types, as well as expenses that are associated with the various items of income and allowable as deductions; and are subject to tax rates generally applicable to domestic individuals or corporations. Under gross-income-based taxation, by contrast, non-resident taxpayers may not need to file a tax return at all: the tax imposed by the

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Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," (2014) Vol. 33, *Virginia Tax Review*, 649.

[22] This is not to say that foreign ownership of domestic real estate is not politically sensitive in developing countries. Indeed it may be so sensitive that it is prohibited outright — in which case the issue of taxing non-residents on capital gains from selling domestic real estate also becomes irrelevant.

source country may simply be withheld by the payer. Even when a non-resident is required to file a tax return, it may be reporting only particular items of income earned in the source country and not all such income earned in a period, and it may not be able to claim expenses or offsetting losses. Finally, the tax rate applied to income taxed on a gross basis is typically lower, in part to reflect the decision not to allow deductions of expenses and losses. Overall, gross-income-based taxation simplifies compliance and tax administration: the amount of gross proceeds is usually easily verifiable from the payer, whereas expenses and losses are more costly to substantiate and verify.

The decision to tax a particular type of income either on a gross- or net-income basis could depend on such administrative considerations alone. For example, if a non-resident has a sufficient physical presence in the source country that periodic contact with the country's tax administration for purposes of filing a return and cooperating with audits is possible, then net-income taxation may be regarded as justified. Such a physical presence might be an office — possibly one that does not operate any business or at least not the business that generates the relevant taxable income — or a regular agent (even an agent that is independent).[23] However, for at least the past half century, it has been more common to tax on a net-income basis only business income attributable to a physical presence that is akin to a PE, whereas, short of a PE, income derived by a non-resident is either not taxed (if it is business income) or taxed on a gross-income basis (if it consists of particular types of investment income). Moreover, net-income taxation has become associated with active business income and gross-income taxation with passive investment income.

Some of these long-standing conventions have recently come under critical scrutiny: questions have been raised especially regarding whether the concept of PE should still undergird the taxation of business profits.[24] In any case, capital gains realized by non-residents

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[23] See paragraph 6 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraph 27 of the Commentary on Article 13 of the OECD Model Convention ("force of attraction" approach to taxing capital gains).

[24] See Chapter VIII, Protecting the tax base in the digital economy, by Jinyan Li.

have always fitted uneasily within the above conventions. On the one hand, capital gains are often a form of passive investment income. On the other hand, the computation of the amount of gain will almost always require the taxpayer to submit information about the original cost of the investment and not just the amount of the gross proceeds. In contrast to dividends, interest and royalties, it is difficult to collect tax on capital gains through final withholding. But once the non-resident taxpayer is already required to file a tax return (because it has crossed the administrative threshold), it can be fairly asked whether net-income-based taxation may be more sensible. This may mean allowing offsetting capital losses from the country against the capital gain; it may also mean permitting other types of expenses to be deducted. On the other hand, it may require a higher tax rate to be applied.

Countries differ widely in this regard in their approaches to taxing non-residents on capital gains. China and Japan, for example, require the reporting of a taxable capital gain by a non-resident, but still apply a reduced rate to such capital gains and do not allow offsetting losses. This can be viewed as being at one end of the extreme. The United States, by contrast, treats capital gains on the disposition of certain real estate-related (FIRPTA[25]) property realized by foreigners as though they are simply business income, and allows other losses realized in connection with a United States trade or business of the foreigner to be offset against such capital gain. This can be viewed as being on the opposite end of the spectrum from China and Japan.[26]

There are important arguments in favour of allowing foreigners to reduce their taxable capital gains by their capital losses from the source country. To begin with, recognizing gains but ignoring losses may discourage investors from taking risks. Moreover, taking losses into account allows a more accurate measurement of the income of the non-resident that has been realized in the country, and imparts greater legitimacy to taxing capital gains. However, allowing loss offsets does reduce the revenue potential from taxing non-residents on capital gains. Moreover, because the tax on capital gains is difficult to

[25] United States Foreign Investment in Real Property Tax Act (FIRPTA).

[26] Canada allows the offsetting of losses from a given period from the disposition of similar investments (taxable Canadian property).

enforce, non-residents who do not have offsetting losses might demonstrate less compliance than those who do.[27]

Whether a gross- or net-income approach is taken also has consequences for the computation of the amount of capital gains on each transaction. For example, should fees paid to lawyers, accountants and investment bankers by the seller be allowed to reduce the amount recognized as the proceeds from sale, and should such fees paid by the buyer be included in the cost of their investment that can be deducted in the future? If the law treats capital gains as a form of passive income, just like dividends and interest, and applies a reduced tax rate to such income earned by foreigners, then the appropriate answer is no: any expense similar to expenses that cannot be deducted from dividends or interests should also not be deductible. This means that from the perspectives of the source country and the residence country, the amount of the capital gains realized on a sale can be very different.[28] From the residence country's perspective, the amount of capital gains may depend on all kinds of expenses that should either be capitalized into the cost of the disposed asset or deducted from the income realized (thereby reducing the amount of capital gain), as well as on any depreciation or other allowance that has been given in respect of the investment (which may increase the amount of capital gains or trigger the recapture of income). From the source country's perspective, unless the capital gains are attributable to a PE, none of the expenses and allowances may be taken into account. This need not in itself cause alarm — it should be remembered that the origin of the difference is that the source country treats the capital gains as a form of passive investment income, subject to a simplified method of collection.[29]

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[27] However, a compliance culture may be buttressed by taxpayers who expect to be able to claim losses, and the tax administration will be able to obtain information from such taxpayers. See section 4 below.

[28] This is recognized in paragraph 4 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraphs 13-16 of the Commentary on Article 13 of the OECD Model Convention.

[29] See paragraph 4 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraph 12 of the Commentary on Article 13 of the OECD Model Convention, where it is stated that "as a rule, capital gains are calculated by deducting the cost from the selling price. To arrive at cost all expenses incidental to the purchase and all expenditure for

3.2 Special issues in taxing transfer of interests in entities

Taxing share sales creates the possibility of excessive taxation of the appreciation experienced by the assets held by the target company (whether immovable properties, operating businesses or some other type of assets): the appreciation may be taxed at both the corporate and the shareholder levels. In fact, the problem arises even for business entities (for example, partnerships) that are not themselves subject to tax: the sale of the assets of a partnership and the sale of the partnership itself are both ways of realizing a gain from the appreciation of partnership assets. Both need to be subject to tax to prevent taxpayer manipulation.[30] However, this means that the same economic gain might be taxed more than once. If such excessive taxation is to be avoided, then potentially complex measures — involving conforming the "inside" and "outside" cost basis of assets and shares — may have to be applied to ensure that a gain that has been taxed at the shareholder level is not taxed again at the entity level (and vice versa).

Such measures are adopted in domestic contexts by some sophisticated tax systems (such as those implemented in Australia and the United States) within regimes for group consolidation or "flow-through" taxation. However, such regimes rarely extend to foreign entities. In domestic contexts, the ability of corporations to claim losses also sometimes mitigates the problem of excessive taxation of corporate assets. If foreign shareholders (or foreign owners of interests in other forms of business entities such as partnerships) are taxed on a gross-income basis and cannot offset losses against gains, however, corporate assets that are ultimately foreign-owned are again more likely to be subject to excessive taxation in this respect. In general, few countries that tax foreigners on the disposition of companies that hold domestic assets (such as immovable property) have systematically committed to mitigating potential excessive taxation.

One approach suggested later in the present chapter (see section 6) in connection with the taxation of indirect share transfers is to

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improvements are added to the purchase price." However, the same paragraph acknowledges that "the Article does not specify how to compute a capital gain, this being left to the domestic law applicable."

[30] See David A. Weisbach, "The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax," supra note 21.

treat such transfers as dispositions of underlying assets. That approach would go some way towards reducing the risk of excessive taxation, as it would adopt a net-income-based approach to taxing non-residents on capital gains.

3.3 Should publicly traded shares be exempt?

Enormous gains may be realized on stock markets, raising the question of whether such gains realized by foreigners on domestic stock exchanges, for example, under "qualified foreign institutional investor" regimes operated in countries like China and India, should be taxed. It used to be said that because trading on stock exchanges tends to have very high volume and frequency, it would be impossible to keep track of the gains and losses realized by investors on exchange trades. But with advancing technology and increasing uses of such technology by financial intermediaries, tracking information on gains or losses realized by investors (including foreign investors) may become less difficult.[31] Moreover, it is possible to require such financial intermediaries, and not the sellers, to act as withholding agents. Therefore, the decision whether to tax stock exchange gains may depend on policies on attracting foreign investment. In addition, trading gains are more likely to reflect risk-taking rather than economic rent, and the case for allowing offsetting losses is thus rather strong.

For gains realized on shares of resident companies listed and traded abroad, it is obviously difficult to secure cooperation from foreign stock exchanges to collect tax, even if such taxation is otherwise legitimate.

For foreign listed companies, there is an important argument against taxing the transfers of their shares by a source country, even if the companies hold substantial assets in the country. The argument is that listed companies are unlikely to be formed for tax avoidance purposes, but will almost invariably possess economic substance. Thus even though the United Nations Model Convention (like the OECD Model Convention) does not distinguish between listed and non-listed

[31] See United States Internal Revenue Service, Notice 2012-34, "Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options."

companies among companies that hold substantial immovable property in the source country — the source country is allowed to tax the capital gains realized on the sale of all such companies in accordance with Article 13 (4)[32] — the distinction is in fact highly relevant to the policy of taxing share sales, when that policy is motivated by anti-avoidance considerations.[33]

3.4 Whether to tax foreign exchange gains

Measurements of capital gains or losses are sometimes affected by foreign exchange gains or losses.[34] For example, local assets purchased with US$ 1 million may sell later for more than that amount, not because the assets have appreciated within the local market (they may even have suffered a slight loss), but because the local currency has appreciated against the United States dollar. Conversely, a real capital gain may be hidden by a foreign currency loss. In designing the rules of taxing capital gains, a country will want to consider how to deal with foreign currency gains or losses. For example, if a country is expecting a steadily appreciating currency against the currency in which the investment is initially denominated, it will collect more revenue by measuring gain in the foreign currency than in the domestic

[32] See section 5 below.

[33] See Article 13 (4) of the United Nations Model Convention. The United Nations Committee of Experts Paper surveyed a number of countries regarding how Article 13 (4) was implemented, and one set of questions posed to the countries related to how shareholders can learn that the companies they own derive their values principally from immovable property in a given country. These questions seem to be pertinent mostly for publicly traded companies, and it seems debatable whether the sale of shares of these companies should be taxed in the source country.

[34] See paragraph 4 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraph 11 of the Commentary on Article 13 of the OECD Model Convention. ("The Article does not distinguish as to the origin of the capital gain …. Also capital gains which are due to depreciation of the national currency are covered. It is, of course, left to each State to decide whether or not such gains should be taxed.") See also paragraph 4 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraphs 16 and 17 of the Commentary on Article 13 of the OECD Model Convention.

currency (thereby capturing some of the gain of currency speculators). Conversely, if a country is expecting a steadily depreciating currency against the currency in which the investment is initially denominated, it will collect more revenue by measuring gain in the domestic currency.

It is worth mentioning in this connection that any capital control regime adopted by a country may create problems for non-residents in paying tax on capital gain. If the amount realized on the disposition is in foreign currency, but tax must be paid in domestic currency, then the non-resident taxpayer must be allowed to exchange the currency for purposes of the tax payment. This issue does not normally arise in connection with passive income, such as dividends, interest or royalties, which has a domestic payer: the payer in these cases should be able to furnish the local currency required.

4. Administering the tax on capital gains of non-residents

Administering a tax on capital gains realized by non-residents faces three fundamental challenges. First, if the sale and purchase of the asset occur between two non-residents, the execution of the transaction and the flow of funds may all take place outside the source country, making such transactions difficult to detect.[35] Second, even if a transaction is detected, if the non-resident seller refuses to pay the tax and becomes delinquent, unless such a seller has other assets in the source country, it could be very difficult to complete tax collection. Third — and this is a point that has received little discussion in the existing literature — it may be difficult to organize tax administration around taxing capital gains. The non-resident taxpayers typically have little or no interaction with the tax authority of the source country. The timing and volume of transactions may be unpredictable, as may be the revenue intake from levying the tax. Such irregularity may be felt to be especially severe if tax administration in the source country is decentralized.

However, none of these challenges need be insuperable.

[35] It should be noted that this is a potential problem for all taxable transfers among non-residents, and not just for the type of indirect transfers discussed in section 6 below (that is to say, transfers of foreign entities that hold, directly or indirectly, domestic assets).

4.1 Detection

Generally, there are three legal mechanisms that enable tax authorities to detect offshore (direct or indirect[36]) transfers of domestic assets or shares: self-reporting by the transferor, reporting by the transferee (whether or not accompanied by withholding) and reporting by third parties.[37] As regards transferor self-reporting, the source country may impose penalties on non-reporting transferors to foster compliance. However, if the chances of detection of taxable transactions are very low, the expected cost of a penalty for non-reporting may also be too low to be effective. If most taxpayers do not comply and the tax authority fails to detect most instances of non-compliance, imposing a heavy penalty on the few detected cases will also seem unfair.

It might thus be surprising that, at least until recently, many countries have solely or largely relied on seller reporting for taxing capital gains. In response to a recent survey conducted by the United Nations Committee of Experts on International Cooperation in Tax Matters, a number of countries, both developed and developing, confirmed the relevant challenges for detection of taxable transfers.[38] For this reason, the Australian government has announced that "to further improve the integrity of the foreign residents' regime in relation to the disposal of Australian real property interests … a 10 per cent non-final withholding tax [will] apply to the disposal by foreign residents of

[36] Indirect transfers are discussed more extensively in section 6 below.

[37] Some recent discussions of the detection problem refer optimally to the exchange of information among tax authorities. See Committee of Experts Paper, at 36-9; IMF Spillovers Report, at 71; Lee Burns, Honoré Le Leuch and Emil Sunley, "Transfer of an interest in a mining or petroleum right," in Philip Daniel, Michael Keen, Artur Swistak and Victor Thuronyi, eds., *Resources without Borders* (Washington: International Monetary Fund, 2014), at Section 4.1. It seems exceedingly unlikely, however, that the seller's resident country will have more information about an isolated transaction than the source country where the transferred asset is located.

[38] See Committee of Experts Paper, at 36-9. The countries confirming difficulties with detection include Australia, Azerbaijan, China, Japan, Malaysia, Mexico, Norway, Russia, South Africa and Zambia. India and the United States, by contrast, did not report such problems because they require transferee withholding.

certain taxable Australian property from 1 July 2016." [39]

As to transferee reporting, if the transferee is a non-resident as well, the failure of such reporting would be just as hard to detect as the failure of transferor reporting. A sanction imposed upon a transferee's failure to report would, in a way, be similar to increasing the penalties on a transferor's failure to report — in both cases, the aggregate penalties on non-reporting are increased. The difference is that the transferee usually has a lot less to lose by reporting, since it is not the party paying the tax. This may be sufficient to create compliance by transferees. Interestingly, however, no government seems to have instituted transferee reporting alone (without further requiring withholding) for taxing either direct or indirect transfers. This points to the magnitude of the collection problem: simply having information that a non-resident engaged in a taxable transaction is of little value; the government still has to make all the efforts to collect the tax.[40]

Besides explicit sanctions, market dynamics may also create incentives to comply with transferee reporting requirements.[41] For example, when taxing capital gain, the source country generally needs to keep track of the tax cost or basis of the assets transferred. If the capital gains realized on a transfer have been subject to tax, the cost basis of the shares transferred should be adjusted ("stepped up" in the case of gain) for purposes of future source-country taxation. Conversely, one can imagine a rule that provides that if a transfer has not been taxed (other than in a case where the capital gains on a transfer are affirmatively exempted from tax, for example, under an applicable treaty), then the basis of the transferred shares would, for the purpose of source-country taxation, remain the same. That is to

[39] Ibid., at 45. Withholding will apply to both capital and revenue transactions and the withholding obligation will rest with the purchaser.

[40] Canada, India and the United States are some of the countries that already impose withholding obligations on purchasers. While China nominally "requires" transferees or other payers of consideration (whether domestic or foreign) to withhold on the capital gains realized on a transfer, when withholding is infeasible, the transferee or payer has no information reporting obligation.

[41] See Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 21.

say, the transferee would not obtain a basis in the shares it acquires equal to the consideration it pays unless the acquisition has been taxed.

This is different from the normal use of the concept of cost basis: the cost basis of an asset is normally determined in respect of a particular owner of the asset. However, the notion can be modified so as to keep track of the relationship of the asset to the taxing authority: which portion of the value of the asset has been subject to tax (in whomever's hands)? With such a rule in place, the failure to report a taxable transfer would result in the risk that the transferee, in the future when it acts as a transferor, would be taxed on gain that accrued to and was realized by previous owners. Indeed, the future transfer itself will need to be reported or detected. Both the tax authority and the non-resident taxpayer may also have difficulty determining what the original basis was in the hands of previous owners.[42] Nonetheless, the risk of the conversion of a seller tax liability into a potential tax liability of the buyer (as a future seller) may well be unacceptable to many buyers. They would then either seek indemnity from the seller, or require, as a matter of contract, the seller to report the sale to the tax authorities and, in addition, to pay tax if required by law.[43]

With regard to third-party reporting, for certain types of property, such as immovable property, shares in companies, mineral and other licences, and sometimes even ships and aircraft (because of regulatory requirements), the country in which they are located may operate ownership registration systems. The transfers of ownership will be recorded in such systems and tax authorities may require those who maintain the systems to report the transfers.[44] In addition, third

[42] The future transfer might also itself be exempt from tax (for example, under treaty protection).

[43] Dynamics in the tax service market may also contribute to compliance. For further discussion, see Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 21, at 680-1, 690-1 and 694. Because the penalties for non-reporting under China's policy of taxing indirect transfers of domestic company shares are very low, most compliance with that policy that has taken place in China since 2009 may have resulted from buyer and adviser monitoring.

[44] It should be noted, however, that the mere transfer of legal ownership may not be sufficient to constitute an ownership change for income tax purposes under the tax laws of many countries.

parties in the transfers of financial claims, that is to say, lessees, borrowers and companies issuing shares, often receive notice of the transfers under either legal or contractual requirements. It may be possible to enlist such parties in reporting taxable transfers, even if they are not party to the transfer.

However, such a requirement could have limits if third-party contractual rights to notice vary widely in the market.[45] Moreover, should both the purchaser/transferee and third parties be required (in the sense of having an obligation backed up by penalties) to report a transaction? Third-party reporting requirements often will call upon market participants to share information which they would not otherwise share.[46] Finally, third-party reporting will not by itself solve the collection problem.[47] Therefore, where it is possible to rely on transferee/buyer reporting, third-party reporting should arguably not be used, unless such reporting (for example, to a regulatory authority) would take place in any case.

4.2 Collection

From a collection and revenue protection perspective, transferee withholding is clearly a more powerful tool than transferee reporting. Canada, India and the United States each require the transferee in a taxable direct (and, in the case of Canada and India, indirect) transfer to withhold from gross proceeds paid to the transferor, regardless of whether the transferee is domestic or foreign.[48] Each also makes the

[45] Nonetheless, a government requirement for third-party reporting may induce changes in contractual terms, such that third parties will demand contractually (and receive) notice of transfers.

[46] For example, shareholders may have reasons to withhold information about a share sale from the managers of the company sold, because these managers may soon be fired. To enlist the assistance of these same managers in notifying tax authorities of the sale could be awkward.

[47] See discussion below regarding objections to imposing a substantive liability on third parties (other than the seller and buyer).

[48] The United States rule, Internal Revenue Code section 1445, requires withholding of 10 per cent from gross proceeds. IRC § 1445 (2013); the Canadian rule, Income Tax Act section 116, requires a significantly higher (25 per cent) rate of withholding, but allows the transferor to prepay or post

amount required to be withheld the personal tax liability of the transferee if it fails to withhold. Note that when the transferee is made personally liable for failing to withhold a tax that was in the first instance imposed on the transferor, the implicit penalty of the no-basis-step-up treatment (which is possible even under transferor reporting) has merely been made explicit.

In countries with weak legal norms, a view may be held that the failure of the transferor to pay tax on a transfer creates a de facto personal liability for the transferee anyway, as the tax authority could always “go after” the asset located in the country and therefore expropriate its value from the present owner of the asset. Unless the transferee (new owner) is legally made liable for the tax that the transferor fails to pay, however, this kind of expropriation is against the rule of law (and is both unnecessary and unproductive for tax administration). Moreover, even when transferees are made liable for failures to withhold, it is important to observe legal distinctions. For example, if it is the tax on the capital gains realized on the alienation of a domestic company’s shares that is at stake, it makes little sense to demand payment from the domestic company itself. To do so would erase the distinction between shareholder and corporate liabilities that lies at the core of an indefinite range of transactions (for example, with creditors, customers and employees) that the company may be engaged in. This would clearly be counterproductive.[49]

Several limitations of the withholding approach should be noted, however. First, if the transferee is a non-resident, the imposition of a withholding obligation alone does not necessarily enhance the transferee’s likelihood of compliance. And delinquent non-resident

collateral with the government based on the amount of capital gains. See Income Tax Act, R.S.C. 1985, c. 1. The Indian rule, Section 195 (1) of the Income Tax Act, 1961, requires withholding simply of the amount of the tax owed, without addressing the issue of how the transferee would know how much tax is owed. See Income Tax Act (195/1961) (India).

[49] For these reasons, several administrative suggestions made in the IMF Spillovers Report, that is to say, treating the target resident company as the agent of the non-resident, so that it will be liable if the tax is not paid by the non-resident, or deeming the resident company to have made the transfer, so that it is liable for the tax, should be viewed with caution.

transferees create collection problems similar to those encountered in respect of delinquent non-resident transferors.[50] Second, withholding on capital gains also cannot generally be expected to be accurate with respect to the ultimate tax liability and therefore is likely to trigger either an application for refund or examination by a tax authority. The overall compliance burden for taxing capital gains, therefore, will be increased by withholding. It also bears mentioning that any obligation to withhold could only sensibly be formulated with respect to the gross amount paid and not the capital gains realized by the payee, because it is only infrequently that a seller would tell a buyer how much profit the seller has made.[51]

4.3 Voluntary compliance

In other areas of tax administration, a key to success in collection, beyond adequate sanctions and effective enforcement powers, is the inducement of voluntary compliance among taxpayers. It would be surprising if this were not the case in levying tax on non-residents. There has not been much research on voluntary compliance on the part of non-residents, however. For example, while intuitively a lower rate of tax should produce greater voluntary compliance, it is not known how low the tax rate would need to be to produce enough compliance. Another suggestion is to increase the contact of non-residents with the tax authority and with other compliant taxpayers. For example, allowing losses and expenses to be taken into account in computing taxable gain may make the contact of non-residents with the source country less "one-shot" in character. Finally, it may be useful to focus on improving compliance among multinationals and foreign investors that deal with the source country on a regular basis. A culture of compliance among such taxpayers (and their advisers) may be an important step towards creating a culture of compliance among non-resident taxpayers in general.

[50] Nonetheless, for the reasons discussed in the previous paragraph, it rarely makes sense to make the target of the transfer liable for tax.

[51] See, however, the Indian withholding requirement, Income Tax Act (195/1961) (India).

4.4 Organization of tax administration

The occurrence of taxable transfers of domestic assets among non-residents can be erratic, which makes the decision to assign dedicated tax administration personnel to collect tax on such transfers difficult. However, non-reporting non-residents — whether they are transferors or transferees — are like domestic taxpayers who do not file tax returns: special efforts have to be made to detect them and bring them into compliance. It is not clear that any country's tax authority has developed well-articulated strategies for dealing with this predicament. In many OECD countries, where both tax administration and the study of tax administration are generally more developed than elsewhere, the scope of capital gains taxation on non-residents tends to be limited. They therefore offer limited expertise insofar as taxing capital gains of non-residents is concerned.

In the United States, for example, an Internal Revenue Service (IRS) publication from 2010 states that a study of the collection of FIRPTA tax was only "planned" and data was "not yet available".[52] Moreover, the "planned" study was based only on returns filed by transferees who had withheld tax from the gross proceeds of sales of United States real estate interest (including shares of United States companies that hold United States real estate) by foreigners.[53] No data seems to be separately available to the IRS on transferor self-reporting of sale of United States real property interests, and there is no sign of any data on audits (if any) of transferors or transferees. In fact, the United States did not attempt to measure non-resident taxpayer compliance until 2008, and even the new attempt to do so is designed only for individual taxpayers.[54]

[52] Melissa Costa and Nuria E. McGrath, "Statistics of Income Studies of International Income and Taxes," (2010) Vol. 30, No. 1 *Statistics of Income Bulletin*, available at http://www.irs.gov/pub/irs-soi/10intertax.pdf, at 192.

[53] Ibid. The most recent IRS Bulletin on Foreign Receipts of United States Income, relating to the year 2010, also reports only FIRPTA withholding information and no information about transferor self-assessment. See Scott Luttrell, "Foreign Recipients of U.S. Income, 2010," (2013) *Statistics of Income Bulletin*, available at http://www.irs.gov/pub/irs-soi/13itsumbulforrecip.pdf.

[54] See United States Internal Revenue Service, "The Tax Gap and International Taxpayers," (2008), available at http://www.irs.gov/Businesses/The-

For developing countries that aim to preserve their tax base consisting of income belonging to non-residents to a greater extent than OECD countries, effective tax administration strategies may therefore have to be developed indigenously. One possible approach is to centralize tax administration in this area so as to allow specialization and economy of scale: the number of taxable transactions as well the revenue outcome will diminish if averaged over too many tax administrators, whereas a small number of specialized tax administrators may be able to deal with a relatively large number of taxable transactions because of the one-shot nature of the taxpayers involved.[55]

5. Article 13 of the United Nations Model Convention and treaty practices among developing countries with respect to taxing capital gains

Article 13 of the United Nations Model Convention allocates non-exclusive taxing rights to the source country in respect of gains on immovable property (paragraph 1), business assets forming part of a PE (paragraph 2), ownership interest in entities that derive value principally from immovable property (paragraph 4) and shares that

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Tax-Gap-and-International-Taxpayers. See also, United States Government Accountability Office, "IRS May Be Able to Improve Compliance for Non-resident Aliens and Updating Requirements Could Reduce Their Compliance Burden," GAO-10-429 (2010), available at http://gao.gov/products/GAO-10-429. The IRS has not developed estimates for the extent of non-resident alien tax non-compliance.

[55] However, in China, where enforcement of the tax on capital gains of non-residents realized on transfers of domestic company shares (including indirect transfers, as discussed in section 6 below) has intensified in recent years, a decentralized approach seems to have emerged, where tax administration staff in local offices take initiatives to find offshore share transfers (which is not hard to do if listed companies are involved and material transactions are required to be disclosed by stock exchanges) and collect revenue that is sizeable for that particular office, even if not for the country's tax administration as a whole. There is no systematic study of this practice, but a sense of it can be gleaned from practitioners' reports. See, for example, Jinji Wei, "Chinese Tax Implications of Indirect Share Transfers," (2014) Vol. 23, No. 7 *Tax Management Transfer Pricing Report*.

represent substantial participation in a resident company (paragraph 5). It assigns exclusive taxing rights to the place of effective management in respect of gains on ships or aircraft operated in international traffic and boats engaged in inland waterways transport (paragraph 3).[56] It then provides that the gain from the alienation of other property not specifically enumerated be taxable only in the residence State of the alienator (paragraph 6). The threshold decisions of whether capital gains should be taxed and, if so, of how they are to be taxed, are left to the domestic law of each contracting State.[57]

The United Nations Commentary on Article 13 repeatedly refers to the "correspondence" between the taxation of gain and the taxation of income, and uses this "correspondence" to explain the purpose of paragraphs 1 and 2 of the Article.[58] Nonetheless, in the restrictions it imposes on source-country taxing rights, the United Nations Model Convention does not generally adhere to this "correspondence": instead of being a consistent implementation of the principle of similar taxation of income and gain (given their economic equivalence), Article 13 of the United Nations Model Convention is very much a compromise. The most salient symptom of this compromise is the structure of the Article. While the language of the United Nations Model Convention, following Article 13 of the OECD Model Convention, proceeds to delineate source-country taxing rights for specific types of property, and then to provide for exclusive resident-country taxation for properties not specifically enumerated, the United Nations Commentary on Article 13 acknowledges that "[most] members from developing countries advocated the

[56] The practical significance of Article 13 (3) is unclear. Ships, aircraft or boats as physical vehicles should generally decline in value during their useful lives, even if the rights to use them may change in value due to fluctuations in demand and supply in shipping and aviation markets. Moreover, the paragraph is limited to alienation by owners who also operate the ships, aircraft or boats; such vehicles operated by parties other than such owners (for example, under dry lease) fall outside the scope of the paragraph. See paragraph 7 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraph 28 of the Commentary on Article 13 of the OECD Model Convention.

[57] Paragraph 3 of the Commentary on Article 13 of the United Nations Model Convention.

[58] See section 3 above.

right of the source country to levy a tax in situations in which the OECD reserves that right to the country of residence."[59] It therefore mentions an alternative provision allowing source-country taxation of gains "from the alienation of any property other than those gains mentioned in paragraphs 1, 2, 3 and 4."[60] This alternative language, adopted with modification in many actual treaties, leads to some obvious interpretive tensions surrounding the Article, as discussed below.

The following aspects of the language of Article 13 are especially relevant to understanding the restrictions that the Article imposes on source-country taxing rights, as well as the anti-avoidance principles the Article acknowledges.

5.1 The definition of "immovable property"

"Immovable property" for purposes of Article 13 is defined by reference to Article 6, which, in the United Nations Model Convention, has "the meaning which it has under the law of the Contracting State in which the property in question is situated." Article 6 (2) of the United Nations Model Convention explicitly states that the term "immovable property" "shall in any case include … rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources." This broad formulation is likely to capture the rich variety of "bundle[s] of infinitely divisible rights"[61] that may be associated with immovable property and transferred at a gain.[62]

[59] Paragraph 2 of the Commentary on Article 13 of the United Nations Model Convention.

[60] Paragraph 18 of the Commentary on Article 13 of the United Nations Model Convention.

[61] Richard Krever, "Tax Treaties and the Taxation of Non-Residents' Capital Gains," supra note 7, at 224.

[62] Nonetheless, Professor Richard Krever has argued that "there are remarkably wide variances in the different definitions" used in different jurisdictions, and that "civil law jurisdictions with limited [natural] resources" tend to adopt the narrowest definitions. He warns that "treaties often fail to operate as broadly as domestic legislation, and domestic legislation itself

5.2 Movable property part of a permanent establishment

Article 13 (2) gives the source country taxing rights on gains from the alienation of movable property forming part of the business property of a PE (or pertaining to a fixed base available for the purpose of performing independent personal services). The United Nations Commentary explicitly notes that "the term 'movable property' means all property other than immovable property … . It includes also incorporeal property, such as goodwill, licenses, etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment [or fixed base] is situated."[63] This is an important observation, because tangible movable properties — such as machines and equipment — tend to experience depreciation and thus have limited potential for capital gain. It is instead the intangible components of a business, including contracts with customers, employment contracts with skilled personnel, brand names, know-how (whether patented or not) and so forth, that give rise to capital gains on the sale of a business.

This broad definition of movable property under Article 13 (2) raises a crucial interpretive issue: is movable property that does not form part of the business property of a PE of a non-resident thereby carved out from the scope of taxation under Article 13? For instance, the vulture fund that has sold a portfolio of non-performing loans at a handsome gain. The loans may be viewed as movable property for the purpose of the fund business, or depending on the fund's structure, they may be held as investment assets but nonetheless are "movable property" in the sense defined above. The fund may have no PE in the country where the business borrowers are located. Does Article 13 (2) imply that the vulture fund's gain is not taxable in the country of the

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may struggle to keep up with new and innovative forms of de facto property owners, including the use of rights, options, or derivatives." Therefore, he suggests that "countries seeking to retain domestic taxing rights through Article 13 must ensure, first, that domestic law is sufficiently robust to capture all gains related to real property realized by resident and non-resident taxpayers and, second, that Article 13 in their tax treaties is equally broad." Ibid., at 223-4.

[63] Paragraph 6 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraph 24 of the Commentary on Article 13 of the OECD Model Convention.

debtors?[64] Since whatever is not immovable property will be regarded movable property, unless there is a subsequent paragraph in Article 13 that prescribes a specific rule (for example, for ships, aircraft and shares), one might infer that capital gains taxation (without PE) is precluded by paragraph 2. If under the same treaty, interest on loans (and rent or royalty from leases, licences and other agreements covered by the "Royalties" article) remain taxable in the source country, a sharp inconsistency between the treatment of income and of gain from the same asset would result.

As discussed below, this difficulty is not necessarily resolved even when the contracting States agree to retain residual taxing rights for the source State over gains not otherwise enumerated in Article 13.

5.3 Entities holding immovable property directly or indirectly

Article 13 (4) of the United Nations Model Convention provides taxing rights over "gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State" to that State.[65] The United Nations Commentary notes that the provision:

> is designed to prevent the avoidance of taxes on the gains from the sale of immovable property. Since it is often relatively easy to avoid taxes on such gains through the incorporation of a company to hold such property, it is necessary to tax the sale of shares in such a company … In order to achieve its objective, paragraph 4 would have to apply regardless of whether the company is a resident of the Contracting State in which the immovable property is situated or a resident of another State … In

[64] Similar questions can be raised for transfers of lease contracts with domestic lessees, or of licences with domestic licensees, and so on, where the lessor, licensor, etc., has no PE in the source country.

[65] Article 13 4 (b) defines "principally" in relation to ownership of immovable property to mean "the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate."

> order to fulfil its purpose, paragraph 4 must apply whether the company, partnership, trust or estate owns the immovable property directly or indirectly, such as, through one or more interposed entities.[66]

However, it does not appear that countries have generally enacted the anti-avoidance measures permitted by Article 13 (4). For example, as discussed in section 6.2 below, surprisingly few countries — in the OECD[67] or in the developing world — have enacted domestic law for taxing transfers of foreign companies ("indirect transfers"). The mere language of Article 13 (4), therefore, sheds little light on the design of anti-avoidance.

Finally, Article 13 (4) of the United Nations Model Convention carves out from source-country capital gains taxation transfers of interests in entities whose property consists directly or indirectly principally of immovable property used by them in their business activities (but not an immovable property management company, partnership, trust or estate). The reason for this carve-out, presumably, is that entities that use immovable property in their business activities are not formed for purposes of avoiding the tax on the sale of immovable property. However, relatively few treaties involving developing countries have adopted this carve-out; nor has Article 13 of the OECD

[66] Despite the anti-avoidance intent of Article 13 (4), it has been argued that it may not encompass all the ways in which non-residents may employ tax structures to avoid taxation. "A convertible debt or option, for example, may not be viewed by a court to constitute an interest in a company, but merely a claim to a company's property in the former case or a right over a shareholder or the company in the latter." See Richard Krever, "Tax Treaties and the Taxation of Non-Residents' Capital Gains", supra note 7, at 229. It has therefore been suggested that a source country may want to subject such claims against a company holding immovable property situated in it to capital gains taxation also. Canada defines taxable Canadian property (that is to say, property whose gain realized by a non-resident is taxable in Canada) as including "an option in respect of" other taxable Canadian property. See Income Tax Act, RSC 1985, c. 1 (5th Supp.), s. 248.

[67] The OECD Model Convention contains a somewhat similar provision for source-country taxation of the shares of real estate holding companies, including shares of non-resident companies.

Model Convention adopted a similar one. An obvious reason is that there are important types of companies which derive their value predominantly from real property, for example, hotel and resort operators, operators of shopping malls and even of restaurants and cinemas, and, of course, companies that extract natural resources. The appreciation in the value of the shares of such companies is likely to reflect the appreciation of the underlying real property, and it is not at all obvious why the source country should give up taxing rights over such shares. This carve-out can also be regarded as a special case in the inconsistent treatment between PEs and subsidiaries of non-residents, mentioned in section 2.2 above and further discussed in the next section.

5.4 Substantial participation in a company

The Commentary on Article 13 of the United Nations Model Convention notes that "some countries hold the view that a Contracting State should be able to tax a gain on the alienation of shares of a company resident in that State, whether the alienation occurs within or outside that State." It then claims that "for administrative reasons the right to tax should be limited to the alienation of shares of a company in the capital of which the alienator at any time during the 12-month period preceding the alienation, held, directly or indirectly, a substantial participation."[68] This position is reflected in Article 13 (5) of the United Nations Model Convention, where the percentage deemed to constitute substantial participation is to be established through bilateral negotiations. Article 13 (5) allows that the substantial holding (which leads to taxability) may be "indirect", partly as an anti-avoidance device.[69]

[68] Paragraph 9 of the Commentary on Article 13 of the United Nations Model Convention.

[69] According to paragraph 11 of the Commentary on Article 13 of the United Nations Model Convention, "It will be up to the law of the State imposing the tax to determine which transactions give rise to a gain on the alienation of shares and how to determine the level of holdings of the alienator, in particular, how to determine an interest held indirectly. An indirect holding in this context may include ownership by related persons that is imputed to the alienator. Anti-avoidance rules of the law of the State imposing the tax may also be relevant in determining the level of the alienator's direct or indirect holdings."

Under the OECD Model Convention, the alienation of shares of companies other than those holding domestic real property assets is not taxable in the country of residence of the companies. As noted earlier, this produces differential treatment between PEs and subsidiaries, and ignores the anti-avoidance argument for taxing both asset and share sales.[70] Article 13 (5) of the United Nations Model Convention can be viewed as constituting an improvement in this regard. What is less clear, especially in view of the analysis of enforcement and compliance in section 4 above, is why administrative considerations dictate a percentage ownership approach to having a threshold for taxing the alienation of shares. For example, if it is the burden of filing a tax return by the non-resident that is at issue, a monetary amount (that is to say, exclusion of small gains) would seem more appropriate.

The Commentary on the United Nations Model Convention also points out arguments against taxing listed shares (that it is "costly," and that "developing countries may find it economically rewarding to boost their capital markets by not taxing gains from the alienation of quoted shares."[71]) It goes on to suggest language for carving out traded shares from the scope of taxation under paragraph 5. The cost of taxing exchange-traded shares and the policy of boosting domestic stock markets, however, seem to be issues better addressed through domestic law. There seems to be little need or justification for negotiating a reciprocal agreement with individual treaty partners.

5.5 Residual taxing power

Article 13 (6) of the United Nations Model Convention, like Article 13 (5) of the OECD Model Convention, gives the residence State exclusive taxing rights over assets not covered by the preceding paragraphs of the Article. However, as mentioned, the Commentary has noted the preferences of developing countries to retain taxing power over assets not specifically enumerated. Such preferences are also reflected in the

[70] See David A. Weisbach, "The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax," supra note 21.

[71] Paragraph 13 of the Commentary on Article 13 of the United Nations Model Convention.

treaty practice of many countries — and not just developing ones.[72] This is not surprising, insofar as the previous paragraphs of Article 13 do not capture all the important elements of the capital gains tax base for the source country (see the discussion at the beginning of section 2 above), and insofar as ceding such residual taxing rights would create disparate treatment between income and gain from the same asset.

However, the way in which residual taxing power can be preserved under Article 13 remains a problematic issue. The Commentary on Article 13 of the United Nations Model Convention proposes the language: "Gains from the alienation of any property other than those gains mentioned in paragraphs 1, 2, 3 and 4 may be taxed in the Contracting State in which they arise according to the law of that State." The question can be raised as to what constitutes a gain "mentioned" in a previous paragraph. For example, consider the gain from the alienation of shares that fall below the ownership threshold set by the contracting State in a provision similar to Article 13 (5) of the United Nations Model Convention. Article 13 (5) states only that the gain realized on the alienation of shares above the threshold is taxable in the source State. Is gain realized on the alienation of shares below the threshold thereby "mentioned"? If the position is taken that it is not, then the residual taxing power paragraph essentially erases the line drawn in Article 13 (5): it is almost as though Article 13 (5) is deleted in its entirety.[73] Interpreted in this way, the approach to drafting in Article 13 would strike many readers as unusual (and unnatural), and even source-country tax authorities may have refrained from

[72] A recent study of Article 13 offers as examples of tax treaties that permit the source State to tax gains from the alienation of property that is not otherwise covered by Article 13, those concluded by Australia (1989 to 2003), Argentina, Brazil, China (the tax treaties with Australia, Canada, the Czech Republic, Germany, Hungary, India, Japan, Malaysia, the Netherlands, New Zealand, Nigeria and Thailand), India (the tax treaties with Canada and the United States) and Turkey (the tax treaties with Canada, Italy, Singapore and Spain). Jinyan Li and Francesco Avella, "Article 13: Capital Gains," *Global Tax Treaty Commentaries* (Amsterdam: IBFD, 2014), section 3.1.6.2, "Other cases dealt with by domestic law."

[73] A similar question can be raised about the 50 per cent-of-assets threshold for real property holding entities in Article 13 (4).

"overlooking" distinctions made in the previous paragraphs of Article 13 if residual taxing power is reserved under Article 13 (6).[74]

6. Preventing avoidance of the tax on capital gains by non-residents

Section 4 of the present chapter identified detection of taxable transfers and enforcement against delinquent taxpayers as the main challenges for administering the tax on capital gains of non-residents. These are the types of challenges more frequently discussed in connection with tax evasion, but for non-residents and for taxing capital gains, the line between tax avoidance and tax evasion is especially blurry: it takes little effort for the taxpayer to hide the relevant taxable transactions and to dodge enforcement — efforts whose undertaking normally distinguishes the tax evader. This may be one reason why tactics for avoiding the tax on capital gains are generally fairly crude. Another reason is that, as discussed in sections 2 and 5 above, both domestic laws of various countries and tax treaties may sometimes give the impression that ceding source-country taxing rights over capital gains (for example, from company shares and from the transfer of other financial claims or intangibles) is normal. But once such concessions are made, taxpayers can be expected to exploit them.

[74] An alternative interpretation is that what is reserved is taxing rights over types of property not referred to in a previous paragraph. This interpretation is made explicit in some treaties. For example: "Gains derived by a resident of a Contracting State from the alienation of any property other than that referred to in paragraphs 1 through 5 and arising in the other Contracting State may be taxed in that other Contracting State." Thus, shares of resident companies are a type of property already covered by Article 13 (5), and the alienation of shares below the threshold would not be taxable even under Article 13 (6). The question is then what is the "type of property" previously referred to. For example, does Article 13 (2) refer to all movable property, or only movable property used in a business, or, even more narrowly, only movable property used in a business conducted by a PE? As discussed above, the reading of Article 13 (2) as referring to all movable property would make the class of "property other than that referred to" in a previous paragraph nearly empty. On the other hand, reading it as referring to "movable property used in a business conducted by a PE" would mean erasing the distinctions drawn in (and therefore the point of) that paragraph.

6.1 Treaty shopping

One obvious strategy for avoiding the capital gains tax is to set up holding companies that otherwise serve little or no business purpose in jurisdictions with treaties that contain favourable provisions on the taxation of capital gains. Even for countries that generally tax transfers of shares of domestic companies (whether all transfers or transfers of substantial ownership, in accordance with Article 13 (5) of the United Nations Model Convention), some of their treaties may exempt such transfers. Still fewer treaties may exempt the transfer of shares of real estate holding companies (contrary to the provisions of Article 13 (4) of the United Nations Model Convention).[75] Moreover, a developing country may not always be able to negotiate the retention of residual taxing rights under Article 13 (6).

Since a separate chapter in this publication deals with the abuse of treaties, there is no need to dwell on the issue here.[76] However, one comment is worth making in connection with Article 13. Unlike some of the other distributive articles in tax treaties (regarding, for example, interest, dividends, royalties and, increasingly frequently, other income), which generally deploy the concept of beneficial owner as a way of preventing treaty abuse, the capital gains article generally does not refer to beneficial owners. This by no means implies that a more permissive attitude towards treaty shopping is intended with respect to capital gains. Instead, it merely reflects the fact that the drafting of the article uniformly refers to capital gains "derived by" residents of a contracting State, and never employs the phrase "paid to". It is indeed this latter phrase that led to the (perceived) need to stress the qualification of the payee as a beneficial owner in the other distributive articles.[77]

[75] The carve-out for companies that use domestic real property in their businesses contained in Article 13 (4) of the United Nations Model Convention is not often adopted, but where it is, it also gives rise to incentives for treaty shopping.

[76] See Chapter VI, Preventing tax treaty abuse, by Graeme S. Cooper.

[77] A rare anti-avoidance provision specifically addressing capital gains is found in Article 14 (6) of the Convention between the Government of the Italian Republic and the Government of the Republic of Ghana for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion, of 19 February 2004: "The provisions of this Article shall

6.2 Indirect transfers[78]

6.2.1 The growing prevalence of taxation of indirect transfers

As discussed in section 2.2 above, if the transfer of an asset is taxable, but the transfer of ownership interest in an entity that holds the asset is not taxable, then the tax on the transfer of the asset can be indefinitely deferred (thus essentially avoided) by using a holding entity. This logic applies no matter how many layers of holding entities are involved and regardless of whether the holding entity (or entities) is (are) domestic or foreign. This is why Article 13 (4) of the United Nations Model Convention permits the country where immovable properties are located to tax foreigners even on transfers of foreign entities, if such entities principally hold, directly or indirectly (for example, possibly through multiple layers of holding companies), the immovable properties. However, it is relatively infrequently that countries adopt domestic law provisions for taxing non-residents on the disposition of shares of foreign companies, whether generally or for real estate holding companies. There are several possible explanations for this. First, many developed countries where anti-tax-avoidance policies are most established have chosen not to tax non-residents on capital gains, on grounds unrelated to tax avoidance.[79] Second, using offshore holding companies to make an investment in a given country may be tax-inefficient for investors from that country (unless domestic investors can evade home-country taxes by going offshore). Thus for any asset market where domestic investors are dominant, it may be unlikely for that asset market to move offshore. This is probably the reason why the United States (unlike Australia, Canada and Japan) has not adopted rules for taxing indirect transfers of United States real property interests: any foreigner investing in United States real estate will want to use investment structures that future United States buyers would not

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not apply if the right giving rise to the capital gains was created or assigned mainly for the purpose of taking advantage of this Article."

[78] The present section is based on Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 21.

[79] See supra notes 16 and 19.

reject.[80] Third, and more generally, there may be other legal factors that either pull the legal structures for foreign investment onshore or push them offshore.[81] Where such other considerations favour using onshore structures, the attraction of offshore structures (in terms of helping to avoid the capital gains tax) may be outweighed.

In the past few years, a number of non-OECD countries, including Chile, China, the Dominican Republic, India, Indonesia, Mozambique, Panama and Peru, adopted the policy of taxing foreigners on the sale of interests in foreign entities that hold, directly or indirectly, the shares of resident companies.[82] While the background to these policy developments may be very diverse,[83] what is likely common among them is the use of active offshore markets to channel investments into these jurisdictions, making tax avoidance through indirect transfers a natural strategy.

6.2.2 Specific and general anti-avoidance rules in taxing indirect transfers

The current approaches to taxing indirect transfers illustrate a well-known dichotomy in legal design for anti-avoidance, namely the use of specific anti-avoidance rules (SAARs) versus general anti-avoidance rules (GAARs). The crucial distinction is that under a SAAR, the content of the legal rule applicable to the relevant circumstances is specified ahead of time, so that it is clear what the outcome of applying the rule will be. By contrast, GAARs tend to be statements of principle, and how the legal standard is applied can be known only after the fact. India's policy illustrates the SAAR approach. The 2012 amendment

[80] See Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 21, 664-6.

[81] Ibid., 666-71.

[82] For Mozambique, see IMF Spillovers Report, supra note 7, at 70; for the other countries, see Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 21, 654-6.

[83] In India, for example, the policy developed as a consequence of the Vodafone case, adjudicated by India's Supreme Court and provoking parliamentary action. In China, by contrast, the taxation of indirect transfers was launched by a piece of informal administrative guidance.

of the Income Tax Act of India provided that "any share or interest in a company or entity registered or incorporated outside India shall be deemed to be … situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India." Therefore, the transfer of such shares would result in the realization of income accruing or arising in India and taxable to a non-resident transferor.[84] In contrast, China determines the taxability of an indirect transfer on the basis of an ex post determination. Under the relevant administrative guidance,[85] in cases where "an offshore investor makes abusive uses of organizational forms or arrangements indirectly to transfer the equity interest in a Chinese resident enterprise, and such arrangements are without a reasonable business purpose and entered into to avoid enterprise income tax obligations," tax agencies are authorized to "re-characterize an equity transfer according to its business substance, and disregard the existence of the offshore holding company which is used for tax planning purposes." That is to say, only a tax authority can determine the taxability of an indirect transfer, and such determination is to be made explicitly on the basis of a finding of tax avoidance motives. The statutory basis of this determination has been attributed to the GAAR in China's Enterprise Income Tax Law.[86]

Using the GAAR to deal with potentially abusive indirect transfers has turned out to be unsatisfactory in China in many respects, for the fundamental reason that indirect transfers of shares of Chinese companies occur too often. Many of the entities used in offshore

[84] It has been proposed that "substantially" be defined to mean 50 per cent or more of the total value of a company's assets.

[85] Often referred to as "Circular 698." Guoshuihan [2009] No. 698, Notice on Strengthening the Management of Enterprise Income Tax Collection on Proceeds from Equity Transfers by Non-resident Enterprises (promulgated by State Administration of Taxation, 2009) (China).

[86] Enterprise Income Tax Law, Article 47 (2008) (China). The statutory language provides: "Where an enterprise enters into [an] arrangement without reasonable commercial purpose and this results in a reduction of taxable gross income or taxable income, tax agencies shall have the authority to make adjustments using appropriate methods." An "arrangement without a reasonable commercial purpose" has been defined as one "the primary purpose of which is to reduce, avoid or defer tax payments." See regulation on the Implementation of the Enterprise Income Tax Law, Article 120 (2008) (China).

structures for investing into China neither serve substantial functions nor display a bona fide, operational business purpose. In this context, the determination that many of the holding companies serve no genuine business purpose, or that whatever business purpose they serve pales in comparison to the potential tax savings through indirect transfers, can be made in a much more routine fashion than case-by-case examinations permit.[87] Furthermore, overreliance on GAARs creates too many opportunities for negotiation between taxpayers and authorities. An industry of tax advisers on indirect transfers has emerged, whose routine tool of trade is to persuade foreign parties who have made indirect transfers first to hire them to report the transfers, and then to pay them literally to "negotiate" with Chinese tax authorities on the taxability of the transfers, often regardless of whether the position of non-taxability has any merit.

These phenomena are consistent with the theory that, when a type of transaction which the law wishes to regulate occurs often, it is socially optimal to spell out the content of the law ahead of time, thus minimizing the costs for regulated subjects, legal advisers and enforcement personnel of interpreting the law.[88] Thus SAARs are likely to be a superior way of dealing with the majority of indirect transfers, while a GAAR should be reserved for the relatively rare cases that are not properly dealt with by SAARs.

However, the existing SAARs adopted by various countries for taxing indirect transfers — in Australia, Canada and Japan for real property holding companies, and in India for all companies that hold sufficient assets in India — are subject to several objections. One is that many of them do not exempt publicly traded companies, even though such companies are unlikely to be formed for tax avoidance purposes (and therefore taxing the transfers of their shares are unnecessary for maintaining the integrity of source-based taxation). Another objection

[87] There are reports of a backlog of indirect transfer cases across China, in which foreign entities have reported indirect transfers already carried out, are prepared to make tax payments, but are kept waiting indefinitely by local tax authorities who have yet to make the determination that the transfers are taxable.

[88] See Louis Kaplow, "Rules versus Standards: An Economic Analysis," (1992) Vol. 42, No. 3 *Duke Law Journal*, at 557.

is that, typically under these rules, transfers of shares of foreign entities by non-residents are treated as giving rise to items of per se taxable income: any capital gains on such transfers are explicitly stipulated to have a domestic source. In Canada, for example, if foreign company A derives more than 50 per cent of the fair market value of its shares directly or indirectly from real or immovable property situated in Canada, then the shares of A constitute "taxable Canadian property," and any capital gains realized on the disposition of shares of A are deemed to arise in Canada. Assuming that A is wholly owned by another foreign company, B, and B has no assets other than the shares of A, the shares of B would also constitute "taxable Canadian property." Any capital gains realized on the disposition of the shares of B are therefore also taxable income in Canada, and are legally distinct from the capital gains that have accrued to or been realized on the shares of A. If the capital gains on the disposition of the shares of A (by B) have been taxed in Canada, that does not prevent the capital gains realized on the disposition of the shares of B (by its shareholder(s)) from being taxed in Canada (or vice versa).

Interestingly, neither Australia, Canada or Japan, nor the Commentaries on the United Nations and OECD Model Conventions, has addressed this problem of multiple taxation arising from the taxation of indirect transfers of real estate. Nor do they (or the United States, in its law taxing the transfer of United States companies that hold United States real property) deal with the issue of proportionality: if the shares of a holding company derive only 50 per cent of their fair market value from domestic assets, under most of the existing SAARs, all of the capital gains realized on the sale of the shares are taxable in the country of the location of the underlying assets. Although the recent "Shome Report" in India recommends that any gain realized on a taxable indirect transfer should be taxed only in proportion to the value of the Indian assets relative to the entity's global assets, this is still different from taxing the gain on the transfer only to the extent attributable to gains realized on the underlying Indian assets.[89]

[89] Expert Committee (2012) (India), *Draft Report on Retrospective Amendments Relating to Indirect Transfer*, available at http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/21/Draft_Report.pdf.

6.2.3 Multiple taxation and other implementation issues

Are governments justified in their indifference to these problems? One view is that the decision on how many layers of intermediate companies are interposed between the domestic asset and ultimate investors is in the control of the taxpayers, as are decisions to make dispositions at different levels. If governments are wary of convoluted and opaque offshore structures to begin with, they will have no motivation to go out of their way to make sure that tax is neutral with respect to the choice of organizational structure in offshore corporate groups.[90] While this argument is probably correct in itself, there is an important competing consideration. As discussed in section 4 above, taxing foreigners on capital gains raises significant challenges for enforcement. If the tax on indirect transfers leads to arbitrary tax consequences because of unmitigated multiple taxation, taxpayers may respond not by simplifying offshore corporate structures, but by non-compliance and evasion. If a government wants to maintain the credibility of its anti-avoidance regime without committing indefinite resources to enforcement, it should try to maximize voluntary compliance. Rationalizing the rules for taxing indirect transfers — including by mitigating the multiple taxation of the same economic gain — would seem to be one strategy for increasing voluntary compliance.

Notably, China's policy for taxing indirect transfers, though problematic in terms of adopting an approach of case-by-case determination, in fact suggests a solution to the problems characterizing the existing SAARs. In China, indirect transfers become taxable only after they have been determined by tax authorities to be, in economic substance, direct transfers. The layers of offshore holding companies, instead of creating separately and distinctly taxable assets under Chinese law, must be disregarded. This implies that if the shares of a Chinese company are treated as having been disposed of indirectly through the transfer of an offshore entity, the fact that the indirect transfer has been subject to tax should be reflected by adjusting the tax

[90] Advanced income tax systems tend to aim to be neutral with respect to such choices when the structures are domestic or "onshore," adopting special regimes such as corporate consolidation and disregarding intragroup transactions.

cost or basis for the Chinese company's shares.[91] This eliminates the possibility of taxing the same economic gain multiple times as a result of multiple layers of indirect transfers. Moreover, the tax on an indirect transfer would necessarily always be proportional. The source country will get to tax only any gain represented by the excess of: (a) the portion of the purchase price paid on the indirect transfer that is allocable to the shares of the target company in the source country regarded as transferred indirectly; over (b) the tax basis, for purposes of the source country, of such shares of the target company.[92]

Overall, it seems possible to improve on all existing practices for taxing indirect transfers by taking the SAAR approach (if indirect transfers occur frequently), while modifying it to incorporate the Chinese approach of treating all indirect share sales as sales of the underlying domestic assets.[93] To implement this approach consistently can be technically complex, and adjusting the tax basis of assets held by an entity to reflect the transfers of interests in the entity by its owners (so as to avoid multiple taxation of the same economic gain) has only recently become feasible for entities with a large number of owners in the United States through specialized accounting software.[94] However, if publicly listed entities are excluded from a tax on indirect transfers, such that most taxable indirect transfers involve only entities with

[91] For example, suppose that foreign investor S forms an offshore company P with equity capital of 200. P, in turn, contributes 200 of equity capital to Chinese company Q. When the value of Q shares grows from the initial value of 200 to 250, S sells the shares of P for 250 to buyer B. If China decides to disregard the existence of P to tax S on the sale, and S is liable for tax on the gain of 50, then the tax basis or cost of Q shares in the hands of P, and of B, should each be adjusted to 250. If either P disposes Q shares now for 250, or B disposes of P shares for 250, there should be no further tax for either P or B.

[92] In more technical terms, disregarding an offshore entity and taxing an indirect transfer is essentially a matter of treating a sale of shares (of the offshore entity) as a sale of underlying assets (that is to say, the shares of a target resident company).

[93] This is discussed as the "ex ante, look-through" approach in Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 21, Section V.

[94] The author gratefully acknowledges Mr. Ameek Ashok Ponda, adjunct professor at Harvard Law School, for providing this information.

few owners, the complexity may be manageable. And the exclusion of shares of publicly listed entities from a tax on indirect transfers is independently justifiable, as they are unlikely to be used mainly for tax avoidance purposes.

One final issue that deserves mention is that the policy of taxing indirect transfers, when implemented by a number of source countries, increases the likelihood that a single share transfer may be taxable in multiple source countries, for example, because subsidiaries in different countries are indirectly transferred when a holding company is sold. The tax authorities in the different source countries may have different assessments of the amount of gain attributable to their country, which may lead to taxation of the same gain by multiple source countries.[95] Notably, there is currently no international arrangement for source countries to coordinate their taxes in such situations.[96]

6.3 Issuance of new shares and corporate reorganizations

Sometimes, taxpayers may try to avoid a tax on the sale of shares (whether direct or indirect) by having the target company issue new shares to new investors. This may or may not be accompanied by a distribution of the proceeds from the new share issuance to existing shareholders. When it is, there is a barely disguised share sale. But even when it is not, there can be an effective transfer of the value of the company from existing to new shareholders.[97] Such tax planning tactics may be used within purely domestic contexts as well, and they need to be dealt with whether used domestically or in cross-border transactions.

Many developed countries adopt tax-deferral regimes for corporate reorganizations, and businesses are accustomed to using such

[95] This problem is worsened if, as is likely under traditional practice in taxing indirect transfers, the source country taxes the entire gain in the transfer even if only a portion of the gain is attributable to it.

[96] The author is grateful to Mr. Peter Barnes for providing this information.

[97] This issue is highlighted in Lee Burns, Honoré Le Leuch and Emil Sunley, "Transfer of an interest in a mining or petroleum right," in Philip Daniel, Michael Keen, Artur Swistak and Victor Thuronyi, eds., *Resources without Borders*, supra note 37.

regimes to reduce their tax liabilities in mergers and acquisitions. However, to protect the domestic tax base, developed country corporate reorganization rules tend to impose more stringent requirements when ownership of domestic assets is transferred to or among non-residents. Developing countries should be equally cautious in granting deferral treatment for purported reorganizations carried out among non-residents.

7. Taxing former residents on capital gains

The present chapter has mainly focused on capital gains taxation from a source-country perspective. This section briefly touches on an issue that properly belongs to the topic of resident country taxation.[98] When the residence of a taxpayer changes on emigration, the taxing rights of the former residence State are reduced to those of a source State. In order to preserve the right to tax gains accrued while the taxpayer is a resident, many countries impose an "exit tax" (also referred to as a "departure tax") and/or a "trailing tax." Under an exit tax, assets owned by an emigrant are deemed to be alienated at market value and reacquired at a cost equal to that value. For instance, under the Australian domestic law exit tax rules, a person ceasing to be resident is deemed to dispose of assets other than taxable Australian assets (on which even non-residents are taxed) at market value.

In the absence of coordination between the treaty States, a problem regarding the potential double taxation of the accrued gain may arise. This occurs when the property is actually alienated and the current residence State taxes the entire gain, computed by reference to the historical cost basis, which includes the gain that has been subject to the exit tax in the former residence State. Countries with exit taxes, such as Australia, Canada, the Netherlands, South Africa and the United States, may include special provisions in their tax treaties to resolve the problem of double taxation. This is usually realized by

[98] The following paragraphs draw largely on Jinyan Li and Francesco Avella, "Article 13: Capital Gains," supra note 72, Section 2.1.8, to which readers are referred for further discussion. See also Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis,* supra note 18, Part IV, Chapter A, Section 2.1.

allowing the taxpayer to use a tax cost for the asset in the new residence State equal to its market value at the time of the change in residence.[99]

Trailing taxes are taxes levied after a change of residence on assets that would normally not otherwise be taxed in the hands of a non-resident, but that are usually taxed under domestic law if alienated within a given period following the change of residence (generally five to ten years). A country may provide for both a trailing tax and an exit tax if a taxpayer has an election to be subject to the exit tax or remain liable to tax for the full gain realized on actual alienation following the change of residence. Special treaty provisions may also be needed to preserve the taxing rights of the former residence State and prevent double taxation.

8. Conclusion

Throughout the discussion in the present chapter, it has not been assumed that revenue from taxing non-residents on capital gains is indispensable to many developing countries.[100] Such an assumption could very well turn out not to be true. For example, in many of the developing countries that recently led efforts to combat base erosion by taxing indirect transfers — for example, China, India, Indonesia, Peru and others — revenue from international taxation in general (not to mention from capital gains taxation of non-residents in particular) is likely to represent a very small portion of overall tax revenue. The pursuit of such base protection measures is thus likely to be motivated by other policy considerations, for example, for maintaining the integrity and fairness of the tax system. Insofar as the administrative apparatus of a developing country can handle such taxation in the normal course of its operation, there should be little that is out of the ordinary.

[99] Indeed, under its domestic law, Australia deems a person who becomes a resident to acquire assets other than taxable Australian assets at market value on becoming a resident. Canadian rules are largely similar.

[100] This can be contrasted with a view expressed in the recent IMF Spillovers Report, whose discussion of capital gains taxation — and the taxation of indirect transfers in particular — was motivated by its technical assistance experience, which "provides many examples in which the sums at stake in international tax issues are large relative to overall revenues [of developing countries]." See IMF Spillovers Report, supra note 7, at 1.

A core contention of the present chapter is that many of the conventional arguments for limiting the taxation of non-residents on capital gains are weak. The conceptual case for generally taxing non-residents on such gains is essentially as strong as for any other form of source-based taxation. For example, the claim that only immovable property has enough of an “economic connection” with the source country is hard to comprehend, except as an unconstructive attempt to gloss over the traditional political sensitiveness of foreign ownership of domestic land. Just as significantly, as discussed in section 5, even Article 13 of the United Nations Model Convention may have started with a baseline too close to the non-taxation of capital gains, such that source countries either are allocated taxing rights over only a few enumerated categories of capital gains or, when they claim broader taxing rights, must struggle against the textual interpretation of the model convention. Insofar as the norms expressed by the United Nations Model Convention matter, one needs to be aware of this special bias against source-country taxation on capital gains.

However, there is obviously little point in declaring a taxing right over capital gains of non-residents if the tax cannot be enforced. Because many developed countries have abandoned taxing non-residents on capital gains, they cannot be viewed as to be experts in implementing the tax. Whether developed countries can succeed in enforcing the tax — and more importantly, foster a culture of compliance with it — is yet to be seen. But it is worth stressing that the conventional assumption that capital gains of non-residents should not be taxed is surely not conducive to producing compliance. Moreover, too much of the international tax discussion over recent decades has been centered on whether non-residents should be taxed on capital gains, rather than on how they are to be taxed. Yet the question of how to tax capital gains (discussed in section 3 above) should arguably matter just as much to the legitimacy of such a tax as the question of whether to tax.

Chapter IV

Limiting interest deductions

Peter A. Barnes*

For many decades — indeed, long before the G20 and the Organisation for Economic Co-operation and Development (OECD) launched their project on base erosion and profit shifting (OECD project on BEPS) — the proper tax treatment of interest payments has challenged tax authorities. The issues include very basic questions (What is interest?) and practical concerns of tax administration (How is "excessive" interest determined?).

The OECD project on BEPS puts the issue of interest squarely into focus. Action 4 of the OECD Action Plan on BEPS[1] is titled "Limit base erosion via interest deductions and other financial payments." The description states, in part, that this action aims to

> [d]evelop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.

Possibly reflecting the difficulty of this task, the completion of Action 4 in the OECD Action Plan on BEPS is expected by September 2015.

This chapter examines many of the issues that arise in designing tax rules to address the deductibility of interest payments, with a

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[1] Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf.

special focus on the challenges faced by tax administrators in developing countries. As discussed more fully below, developing countries face many of the same challenges with respect to interest payments as developed countries, albeit with fewer resources to audit taxpayers and enforce the laws, and a greater need to attract investment capital. Accordingly, developing countries may choose to adopt more bright-line rules with respect to the tax treatment of interest payments than developed countries, where often complex and overlapping limitations and exceptions apply.

1. Background

1.1 Debt and equity

Intuitively, taxpayers and tax administrators know what is meant by the terms "debt" and "equity":

- ➢ A debt instrument, classically a loan (from a bank, for instance) or a bond (issued by a government or corporate borrower), entitles the holder to receive a fixed, periodic return, typically called interest. The holder does not have an ownership interest in the borrower, so the holder does not share in profits of the borrower. But, for the same reason, the holder ranks ahead of the owners of the borrower in the event of a default or bankruptcy;
- ➢ Equity, in whatever form issued, represents an ownership interest in the underlying entity.

For business taxpayers, interest payments generally are viewed as an ordinary business expense and may be deducted by the taxpayer in determining taxable income. The interest payment is normally treated as income to the recipient in determining the recipient's taxable income.

Payments with respect to equity, on the other hand, are typically not deductible by the payer, since the payments represent an after-tax return on a capital investment. The tax treatment of the equity payment in the hands of the recipient depends on the tax system applicable to the recipient; in some cases, the payment will be fully taxable in the recipient's home country, but in other cases, the payment will be partially or wholly exempt. The country from which the dividend is paid may levy a withholding tax on the dividend, representing a tax on the shareholder.

Although it is often clear that a particular instrument should be classified as debt or equity — and, therefore, the proper tax treatment for payments on that instrument can be readily determined under the applicable tax laws — there are some instruments in respect of which the classification is less certain. For instance, an instrument may provide for fixed payments of interest but also provide for a share of profits, in the event the profits exceed a certain level. It is beyond the scope of this chapter to discuss the variations in financial instruments that exist today (and new instruments are being designed regularly by financial engineers), but it is important to acknowledge that determining whether a particular payment is "interest" for tax purposes is not always easy.

A most difficult issue for tax officials seeking to prevent improper tax base erosion and profit shifting is the proper treatment of hybrid instruments: financial instruments that are treated as debt by one taxing authority but as equity by another. Hybrid instruments are the subject of Action 2 of the OECD Action Plan on BEPS and are dealt with in chapter V on neutralizing effects of hybrid mismatch arrangements.

1.2 Use of debt by taxpayers

The availability and use of debt is widely recognized as an important element of a healthy business environment. Indeed, a lack of credit can deter economic growth. This point is illustrated by the efforts of governments today to ensure that increased regulation of financial institutions is balanced against the need for these institutions to lend readily to growing businesses. The importance of credit is also illustrated by the wide support for microlending and other programmes to extend credit markets to small businesses (including individuals) in developing countries as a means for generating economic growth.

For a business, the availability of debt is often essential to growth. There are several reasons why an investor may need to borrow funds to grow a business (and, accordingly, make interest payments).

First, debt may be incurred as part of the capitalization of the enterprise, in combination with equity:

(a) Using debt, the initial investor increases the pool of available capital by bringing in additional sources of capital that want the comparative safety of being paid before equity investors receive a return;
(b) Debt allows the owners to expand the business without diluting control. If expansion can be funded only through new equity, the original owners will have a reduced stake in the larger enterprise;
(c) Economic studies have shown that the use of debt can bring discipline to the operation of an enterprise, resulting in long-term improved profitability and operation.

Second, debt may be incurred in connection with the purchase of property or goods. For instance, real property may be purchased with a mortgage, or goods may be purchased with extended payment terms that trigger interest on unpaid balances. In each of these situations, the lender typically has a priority right to the property or goods as security for the loan, and therefore may be willing to extend the loan on favourable interest terms.

Third, an enterprise will typically require a line of credit to provide or to support working capital.[2] This line of credit may be drawn upon, or it may simply be available for a future need.

In each of these situations, the interest expense incurred in connection with the debt is generally treated as an ordinary and necessary business expense and will be allowed as a deductible expense in computing the taxable income of the enterprise. While these deductible payments "erode" the tax base of the enterprise, they are inherently no different from any other ordinary or necessary deductible expenses, such as wages, rents or purchases of services and raw materials.

Although the use of debt and the payment of deductible interest expense are fully appropriate, governments are rightly concerned about

[2] The term "working capital" generally refers to the readily available funds required to pay salaries, suppliers and other expenses in the ordinary course of business.

the potential for these payments to become excessive and erode a country's tax base. Excessive payments can arise either because the amount of the debt is excessive, or because the rate of interest is inappropriate. Today, tax audits tend to focus more on the second concern — excessive interest rates — than on the first issue. Transfer pricing audits frequently focus on the rate of interest charged. Determining whether the total amount of debt is excessive is generally a more difficult issue to analyse.

1.3 Related-party debt in capitalizing an enterprise

As noted above, debt may be used in connection with the capitalization of an enterprise. One situation deserves special focus: the simultaneous use of debt and equity by a single investor (or an investor and its related affiliates) to capitalize a new investment, as can be demonstrated by the following example:

Acme Corporation, a resident of Country X, seeks to create a subsidiary corporation, Beta Corporation, in Country Y. Beta requires initial funding of $1,000 in order to begin business. Acme could provide that funding by:

- Investing $1,000 of equity; or
- Investing $500 of equity and $500 of debt (or any other combination of debt and equity).

The choice of whether to use equity only, or a combination of debt and equity, generally will depend on a complex blend of both tax and non-tax considerations.

1.3.1 Tax considerations

Returning to the example above, if Acme Corporation invests wholly with equity, Beta will not be required to make any interest payment (because there is no debt) and Beta will have no tax deduction related to its initial funding. Acme's return on the investment will be entirely in the form of dividends.

If the initial funding is partly in the form of equity (say, $500) and partly in the form of debt ($500), the interest payments of Beta Corporation on the $500 worth of debt generally will be deductible in Country Y, reducing the corporate income tax expense for Beta Corporation.

This deduction for an interest payment may be a positive benefit for Acme and Beta, taken as a group, depending on the following tax considerations:

- Does Beta have sufficient taxable income against which to deduct the interest payments to Acme such that the deduction for interest expense is economically valuable? If no deduction is available in the current year, will the deduction be available in a future year? The answer to the latter question requires consideration of both future earnings of Beta and the rules of Country Y on the carry-forward of losses;
- Does Country Y impose a withholding tax on the interest payment to Acme, and, if so, what is the rate? How does the economic impact of that withholding tax compare with the potential economic benefit of the income tax deduction to Beta for the interest payment?
- What is the tax treatment of Acme in Country X? Is the interest taxable to Acme? At what rate? How does the tax treatment of the interest received by Acme in Country X compare with the tax treatment of a dividend received by Acme in Country X?
- If there is a withholding tax imposed by Country Y on dividends or interest, or both, can that withholding tax be claimed as a credit against the tax in Country X, or are there other considerations (for example, excess foreign tax credits for Acme) that make the withholding tax imposed by Country Y a deadweight cost?

If the debt investment to Beta is not made by Acme, but by an affiliate of Acme and Beta in a third country, Charlie Corporation in Country Z, then the analysis of the tax consequences of the interest payments will be made with respect to Charlie Corporation.

Of course, Acme and Beta (and Charlie) will have some (but not complete) information to determine whether the interest deduction will benefit the two related companies as a group, and that information will guide the decision whether to invest in Beta wholly with equity or with some combination of debt and equity. But it is useful to recognize that the decision whether to invest with debt (and therefore potentially erode the local tax base through deductible interest payments) requires a complex projection of both current and future business and tax developments.

1.3.2 Non-tax considerations

While tax issues are often an important driver in deciding whether to use debt to capitalize an investment, there can be significant non-tax considerations as well.

In particular, two factors deserve focus. First, it may be difficult to reduce the level of equity investment in a corporation. To use the example above, if Acme invests $1,000 entirely as equity into stock of Beta, the corporate law of Country Y may limit the ability of Acme to reduce that equity investment, even if the full $1,000 is no longer required in order to operate the Beta business.

For instance, corporate law may require Acme (and Beta) to seek court approval for a capital reduction, with extensive notice to creditors (and potential creditors) as well as submissions to the court of detailed financial information. This procedure can be lengthy and expensive, and it may or may not be successful.

Accordingly, Acme may choose to capitalize Beta in part with debt, even though an all-equity investment would potentially be more tax-efficient. Using debt as part of the capital for Beta allows Acme to withdraw the debt at a future time (by having Beta repay the debt, possibly by means of obtaining alternative debt from other parties). This capital flexibility for Acme can be an important factor in determining how best to capitalize Beta.

A second non-tax factor for Acme to consider is the accounting treatment for any debt investment that it makes in Beta. The applicable accounting rules can be exceptionally complex, but in simple terms, Acme or Beta may be required to recognize on a periodic basis certain gain or loss from any currency fluctuations related to the debt. This would arise, for instance, if the functional currency for Acme is different from the functional currency for Beta, which is often the case for two companies located in two different countries. In such a case, the debt instrument will necessarily be denominated in a non-functional currency for one party or the other. Depending on the currency in which the debt is denominated, on whether that debt can be properly hedged and on other factors, the use of debt to partially capitalize Beta may result in the recognition of substantial periodic gain or loss for purposes of financial reporting. This non-tax consideration may drive Acme to capitalize Beta with equity.

1.3.3 Summary

The above example, and the considerations that influence the way in which Acme chooses to capitalize its new investment in Beta, sets a framework for the issues discussed below. Although the analysis for any specific investment can be complex, two general observations are widely applicable:

- There is no simple rule that dictates whether the use of all-equity or some combination of debt and equity to capitalize an investment will yield the most favourable tax result, taking into consideration both home and host country tax considerations;
- Taxpayers have flexibility in their decision-making on this issue, and will generally seek to maximize the benefits from the investment, taking into account both tax and non-tax considerations. Whether the benefits are, indeed, maximized often depends on future business consequences that are not entirely knowable at the time of the investment.

1.4 Branch operations

The above discussion of debt and equity assumes that a corporation in one country (for example, Acme in Country X) will establish a separate legal entity in the other country (for example, Beta in Country Y). In many cases, however, there is no separate legal entity; rather, Acme may establish a branch in the other country. Typically, Acme would be taxable in Country Y on the profits of its branch there. If a tax treaty exists between Country X and Country Y, then the relevant enquiry would be whether Acme has a permanent establishment in Country Y.

Concerns regarding the deductibility of interest — and the possible erosion of tax base — arise in connection with branches, just as they do in connection with related corporations. But while many of the considerations and concerns are the same for both corporations and branches, some issues are different. The concerns regarding interest payments for branches are discussed in section 4 below.

2. Non-tax concerns regarding excessive debt

Although the focus of this chapter is on tax issues and the appropriate limitations under tax law regarding excessive interest, it is important to recognize that erosion of the tax base is only one driver — and often a limited one — for imposing legal limits on the use of debt by business enterprises. An equally strong motivation for limiting debt in most countries is a concern over corporate governance and a prudential limit on the amount of risk that a business enterprise can assume. Tax rules must respect and be integrated with these non-tax concerns regarding excessive debt and the resulting excessive interest payments.

Government regulators may seek to limit the amount of debt that an enterprise takes on, in order to reduce the risk of a business failure having knock-on effects for workers, suppliers, customers and others. Businesses are necessarily linked to each other in national and international economies. The most forceful example of these connections arose during the financial crisis of 2008. At that time, the failure of some businesses and the potential failure of many more demonstrated the consequences that arise for the global economy when a single business takes on too much risk and fails, thereby triggering a succession of failures in other businesses.

Government restrictions may be explicit. For example, specific debt/equity limits imposed by law at the time the business is created and, in some cases, on an annual or periodic basis going forward. Alternatively, the government restrictions may be applied in a more flexible fashion, such as through reviews by financial regulators requiring financial institutions to seek approval (and demonstrate financial soundness) before paying dividends or making certain acquisitions.

In addition to legal limits on the assumption of debt and debt/equity ratios, business realities are imposed by market forces. For instance:

- In order to secure contracts, especially from governments but also from non-government customers, an enterprise often must provide a balance sheet and other financial information that demonstrates financial fitness;
- Lenders often impose financial covenants that limit an enterprise's ability to borrow;
- Rating agencies review creditworthiness with a view towards assessing excessive debt.

These non-tax limitations on debt are consistent with, but separate from, any tax rules that limit the ability of an enterprise to take a tax deduction for interest payments on excessive debt. In some cases, the non-tax considerations will be significantly greater factors than the tax concerns in a taxpayer's decision regarding how to capitalize a new investment.

3. Tax considerations regarding thin capitalization and related concerns

"Thin capitalization" is the preferred term for the condition in which a taxpayer is determined to have excessive debt and therefore excessive interest expense. In most cases, tax rules regarding thin capitalization focus on the debt owed and the interest paid to non-residents. Since the global financial crisis in 2008, non-tax regulators increasingly are focused on thin capitalization without regard to whether the debt is owed to residents or non-residents.

Participants in the OECD project on BEPS and outside commentators have identified a wide range of issues to consider with respect to thin capitalization and related concerns. But, at core, there are five primary areas for inquiry:

(a) What is the best way to determine whether a taxpayer has excessive debt, such that some portion of the interest expense incurred should be disallowed either temporarily or permanently? This is the classic problem of defining thin capitalization and is discussed in section 3.1 below;

(b) A related question is how to identify interest expense that arises in connection with exempt or deferred income. This issue most frequently occurs in connection with a taxpayer that earns foreign source income that is taxed favourably in the taxpayer's home country. Although the interest expense may not be excessive, allowing a current deduction for the interest expense may improperly erode the tax base. This issue is discussed in section 3.2 below;

(c) Should certain types of debt (and the associated interest expense) be treated differently from other types of debt with respect to tax deductibility? Or, should all of a taxpayer's debt and interest expense be considered as a single tax item for deductibility or limitation? These issues are discussed in section 3.3 below;

(d) Is related-party debt particularly susceptible to abuse, such that related-party debt and the associated interest expense should be subject to special limitations? If limitations are deemed appropriate, how should those limitations be designed? This concern is discussed in section 3.4 below;

(e) What role can withholding taxes play in preventing erosion of a country's tax base in connection with cross-border payments of interest? This matter is discussed in section 3.5 below.

In discussing these important issues, this chapter seeks to emphasize the competing considerations that could be taken into account to prevent erosion of the tax base while ensuring availability of credit to support and grow business activities.

3.1 Determining whether a taxpayer has excessive debt

Tax laws in a country generally do not — indeed, cannot — forbid an enterprise from having an excessive level of debt, however that limit may be defined. Rather, other government agencies may impose (and measure whether an enterprise exceeds) acceptable levels of debt.

Tax rules, however, frequently limit the amount of interest that may be deducted by an enterprise in determining its taxable income. These limitations are valuable, because they backstop and help enforce non-tax rules that restrict excessive debt. Moreover, they prevent taxpayers from incurring so much debt that the relevant tax base is eroded.

Taxpayers may argue that the tax law should not limit interest deductions; as long as the taxpayer is compliant with non-tax rules establishing the level of debt that can lawfully be incurred (and any prudential limitations imposed by lenders or others), then the interest expense incurred is a reasonable business cost and should be deductible in determining taxable income. But tax laws often set limits on deductible expenses as a matter of tax or public policy; examples include deduction limitations for entertainment, advertising and highly compensated personnel. In similar fashion, tax laws sometimes allow exceptional deductions (for research and development or the purchase of capital equipment) as a statement of policy.

It is consistent with the use of tax rules as an instrument of policy to impose limitations on the deductibility of interest when that interest is determined to be "excessive." These tax rules work in parallel with the non-tax rules that limit the amount of debt an enterprise may incur when the company is formed or at particular times after formation.

In order to determine whether an enterprise has "excess" interest, authorities typically consider one or both of the two measurements discussed in sections 3.1.1 and 3.1.2 below.

3.1.1 Debt/equity ratios

The most frequently adopted measure for whether an enterprise has a reasonable amount of debt is the debt/equity ratio of the enterprise. This is frequently expressed as a fixed ratio; for instance, an industrial company may be required to have a debt/equity ratio no higher than 3:1, while a financial institution may be required to have a debt/equity ratio no higher than, say, 6:1. There is an admittedly arbitrary element in using a test involving debt/equity ratios, because there is no "correct" ratio for businesses. But standards can be identified by observing ratios found in a broad range of businesses.

The higher ratios customarily permitted for financial institutions arise because their assets are generally viewed as being more readily marketable. For instance, a bank may hold as assets loans or receivables for which there is an easily identifiable market and market price, in the event the bank needs to sell the assets to raise cash (assuming there is not a financial crisis). Furthermore, financial institutions are in the business of "intermediation," so borrowing is a fundamental part of the business model. An industrial company, on the other hand, may have plant and equipment as its major assets, which are more difficult to sell quickly. The higher debt/equity ratios for financial institutions are readily observable in the marketplace.

Tax rules may disallow interest expense that arises from a debt/equity ratio higher than the prescribed ratio. The fact that the taxpayer's capital structure appears to have excessive debt supports a conclusion that the related interest expense is "excessive" and should not be allowed as a deduction for tax purposes.

3.1.2 Interest as a share of a prescribed financial ratio

An alternative approach adopted by some countries is to disallow interest expense if the amount of interest exceeds a certain prescribed financial ratio. For instance, a taxpayer may be denied a deduction for the portion of interest expense (or, alternatively, in some countries, net interest expense) that exceeds a fixed percentage (for example, 50 per cent, or 30 per cent) of a prescribed financial measurement, such as gross income less certain expenses, or the familiar earnings before interest, tax, depreciation and amortization (EBITDA).

Some governments in developed countries are currently examining whether new ratios would be useful in testing for excessive interest. For instance, the ratio of debt to EBITDA provides information on the number of years that would be required for a taxpayer to pay off its debt if the borrower's cash flow were entirely dedicated to repayment. Therefore, this ratio could be a useful measure of the borrower's ability to repay the debt. Financial lenders sometimes use this ratio as a covenant.

Determining "excessive interest" by means of a financial ratio or by using the more traditional test of a debt/equity ratio are not mutually exclusive approaches. The United States of America, for instance, combines the two tests under section 163 (j) of the United States Internal Revenue Code. That provision, generally referred to as the "earnings stripping" provision of the Code, applies to United States companies that pay interest to foreign lenders, often related parties. A portion of the United States taxpayer's interest expense is disallowed if the taxpayer breaches a debt/equity limitation and also the interest expense exceeds 50 per cent of adjusted taxable income.

3.1.3 Considerations in selecting a tax test for "excessive" interest

Both of the above-mentioned approaches for determining whether a taxpayer has excess interest expense that should be disallowed are fully consistent with international norms. Both approaches have strengths and vulnerabilities.

3.1.3.1 Debt/equity ratios

Balance sheet calculations: Debt/equity ratios are typically determined by examining a taxpayer's financial balance sheet. For larger companies, and companies that are publicly traded, such a balance sheet is often regularly available. For smaller companies, there may not be a need (other than for purposes of this tax rule) to create such a balance sheet.

This approach offers ease of administration, but raises important questions.

Under financial accounting, the equity of an enterprise is often based on historical measures, such as the initial equity investment plus retained earnings. This may undervalue the asset side of the enterprise. For instance, if the enterprise has assets that have appreciated in value, or if the enterprise has substantial goodwill, then the ratio of debt to equity may be overstated if the debt is measured at current values but equity is measured based on historical data or pursuant to a formula.

On the other hand, if the enterprise seeks to measure its equity on a fair market value basis, that valuation can be costly and complicated. Valuations also potentially create controversy between the taxpayer and tax authorities.

Fluctuating interest rates: Determining whether an interest deduction is allowable based on compliance with a maximum debt/equity ratio has one interesting and often overlooked shortcoming: the approach does not take into consideration the rate of interest paid on the debt. And yet, the interest rate can be keenly important in determining whether a particular amount of debt is "reasonable" or "excessive."

Specifically, in a low-interest rate environment, an enterprise may be able prudently to carry a higher level of debt than it could in a higher interest rate environment. For instance, the amount of income required for a company (or an individual) to comfortably support a loan may be very different based on whether the loan carries an interest rate of 4 per cent or an interest rate of 12 per cent.

Interestingly, countries have been reducing the levels of debt for which interest is deductible in recent years, even though interest rates have fallen and therefore the amount of interest required to carry a fixed amount of debt has likewise fallen. These reductions are sound only if the consensus view of the maximum amount of appropriate interest expense has declined even more sharply than the decline in interest rates.

Financial institutions: One challenge in determining appropriate debt/equity ratios in the case of financial institutions is the fact that such institutions differ significantly in their business models. These differences arise with respect to both funding (for example, banks that rely on deposits versus banks that rely on short-term borrowing in the commercial paper markets) and the assets in which they invest (for example, readily marketable securities or credit card receivables versus capital goods leased to customers). These differences in funding and in assets are reflected in the marketplace; different financial institutions have significantly different debt/equity ratios.

For a tax rule, this creates the challenge of whether to try to apply a single rule to all institutions (for example, a permissible ratio of 6:1 or 3:1) as a bright-line test, or whether to seek to permit different ratios based on different business models.

Determining the disallowed interest: A mechanical, but sometimes challenging, issue is how to determine the amount of interest that should be disallowed in the event a taxpayer exceeds a permissible debt/equity ratio. Presumably, the best approach is a form of proration, in which interest is disallowed based on the degree to which the enterprise exceeds the debt/equity limitation. But that test may be easier to describe than to apply.

3.1.3.2 Prescribed financial ratios

As an alternative to capping the allowable interest expense based on a ratio of debt to equity, some countries limit deductible interest to a stated percentage of the enterprise's earnings before tax, or other financial measurements. As with a measurement based on a debt/equity ratio, this approach has both strengths and weaknesses.

Base erosion: The approach has one primary virtue — it directly limits base erosion. A taxpayer cannot deduct interest in excess of the limitation amount. By contrast, a test that uses debt/equity ratios has only an indirect limitation on base erosion. For instance, depending on interest rates, two enterprises with the same, permissible debt/equity ratios will have different levels of interest expense — and one enterprise's deductible interest expense may be much higher than the other enterprise's level of interest expense.

The approach does not ensure that every enterprise will have positive income and pay taxes; the enterprise may be limited in its interest deduction but have other expenses that generate a loss, or a low taxable income. If the concern is that an enterprise may have excessive debt and excessive interest expenses that improperly erode or reduce the tax base, however, then this approach tackles the concern directly.

Fluctuating interest rates: Unlike limitations based on debt/equity ratios, a tax rule that denies (or defers) interest deductions based on a prescribed financial ratio automatically causes taxpayers to adjust their behaviour as interest rates fluctuate. This approach creates positive incentives for an enterprise to reduce its debt and accompanying interest expense when interest rates are rising. In this way, such a rule reinforces the goal of non-tax regulations that generally seek to drive an enterprise to reduce its debt level in such a situation.

Disallowed interest expense: In the case of a rule that disallows interest in excess of a certain prescribed financial measure, determining the disallowed interest is generally easy — it is the amount of interest expense in excess of the limitation.

3.1.3.3 Net interest or gross interest? Net debt or gross debt?

One important issue is veiled in the discussion above: in seeking to determine whether a taxpayer has excessive interest, such that some portion of the interest expense should be disallowed,

- Should the debt/equity test be based on gross debt (treating cash as an asset) or net debt (such that gross debt is reduced by cash); and
- Likewise, should the calculation whether an enterprise incurs interest expense in excess of a prescribed limitation be made on the basis of gross interest expense or net interest (gross interest expense minus interest income)?

There is, of course, no single right answer. And both approaches are readily administrable, since the data required to apply either approach lies in the financial statements and tax return information.

There are differences in the two approaches, however. For instance, a taxpayer may have high debt, but also high cash balances. Should interest payments on the debt be viewed as excessive and base-eroding, or does the fact that the company has available cash (which may be earning interest income) dampen any tax concern about base erosion?

The key point for tax administrators and taxpayers to recognize is that the question whether to adopt a test that uses gross debt and gross interest or net debt and net interest expense will have a major impact on what ratios or financial limitations should be adopted.

3.1.3.4 Tax treatment of disallowed interest

Assuming that a taxpayer has "excess" interest in a taxable year, the question arises whether the excess amount should be permanently disallowed as an interest deduction, or whether the interest should be carried forward and allowed as a deduction in a future year, when the taxpayer fully satisfies the limitations on interest expense.

Because of business cycles, some measure of carry-forward may be appropriate. The interest expense would be allowable in the future year only to the extent the enterprise incurs interest expense in the future year that is less than the amount otherwise allowable in that future year. Such a carry-forward rule would, of course, create administrative challenges for both government tax examiners and taxpayers.

In the event there is not a carry-forward rule, then a question arises as to how to characterize the disallowed interest payment. Should the payment be treated as a dividend in the current year? If so, would the applicable withholding tax be the rate of withholding on dividends, rather than the rate on interest? What is the tax impact of the recharacterization in the recipient's country?

These issues can all be answered, but they require that explicit rules be issued in order to minimize tax disputes.

3.1.3.5 Summary

As a matter of policy, it is appropriate — and consistent with international norms — to deny a deduction for interest expense that is "excessive" by some measure. This tax policy parallels and reinforces non-tax limitations on the amount of debt that an enterprise may incur. There are two primary methods for determining whether interest is excessive: measuring the debt/equity ratio, or measuring the interest expense as a percentage of some financial measure such as pre-tax income. Each method has strengths and weaknesses, but each approach can be usefully adopted.

3.2 Interest allocable to exempt or deferred income

In addition to a disallowance of interest on excessive debt — however "excessive" may be defined — a related issue arises in connection with income that is either exempt from taxation or on which the tax is deferred. The issue arises most frequently when a taxpayer earns income sourced outside of the home country and the income receives favourable tax treatment in the home country.

This is a challenging topic that could usefully be discussed at length elsewhere; in many countries, there has been a long, high-octane debate on how best to allocate interest that may be attributable to deferred or exempt income, especially foreign source income such as dividends from foreign corporations. But at least a few concerns need to be noted.

The issue is not limited to developed countries. It affects developing countries as well:

- For instance, many developing countries tax their multinational corporations on worldwide income. But, income earned outside the home country may be deferred for a period of time, before home country tax is imposed. If a resident company incurs interest expense within its home country, should some portion of that expense be allocated to the investments and income earned from those investments outside the home country? And, if so, should a portion of the current interest expense be disallowed (or deferred) until the foreign income is taxable in the home country? If the answer is yes, how should the allocable expense be determined?
- In countries with a territorial tax system, where active earnings outside the home country of a taxpayer are not subject to home country tax, a similar issue arises. Should some portion of the home country interest expense be allocable to this exempt income and disallowed permanently?

The concern for developing countries will increase as more multinational corporations grow within developing countries and outbound investment from developing countries increases. In the near future, existing multinationals resident in developing countries will be joined by a dramatically increasing number of home country peers.

In determining how to allocate interest expense to outbound investment, countries have struggled to balance appropriate tax rules with a public policy desire to encourage and support home country champions as they invest abroad. As a result, there is no single approach that has garnered consensus support.

There are several options:

(a) Countries can impose no (or very modest) limits on the deduction for interest expense on debt incurred to support outbound investment. This approach is not "pure," but garners support on the well-grounded theory that a home country benefits when companies headquartered in that country have strong investments outside the country. Having the headquarters of a multinational enterprise (MNE) in a country typically brings with it well-paying jobs for executives, business opportunities for suppliers, philanthropy and other benefits. But — and this is an important caution — such an approach can be viewed as favouring MNEs over companies that operate purely domestically, since the rate of tax paid on the foreign income may be lower than the rate incurred by domestic companies that earn all of their income in the home country;

(b) Countries can impose a proxy charge to account for interest expense that may be attributable to exempt or deferred income. For instance, some countries exempt certain foreign income from home country tax but limit the exemption to, say, 95 per cent of the income. Local country tax is imposed on 5 per cent of the income as a proxy for disallowing expenses attributable to earning that foreign income. This approach is applied by several countries with respect to dividends paid by non-resident corporations to resident corporations that hold a substantial interest in the foreign corporations;

(c) Finally, a country may seek to allocate and apportion interest expense between home country income (which currently is typically subject to full tax) and income that is exempt or deferred. The interest expense attributable to that exempt or deferred income will, likewise, be denied as a deduction or the deduction will be deferred until the income is taken into account for tax purposes.

There are precedents for each of these options, but no clear consensus on the most appropriate approach. As corporations resident in developing countries increasingly engage in outbound investment, each country will need to determine which rules for interest allocation best serve its national development goals and its sense of fairness.

3.3 Is all interest equal?

As discussed previously, debt (and the associated interest expense) may arise from any of several different business needs:

- A need for initial capital to form the business, or to fund subsequent expansion, in which case the debt and interest can be viewed as a substitute (or companion) for equity;
- Debt may be incurred for a specific purpose, such as a mortgage obtained to purchase a piece of real property or a loan associated with the purchase of a piece of capital equipment. When a business obtains goods from a supplier on extended terms, the business may pay interest if the payment is delayed beyond a certain period (such as 30 or 60 days). In this case, the debt can (sometimes) be traced to the specific asset, and the asset often serves as security for the debt;
- Debt may be in the form of a line of credit, or other generalized borrowing, as a source of funding for the ongoing operations of a business. This debt may, of course, be closely analogous to debt incurred as part of the initial capital of the business, or debt incurred to purchase property or equipment.

It is frequently said that "money is fungible," which suggests that all debt is equivalent, if not fungible. Under this view, all interest expense should be considered as a single item of expense for determining whether some or all of that interest should be deductible in determining taxable income. But this view is not the only approach that may be adopted.

For instance, tax rules may treat debt incurred on initial capital differently (and, generally, less favourably) from debt incurred for the ongoing operations of a business, either for the purchase of goods or services or for a line of credit. If an enterprise is deemed to have excess debt related to its formation (for example, a debt/equity ratio that exceeds a stated level), then some of the interest on that debt may be disallowed. But, interest attributable to specific purchases of goods or services would be viewed as ordinary business expenses and fully deductible.

In determining whether to treat all interest alike (as a single expense item) or whether to treat some interest differently from other interest in terms of deductibility, there are several factors to consider:

(a) *Ease of administration*: Treating all interest expense as a single item is generally easier for both taxpayers and tax administrators. Otherwise, taxpayers and tax officials must analyse the sources of debt and separate interest payments into different categories for purposes of tax deductibility. Further, if interest expenses are treated differently for tax purposes, depending on the source of the debt, taxpayers will be encouraged to favour certain kinds of debt (for example, debt associated with the purchase of specific real property, equipment or goods) and disfavour other kinds of debt (most frequently, debt that would be a substitute for equity);

(b) *Perceptions of "base erosion"*: On the other hand, some kinds of debt may be perceived as more susceptible to abuse than others. As discussed further in section 3.4 below, and previously in section 1.3, an investor in a company may invest $1,000 of equity and no debt, or some combination of equity (say, $400) and debt ($600). Interest paid on this initial debt — which is often, although not always, paid to a related person — may be viewed as being created artificially and seen as more likely to be an improper "base erosion" payment than interest paid to an unrelated party in connection with a mortgage on real property;

(c) *Policy*: Allowing full deductibility for interest on purchases of real property, capital goods and supplies encourages business operation and expansion. The same argument could be made for allowing full deductibility of interest paid on initial debt investment into the capital of a company, but the argument is generally more immediate and persuasive in the case of debt related to ongoing operations.

In weighing these factors, different countries reach, and will continue to reach, different conclusions.

3.4 Interest paid to related parties

The most controversial — and most emotional — issue regarding the deductibility of interest payments arises in connection with the payment of interest to related parties. The example of Acme Corporation, Beta Corporation and Charlie Corporation was outlined above. Although interest payments to related parties most frequently arise in connection with the initial formation of a company — and the decision of how much investment to make with equity and how much (if any) to make with debt — the issue of related-party debt arises in other situations as well. Related parties are often suppliers and customers of one another, and payments in connection with their transactions may incur interest charges. Additionally, a related party may serve as a source of regular funding, either through fixed loans or a line of credit.

Related-party payments are a concern only when the related party receiving the interest is outside the country of the party that is paying the interest. If the two related parties are in the same country and each company is subject to local country tax, there should be no concern. When the related party receiving interest is located outside the country of the interest payer, however, the debt and associated interest payments are viewed as a major risk for improper "base erosion." This suspicion arises for several reasons:

(a) Although the decision on whether (and how) to extend a loan to a related party can be complex, as discussed previously, the related parties can work together to try to fashion a loan that has the most favourable tax result. In most cases, the payment of interest is more tax-advantaged to the borrower and lender, considered together, than an investment of equity. In some cases, the payment is very favourable, for instance, when the interest is deductible to the borrower and subject to low or no tax in the hands of the lender;

(b) Related-party loans are not subject to market discipline, in the way that a debt from an unrelated party would be. The amount of the loan may be in excess of the amount that a third party would be willing to lend, or the loan may be for an extended period or subject to fewer conditions than a third party would demand;

(c) Importantly, there can be transfer pricing concerns with respect to the rate of interest paid and other terms of the loan.

Recognizing these concerns does not, however, suggest a single answer regarding whether interest paid on related-party debt should be subject to different (presumably, less favourable) tax terms than interest paid on debt to parties that are not related.

From the perspective of the country in which the interest expense arises, the key question is whether it is relevant that the recipient of the interest payment is related to the payer. The answer may be yes:

- There is a potential for transfer pricing abuse, and disallowing some or all of the interest paid to a related party is a preventive means of addressing that potential abuse;
- Even if the amount of interest paid is appropriate (and would be allowed if paid to a third party), there is a concern that the interest may not be properly taxed in the hands of the recipient. To prevent base erosion on a global basis, the country of the payer may limit the interest deduction.

On the other hand, treating related-party interest less favourably creates costs. In particular:

- As discussed previously, there are non-tax reasons as well as tax reasons why an investor may choose to invest partially with debt and not wholly with equity. If tax rules impose additional costs on the use of debt, that may affect investment decisions; not all investors will be willing to bear those additional tax costs;
- Enforcing special rules on related-party lending creates administrative costs because it can be difficult to define what a related party is for purposes of the rule. For instance, a nominal lender may be an unrelated party; however, the loan would not have been made but for a deposit with the lender from a party related to the borrower. Or a party related to the borrower may offer a guarantee to the lender; such guarantees vary considerably, from formal and binding agreements to "comfort letters" that have no legal consequences. If special rules are applied to related-party lending, there will need to be anti-avoidance rules to prevent abuse.

Another factor to consider is whether the tax administration of a country can minimize the risk that related-party lending would abuse the tax system. The risk of related-party lending being on non-arm's length terms can be addressed by stronger transfer pricing enforcement, including the possibility of published permissible lending rates, although efficient and effective application of transfer pricing rules is a challenge for all tax authorities. Excessive base erosion can be addressed through limits on the deductibility of all interest expense, whether paid to a related party or unrelated parties, insofar as the rules are consistent with any applicable treaty limitations.

At bottom, the question for tax administrators is whether the potential abuse that can arise from related-party lending is sufficiently great that it warrants special rules, or whether the potential concerns can be minimized through other, less restrictive means.

3.5 Withholding taxes

Developing countries traditionally favour withholding taxes on payments of interest to non-resident lenders. The withholding tax is perceived as a tax cost to the non-resident lender, with the benefit of raising tax revenue that partially offsets the tax cost of the local interest deduction.

An example may be useful:

- Dart Corporation, resident in Country A, needs to borrow $1,000. It obtains a loan from Extra Corporation, resident in Country B, for $1,000 at an interest rate of 8 per cent, or $80 annually;
- Dart pays the $80 to Extra, subject to a 10 per cent withholding tax. Extra will receive $72 in cash, plus a credit for the $8 that Dart has withheld and remitted to the Country A tax authorities;
- Dart deducts the $80 worth of interest in determining its taxable income. The tax rate in Country A is 25 per cent, and Dart has sufficient income to fully benefit from the $80 deduction. Dart saves $20 in Country A tax because of the tax deduction;
- Country A receives $8 in withholding taxes on the payment to Extra, but gives up $20 in tax revenue it otherwise would have received from Dart. There is a negative tax rate arbitrage to the Country A treasury from this transaction, but the withholding tax has reduced the revenue loss from $20 to $12.

Historically, it was generally believed (and probably true) that most lenders could absorb the withholding tax as a credit against home country taxes that the lender would otherwise pay. Therefore, the withholding tax — $8 in our example — did not increase costs to the lender (or the interest rate that the lender would charge the borrower); rather, the economic burden of the withholding tax was transferred to the treasury of the country in which the lender was a taxpayer. In the example above, Extra would claim a foreign tax credit in Country B for the $8 in withholding taxes it had paid to Country A. Extra's total tax cost to Countries A and B would be unchanged but country B would receive $8 less revenue.

This traditional perspective has been eroding in recent years. Lenders are often able to minimize the taxation of interest income, such that withholding taxes are real costs. Accordingly, lenders regularly request a "gross up" for any taxes withheld, so that the borrower bears the cost of the withholding tax in the form of a higher interest charge.

The higher interest charge is, of course, generally tax deductible, which has the effect of increasing the tax deduction available to the borrower and reducing the borrower's home country taxes.

The decision whether to impose a withholding tax on cross-border payments of interest, and at what rate to impose withholding, requires juggling several factors.

Availability of local funds for lending: If a country has sufficient funds within its jurisdiction to meet all reasonable needs for borrowing, then it is more beneficial to impose a withholding tax.

When a company borrows funds from a lender within the same country, the interest paid on the loan is normally not subject to a withholding tax. In the few countries that impose withholding on domestic payments, the withholding tax is generally treated as a prepayment of tax that will be calculated on a net basis. The lender receives the interest income and will be subject to tax on a net basis. The ready availability of local funds for lending sets a market rate of interest that applies equally to lenders from offshore. Any withholding tax and gross-up requirement will not affect the economics of the transaction because the borrower has local lenders available as competition to the offshore lender.

On the other hand, if a country needs investment capital from offshore, a withholding tax will likely increase local borrowing costs, and a gross-up provision will increase that cost further. To return to the example, if Extra Corporation insisted on a gross up for its loan, Dart Corporation would remit $80 to Extra, plus $8.89 in withholding taxes to the local authorities. The gross up would yield an additional $0.89 in taxes to Country A, but at a cost of an additional tax deduction of $8.89 for Dart Corporation and a tax cost to Country A of 25 per cent of that amount, or $2.22.

Determining an appropriate withholding tax rate: When the local income tax rate (25 per cent for Country A in our example) is higher than the withholding tax rate (10 per cent in the example), a tax rate arbitrage arises that reduces tax revenues. It is natural to assume that the best way to avoid the arbitrage is to set the withholding tax at the same rate as the local income tax rate.

There is another perspective, however: the withholding tax rate arguably should be set at a level that mirrors the tax revenues that would be raised if the lender were a domestic company. In that case, a fairly low withholding tax rate may be appropriate as a proxy for a tax on net income.

The lender will often be a financial institution, which has an interest expense of its own associated with raising the funds that are lent to the borrower. In the example, assume that Dart Corporation borrows the $1,000 from Forest Corporation, a financial institution in Country A.

Because financial institutions often have high leverage ratios (for example, 6:1, or even 20:1), Forest Corporation will have substantial interest expense of its own arising from the $1,000 that it raised for the loan to Dart. This interest expense will reduce the net income taxable on the $80 of interest income that it received from Dart. For instance, Forest may have net taxable income of only $8 ($80 of interest income, reduced by an assumed $72 of interest expense) from the Dart transaction. At a 25 per cent income tax rate, Forest will pay tax of $2 on its net income.

In such a case, even a 10 per cent withholding tax (which yielded $8 on the interest payment to Extra Corporation) would appear too high compared with the tax revenue derived from Forest Corporation on its domestic loan to Dart. When the corporate income tax in Country A is imposed on the small net interest income of Forest Corporation, the total tax revenue raised may be equivalent to a withholding tax on cross-border interest of only 1 or 2 per cent, well below the withholding tax rate generally imposed on cross-border interest.

Summary: One way in which to address the difficulty of determining an appropriate withholding tax rate on cross-border payments of interest is to adopt differential rates, and this is often the approach followed in tax treaties. When the lender of a loan is a financial institution, a treaty may impose lower withholding tax rates than when the loan is extended by a non-financial institution that may not have significant interest expense of its own. The challenge for a developing country in considering withholding taxes on interest is to balance the desire to minimize tax costs from the tax deduction for interest against the need to ensure that any withholding tax does not increase costs (through a gross-up or higher interest rates) or limit the availability of needed investment.

4. Branch operations

The discussion above generally assumes that taxpayers are conducting business through separate corporations. In such a case, each corporation keeps its own books and records, and each corporation is expected to deal at arm's length with all related entities.

In many cases, multinational operations are conducted through branches, not separate corporations. Many of the tax issues relating to branches are substantially identical to the issues that apply to corporations. Interest expense is one issue where there can be differences.

Under Article 7 of most treaties based on the United Nations Model Double Taxation Convention between Developed and Developing Countries[3] (United Nations Model Convention) or the

[3] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

OECD Model Tax Convention on Income and on Capital[4] (OECD Model Convention), a corporation that has a taxable presence (a "permanent establishment," or PE, under Article 5) in another country is taxable in that other country on the profits "attributable to" the PE, determined by treating the PE as if it were a distinct and separate legal entity from the rest of the enterprise, engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE. The PE will maintain books and records of its income and expenses.

With respect to interest expense, however, there is some inconsistency:

- In some cases, the PE calculates its interest expense as if it were a separate legal entity from the parent, based on its own books and records;
- In other situations, however, the PE determines its interest expense as a share of the total interest expense incurred by the enterprise of which it is a part. Article 7 (Business profits) of the United Nations Model Convention specifically provides that, except in the case of a bank, a PE will not be allowed a deduction for any interest that is notionally charged to the PE by the head office (nor will the PE be considered to earn any interest that it notionally charges to the head office or another branch). Instead, the PE will be entitled to a deduction for its "allocable share" of interest expense incurred by the enterprise as a whole.[5]

If a branch is allocated a share of the interest expense incurred by the enterprise to which it belongs, that amount may, of course, be greater or smaller than the amount that would be determined by treating the branch as a separate entity. The argument in favour of

[4] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

[5] For more information on this issue, see paragraph 3 of the Commentary on Article 7 of the United Nations Model Convention; and Jinyan Li, "Taxation of non-residents on business profits," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (New York: United Nations, 2013), available at http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf.

allocation, however, is that the PE is not a separate legal entity and its assets and liabilities are therefore not separate from the assets and liabilities of the larger enterprise, at least in terms of exposure to creditors.

It is important for a country to make clear how interest expense of a PE will be determined in order to minimize tax disputes.

5. Relevance of tax treaty provisions

In fashioning rules that affect the taxation of interest to a recipient or that limit the availability of deductions for interest expense, countries do not have unfettered discretion, at least where they have entered into tax treaties with other countries. In the case of a treaty, countries mutually limit their taxing authority in order to foster trade and economic growth.

For instance, Article 11 of the United Nations Model Convention sets forth principles regarding the tax treatment of interest "arising" in one State and paid to a resident of another Contracting State. Article 24 (4) of the United Nations Model Convention deals with the elimination of tax discrimination, including with respect to the deductibility of interest paid by an enterprise of a Contracting State to a resident of the other Contracting State.

The parameters of Articles 11 and 24 are often debated, and occasionally these provisions give rise to legal disputes. But the basic concepts of these treaty provisions are clear and do limit some actions that a country may wish to take with respect to the taxation of interest paid to or incurred by non-residents.

6 Conclusion

Loans and the free flow of credit are vital to international business and to economic growth. Interest payments are an ordinary business expense and generally will be deductible by the borrower in calculating both financial statement income and taxable income. The interest income generally will be taxable income to the lender.

However, as the OECD project on BEPS has recognized, debt can be a strong tax-planning tool. In some circumstances, interest payments may be considered excessive, to the extent that the relevant tax base is improperly eroded. Tax professionals have struggled for many years to determine when interest payments are excessive, such that tax deductions for those payments should be limited. The OECD project on BEPS and the work of many countries seeking to apply the lessons of this project promise to shine new light on this continuing challenge.

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Chapter V

Neutralizing effects of hybrid mismatch arrangements

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The use of hybrid mismatch arrangements is one of the ways in which large multinationals can end up effectively paying lower tax rates than the small domestically bound enterprises that multinationals often compete with. This is a major concern for most countries, including developing countries. Hybrid mismatch arrangements are not new in international tax.[1] Conceptually, it has always been possible to engage in such arrangements for the purpose of minimizing tax. What has changed is the proliferation of hybrid mismatch arrangements, the ease with which they can be achieved and their comparative importance. This change is largely a function of the increase in electronic commerce and globalization. Such arrangements are not "wrong" per se — they are simply a function of two countries having, typically unilaterally, decided not to tax a particular cross-border dealing or give some other favourable tax effect (such as a deduction). What might be considered "wrong" is the manner in which tax advisers and multinationals have in recent years aggressively sought out and exploited such arrangements.

Before discussing manners in which "hybrid mismatch arrangements" can be "neutralized," it is necessary to identify exactly what such arrangements are. This is not an easy task because the phrase hybrid mismatch arrangement is not logically bound from a tax perspective and so it is only possible to discuss a generally understood meaning.[2] It

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[1] See Nathan Boidman and Michael Kandev, "BEPS Action Plan on Hybrid Mismatches: A Canadian Perspective," (2014) Vol. 74, *Tax Notes International,* 1233.

[2] Organisation for Economic Co-operation and Development, OECD/G20 Base Erosion and Profit Shifting Project: *Neutralising the Effects of Hybrid Mismatch Arrangements — Action 2: 2014 Deliverable (*Paris: OECD, 2014) (OECD Action 2 — 2014 Deliverable), available at http://www.oecd.org/

is part of the purpose of the present chapter to identify that meaning and relate it to the fundamentals of income taxation.

The "hybrid" part of the phrase means that, in a particular case (taken to be an "arrangement"), two countries do not agree on the classification or characterization of some feature of the arrangement that is fundamental for income tax purposes. From this perspective, all of the fundamentals of income taxation can give rise to hybrid arrangements. In order to understand the scope for hybrid arrangements, it is thus necessary to investigate the fundamentals of income taxation.

The "mismatch" feature is different and suggests that the different ways in which two countries view the particular arrangement produce some sort of inconsistent outcome when looked at as a whole. From this perspective, not all hybrid arrangements give rise to mismatches, because in some cases the differing views of the two countries do not produce an inconsistent outcome. One of the complexities in seeking to establish rules to neutralize hybrid mismatch arrangements is identifying which arrangements give rise to inconsistent outcomes. By the very nature of a hybrid mismatch arrangement, this means that the countries in question need to look closely at how the tax law in the other country applies to the arrangement. Historically, countries (especially source countries) have not looked closely or sought to understand or apply the tax law in another country interested in a cross-border arrangement (see section 4 below). One core issue is whether it is realistic, even presuming high levels of cross-border cooperation between tax administrations, to believe that tax

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tax/beps-2014-deliverables.htm, paragraph 41, defines a "hybrid mismatch arrangement" as "an arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more jurisdictions to produce a mismatch in tax outcomes." Like the earlier definition in OECD *Public Discussion Draft, BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* (Paris: OECD, 2014) (OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues), available at http://www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf, paragraph 17, this is limited to "entities" and "instruments." Further, while no longer referring to "payments," subsequent discussion in the OECD Action 2 — 2014 Deliverable suggests this is a further requirement.

administrations, especially those of developing countries, can or will effectively interpret the tax laws of other countries.

Mismatches arising in the context of a hybrid arrangement may be one of two basic types. A mismatch may be harmful to the tax outcome of the taxpayer (when compared with a consistent treatment by both countries) or it may be beneficial to the taxpayer. Historically, tax treaties have, in a number of ways, dealt with styles of mismatch that are harmful to taxpayers. These include the reconciliation of residence of the taxpayer, often the source of income and transfer pricing adjustments (through corresponding adjustments) and even the provision of foreign tax relief (where otherwise both source and residence countries would exercise full taxing rights). The primary purpose of tax treaties has been to relieve international double taxation in order to facilitate cross-border investment.[3] In the face of globalization, countries are more clearly than ever in a market place for attracting investment, a market place that demands relief from double taxation, which is reflected in the proliferation of unilateral measures for such relief.[4] In this way, globalization fundamentally challenges the necessity of tax treaties.

Current concerns with hybrid mismatch arrangements are with arrangements that are beneficial to taxpayers. While mismatches might also be harmful to taxpayers, it is likely that a well-advised taxpayer will plan to avoid such mismatches. As Action 2 in the Organisation for Economic Co-operation and Development Action Plan on Base Erosion and Profit Shifting (OECD Action Plan on BEPS)[5] highlights, the focus

[3] For example, see Hugh J. Ault, "Some Reflections on the OECD and the Sources of International Tax Principles," (2013) Vol. 70, *Tax Notes International,* 1195.

[4] These unilateral measures involve not only foreign tax relief as a residence State, but most importantly for present purposes the reduction of source-State taxation to realistic levels, for example, with respect to outbound withholding taxes. Many developing countries now have outbound domestic withholding taxes that are close to those that traditionally would have been agreed only under a tax treaty.

[5] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) (OECD Action Plan on BEPS), available at http://www.oecd.org/cctp/BEPSActionPlan.pdf. Action 2 calls for the development of "model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effect … of hybrid instruments and entities."

of current concerns (and the present chapter) is on multinationals that intentionally plan for hybrid mismatch arrangements to reduce their overall tax liability. Action 2 essentially focuses on double non-taxation of income and claiming deductions simultaneously in more than one country against different items of income, that is to say, the OECD sees hybrid mismatch arrangements as essentially involving tax base issues.[6]

The tax results from use of hybrid mismatch arrangements are often comparable to those involving the use of tax havens and there is thus a clear synergy with the OECD project on harmful tax competition. The difficulty with hybrid mismatch arrangements is that they can and most commonly do involve countries that are not classically tax havens. Indeed, they commonly involve countries that are parties to a tax treaty, reinforcing the fact that the fundamental purpose of tax treaties has historically been to relieve international double taxation and not prevent international double non-taxation. Hybrid mismatch arrangements that are beneficial for taxpayers seek to simultaneously erode both taxation in the source State and taxation in the residence State. Accordingly, the present chapter is closely related to other chapters in the present publication.

The present chapter discusses hybrid mismatch arrangements in four sections. The first section seeks to determine the scope of the issue by conceptualizing it. It does so by identifying income tax fundamentals and highlighting how they can give rise to mismatches across borders. Some simplified examples are used in the discussion to illustrate potential taxpayer benefits from hybrid mismatch arrangements. In this way, the present chapter seeks to explain as simply as possible why mismatches arise and their possible range.

The second and third sections look more particularly at how the OECD proposes to deal with such arrangements under Action 2. The second section identifies which types of mismatches outlined in the first section are the subject of Action 2 and which are not. The third section considers how recommendations in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues propose to deal with the targeted mismatches. In particular, it assesses the practicality

[6] See OECD Action 2 — 2014 Deliverable, supra note 2, 43, and particularly the references to "payments" being "included," or "deductible."

of implementing the OECD proposals, especially from the perspective of a developing country.

The fourth section returns to the basics discussed in the first section and considers whether there are simpler steps that countries, especially developing countries, may take to alleviate the problems caused by hybrid mismatch arrangements. In particular, the OECD recommendations require an unprecedented level of integration between countries' tax systems and laws. Discussion in the section considers whether the problem of hybrid mismatch arrangements can be dealt with in ways that require lower levels of integration. The focus is on two anti-base erosion measures that a source State can take, but measures that may be taken by a residence State are also considered. Inevitably, there is no "one-size-fits-all" solution to the problems of hybrid mismatch arrangements and countries must make their own decisions based on their own capacity and economic needs.

1. Determining the scope of the problem

1.1 Income tax fundamentals

There are three essentials that all income tax laws incorporate and each of them (persons, earning activities and income) demonstrates a number of fundamental features that income tax laws must detail. Income tax laws are personal taxes and so must identify the "persons" to whom they apply. Persons are taxed with respect to their "income." However, not all amounts that "come in" or which may be allocated to a person fall within the ambit of a typical income tax. Inevitably (and through differing legislative mechanisms), only income that can be related to an "earning activity" (an activity that is not private) falls within the scope of an income tax. Within the scope of an earning activity, certain amounts positively enter into the calculation of income and some amounts are entered negatively, that is to say, for most countries income is a net concept (although there are exceptions, for example, sometimes for employment income).

All income tax laws must identify what constitutes a person (a tax subject or at least things that can be attributed to earning activities and income). As with many other areas, here an income tax law may present two choices: it can either follow general legal classification (for example, individuals and corporations as legal persons) or a disjointed approach can be adopted. Under the disjointed approach (which most countries follow), a "person" for income tax purposes might include some entities that are not persons for general law purposes or exclude as a tax person some entities that are persons for general law purposes. It is also possible for one person to be given two capacities for tax purposes, in which case the one person might be viewed as two persons for income tax purposes (such as the distinction between the personal capacity of a person and their capacity as a trustee of a trust). It is also possible for two or more persons to be given a single capacity for tax purposes, such as in the case of some tax consolidation regimes for group companies.

The rules that a country's income tax law adopts for identifying what constitutes a "person" must, in principle, be capable of characterizing every entity that is formed anywhere in the world. This is a function of globalization and the breaking down of trade barriers. It is possible for an entity formed anywhere in the world to do business in a particular country. So, as a source State, a country must be able to say whether the foreign entity is a tax person or whether the persons underlying the foreign entity are the tax persons. Similarly, globalization means that every resident of a country may invest in a foreign entity. Presuming the country taxes foreign source income of its residents, the country must be able to classify the type of foreign income derived from the foreign entity, and that will require a classification of whether the foreign entity is a person or not for tax purposes.

The various ways in which an income tax law may classify "persons" is fundamental to understanding the manner in which some hybrid mismatch arrangements operate, but there are other features of a person that can give rise to hybrid effects. In particular, an income tax law will characterize persons according to various types, for example, individual, partnership, trust or company. An income tax law will incorporate a situs test for persons, usually based on the concept of residence. An income tax law must also deal with the eventuality of a person beginning to exist and a person ceasing to exist. An income tax law might also identify the relationship of a particular person with another person or persons, such as in the case of related individuals, group companies or other closely held companies.

As for the activities through which income is earned, these are generally of three types: employment, investment and business, reflecting resources available for earning income. Income may be earned through the exclusive provision of labour — most employment falls into this category. Income may be earned through the exclusive provision or use of assets — often called "investment." Income may also be earned, in a myriad of combinations, through the use of labour and assets — most commonly referred to as "business." Just as it is possible that different countries classify "persons" differently, it is common for countries to classify earning activities differently. Further, earning activities also demonstrate some fundamental features. Earning activities must be allocated as being conducted by particular persons. These activities may be allocated a particular situs (often related to the location of the individual activities making up the earning activity). It may also be necessary to determine when an earning activity commences and when it ends.

Each earning activity constitutes the aggregate of the provision of resources on isolated occasions (transactions) within the scope of that activity. Thus, in the context of an employment, these are the occasions on which the individual renders services as an employee. In the context of an investment, it is the provision (transfer or use) of the investment assets. In the context of a business it is either or a combination of both.

Each isolated provision of resources (labour and assets) must be classified for income tax purposes and will demonstrate certain fundamental features. For example, in the context of the rendering of services, it will be necessary to identify the time when the services are rendered (usually during the period when the physical labour is performed) and where the services are rendered (usually where the individual is who is physically performing the labour or where the services are used or consumed).

The use of assets is more complex (than the rendering of services) and an income tax law is likely to have more detailed rules associated with assets. There is the need to identify what constitutes an asset (or two or more assets) for income tax purposes, including a negative asset in the form of a liability. There is also a need to classify different types of assets and liabilities, which can be important because different tax consequences may be attached to the holding and sale of different types of assets and income derived from them. Third, assets must be allocated to particular persons (for example, ownership) and the earning activities of that person. Fourth, an income tax law is concerned with movements in the value of assets, whether while held (for depreciation purposes) or at least when they are disposed of (for purposes of calculating gains).

"Income" is the return derived from the provision of resources in the context of an earning activity calculated for a particular period, usually the tax year, less any assets used in the provision. In the context of a realization-based income tax (in practice the residual basis of all income taxes) this means the netting of amounts paid against amounts received in the context of an earning activity.

Payments are the building blocks of the calculation of income and, as with other income tax essentials, payments must be identified and have certain fundamental features. A "payment" is broadly the bestowal of value by one person on another person.[7] The ways in which a person may make a payment reflect the resources available to that person, that is to say, the provision of labour, the use of assets, the ownership of assets or a combination thereof. A payment may be made by one person transferring an asset, including cash, to another person. There is also a bestowal of value when one person gives up rights (an asset) that they have against another person (a liability). So the reduction of a liability is also a payment. This type of payment involves the destruction of an asset by one person without the acquisition of an asset by another person. The third type of payment involves the opposite, where one person uses their resources to create an asset that becomes owned by another person, even though the first person never owned the asset created. The fourth type of payment involves the payer permitting another person to use an asset that the payer owns. The fifth type of payment is similar and involves one person providing services (labour) for the benefit of another person.

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[7] See OECD Action 2 — 2014 Deliverable, supra note 2, 21, which only provides examples of payments (and "includes" definition) and specifically excludes "payments that are only deemed to have been made for tax purposes and that do not involve the creation of economic rights between the parties." See OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, 45.

Often countries do not agree on the fundamental features of a payment and this disagreement gives rise to some common forms of hybrid mismatch arrangements. In particular, an income tax law must allocate payments to persons, earning activities, a location and perhaps to assets or liabilities. An income tax law must determine the quantum of the payment, especially when the payment does not involve a transfer of cash in the currency in which the tax base must be reported. An income tax law must determine the timing of the payment and, in particular, the tax period or periods in which the payment is to be recognized as having a tax effect. Finally, an income tax law often places critical importance on the character of a payment (not to be confused with its form), that is to say, a label assigned to it which is usually determined by reference to the reason why the payment is made. The character of payments is particularly important in the context of allocating taxing rights between countries, and the source of a payment is viewed as one of the characteristics of a payment.

1.2 Mismatches in respect of payments and the fundamental features of payments

Disagreement between two countries as to any of the fundamentals of income taxation discussed in the previous section may be exploited by taxpayers through the use of hybrid mismatch arrangements. However, as these fundamentals are cumulative in producing a tax liability, it is common that a mismatch with respect to one of the essentials may give rise to a mismatch with respect to another essential. For example, disagreement as to whom or what constitutes a person, may give rise to disagreement as to who owns an asset or who receives a payment with respect to use of the asset. Disagreement as to whether two persons are related may give rise to a disagreement as to the value at which a transaction between the persons should be quantified and the character of payments under it.

The reasons why countries disagree on the fundamentals of income taxation often pertain to one country accepting legal form and another adopting some type of substance approach, including one based on financial reporting (accounting standards).[8] The

[8] For a similar observation, see Stephen Edge, "Base Erosion and Profit

difference between following legal classification and adopting a disjointed approach for identifying persons was discussed above in section 1.1. Another common example involves disagreement as to whether a transaction transfers the ownership of an asset or not. At one extreme, a finance lease does not transfer legal ownership but might be considered in substance to do so. At the other extreme, a sale and repurchase agreement does transfer legal ownership but might be considered in substance not to do so. In the middle there can be legal mortgages (for example, securities lending arrangements) under which the legal title to an asset is transferred as collateral for a loan.

Most commonly (although not always) mismatches with respect to persons and earning activities (and the provision of resources) manifest themselves in mismatches in the fundamentals of a payment.[9] Therefore, the following discussion starts by considering how disagreement between two countries in the fundamentals of a payment may give rise to cross-border mismatch opportunities. This is done in the context of six examples. Subsequent subsections proceed to develop other examples demonstrating how mismatches in the fundamentals of a payment can be triggered by disagreement with respect to the identification of earning activities or of who or what is a person.

Example 1 is a simple illustration of a mismatch between two countries regarding whether a payment exists for tax purposes.

Example 1
Mismatch in identifying payment — Deduction but no income

Z, a resident of Country A, owes money to Y, a resident of Country B. Z enters into an arrangement with its creditors whereby part of the debt owed to Y is written off. Under the Country B tax law, Y can deduct the amount of the debt that is written off. Under the Country A tax law, Z is not required to report any income.

Shifting: A Roadmap for Reform — Tax Arbitrage with Hybrid Instruments," (2014) Vol. 68, No. 6/7 *Bulletin for International Taxation*, 318-20.

[9] As noted above, OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues and OECD Action 2 — 2014 Deliverable, supra note 2, focus on hybrid mismatch arrangements involving payments.

If the reduction in the debt is looked at in isolation, there is a mismatch that gives rise to a cross-border tax benefit (deduction in Country B) with no pick-up in Country A (no income). In many cases, such a scenario is not abusive, presuming that Z has unrelieved (or cancelled) losses in Country A. However, the mismatch can result in untaxed funds if, from a tax perspective, Z has managed to set off all of the negative results that gave rise to the arrangement against income. This income might be in Country A or elsewhere, for example, through carry back of losses or setting losses against income from other activities, including those of related parties.

In this example, Country B (country of creditor) sees value passing from Y (creditor) to Z (debtor) when Y forgives part of the debt. Country B also sees this "payment" as having a sufficient business purpose and grants a deduction for it. By contrast, Country A (country of debtor) does not recognize the payment received by Z in the form of a reduction in liability. The result is a cross-border mismatch. This example focuses on countries disagreeing as to the very nature of whether there is a bestowal of value (payment) that should be recognized for tax purposes. This case should not be confused with similar examples that focus on other income tax fundamentals, such as where both countries recognize a payment but characterize it differently, for example, Country A characterizes the forgiven debt as a payment of capital and does not tax it because Country A does not tax capital gains.

Example 2 is a simple illustration of a mismatch between two countries that recognize a payment, but disagree as to who (which person) should be treated as receiving it.

Example 2
Mismatch in recipient of payment — No income

Z, a resident of Country A, makes a payment that is deductible for Country A tax purposes. Country A considers that the payment is made to Y, a resident of Country B. Country B considers that the payment is made to X, a resident of Country A.

If the taxation of the recipient in their State of residence is looked at in isolation, there is a mismatch that gives rise to a cross-border tax benefit (deduction in Country A) with no pick-up as income of the recipient in a residence State. If Country A taxes the payment substantially at source (for example, by withholding) there may be little or no benefit. However, if that tax at source has been eroded (whether unilaterally or by tax treaty) then the cross-border benefit can be substantial. A common form of this type of mismatch is where the two countries do not agree on what constitutes a tax subject (hybrid entity). However, this style of mismatch is generic and not limited to the use of hybrid entities. For example, it can also arise where two countries disagree as to which of two related parties receives a payment.

In this example, both Country A and Country B see a payment as being made by Z, but they do not agree on who receives the payment. So Country A grants a deduction for the payment but neither country taxes the receipt because neither country considers the recipient of the payment to be a resident. The example notes that this is a problem particularly when source-State taxation of the payment has been eroded. The example also notes that this style of mismatch is commonly triggered in the context of hybrid entities (one country considers an artificial entity as a tax subject but another country does not), discussed below.

Example 3 is a simple illustration of a mismatch between two countries that recognize a payment, but disagree as to who (which person) should be treated as making it.

Example 3
Mismatch in maker of payment — Double-dip deduction

Y, a resident of Country B, receives a payment that is included in income. Country A considers that the payment is made by Z, a resident of Country A, and that the payment is deductible for Country A purposes. Country B considers that the payment is made by X, a resident of Country B, and that the payment is deductible for Country B purposes.

Presuming that both Z and X can deduct the payment against taxable income, there is a cross-border mismatch that gives rise to two tax benefits (deduction in Country A for Z and in Country B for X) with only one pick-up as income (for Y in Country B). If Country A taxes the payment substantially at source (for example, by withholding) there may be little or no benefit. However, if that tax at source has been eroded (whether unilaterally or by tax treaty) or if Country B grants Y foreign tax relief for that taxation at source (whether unilaterally or by tax treaty) then the cross-border benefit can be substantial. A common form of this type of mismatch is where the two countries do not agree on what constitutes a tax subject (hybrid entity). However, this is a generic mismatch issue and is not limited to the use of hybrid entities. For example, it can also arise where two countries disagree as to which of two related parties makes a payment.

In this example, both Country A and Country B see a payment as being received by Y, but they do not agree on who makes the payment. The income tax fundamental at issue (allocation of payment) is the same as in example 2, but this is a different variation involving "double-dip" deductions. Thus, Country B includes the payment in calculating the income of Y, but both Country A and Country B grant a deduction for the payment to different entities, that is to say, two deductions, one income. Again, this type of mismatch is often triggered in the context of payments made by hybrid entities.

Example 4 is a simple illustration of a mismatch between two countries that recognize a payment, but disagree as to the quantum of the payment.

Example 4
Mismatch in quantifying payment - Large deduction but small income

Z, a resident of Country A, transfers an asset to Y, a resident of Country B, in return for a payment of 100 in cash, which is equal to the tax cost of the asset for Country A purposes. Z and Y are related and both Country A and Country B agree the market value of the asset is 150. Country A accepts the transaction at the price of 100 for tax purposes and considers that Z has no gain or loss. Because Z and Y are related, Country B applies a market value rule to the transaction and so considers the asset to have been purchased for 150. Country B proceeds to grant a deduction for that 150 (either through depreciation or on sale of the asset by Y).

There is a mismatch between Country A and Country B in the price considered paid for the asset for tax purposes. The discrepancy of 50 (difference between 100 and 150) results in a tax benefit (deduction in Country B) with no pick-up in Country A (no income or gain). In a reverse scenario (price considered received is higher than price considered paid), there is scope for application of corresponding adjustment rules in the transfer pricing provisions of tax treaties. While these rules protect taxpayers from many types of double taxation, in most countries they have no application in this scenario where the application of domestic rules results in undertaxation.

In this example, there are two payments (bestowals of value); one being the transfer of the asset from Z to Y and the second being the cash payment from Y to Z. Both Country A and Country B agree as regards the quantum of the first payment (the asset). However, they disagree as to the quantification of the consideration paid for the transfer (the cash payment). Country A accepts the payment at its face value and calculates the gain/loss of Z from the transaction accordingly. By contrast, Country B deems Y to have paid an amount equal to the market value of the asset received. The result is that Country B grants a deduction (currently or in the future) for an amount that is more than was brought into account in Country A when calculating the gain or loss of Z. Again, this case should not be confused with similar examples that focus on other income tax fundamentals but also result in a smaller amount being brought into account in one country than is deducted in another country. One such similar example is where one country considers a payment received to be wholly capital in nature but the country of the payer considers it a mixture of revenue (for example financing expenses) and capital.

Example 5 is a simple illustration of a mismatch between two countries that recognize a payment, but disagree as to the time at which the payment should be recognized for tax purposes.

Example 5
Mismatch in timing payment — Early deduction but late income

Z, a resident of Country A, borrows money from Y, a resident of Country B. The loan is for a term of three years and the agreement requires Z to pay interest in one lump sum at the end of the three-year period. Country A permits Z to deduct the interest for tax purposes as it accrues, for example, one third of the interest in each of the three years. Country B does not tax the interest as income to Y until it is received in year three.

There is a mismatch between Country A and Country B in the time at which the interest should be recognized for tax purposes. This gives rise to a cross-border tax benefit because most of the interest is deductible in Country A in tax years before it is included in income in Country B. Commonly, this timing benefit is not resolved if Country A taxes the interest at source (for example, by withholding) because withholding is typically only at the point the interest is paid, that is to say, when, given these facts, Country B also taxes.

In this example, Country A grants Z a deduction for interest payments as they accrue over the three-year term of the loan because Country A tax law follows financial reporting in this regard. By contrast, Country B requires Y to include the interest in calculating income when it is received (cash basis). The example notes that source-State taxation of the interest often does not resolve the timing mismatch because that taxation (like taxation in the residence State in this example) is most often imposed on a cash basis. This case should not be confused with similar examples that focus on other income tax fundamentals but also result in timing benefits across borders, for example, where two countries do not agree as to ownership of an asset and so simultaneously both grant depreciation deductions for the asset (see example 9 below).

Example 6 is a simple illustration of a mismatch between two countries that recognize a payment, but disagree as to the character of the payment for tax purposes.

Example 6
Mismatch in characterizing payment — Deduction but specific tax relief

Z Co, a company resident in Country A, issues perpetual, subordinated, profit-sharing debentures to Y Co, a company resident in Country B. Country A characterizes the return payable on the debentures as deductible interest. Country B characterizes the return as dividends and grants a participation exemption (exemption for dividends paid between two companies) to Y Co with respect to receipt of the dividends.

There is a mismatch between Country A and Country B in characterization of the return payable on the debentures (interest or dividends). This gives rise to a cross-border tax benefit (deduction in Country A) with no pick-up in Country B (exemption granted). There are many variations of this style of mismatch. Some occur, as here, even though the two countries classify the investment in the same manner. Others occur because the two countries characterize the investment differently, for example, as debt or equity.

In this example, Country A characterizes the payment as interest for tax purposes and so grants Z a deduction for it. By contrast, Country B characterizes the payment as a dividend, grants indirect foreign tax relief (cross-border dividend relief) and so does not tax Y with respect to the receipt. The result is a deduction in one country with no inclusion in income in the other country. This case should not be confused with similar examples that focus on other income tax fundamentals but also result in a deduction with no inclusion in income, for instance, as in examples 1 and 2.

1.3 Mismatches in respect of earning activities and the provision of resources

Disagreement between countries in identifying earning activities can also give rise to cross-border mismatches, as demonstrated in example 7.

In example 7, Country A characterizes the activities of Y as investment and Country B as business. This results in Country A not taxing and Country B also not taxing due to the provision of foreign tax relief. This case produces "double non-taxation" in a similar fashion to that in example 6, but in this case Country B is providing direct foreign tax relief as opposed to indirect foreign tax relief (dividend relief). Similar examples arise where the residence State thinks that a person is engaged in an earning activity, for example, employment, and the source State thinks there is insufficient activity to constitute an earning activity (for example, private activity).

Example 7
Mismatch of earning activities — No source-State tax but foreign tax relief

Y, a resident of Country B, deals in securities in Country A. Country A does not consider that the activities of Y are sufficient to amount to conducting a business and so classifies them as an investment. As a result, Country A does not tax Y with respect to the dealings. By contrast, Country B considers that Y is conducting a business in Country A (for example, through a permanent establishment) and so grants Y foreign tax relief in the form of an exemption.

There is a mismatch between Country A and Country B regarding the type of earning activity Y is conducting (investment or business). This gives rise to a cross-border tax benefit in that neither country taxes income derived from the dealing in securities. There are many variations of this style of mismatch. Some occur even though the two countries classify the activity in the same manner, as in example 8 below.

Disagreement as to whether a source-State tax threshold such as permanent establishment (PE) is met can also give rise to a mismatch, as illustrated in example 8.

Example 8
Mismatch of who contracts — No income but foreign tax relief

Y, a resident of Country B, sells stock in Country A through a commissionaire arrangement. Under this arrangement, the commissionaire, Z, who is resident in Country A, sells the products of Y to third parties in the name of Z but on account of Y. Country A considers that Y is not bound by the contracts with third parties and so is not conducting the activity associated with these contracts. As a result, Country A does not consider Y to have a PE there and does not tax Y (but does tax Z on commission received from the sales). By contrast, Country B considers Y to be conducting business in Country A through an agent (Z) and so considers that Y does have a PE in Country A. As a result, Country B grants Y foreign tax relief in the form of an exemption for profits from the sales.

The mismatch in this example produces results similar to those in example 7.

Here, the two countries agree as to the nature of the earning activity being conducted (business) and who is conducting it. However, the two countries do not agree in respect of whether there is sufficient activity to constitute a PE. This might happen due to disagreement as to which transactions are considered conducted or assets owned by the person (see example 9). In example 8, Country A and Country B do not agree as to who contracted with the customers of the goods of Y. As a result, Country A thinks the activity of Y is insufficient to constitute a PE, while Country B thinks it is sufficient and so grants foreign tax relief.

Example 9 demonstrates a simple mismatch of ownership of an asset, which gives rise to double dip depreciation.

Example 9
Mismatch of who owns an asset — Double-dip depreciation

Y, a resident of Country B, leases by way of a finance lease an asset to Z, a resident of Country A. Country A considers the substance of the lease and treats it as a sale with debt financing. Accordingly, Country A grants Z tax depreciation and a deduction for notional interest paid to Y with respect to the debt financing. Country B accepts the form of the agreement as a lease and so treats Y as the owner and grants Y tax depreciation. Country B requires Y to include the rent payments received from Z in income, but also grants foreign tax relief with respect to them. In particular, Country B considers that the rent is derived through a PE in Country A.

Conceptually, it may be argued that an accurate rate of depreciation for a leased asset is equal to rent charged for the asset less a notional interest charge. In such a case, there might be little tax advantage in an example such as this one. However, most countries grant tax depreciation at a rate in excess of economic depreciation and sometimes for more than 100 per cent of the cost of an asset. In such a situation, a mismatch such as in this example that gives rise to two sets of depreciation can give rise to substantial cross-border timing advantages, irrespective of whether there is also a mismatch in the tax treatment of the rent payments because the countries characterize them differently.

As in example 8, example 9 involves a mismatch in the fundamentals of a provision of resources, in this case whether the provision of an asset is by way of transfer or lease. In this example, Country A characterizes a finance lease as a transfer of an asset with debt financing. By contrast, Country B characterizes the finance lease as a lease. The result is that Country A considers Z to be the owner of the asset and Country B considers Y to be the owner of the asset and so both countries simultaneously grant tax depreciation to two different persons. Depending on the facts, it is possible for the reverse scenario also to give rise to tax benefits, that is to say, where Country A considers Y to be the owner of the asset and Country B considers Z to be the owner of the asset. If the asset is an appreciating asset, neither country may tax a gain arising on the disposal of the asset.

Example 9 also demonstrates that disagreement as to ownership of an asset can trigger mismatches in the character of a payment, but such mismatches may also be triggered by simple disagreement as to the character of an asset. In example 9, the mismatch in ownership causes Country A to consider the payments under the finance lease to be a mixture of interest and capital (purchase price), whereas Country B considers the payments to be purely rent. Such a mismatch can be caused where two countries do not agree as to the character of an asset, even if they agree as to its ownership. For example, if one country (Country A) considers a particular financial instrument to be debt and another (Country B) considers it equity, this can give rise to mismatches of the type illustrated in example 6.[10]

Example 10 illustrates that mismatches in the character of an asset can also give rise to cross-border tax benefits where the indirect foreign tax credit method (cross-border dividend relief) is used.

Example 10
Mismatch in characterizing an asset — Double-dip dividend relief

Y Co, a company resident in Country B, owns shares in Z Co, a company resident in Country A, such that Z Co is a subsidiary of Y Co. X, a resident of Country A, holds profit-sharing debentures in Z Co. Country A treats the profit-sharing debentures as shares for Country A tax purposes. As a result, Country A denies Z Co a deduction for interest paid on the profit-sharing debentures, but grants X dividend relief with respect to receipt of the interest in the form of dividend tax credits. By contrast, Country B considers that Y Co is the only shareholder in Z Co and so when Y Co receives a dividend from Z Co, Country B grants Y Co an indirect foreign tax credit for all of the Country A corporate tax paid by Z Co.

There is a mismatch between Country A and Country B in the character of the investment (shares or debt) held by X and the return payable on it (dividends or interest). This gives rise to two tax benefits in the form of crediting the same corporate tax paid by Z Co to both X (in Country A) and Y Co (in Country B). This style of arrangement is often referred to as a "tax credit generator."

In this example, there are two payments: payment of interest on the profit-sharing debentures held by X and payment of dividends on the shares held by Y Co in Z Co. The same corporate income tax

[10] For an in-depth analysis of distinguishing between debt and equity in domestic and international tax law, see Wolfgang Schön, Andreas Bakrozis, Johannes Becker and others, "Debt and Equity in Domestic and International Tax Law — A Comparative Policy Analysis," (2014), No. 2 *British Tax Review*, 146-217.

paid by Z Co in Country A is credited to both X and Z Co and the duplication causes a mismatch benefit. For this style of mismatch to produce effective benefits, it is likely that the corporate tax rate of Y Co in Country B is comparatively high and/or Country B has a broad method of calculating the limitation on credit under its foreign tax credit system, for example, where it calculates the limitation on credit on a worldwide basis.[11]

1.4 Mismatches in respect of persons and personal characteristics

Countries may disagree as to whether an entity constitutes a person for tax purposes (hybrid entity) and this may give rise to mismatches regarding whether a payment has been made, as illustrated in example 11.

Example 11
Mismatch in identifying a person — Deduction but no income

Y, a resident of Country B, establishes Z Co in Country A. Y lends money to Z Co and Z Co pays interest in return. Country A considers Z Co to be a taxable person and thus grants a deduction for the interest paid. Country B considers Z Co to be transparent (not a taxable person) and thus does not recognize any loan transaction or payment of interest between Y and Z Co. Rather, Country B considers the activities of Z Co as a PE of Y in Country A and as a result grants Y foreign tax relief in the form of an exemption of the activities of Y in Country A.

There is a mismatch in the treatment between Country A and Country B. The mismatch gives rise to a cross-border tax

[11] For different methods of calculating the limitation on credit, see Peter A. Harris, "Taxation of residents on foreign source income," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (New York: United Nations, 2013), available at http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf, chapter III, 109-71.

benefit (deduction in Country A) with no pick-up in Country B (no income). In this sense the example is similar to example 1. The cross-border benefit may be minimized if Country A imposes a substantial source-based tax. Further, the benefit may be minimized if Country B adopts the foreign tax credit method of foreign tax relief. Tax planning of this variety presumes that the residence State (Country B) calculates the exemption for the Country A PE without a deduction for the interest. As such, the exemption will be larger than what Country A taxes to Z Co. A foreign tax credit would credit to Y only tax actually paid in Country A (although mismatches in calculating the Country A income can cause difficulties in calculating the limitation on credit).

In example 11, Country B sees Z Co as part of the entity that is Y, whereas Country A considers Z Co and Y to be separate tax entities. This makes Z Co a "hybrid entity." The interest payment by Z Co is recognized by Country A (paid between two persons), but not by Country B (paid by Y to itself). In this sense, example 11 is similar to example 1 and demonstrates how the classification of persons for tax purposes can impact on whether a payment is recognized. Example 11 is also similar to example 7 in that Country A sees the activities of Y as an investment (a loan), whereas Country B sees the activities of Y in Country A as business activities.

Mismatches of the type illustrated in examples 2 and 3 can also be triggered by disagreement between two countries as to whether an entity is a taxable person or not (hybrid entity). In example 2, therefore, it may be that X is a hybrid entity established by Y. Country A does not recognize X and so considers the payment to be made to Y. Country B does recognize X and considers it to be the recipient of the payment. The tax effects are then the same as discussed in example 2. Similarly, in example 3, X may be a hybrid entity because Country A considers it to be a taxable person and Country B does not. Again, this may give rise to a double-dip deduction, as discussed in example 3.

Mismatches of the type illustrated in examples 2 and 3 can also be triggered by disagreement between two countries as to whether an entity is a resident person, as illustrated in examples 12 and 13.

Example 12
Mismatch in residence — Deduction but no residence taxation

Z, a resident of Country A, pays for goods bought from Y. Y is formed under the laws of Country A and managed from Country B, but neither Country A nor Country B considers Y to be resident in their jurisdiction (different tests of residence). As a result, neither Country A nor Country B taxes Y with respect to the proceeds of sale.

There is a mismatch between Country A and Country B as regards the residence of Y. This gives rise to a cross-border tax benefit because the sales proceeds are likely to be deductible to Z in Country A with no pick-up in the taxation of Y because it is not resident anywhere (presuming the sale is not attributable to a PE in Country A or Country B, for example, goods shipped from a third country).

Example 13
Mismatch in residence — Double-dip deduction

Z Co is a member of a multinational group of companies. It has been making losses. It is managed from Country A but formed under the laws of Country B. Both Country A and Country B consider Z Co to be resident in their jurisdiction. As a result, both Country A and Country B provide tax loss relief, including by way of setting the losses of Z Co against income derived by other group members resident in their jurisdiction.

There is a mismatch between Country A and Country B in respect of the residence of Z Co. This gives rise to a cross-border tax benefit because the losses of Z Co are simultaneously used to reduce the income of more than one member of the corporate group.

Examples 12 and 13 help to demonstrate that much mismatch tax planning revolves around inconsistencies in the manner in which countries exercise their jurisdiction to tax. What constitutes a “person” and the fundamental features of the person are important where taxation on the basis of residence is at issue. As in examples 1, 2 and 11, in example 12 there is a deduction but no effective pick-up in taxable income. Similarly, as in examples 3 and 9, in example 13 a deduction is granted more than once for the same expenditure (that is to say, the expenditure producing the loss). Example 10 is also similar to example 13 in that the same tax benefit (credit in example 10 and loss in example 13) is used more than once.

2. What is covered by OECD Action 2 in the OECD Action Plan on BEPS

Categorization of hybrid mismatch arrangements in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues [12] and in the OECD Action 2 — 2014 Deleverable[13] is very different from the above categorization.[14] This is because Action 2 is targeted at only some types of cross-border mismatch arrangements that may give rise to cross-border tax benefits. In particular, Action 2 targets only hybrid instruments and entities.[15] It is, therefore, limited in scope to "hybrid financial instruments and transfers," "hybrid entity payments" and "imported mismatches and reverse hybrids." [16] As the discussion in section 1 above illustrates, "hybrid mismatch arrangements" need not be limited to these categories. The OECD Action 2 — 2014 Deliverable no longer claims to have comprehensive coverage.[17]

[12] See note 2.

[13] See note 2.

[14] As the OECD Action 2 — 2014 Deliverable does not dicount anything in OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, it is presumed the OECD Action 2 — 2014 Deliverable is a development of the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues and thus the latter can be used to detail an understanding of the former.

[15] OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 47.

[16] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, chapters IV, V and VI, respectively. OECD Action 2 — 2014 Deliverable changes the focus from the type of arrangement to the outcome, but the limitations in OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues effectively still apply.

[17] OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 49, suggests it is "impossible … to comprehensively identify and accurately define"

2.1 Hybrid mismatch arrangements

While the OECD does not comprehensively define hybrid mismatch arrangement, the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues does outline the key elements of such an arrangement. These elements are:

- The arrangement results in a mismatch in the tax treatment of a payment;
- The arrangement contains a hybrid element;
- The hybrid element causes a mismatch in tax outcomes;
- The mismatch in tax outcomes lowers the aggregate tax paid by the parties to the arrangement.[18]

There is no attempt to separately define "hybrid," "mismatch" or "arrangement," but it seems the OECD views at least the first two in a similar fashion, as discussed in the introduction to the present chapter. In particular, "hybrid" clearly focuses on two countries viewing the same income tax fundamental in a different way, and "mismatch" focuses only on outcomes that are beneficial to the taxpayer (and not those that might result in double taxation).

There is little discussion of the scope of "arrangement" in the OECD Action 2 — 2014 Deliverable or in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, and the matters covered are restricted in a number of ways. The OECD does not intend that arrangement cover all dealings that can have a tax effect. One major difficulty with both documents is identifying what is intended to be covered and what is not. In particular, it seems that "payment" is a critical feature of the scope of both, and then only payments involving hybrid financial instruments and hybrid entities.

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even mismatches involving only financing instruments, which seems too negative. See OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 50.

[18] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, 8-10. OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 41, is more obscure, but when paragraphs 42 to 44 are also considered, it covers the same ground.

The OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues are concerned with two key mismatches; deduction/no inclusion (D/NI) outcomes and double deduction (DD) outcomes.[19] These outcomes are not comprehensively defined and can lead to confusion. It is now clear that an amount need not be wholly deductible or included for the proposed rules to apply. The "extent of a mismatch" is relevant and so is the "proportion" of a payment that is deductible or included.[20] However, there is little detail on apportionment and inevitably apportionment is more difficult to administer (see also the discussion later in this section regarding bifurcation in the context of quantification of amounts).

Second, it is not clear how deduction and inclusion interface with the "transactional" part of an income tax. The OECD Action 2 — 2014 Deliverable suggests that "deduction" is a payment that "is taken into account as a deduction or equivalent tax relief under the laws of that jurisdiction in calculating the taxpayer's net income."[21] It continues in a similar vein with respect to amounts treated as "included in ordinary income."[22] It is clear that the OECD Action 2 — 2014 Deliverable covers amounts that are directly deducted or included in calculating income. However, a payment might have an indirect effect, such as where it is included in the cost of an asset or received with respect to a liability. Such amounts may be recognized over the life of an asset or liability or when a transaction occurs with respect to the asset or liability. It is not clear whether the OECD Action 2 — 2014 Deliverable is intended to cover these types of indirect amounts (see also below regarding timing).[23]

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[19] OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 43, and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 20.

[20] OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 44.

[21] Ibid., 72. The OECD Action 2 — 2014 Deliverable no longer defines "equivalent tax relief"; see OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 92.

[22] OECD Action 2 — 2014 Deliverable, supra note 2, 73.

[23] For example, a company buys an asset from a foreign shareholder and pays 100 for it. The State of the company recognizes the full 100 as the purchase price. The State of the shareholder considers the purchase price to be 70

Despite a focus on D/NI and DD outcomes, "Action 2 is not intended to capture all arrangements that have the effect of lowering the aggregate tax burden of the parties to an arrangement."[24] The problem is that the OECD is not focused on lower taxation as such, but mismatches leading to lower taxation.[25] The OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues recognizes that some countries may intentionally create a mismatch that is "economically closer to a tax exemption or similar taxpayer specific concession." It seems that such intentional mismatches are not "tax outcomes in the sense contemplated by Action 2."[26] This seems an impossible distinction to administer and the OECD Action 2 — 2014 Deliverable avoids the issue by isolating it in the context of "deemed" payments, but that raises its own issues.[27] There are many circumstances in which countries that are viewed as financial centres create intentional mismatches for exemption or concessionary purposes. It is not clear how a country would be expected to identify these and whether one country is expected to respect the intentions of another.[28]

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and the remaining 30 to be a dividend, which it exempts (for example, participation exemption). Subsequently, the company sells the asset at a loss and claims a deduction for it. Is this arrangement caught by a D/NI rule?

[24] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 22.

[25] Nathan Boidman and Michael Kandev, "BEPS Action Plan on Hybrid Mismatches: A Canadian Perspective," supra note 1, 1234-1235, make a similar point.

[26] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 22. The example given is where a country has created a specific deduction "for invested equity" as under an allowance for corporate equity ("ACE") system. For the ACE system, see Institute for Fiscal Studies, *Equity for companies: A corporation tax for the 1990s* (London: Institute for Fiscal Studies, 1991) and James Mirrlees, Stuart Adam, Tim Besley and others (2011), *Tax by Design [The Mirrlees Review]* (Oxford: Oxford University Press, 2011), 421-5, available at http://www.ifs.org.uk/mirrleesReview/design.

[27] OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 45, confirms that the proposals are not meant to cover an ACE allowance. However, what about a country like Brazil where the interest on net equity system is similar to the ACE system but does require a payment?

[28] For example, would a general deduction for dividends such as can arise in Australia for redeemable preference shares with a term of less than 10 years

This lack of focus on tax burden means that the relationship between Action 2 and the general use of low-tax jurisdictions is unclear, or at least is not specifically addressed in the OECD Action 2 — 2014 Deliverable and the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues. As noted above, the effect of a hybrid mismatch arrangement can be similar to using an intermediary in a third country (triangular arrangement). For many decades, tax planners have used companies in third countries to change the allocation, timing, quantity and character of payments ultimately passing from the jurisdiction of the investment to the jurisdiction of the investor. The novelty of hybrid mismatch arrangements is that they can do this without the use of a third country (even though they often do involve third countries).[29] Because intermediaries and hybrid mismatch arrangements are being used in the same manner, it may be suggested that rules designed to regulate them should be developed together to ensure a consistent treatment (see section 4.4 below).

The OECD Action 2 — 2014 Deliverable does not "address differences in the timing of payments," although it is not exactly clear what this means.[30] The OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues makes clear that a timing difference of the type identified in example 5 would not be covered.[31] Notably, however, while a timing mismatch under an "original issue discount" is not covered, one example provided in the OECD Public Discussion Draft on

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be something that another country can neutralize or not? Are the OECD proposals intended to apply only where there is a mismatch in the character of the financial instrument or entity? If the latter approach is adopted, it would drive a large hole through the impact of the OECD proposals. OECD Action 2 — 2014 Deliverable, paragraph 48, instils little confidence by suggesting that such a fundamental matter should be dealt with "separately or in the context of Action Item 4 on Interest Deductibility."

[29] Peter A. Harris and David Oliver, *International Commercial Tax* (Cambridge: Cambridge University Press, 2010), 369-70.

[30] For example, see OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 50 and page 72, and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 26.

[31] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 88.

BEPS Action 2 — Domestic Issues does cover a timing mismatch under a deferred purchase price agreement.[32] The OECD Action 2 — 2014 Deliverable removes this discussion. Beyond that there are other difficulties. In particular, at one level, the difference between an immediate deduction of an amount on an accrual basis and the inclusion of an amount in the cost base of an asset is a question of timing, that is to say, accrual versus realization of the asset. Similarly, an amount received may be immediately included in income or it may represent an amount that will be brought into account only on a transactional basis, for example, when a liability with respect to which the amount is received is disposed of. It is not clear how the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues means to deal with, for example, issues of double dips through simultaneous deduction of an amount and inclusion in the cost base of an asset.[33]

The OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues contain virtually no mention of quantification issues. Perhaps this is because Actions 8, 9 and 10 are intended to deal with transfer pricing issues. The OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues makes a difficult distinction between "differences in the way jurisdictions measure the value of money paid under a financial instrument" and "differences in the amount attributable to a financial instrument if the difference is attributable to differences in the value of the payment (as calculated in monetary terms)."[34] The intention seems to be to differentiate between foreign exchange movements (not covered) and differences in valuing a discount (covered). There seems little conceptual

[32] Ibid., note 2, figure 5, 36. The amount immediately deducted in Country B will be picked up should B Co sell the asset (because the deduction reduces the cost base of the asset). This is not much different from the tax effect of accelerated depreciation (for example, a first year allowance), which presumably is not covered by the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues.

[33] It should be noted that the OECD Action 2 — 2014 Deliverable refers to the timing issue in the definition of "D/NI outcome" but not in the definition of "DD outcome." See OECD Action 2 — 2014 Deliverable, supra note 2, 71-72.

[34] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraphs 89 and 90, respectively.

basis for making such a distinction (and the question arises whether it is practical to do so). The OECD Action 2 — 2014 Deliverable refers to the former, but not to the latter.[35]

There are points at which the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues deals with the bifurcation of an amount into two parts of a different character, for example, revenue and capital.[36] However, this is a matter of identifying a particular payment (as opposed to two payments) and characterization. It is not a matter of pure quantification. Again, the OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues do not make connections in this regard or expressly coordinate with Actions 8, 9 and 10.

While there is some uncertainty about the scope of Action 2 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, it is supported with 21 worked examples ("Figures") which reveal much about the scope of the proposals. The OECD Action 2 — 2014 Deliverable reproduces only seven of these examples, but the others may yet reappear in further work of the OECD on this topic. The table in annex I of the present chapter attempts to categorize the OECD examples by reference to the conceptual framework outlined in section 1 above and through comparison with the 13 examples discussed there. The 13 examples are intentionally spread across the potential types of mismatch. By comparison, the numbers in square brackets in the OECD examples are to the figures in the OECD Action 2 — 2014 Deliverable.

The OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues contains no pure examples of mismatches with respect to payments, only such mismatches triggered by mismatches in allocation and character of assets and identification of persons. The OECD examples focus on mismatches regarding ownership of assets, character of assets, identification of persons and dual residence. This raises fundamental questions with respect to whether any other types of mismatches are

[35] For example, OECD Action 2 — 2014 Deliverable, supra note 2, 72.

[36] For example, see OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, figure 19, 73, where the bifurcation is between financing expense and purchase price (discussed further in the text below). The OECD Action 2 — 2014 Deliverable does not repeat this example.

intended to be covered (it would seem at least some are). Further, this is not to suggest that the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues intends to cover all mismatches that fall within these categories and, also, the OECD examples are essentially limited to secondary mismatches as regards payments. Moreover, the OECD examples are largely limited to mismatches in characterization of a payment and allocation of maker and recipient.[37] The OECD examples are further analysed in annex II to the present chapter.

2.2 Hybrid financial instruments and transfers

A primary focus of the OECD is on mismatches in the character of a payment made under "financial instruments." The OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues cover both pure mismatches in the character of a payment (even where there is no mismatch in the character of the asset with respect to which the payment is made) as well as such mismatches that are triggered by a mismatch in the character of the underlying asset.[38] The former is apparently covered despite no example being dedicated to it, that is to say, all OECD examples of mismatches in characterizing a payment are triggered by other mismatches, such as the character of a financial instrument or allocation of its owner.

While "financial instrument" seems a limiting factor in the OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, there is no effective definition of the phrase. The latter recommends that this be determined by reference to domestic law.[39] The OECD Action 2 — 2014 Deliverable defines "financial instrument" to include "an arrangement taxed under the rules for taxing debt, equity or derivatives under the laws of the payee

[37] Amanda Athanasiou, "OECD's Hybrid Mismatch Proposals Too Drastic, Commentators Say," (2012) Vol. 94, No.1 *Worldwide Tax Daily,* notes that the OECD Business and Industry Advisory Committee considers "the rules are both broad and underinclusive."

[38] Compare examples 6 and 10 above with figures 1 and 19 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, 19 and 73.

[39] Ibid., note 2, 25.

and payer jurisdictions" and certain other arrangements to the extent they involve "financing or equity" returns.[40] The terms used within this definition are not further defined and it is not clear what happens if jurisdictions do not agree on whether what is at issue is a financial instrument. Many countries will adopt a definition consistent with that used for financial reporting purposes. For example, the definition used in the International Financial Reporting Standards (IFRS) is a particularly difficult and complex one.[41] While financial instruments should be a primary target, it is not clear that anti-mismatch rules should be limited by the concept of "financial instrument."[42]

Two countries may not agree as to whether an arrangement is a financial instrument, and this will give rise to a different sort of mismatch. This could be a problem particularly with respect to leases, which may be viewed as a finance lease by one country (and so a financial instrument) but as an operating lease by another (and therefore not a financial instrument).[43] Notably, the OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues contain no example relating to a finance lease of a tangible asset (see example 9 above).

It is not clear whether under the OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues "hybrid transfers" are also limited to "financial instruments," but that seems the intention. The core feature of such transfers seems to be that they result in a mismatch as regards ownership of an asset

[40] OECD Action 2 — 2014 Deliverable, supra note 2, 38-39.

[41] International Accounting Standard 32, paragraph 11, available at http://www.ifrs.org/IFRSs/Pages/IAS.aspx.

[42] A common reason giving rise to a mismatch in tax law characterization of a financial instrument is that either or both countries do not follow financial reporting standards for purposes of distinguishing debt and equity. Some view blindly following accounting standards in tax law as potentially harmful, for example, see Peter A. Harris (forthcoming), "IFRS and the Structural Features of an Income Tax Law," in Victor Thuronyi and G. Michielse, eds., *Tax Design Issues Worldwide* (Netherlands: Kluwer Law International).

[43] International Accounting Standard 32, Financial Instruments, paragraph AG9 confirms that a finance lease is a financial instrument but an operating lease is not.

(although, as noted in annex II to the present chapter, figure 19 seems to lack some detail). As the examples in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues note, such mismatches often result from different characterizations of repurchase agreements.[44] As example 9 above notes, such a mismatch can also arise as a result of different characterization of a lease (finance versus operating).

2.3 Hybrid entity payments

The hybrid entity payments part of the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues covers only payments made by hybrid entities. These are of two basic types. The first involves two countries recognizing that a payment is made by different entities, with each granting a deduction. This was discussed in section 1.2 above and is illustrated by OECD figure 6.[45] The second involves one country recognizing a payment made by an entity while another does not recognize a payment at all. This was illustrated in example 11, discussed in section 1.4 above — see also OECD figure 9.[46]

Conceptually, the second type of mismatch covered under this heading is confusing. It is true that it involves a payment made by a hybrid entity, but equally it involves a payment received by a hybrid entity.[47] Inherently this second type is therefore related to what the

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[44] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, figures 2, 3, 5 and 20; pages 21, 23, 36 and 74, respectively. It is clear that while this type of mismatch often involves shares of controlled entities, "virtually any asset that generates" some form of tax relief can be used (see paragraph 66).

[45] Ibid., supra note 2, 44. Figure 3.1 in OECD Action 2 — 2014 Deliverable, supra note 2, 51, illustrates the same example.

[46] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, 48. Figure 2.3 in OECD Action 2 — 2014 Deliverable, supra note 2, 42, illustrates the same example.

[47] For example, in figure 9, OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, 48, Country B sees the head office of A Co (or A Co less B Co) as an entity separate from B Co and so sees the head office as the recipient of the payment. By comparison, Country A does not see the head office as separate from the rest of A Co (B Co being considered part of A Co), making the head office a hybrid entity.

OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues refers to as a "reverse hybrid mismatch."[48] Indeed, many of the OECD examples overlap in unexplained ways. The overlaps seem to result from trying to relate the examples to vague observations rather than to income tax fundamentals. The OECD Action 2 — 2014 Deliverable separates these two types of mismatches into two chapters, but still refers to both as "'payments made by a hybrid payer."[49]

Two of the examples given by the OECD reveal the potential depth of the entity mismatch problem. The problem is not just with the identity of an entity in the traditional sense, for example, identifying what constitutes a "corporation" for tax purposes. The problem is with identifying the levels at which income is calculated and has a tax effect.

The first OECD example (figure 7) demonstrates that PEs are hybrid entities and can create mismatches with respect to payments.[50] Article 7 (2) of the OECD Model Tax Convention on Income and on Capital[51] (OECD Model Convention) requires a PE to calculate its income in the host State as if it were separate and independent of the rest of the enterprise of which it is a part.[52] The same prescription is not required when a residence State calculates an income of the enterprise (although it is required for purposes of calculating foreign tax relief under Article 23). Hence, tax treaties treat PEs as separate persons for income tax calculation purposes in the host State, but often that is not the case in the residence State. Hence, a PE is often a hybrid that can give rise to mismatches of the type identified in example 3 (OECD figure 6).

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[48] Any suggestion that one country does not see the payment received is countered by the equal observation that one country does not see the payment made. Hence, this second type either involves both a hybrid entity payment and a reverse hybrid mismatch, or neither of the two.

[49] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, 42 and 51.

[50] Ibid., supra note 2, 45. The OECD Action 2 — 2014 Deliverable does not reproduce figure 7, but see paragraph 96 therein, at 52.

[51] Organisation for Economic and Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

[52] That is to say, the so-called Authorised OECD Approach; see OECD, *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, 2010), for example, at paragraph 3.

The second OECD example (figure 10) demonstrates that the erosion of the separate identity of corporate group members resulting from group regimes can give rise to the same style of mismatch.[53] This is most obvious where a country adopts a consolidation regime that removes the separate identity of a group member. However, other forms of group relief can produce similar results, the critical feature being the ability to have a transaction between two group companies ignored or its tax consequences deferred.

A third OECD example (figure 8) demonstrates a different point.[54] This example is similar to example 13 and involves a dual resident company and the dual use of deductions/losses. A similar result can be achieved with a PE, as in figure 7. These examples involve no disagreement between the countries in the fundamental features of a payment. Both countries agree as to who made the payment and even that the payment made is attributable to activities in Country B. The fundamental problem in these cases is what tax treaties and foreign tax relief do not deal with.

Tax treaties and foreign tax relief deal only with positive tax results and seek to ensure that the same amount of income is not subjected to tax twice. This is most clear in the obligation of the residence State to provide foreign tax relief.[55] However, tax treaties and foreign tax relief are not symmetrical. In the context of negative results (deductions, losses, payment of foreign tax), there is no attempt to ensure that the benefit of the negative result is not duplicated in the source (host) and residence (investor) States, although domestic law can prevent this. This duplication is precisely what is taking place in OECD figure 7.

A symmetrical approach would be if the residence country defers to the tax consequences in the source State where income is taxable in

[53] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, 49. The OECD Action 2 — 2014 Deliverable does not reproduce figure 10.

[54] Ibid., note 2, 47. Figure 3.2 in OECD Action 2 — 2014 Deliverable, supra note 2, 55, illustrates the same example.

[55] Of course, the removal of double taxation is far from perfect. See, generally, Peter A. Harris, "Taxation of residents on foreign source income," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries,* supra note 11.

that State, it should also defer recognition of a negative result where that result is granted relief in the source State.[56] There is a similar problem in the dual residence scenario (example 13, OECD figure 8). A tax treaty residence tiebreaker is effective only for purposes of relieving double taxation and not for purposes of ensuring that the same relief is not claimed twice. Again, the OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues do little in terms of explaining this fundamental limitation of tax treaties,[57] but rather mix conceptually dissimilar examples.

2.4 Reverse hybrid and imported mismatches

The OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues categorize the receipt of payments by a hybrid entity separately from other hybrid payments and refer to them as "reverse hybrid" payments. While this may (or may not) be a phrase used in practice, it is counter-intuitive and does not explain what is taking place, especially by comparison to payments made by hybrid entities. The potential for income to disappear in the context of payments received by a hybrid was discussed in section 1.4 above. OECD figure 11 also illustrates this scenario, but involves the use of three countries.[58] While noting that mismatches in reverse hybrid structures can arise in a bilateral context (as in the extension of example 2 discussed in section 1.4 above), the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues justifies the use of a triangular structure by suggesting that "more commonly the intermediary

[56] Conceptually, the potential for dual benefits is not limited to deductions and losses. For example, a PE may have foreign income and pay third-country tax. It is possible for that third-country tax to be granted a foreign tax credit in both the PE State and the head office State, including by way of transfer to other group members (for example, through a consolidation regime).

[57] Rather, they gloss over the issue with technical terms, including "duplicate deduction" and "dual inclusion income," which, while accurate, are unnecessarily confusing.

[58] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, 56. Figure 2.4 in OECD Action 2 — 2014 Deliverable, supra note 2, 45, illustrates the same example.

is established in a different jurisdiction."[59] While that may be, it fails to highlight the significance of a mismatch structure involving receipt of a payment by a hybrid entity.

As with payments made by hybrid entities, the significance of a mismatch with respect to receipt of a payment by a hybrid entity is that it can be achieved in a bilateral setting. After all, the tax benefits of the structure in figure 11 of OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues can also be achieved by using a non-hybrid entity established in a favourable third country.[60] It may be argued that the State of the payer could unwittingly reduce withholding tax by presuming a tax treaty with the intermediate State applies. But this can be countered with what seems to be the position of the OECD itself. It seems that a hybrid in such an intermediate State is not "liable to tax" there and so is not a "resident" of the intermediate State for tax treaty purposes and the treaty does not apply.[61] The risk with the extension of OECD is that tax administrators may think that mismatches arising with respect to receipt of a payment by a hybrid entity arise only in triangular cases.

This causes the OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues to turn immediately to what they term "imported mismatches," which are "hybrid structures created under the laws of two jurisdictions where the effects of the hybrid mismatch are imported into a third jurisdiction."[62] The connection between "reverse hybrids" and "imported mismatches" is

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[59] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 201. This comment is not repeated in the OECD Action 2 — 2014 Deliverable.

[60] Peter A. Harris and David Oliver, *International Commercial Tax,* supra note 29, 388-89.

[61] Paragraph 8.8 of the Commentary on Article 4 of the OECD Model Convention, although this comment is made in the context of hybrid partnerships. See also Peter A. Harris and David Oliver, *International Commercial Tax,* supra note 29, 63 and 348.

[62] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 206, and see the slightly different description in OECD Action 2 — 2014 Deliverable, supra note 2, 61.

not clear, at least from a conceptual perspective.[63] Inevitably, any form of hybrid mismatch arrangement can arise in the context of three or more countries. Issues raised through the use of an intermediary State seem to be little more than the usual issues pertaining to treaty shopping and tax havens. The OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues incorporate little explanation of the relationship between hybrid mismatch arrangements and these issues of treaty shopping and the use of tax havens.[64]

A subsequent example (figure 18) in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues demonstrates two further points: that a hybrid mismatch can be "imported" into a recipient State through an intermediate State and that a PE may be used in the intermediate State.[65] The OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues contains part VII entitled "Further Technical Discussion and Examples." This part is not clearly linked with, and the examples used are not categorized by reference to, the prior parts. The OECD Action 2 — 2014 Deliverable largely ignores it. Like the discussion of imported mismatches in part VI, using a PE in a third State raises few issues in addition to those that generally arise when locating a PE in a low-tax jurisdiction, especially where the residence State provides foreign tax relief in the form of an exemption.[66]

[63] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 216, attempts to explain the connection. Paragraph 217 explains the "difference between reverse hybrids and imported mismatch arrangements … as a difference between direct and indirect mismatches." This seems to be a virtual non-distinction and to say little more than that the latter involves a third country and the former need not. The same could be said with respect to other (non-reverse) types of direct hybrid mismatch arrangements. This explanation is not repeated in the OECD Action 2 — 2014 Deliverable, but see paragraph 88 therein, at 47.

[64] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 209, notes that an intermediate jurisdiction will have "little incentive" to introduce rules to neutralize hybrid mismatch arrangements.

[65] Ibid., supra note 2, 72.

[66] For example, see Peter A. Harris and David Oliver, *International Commercial Tax,* supra note 29, 353 and 389-91.

3. How Action 2 in the OECD Action Plan on BEPS proposes to deal with the problem

3.1 General approach

The OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues lack detail in identifying and classifying hybrid mismatch arrangements and, as a consequence, the suggested response to these arrangements seems somewhat disjointed. Difficulties with the approach suggested in the OECD documents are revealed in table 1 of each, which sets out an overview and summary (respectively) of the recommendations.[67] The recommendations are a patchwork of highly specific rules that at points may appear almost random and which are likely to be highly complex in detail in domestic implementation. Implementation may involve high compliance costs and potentially facilitate tax planning involving the technical details of what is covered by one country and what is covered differently by another country.[68] A comprehensive resolution to hybrid mismatch arrangements seems unlikely.[69]

The OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues contain no general response, but rather targeted rules with different outcomes. Complex detailed definitions are needed with respect to each cell in table 1, with the consequent likelihood of difficult issues about whether a particular arrangement falls within one cell, another cell, more than one cell or within no cell at all. The OECD Action 2 — 2014 Deliverable is

[67] OECD Action 2 — 2014 Deliverable, supra note 2, 17, and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, 18.

[68] See Michael L. Schler, "BEPS Action 2: Ending Mismatches on Hybrid Instruments," (2014) Vol. 154, No. 15 (Part 1), Vol. 160, No. 11 (Part 2), *Worldwide Tax Daily*, at 580-81. This article is by a partner in a United States law firm who, at 580, describes the OECD recommendations as "enormously complicated."

[69] Regarding the patchwork nature of the OECD proposals and particularly regarding difficulties for developing countries, see Stephanie Soong Johnston, "Hybrid Mismatch: Proposed Rules May Expect Too Much From Developing Countries," (2014) Vol. 74, *Tax Notes International*, 314.

generally less detailed than the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues and this is also true of table 1. In particular, two differences between table 1 of each document are worthy of mention.

The table in the OECD Action 2 — 2014 Deliverable reorders the first column to focus on the outcome (type of mismatch). The table in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues is more intuitive in that it starts with the type of arrangement. Second, the table in the OECD Action 2 — 2014 Deliverable does not reproduce the column containing the "hybrid element." These alterations are unfortunate because they make the table less intuitive and conveying less information than the table in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues. This may reflect caution on the part of OECD and the attitude in the OECD Action 2 — 2014 Deliverable noted above that OECD feels it cannot "comprehensively identify and accurately define" hybrid mismatch arrangements.[70] The following discussion focuses on the table in the OECD Action 2 — 2014 Deliverable.

3.1.1 Defining scope: Columns 1 and 2 of table 1

Just as the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues was structured (in terms of parts) around the first column of its table 1 (according to category of arrangement), the OECD Action 2 — 2014 Deliverable is structured around the first column of its table 1 (according to type of mismatch). The OECD Action 2 — 2014 Deliverable then proceeds to deal with categories of arrangement in its second column. While its chapters follow mismatch categories, they are then broken into discrete parts for different categories of arrangement. The difference between both documents is therefore often a matter of presentation rather than substance. At the end of each relevant part of a chapter in the OECD Action 2 — 2014 Deliverable there are recommendations for "specific changes to domestic law."[71] These must be read with "definitions in relation to scope" and "agreed definitions," which appear later in chapters 6 and 7 of the OECD Action 2 — 2014 Deliverable, respectively.

[70] OECD Action 2 — 2014 Deliverable, supra note 2, 31.

[71] Ibid., supra note 2, paragraph 14.

The OECD does not expect countries literally to transcribe its recommendations into their domestic law, and generally the recommendations are not suited to this purpose. However, there must be a risk that some countries will do so. The OECD recommendations are coordinated, but nevertheless are broad statements that are likely to be insufficiently precise for direct implementation by countries. Further, direct implementation may cause inconsistencies with other parts of a country's tax law. Many domestic tax laws are littered with foreign imports of this variety that cause substantial dislocations within the law. Proper implementation of the OECD recommendations requires that they be understood and adapted to fit into the legal system in which they are being adopted.

To work out which chapter of the OECD Action 2 — 2014 Deliverable is at issue, it is necessary to determine whether there is a "D/NI" or "DD" outcome. The definitions of these terms in chapter 7 of the OECD Action 2 — 2014 Deliverable have many difficulties and much imprecision. At least three steps are necessary to determine either outcome: (a) identify a payment, (b) identify the jurisdictions of the payer and payee and (c) determine the deductibility and inclusion in ordinary income of the payment.

The reference to "payment" raises all of the issues surrounding that concept discussed in section 1.2 above. The definition of "payment" is fundamentally inadequate and raises more issues than it solves. "Payment" is defined to include anything that is "capable of being paid" but to exclude "deemed" payments (if they do not "involve the creation of economic rights") and to include "aggregate amounts" under a hybrid transfer. Suffice it to say that none of these terms is precise, none of them is defined and all are likely to give rise to dispute. Further, it is unclear whether in-kind benefits should be included and if so which types. Only the definition of "D/NI outcome" notes that timing and some quantification issues regarding a payment are to be ignored, that is to say, the definition of "DD outcome" does not.

It is also necessary to identify the "payer jurisdiction" and the "payee jurisdiction." Each phrase is defined by reference to other terms. These definitions seem to suggest that it will be clear who made a payment and who receives it. The definitions do not account for the inevitability that different jurisdictions will consider different persons to be the payer or payee. So there may be multiple jurisdictions that might be considered the payer jurisdiction or the payee jurisdiction, or there might be none. It is not clear how the rules are intended to operate in these eventualities.

Problems with the scope of what "deduction" or "including in ordinary income" mean were discussed in section 2.1 above. In particular, there are issues regarding amounts included in the cost of an asset and the classification of consideration received on the disposal of an asset. "Ordinary income" is a peculiar phrase that will have independent meaning in only a few jurisdictions. The definition refers to "income that is subject to tax at the taxpayer's full marginal rate." There is no definition of "full marginal rate" and in the context of countries with schedular systems, it may make little sense. Many countries, especially developing countries, tax some types of income, such as dividends, interest and certain rents, at final flat rates on the gross amount.

In any case, there seems little use in identifying a D/NI or DD outcome if the arrangement does not fall within the scope of the provisions. It is more intuitive to focus on the second column of table 1 of the OECD Action 2 — 2014 Deliverable and consider whether the arrangement is one of the target arrangements, and then consider whether it gives rise to a D/NI or DD outcome. Focusing on categories of arrangements requires consideration of the definitions of "financial instrument" and "hybrid transfer" (recommendation 1, paragraph 2), "hybrid payer" (recommendation 3, paragraph 2 — but defined differently in recommendation 6, paragraph 2), "reverse hybrid" (recommendation 4, paragraph 2), "dual resident" (recommendation 7, paragraph 2) and "imported mismatch arrangement" and "hybrid deduction" (recommendation 7, introduction and paragraph 2).

There is no overarching coordination between these definitions and there is thus no indication of any relationship between them. This dislocation is greater in the OECD Action 2 — 2014 Deliverable than in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues. Further, the definition of each of these concepts raises difficult interpretation issues. For example, the definition of "financial instrument" refers to "debt, equity or derivatives," but these terms are not defined. The relevance of the definition of "equity interests" is not clear.

In the definition of "hybrid transfer," it is not clear whether the jurisdiction of the "owner" and the "counterparty jurisdiction" bear any relationship to the "payer jurisdiction" and the "payee jurisdiction" in recommendation 12, and if so what.

3.1.2 Nature of recommendations: columns 3 and 4 of table 1

The next two columns in table 1 are interesting, especially by comparison with tax treaties. These columns move beyond identifying the scope of application and move to the content of the recommendations. Many of the problems caused by hybrid mismatch arrangements are not regulated by tax treaties, that is to say, tax treaties contain gaps and do not deal with them.[72] Rather than seek to develop tax treaties more fully through changes to its Model Convention, OECD proposes other recommendations for dealing with the identified hybrid mismatch arrangements. These recommendations are of two types.

The third column in table 1 incorporates recommendations for changes to the domestic law of countries. These are suggestions for unilateral action. The OECD Action 2 — 2014 Deliverable has tidied up some of the uncertainty about what is being recommended, but some difficult areas remain. For example, the scope of the recommendation to deny a dividend exemption for a deductible payment is still not clear.[73] There is now a suggestion that a country "should consider adopting similar restrictions for other types of dividend relief" but there are no details of how this might be achieved. The other three recommendations for unilateral action may appear quite random and relate to broader issues that are not adequately discussed in the OECD

[72] See, generally, Peter A. Harris and David Oliver, *International Commercial Tax*, supra note 29, 345-68.

[73] Recommendation 2, paragraph 1, OECD Action 2 — 2014 Deliverable, 41, refers to a "dividend payment" being deductible. What happens if an allowance for corporate equity is granted irrespective of a payment? Have dividends, paid out of funds protected from corporate tax by the deduction, been in effect deducted? If not, why should such a system be favoured when compared with a system such as that of Brazil, which requires an actual payment before the allowance is granted. What if a deduction is granted for depreciation in the value of shares and the depreciation broadly tracks dividend payments. Again, have the dividends been in effect deducted?

Action 2 — 2014 Deliverable or OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues.[74]

The fourth column in table 1 contains the so-called linking rules. Here it is still intended that countries adopt the rules unilaterally, but the unilateral rules will integrate with and be dependent upon rules in other countries. In the past decade and a half there has been a steady increase in unilateral rules (outside granting foreign tax relief) that depend on tax treatment in another jurisdiction, especially with respect to hybrid mismatch arrangements. The difference in the OECD Action 2 — 2014 Deliverable and the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues is that an international organization is recommending coordination of this specific set of rules. Historically, this sort of coordination in the tax field has been reserved for treaties.[75] This seems a fundamental shift in approach by the OECD and is at odds with the OECD recommendations of what should appear in the OECD Model Convention and the tax treaties based on it.[76]

[74] For example, recommendation 2, paragraph 2, OECD Action 2 — 2014 Deliverable, 41, with respect to withholding tax credits, specifically addresses the repurchase transaction illustrated in figure 2.2. This is clear from OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, 25. However, as explained above in section 2 in the context of losses, the problem lies more fundamentally in preventing the simultaneous granting of a tax benefit in more than one jurisdiction. Recommendation 5, paragraph 1, OECD Action 2 — 2014 Deliverable, 49, contains a broad statement regarding "CFC or other offshore investment regimes" with no attempt to analyse the pros and cons of such regimes. Recommendation 5, paragraph 2, refers to income "not brought within the charge to taxation." As noted in section 2.1 above, the OECD proposals are not targeted at the level of tax, and so it seems that a tax rate of 0.5 per cent would be enough to neutralize this rule.

[75] As Hugh J. Ault predicted in "Some Reflections on the OECD and the Sources of International Tax Principles," supra note 3, 1196, the OECD approach may be viewed as a development of "some of the ideas in the OECD partnership report." See OECD, *The Application of the OECD Model Tax Convention to Partnerships* (Paris: OECD, 1999), adopted by the OECD Committee on Fiscal Affairs on 20 January 1999.

[76] Peter A. Harris and David Oliver, *International Commercial Tax,* supra note 29, 467, suggest that a major question and challenge for the international tax "system" in this century is whether the "old system of bilateral tax treaties … will be abandoned in favour of an intentionally structured system designed

The fourth column in table 1 contains three subcolumns: (primary) response, defensive rule and scope, but the latter seems to place further limitations on ("exceptions" to) the application of the rule. The approach is that one State is the primary State for responding to a mismatch, with a secondary State responding only if the primary State fails to act. This coordination aims to "stop the potential for double taxation."[77] The OECD proposals seem to be particularly concerned with the potential that anti-hybrid rules might produce double taxation, and avoiding this seems to be a source of much complexity in the proposals.[78] This is consistent with the OECD approach to transfer pricing,[79] but not with respect to economic double taxation of dividends and controlled foreign corporation (CFC) rules.[80] It is not clear that countries are as concerned about such accuracy with respect to preventing double taxation. This is evident in domestic rules that cause double taxation, such as the denial of interest deductions for excessive debt (for example, under earnings stripping rules) without recharacterization as a dividend qualifying for dividend relief.[81]

The OECD uses no express guiding principle in identifying the primary State.[82] The OECD is adamant that a State applying the

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to best deal with modern situations or whether the new system will develop as a set of ad hoc rules with a loose attempt at coordination."

[77] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 52.

[78] Ibid., paragraph 33, for example.

[79] See the corresponding adjustments in Articles 7 (3) and 9 (2) of the OECD Model Convention.

[80] The OECD Model Convention has no provision for underlying foreign tax relief and does not resolve the potential for double taxation through the simultaneous application of CFC rules by more than one country. See, generally, Peter A. Harris and David Oliver, *International Commercial Tax,* supra note 29, 291 and 303.

[81] For example, see Peter A. Harris, *Corporate Tax Law: Structure, Policy and Practice* (Cambridge: Cambridge University Press, 2013), 198-204.

[82] Traditionally, the allocation of international taxing rights has been guided by "source country entitlement" (first entitlement to tax), although this principle more clearly underlines the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention) than the OECD Model Convention. See, gener-

rule not be required to “establish that it has ‘lost’ tax revenue.”[83] The OECD Action 2 — 2014 Deliverable made some adjustments to the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues such that there is now greater consistency based on D/NI or DD types of mismatches. Generally, D/NI outcomes result in a denial of deduction in the State of the payer. The DD outcome results in the denial of a deduction in the investor State.

The exceptions to the responses (scope) have the potential to add a substantial layer of complexity to the design and implementation of the recommendations. It is not the purpose of the present chapter to consider these exceptions in detail. While they overlap substantially, they are not consistent and their scope therefore depends on the rule in question and which State is applying it. The drivers for these exceptions seem to be the potential for capturing “arrangements outside the intended policy” and ability to administer the rules.[84] As in many instances, the intended policy is unclear; it is difficult to assess when a rule is worth administering more broadly or narrowly and when it is not.

3.2 Actions by payer/source/host State

3.2.1 D/NI mismatches

In the context of D/NI types of mismatch for both hybrid financial instruments and transfers and hybrid entity payments, the OECD recommends that the State of the payer is the primary State. Accordingly, this State will deny the payer a deduction for the payment made that is not included in the income of the recipient. In the context of hybrid financial instruments and transfers, this is subject to the general recommendation that the State of the recipient unilaterally deny a dividend exclusion or exemption for any amount that is deductible in the

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ally, Peter A. Harris and David Oliver, *International Commercial Tax*” supra note 29, 103-5.

[83] For example, OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 27 (a), and OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 36.

[84] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 117.

State of the payer. It seems that this rule is intended to apply with priority over the rule for the State of the payer to deny a deduction.[85] However, the denial of a deduction in the payer State does not seem to be triggered where the investor State offers a different form of dividend relief, such as a lower tax rate or dividend tax credits. This is because there is no D/NI outcome.

To apply the primary rule in the context of hybrid financial instruments and transfers, the State of the payer must determine whether the recipient is exempt in the investor State. For this purpose, the State of the payer will require information about the investor's tax affairs of a nature that many countries are not used to asking for. Further, the State of the payer must be satisfied that the exemption is due to the hybrid mismatch arrangement and not, for example, some other status, such as an exemption for non-profit organizations.[86] For this purpose, the OECD proposes a test of whether the mismatch would arise if the arrangement were "directly entered into between resident taxpayers of ordinary status."[87] It may be difficult to determine whether a foreign investor is of "ordinary status" in another State, for example, what should be compared if two "ordinary" taxpayers have a different treatment, such as that for individuals and that for companies?

Further, the payer State adjustment should only be "to the extent" that the amount is not included in ordinary income.[88] The OECD suggests that the methodology for this apportionment should be left to domestic law, but no guidance or examples are provided.[89] This could be an administratively difficult task, for example, would the

[85] Ibid., paragraphs 113-116. OECD Action 2 — 2014 Deliverable, supra note 2, is unclear about the interface between Recommendation 1 and Recommendation 2, paragraph 1.

[86] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraphs 96-102.

[87] Recommendation 1, paragraph 3, OECD Action 2 — 2014 Deliverable, supra note 2, 38.

[88] Recommendation 1, paragraph 1 (a), OECD Action 2 — 2014 Deliverable, supra note 2, 37.

[89] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 103.

payer State have to consider the potential allocation of expenses in the investor State (such as where the investor is in a loss position there)?

The rule for hybrid entity payments is subject to an additional qualification — a deduction should be allowed to the extent it does not exceed the taxpayer's "dual inclusion income" for the same period.[90] This qualification recognizes that income will often be subject to tax twice, once in the source State and again in the residence State, and so the expense claimed, for example, in the source State, can result in greater taxation in the residence State. Accordingly, the rule is targeted at setting the deduction against income that is not included in the other country. To facilitate this qualification, the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues contains difficult definitions of "disregarded payment" and "dual inclusion income."

Not only are the concepts of "disregarded payment" and "dual inclusion income" difficult to understand, they also instil little confidence that they are balanced and robust against abuse. For example, it is possible that the income of a related party against which the deduction is set is "dual inclusion income" (also taxable in the residence State or another State). Under the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, it appears that did not count because it referred to the "taxpayer's dual inclusion income."[91] While the OECD Action 2 — 2014 Deliverable removed most of the references to "taxpayer" in this regard, it did not clarify its intention with respect to whose income it must be. Further, it is the whole of the taxpayer's dual inclusion income that counts irrespective of whether the deduction is actually set against that income. For example, where the taxpayer has other income that is taxable in the source State by way of low withholding tax that is also taxable in the residence State (with foreign tax credit). If the deduction claimed is transferred to another source-State group member but does not exceed the income subject to withholding tax, would the primary rule still apply?[92]

[90] Recommendation 3, paragraph 1 (c), OECD Action 2 — 2014 Deliverable, supra note 2, 44.

[91] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, 51, paragraph (h).

[92] This may be countered by the discussion in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 187,

The exceptions in the payer State for D/NI mismatches with respect to hybrid financial instruments and transfers and hybrid entity payments are not the same. The OECD intends the rules always to apply in the context of "structured arrangements." However, the rules on hybrid financial instruments and transfers apply only as between "related persons," whereas the hybrid entity payments rules apply only as between members of the same "control group." Recommendation 10 of the OECD Action 2 — 2014 Deliverable defines "structured arrangement" and Recommendation 11 defines "related persons" and "control group."[93] While these concepts are broadly similar to concepts used in the tax laws of most countries, integrating them properly with those local concepts may not be straightforward.

In the context of reverse hybrids and imported mismatches, again the host (payer) State must investigate whether the payment was included in calculating income in the investor State or any intermediate State. If not, the host State is to deny a deduction for the payment. Again, the level of coordination in looking not only to the investor jurisdiction but through potential intermediaries in potentially uncooperative third countries could be substantial or impossible for many tax administrations. The exceptions for the application of this primary rule in the host State are the same as in the case of hybrid entity payments.

3.2.2 DD mismatches

In the context of DD types of mismatch for hybrid entity payments, the OECD recommends that the host State be the secondary State. One reason for this may be because, for the host State, the expense is likely to have been incurred in deriving domestic source income. By comparison, for the investor State the expense is likely to have been incurred in deriving foreign source income. This reversal of roles of the host and investor States as the primary State raises critical questions regarding the allocation of expenses between domestic and foreign activities (although the OECD Action 2 — 2014 Deliverable and

but that is not clear. A further question with respect to dual inclusion income is whether it will include the profits of a subsidiary that will be taxable when a dividend is distributed to a parent company.

[93] OECD Action 2 — 2014 Deliverable, supra note 2, 67-70.

OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues make no reference to this). This is revisited in section 4 below.

In the context of hybrid entity payments, the host State, as the secondary State, must investigate whether a deduction was granted in the investor State and, if so, deny a deduction for the expense. Again, this may be particularly difficult to administer, not only in terms of finding out what happened in the investor State, but also in characterizing it. For example, will the secondary rule apply if the investor State considers that the payment was for the acquisition of an asset and then grants depreciation for that payment? What if the investor State does not offer a deduction but grants some other form of tax relief such as an investment credit? [94]

Further, the secondary rule is qualified by reference to the concept of "dual inclusion income," as discussed in section 3.3 below in the context of the primary rule. Further, there are similar rules for carry forward of denied deductions and stranded losses as will be discussed in that section. For the host State only, the scope of the rule is limited to controlled group and structured arrangement scenarios. The complexity of applying these rules may verge on the impossible for many tax administrations.

In the context of payments made by dual residents, the primary rule applies to both countries of residence. It is not clear whether the intention is that no deduction be permitted at all or whether the application of the rule by one country will resolve the issue so that the other country cannot apply the rule. Again, the rule is qualified by reference to "dual inclusion income," carry forward of denied deductions and stranded losses. However, there is no limitation to scope on this recommendation (for example, no limitation to related-party or structured arrangement scenarios).

3.3 Actions by investor/residence/home State

In the context of D/NI types of mismatch (including imported mismatches) the OECD recommends that the State of the investor be the

[94] Other forms of relief may be covered by the "equivalent tax relief" concept, discussed in section 2.1 above.

secondary State. As such, it must determine whether the payer State denied a deduction for the payment under the primary rule before deciding to include an amount in the income of the recipient/investor. As noted above, it seems that in the context of financial instruments, this is subject to the rule that the investor State refuse a dividend exemption for any deductible payment.

As previously explained, mismatches may also arise even where the investor State includes the receipt of the payment in the investor's income if that State grants some type of relief with respect to the payment. Tax credits (whether foreign tax credits or dividend tax credits) are one example. The OECD Action 2 — 2014 Deliverable contains an additional rule pertaining to the granting of foreign tax credits. An investor State should limit foreign tax credits for source-State withholding tax "in proportion to the net taxable income of the taxpayer under the arrangement." This rule is limited to hybrid transfers of financial instruments.[95] In any case, it seems particularly narrow and is unlikely to resolve the problem of duplicating credits.[96]

[95] Recommendation 2, paragraph 2, OECD Action 2 — 2014 Deliverable, supra note 2, 41.

[96] For example, the United Kingdom of Great Britain and Northern Ireland (United Kingdom) often grants both direct foreign tax credits and dividend tax credits when an individual receives foreign dividends (largely as a result of decisions of the Court of Justice of the European Union). When a New Zealand company distributes a dividend to a foreign shareholder it must withhold tax. However, that tax can be credited against the company's own tax liability. Therefore, when a dividend is distributed by a New Zealand company to an individual in the United Kingdom, multiple credits may be granted; one to the New Zealand company and two others to the individual in the United Kingdom, who will also be entitled to the lower tax rate applicable to dividends. See, generally, Peter A. Harris, *Corporate Tax Law: Structure, Policy and Practice,* supra note 81, 350-51 and 377-78. Similarly, if an individual in the United Kingdom receives dividends paid by a Brazilian company entitled to deduct part of the dividend, the individual will still receive a dividend tax credit and the benefit of the lower dividend tax rates in the United Kingdom. Applying the OECD recommendations to these scenarios is anything but clear. In particular, it is not clear whether the New Zealand and Brazilian reliefs give rise to a "deductible"/"payment" or whether the dividend is included in that individual's "ordinary income."

In the context of DD types of mismatch for hybrid entity payments, the OECD recommends that the investor State be the primary State. In the DD case, the investor State is to deny a deduction for the expense.

As with D/NI mismatches for hybrid entity payments, the DD case is subject to an additional qualification — the dual deduction can be claimed to the extent it does not exceed "dual inclusion income" (income brought into account for tax purposes under the laws of both jurisdictions).[97] The difficulties of complexity, balance and robustness identified above are again at issue. In addition, an amount for which a deduction is denied should be carried forward for set-off against any future dual inclusion income. Further, in the case of DD, in a virtual tertiary rule, the investor State should allow a deduction to the extent the taxpayer can show that the payment "cannot be set off against the income of any person" in the host State (the "stranded losses rule").

In respect of exceptions to these investor State rules, there is less consistency than in the case of payer/host States. The exceptions for D/NI types of mismatch are the same as in the case of the payer/host State, discussed in section 3.2 above. By contrast, in DD types of mismatch for hybrid entity payments there is no limit on the investor State applying the primary rule. This can be contrasted with the situation in the payer State where the secondary rule can only be applied in controlled group and structured arrangement situations.[98]

As noted in section 3.2 above, the recommendation for dual residents applies equally to both residence States and there is no limitation to scope.

3.4 Actions by intermediate State

Actions by an intermediate State are relevant only in the context of "imported mismatches." The OECD Action 2 — 2014 Deliverable continues to emphasize that the "most reliable protection against imported

[97] Recommendation 6, paragraph 1 (c), OECD Action 2 — 2014 Deliverable, supra note 2, 53.

[98] Recommendation 6, paragraph 1 (c), OECD Action 2 — 2014 Deliverable, supra note 2, 54.

mismatches will be for all jurisdictions to introduce rules recommended in this Report."[99] The OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues specifically recommended that in certain circumstances intermediate States treat hybrid entities as tax residents, especially where that is consistent with the characterization of the entity in the investor State.[100] The OECD Action 2 — 2014 Deliverable no longer makes any specific recommendations with respect to intermediate States.

4. Other steps that may be taken

The recommendations in the OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues are long, disjointed, complex and difficult to follow, and this discussion has sought to avoid some of their more complex parts.[101] The OECD documents contain a clear and appropriate set of design principles.[102] However, the recommendations appear to promote few of these. The recommendations are not "comprehensive" and would not "minimise the disruption to existing domestic law," "be clear and transparent in their operation," "be workable for taxpayers and keep compliance costs to a minimum" or be "easy for tax authorities to administer."[103] Further, as noted in section 3.1 above, in the face of

[99] OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 108; Nathan Boidman and Michael Kandev, "BEPS Action Plan on Hybrid Mismatches: A Canadian Perspective," supra note 1, 1244, refer to this as "plainly utopic."

[100] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, 61, paragraph (b).

[101] Such as the examples in OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraphs 237-240, some of which involve situations where two countries disagree on the identity of both the payer and the recipient of a payment.

[102] OECD Action 2 — 2014 Deliverable, supra note 2, 64-65, and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 27.

[103] See Amanda Athanasiou, "Hybrid Mismatch Proposals: Practical Problems Remain," (2014) Vol. 74, *Tax Notes International*, 1083, who notes that "foremost among stakeholder concerns during this process has been the fear that administration of the rules and coordination among jurisdictions,

other instances of "double taxation of the same economic income" not addressed by tax treaties,[104] it is not clear why the recommendations must necessarily "avoid double taxation through rule co-ordination."[105] The critical thing is to ensure sufficient taxation. Failure to meet the design principles may stem from the OECD attempting to be more targeted and precise than is necessary for this limited purpose.[106]

The OECD recommendations will create interface issues with other domestic rules. For example, the OECD suggests that the hybrid mismatch rules should be applied "after" general domestic tax base rules "but before the application of any general non-transaction specific limitation such as a thin capitalisation rule."[107] These "non-transaction specific" rules may be more difficult to identify than suggested. Further, rules like these that affect a tax base can play havoc with other rules that apply by reference to the tax base, such as earnings stripping rules, quarantining rules and even rules for limiting the deductibility of charitable donations. In addition, the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues notes the need for order-

as well as with other base erosion and profit-shifting initiatives and domestic law, will be prohibitively difficult, leading to double taxation, competitive inequities, inefficiencies, and impossible compliance burdens." See also Michael L. Schler, "BEPS Action 2: Ending Mismatches on Hybrid Instruments," (Part 2), supra note 68, 581.

104 OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 33.

105 OECD Action 2 — 2014 Deliverable, supra note 2, 64, Recommendation 9, paragraph 1 (d); and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 27 (d). Double taxation is a question of degree, not absolutes. Investors are likely to be deterred less by two light impositions of tax that are reasonably predictable and certain, than one high level of tax with substantial degrees of uncertainty.

106 Hugh J. Ault, "Some Reflections on the OECD and the Sources of International Tax Principles," supra note 3, 1199, doubts that "the rules dealing with the BEPS issues can be structured so accurately that they hit only the desired targets and there will inevitably be situations when undesirable double taxation could arise."

107 OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 241. Not repeated in the OECD Action 2 — 2014 Deliverable.

ing rules in respect of the recommendations.[108] These are needed because the scope of the rules is not uniform. While the OECD Action 2 — 2014 Deliverable has increased uniformity, there is no assessment of whether the ordering rules are still required.

The level of coordination required between countries for implementation of the OECD recommendations is unprecedented. The recommendations are prescriptive as regards domestic tax law amendments in a manner not seen before. Further, the recommendations require a country not only to investigate the terms of a financial instrument or entity and the tax treatment of it under the tax law of another country,[109] but the country might also need to investigate the relationship between each party to a payment and sometimes (as in structured arrangements) their motives.[110] Coordination between countries and responding to anti-avoidance is not new. What is new is the intensity of the focus and the lack of clarity in what is trying to be achieved. "Neutralizing" is no guiding principle without specifying a comparator or context, that is to say, neutralized by comparison to what.

The OECD rates the relevance of neutralizing hybrid mismatch arrangements for developing countries as "low." [111] While the relevance

[108] Ibid., supra note 2, paragraph 242.

[109] OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 115. Even for a residence country, Jurgen Lüdicke, "'Tax Arbitrage' with Hybrid Entities: Challenges and Responses," (2014) Vol. 68, No. 6/7 *Bulletin for International Taxation*, 313, suggests that knowledge about foreign taxes for purposes of foreign tax credit and CFC rules "seems easier" and requires "less technical understanding about the foreign tax rules" than knowledge required to implement the OECD proposals.

[110] Amanda Athanasiou, "OECD's Hybrid Mismatch Proposals Too Drastic, Commentators Say," supra note 37, quotes Ernst and Young as saying "[a]pplying different rules to several categories of hybrid arrangements is 'more complicated than any domestic law regime of any country in place today.'" Lee A. Sheppard, "News Analysis: Dual Consolidated Loss Rules and BEPS," (2014) *Worldwide Tax Daily*, 144-2, says that "[n]eeding to know with some precision the other country's treatment is a serious weakness" in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues.

[111] OECD, *Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* (Paris: OECD, 2014), Annex A.

of the OECD recommendations in this regard may well be "low," developing countries must be aware of the revenue risk raised by hybrid mismatch arrangements. There is a need to consider and respond to such arrangements, but not necessarily using the OECD recommendations.

Many countries will look for simpler ways of addressing hybrid mismatch arrangements, particularly if they can be coordinated more generally with measures to prevent base erosion and profit shifting.[112] In order to identify other options, it is necessary to return to basics to identify the core of the problem. After all, financial instruments and different types of entities are not the problem; they are only vehicles that are used to exploit flaws in tax fundamentals. Those tax fundamentals need to be investigated to see what can be done.

Annex II considers what effect the other options identified under this heading might have on the 13 examples used in the present chapter and the 21 examples used in the OECD documents.

4.1 Stepping back: the bigger picture

The core structural problem that hybrid mismatch arrangements demonstrate is the mixing of source and residence tax bases. Historically, most income tax laws in Europe developed from separate taxes on the basis of source that were subsequently supplemented with a general tax on the basis of residence. The taxes on source and those on residence were quite distinct.[113] It was from this basis that the first tax treaties evolved, which not surprisingly incorporated a schedular approach.[114] This was not the case in the United Kingdom of Great Britain and Northern Ireland and the United States of America, which

[112] Amanda Athanasiou, "OECD's Hybrid Mismatch Proposals Too Drastic, Commentators Say," supra note 37, also notes that the issues covered by Action 2 "overlap with a number of other BEPS actions."

[113] For example, see Peter A. Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems* (Amsterdam: IBFD, 1996), 73-88 and 286-300.

[114] Ibid., 286-306. The difference between schedular taxes on different sources of income and a complementary comprehensive income tax on the basis of residence is evident in some of the early model tax treaties of the League of Nations.

had general income taxes. Even though the categorization of income might have been schedularized, under a general income tax all income of a resident (foreign or domestic) is taxed at the same rate and domestic source income of non-residents is also taxed. This mixed or fused general income tax causes overlapping tax jurisdictions. As the twentieth century progressed, most countries moved to a mixed system.

Unlike earlier schedular source taxes with a supplementary residence tax, the mixed system provides no obvious allocation of taxing rights between countries. The allocation subsequently developed was based on tax treaties. As the OECD Model Convention demonstrates, tax treaties produce an uneven, somewhat random, schedularized source-based tax. This is then overlaid with a residual tax in the residence State that is subject to the provision of foreign tax relief. Wherever the source tax rate and the residence tax rate are different, this system facilitates gaming between different types of income. At one level, hybrid mismatch arrangements facilitate such gaming as one country thinks that income falls into one category and the other thinks that it falls into another.

Historically, residence-based taxes worked in an overarching fashion that attempted to ensure "equity" between particular residents and in doing so would often remove some of the benefits of gaming. The countries from which most investment was derived were often comparatively high tax countries and this facilitated the protection role of residence-based taxes. When residence-based taxes began to be seriously challenged by deferral through third-country holding company structures, many "investor" countries implemented anti-deferral rules such as CFC rules. That was manageable where the ultimate investor was clearly within the jurisdiction. Often that is not the case anymore.

Globalization and the information age have made fragmentation of investment in artificial entities both easy and lightning fast, and this has made taxation purely on the basis of corporate residence inherently problematic. It is now common for persons resident in many countries to hold shares directly in multinational entities that derive income from many different countries. Any attempt by one country to impose any substantial tax on such a multinational entity purely on the basis of corporate residence (that is, to tax foreign source income) is likely to cause the entity to move its residence, which is not a difficult matter. And in many cases, not taxing on the basis of corporate residence is appropriate. Why should a country tax foreign source income of a resident corporation if the majority of its shareholders are foreign or tax exempt (for example, pension funds)?

Ensuring balanced taxation in the source State is a different matter and perhaps this is where the focus of attention with respect to hybrid mismatch arrangements and other base erosion and profit shifting efforts should be. Many source States care little about where investment comes from and, in any case, have little control over it. They care little whether the ultimate investor is some taxable entity or a non-taxable entity. Often source States even have little interest in whether an investment is from a high-tax country, a financial centre or a tax haven.[115] However, there are other things that a source State will care about. It will be concerned if the investment is insubstantial or from illegitimate funds. It will also wish to make sure that it does not obstruct the free flow of new technology and innovation into its jurisdiction.

Residually and critically, a source State will care (very much) whether its tax system favours foreigners over domestic enterprises in accessing the domestic market. At a minimum, a source State needs to protect the competitiveness of local business in the domestic market. There are things a source State can do to encourage foreigners seeking to access the domestic market to create a more substantial presence (for example, a PE) that is taxed on a non-discriminatory basis with domestically owned enterprises.[116] Taking action in this direction will also reduce tax benefits from hybrid mismatch arrangements and provide a useful context for assessing whether such arrangements are "neutralized."

[115] For example, Nathan Boidman and Michael Kandev, "BEPS Action Plan on Hybrid Mismatches: A Canadian Perspective," supra note 1, 1237, note that "historically, tax law design has not conditioned deductibility of payments on their tax treatment for the recipient. If a source country wishes to reduce the level of tax incentives provided to inbound investors, it can simply tighten the deduction limitations already in place."

[116] Stephen Edge, "Base Erosion and Profit Shifting: A Roadmap for Reform — Tax Arbitrage with Hybrid Instruments," supra note 8, 319, suggests that as a matter of fairness "businesses should be treated equally within the jurisdiction in which they are operating."

4.2 Joint steps: separating source and residence tax bases

The OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues notes that its recommendations do not require a "jurisdiction applying the rule to establish that it has 'lost' tax revenue under the arrangement."[117] This is perceived to be a benefit of the recommendations, but at another level it seems a failure. If the international allocation of taxing rights was more specific, uniform and clear, perhaps it would be obvious whose rights were being eroded by hybrid mismatch arrangements. The tax benefits of many of the examples in these documents would be thwarted if source-country taxing rights were not eroded or denied by tax treaties. Other tax benefits in the examples would be thwarted if residence countries imposed CFC rules, something that to date the OECD has refused to bring into the body of its Model Convention (relying rather on observations in the Commentary). An intermediate jurisdiction is neither the ultimate source State nor the State of the ultimate investor and has little incentive to protect source and residence-State tax bases. Fragmentation of investment due to globalization means that more and more countries find that they are an intermediate jurisdiction in whole or in part.

To protect taxation from hybrid mismatch arrangements, countries should, perhaps, focus on what they are trying to protect — countries need to identify clearly and distinguish between their source (domestic) and residence (foreign) tax bases. This means more than just identifying the geographical source of income, whether domestic or foreign. A country needs to identify the source of the building blocks that make up income and, particularly, the source of payments. Some countries do have relatively clear rules on source of income and receipts, although not usually as separate matters. In other countries there are very few rules. What most countries do poorly is specifically identify which expenses can be deducted in calculating domestic source income and which can be deducted in calculating foreign source income. That is to say, most countries fail to identify the source of expenses and limit their use in a manner that is consistent with the taxation of receipts.

[117] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 28. This statement is not expressly repeated in the OECD Action 2 — 2014 Deliverable.

The source of expenses may be determined in a similar manner as the source of receipts. As a broad outline, domestic source income could be calculated as the net of receipts with a domestic source less expenses with a domestic source. Foreign source income could be calculated in a similar fashion.[118] This is a point at which it makes little sense to follow financial reporting rules because those rules are designed for global reporting of income. They are inadequate for purposes of allocating tax bases between countries.[119] It seems inappropriate for taxpayers to be given discretion over whether foreign expenses offset domestic receipts or domestic expenses offset foreign receipts. It should be a conscious decision for a country, as a policy matter, to permit domestic losses (domestic expenses less domestic receipts) to offset foreign income (foreign receipts less foreign expenses) or foreign losses against domestic income.

4.3 Source-State steps: plugging the gaps

Granting a resident entity a deduction for an outbound payment that is not subject to withholding and that does not result in an equal inflow of resources into the country erodes the source country's tax base. These are the types of payments that are targeted by hybrid mismatch arrangements. They are particularly facilitated by the OECD Model Convention,[120] which presumes that such payments will be picked up by taxation in the residence country of the recipient. However, if residence-country taxation of artificial entities is failing in the face of globalization, this is something that needs to be revisited. There are

[118] For an example of rules of this nature, see Peter A. Harris, "The Symmetrica Income Tax Act 20** and Commentary," (2000), section 68, International Monetary Fund (a hypothetical tax law commissioned and peer reviewed by the Legal Department of the International Monetary Fund), available at http://www.imf.org/external/np/leg/tlaw/2000/eng/preface.htm. Some of these rules need refinement.

[119] See Peter A. Harris (forthcoming), "IFRS and the Structural Features of an Income Tax Law," in Victor Thuronyi and G. Michielse, eds., *Tax Design Issues Worldwide*, supra note 42.

[120] For example, lack of source-State taxation due to limits in Articles 7 (Business profits), 11 (Interest) and 12 (Royalties) and limitations on a source State's ability to deny deductions under Article 24 (Non-discrimination).

only two ways to address source-State tax erosion: increase the scope and rate of withholding taxes or deny a deduction.

To prevent tax base erosion, source States might seek full and uniform withholding tax on all outbound payments that do not result in an equal inflow of resources into the country.[121] The rates should be sufficient not to discourage local provision of the service paid for. This can be a problem particularly with the provision of services, where many countries lack substantial withholding taxes. Services are commonly provided by foreigners into a source State through tax havens. The lack of taxation often means that foreigners can undercut the provision of equivalent services by a domestic provider. The same is true with respect to rent payments for the use of mobile assets. In a globalized world, a source State cannot presume that there will be appropriate taxation in the residence State. It is often fair to (and perhaps a source State should) presume that incoming resources will be provided through a tax haven or equivalent (such as a hybrid mismatch arrangement).

Tax treaties are particularly inflexible instruments that give away source-State taxing rights, sometimes unwittingly. A number of developing countries with substantial natural resources have concluded tax treaties that can be exploited to erode the country's tax base in ways that were not envisaged when the treaties were concluded. This can create tax administration resistance to applying such treaties, especially when local service providers are discriminated against. With

[121] Michael Lennard, Chief, International Tax Cooperation Unit, Financing for Development Office (FfDO), United Nations Department of Economic and Social Affairs, has been reported as saying that "[o]ne of the things that is important for developing countries, but that is not in the OECD Action Plan, as such, is the preservation of withholding taxes generally… I think that one of the outcomes of BEPS will be developing countries will be more and more recognizing the importance of preserving their withholding taxes, and not giving them away too readily in treaties." See David D. Stewart, "Lennard Distinguishes U.N. and OECD Approaches to BEPS, Previews Future Work," (2014) Vol. 95, No. 3 *Worldwide Tax Daily*. The second part of the OECD report on the impact of BEPS in low-income countries does not make a recommendation to that effect (nor does the first part of its report) and only mentions withholding tax once. See OECD, *Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* (Paris: OECD, 2014).

appropriately selected withholding tax rates, a country can encourage foreign service providers to establish a taxable presence in their jurisdiction (for example, a PE) so that local expenses can be deducted, that is to say, taxation on a net basis.

The OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues make little reference to withholding tax in their examples and none in their recommendations. It seems that the OECD is not able or willing to reconsider the provisions in its Model Convention that facilitate tax base erosion and profit shifting, at least not directly in the context of hybrid mismatch arrangements.[122] While the United Nations Model Convention provides greater scope for protecting source-State taxing rights, care still needs to be taken in concluding tax treaties. If a country's representatives are not fully aware of the potential consequences of concluding a tax treaty, the safe option is not to do so.[123]

The second way to prevent source-State tax base erosion is to quarantine foreign expenses. This is the natural consequence of the rule option noted in section 4.2 above for calculating foreign source income separately from domestic source income. If a payment made by a resident of a State has no source in that State and the State can therefore not impose withholding tax, then the resident should be permitted to deduct only that expense in calculating foreign source income.[124] This option will protect the State of the investor in some hybrid mismatch arrangements as much as the State of the payer. As demonstrated in annex II, many of the examples in the OECD Public

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[122] See OECD, *Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries*, supra note 121 paragraph 12, which focuses on "denial of deductions in the payer state and/or forcing the inclusion in the payee state."

[123] Treaties that involve coordination of tax administration do not erode source-country taxing rights and do not fall into this category, for example, the 2011 multilateral Convention on Mutual Administrative Assistance in Tax Matters.

[124] For the reasons discussed in OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 24, and OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 144, the better view is that such a rule does not breach Article 24 (4) of tax treaties.

Discussion Draft on BEPS Action 2 — Domestic Issues involve investors deducting foreign expenses against their domestic source income.[125]

Unlike the OECD recommendations, the effect of the above option is not to deny a deduction and the rule is a uniform rule irrespective of the country of the investor. This is a prime method by which source States can seek to ensure that foreign service providers are not indirectly granted a better tax treatment than local service providers. By contrast, the OECD recommendations seek to cherry pick certain payments for the denial of a deduction. This could be particularly distorting and difficult to administer. OECD recommendations often require that the tax treatment in the payer jurisdiction depends on who holds an investment. Therefore, changes in circumstances of the investor and transfers of an investment (something over which the payer may have no control) may result in a changed tax treatment of the payer (denial of a deduction). In turn, this could have a serious impact on the terms and interest rate on which instruments are issued.[126]

At a more extreme level, source States might consider introducing or broadening the scope of their earnings stripping rules. Many countries already have rules that deny a deduction for excessive interest. Some of these are based on transfer pricing (borrowing beyond an arm's length amount), debt to equity ratio (thin capitalization) or earnings stripping (interest beyond a set proportion of prefinancing expense income) methodology.[127] However, interest payments are only one way in which a source-State tax base may be eroded. In particular, it is possible to modify an earnings stripping approach to cover all types of base-eroding payments. The total of deductions granted for payments made to entities with limited tax liability might be restricted

[125] Wolfgang Schön, "International Taxation of Risk," (2014) Vol. 68, No. 6/7 *Bulletin for International Taxation*, 280-94, at 284, notes the "asymmetry" in setting foreign expenses against domestic source income.

[126] OECD, *Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries*, supra note 121, section 3, does consider "base eroding payments" but only in the context of developing countries' denying deductions for payments between related parties.

[127] For example, see Johanna Hey, "Base Erosion and Profit Shifting and Interest Expenditure," (2014) Vol. 68, No. 6/7 *Bulletin for International Taxation*, 332-45, at 335-36.

to a certain percentage of the value of assets used in an earning activity.[128] Particularly, such a rule might be considered by source States that have already given up substantial taxing rights under tax treaties.[129]

4.4 Residence-State steps: do not discourage domestic investment

Deferred or non-taxation in the residence State of foreign income that has been lowly or not taxed overseas encourages foreign over domestic investment by residents. The only solution to this problem is a foreign tax credit system with anti-deferral rules, for example, CFC rules. The problem is that these rules need to be carefully crafted or they may discourage foreign investment into a country, at least where that foreign investment may bring with it a need or potential for deriving third-country income. In this context, it is natural for countries that are or wish to be financial centres to resist the adoption of (or erode existing) CFC rules. As noted in section 4.1 above, if the ultimate investor is a non-resident or tax exempt then CFC rules are distorting (in terms of location and form of investment). If the ultimate investor is a local wealthy individual, then the lack of CFC rules is distorting. This suggests a need for investigating the better targeting of CFC rules at this latter category.[130]

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[128] For an example of such a rule, see Peter A. Harris, "The Symmetrica Income Tax Act 20** and Commentary," supra note 118, section 27. This is a general rule which for administrative reasons is not restricted to related-party arrangements. See OECD, *Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries,* supra note 121, section 3.

[129] Again, for the reasons discussed in OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraph 24, and OECD Action 2 — 2014 Deliverable, supra note 2, paragraph 144, the better view is that such a rule does not breach Article 24 (4) of tax treaties.

[130] Guglielmo Maisto, "Controlled Foreign Company Legislation, Corporate Residence and Anti-Hybrid Arrangement Rules," (2014) Vol. 68, No. 6/7 *Bulletin for International Taxation*, 327-31, at 328, suggests that a "key element to be addressed in the design of effective CFC legislation is how should states frame such legislation to take account of whether or not the ultimate individual investors are domestic or foreign."

A number of the recommendations in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues sit uncomfortably with OECD past practice with respect to CFC rules. As noted in section 3.3 above, a number of the recommendations prescribe taxation in the residence State (whether under a primary or secondary rule) in the case of reverse hybrids by lifting what the investor State perceives to be a corporate veil. To this extent, the recommendation is effectively the same as CFC rules, but more specific and prescriptive than the OECD has ever been on this front. The OECD Action 2 — 2014 Deliverable now contains a specific recommendation in this regard for at least a limited-scope CFC regime.[131] It is not clear why a more aggressive position should be taken with respect to reverse hybrids than with respect to deferral or avoidance through more traditional tax havens.[132] Perhaps this issue of consistency will be addressed by the OECD Action Plan on BEPS, Action 3: Strengthen CFC Rules.[133]

The same could be said of the recommendation that no dividend exemption be given for a payment that is deductible for the payer. Without questioning the appropriateness of such a rule, it is not clear that it is sensible without strong CFC rules. If countries grant a dividend exemption for payments from tax havens (or just low-tax countries), it is not clear why they should deny an exemption for payments that are deductible, which can produce the same result.[134] Trying to tax the deductible payment is likely to drive more business to be intermediated through tax havens. The point is that as a tax design matter, the denial of a dividend exemption for deductible payments should be integrated into and coordinated with CFC rules.

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[131] Recommendation 5 (1) in OECD Action 2 — 2014 Deliverable, supra note 2, 49. The thrust of the recommendation is that if a country has CFC rules it should ensure they cover reverse hybrids (and imported mismatches) and if it does not, it should introduce such rules to specifically cover them.

[132] See also Michael L. Schler, "BEPS Action 2: Ending Mismatches on Hybrid Instruments," (Part 1), supra note 68, 488.

[133] OECD Action 2 — 2014 Deliverable, supra note 2, paragraph. 88; Guglielmo Maisto, "Controlled Foreign Company Legislation, Corporate Residence and Anti-Hybrid Arrangement Rules," supra note 130, 329, considers coordination of OECD Action 2 and Action 3 to be "a critical matter."

[134] See also Nathan Boidman and Michael Kandev, "BEPS Action Plan on Hybrid Mismatches: A Canadian Perspective," supra note 1, 1237.

Problems of favouring foreign investment are dramatically aggravated where expenses pertaining to foreign source income can be set against domestic source income. This is a problem particularly with financing expenses. It makes little sense to permit residents to set expenses incurred in deriving potentially lowly taxed foreign source income against domestic source income. The result not only encourages source base tax erosion (taxation of income sourced in the residence State), but encourages residents to derive lowly taxed foreign source income (that is, income lowly taxed, expenses deducted against high tax amounts). This may be addressed, but it seems to be done only in part, by the OECD Action Plan on BEPS, Action 4: Limit Base Erosion via Interest Deductions and Other Financial Payments.

As noted above, one way to prevent such distortions is to quarantine foreign expenses so that they can be deducted only in calculating foreign source income. Further, as noted below in annex II, this is an effective measure in addressing some forms of hybrid mismatch arrangements. There are a number of considerations in the form of any such quarantining of a type that are faced when designing a limitation on credit under a foreign tax credit system, for example, whether the quarantining is worldwide, country by country, by type of income or item by item (slice by slice). These considerations are discussed elsewhere, but there should be consistency between quarantining foreign expenses and the limitation on foreign tax credit (or calculation of exempt foreign income).[135]

Granting a benefit with respect to foreign source income (whether deduction, loss, exemption or credit) should be denied where a similar benefit is granted in another State. Here, some of the OECD recommendations are underprescriptive and others are unnecessarily prescriptive. The rule on no dividend exemption if the dividend is deductible to the payer is underprescriptive; it should apply where anyone else gets a deduction for the dividend, not just the payer. The rules on hybrid payments (DD outcome) and disregarded hybrid payments (D/NI outcome) are unnecessarily prescriptive in that they create complexities that are difficult to administer for little benefit.

[135] See Peter A. Harris, "Taxation of residents on foreign source income," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries,* supra note 11, at 141-48.

Many of the worst of these complexities would be addressed by appropriate quarantining (foreign expenses and foreign tax credits) and careful targeting of the use of exemptions for foreign source income.

Irrespective of quarantining, no relief should be given for foreign expenses, losses and taxes if relief is given to any other person anywhere. Clearly, no foreign tax credit should be given for foreign taxes that are credited to someone else. No relief should be granted for a foreign loss (even if quarantined) if relief for the loss is granted to someone else. Concerns that such a rule might work harshly in some cases can be left for tax advisers to plan around, as they often have to do with matters such as limits on interest expense. For this purpose, whether another person has been granted relief, other than the resident person claiming the benefit, is logically determined according to the rules of the residence State.[136]

5. Conclusion

While the OECD Action 2 — 2014 Deliverable and OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues contain much to analyse that is worthy of consideration,[137] none of the examples provide compelling reasons for the tax treatment in the represented States to be coordinated. The perceived tax benefits in all of the examples, while presented in some complex and sophisticated settings, all boil down to a disagreement on some basic fundamentals of income tax. In particular, many of the inconsistencies are a result of countries following different approaches to identifying income tax fundamentals and, in particular, of whether legal form is accepted or more focus is given to substance, as when a country relies on classification for financial reporting purposes.

[136] In the case of a reverse hybrid, therefore, the residence State would not consider that a PE loss has been used by a person other than its resident where the host State happens to view the PE as a separate person.

[137] The United States has highly complex anti-hybrid rules that have been implemented on a unilateral basis and is considering whether these need amending in the light of the examples in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, see Lee A. Sheppard, "News Analysis: Dual Consolidated Loss Rules and BEPS," supra note 110.

Even if coordination is considered necessary, a country should critically assess whether it will follow the OECD recommendations. The level of complexity and difficulty in administering these rules should not be underestimated, nor should the costs for taxpayers in complying with these rules. The OECD promise for a Commentary on the Action 2 — 2014 Deliverable by September 2015 is likely to add further substantial detail to already complex recommendations.[138] For a few sophisticated economies with well-funded and highly trained tax administrations, the payoff in shutting down perceived abuses may be considered worthwhile. For a large number of countries (perhaps a great majority), the cost-benefit analysis may not look proportionate and for countries with struggling tax administrations, implementation may seem impossible.

In any case, as identified in section 4 above, there are other unilateral steps that countries may take to address hybrid mismatch arrangements that are consistent with addressing base erosion and profit shifting more generally. Consistent with the traditional approach to international tax matters, the identified measures that source States may take require no coordination with residence States. The identified measures that residence States may take do require them to consider tax treatment in source States, but not to any greater extent than has been usual for the purposes of providing foreign tax relief.

A basic task for countries in considering hybrid mismatch arrangements is to analyse them by reference to the income tax fundamentals of their own system. A country needs to perform this analysis both from the perspective of the country as a source State and separately as a residence State. For this purpose, the country will need to consider very clearly "What is our source tax?" and "What is our residence tax?" In addition, it will need to ask whether the tax law currently makes a sufficient distinction between these two taxes. If it does not, the country should consider ways in which it can clarify that distinction.

After identifying whether hybrid mismatch arrangements expose any flaws in the fundamentals of its tax law, a country needs to consider how to respond. The logical and traditional response to flaws in a tax law is to make adjustments unilaterally. Another possibility, as

[138] OECD Action 2 — 2014 Deliverable, supra note 2, paragraphs 5 and 7.

recommended by the OECD, involves coordination with other countries. This coordination may be implemented through amendments to domestic law or by conclusion or amendment of tax treaties. A country must be up to the task before concluding tax treaties, for fear that it will introduce restrictions on its unilateral ability to respond to flaws and abuses.

In considering the response to hybrid mismatch arrangements, a country must consider what is and what is not capable of administration by its tax authority. It is possible to understand the basic types of benefits sought from hybrid mismatch arrangements in terms of the fundamentals of income taxation and to formulate a response accordingly. A more difficult issue is administratively looking through the myriad types and complexities of arrangements to identify what is happening and then administering the formulated response.

At a fundamental and cynical level, hybrid mismatch arrangements are just a means by which tax planners use two countries with normal (and decent) tax systems to produce mismatches comparable to those achieved by routing investment through a tax haven. Globalization and the electronic age mean that source States must be cautious in presuming that any foreign country will, as a residence State, tax appropriately a flow of funds that has been let out of the source State with minimal tax. Similarly, a residence State must be cautious in presuming that foreign source income of its residents has suffered sufficient foreign tax such that the income warrants foreign tax relief or any other relief. Neither presumption is warranted simply because the country has a tax treaty with the other country involved. A country's response should be similar and coordinated, irrespective of whether a mismatch is achieved directly as between two countries or indirectly involving a third country.

Annex I

Categorizing hybrid mismatch examples

Table

Payments

Identification

Example 1: Mismatch in identifying payment — Deduction but no income

Allocation of recipient

Example 2: Mismatch in recipient of payment — No income

Allocation of payer

Example 3: Mismatch in maker of payment — Double-dip deduction

Quantification

Example 4: Mismatch in quantifying payment — Large deduction but small income

Timing

Example 5: Mismatch in timing payment — Early deduction but late income

Character

Example 6: Mismatch in characterizing payment — Deduction but specific tax relief

Earning activities and provision of resources

Identification of earning activity

Example 7: Mismatch of earning activities — No source-State tax but foreign tax relief

Threshold of earning activity

Example 8: Mismatch of who contracts — No income but foreign tax relief

Ownership of assets

Example 9: Mismatch of who owns an asset — Double-dip depreciation

Figures[a b]

OECD Figure 2 [2.2]: Collateralised Loan Repo

OECD Figure 3: Bond Lending Repo — Tax Credit Double Dip

OECD Figure 19: Simple Collateralised Loan Repo Utilising Tax Exemption

OECD Figure 20: Share Lending Repo

Character of asset

Example 10: Mismatch in characterizing an asset — Double-dip dividend relief

Figures

OECD Figure 1 [2.1]: Hybrid Financial Instrument

OECD Figure 4: Application of the Hybrid Financial Instrument Rule to a Tax Exempt Holder

OECD Figure 5: Basic Hybrid Financial Instrument Structure

OECD Figure 12 [4.1]: Importing Mismatch from Hybrid Financial Instrument

OECD Figure 16: Foreign Tax Credit Generator Transaction involving use of Hybrid Financial Instrument

Persons and personal characteristics

Identification

Example 11: Mismatch in identifying a person — Deduction but no income

Figures

OECD Figure 6 [3.1]: Basic Double Deduction Structure Using Hybrid Entity

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[a] Unless otherwise indicated by the numbers in square brackets, the figures shown are included in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues.

[b] The numbers in square brackets indicate that they are included in the OECD Action 2 — 2014 Deliverable.

Annex II

Effects of other steps on the 13 examples and OECD figures

A.1 Mismatches in respect of payments: examples 1, 2, 3, 4, 5 and 6

A.1.1 The mismatch in example 1 would largely be addressed by quarantining foreign expenses. Country B might deny this loss on the debt instrument to be deducted against domestic source income if the return on the instrument has a foreign source. Country A might consider amending its law to include debt forgiveness.

A.1.2 The mismatch in example 2 would largely be addressed by comprehensive withholding in Country A. Further, presuming that X is a subsidiary of Y, CFC rules would prevent any avoidance of tax in Country B, whether imposed on Y or directly on the shareholders of Y. Alternately, if Y is a subsidiary of Z or X, Country B has little concern in this matter. CFC rules in Country A would then address deferral of residence-State tax.

A.1.3 The mismatch in example 3 would largely be addressed by quarantining foreign expenses. There are three possibilities here. First, the payment is made through a PE situated in Country B. In this case, quarantining of foreign expenses in Country A would protect its tax base and the deduction in Country B seems appropriate. If Country B permits a loss of the PE to offset profits of, say Y, then the deduction in Country A would be denied (irrespective of quarantining). Second, the payment is made through a PE situated in Country A. In this case, comprehensive withholding in Country A will largely address its tax base erosion, and B will get a foreign tax credit for this tax. Country B will be protected by quarantining the foreign interest expense of X and denying it if Z transfers a loss to a related party in Country A.

A.1.4 The third possibility in example 3 is that there is no PE in Country A or Country B through which the payment is made. If the payment is made through a PE in a third country, then both Country A and Country B will quarantine and potentially deny a deduction for what both believe to be a foreign expense, which will resolve any mismatch. It is conceivable that the interest expense is not incurred through a PE anywhere, or Country A and Country B each consider the expense to be incurred through a PE situated in their jurisdiction. Comprehensive withholding in Country A will largely address its tax base erosion. The risk is in Country B if X is granted a deduction and the tax liability of Y is offset with a foreign tax credit granted in respect of Country A withholding tax.[a] Country B could deny a deduction to X in such a case, but perhaps this approach is overly prescriptive and dependent upon the treatment in Country A.

A.1.5 A more straightforward rule would be to presume, for the purposes of quarantining expenses but not withholding tax, that a payment made by a resident that is not attributable to a local PE is considered to be a foreign expense and so quarantined. The risk in this version of example 3 is that both Country A and Country B quarantine the expense. Tax planners should be able to ensure that such a scenario does not arise. The chance that both Country A and Country B simultaneously presume that the expense is attributable to a PE in their own jurisdiction is quite remote and can be left for general anti-abuse rules. Either country may also take the position that the expense has been granted relief to another person and deny the deduction on that basis. Again, the risk of the expense not being deducted anywhere is remote and can be discounted.

A.1.6 The mismatch in example 4 would have to be addressed by Country A changing its domestic law. Country A has let a gain escape its jurisdiction without taxation, perhaps by presuming that Country B will tax, which it will not. Perhaps Country A should treat Z as receiving full market value for the sale even if domestically it has a no gain/no loss rule for related-party transfers. Sales to non-residents would always be treated as made at market value, unless the purchased asset is included in the assets of a domestic PE.

[a] Some countries may take the view that where they are Country B, they will not grant a foreign tax credit for foreign tax on a payment that they consider is made by a resident of Country B. This is a well-grounded position. However, there is at least some risk that as a matter of law the relief from the double taxation article in a tax treaty (Article 23) requires that a foreign tax credit be granted.

A.1.7 The mismatch in example 5 would largely (though not entirely) be resolved by aligning comprehensive withholding of tax from the payment with the granting of a deduction for it. Tax treaties may be interpreted as limiting the ability of a source State (Country A) to withhold tax at the time of accrual (when the deduction is claimed).[b] However, it might be possible to require the payer to make a prepayment of tax equal to the withholding at the time of accrual or deny a deduction for payments to non-residents until the payment is made, although the latter option might also be limited by tax treaties.[c] Country B should be aware that in a case like this, it might be encouraging its residents to invest offshore. Accordingly, it might consider accelerating the time of recognition of income under this style of deferral instrument. In any case, both Country A and Country B should consider domestic rules to regulate the taxation of deferral instruments and these rules should cater for the foreign elements.

A.1.8 The mismatch in example 6 would largely be addressed by comprehensive withholding in Country A and denial of an exemption in Country B. If Country A does impose withholding tax on the outbound payment and is satisfied that granting a deduction is unlikely to produce a benefit for foreign investors over domestic investors, there seems little reason for Country A to care whether Country B taxes or not. Even if it looks through to the investor, it may find an entity that is exempt in Country B for whatever reason. Country A could make a value judgement on the appropriateness of the exemption or on whether Country B really intended it, but the administrative burden of doing so will often be disproportionate for a country in the position of Country A. Further, to deny a deduction depending on the tax status of the holder is likely to cause substantial distortions and complications in the administration of the tax law of Country A.

A.1.9 As a general rule, in the context of example 6, Country B would deny dividend relief for deductible payments. This applies to all types of dividend relief, whether traditional underlying foreign tax relief

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[b] For example, by suggesting that Article 11 (2) of the OECD Model Convention limits not only the amount of source-State tax but also the time of taxing.

[c] In particular, by Article 24 (4) of the OECD Model Convention.

given to a parent company or any domestic form of dividend relief extended to foreign dividends. The OECD focuses on an exemption for foreign dividends and, in the face of substantial source-State withholding tax, the benefits of an exemption will not be significant. Further, it is possible for some abuse to occur if an indirect foreign tax credit is granted for a deductible payment.[d] The same is true of other forms of dividend relief, for example, notional dividend tax credit or lower tax rate for dividends.

A.1.10 Country B may consider the payment in whole or in part as having some other character (other than a dividend) for which it grants relief. The most likely example is a return of capital on the investment and the consequence that Y may have to recognize income or gain at some future point, for example, when the asset is disposed of. Accordingly, this could be viewed as largely a timing issue similar to (though not the same as in) example 5. The comments for Country B with respect to example 5 equally apply with respect to this version of example 6.

A.2 Mismatches in respect of earning activities: examples 7, 8, 9 and 10

A.2.1 The importance of examples 7 and 8 in the context of hybrid mismatch arrangements is that they demonstrate a mismatch between countries in determining whether there is a taxable presence (PE). This makes the examples similar to those involving hybrid entities, for example, as in example 11, which also turns on whether there is a taxable presence or not.

A.2.2 The mismatch in example 7 would have to be addressed by Country B changing its domestic law. For example, Country B may limit its foreign PE exemption to situations in which the foreign State (Country A) recognizes a taxable presence. Country B might also limit the exemption to the amount of the income of the PE subject to full tax in Country A. Such requirements are unlikely to breach tax treaties.

[d] This is because the credit is likely to be calculated by reference to the corporation tax on the whole of the profits of the payer and not just on the funds used to pay the dividend (which the deduction causes to suffer no corporation tax).

Subject to tax treaties, Country B might also use the foreign tax credit method or a subject-to-tax clause.

A.2.3 The mismatch in example 8 would have to be addressed in domestic law, but tax treaties may override this. Country A might ensure that, as a matter of domestic tax law, the profits of Y from the sale of goods through a local commissionaire are treated as sourced and taxable in Country A. Tax treaty issues involving commissionaire structures are complicated and are covered in the OECD Action Plan on BEPS, Action 7: Prevent the Artificial Avoidance of PE Status. Source countries might seek to ensure that their tax treaties are sufficiently broad so as not to deny a taxing right in this sort of case. The position of Country B is similar to that discussed with respect to example 7.

A.2.4 The mismatch caused by double-dip depreciation through a finance lease in example 9 would largely be addressed by quarantining foreign expenses. As discussed above with respect to example 3, a quarantining rule may be constructed in such a fashion that it would be difficult for both Country A and Country B to consider that the depreciation expense has a domestic source. Here the focus of the mismatch is on deduction of depreciation in both jurisdictions and not on the character of the payments under the finance lease. However, sale and repurchase agreements can be structured in such a way as the primary benefit from disagreement as to ownership of an asset results in a mismatch of the character of payments made with respect to the asset.

A.2.5 Figures 2 [figure 2.2 in the OECD Action 2 — 2014 Deliverable], 3, 19 and 20 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues are examples of mismatches in character of payments caused by disagreement as to who owns an asset as a result of a sale and repurchase agreement. Here one country views a transaction with respect to the asset as a sale and the other views it as a financing transaction (loan). In figures 2 [2.2] and 3, the country of the acquirer (Country B) views the transaction as a sale whereas the country of the seller (Country A) sees no transfer of ownership (views it as a financing transaction). In figure 19 the situations are reversed (as are the country names), the country of the seller (Country B) views the transaction as a sale and the country of the buyer (Country A) views it as no transfer (a financing transaction).

A.2.6 The mismatch in figure 2 [figure 2.2 in the OECD Action 2 — 2014 Deliverable] in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues would largely be addressed by Country A denying underlying foreign tax relief to B Co for foreign tax that is granted relief in Country B and comprehensive withholding tax in Country A for the deductible financing expenses. In particular, during the term of the repurchase agreement, Country A might deny A Co underlying foreign tax relief because B Co is granted dividend relief in Country B for the same dividend. In this sense, the example is similar to that in example 10, discussed below (a discussion that is relevant here). In addition, if Country A simultaneously grants A Co a deduction for the dividends as a financing expense, it might subject the dividends to comprehensive withholding tax, even though Country B does not see that income and thus will not grant a foreign tax credit for the tax.

A.2.7 The mismatch in figure 3 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues would be addressed in the same manner as the mismatch in figure 2 [figure 2.2 in the OECD Action 2 — 2014 Deliverable] except that the comprehensive withholding tax for the deductible financing expenses would be imposed by Country B. Again, it makes little sense for Country B to refund interest withholding tax to B Co and not impose withholding tax on the corresponding manufactured interest payment made by B Co.[e] Further, it makes little sense for Country A to give A Co a foreign tax credit for Country B tax that is credited (and partly refunded) to B Co.

A.2.8 The mismatch in figure 19 of the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues would largely be addressed by comprehensive withholding tax in Country A for the deductible financing expense. Beyond that, it is hard to comment with respect to the example because it lacks sufficient detail, for example, on timing of the deduction for the financing expense, whether A Co receives income from the asset during the term of the repurchase agreement and what amount it receives for the resale under the agreement.

[e] This is less likely to be hampered by Article 21 (Other income) of the United Nations Model Convention, which preserves greater source-State taxing rights over other income when compared with Article 21 (Other income) of the OECD Model Convention.

A.2.9 The mismatch in figure 20 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues results in a mismatch in identification and characterization of a payment. Country A does not recognize the transfer of the shares from A Co to B Co but Country B does. As a consequence, Country B sees two payments (from the distributing company and from B Co to A Co) whereas Country A sees only one (from the distributing company through B Co to A Co). This means that Country A characterizes the payment received by A Co as a dividend but Country B sees it as interest paid (B Co having received the dividend). As in example 6, the cross-border mismatch may be addressed through comprehensive withholding tax imposed by Country B on the outbound deductible payment. Further, Country A might deny underlying foreign tax relief for a payment that is deductible, irrespective of whether it considers the payer to have been granted the deduction.

A.2.10 The mismatch in example 10 would largely be addressed by denying a foreign tax credit for foreign tax that has been relieved. There are no considerations for Country A in this case. As noted in section 4.4 above, the broad issue here is that a residence country like Country B arguably should not grant relief for, in this case, foreign tax that has already been relieved to another person. A detailed consideration of this example is beyond the scope of the present chapter, but the example demonstrates that care must be taken in designing an indirect foreign tax credit system.[f] Similar issues could arise for Country B if Country A exempts the amount received by X instead of granting dividend tax credits (as in figure 16 of the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, mentioned below).

A.2.11 Figure 1 [figure 2.1 in the OECD Action 2 — 2014 Deliverable] (and presumably figure 4 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues) involves a mismatch in the characterization of an asset that causes a mismatch in characterizing payments in respect of the asset. The consequences are similar to those in example 6 and the mismatch would largely be addressed as discussed above with respect to that example, for instance, by denying dividend relief for deductible payments.

[f] Broadly, the issue is one of allocating foreign tax to the profits considered distributed; see Peter A. Harris, *Corporate Tax Law: Structure, Policy and Practice*, supra note 81, 378-79.

A.2.12 Figure 12 [figure 4.1 in the OECD Action 2 — 2014 Deliverable] in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues is presumed to cover a similar example, except that three countries are involved. As the third country adds nothing to the mismatch feature, the mismatch would still be largely addressed as discussed in example 6. In this case, it is the added country (Country C) that has the greatest interest in imposing comprehensive withholding tax.

A.2.13 Figure 5 of the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues involves a simultaneous mismatch in identifying assets (and liabilities) and also in the character of an asset leading to a mismatch in character of payments. Country B views the sale with a deferred acquisition price as a sale with debt financing (an additional financial instrument), whereas Country A sees only a sale. This scenario would largely be addressed by comprehensive withholding tax in Country A for the deductible financing expense. Beyond this, the matter is largely a timing issue for Country A. The deduction of the financing expense will mean that B Co has a lower cost base for the asset and so a smaller amount will qualify for depreciation or as a deduction in calculating any gain when B Co subsequently sells the asset. It is not clear why the OECD thinks adjustment should be made in this scenario when no adjustment would be made if Country B simply gave B Co accelerated relief for the price paid, for example, through early depreciation or a deduction for part of the purchase price.

A.2.14 Figure 16 of the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues involves the simultaneous mismatch in the character of a financial instrument leading to a mismatch in character of payments as well as a mismatch in allocation of the instrument (related to who owes the liability). The example adds nothing to the above analysis (particularly that for examples 6 and 10). The issue would largely be addressed by comprehensive withholding of the outbound payment (by Country B). Further, Country A might deny underlying foreign tax relief for a dividend that was deductible by another person, irrespective of whether that person is the payer. Further, Country A might deny underlying foreign tax relief for foreign tax on the basis that it was relieved to another person (B Co).

A.3 Mismatches in respect of persons: examples 11, 12 and 13

A.3.1 The mismatch in example 11 (identifying person) would largely be addressed by comprehensive withholding in Country A. As it sees Z as an entity, it is not clear that Country A has any greater interest in this arrangement. There are likely to be many other scenarios in which a Country A resident is allowed a deduction for a payment to a non-resident that is not subject to substantial taxation, for example, where the recipient is exempt, in a loss position or resident in a tax haven. It is not clear that this scenario warrants any special treatment. As for Country B, this situation is similar to examples 7 and 8 in that it may be granting an unnecessary PE exemption and should perhaps limit its exemption to the amount of income of Z subject to tax in Country A. Further, the scenario in example 11 is unlikely to give rise to tax benefits if Country B adopts a foreign tax credit system. The other comments discussed with respect to Country B for examples 7 and 8 apply equally to example 11.

A.3.2 Figure 9 [figure 2.3 in the OECD Action 2 — 2014 Deliverable] in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues is effectively the same as example 11, but a similar effect may be achieved using a PE instead of a hybrid entity. As discussed in section 2.3 above, a mismatch with a PE may arise under the OECD Model Convention, which under the Authorised OECD Approach under Article 7 (2) requires treating the PE in the host State as a separate entity for purposes of calculating its income.[g] While a similar approach is suggested for the residence State in calculating foreign tax relief, the domestic law of many countries will not authorize this, that is to say, domestic tax law will ignore dealings between a PE and its owner. This may give rise to a mismatch of the same style as in example 11 and the comments there are relevant here. One difference is that tax treaties may see the payment for purposes of calculating the income of the PE but not for purposes of imposing withholding tax on such a payment. Tax treaties may therefore prohibit withholding tax on the deemed payment.[h]

[g] Paragraph 15 of the Commentary on Article 7 of the OECD Model Convention.

[h] Paragraphs 28 and 29 of the Commentary on Article 7 of the OECD Model Convention.

A.3.3 Figure 10 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues is of a similar nature and does involve a payment by a PE, but here the payment is to a recipient that is part of the same group of companies as the owner of the PE. Here the domestic law of the owner of the PE also disregards the payment by the PE, but this time by reason of a rule disregarding transactions between members of a corporate group. The analysis is similar to that for example 11. As in that example, because there is an actual payment made by the owner of the PE (through the PE), the host State can impose withholding tax (and should do so), subject to any limits in tax treaties.

A.3.4 Figure 6 [figure 3.1 in the OECD Action 2 — 2014 Deliverable] in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues involves a mismatch in identification of a person that causes a mismatch regarding who owes a liability and therefore who makes a payment. The consequences are similar to those in example 3 and the mismatch would largely be addressed as discussed above with respect to that example, for instance, by quarantining of foreign expenses.

A.3.5 Figure 7 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues is similar, but involves a mismatch in identifying a PE as a separate income tax calculation entity. As discussed above with respect to figure 9 [figure 2.3 in the OECD Action 2 — 2014 Deliverable], this mismatch arises under the OECD Model Convention as a result of the Authorised OECD Approach under Article 7 (2). Again, the consequences in figure 7 are similar to those in example 3 and the mismatch would largely be addressed as discussed above with respect to that example, for example, by quarantining foreign expenses.

A.3.6 Figure 11 [figure 2.4 in the OECD Action 2 — 2014 Deliverable] in the OECD Public Discussion Draft on BEPS Action 2 involves a mismatch in identification of a person that causes a mismatch as regards who owns an asset (loan) and therefore who receives a payment. Even though this example involves three countries, the consequences are similar to those in example 2 and the mismatch would largely be addressed as discussed above with respect to that example, for instance, by comprehensive withholding in the State of the payer and CFC rules in the State of the ultimate investor.

A.3.7 Figure 17 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues similarly involves a mismatch regarding recipient, this time because of the separate identity of the PE, does not require consideration. This is because this scenario is not beneficial to a taxpayer because the entity characterization is opposite to that in figure 11 [figure 2.4 in the OECD Action 2 — 2014 Deliverable], that is to say, the host State sees the PE as recipient and the residence State sees the owner (head office) as recipient. This requires no adjustment because the potential for double taxation is precisely what is reconciled under tax treaties and unilateral foreign tax relief. Nevertheless, the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues contains only vague comments about how and why this example should be excluded from its recommendations.[i]

A.3.8 Figure 18 of the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues is similar to figure 17 but the PE is in a third State. If the instrument is a hybrid financial instrument, then the consideration with respect to example 6 is relevant. If the instrument is not and the reason why the intermediary country does not tax is because it is a tax haven, it is not clear why the country of the ultimate investor (Country A) is granting foreign tax relief in the form of an exemption for the PE profits. The mismatch would be addressed through comprehensive withholding in the payer State and better targeted foreign tax relief in the investor State.

A.3.9 Figure 13 of the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues is similar to figure 11 but involves the use of two intermediary hybrid companies and two payments. The first payment (Borrower Co to B Co Sub) is the same as in Figure 11 [figure 2.4 in the OECD Action 2 — 2014 Deliverable] and thus the discussion of example 2 is relevant. The second payment (B Co to A Co) is the same as in example 11 and figure 9 [figure 2.3 in the OECD Action 2 — 2014 Deliverable] and thus the discussion of example 11 is relevant. These mismatches would largely be remedied by comprehensive withholding in the State of the ultimate payer (Country C), and the State of the ultimate investor (Country A) taking greater care in structuring its provision of foreign tax relief.

[i] OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues, supra note 2, paragraphs 255 and 256.

A.3.10 Figure 14 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues involves a payment between two hybrid entities and thus a mismatch with respect to both the maker of a payment and the recipient of the payment. The example does not add to the above analysis (particularly that for examples 2 and 3), although it does raise issues regarding whether a foreign tax credit will be granted in the recipient State for any withholding tax imposed by the payer State. The example also demonstrates the danger of the cascading complexity that can arise if the treatment in either State depends on the treatment in the other State.

A.3.11 Figure 15 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues involves a payment under a hybrid instrument made by a hybrid entity. Again, the example does not add to the above analysis (particularly that for examples 6 and 11). What this example demonstrates is the danger of the OECD recommendations overlapping and the need for reconciliation rules.

A.3.12 The mismatch in example 12 is not clearly a direct issue for either Country A or Country B. The benefit of the goods has passed into the jurisdiction of Country A and presuming a market value price is paid, there are no immediate tax consequences in Country A for Z. A may deduct the cost of the goods either as trading stock (inventory), a depreciable asset or other capital asset and is unlikely to have any right to withhold tax from the purchase price. If the goods are sold by Y through a PE situated in either Country A or Country B, then the country where the PE is located will tax accordingly. If Y does not sell through such a PE, then Country A and Country B have no taxing rights with respect to the sale. The unease with this type of example is that Y may avoid paying tax anywhere in the world and as a result have a market advantage in terms of price over other market competitors.

A.3.13 Country A and/or Country B could expand their test of corporate residence (to include both management and formation) or expand their test of PE, but neither would be a complete answer to the problems of so-called toll manufacturing or toll processing. Any such attempt will simply cause Y to be formed and managed in a more tax-friendly environment. If Y is a company controlled by a resident of Country A or Country B, then the country of the controller may apply CFC rules to ensure that there is no bias against making a sale through a PE in the jurisdiction of the controller. That is also not a satisfactory answer because corporate groups that suffer CFC rules are at a competitive disadvantage to groups that do not, whatever the market, including the market in the jurisdiction of the controller. There have been a number of recent headline examples involving base erosion and profit shifting which demonstrate that CFC rules should be careful when incorporating an exemption for foreign active business.[j]

A.3.14 The mismatch in example 13 would largely be addressed by quarantining foreign expenses and denying duplication of losses. This example is similar to the double-dip deduction in example 3, and the discussion with respect to that example is relevant here. The losses of Z are likely to have a foreign source for either Country A or Country B (or both) and thus would not be available to offset domestic source income. If, for example, the losses have a source in Country A and are surrendered to a related company there, then Country B would deny a deduction for the losses. Similarly, Country A would deny the losses if they are surrendered under group relief in Country B. The possibility that the loss would be denied in both countries is something that tax planners can usually address and does not seem to warrant specific consideration. Figure 8 [figure 3.2 in the OECD Action 2 — 2014 Deliverable] in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues is effectively the same as example 13.

A.3.15 Figure 21 in the OECD Public Discussion Draft on BEPS Action 2 — Domestic Issues involves a mismatch in characterizing an entity (not whether it exists or not) that causes a mismatch in determining who is allocated the benefit of a payment made by the entity. The host State (Country B) sees B Co as a taxable entity and thus recognizes that B Co has the benefit of the deduction for interest, which can be surrendered under group relief to B Sub 1. The investor State (Country A) sees a partnership and allocates the interest expense to the partner (A Co). The result is a double deduction for (part of) the same expense. Comprehensive withholding by the State of payer (Country B) will largely address the mismatch in this case. For the investor State, the expense is foreign and might be quarantined for use only against

[j] For example, see Anthony Ting, "iTax — Apple's International Tax Structure and the Double Non-Taxation Issue," (2014), No. 2 *British Tax Review*, 40-71.

foreign source income, although in this case A Co has plenty of foreign source income. In addition, the investor State should arguably not give relief for an expense that has been relieved to another person. In this case, as the expense of B Co is used by B Sub 1 in the host State (Country B), the investor State (Country A) might deny A Co a deduction in that respect.

Chapter VI

Preventing tax treaty abuse

Graeme S. Cooper*

1. Introduction

Many developing countries have already negotiated a number of tax treaties with their neighbours and with capital exporting countries. Others are keen to expand their existing tax treaty network. An extensive treaty network is typically considered to be an important indicator that a developing country can use to signal that it is keen to attract foreign direct investment (FDI) and that it is willing to impose tax on foreign investors according to internationally accepted taxation norms. Bilateral income tax treaties are a manifestation of a country's desire for economic development and greater integration in the global economy.

While income tax treaties are thus important indicators to the international community, the experience of developing countries, like developed countries, is that treaties can be misused as part of sophisticated tax planning to frustrate the tax claims of developing countries. Tax treaty abuse is a matter which has caught the attention of the revenue authorities of some developing countries already. For example, in response to the questionnaire circulated in 2014 by the United Nations Committee of Experts on International Cooperation in Tax Matters — Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries, Mexico noted that, "our priorities are Action 6 and the Actions related to Transfer Pricing (Actions 8, 9 and 13)." [1] Similarly, part 1 of the report of the Organisation for Economic

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[1] Government of Mexico, "Mexico's Experiences Regarding Base Erosion and Profit Shifting Issues," available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsMexico.pdf. The responses from Chile, India, Thailand and Zambia also emphasised the importance of treaty abuse: see http://www.un.org/esa/ffd/tax-committee/tc-beps.html.

Co-operation and Development (OECD) on the impact of the project to deal with base erosion and profit shifting (BEPS) in low income countries[2] lists treaty abuse as one of the high priority action items for developing countries, noting concerns from Zambia and Mongolia. The present chapter is about how developing countries can protect their domestic tax base against erosion arising from the abuse of the tax treaties they have negotiated or are pursuing.

1.1 OECD Action Plan on BEPS (July 2013)

Action 6 in the OECD Action Plan on Base Erosion and Profit Shifting (OECD Action Plan on BEPS) refers to the ways in which taxpayers can abuse a country's network of tax treaties and mechanisms designed to counter this behaviour. Action 6 requires the OECD to:

> Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be coordinated with the work on hybrids.[3]

This Action, as originally presented in 2013, covers three distinct themes:

- Developing recommendations to prevent inappropriate access by taxpayers to a country's tax treaty network. These recommendations will involve both changes to the text of the Organisation for Economic Co-operation and Development

[2] Organisation for Economic Co-operation and Development, *Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* (Paris: OECD, 2014), available at http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf.

[3] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf.

Model Tax Convention on Income and on Capital[4] (OECD Model Convention) and changes to domestic tax rules;

- Clarifying, possibly within the text of the OECD Model Convention, the Commentary or elsewhere, that tax treaties are not intended to generate double non-taxation. It is presumably this theme which would be coordinated with the work on hybrids;[5] and
- Developing recommendations about the considerations which should influence a country in deciding whether to enter into a tax treaty with another country.

1.2 Public Discussion Draft (March 2014)

In March 2014, the OECD issued a second document, Public Discussion Draft, BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances[6] (OECD Public Discussion Draft on Action 6), elaborating the Action in more detail.[7] It made recommenda-

[4] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

[5] A separate discussion paper was issued by the OECD in March 2014 dealing with amendments to the OECD Model Convention and Commentary to address the problem of hybrid entities and instruments. See OECD, *Public Discussion Draft, BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)* (Paris: OECD, 2014), available at http://www.oecd.org/ctp/treaties/hybrid-mismatch-arrangements-discussion-draft-treaty-issues-march-2014.pdf.

[6] OECD, *Public Discussion Draft, BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (Paris: OECD, 2014), available at http://www.oecd.org/ctp/treaties/treaty-abuse-discussion-draft-march-2014.pdf.

[7] The OECD Action Plan on BEPS in 2013 had identified as the outputs from this Action both proposals for changes to the text of the OECD Model Convention and "recommendations regarding the design of domestic rules." See OECD, *Action Plan on Base Erosion and Profit Shifting,* supra note 3, at 31. The March 2014 document focuses principally on proposals for changes to the text of the OECD Model Convention and the Commentary thereon. It is not clear whether future OECD work will propose drafts of domestic legislation designed to implement or buttress the treaty proposals.

tions for action with regard to the above-mentioned themes, but it also added a fourth and fifth dimension to the issue. It referred to:

- Instances where a treaty is used as the pretext for an argument that a domestic anti-abuse rule is rendered ineffective; and
- A number of specific instances where the drafting of the OECD Model Convention should be tightened or clarified to control identified abusive practices.

While the latter involves measures that are largely routine monitoring and housekeeping, adding the impact of treaties on domestic anti-abuse rules is important because it adds an additional dimension to the notion of treaty abuse. The first theme focuses on "abuse" consisting of non-residents inappropriately gaining access to a treaty in order to enjoy treaty benefits. It is abuse "of" a treaty. But in the fourth theme, the abuse consists of structures or transactions, especially those undertaken by residents, which are designed to enliven a treaty with the expectation that it will defeat a domestic anti-abuse rule; the abuse is not in inappropriately accessing a treaty network, but in employing a treaty to defeat a domestic anti-abuse outcome. It is abuse "by" a treaty.

The OECD agenda for countering tax treaty abuse is thus rather more expansive than typical discussions of "treaty shopping," which focus merely on the issue of inappropriately accessing treaty benefits. The potential for treaties to thwart anti-abuse rules, the exploitation of treaties to generate double non-taxation and the policy drivers for selecting appropriate treaty partners, which have all been incorporated into this Action, are examined far less often.

1.3 Recommendations (September 2014)

The OECD received many submissions on the OECD Public Discussion Draft on Action 6[8] and in September 2014 released its response to those comments in its related recommendations on measures to address treaty abuse.[9] These recommendations retain the same basic themes

[8] OECD, *Public Discussion Draft, BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, supra note 6.

[9] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Cir-*

and approaches as the OECD Public Discussion Draft on Action 6, with the addition of more detailed commentary on the meaning and operation of some of the changes being advanced.

However, with respect to the first theme of the OECD work — the problem of non-residents gaining inappropriate access to treaties — a new approach was proposed. It is recommended that countries should have some flexibility in how they implement measures to protect their treaties so as to achieve a set of "minimum standards." These "minimum standards" are about how to combine the multiple proposals made in the OECD Public Discussion Draft on Action 6 and any existing measures that countries might already have in place. As will be seen, a combination of general approaches to treaty abuse are proposed in the recommendations (the changes to the Preamble, a structural limitation on benefits clause and a purpose-based limitation on benefits clause) along with a number of specific measures directed at particular current problems. But given that many countries have already adopted particular anti-abuse measures in their model treaties, such as specific limitation of benefit articles (especially in the dividend, interest and royalties articles) and specific rules for conduit financing (back-to-back transaction rules), there was some question whether existing practices were meant to be superseded by the changes proposed in the OECD Public Discussion Draft on Action 6. The minimum standards offer a matrix of combinations of these individual elements and a country's existing anti-abuse measures, permitting a suite of measures to be used to achieve an acceptable level of protection. As stated in the recommendations:

> given the variety of approaches, a number of treaty provisions recommended in this report offer alternatives and a certain degree of flexibility. There is agreement, however, that these alternatives aim to reach a common goal, that is to say, to ensure that States incorporate in their treaties sufficient safeguards to prevent treaty abuse, in particular as regards treaty shopping. For that reason, the report recommends a minimum level of protection that should be implemented.[10]

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cumstances — Action 6: 2014 Deliverable (Paris: OECD, 2014). The text contains related recommendations.

[10] Ibid., at 9.

1.4 General effects

It is worth noting that if the OECD work on this portion of the BEPS agenda is fruitful, it is likely to be valuable to developing countries. One of the principal effects of a tax treaty is to limit the ability of source countries to retain tax claimed under domestic law. This can come about explicitly through the allocation rules in a treaty (for example, the requirement of a permanent establishment (PE) before the source country can tax business profits), through the rate limitation provisions (for dividends, interest and royalties), and less obviously through income classification rules.[11]

As developing countries are predominantly source countries, and less prominent capital exporting countries, limits on the ability of source countries to insist on domestic law tax claims are particularly important for them. When developing countries negotiate a treaty, therefore, they are making a decision to surrender tax claimed under domestic law in exchange for the benefits that the treaty promises. Because this item in the OECD Action Plan on BEPS is directed at curtailing the circumstances where treaties can be invoked — and source-country tax claims reduced — it should be especially valuable for developing countries. The OECD notes that the impact of work on this action item should be to reinforce source-country tax claims:

> Tight treaty anti-abuse clauses coupled with the exercise of taxing rights under domestic laws will contribute to restore source taxation in a number of cases.[12]

[11] Limits on the taxing rights claimed by source countries can come about through the income classification rules that treaties employ. For example, income which a source country might classify and tax under domestic law as a royalty (and thus amenable to tax at source under Article 12 of the United Nations Model Convention) might, where the treaty supplants domestic law definitions, be classified for the purposes of a treaty as business profits (and thus taxable at source only if a permanent establishment (PE) exists). One obvious example of this kind of outcome arose from the reclassification in the OECD Model Convention of income from the leasing of cargo containers in the mid-1990s.

[12] See OECD, *Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries*, supra note 2, at 18.

Finally, it is worth thinking about the relationship between the work being undertaken at the OECD and the work being conducted under the auspices of the United Nations. The OECD project on BEPS will likely lead to changes to the text of the OECD Model Convention and Commentary and recommendations for changes to domestic tax laws. The United Nations response to this work may lead to parallel changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention)[13] and its Commentary, as well as recommended changes to domestic laws. But it is worth noting that the items on the OECD Action Plan on BEPS are not necessarily exhaustive of the range of issues that may concern developing countries, nor are the solutions proposed necessarily ideal for developing countries. The United Nations may wish to explore other options for protecting the tax base of developing countries. Some other possibilities not currently being considered are mentioned below.

2. Theme 1 — Inappropriately accessing treaty benefits

Arrangements by which taxpayers from a third country can gain access to a State's treaty network may pose a serious threat to the tax system of that State. Tax treaties are individually negotiated bargains between sovereign States, and one significant effect for a source country from concluding a treaty is that its ability to retain tax claimed under domestic law will be constrained. Presumably source countries have taken this decision and entered into a treaty in the expectation that this reduction in tax will be enjoyed only by the residents of the other contracting State. Where residents of third States are able to enjoy those benefits, governments cannot be sure that they have appropriately quantified the amount of revenue loss that the treaty will produce. Similarly, source countries may find that other benefits they hoped to secure from the treaty — access to information held offshore, a formal system for resolving tax disputes, the promise of non-discrimination, assistance in collecting taxes, and so on — cannot be fully provided by

[13] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

the tax administration of the treaty partner because the taxpayer lacks any real presence in the other contracting State.

A State might, nevertheless, be tempted by the argument that any new investment is to be welcomed, even if it comes as a result of third State investors shopping into the country's treaty network. After all, the point of the treaty was to encourage greater inward investment and this has been achieved, albeit from an investor resident in a third State. This position may be tempting, but it is short-sighted.[14]

Just how serious the threat of improperly accessing a country's tax treaties is depends to some extent on who is gaining access to the treaty. It can be helpful to draw a distinction between two different forms of inappropriate access to a treaty:

- Shopping into a tax treaty — a taxpayer resident in State C (a State which does not have a treaty with the source country, State A) puts in place a mechanism to get access to the treaty between State A and State B; and
- Shopping between tax treaties — a taxpayer resident in State C (a State which has a treaty with the source country, State A) puts in place a mechanism to get access to the treaty between State A and State B, instead of being subject to the terms of the treaty between State A and State C.

The second situation may, but need not, be problematic for State A. As will be seen, the difference can matter when tax officials try to decide what situation should be taxed in lieu of the offending situation — that is to say, if the benefits of the treaty are to be denied, should other tax consequences follow instead?

The principal factors which encourage shopping into tax treaties and shopping between tax treaties are:

[14] The considerations for capital exporting countries are slightly different. Their concern will likely be that third countries will see less need to negotiate a treaty if their residents can free-ride on the treaty of another country. The residents of the capital exporting country will not enjoy reduced source-country taxation in those third countries. This will mean that the capital exporting country will reduce its revenue claims without the offsetting increase in revenue expected to arise from a corresponding reduction in the source country.

- The extent of the divergence of the tax treaty from the claims made under domestic tax law; and
- The extent of the divergences between treaties negotiated with different States.

Where the tax claims made by domestic law are not significantly reduced by the terms of a treaty and the terms of the individual treaties in a State's treaty network are not significantly different, the attractiveness of treaty shopping is much reduced. Thus there is a place for States to consider the settings in their domestic law as a means of controlling treaty abuse.

This point is worth emphasizing as developing countries have traditionally expressed the view that the architecture of the international tax framework should provide greater scope for the taxation of income at source. While greater source taxation may seem appealing, given international competition for investment, it is likely to be sustainable only in cases where the source country has some specific advantage which is peculiar to the country, such as a particular resource. In the absence of some particular advantage, source countries may discover that insisting on high source-country taxation produces reduced levels of foreign investment. Consequently, it may well be that in many cases — for example, withholding taxes on interest paid to unrelated lenders — low source-country taxation is necessary in order to attract capital and has the added advantage of reducing the scope for treaty abuse.

The most difficult part of any discussion of "inappropriate" access to treaties lies in defining what is, and is not, appropriate. The Commentary on Article 1 of the United Nations Model Convention contains a long description of various forms of abuse of treaties and some mechanisms that countries may employ to counter these practices.[15] It is not always easy to identify when non-residents claiming to

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[15] See paragraphs 8-103 of the Commentary on Article 1 of the United Nations Model Convention. See also Philip Baker, "Improper use of tax treaties, tax avoidance and tax evasion," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties* (New York: United Nations, 2013), available at http://www.un.org/esa/ffd/wp-content/uploads/2014/08/UN_Handbook_DTT_Admin.pdf.

be entitled to the benefits of a treaty should be denied those benefits. Many different definitions and different terms are used to denote the inappropriate enjoyment of treaty benefits, the most common being "treaty shopping." Most of the definitions of treaty shopping or treaty abuse involve some notion of purpose or intention — that is to say, the result of deliberate planning and conscious decision-making, rather than a more objective set of facts and circumstances. Tests which rely upon notions of "purpose" or "intention" are notoriously difficult for tax administrations to administer and for taxpayers to comply with. It is not surprising, therefore, that other more mechanical tests are used to control the misuse of treaties. These tests, however, can create their own problems if they are triggered in inappropriate circumstances. It can, therefore, be important to have a further fallback, allowing the competent authorities to deliver access to treaties or deny access that might otherwise be given. As will be seen below, the approach being advocated by the OECD combines all three elements: a test based on the taxpayer's purpose, a test that is more mechanical and describes a state of affairs, and a safety valve in the form of negotiations between the competent authorities.

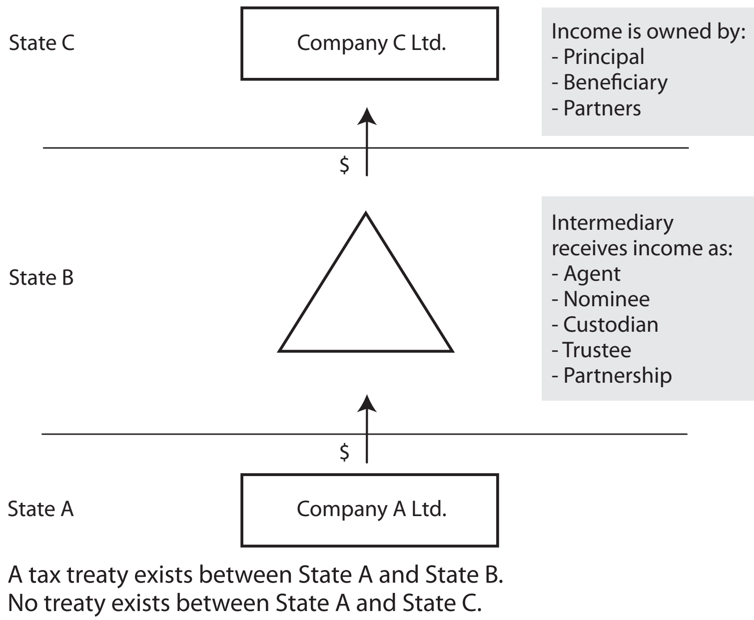
2.1 Examples of some structures for accessing treaties

There are many mechanisms by which treaty benefits can be inappropriately enjoyed unless they are monitored and countered. The simplest arrangements involve the creation in the treaty partner of a contractual or legal arrangement that is transparent for tax purposes under the law of that State. For example, income may be paid to an entity in the treaty partner which receives the income:

- As an agent for a principal resident in the non-treaty State;
- As a nominee or custodian for a taxpayer resident in a third State;
- As trustee of a bare trust for a beneficiary resident in a third State;
- As trustee of an active trust for beneficiaries primarily resident in a third State;
- As a partnership of entities primarily resident in a third State.

If, under the law of State B, these arrangements are fiscally transparent — that is to say, no tax is levied in State B on the income in the hands of the agent, nominee, custodian, trustee or partnership — the treaty between State A and State B should not be invoked to limit State A tax claims.

Example 1



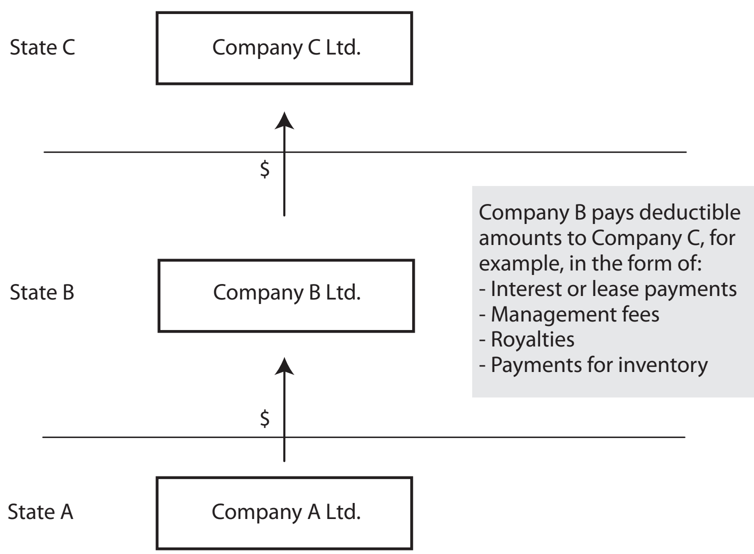
This may already be acknowledged. Accepted interpretations of several explicit provisions in tax treaties would deny treaty benefits to the intermediary in State B. For example, where the relevant arrangement is simply contractual (the resident of State C has organized for its income to be collected by an agent or custodian), the relevant "person" for treaty purposes is the person with whom the resident is dealing, and that is the resident of State C not its agent.[16] Second, the intermediary may not satisfy the requirements of being a "resident" of State B for the purposes of the treaty — if the tax liability falls on the principal, beneficiary or partners and not the intermediary, the intermediary is not a "person

[16] See Joanna Wheeler, "Persons qualifying for treaty benefits," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*, supra note 15.

who, under the laws of that State, is liable to tax therein." Similarly, if the income involved is a dividend, interest or royalty, the intermediary ought not to be regarded as the "beneficial owner" of the income.

However, there will often be less obvious arrangements by which taxpayers can gain access to a treaty network. For example, an entity may be established in the treaty partner which is a taxpayer in that State in its own right and a resident, but in effect it is an empty shell because it pays its entire income to a taxpayer resident in a third country (that is, base erosion). While these payments might sometimes trigger withholding tax on the way out of State B, they may not bear tax at the full corporate rate levied in State B. Indeed, the withholding taxes levied by State B may themselves be reduced if a treaty exists between State B and State C.

Example 2



A tax treaty exists between State A and State B.
No treaty exists between State A and State C.

In this situation it is less obvious that the transaction will be easily amenable to challenge without provisions in the treaty or perhaps domestic law — provisions which the laws and treaties of a developing country might currently lack. Company B is clearly a "person" for the purposes of the treaty; it is likely to meet the tests for being a "resident" of State B; and it is harder to argue that Company B is not the "beneficial owner" of the amounts it has received merely because it has undertaken obligations which will result in it having to spend that income or choosing to distribute it as a dividend.[17]

2.2 Challenging inappropriate access using domestic law

Most countries will have domestic rules which aim to prevent or minimize the scope for tax avoidance, and these measures may be suitable to use as weapons against treaty abuse.

The first issue that arises is to ensure that a country has a complete set of domestic anti-avoidance rules. Developed countries will often have a very large suite of domestic anti-avoidance rules, such as thin capitalization rules, controlled foreign company and foreign investment fund rules, indirect asset transfer rules, transfer pricing rules, specific anti-avoidance rules and statutory general anti-avoidance rules. Developing countries which lack comprehensive anti-abuse rules make the task of countering the most common forms of abuse more difficult.

Similarly, existing judicial doctrines (with labels such as "business purpose," "economic substance," "abus de droit" or "substance over form") which were developed initially to control domestic tax abuse may also play a role in preventing tax treaty abuse.

The obvious issue is whether the suite of domestic legislative and judicial rules can be raised against practices which rely upon a treaty but are regarded as treaty abuse. It is sometimes argued that domestic anti-avoidance rules and existing judicial anti-avoidance doctrines cannot be applied if they would have the effect of denying the benefits which a treaty apparently offers. The Commentaries on both the United Nations and the OECD Model Conventions accept that specific

[17] The meaning of "beneficial owner" is examined at length in Joanna Wheeler, "Persons qualifying for treaty benefits," supra note 16. See also OECD, *OECD Model Tax Convention: Revised Proposals Concerning the Meaning of "Beneficial Owner" in Articles 10, 11 and 12* (Paris: OECD, 2012), available at http://www.oecd.org/ctp/treaties/Beneficialownership.pdf.

legislative anti-abuse rules, general anti-abuse rules and general judicial doctrines that are part of domestic law do have the potential to generate conflicts between the treaty and domestic law, and that in cases where the other treaty partner considers that the domestic rule results in a direct conflict, the treaty must be given priority.[18]

The issue is not simple, however. It is worth noting that Canada, which is currently undertaking a review into mechanisms to curb treaty abuse, appears inclined to approach the problem through amendments to its domestic law.[19] The position taken by the Government of Canada is that it can approach the problem through domestic provisions because "domestic law provisions to prevent tax treaty abuse are not considered by the OECD or the United Nations to be in conflict with tax treaty obligations and a number of other countries have enacted legislation to that effect."[20] Australia has attempted to resolve any doubt by inserting a provision in its domestic law which asserts that its general anti-abuse rule will prevail over its treaties, and since that 1981 provision has been in place, it has been assumed that all treaties entered into thereafter were negotiated on the basis that this provision was acceptable to the treaty partner.

The Commentary on the United Nations Model Convention proposes another way of dealing with any argument about inconsistency.[21] It suggests mechanisms inside a treaty which are likely to mirror the

[18] See paragraph 15 of the Commentary on Article 1 of the United Nations Model Convention.

[19] The Government of Canada announced in its 2013 Budget that it would initiate a project to address treaty abuse. The Ministry of Finance of Canada released a consultation paper in August 2013: Government of Canada, *Consultation Paper on Treaty Shopping — The Problem and Possible Solutions*, available at http://www.fin.gc.ca/activty/consult/ts-cf-eng.asp. In the February 2014 Budget, the Government of Canada canvassed a domestic provision to curb treaty shopping: Government of Canada, *Budget 2014, Annex 2 — Tax Measures; Supplementary Information*, available at http://www.budget.gc.ca/2014/docs/plan/anx2-1-eng.html.

[20] Government of Canada, *Budget 2014, Annex 2 — Tax Measures; Supplementary Information*, supra note 19.

[21] See paragraphs 34 ff. of the Commentary on Article 1 of the United Nations Model Convention.

intended scope and operation of domestic rules. Being inside the text of the treaty, the possibility of a conflict is removed — the domestic law provisions need not be called upon to counter the abuse. The OECD Action Plan on BEPS suggests some similar approaches to be included in the text of the OECD Model Convention and the Commentary. These recommendations are discussed further in section 2.3 below.

The administrative requirements necessary to enjoy treaty benefits may also play a part in detecting and countering treaty abuse.[22] Clearly, some evidence must exist to establish the entitlement of a non-resident to treaty benefits and States should consider carefully the kind and the extent of the evidence that needs to be provided, the entity to whom this evidence should be provided and who is responsible for retaining this evidence. For income such as dividends, interest, royalties or gains, there may be a question whether treaty benefits are delivered at source or whether non-resident taxpayers must apply to have the relevant tax refunded to them. It may be appropriate for the revenue authority's audit programmes to undertake subsequent confirmation and verification to ensure that the facts which justified the granting of treaty benefits still exist. Part of this process may involve using the exchange of information provisions of a bilateral treaty or the Multilateral Convention on Mutual Administrative Assistance in Tax Matters[23] to verify and detect instances of inappropriate access.

This role that administrative systems can play in controlling inappropriate access to tax treaties is not discussed in the OECD Action Plan on BEPS, but States should carefully consider how their administrative regimes are established so that they both clearly deliver the benefits that the treaty requires and have inbuilt safeguards that can impede the inappropriate access of treaties. Clearly, excessive administrative obligations have the potential to undermine the benefits that

[22] See generally, paragraphs 100 ff. of the Commentary on Article 1 of the United Nations Model Convention. See also, Peter A. Harris, "Taxation of Residents on Foreign Source Income," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*, supra note 15.

[23] OECD-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, available at http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf.

the treaty was intended to secure, and so the issue becomes one of balancing the need for a quick and streamlined process against the possibility of ongoing undetected abuse.[24]

In summary, domestic substantive and administrative rules can play a part as weapons against treaty abuse. The next stages in the OECD Action Plan on BEPS may well suggest some draft domestic legislation to buttress the proposals for changes inside the text of treaties.

2.3 Challenging inappropriate access under the terms of the treaty

The problem of inappropriate access to treaty benefits is not something that has taken the international community by surprise. The United Nations and the OECD have very detailed Commentaries on the operation of their Model Conventions and each Commentary already outlines a number of strategies and approaches which might be invoked to counter treaty abuse.

The Commentary on the OECD Model Convention (endorsed in the Commentary on the United Nations Model Convention) examines the notion of the abuse of a treaty as a doctrine of international law which might allow the benefits of a treaty to be denied; that is to say, a notion which already underlies the operation and interpretation of tax treaties as international instruments:

> [A] proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties).[25]

[24] See generally, paragraphs 100 ff. of the Commentary on Article 1 of the United Nations Model Convention; see also paragraph 26.2 of the Commentary on Article 1 of the OECD Model Convention.

[25] See paragraph 9.3 of the Commentary on Article 1 of the OECD Model Convention.

The Commentaries on individual articles in each Model Convention also contain many passages which draw attention to possible interpretations of the text which can buttress the arguments of tax officials seeking to deny treaty benefits.

The OECD recommendations encourage some new approaches to the problem which will be incorporated in the OECD Model Convention and Commentary. Some of these measures are in common use; others are not. Developing countries may wish to include provisions such as these in their treaties in order to enhance the integrity of future treaties. Four separate strategies are being proposed:

- A general limitation of benefits article based on observable structural features;
- A general limitation of benefits article based on a purpose or state of mind;
- A change to the Preamble to the OECD Model Convention to reiterate that the treaty is not intended to provide relief from tax to residents of third States; and
- A list of potential individual changes to the Model Convention and Commentary to address a number of particular issues that have been identified as abuses of treaties.

The "minimum standard" proposed in the recommendations sets out a matrix of recommended combinations of these individual elements and a country's existing anti-abuse measures.

2.3.1 A general limitation on benefits article

One of the measures likely to follow from the OECD project on BEPS is the inclusion in the text of the OECD Model Convention of a general "limitation on benefits" (LOB) article. An LOB article is already discussed in the Commentary to the United Nations Model Convention[26] and the Commentary to the OECD Model Convention.[27]

[26] See paragraph 56 of the Commentary on Article 1 of the United Nations Model Convention.

[27] A limitation on benefits article is already set out in paragraph 20 of the Commentary on Article 1 of the OECD Model Convention.

But the clause will be given much greater prominence if it is moved to the body of the treaties. The clause proposed in the recommendations differs in some important respects from the texts in the United Nations and OECD Model Conventions, no doubt reflecting current thinking about how to design LOB clauses. Some other countries routinely employ LOB provisions (the clause being proposed resembles Article 22 of the United States Model Income Tax Convention of November 15, 2006[28] (United States Model Convention)) and making the article part of both Model Conventions will likely lead to more widespread adoption.

The proposed LOB clause adds a further requirement before treaty benefits will be conferred. It is not sufficient that the relevant taxpayer is a "resident" of the other contracting State. In addition, the taxpayer will have to meet one of two (or perhaps three) other tests.

2.3.1.1 Qualified person

The first option will be if the taxpayer can demonstrate that it meets the definition of a "qualified person". The clause proposed in the OECD Public Discussion Draft on Action 6 states:

> 1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to the benefits of this Convention otherwise accorded to residents of a Contracting State unless such resident is a "qualified person" as defined in paragraph 2.

Where this test is met, the entity will enjoy all of the benefits of the treaty. Whether or not an entity is a "qualified person" is reassessed for each year:

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if …

The definition of "qualified person" is drafted using a number of observable criteria. They are alternative means of satisfying the "qualified person" test. The discussion below breaks down the proposed

[28] United States Model Income Tax Convention of November 15, 2006.

OECD clause into a series of discrete clauses, and explains the kinds of entities and situations to which it is catering. The qualifications and limitations surrounding the rules are also examined.

One set of tests focuses on the status of the foreign entity. Therefore, an individual who is a resident of one of the contracting States will always be a "qualified person":

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:
>
>   a) an individual;

In the same way, the government of the other contracting State and some government-owned agencies will also be a "qualified person":

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is…
>
>   b) a Contracting State, or a political subdivision or local authority thereof, or a statutory body, agency or instrumentality of such State, political subdivision or local authority;

Third, various types of charities, benevolent and cultural institutions will typically be a "qualified person" if they are established for one of the specified purposes:

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is…
>
>   d) a person, other than an individual, that
>
>   i) was constituted and is operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes;

In this formulation, it is not necessary that the entity be exempt from tax in the residence country, although this will often be the case for religious, charitable and similar organizations. Similarly, it is not sufficient that the entity is exempt from tax in the residence country — for example, various sporting organizations or hospitals might be tax exempt in the residence country but they would not qualify under subparagraph d).

Presumably, an entity is being "operated exclusively" for the appropriate purposes if it owns investments which generate income, even if some of that income might be retained rather than applied to current works. It may be more difficult to say that a company wholly owned by a charity or similar entity is being "operated exclusively" for the appropriate purposes when its function is to fund activities rather than conduct them itself. Similar issues could arise if charities are permitted for tax and regulatory purposes to undertake commercial activities, provided the profits generated from those activities are applied to the charitable works in question — for example, a charity which operates a second-hand bookshop selling donated books, where the proceeds are paid to the charity to further its work. The status of "qualified person" can be lost if business activities occur within the entity: the person must be "operated exclusively" for one of the listed purposes and it is not obvious that the book sales amount to charitable works even if they are undertaken to fund charitable works. There would be some doubt whether this problem could be solved by conducting the business activity through a wholly owned subsidiary. Again, the issue would be whether the entity is "operated exclusively" for one of the purposes if it is operated to fund the activity.

Fourth, subparagraph d) also extends the status of "qualified person" to private pension funds established to provide pension and similar benefits principally to persons who are residents of either of the contracting States:

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is…
>   - d) a person, other than an individual, that…
>   - ii) was constituted and is operated exclusively to administer or provide pension or other similar benefits, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident in either Contracting State.

The formulation used in this section appears to refer to the number of beneficial interests ("more than 50 per cent of the beneficial interests") rather than the value of the interests or the way the income is being applied in any year.

Subparagraph d) also extends to include investment funds, presumably investment funds that are not providing retirement income benefits:

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is…
>
>   d) a person, other than an individual, that…
>
>   iii) was constituted and is operated to invest funds for the benefit of persons referred to in subdivision ii), provided that substantially all the income of that person is derived from investments made for the benefit of these persons.

The Commentary on this provision suggests that it is intended to apply to an investment fund that is established to invest funds for the benefit of other pension funds. In practice, there would likely be difficulties unless a separate class of investment fund emerges in the market which accepted investments only from pension funds. An investment fund which accepted investments from pension funds and, say, banks and life insurance companies, would probably not satisfy the requirement that "substantially all the income of that person is derived from investments made for the benefit of the pension funds."

For this reason, the recommendations provided by the OECD in Preventing the Granting of Treaty Benefits in Inappropriate Circumstances — Action 6: 2014 Deliverable (OECD Action 6 — 2014 Deliverable) also include possible provisions for collective investment vehicles (CIVs). However, the drafters obviously feel that the identification of appropriate CIVs is not straightforward and so they include two variants:

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is…
>
>   f) a CIV [a definition of CIV would be included in subparagraph f) of paragraph 6];
>
>   [or]
>
>   f) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the CIV are owned by residents of the Contracting State in which the

> collective investment vehicle is established or by equivalent beneficiaries;

A second part of the "qualified person" test focuses on the ownership structure of the entity. This part of the test is intended for artificial legal entities such as companies, trusts and partnerships. For these kinds of entities, the tests focus on a number of different criteria — sometimes the residence of the owners of the entity, sometimes the place where it is managed, sometimes the place where its shares are traded, and so on.

First, a rule is created for a publicly traded company — that is to say, a company in which the principal class of shares is regularly traded on a recognized stock exchange in either State (or in a third State, if the competent authorities agree). Such a company can be a "qualified person" in one of two ways based on where its shares are traded or where its executives work. The rule applies only to "companies." Other entities which have interests that are listed on a stock exchange and regularly traded do not fall under this provision.

The first option for becoming a "qualified person" is to demonstrate that the listed company's main class of shares is principally traded on the recognized stock exchanges of its State of residence — that is to say, its shares are locally traded:

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is…
>   c) a company, if:
>   i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and…
>   A) its principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident;

This test looks to the location of the stock exchange rather than to the location of the ultimate shareholders. It is quite possible, therefore, that a company will qualify under this test even though a substantial proportion of its ultimate shareholders will not be residents of the State where the stock exchange is located. This test looks no further than the location of the stock exchange.

The test also does not expressly disqualify a listed company based on the degree of concentration of ultimate share ownership. It is quite possible, therefore, that a company could qualify under this test even though a significant parcel of its shares is held by a single shareholder resident in a third country. There is no express indication how many of the principal class of shares must actually be actively traded or how frequently.[29]

The test is applied to the company's "principal class of shares" and any "disproportionate class of shares," and it is these shares which must be "primarily traded" on one of the appropriate stock exchanges. Other classes of shares which are insignificant will not count for the purposes of this test; minor trading even in the "principal class of shares" on other exchanges will not disqualify the company. And a special provision is added to deal with dual-listed company structures.

Notice should also be taken of the interplay between the place of the company's residence and the place where its shares are principally traded. A company which is a resident of a third State cannot become a "qualified person" under this paragraph merely because its shares are traded on the stock exchange of one of the contracting States. Moreover, a company which is a resident of one State would lose access to treaty benefits if its shares are traded primarily on the stock exchange of the other State or a third State.

For publicly traded companies, the second possibility is that the company's principal place of management and control is located in its State of residence — that is to say, it is locally managed:

[29] The United States Model Convention includes a similar phrase and the Technical Explanation Accompanying the United States Model Convention takes the view that shares would be "regularly traded" if trades in the shares occurred on at least 60 days per year and the aggregate number of shares which turned over during the year was at least 10 per cent of all the shares on issue. This interpretation follows from United States law but it gives an indication of the kind and level of activity that might satisfy a "regularly traded" test. See Commentary on Article 22 of the United States Model Convention, available at http://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf.

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is…
>   c) a company, if:
>   i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and…
>   B) the company's primary place of management and control is in the Contracting State of which it is a resident;

The definition of "primary place of management and control" in paragraph 5 reads:

> d) a company's "primary place of management and control" will be in the Contracting State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that Contracting State than in any other state and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions in that Contracting State than in any other state.

That is to say, the test focuses on the place where operating decisions are made, not, for example, where the company's directors meet nor where shareholder meetings occur. The test involves many components:

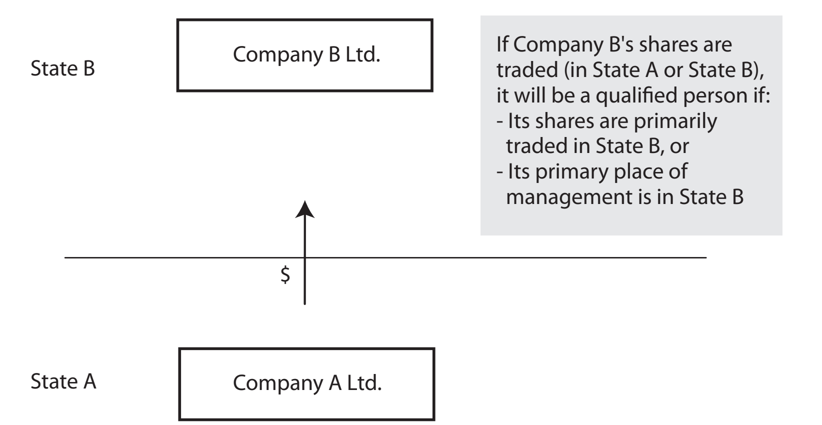
- First, it is applied by looking at only certain corporate executives: "executive officers and senior management employees" and "the staff of such persons." It seems that the test will be failed if either group does not satisfy the test;
- Second, within that group, the test examines only those involved in "strategic, financial and operational policy decision making." They must have and exercise day-to-day decision-making responsibilities;
- Third, the test recognizes that management decisions can be spread throughout a corporate group, so the requirement is that

more of the relevant preparation and ultimate decisions occur in the residence State than occur elsewhere;

- The test appears to focus on the number of decisions rather than their importance;
- The test requires an examination of the decision-making for the company claiming to be entitled to treaty benefits and any "direct and indirect subsidiaries." Clearly, the listed company will not be a "qualified person" under this option if it is effectively managed from offshore, but the drafting suggests that the listed company must assume responsibility for the decision-making of subsidiaries; relevant operational policy decisions cannot apparently be left to the executives of the operating subsidiaries.

Where either the "locally traded' or "locally managed' test is satisfied, the listed company will enjoy access to all treaty benefits, but the most important ones are likely to be treaty benefits for dividends, interest and royalties received from its subsidiary in the source country, and treaty benefits for income from business activities conducted in the source State without a permanent establishment (PE).

Example 3

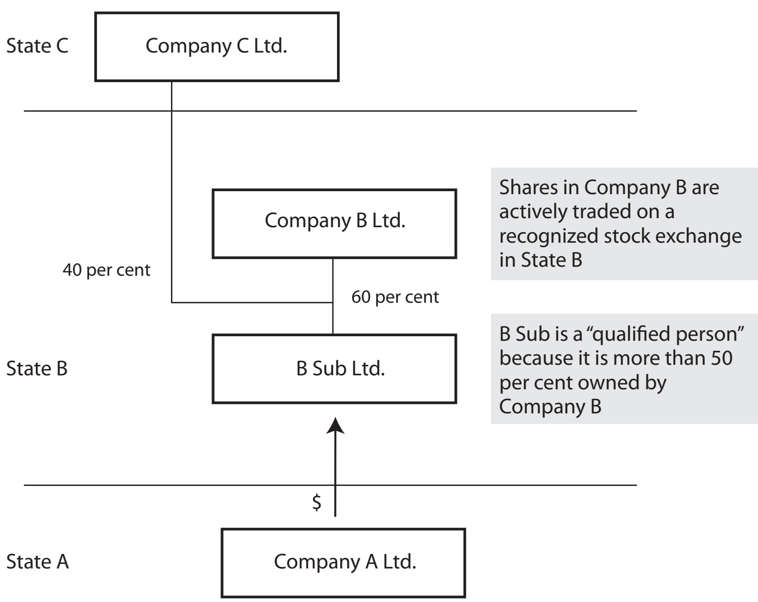


A second rule exists for companies that are subsidiaries of publicly traded companies — that is to say, a company can be a "qualified person" if it is at least 50 per cent owned by a listed and publicly traded company that is resident in one of the States and itself a "qualified person":

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is…
>   c) a company, if…
>   ii) at least 50 per cent of the aggregate voting power and value of the shares (and at least 50 per cent of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subdivision i) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;

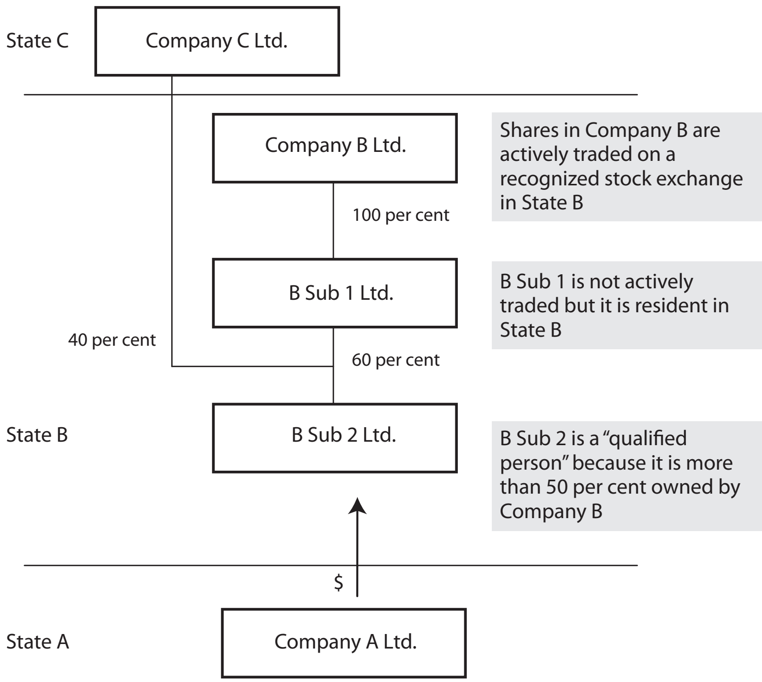
The test can extend to partly owned subsidiaries and joint-venture companies: the test will be satisfied by tracing at least 50 per cent of the shareholding in the relevant company to one or more publicly traded companies resident in either State. And the test does allow for a significant portion of the company being examined to be owned by shareholders resident in a third State.

Example 4



Subdivision c) ii) also allows a company to become a "qualified person" by tracing through any intermediate companies to rely upon the status of the listed and actively traded parent company, provided all the relevant companies (the parent, the intermediary and the company receiving the foreign source income) are all resident in either contracting State.

Example 5



The final rule in subparagraph e) is a residual test that applies to any "person other than an individual." Therefore, for example, subparagraph e) could apply to:

- An entity that is not a company — for example, a trust or partnership. The test extends beyond companies and refers to entities which issue "shares" and those which issue other types of "beneficial interest." This may be relevant, for example, for investment funds and other CIVs if they are not structured as companies;

- An entity that is privately held — that is to say, its shares are not listed on a stock exchange. Again, this may be relevant for investment funds where interests in the fund are issued and redeemed, rather than traded on a stock exchange;
- A listed company that is actively traded on a stock exchange but does not satisfy either the "locally traded" or "locally managed" elements of that test; and
- A subsidiary of a listed entity which, for example, is owned by the listed entity, but through a third country intermediary.

In order for this type of entity to be a "qualified person" two tests must be satisfied:

- An ownership test: during at least half of the year, more than 50 per cent of the interests in the entity must be held by taxpayers which are (a) resident in the same contracting State and (b) are themselves "qualified persons"; and
- A base erosion test: less than 50 per cent of its gross income can be paid in any year in the form of tax deductible payments either to non-residents or to persons who are not themselves "qualified persons" (although this requirement is not applied to payments made to purchase goods, real estate or services at arm's length prices in the ordinary course of business).

Subparagraph e) sets out the test in these terms:

> e) a person other than an individual, if:
>
> i) on at least half the days of the taxable year, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph a), subparagraph b), subdivision i) of subparagraph c), or subparagraph d) of this paragraph own, directly or indirectly, shares or other beneficial interests representing at least 50 per cent of the aggregate voting power and value (and at least 50 per cent of any disproportionate class of shares) of the person, provided that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State, and

ii) less than 50 percent of the person's gross income for the taxable year, as determined in the person's Contracting State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), subparagraph b), subdivision i) of subparagraph c), or subparagraph d) of this paragraph in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property).

There are several important aspects of the ownership test. First, given that the ownership of interests in the entity may change during the year, the test needs to be satisfied only for at least half the year. Second, the owners must be resident in the same State as the entity being tested. Third, the owners must account for at least 50 per cent of ownership which still permits a substantial portion of the ownership of the entity to be held offshore. Fourth, ownership is measured by looking to the "aggregate voting power" and to the "value" of the interests being tested, and apparently both aspects must be satisfied. Finally, not all entities which are "qualified persons" will suffice for this test: the list in subdivision i) omits entities which are owned by listed entities. This means that a subsidiary of a listed entity is eligible to become a "qualified person" by applying this section, but a subsidiary of that company cannot rely upon the status of its immediate owner; it must trace through to the ultimate listed parent.

The base erosion test focuses on the proportion of gross income that is paid to residents of third countries or to persons who are residents but are not "qualified persons." Again, up to 50 per cent of the gross income of the tested entity can leak to residents of third countries without offending this rule. The reference to amounts flowing "directly or indirectly" to such persons may prove very problematic in practice where income flows are supplemented or dissipated as they move through successive taxpayers.

The exception for payments for "services or tangible property" will need some explanation in the Commentary. The obvious intention of the provision is to require that payments for interest and payments for the use of intangibles (for example, royalty payments for the use of intellectual property) must be examined; payment of arm's length prices for inventory, equipment or real estate do not need to be examined. Developing countries may however be concerned that payments of management fees would not need to be tested provided they are at arm's length prices — they are presumably payments for "services."

The base erosion test focuses on one particular mechanism by which income might leak to a third country — an amount is "paid or accrued … in the form of payments that are deductible for purposes of the taxes covered by this Convention." The situation being described is one where the recipient of the income would be taxable, but it reduces the tax payable by making tax deductible payments. The same result could, however, be achieved in other ways: the recipient might not be taxable at all if it distributes sufficient of its receipts — in other words, the recipient is or can become transparent for tax purposes. Alternatively, the relevant domestic rules might make the fund the proper taxpayer on retained income and the investor the proper taxpayer on distributed income. In this respect, it is worth returning to subdivision d) iii), which was mentioned above. It includes as a "qualified person":

> d) a person, other than an individual, that…
>
> iii) was constituted and is operated to invest funds for the benefit of persons referred to in subdivision ii), provided that substantially all the income of that person is derived from investments made for the benefit of these persons.

It was noted above that this clause seems directed at investment funds and that subparagraph e) is potentially also applicable to investment funds. It would be of interest to determine whether the test in subparagraph e) is easier or harder to satisfy than that in subparagraph d) in any year: subparagraph e) might be easier to satisfy where the mechanism under domestic law which shifts the tax burden works through something other than a tax deduction; but subparagraph e) may be more difficult to satisfy since it requires "substantially all" of the relevant income to belong to residents.

2.3.1.2 Active business income

A second way in which a taxpayer will be able to enjoy (some) treaty benefits is if the taxpayer satisfies an active business income test. Again, this test can be satisfied regardless of the legal form of the taxpayer.

While a "qualified person" will enjoy all of the benefits of the treaty, satisfying the active business income test will entitle the taxpayer to enjoy treaty benefits for only "an item of income." Subparagraph 3 a) provides:

> A resident of a Contracting State will be entitled to benefits of this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person…

In order for the entity to be a "qualified person" for a particular item of income, the taxpayer must meet two and sometimes three tests. It must be:

> engaged in the active conduct of a trade or business in [its State of residence] (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer respectively),

This test will clearly be satisfied for taxpayers that are exclusively engaged in manufacturing, assembly, extraction, production activities or the provision of professional services. It is not entirely clear how a company which is a holding company should be regarded but presumably holding shares in subsidiaries would not amount to the "active conduct of a trade or business" and even if it did, this activity would fall into the exclusion for an entity that exists for "making or managing investments." The same analysis might apply to a company that exists just to hold intellectual property assets and receive royalty payments, or which is an in-house finance company for the corporate group and exists just to receive interest payments. On the other hand, a company which holds and manages a portfolio of investments for external clients would likely be regarded as engaged in "the active conduct of a trade or business" and this business is not one which is carried on "for the resident's own account."

A more complicated question arises for companies that do more than engage in "active trade or business" — for example, a single company which is both a manufacturer and which licenses intellectual property to related entities. The drafting of the clause suggests that such a company would satisfy this part of the test as long as its manufacturing operations were more than merely cosmetic.

The second part of the active business income test requires that:

> the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business.

In other words, a company which satisfies the active income test based on its status as a manufacturer cannot rely on that status to enjoy treaty benefits for all items of income it earns from the source country — merely for income which is earned in connection with its manufacturing operations. Where a single company is both a manufacturer and licenses intellectual property to related entities, it may be argued that the royalties derived from the intellectual property that it licenses is income that is "in connection with, or is incidental to, that [manufacturing] trade or business." On the other hand, royalties derived from unrelated intellectual property are presumably excluded from enjoying treaty benefits.

The third part of the active income test (subparagraph b) is an additional requirement which must be met if the resident is earning active business income through its offshore branch or from an associated enterprise in the source country. That is to say:

> if a resident of a Contracting State derives an item of income from a trade or business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from an associated enterprise…

Where either situation exists, the added requirement is that the business operations of the recipient are regarded as "substantial" when compared with the business operations conducted by the payer. In other words, income will not enjoy treaty benefits if it is being paid to an entity that is largely packaging some modest business activities. Subparagraph 3 b) further states that:

> subparagraph a) shall be considered to be satisfied with respect to such item only if the trade or business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the trade or business activity carried on by the resident or associated enterprise in the other Contracting State. Whether a trade or business activity is substantial for the purposes of this paragraph will be determined based on all the facts and circumstances.

In applying this test, the payer and the recipient are allowed (and required) to aggregate any "activities conducted by persons connected to a person." This aggregation occurs for any entity that shares 50 per cent common ownership or more and may have significant effects in deciding whether activities conducted in the recipient State are substantial when compared with those conducted in the source State.

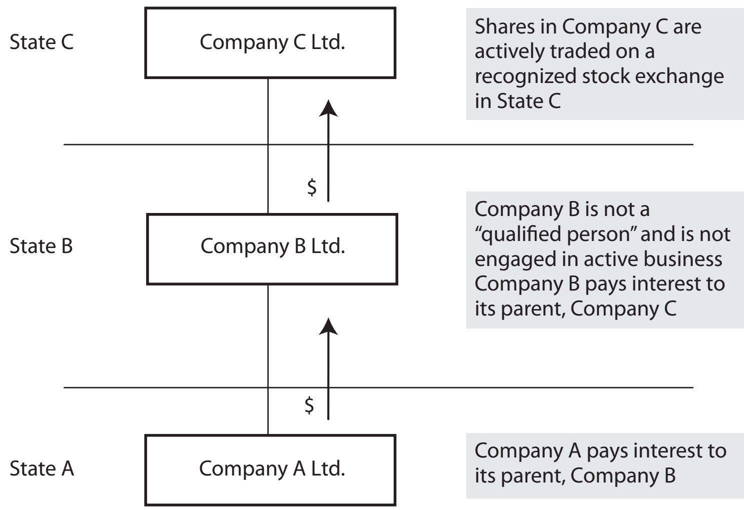
The active income test does not contain a restriction or qualification where base-eroding payments are made. Therefore, a company that conducts active business operations in the residence State faces no denial of treaty benefits even though most of its income leaks from the residence State to a third country. This creates a curious outcome. A privately held company might not satisfy the tests to be a "qualified person" under subparagraph 2 e) because a substantial portion of its income is eroded by deductible payments made to third countries. If, however, that same company conducts an active business, the ultimate destination of its income becomes irrelevant.

2.3.1.3 Equivalent benefits

The OECD Action 6 — 2014 Deliverable also includes in paragraph 4 a third method for qualifying for treaty benefits. This option would deal with structures that appear to involve shopping between treaties (rather than into treaties). For example, a structure might exist which would not satisfy the objective LOB tests for a particular treaty, but the participants in that structure would all be entitled to similar benefits under other treaties. The obvious question is: should the source country simply apply the original treaty anyway, given that it would afford similar benefits if it applied the other relevant treaties instead?

In the example below, Company B may not be entitled to treaty benefits under the A-B treaty where its shares are not traded on a local stock exchange, its only shareholder is resident in State C, and its only activity is to collect and remit interest from Company A. While the structure may seem abusive, it is not obvious that State A has suffered any loss of revenue from applying the A-B treaty when the ultimate owner of the income is an entity that would be entitled instead to the benefits of the identical A-C treaty.

Example 6



A tax treaty exists between State A and State B. The rate in article 11 (2) therein is 10 per cent.
A tax treaty exists between State A and State C. The rate in article 11 (2) therein is 10 per cent.

This issue is alluded to in the OECD Action 6 — 2014 Deliverable and a possible clause is examined. The clause would reinstate the original treaty [in the example, the A-B treaty] in its entirety where a company (and only a company) is (predominantly) owned by an "equivalent beneficiary." The original treaty will be reinstated if both an ownership test and a base erosion test are met. In the proposed paragraph 4, full treaty benefits are given to:

> [a] company that is a resident of a Contracting State … if…
>
> a) at least 95 percent of the aggregate voting power and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly,

by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary, and

b) less than 50 percent of the company's gross income, as determined in the company's State of residence, for the taxable period that includes that time, is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm's length payments in the ordinary course of business for services or tangible property) that are deductible for the purposes of the taxes covered by this Convention in the company's State of residence.

Both the ownership test and the base erosion test are framed around the term "equivalent beneficiary." The notion of "equivalent beneficiary" relies upon the "qualified person" tests discussed above and the rates prescribed in the treaty with the third State.

The first option for being an "equivalent beneficiary" is for entities that are resident in a third State and again consists of two elements. The first element is that the company resident in the third State must be entitled to full benefits under that treaty, including being a "qualified person" under that treaty where it contains an LOB clause. If there is no comprehensive LOB clause, the entity must qualify as "qualified person" under the current treaty according to the following proposed definition:

f) the term "equivalent beneficiary" means a resident of any other State, but only if that resident:

i) A) would be entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed under provisions analogous to subparagraphs a), b), or d), or subdivision i) of subparagraph c), of paragraph 2 of this Article, provided that if such convention does not contain a comprehensive limitation on benefits article, the person would be entitled to the benefits of this Convention by reason of subparagraphs a), b) or d),

> or subdivision i) of subparagraph c), of paragraph 2 of this Article if such person were a resident of one of the Contracting States under Article 4 of this Convention;

The second requirement is that, for dividends, interest and royalties, the rates stipulated in the treaty with the third State must be the same or lower than the rates in the current treaty:

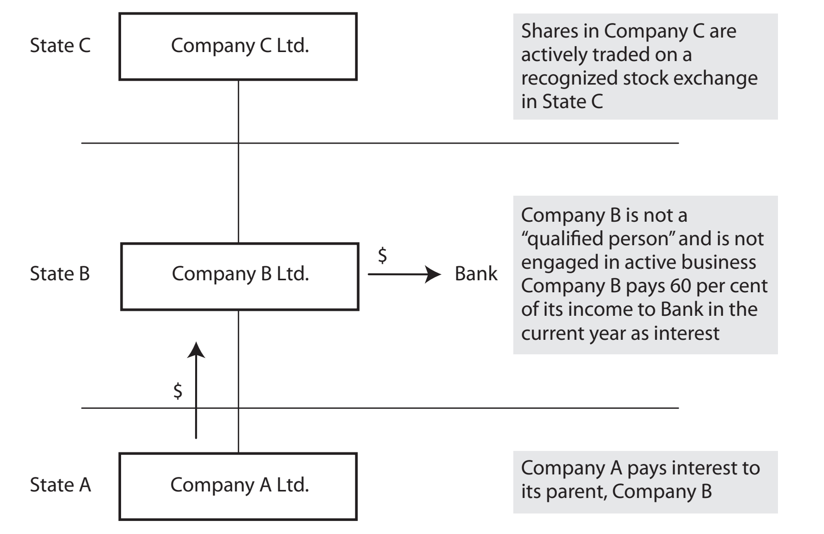
> ii) B) with respect to income referred to in Articles 10, 11 and 12 of this Convention, would be entitled under such convention to a rate of tax with respect to the particular class of income for which benefits are being claimed under this Convention that is at least as low as the rate applicable under this Convention;

A second option for becoming an "equivalent beneficiary" is for entities that are resident in one of the contracting States:

> f) the term "equivalent beneficiary" means a resident of any other State, but only if that resident …
>
> ii) is a resident of a Contracting State that is entitled to the benefits of this Convention by reason of subparagraphs a), b), subdivision i) of subparagraph c) or subparagraph d) of paragraph 2 of this Article;

This part of the clause is significant principally for its impact on other taxpayers, rather than on the company being described; it will assist other taxpayers in meeting the base erosion tests and in indirect ownership situations. In the example below, Company B is 100 per cent owned by Company C so that subparagraph a) is satisfied if Company C is an "equivalent beneficiary". Company C will be an "equivalent beneficiary" if there is an A-B treaty and Company C is entitled to full benefits under that treaty. However, since 60 per cent of the gross income of Company B is paid to Bank, it will also be necessary for Bank to be an "equivalent beneficiary" if Company B is to satisfy subparagraph b). If Bank is both a resident of State B and a "qualified person" under the terms of the A-B treaty in its own right, this will have an effect on Company B: Company B can now enjoy the benefits of the A-B treaty.

Example 7



The related recommendation is ambivalent about recommending the adoption of such a clause, noting that in some cases the clause might not work appropriately. It may be that a better solution to this problem lies in the discretionary power proposed in the general LOB clause which would permit the competent authorities to treat a resident as a "qualified person" in circumstances such as this.

2.3.1.4 Residual power to cure problems

Because the LOB rule will be drafted using objective observable criteria, there is a residual power in the competent authorities to overcome any unintended exclusion from treaty benefits. The proposal in the OECD Public Discussion Draft expresses the residual power in the competent authority to permit other entities to be a "qualified person" in this way:

> If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 nor entitled to benefits with respect to an item of income under paragraph 3 of this Article, the competent authority of the other Contracting State shall nevertheless treat that resident as being entitled to the

> benefits of this Convention, or benefits with respect to a specific item of income, if such competent authority determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention.

2.3.2 A general limitation of benefits article based on purpose and abuse

A further recommendation on this subject is to include a purpose-based general LOB clause. The clause is intended to operate as a further and independent ground for denying treaty benefits, even where a taxpayer was able to satisfy the objective observable LOB clause discussed above. The proposed clause in the OECD Public Discussion Draft states:

> Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the main purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

The clause thus contains two distinct elements — a rule which would deny access to treaty benefits based on the "purposes of any arrangement or transaction," and an exception which would reinstate access to treaty benefits where doing so "would be in accordance with the object and purpose" of the treaty provision. The second aspect of the clause is clearly very important: many taxpayers will undoubtedly undertake investments and transactions in the knowledge of the effects of the treaty and intending to enjoy its benefits. Indeed, treaties are negotiated in order to induce taxpayers to change their behaviour; therefore, denying treaty benefits simply on the basis that taxpayers have responded to that inducement is inappropriate. Rather, the clause is meant to focus on whether the way in which taxpayers have responded to that inducement — the way they structured their investment or transaction — has produced an outcome that is not in accordance with the object and purpose of the treaty provision being relied upon.

According to the OECD Action 6 — 2014 Deliverable, this article would simply express in the text of the model treaties notions that are currently contained in the Commentary. Consequently, the new provision is not seen as a major departure from existing principles:

> [It] mirrors the guidance in … the Commentary to Article 1. According to that guidance, the benefits of a tax convention should not be available where one of the principal purposes of certain transactions or arrangements is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax convention. [It] incorporates the principles underlying these paragraphs into the Convention itself …[30]

The discussion in the OECD Action 6 — 2014 Deliverable suggests that this is an objective enquiry to be undertaken based on the evidence of transactions which occurred. The subjective state of mind of the participants is not the focus of attention in this formulation. Instead, the investigation is meant to be about the purpose of "the arrangement." This formulation is intended to make the enquiry more objective and more focused on observable facts and circumstances than would be the case if the enquiry was directed to finding the state of mind of a particular taxpayer or their advisers.

2.3.3 Changes to the Title and Preamble

The OECD Action 6 — 2014 Deliverable also proposes changes to the Title and Preamble to the OECD Model Convention to reinforce the notion that treaties are not meant to be exploited through inappropriate access to the treaty by residents of third countries.

The changes to the Title will reinstate the proposition that the treaty is being negotiated both to relieve double taxation and prevent tax avoidance and evasion:

[30] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances — Action 6: 2014 Deliverable*, supra note 9, at 66.

> Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance

The Preamble will also provide that two contracting States are entering the treaty:

> intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)…

The OECD suggests that the new Title and Preamble will have effect in interpreting treaty provisions because the Title and Preamble should play an important role in the interpretation of the provisions of the Convention "according to the general rule of treaty interpretation contained in Article 31(1) of the *Vienna Convention on the Law of Treaties*."[31]

2.3.4 The "minimum standards"

It was noted above that it was proposed by the OECD that countries should have some flexibility in how they implement measures to protect their treaties as long as they achieve "minimum standards." In part, that recommendation is because there are a multitude of rules that might be invoked to counter the problem:

- Existing judicial doctrines in domestic law;
- Existing specific and general anti-abuse rules in domestic law;
- Existing structural rules inside treaties and interpretations of treaty provisions which could counter treaty abuse; and
- Existing targeted anti-abuse rules already in treaties;

as well as:

[31] Ibid., at 99.

- The proposed changes to the Title and Preamble;
- The proposed structural limitation of benefits article; and
- The proposed purpose-based anti-abuse rule.

These “minimum standards’ are about how to combine the multiple proposals made with the existing measures that countries might already have in place. The minimum standards are a matrix of combinations of these individual elements.

The OECD Action 6 — 2014 Deliverable proposes, first, that all countries should adopt all three proposals set out:[32]

- The proposed changes to the Title and Preamble;
- The proposed structural limitation on benefits article; and
- The proposed purpose-based anti-abuse rule.

However, it is acknowledged that this “combination … may not be appropriate for all countries [particularly countries with] domestic anti-abuse rules, or [where] the courts … have developed various interpretative tools (for instance, economic substance or substance-over-form), that effectively address various forms of domestic law and treaty abuses.”[33] For countries that do not wish to implement all three elements, it is proposed that:

- These countries should nevertheless still make the recommended changes to the Title and Preamble of their treaties; and
- They should supplement that with either:
    - A purpose-based anti-abuse rule in the treaty, or
    - The structural limitation on benefits article, supplemented by some extra mechanism to deal with conduit arrangements not otherwise dealt with.

2.4 Theme 5 — Targeted anti-abuse provisions in the treaty

It was noted above that the OECD Action 6 — 2014 Deliverable proposes a list of potential individual changes (sometimes to the text

[32] Ibid., at 22.

[33] Ibid., at 23.

of the OECD Model Convention and sometimes to the text of the Commentary) to deal with a number of transactions that have been identified as currently causing problems:

- Splitting of contracts for construction, exploration and similar projects into several short periods so that no permanent establishment (PE) arises;
- Labour hire arrangements;
- Recharacterization of dividends to avoid source-country taxation;
- Share transfers occurring just prior to dividend payments to access lower withholding tax rates in the hands of the recipient;
- Transactions attempting to eliminate source-country taxation from the sale of shares in land-rich companies;
- Replacement of the automatic tie-breaker rule for entities other than individuals with a case-by-case judgment by the competent authorities; and
- Prevention of abuse through the creation of a permanent establishment in a third State.

Some of these transactions are already examined in the Commentary on Article 1 of the United Nations Model Convention.

2.5 Impact on existing treaties

The recommendations will lead to proposed changes to the text of the OECD Model Convention, some of which may flow through to changes to the United Nations Model Convention. Recommended changes to the Model Conventions will clearly be influential in the negotiation of future treaties between States, but there is an obvious question about how to treat the text of existing treaties in the light of these recommendations.

At this time, there is no easy answer to this problem. It is obviously impractical for a country to renegotiate all of its existing treaties to include changes to the text proposed in the recommendations. However, minor adjustments to the terms of the treaty might be effected through a protocol or exchange of notes between the competent authorities, where both States agree with the adjustment. Where one State was unwilling to adjust the existing text and was unwilling to accept changes based on these recommendations, a State might decide that it should simply unilaterally override or even terminate a treaty with the treaty partner, though either would be an extremely drastic action.

In the longer term, it may be that the proposed multilateral instrument being considered in Action 15 of the OECD Action Plan on BEPS offers the best hope for simple and clear procedures for updating existing bilateral treaties to accommodate subsequent developments in treaty practice. Action 15 proposes exploring "a multilateral instrument" so that jurisdictions could "implement measures developed in the course of the work on BEPS and amend bilateral tax treaties."

There will also be changes to the Commentary to the OECD Model Convention as a result of the OECD project on BEPS, which again may flow through to changes to the Commentary to the United Nations Model Convention. Here, there may be more flexibility regarding the impact of these changes on the interpretation of existing treaties. The OECD maintains the position that changes to the Commentary can have retrospective effect — that is to say, additions or revisions to the Commentary should be understood to apply to the interpretation of existing treaties:

> [O]ther changes or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD member countries as to the proper interpretation of existing provisions and their application to specific situations.[34]

This position may be somewhat ambitious. Some domestic courts have taken the view that, as commentaries form part of the background against which a treaty was negotiated, subsequent changes to the Commentary cannot assist the Court to uncover the intention of the contracting States at the time they negotiated their treaty.

[34] See paragraph 35 of the Introduction to the OECD Model Convention.

3. Theme 2 — Negating double non-taxation through treaties

Another aspect of Action 6 of the OECD Action Plan on BEPS is an examination of measures "to clarify that tax treaties are not intended to be used to generate double non-taxation."

The recommendations propose that this part of Action 6 be dealt with by changes to the Title and Preamble to the OECD Model Convention (see section 2.3.3 above), and some changes to the Commentary explaining what the changes mean. The recommended Title to the Convention would become:

> Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance.

and the Preamble would now specifically provide that the intention of the States in signing the treaty was "to further develop their economic relationship and to enhance their cooperation in tax matters" through "a Convention for the elimination of double taxation with respect to taxes on income and on capital," but to do so:

> without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States).

While these changes do not directly amend the text of the distributive articles in the treaty (Articles 6-22), the OECD suggests that the new Title and Preamble would affect the interpretation of those provisions because the Title and Preamble should play an important role in the interpretation of the provisions of the Convention "according to the general rule of treaty interpretation contained in Article 31 (1) of the Vienna Convention on the Law of Treaties." [35]

It is important to note that this recommendation is quite limited. The proposal does not seek to overturn all instances of double

[35] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances — Action 6: 2014 Deliverable*, supra note 9, at 99.

non-taxation. It does not even seek to overturn double non-taxation due to some lack of clarity or uncertainty about how the rules are meant to operate. Rather, it is directed to a much smaller class: "non-taxation or reduced taxation through tax evasion or avoidance." That is a very important qualification — the changes are directed at situations where double non-taxation arises and it involves abuse.

That said, no doubt the Title and Preamble can and would be referred to when there is some question about the scope and operation of a particular provision. Article 31 of the Vienna Convention requires a State to interpret a treaty "in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."

But in many cases, there will be no doubt that double non-taxation will result from the operation of the treaty, and that result is both clear and unambiguous and is a result that a State "acting in good faith" must reach. And because it does not involve "tax evasion or avoidance" the result will be allowed to survive.

For example, assume Company A sells all the shares of Subsidiary, a company resident in State B, for a profit. It is quite conceivable that no tax will arise in either State — with a few exceptions, State B will be precluded from taxing Company A under the treaty, and State A may have a participation exemption so that it does not tax profits made on the sale of shares in offshore operating subsidiaries. The result is double non-taxation of Company A, and it seems clear that, in the absence of some indication of tax evasion or avoidance, the changes to the Title or Preamble are not meant to overturn that result.

Thus, the recommended changes may be helpful in cases where there is evidence of tax evasion or avoidance, and cases where there is some doubt about the way a particular provision should be understood and applied, but the recommended changes would not create a universal rule to negate the operation of a treaty just because double non-taxation will result.

It is worth noting that it would be possible for a developing country to be more ambitious than this proposal, and to insist that treaty provisions may be invoked against a State only where the same amount of income will be (or perhaps, has been) taxed in the hands of the same taxpayer in the other State. This would require specific drafting and goes beyond the current recommendation. But since one major objective of a treaty is to remove double tax as a barrier to closer economic integration, it is entirely consistent with that objective to insist that treaty benefits be conditional upon proving the imposition of tax by the other State.

4. Theme 4 — Abuse of domestic law by treaties

One theme which emerged in the OECD Public Discussion Draft on Action 6[36] was the need "to ensure that treaties do not prevent the application of specific domestic law [anti-abuse] provisions that would prevent [abusive] transactions."[37] The OECD Action 6 — 2014 Deliverable notes arguments have been made that various treaty provisions prevent the application of a wide variety of domestic anti-abuse rules: domestic thin capitalization rules, CFC rules, exit taxes, rules restricting tax consolidation to resident entities, anti-dividend stripping rules, assignment of income rules and specific and general anti-avoidance rules. The OECD Action 6 — 2014 Deliverable does not accept that these arguments have technical merit, pointing to various parts of the Commentary on the OECD Model Convention where these arguments are considered and rejected,[38] but the OECD does acknowledge the value of trying to express more clearly which domestic provisions will survive the application of a treaty. While the Commentaries to the United Nations and OECD Model Conventions currently try to protect domestic anti-abuse rule, the OECD recommendations note the practical difficulty in trying to distinguish rules which are anti-abuse rules from those which are not. They also note the difficulty in trying to distinguish general anti-abuse rules (which

[36] OECD, *Public Discussion Draft, BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, supra note 6.

[37] Ibid., at 21.

[38] The Commentaries to the OECD Model Convention address challenges from a treaty to the operation of CFC rules (paragraph 23 of the Commentary on Article 1), thin capitalisation rules (paragraph 3 of the Commentary on Article 9) and specific and general anti-avoidance rules (paragraph 22 of the Commentary on Article 1).

are meant to be immune from challenge under a treaty) from specific or targeted anti-abuse rules which might be drafted around objectively observable facts and circumstances.

The approach put forward by the OECD does not seek to entrench or buttress a long list of domestic regimes which will be immune from challenge because of a treaty, although it notes that other parts of the OECD project on BEPS might lead to recommendations to this effect. Instead, the OECD approaches the problem in a much more ambitious way. They focus on the fact that many of these regimes are directed at the tax position of residents and propose inserting a new clause which would preserve any regime (whether viewed as an anti-abuse measure or not) directed at the taxation of residents, with a few exceptions. The text notes that this approach is already seen in the "savings clause" included in United States tax treaties.[39] The new clause would allow a State to tax its residents without any concern that treaty measures, which exist primarily for the benefit of non-residents, will also constrain the ability of a State to tax its residents. The new clause would provide:

> This Convention shall not affect the taxation, by a Contracting State, of its residents…

The proposed Commentary to this new provision specifically alludes to the problem of dual residence and notes that a dual resident will not be affected by this clause, even if it is a resident of one State under the domestic laws of that State, if it is taken to be a resident only of the other State under the residence "tie-breaker" rule in the treaty. Put the other way, the domestic tax laws of the residence State can be applied to a dual resident without interference from the treaty if the entity is still a resident after the application of the "tie-breaker" rule.

The blanket immunity for any rule being applied to residents is then made subject to specific exceptions. The residence State must still give effect to those parts of a treaty which:

- Adjust the tax position of a resident consequent upon a transfer pricing analysis reallocating profits between the resident and an offshore branch or associated company;

[39] See Article 1 (4) and (5) of the United States Model Convention.

- Protect from tax income from services rendered by a resident to the government of the other State or as a member of a diplomatic or consular mission of the other State;
- Protect from tax income earned by a resident student or apprentice in the form of a scholarship provided from another State;
- Give tax relief in the residence country for income taxed in the other State; and
- Ensure residents have unfettered rights to protection against discrimination and the ability to seek assistance from the competent authority.

The OECD also notes the possibility that the list could be expanded to deal with other possible situations where the parties might wish to afford treaty benefits to a resident, and gives the examples of pensions and social security benefits.

5. Theme 3 — Tax considerations in choosing treaty partners

Action 6 in the OECD Action Plan on BEPS refers specifically to addressing “the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.”[40] The OECD Action 6 — 2014 Deliverable proposes to add text to the Introduction to the Commentary articulating some of the relevant considerations explaining why countries should be very reluctant to negotiate tax treaties with low- or no-tax jurisdictions. This is an important discussion because it serves as a counter to the apparent assumption in many countries that a bigger tax treaty network is always to be preferred, even if those treaties are with low- or no-tax jurisdictions. Clearly, there are significant non-tax considerations that have a bearing on the decision whether to have a tax treaty with another country, but insofar as tax considerations are important, developing countries should have a clear understanding of the tax costs and tax benefits for them from negotiating a treaty.

[40] OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 3, at 19.

One of the main tax considerations that should have a bearing on the issue is the recognition that source countries surrender tax claimed under domestic law in exchange for the economic benefits that the treaty promises. Thus the initial question for a country should be "Is there a real likelihood of significant and increased inward investment from negotiating a treaty with the treaty partner?" Another way of thinking about this question would be to ask: "Are there significant tax-driven impediments to greater cross-border trade and investment for which the best solution is a tax treaty?" The proposed Commentary puts it this way:

> [T]he existence of risks of double taxation resulting from the interaction of the tax systems of the two States involved will be the primary tax policy concern.[41]

It is important to appreciate why this is put with an inbound investment focus. A State might wish to pursue a treaty as a means of encouraging greater outbound investment and trade, but many instances of double taxation for outbound investment can be solved unilaterally without the need to negotiate a treaty. It may be that tax impediments to outbound trade and investment can be adequately addressed by domestic law.

In deciding whether and with whom to negotiate a treaty, source countries should thus consciously take into account whether amounts of income, which they will no longer be taxing, will be taxed in the residence country. The proposed Commentary will restate that this is part of the bargain which underlies a treaty:

> [W]here a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State.[42]

This is not simply a self-serving position of "if the treaty partner is not going to tax the income we might as well tax it." Rather, if the income is not taxed in the residence country, the possibility of double

[41] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances — Action 6: 2014 Deliverable*, supra note 9, at 103.

[42] Ibid.

taxation and tax-driven impediments to greater trade and investment are less plausible. The source-country tax is being curtailed but, in the absence of significant residence country tax, there is little scope for double taxation and any argument that unrelieved double taxation is frustrating trade and investment is unconvincing.

While the benefit usually sought from a treaty is eliminating tax as an impediment to greater levels of cross-border trade and investment, a State may wish to conclude a tax treaty with a low- or no-tax country in order to secure some of the other benefits that tax treaties promise, particularly assistance from abroad in the administration and collection of domestic taxes: access to information held offshore that is currently not available, a formal system for resolving tax disputes between States, promises of non-discrimination, assistance in collecting domestic taxes, and so on. The OECD makes the judgement that these benefits:

> would not, by themselves, provide a sufficient tax policy basis for the existence of a tax treaty because such administrative assistance could be secured through more targeted alternative agreements, such as the conclusion of a tax information exchange agreement or the participation in the multilateral Convention on Mutual Administrative Assistance in Tax Matters.[43]

Moreover, there will undoubtedly be instances where the treaty partner will be unable to perform fully the administrative commitments they undertake in signing a treaty, whether through legal impediments, administrative capacity limitations or for other reasons. A treaty signed in the hope of gaining merely administrative benefits may ultimately produce little of lasting value, while at the same time curtailing the source country's tax base.

Finally, the discussion above has suggested an overarching principle that tax treaties should not result in double non-taxation. Where the source country curtails its own tax claims knowing that the residence country imposes no significant taxation, the country is in effect assisting in producing a double non-taxation outcome.

[43] OECD, *Public Discussion Draft, BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, supra note 6, at 31.

Chapter VII

Preventing avoidance of permanent establishment status

Adolfo Martín Jimenéz*

1. Introduction

Action 7: Prevent the Artificial Avoidance of PE Status (Action 7) in the Organisation for Economic Co-operation and Development Action Plan on Base Erosion and Profit Shifting[1] (OECD Action Plan on BEPS) deals with very complex issues, from both a theoretical and practical perspective. First, it affects one of the most relevant and complicated concepts in international taxation, the definition of permanent establishment (PE), as well as Article 5 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention)[2] and the OECD Model Tax Convention on Income and on Capital[3] (OECD Model Convention). Second, it impacts the attribution of profits to PEs under Article 7 (Business profits) of the United Nations and OECD Model Conventions, which is another intricate and controversial issue. Third, this topic has a direct connection to transfer pricing issues and international taxation of groups of companies. Fourth, Action 7 has a very close connection to the division of the tax base between residence and source countries and the role of the PE as a threshold for source taxation. From a practical perspective, having a PE in a jurisdiction is

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[1] Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf.

[2] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[3] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

crucial for tax administrations and taxpayers since the threshold effect of the PE concept denotes whether a taxpayer obtaining business profits is subject to tax (or not) in the source country. The conceptual difficulties connected with PEs and their evolution, and the attribution of profits thereto, have an important impact upon practical situations: lack of clarity and different interpretations of the same concepts mean that there is a wide margin for conflict between tax administrations and taxpayers, on the one hand, and the tax administrations themselves, on the other. Still, tax administrations in general, and those in developing countries in particular, should be able to identify when a taxpayer is conducting a relevant business activity within their territory while attempting to avoid the presence of a PE, and should know how to react in order to tax economic activity carried on within the source State. For taxpayers, it is also critical to know when they may have a PE in a given jurisdiction so as to avoid disputes, manage tax risk and, ultimately, pay the correct taxes that are due to every jurisdiction where economic activity is conducted.

It is, therefore, crucial for tax administrations in developing countries to understand that Action 7 will have an impact upon a domain that is extremely complex, and subject to scrutiny and discussion in the international tax arena, where there are controversial issues that have not been fully settled, and where, as a consequence, disputes may often arise. In this context, it is difficult to speak about "artificial avoidance of PE status": if the concept of PE, a central element of international taxation, is not completely clear, it is hard to establish the contours of artificial avoidance of PE status. Moreover, as this concept works mainly in favour of residence countries and, to a large extent, permits taxpayers to avoid source taxation even if relevant economic activity is carried out in the source State, developing countries should consider whether to focus on artificial avoidance or on plain avoidance of PE status in order to recover (or keep) the right to tax activities taking place within their borders.

These ideas form the basis of the present chapter. Before trying to define what is abusive in terms of avoiding a PE, it is essential to discern, first, the scope and context of Action 7 in the OECD Action Plan on BEPS and the importance of PEs for tax administrations and taxpayers (see section 2 below, which attempts to answer the question why action in this area is needed and what the extent of it may be). Second, as it is difficult to grasp when there may be artificial avoidance of PE status if the main features, configuration and evolution of PEs over time are not known, a study of the historical evolution of this concept in the OECD context is required (see section 3 below). Only after that can an attempt be made to describe an anti-avoidance standard for Article 5 of the OECD Model Convention (see section 3.5 below). This complex, albeit necessary, exercise seeks to explain why it is difficult to speak of artificial avoidance of PEs in the OECD context. This is because such a concept is designed to work in favour of residence countries and to avoid source taxation, and only a very limited number of cases will fall under the label of "artificial." Therefore, one of the main conclusions of the historical overview in section 3 below is that if developing countries would like to address tax base erosion issues, it would probably be more productive to focus on avoidance of PE status and methods of dealing with it rather than to concentrate on "artificial" avoidance. In section 4 below, the contribution of Article 5 of the United Nations Model Convention to this subject is examined, together with the relevant differences between the United Nations and the OECD Model Conventions. The conclusion is reached that even if Article 5 of the United Nations Model Convention works more in favour of source countries, it is basically anchored in the same principles and foundations of the OECD Model Convention. Finally, potential solutions and tools for use by developing countries in combating artificial or simple avoidance of PE status are explored in section 5 below.

It should be noted that the effects of Action 7 go beyond the strict boundaries defined therein and that there is important overlap with and direct connections to other parts of the OECD Action Plan on BEPS[4] (for example, Action 1 on addressing the tax challenges of the digital economy; Action 6 on preventing treaty abuse; and Actions 8, 9, 10 and 13 on transfer pricing) and other chapters of the present publication.[5] The present chapter will, however, try to focus on the main problems of avoidance of PEs from the perspective of Action 7 in the OECD Action Plan on BEPS and developing countries, and will touch on other Actions only indirectly.

[4] OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 1.

[5] See chapter II, Taxation of income from services, by Brian J. Arnold; and chapter VIII, Protecting the tax base in the digital economy, by Jinyan Li.

2. Action 7 in the OECD Action Plan on BEPS: Prevent the artificial avoidance of PE status — context and scope

2.1 Introduction

The present section describes the scope of Action 7 in the OECD Action Plan on BEPS on preventing the artificial avoidance of PE status, including reference to the OECD Public Discussion Draft[6] released by the OECD on this subject, and explains the policy and practical problems behind it. First, reference is made to the OECD documents in which Action 7 is considered. Second, some observations are added on the policy difficulties inherent in this Action. Last, it is shown that there is a connection between Action 7 and the current problems faced by taxpayers and tax administrations (including those in developing countries) regarding PEs. These are very intensively linked with the policy issues and problems dealt within the Action. The aim of the present section is to explain that the scope of Action 7 is more complex than may be thought because it touches on core issues in international taxation; it also makes developing countries aware of the difficulties of trying to rely on Action 7 to fight avoidance of taxation in source countries or to achieve a closer alignment of economic activity and taxation.

2.2 The scope of Action 7 in the OECD Action Plan on BEPS and in the relevant OECD Public Discussion Draft

Action 7 should be read in the context of the main policy goal of the OECD Action Plan on BEPS:

> No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.[7]

Therefore, Action 7 is expected to deal with the disconnect between business activity and taxation in a country produced by

[6] OECD, *Public Discussion Draft, BEPS Action 7: Preventing the Artificial Avoidance of PE Status* (Paris: OECD, 2014), available at http://www.oecd.org/ctp/treaties/action-7-pe-status-public-discussion-draft.pdf (OECD Public Discussion Draft on BEPS Action 7).

[7] OECD, *Action Plan on Base Erosion and Profit Shifting,* supra note 1, at 10.

the concept of PE or, rather, by the artificial avoidance of PE status. Artificial avoidance of a PE may deprive a country of taxing rights over income derived from substantial activities which are carried out in its jurisdiction.

However, in the OECD Report on Addressing Base Erosion and Profit Shifting[8] the issue of artificial avoidance of PE status was not directly mentioned, there being only some general references to the problems of PEs.[9] Artificial avoidance of PEs arose, therefore, to some extent as a new issue — although not surprisingly — in Action 7 in the OECD Action Plan on BEPS, which explained and proposed the following:

> **The definition of permanent establishment (PE) must be updated to prevent abuses**. In many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by "commissionaire arrangements" with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. Similarly, MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.
>
> *ACTION 7 - Prevent the artificial avoidance of PE status*
>
> *Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through*

[8] OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/tax/beps-reports.htm.

[9] Ibid., at 35 (on the need for adequate international tax rules in a world of changing business models and increasing advances in technology and communications) and at 84 (on the connection between BEPS-related work and the previous work of the OECD on PEs).

> *the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.*[10]

Basically, as described in the OECD Action Plan on BEPS, Action 7 seems to be concerned with two specific cases: commissionaire agreements, which refers to Article 5 (5) of the OECD Model Convention, and artificial fragmentation of activities to take advantage of the exemptions in Article 5 (4) of the OECD Model Convention. As such, the scope of Action 7 may be limited. It has been interpreted that this Action might have wider effects[11] in the form of a revision of the PE concept and rules on attribution of profits to PEs. The emphasis on significant people functions in the current system of attribution of profits to PEs, as opposed to all functions in a corporation, opens up avenues for significant tax planning. The current overestimation of risks as a profit driver and the possibility of shifting risks by contract within a multinational group is one of the main reasons for tax planning nowadays.[12]

As a matter of fact, the OECD invitation that was extended to interested parties to identify strategies that would allegedly result in artificial avoidance of PE status[13] seemed to adopt a wide perspective and was not solely focused on commissionaires or artificial fragmentation. The only response received also adopted that perspective.[14] The

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[10] OECD, *Action Plan on Base Erosion and Profit Shifting,* supra note 1, at 19.

[11] See R. Collier, "BEPS Action Plan, Action 7: Preventing the Artificial Avoidance of PE Status," (2013), No. 5 *British Tax Review*, 641.

[12] See J. Sasseville and R. Vann, "Commentary on Article 7 of the OECD Model Convention," in IBFD, *Global Tax Treaty Commentaries* (Amsterdam: IBFD, 2014). These authors anticipate that "a combination of revamping the separate entity arm's-length principle and the PE definition will occur." See also R. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," (2013) Vol 2, No. 3 *World Tax Journal*, 291 ff.

[13] OECD, *Public Discussion Draft, BEPS Action 7: Preventing the Artificial Avoidance of PE Status*, supra note 6, at 10.

[14] See the response by Mr. Tejas Chandulal Shah of 9 November 2013, who did not focus exclusively on abuse and essentially advocated for greater source-country tax jurisdiction.

limited response to the invitation of the OECD should not be taken as an indication that the issue is not relevant or important. As explained below, this problem is crucial to both developed and developing countries.

To date, however, the work on Action 7 has been very limited in scope, perhaps more so than could have been expected.[15]

2.2.1 Commissionaire agreements

Commissionaire agreements are well known and for some time have been a matter of concern to tax authorities all over the world, and the OECD.[16] Commissionaire agreements exploit the differences between civil and common law regarding agency. In civil law countries there is no dependent agent PE where the subsidiary located in that country sells the products/services of a group, acting ostensibly in its own name but actually on behalf of a foreign company, usually located in a low-tax jurisdiction, or where it is regarded as a hybrid, to obtain low-tax treatment. These structures are based on a literal and legal interpretation of Article 5 (5) of the United Nations and OECD Model Conventions. In addition, remuneration attributed to the subsidiary acting as commissionaire in high-tax countries is normally low — determined by applying a cost-plus method with a low margin — because, ultimately, most of the relevant risks (for example, inventory, obsolescence, bad

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[15] See OECD, *Public Discussion Draft, BEPS Action 7: Preventing the Artificial Avoidance of PE Status,* supra note 6. The present chapter will not comment extensively on the proposals of this draft, which is still of a provisional nature and has not presented conclusive solutions with regard to very relevant issues (for example, commissionaire agreements or fragmentation).

[16] For a recent discussion on commissionaire agreements and the problems of Article 5, paragraphs 5-7, see B. Arnold, "Commentary on Article 5 of the OECD Model Convention," in IBFD, *Global Tax Treaty Commentaries*, supra note 12, at 47 ff.; N. Carmona Férnandez, "The Concept of Permanent Establishment in the Courts: Operating Structures Utilizing Commission Subsidiaries," (2013) *Bulletin for International Taxation* (online version); L. Sheppard, "The Brave New World of the Dependent Agent PE," (2013) Vol. 71, *Tax Notes International*, at 10 ff.; and B. Obuoforibo, "In the Name of Clarity: Defining a Dependent Agent Permanent Establishment," in C. Gutiérrez and A. Perdelwitz, eds., *Taxation of Business Profits in the 21st Century* (Amsterdam: IBFD, 2013), 57 ff.

debts) connected with the sales belong to companies of the same group located abroad in tax environments more favourable than that offered by the source country.

Despite what Action 7 seems to suggest, focusing on strict commissionaire arrangements would confer too narrow a scope on the relevant analysis. A broader study of commissionaire-like or other profit-stripping structures having the same effect[17] might be needed, because if changes were to affect "commissionaire structures" only, the resulting norm would be easy to avoid.[18] The abundance of different forms of outsourcing and organization of value chains and business models also favours provision of general solutions rather than the making of ad hoc agreements on a specific type of structure alone.[19]

The OECD Public Discussion Draft on BEPS Action 7 has, however, adopted a rather narrow approach. It assumes as a policy principle that "where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business."[20] To implement that policy principle, the OECD proposes four

[17] For instance, contractual arrangements with the same effect as commissionaire agreements in common law countries, or risk-stripped structures in subsidiaries which minimize profits in the source State, either as a distributor or as a manufacturer (for example, conversion of contract manufacturers to toll manufactures). All of these have similar features and operate by transferring risks from the source country to the residence country of the entity to which most of the profits are attributed. For simplicity, the term "commissionaire-like structures or agreements" will sometimes be used to refer to this group of tax planning techniques which are based on stripping risks from subsidiaries in source countries.

[18] R. Collier, "BEPS Action Plan, Action 7: Preventing the Artificial Avoidance of PE Status," supra note 11, at 641-642.

[19] On outsourcing, see P. Desai and S. Goradia, "Cross Border Outsourcing: Issues, Strategies and Solutions," in *Cahiers de droit fiscal international* (The Hague, The Netherlands: Sdu Uitgevers, 2014) Vol. 99a.

[20] OECD, *Public Discussion Draft, BEPS Action 7: Preventing the Artificial Avoidance of PE Status,* supra note 6.

alternative changes to Article 5 (5) of the OECD Model Convention to define (in more material and, therefore, less formalistic terms) when the intervention of a person with regard to a contract with a third party that binds the foreign company will create a dependent agent PE. The independent agent concept in Article 5 (6) of the OECD Model Convention would also be changed to eliminate independence where the agent acts exclusively, or almost exclusively, for the same company or associated companies.

Although discussion of these modifications is not the objective of the present chapter, the main observations that can be made are as follows: (a) habitual "intervention in the negotiation of contracts" or "negotiation of contracts" is not by itself a measure of economic presence in a country, so focusing on the intervention of the agent in the process of closing a contract may result in many activities falling outside the scope of the PE threshold; (b) the new definition of independence does not transform the "dependent agent" in a PE automatically, as this would occur only if the foreign enterprise met the tests in Article 5 (1) and (5) of the OECD Model Convention and, therefore, its premises were at the disposal of the foreign company or it performed relevant functions in the process of contracting with final clients; (c) the main issue with the dependent agent PE is how profits are attributed to it, because if there was a limited profit attribution (for example, cost-plus remuneration of the subsidiary activities) the problem of base erosion would not be solved, although it seems that this issue might be dealt with at a later stage or by other BEPS Actions in the OECD Action Plan. This means that the OECD proposal regarding commissionaires only approximates "presence in a jurisdiction" and "tax base" in a limited form, even if this proposal may affect some of the current more widespread forms of tax planning with "commissionaires."

2.2.2 Fragmentation of activities

Fragmentation of activities is closely related to "commissionaire-like agreements." Fundamentally, fragmentation pursues the same outcome, that is to say, to avoid taxation in the source country by splitting functions among different persons or places of business in the same jurisdiction, and this tax planning technique is usually combined with "commissionaire-like" structures. From 1992 onwards (but also prior to that), relevant work on this issue of fragmentation was contemplated with some concern in the Commentary on Article 5 of the OECD Model Convention, but a comprehensive study of the effects of Article 5 (4) was left aside. This is particularly the case where the exceptions in Article 5 (4) are combined with fixed places and dependent agents that do not meet the PE test, or even independent agents for the same company or other companies in the group, which may be in the same jurisdiction. This type of fragmentation was already explored in the context of the preparatory work for the OECD Model Convention that was published in 1977 and, therefore, like commissionaires, is not new. Ultimately, fragmentation permits a company or group to have a substantial economic presence in a country without incurring tax liabilities there commensurate with it. As in the case of commissionaires, a horizontal or holistic view of fragmentation from the perspective of Articles 5 (1), (4), (5) and (7) of the OECD Model Convention may be needed.

However, the OECD Public Discussion Draft on BEPS Action 7 has also opted for a very limited approach that will hardly eliminate all the problems of fragmentation and simply seeks to adapt Article 5 (4) of the OECD Model Convention to new types of business. First, it is proposed that it be made clear that Article 5 (4) of the OECD Model Convention is limited to preparatory or auxiliary activities or, alternatively, that some activities be eliminated from the scope of that Article ("delivery" in subparagraphs a) and b), "purchasing goods or merchandise" in subparagraph d) — or subparagraph d) altogether). Second, it is proposed that a new paragraph 4.1 be added to the Commentary on Article 5 of the OECD Model Convention that would make clear that "accumulation of activities within one jurisdiction" can result in a PE and remove them from the scope of Article 5 (4) of the OECD Model Convention. Two options are presented by the OECD Public Discussion Draft on BEPS Action 7 in this regard, which deal with: (a) fragmentation of complementary functions, which are part of a cohesive business in the same or different places, between associated companies, provided that at least one of the places is a PE; or (b) fragmentation that splits a coherent business in the same manner as in the first option, but without having any PE because all the activities and places fall within the exceptions provided under Article 5 (4) of the OECD Model Convention. As was the case with commissionaires, the proposal seeks to address the most aggressive forms of fragmentation, but it does not pursue a holistic view of all the presences a company or associated companies may have in a jurisdiction and, except where it can be maintained that a certain degree of artificiality is present, accumulation of different presences will not be the rule. The geographical coherence test of the PE concept is left untouched and, therefore, the effects of the proposed paragraph 4.1 would be limited.

Splitting-up of contracts for the purposes of Article 5 (3) of the OECD Model Convention or the alternative service PE provision in paragraph 42.23 of the Commentary on Article 5 of the OECD Model Convention is also another concern of the OECD Public Discussion Draft on BEPS Action 7. Again, two proposals have been advanced: (a) to include a new paragraph in Article 5 (3) of the OECD Model Convention that accumulates the activities in the same place of associated companies for the purposes of computation of the 12-month period in that Article; or (b) to add an example in the Commentary, which is linked to the treaty General Anti-Avoidance Rule (GAAR) under Action 6 of the OECD Action Plan on BEPS, so that it captures only tax-driven splitting-up of contracts (the rule in the first proposal would also include splitting-up of contracts which is not tax driven). The scope of the rule is very limited as it affects only the computation of the time period and does not affect fragmentation involving different places of business, that is to say, it refers to a contract regarding one site, but not to splitting-up that involves different sites or projects (which is dealt with only by the limited changes to paragraph 4.1 of the Commentary on Article 5 and the changes in Article 5 (5) of the OECD Model Convention).

Insurance companies have also been the object of some consideration in the OECD Public Discussion Draft on BEPS Action 7 and two proposals have been made: (a) to add a new clause on insurance companies to Article 5 of the OECD Model Convention in line with paragraph 39 of the Commentary on Article 5 of the OECD Model Convention and Article 5 (6) of the United Nations Model Convention; or (b) to deal with insurance companies through the more general changes to Article 5 (5) and (6) of the OECD Model Convention mentioned above for commissionaires.

The importance of joint consideration of these changes with the work on attribution of profits to PEs is also underlined by the OECD

Public Discussion Draft on BEPS Action 7, but it is likewise stressed that no substantial changes to the current rules seem to be needed even if additions and clarifications may be useful. Notwithstanding the latter, no more clarifications are included in the OECD Public Discussion Draft on BEPS Action 7, as the work on attribution of profits is closely linked with other Actions in the OECD Action Plan on BEPS, namely: Action 9 on transfer pricing aspects of risks and capital and, more generally, Action 4 on the limitation of interest deductions and other financial payments and Action 8 on intangibles. Until this work is further developed, it is acknowledged that no other conclusions on attribution of profits to PEs can be reached. In fact, it can be argued that the problem of artificial avoidance of PE status has a lot to do not only with the concept of PE in Article 5 of the OECD Model Convention, but also with the system of attribution of profits to PEs as designed by the different versions of Article 7 of the OECD Model Convention (pre- and post-2010), and with Article 9 of the OECD Model Convention. Judging by the OECD Public Discussion Draft on BEPS Action 7, it would seem, however, that no major revamp of the current system is expected; it remains to be seen whether major changes are advanced in the context of other Actions.

It appears, therefore, that major changes cannot be expected from Action 7 as it is limited to extreme cases that are of common concern. Therefore, States that want to tax economic activity carried on in their territory may want to consider options other than (or complementary to) those proposed in the context of Action 7. However, before studying those options, it is necessary to fully understand what "artificial avoidance of PE" may mean and the policy implications of PE rules. This is very relevant for countries, and especially developing countries, to help them consider whether they want to adhere to the PE concept in the OECD Model Convention (as slightly modified by Action 7 in the OECD Action Plan on BEPS) or the United Nations Model Convention, or want to change it and complement it with other options to make sure that they are able to tax activities carried out in the State of source.

2.3 Policy issues behind Action 7: How can artificial avoidance of PEs be defined?

As mentioned above, Action 7 has several inherent weaknesses:

- If Action 7 ultimately concentrates on very limited issues, it will not solve the problems with tax planning structures and avoidance of PE status nor will it help to fully align economic activity and taxation. However, the limited time allowed for completing this Action (by September 2015) makes it very difficult to expect a transformative approach that can solve all the problems regarding the concept and attribution of profits to PEs that have not been dealt with satisfactorily in almost a century of experience with PEs;
- The importance of the problems with the PE definition in Article 5 makes it very difficult not to think about lowering the PE threshold, which would open the source/residence-country rights debate (an issue which seems to be embedded also in Action 1 on addressing the tax challenges of the digital economy). In view of the limited changes to Article 5 of the OECD Model Convention which could derive from the OECD Public Discussion Draft on BEPS Action 7 and the technical difficulties in applying Articles 5 and 7 of the OECD Model Convention, this might be an option to be considered, especially by developing countries (see section 5 below). In themselves, the changes proposed by the OECD Public Discussion Draft on BEPS Action 7 are a move towards more source taxation, even if they are limited in scope;
- The ambiguity of the Commentary on Article 5 of the OECD Model Convention and its evolution, without a guiding policy principle that is clearly explained, has produced different interpretations, in different countries, of the concept of PE and resulted in a real need for taxpayers and administrations to have more certainty in this area. This may actually affect the outcome of Action 7. Rather than remove current uncertainty, some of the solutions proposed by the OECD Public Discussion Draft on BEPS Action 7 may contribute to it because of the use of terms that are not easy to interpret or that admit different interpretations by the tax administrations of different countries.

Action 7 comprises different elements that do not easily lend themselves to obtaining a satisfactory and holistic solution. It touches the definition of PE, as well as attribution of profits to it, but without having a well-defined approach to aligning economic activity and the tax base (except for limited changes to the status quo). It also moves in a context where it is easy to connect its scope with the debate on source/residence-country taxation and, at the same time, have an effect on a domain that is subject to different interpretations and approaches in different jurisdictions. All of these aspects make it difficult to take any kind of coordinated action at the international level and they may cloud the outcome of Action 7, given that countries will independently assess which models better fit their specific situation. The proposal of the United Kingdom of Great Britain and Northern Ireland on the diverted profits tax (see section 5.4 below) is the best example of how easily this Action can be derailed or why countries may want to follow their own models on this issue and not necessarily those proposed by the OECD.

Additionally, it may be perceived that combating artificial avoidance of PEs would be easier with increased source-country taxation. It is important to keep in mind that two issues are intertwined in the discussions on Action 7 (that is, adjusting Article 5 and giving source countries more taxing rights), but it should be clear from the outset that they should not be confused. Whereas opposing artificial avoidance might amount to restoring source-country rights that are already (or should be) recognized in the present system of distributing tax jurisdiction, the discussion about them seeks to lower the threshold of source taxation. This theoretically clear-cut difference may not be so evident in the practice of PEs: the contours of this notion are not clearly defined in the current international tax framework and, therefore, the two conceptually different issues of restoring tax jurisdiction and attributing more source-country jurisdiction may become conflated. This is especially the case for countries with less sophisticated tax administrations for which the easiest way to tax activities taking place within their borders would be to have more taxing rights, rather than to address issues of PE and attribution of profits to PEs from the position of more developed tax administrations. One of the main problems for the tax administrations of developing countries is that when they have found a PE, they do not really know how to attribute profits to it, because either they do not have the appropriate legislation in this regard or they lack the know-how to do it, or both. Inevitably, therefore, the debate on Action 7 for developing countries raises the issue of source-country taxation and it is difficult to limit it to the contours of preventing artificial avoidance of PEs. To a certain extent the OECD Public Discussion Draft on BEPS Action 7, while trying to adapt the PE concept, also represents a move in favour of broader source taxation.

These observations are an attempt to underscore that countries — and especially developing countries — should consider whether the PE, as it is now defined, is the right threshold for taxation of business profits at source, whether they should pursue the elimination of artificial avoidance of PEs with domestic tools alone or adhere to the new approach proposed by the OECD as a result of Action 7, or whether they should opt for other models that recognize more source-taxation rights. This theoretical debate requires a full understanding of the limits and conditions of the PE threshold in order to know whether countering artificial avoidance is really what a (developing) country needs to do to align economic activity and taxation within its borders.

The foregoing reveals that the PE concept and the debate surrounding it currently present many difficulties[21] and that Action 7 in the OECD Action Plan on BEPS will develop in a fragile and difficult context from a technical policy perspective. From a practical perspective, PEs and artificial avoidance of PE status pose no fewer problems. All this may affect the outcome of Action 7.

2.4 The importance of managing PE risks for companies and tax administrations, especially in developing countries

The limited response to the invitation by the OECD for comments on Action 7 of the OECD Action Plan on BEPS does not mean that artificial avoidance of PE status is not of relevance to taxpayers and tax administrations. A number of factors have contributed to raise the practical importance of PEs in recent years.[22] Doubtless, the evolution of the business models of multinational companies, their virtualization and internationalization, the "presence" of these companies in more and

[21] R. Collier, "BEPS Action Plan, Action 7: Preventing the Artificial Avoidance of PE Status," supra note 11.

[22] See PwC, "Permanent Establishments 2.0: At the heart of the matter" (2013), available at http://www.pwc.com/gx/en/tax/publications/permanent-establishments.jhtml.

more jurisdictions, together with the increased mobility of employees and assets around the world, have increased the attendant risk of having PEs in different jurisdictions. For taxpayers, therefore, the need to plan for contingencies and manage PE risks is critical, as the aspiration to reduce their overall tax exposure in different jurisdictions, among other things, by avoiding having a PE (as long as this cannot be labelled artificial) is legitimate. For multinational groups, the current state of uncertainty with regard to PEs is not satisfactory: taxpayers often prefer to pay something rather than be subject to the uncertainty of arbitrary tax claims, double or multiple taxation, and lengthy disputes.

In recent years, the PE concept has provided tax administrations with a powerful tool to increase the tax base within their jurisdiction, especially when transfer pricing policies of multinationals cannot be challenged under national law or the OECD standard, as represented by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[23] (OECD Transfer Pricing Guidelines). A PE audit, if successful, may bring more revenue to the source country than transfer pricing audits of domestic subsidiaries of a group. The PE concept has even been used in the context of transfer pricing audits as a threat to increase attribution of profits to domestic subsidiaries. In this respect, some high-profile cases (for example, in Spain[24]) have probably increased the appetite of tax administrations to enter into PE audits, especially in a context where it is widely known

[23] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2010).

[24] See the following cases: *Borax* (Judgment of the Audiencia Nacional of 9 February 2011, rec. n. 80/2008, confirmed by the judgement of the Supreme Court of 18 June 2014, rec. 1933/2011); *Roche* (Judgment of the Audiencia National of 24 January 2008, rec. 894/2004, confirmed but with a different reasoning by the Judgment of the Supreme Court of 12 January 2012, rec. 1626/2008); *Dell* (Decision by the Central Administrative Court (TEAC) 15 May 2012, RG 2107/2007); and *Honda* (Decision by the Central Administrative Court (TEAC) 20 December 2012, RG 221/2009). For a commentary on these cases, see N. Carmona Férnandez, "The Concept of Permanent Establishment in the Courts: Operating Structures Utilizing Commission Subsidiaries," (2013) *Bulletin for International Taxation* (online version). All these court decisions seem to deviate from the conventional OECD approach in interpreting Article 5 of the OECD Model Convention.

that multinational companies have diverted profits from source countries through well-known structures like commissionaires and other risk-stripping strategies, as well as fragmentation of activities in source jurisdictions. An example of this reality is also provided by the International Manual of HM Revenue & Customs in the United Kingdom, and its consideration of commissionaire arrangements. It proposes that where significant people functions and risks are connected with United Kingdom activities, it is feasible to argue that there is a PE in the United Kingdom and that profits can be attributed to the foreign head office by using a cost-plus method so that the rest of the profits would be taxable in the United Kingdom.[25] Uncertainty and ambiguity on the interpretation of key concepts of Article 5 of the OECD Model Convention have created a breeding ground for more aggressive application of the PE concept by tax administrations.[26]

[25] See HM Revenue & Customs (United Kingdom), "Transfer pricing: Transactions and Structures: business structures: marketing and distribution — commissionaires: practicalities," in *International Manual*, INTM441050, available at http://www.hmrc.gov.uk/manuals/intmanual/intm441050.htm. The following excerpt is illustrative of the approach of the United Kingdom tax administration: "Attribution of profit between a principal and a PE in another country involving the transfer of function and risk cannot be dictated by a legal agreement alone — there must be a detailed consideration of whether in fact the risks and functions lie with a PE or the principal overseas. Once the functions and risks have been allocated between the PE and the home territory of the principal, appropriate profits can be allocated to those functions and risks. It will be simpler to establish a reward for the activities, which relate to ownership of the assets, such as managing and insuring stock. A cost-plus method could be used, leaving the balance of the profits from the overall selling activity to be allocated to the PE. The questions of whether there is a PE of the principal trading in the UK, and if so the profits that should be attributed to the PE are very complex issues. The OECD guidelines on the attribution of profits to a PE say that there should be no automatic force of attraction of profits to the PE. In the same way, there should be no automatic force of attraction to the head office of the enterprise. Only a careful examination of the facts will show whether functions are carried out by the PE in the United Kingdom or by the rest of the entity overseas."

[26] See PwC, "Permanent Establishments 2.0: At the heart of the matter," supra note 22, with warnings in this regard to companies to manage the risk of PEs by establishing adequate procedures and safeguards as a consequence of the reaction of some tax administrations.

In the final analysis, an evolutionary interpretation of the PE concept by tax administrations of some developed countries reveals not only that there is scope for different interpretation and application of the same concept, but also that tax planning is occurring in this domain, that there is discontent with the current situation and that something should be done. There is also some evidence that avoidance of PE status is not only a problem for developed countries but that it is also affecting developing countries. A recent International Monetary Fund (IMF) paper explains the following:

> [A] large proportion of non-natural resource based multinational businesses located in developing countries are organized as low risk, routine, light manufacturing or commercial ventures, rewarded with accordingly low profit rates. It is common, under the application of transfer pricing methods, to assign these operations a fixed rate of return for tax purposes, under which productivity gains rarely translate themselves into higher local profit margins. A risk in introducing such simplified schemes, despite their attractions for administration, is that they thus may not respond to changing commercial circumstance, and can perpetuate inappropriately low fixed profit rates in developing countries…
>
> Countering this aggressiveness would be greatly facilitated by developing concrete guidance where it is lacking and repudiating perverse interpretations of the ALP [arm's length principle] (commonplace and often tacitly accepted), such as condoning risk stripping and other arrangements that provide no documented productivity gain for the MNE. Carefully designed harbours that apply a fixed mark up to certain costs can play a greater role than generally recognized [Brazil rules for transfer pricing could be an example: minimum gross profit margins, very specific rules upon indices of commodities transactions, limitations on intracompany export transactions as a total of net export transactions].[27]

While the latter part of the quote considers the problems of tax base shifting from developing countries and solutions thereto from a "transfer pricing perspective," ultimately it refers to "commissionaire"

[27] IMF, "Spillovers in International Corporate Taxation," (2014) *Policy Paper, International Monetary Fund*, at 33.

and "fragmented" structures that keep a substantial presence in a developing economy but manage to substantially reduce source-country taxation by avoiding PE status. In this regard, tax administrations of developing countries should be aware of the fact that transfer pricing may help bring a part of the tax base to the source country, but identifying the existence of PEs or lowering PE thresholds may be an alternative to that route (sometimes an even more productive or easier one).[28]

From the perspective of developing countries, the answers to the questionnaire circulated in 2014 by the United Nations Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries also reveal that Action 7 is regarded as very important, which shows the need to act in this area.[29]

The question is whether developing countries should focus on the PE concept and the OECD Action Plan on BEPS or whether they should consider other routes to align activities carried out within their territory and tax bases that can be taxed by them. The answer depends on the limits of PE as a concept and on what can be regarded as artificial avoidance of PE status in the State of source. This issue is explored in section 3 below.

3. What is the PE function and when is it (artificially) avoided? The concept of PE and its evolution in the context of the OECD Model Convention

3.1 The basic function of PE

Artificial avoidance of PE status — and, therefore, the scope of Action 7 in the OECD Action Plan on BEPS — can be fully understood only if the function and role of PE is clear.

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[28] See, on this issue, section 5 below. See also HM Revenue & Customs (United Kingdom), "Transfer Pricing: Transactions and Structures: business structures: marketing and distribution — commissionaires: practicalities," supra note 25.

[29] Answers to the questionnaire circulated by the Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries are available at http://www.un.org/esa/ffd/tax-committee/tc-beps.html.

The concept of PE is defined in Article 5 of the United Nations and OECD Model Conventions and has been used in the international tax arena from the outset, starting with the work of the League of Nations[30] and the first bilateral tax treaties negotiated between countries. The PE concept is one of the thresholds — perhaps the most important one — in the United Nations and OECD Model Conventions, as well as in actual tax treaties. It identifies a level of presence in the source country which allows that country to tax non-residents on business profits that are attributable to a PE located within its territory, under Article 7 of the United Nations and OECD Model Convention.

A fixed place of business (Article 5 (1) of the OECD Model Convention), construction projects that last more than a fixed time (12 months under Article 5 (3) of the OECD Model Convention), or a dependent agent with the authority to habitually enter into contracts in the name of the taxpayer (Article 5 (5) of the OECD Model Convention) may constitute a PE.[31] However, Article 5 (4) of the OECD Model Convention excludes the right of the source country to tax business profits that can be attributed to specific activities listed therein or other activities of a preparatory or auxiliary character, even if these activities are carried out through a fixed place or through a dependent agent in that country.

At first glance, the function of the PE concept is clear, although its interpretation and application are not. The Commentary on Article 5 of the OECD Model Convention can be read in different — sometimes even contradictory — ways, with the consequence that there are no uniform interpretations by tax authorities or courts in different countries. The underlying economic/policy principles behind the PE clauses in Article 5 of the United Nations and OECD Model

[30] For a thorough study of the concept, see, for instance, B. Arnold, "Commentary on Article 5 of the OECD Model Convention," in IBFD, *Global Tax Treaty Commentaries*, supra note 12; and A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Deventer: Kluwer, 1991).

[31] There are relevant differences between Article 5 of the OECD Model Convention and Article 5 of the United Nations Model Convention. Similarly, attribution of profits does not follow the same principles in Article 7 of the OECD Model Convention and Article 7 of the United Nations Model Convention. These differences will be discussed in section 4 below.

Conventions are not always obvious either: the PE was designed to tax significant activity carried on in the State of source, but it permits some relevant presence and activity taking place there to go untaxed. Furthermore, the system of updating the Commentaries on the OECD Model Convention from time to time without having a fully established policy direction may add confusion and lead to divergent interpretations. From time to time, the perception of what is admissible may vary, the boundaries of the PE threshold may move over the years and what is admissible in a country today may not be accepted tomorrow, thus creating an issue for discussion between countries with fiscal systems in different stages of development.

In this context, it is complex to talk about "artificial avoidance" of PE, because what may be "artificial" for one country may not be the same for another that interprets the PE concept in a different way. This is obvious, for instance, in the Dell cases decided in Norway and Spain: a typical commissionaire structure withstood the examination of the Norwegian Supreme Court,[32] which ruled that there was no PE in such a situation, although the same agreement was regarded as a PE in Spain.[33] Perceptions of what is admissible also change over the years.

In these circumstances, understanding the current problems of the PE concept — and, therefore, defining what artificial avoidance of PE is — calls for a reference to its historical evolution; without it, it is not easy to fully comprehend the present problems relating to it. Moreover, history may help to create an understanding of the policy, economics or legal reasoning behind the PE concept. It will also aid in establishing whether there has been any behaviour over the years that could be regarded as artificial, a kind of "common," internationally accepted standard of when avoidance of PE is artificial. In addition, it would make it easier to assess the scope of Action 7 and determine whether the concept of PE may help to align economic activity within a country and tax bases or whether other options should be considered. Due to the complex nature of this work, only a summary of the historical evolution of the PE concept through the years is provided.

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[32] Norwegian Supreme Court, *Dell Products v. Tax East*, 2 December 2001, H-R-2011-02245-A, sak 2011/755.

[33] Decision by the Central Administrative Court (TEAC), 15 May 2012, RG 2107/2007.

3.2 League of Nations and the PE concept: priority of residence taxation, legal form and arm's length as basic principles

The 1923 Report on Double Taxation of the League of Nations[34] marked a significant change in international taxation: from a more or less active defence of the situs or origin principle, this report initiated a change in the status quo when it proposed a move to resident-State taxation. In the ensuing years, the pillars of the current international tax system were established: the primary right of taxation should correspond to the State of residence and the source State should have a right to tax only as an exception.

The reasons behind the acceptance of the residence taxation principle as a general rule and the PE concept as an exception were not clearly explained — neither in the League of Nations materials nor later on in the documents of the Organisation for European Economic Co-operation (OEEC, later OECD). The main arguments for changing the status quo were that tax treaties embraced only the residence principle and that it was difficult to tax foreign enterprises efficiently and equitably if they did not have a PE in the source country. The concern of industrialized countries about giving up revenue in favour of source countries probably was a very important driving force behind the position adopted, first by the League of Nations and later on by the OECD.[35] A mixture of economic theory, administrative convenience and political interest after the First World War explains the bias in the current international system towards residence taxation.[36]

It was in this context, in the 1920s and 1930s, that the PE concept began to exist in its current form, and its main features were

[34] See "Report on Double Taxation: Document E.F.S.73.F.19; April 5, 1923," (1962) Vol. 4, *Legislative History of United States Tax Conventions* (electronic version available at http://setis.library.usyd.edu.au); see also A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle*, supra note 30, 80 ff.

[35] Ibid., 82 ff.

[36] For a thorough review of the foundational premises of the current international tax system, see B. Wells and C. Lowell, "Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin," (2011) Vol. 65, *Tax Law Review*, 535-617.

defined to reduce the level of taxation in the source country along the following lines:[37]

- Only profits attributable to a fixed presence in the source country should be taxed by it. This was a natural option as most business models at the time required fixed presence to do business, even if the concept of fixed place was limited;
- The concept of PEs and companies within the same group was conceived of in terms of a legal definition — which facilitated the independent consideration of foreign subsidiaries — rather than as a substantive/economically oriented notion of group activities. Subsidiaries were first regarded as PEs of their foreign head offices, but soon they were removed from that definition;
- Dependent (in a legal, not in an economic sense) agents were included within the PE definition, but independent (even if not economically) agents were not included within it.

The genesis of the current system of attribution of profits also originated at that time, with the work of Carroll,[38] as a tool to serve the interest of resident countries. By establishing the principle that subsidiaries or PEs have to deal with their head offices at arm's length, the residual value of transactions — the reason why corporate groups exist — was diverted from the source countries. In this model, remuneration of PEs or subsidiaries for the "service provided" is natural, as the PE/subsidiary is assumed to be remunerated as an independent party, but profits are allocated mainly to where managing activities are carried out, that is to say, the head office/parent company.[39] The

[37] See R. Vann, "Tax Treaties: The Secret Agent's Secrets," (2006), No. 3 *British Tax Review*, 345 ff.; and R. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 12, 291 ff.

[38] See M. Carroll, *Prevention of international double taxation and fiscal evasion: two decades of progress under the League of Nations* (Geneva: League of Nations, 1939).

[39] In cases of contract manufacturing, the manipulation of the outcome of the transaction is relatively easy: a manufacturing subsidiary is set up in the country of source as a contract manufacturer that sells to the parent company, which, in turn, sells back to another subsidiary situated in the country of source, but in such a way that the subsidiary is only providing services to

advantages of this system were immediately noticed by multinational corporations and the first cases of commissionaire-like arrangements and fragmentation started to be heard by courts during this period.[40]

Another feature of Carroll's theory was that profits were attributable to each PE. This is probably the genesis of most of the historical and modern problems of PEs as the tax base of a single taxpayer could be fragmented among different presences in a country. The result was that if some of them did not meet the PE threshold, the taxable income was attributed to the residence country and, if the PE threshold was met, the independent enterprise theory accepted by Carroll also favoured attribution of residual value to the same residence country.[41]

3.3 OEEC work and the preparation of the (Draft) OECD Model Convention (1963-1977): establishing the contours of the modern PE concept

From 1957 to 1958, the contours of the modern PE concept were further refined in two mutually reinforcing movements: the definition of PE and the attribution of profits to it. In 1957, the concept of PE was further reduced by: (a) linking PEs with fixed places and, therefore, explicitly removing itinerant business from the concept; (b) including the exceptions of the, by then, Article 5 (3) (present Article 5 (4) of the OECD Model Convention), which encompassed the maintenance of a stock of goods in the source country (previously included within the PE concept); and (c) detaching the concept of dependent agent from a fixed place and linking it to the authority to conclude contracts on

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the parent and not acting as its legal agent by assisting in the sales to the third parties. See R. Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37.

[40] Ibid., 345 ff.

[41] See R. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 12, 319. According to this author, the separation of activities in determining PE status is the "more important problem," as "[i]t encourages tax planning by artful segregation of activities and reliance on the implied or express limitations in the fixed place/agency/minor activities rules . . . More significantly, separation of activities pervades the whole transfer pricing mindset by shifting the focus from the overall to individual activities of the firm in a country."

behalf of the principal.[42] These developments reduced further the rights of source countries and introduced the dependent agent PE concept without any policy explanation of whether or not it was a measure of economic activity. The policy reasons behind this option were explained only in 2002.

In 1958, a report on allocation of profits to PEs and subsidiary companies,[43] in addition to accepting Carroll's system of attribution of profits to separate enterprises, proposed a "per PE" taxation and formally rejected the force of attraction principle, with the consequence that the various presences of a foreign taxpayer in a jurisdiction could give rise to more than one PE to which profits should be attributed.[44] This understanding is at the core of fragmentation of activities in the source State because several business presences in a country, regardless of whether or not they give rise to a PE, cannot be "horizontally" accumulated.

The drafters of the 1958 report were well aware of the fact that rejection of the force of attraction principle and attribution of profits per PE facilitated avoidance of the PE status through fragmentation of activities in the source State, but they preferred to protect free trade without "undue restrictions," as fragmentation could in any case result for genuine reasons and the most problematic cases could be dealt with by adequate domestic provisions (that is to say, anti-avoidance norms). The respect accorded to business dealings and structures, as well as the goal of simplification and administrative convenience, were fundamental features of a system geared towards promoting free trade. This left little margin for attention to tax avoidance doctrines: any business reason for not meeting the PE threshold and for fragmentation of activities discounted the effects of anti-avoidance theories, regardless of the fact that tax reasons could also be a powerful motive for the

[42] OEEC, FC/WP1 (57) 3, 8 November 1957.

[43] OEEC, FC/WP7 (58) 1, 4 September 1958.

[44] Ibid., Appendix II, where it is stated that "the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. In taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate items of profit that the enterprise derives from their country and should apply to each item of profit the permanent establishment test."

business structure. The arm's length and the independent and separate entity principles, as well as the legal consideration of subsidiaries as "independent entities," also facilitated the reduction of the tax base in source countries and the proliferation of structures designed to avoid source-country taxation.

After 1963, further refinement of the PE concept was needed and the work on it in connection with the 1977 OECD Model Convention and Commentary on Article 5 began to reveal some of the inherent problems of PEs and the tension between a formalistic and a more substantive interpretation of it. The most relevant document in this regard is the OECD 1970 Preliminary Report on the questions in connection with the definition in Article 5 of the term "permanent establishment."[45] In this report, fragmentation of activities of the same enterprise, even though limited to the same place of business, received some consideration in support of a more economic and less legalistic interpretation of Article 5 (3) (current Article 5 (4)) of the OECD Model Convention. At the same time, however, the report introduced explicit references to the "per project" computation of the time period in Article 5 (3) (current Article 5 (4)) of the OECD Model Convention and to the geographical and commercial coherence test for that Article. This report was in fact the precursor of the "commercial and geographical coherence test" which, according to its evolution, is applied nowadays in the context of Article 5 (1) (since 2003) and Article 5 (3) of the OECD Model Convention (since 1977).

Even if the Commentaries on Article 5 of the 1977 OECD Model Convention represented a tepid change in approach, as they gave a less literal interpretation of the concept of PE,[46] they basically

[45] OECD, FC/WP1 (70) 1, 17 August 1970.

[46] For example, the fixed place of business test in Article 5 (1) was more flexible, with the result that several fixed places could be accumulated within the same PE; a fixed place could exist even if no premises were available or simply because there was space at the enterprise's disposal; the construction works to be taken into account for the 12-month period were those not totally unconnected (if they were a single project, they would form a coherent whole commercially and geographically); some mobile activities could qualify for the test in Article 5 (1) if they moved from one place to another as a result of the project undertaken; Article 5 (3), as well as Article 5 (4), admitted a more

followed the principles established in the preceding periods and did not involve any substantial change in this respect. In other words, the more substantive view regarding "preliminary" and "auxiliary" activities, which was contained in the 1970 report, was not totally accepted in the Commentary in 1977, which continued to support the basic pillars of the PE concept as established in the 1950s. Therefore, the rights of source countries were not increased — neither directly (the same principles applied to PEs as before) nor indirectly — by recognizing their right to apply anti-avoidance norms or doctrines.

In the period from 1958 to 1977, there is no discussion of anti-avoidance/economic doctrines in the Commentary on Article 5 of the OECD Model Convention, although the problem of avoidance had emerged in some of the reports (1958, 1970) used in developing it. It is not known whether avoidance is not referred to in the Commentary because it was an ancillary worry for the delegates — which is confirmed by the reports of the 1950s — or because they (and, as a result, the OECD) adopted a rather formalistic position in which anti-avoidance doctrines could not be accommodated easily in the context of tax treaties. Certainly, promotion of free trade and administrative simplification ranked high in the preferences of the drafters of the Commentaries on Article 5 of the OECD Model Convention (1963 and 1977) and avoidance was not a fundamental concern. In defence of the drafters of the Commentaries, it should be remembered that the foundations of the modern concept of PE were established in eras of (sometimes desperate) promotion of free trade as a goal (first, after the First World War and the Great Depression; and, second, after the Second World War and in the context of the GATS[47] and the, by then, nascent European Economic Community (EEC)). It is understandable that in such an environment, promotion of free trade and elimination of obstacles to commerce was the main priority of the delegates.

In view of this evolution, only in very limited cases could it be said that there was artificial avoidance of PEs in the source State

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substantial interpretation when several preliminary or auxiliary activities were combined within the same place.

[47] General Agreement on Trade in Services, 15 April 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, available at http://www.wto.org/english/docs_e/legal_e/26-gats.pdf.

where it could claim its right to tax non-resident taxpayers. The PE was designed to foster residence-country taxation and avoid source-country tax (except where the fixed place and dependent agent thresholds were met) and, therefore, only modifications in the PE threshold could increase taxing rights of the source country.

3.4 (R)evolution of the PE concept: 1990s to present

3.4.1 PEs reveal their limits

In the 1990s the debate over the PE concept continued for several reasons: removal of barriers to banks and financial institutions, integration of financial markets, technological advances, developments and substantial increase in the trade in services, new business models, the incremental importance of services; and not least, increased tax planning opportunities, which were facilitated by all these factors and the specific configuration of the PE in Article 5 of the OECD Model Convention and the system of attribution of profits in Article 7 of the OECD Model Convention.[48] All these developments marked another phase in the evolution of PEs; in particular, the PE concept and attribution of profits to PEs were the object of new studies, especially after the arm's length principle was developed and explained in the 1995 OECD Transfer Pricing Guidelines.

These changes revealed not only the limits of the PE concept, but also those of "artificial avoidance" of PEs. First, the fixed place of business under Article 5 (1) and the threshold for construction projects in Article 5 (3) were relatively easy to avoid — in some cases not necessarily in an artificial manner — as described below:[49]

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[48] R. Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37, 373.

[49] See, on this issue, A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle*, supra note 30, 109 ff.; B. Arnold, "Threshold Requirements for Taxing Business Profits Under Tax Treaties," in B. Arnold, J. Sasseville and E. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties* (Toronto: Canadian Tax Foundation, 2004), 81-84; and J. Schaffner, *How fixed is a Permanent Establishment?* (Alphen aan den Rijn: Kluwer Law International, 2013).

- Some business models do not need physical presence in a country, and this does not involve any type of avoidance or aggressive planning. This is especially the case with mobile businesses, services, technological enterprises and the digital economy.[50] Simply put, in these cases the fixed place of business may not be relevant to capturing profits in the source State;[51]
- The separate consideration of various fixed places of business/projects of the same taxpayer could allow for the PE threshold to be easily avoided. It may even be said that this principle, which affects Article 5 (1) and (3) of the OECD Model Convention equally, encourages tax avoidance in the State of source. The separate consideration of the activities of different companies, even if within the same group or for the same project or line of business, also increases the possibilities of avoiding the PE threshold;[52]
- The connection between the fixed place of business and the carrying on of business could be severed by conducting business at places that, in theory, may not be considered to be available to or at the disposal of the non-resident taxpayer: for example, hotels, homes of employees, premises of clients. Certain elements of artificiality — attempts to avoid PEs — might be present in some models, however. This also affects the permanence test of the PE concept, as it is very easy for some businesses to have short-term or intermittent presences in a country without being continuously in the same location (for example, rental of

[50] The subject of the digital economy is not covered under the present chapter and is dealt with in chapter VIII, Protecting the tax base in the digital economy, by Jinyan Li. See also T. Falcao and B. Michel, "Assessing the Tax Challenges of the Digital Economy: An Eye-Opening Case Study," (2014) Vol. 42, No. 5 *Intertax*, 317 ff.

[51] See W. Hellerstein, "Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments," (2014) Vol. 68, No. 6 *Bulletin for International Taxation*, 346 ff., where it is argued that the virtual PE may not be a solution either.

[52] See B. Arnold, "Threshold Requirements for Taxing Business Profits Under Tax Treaties," supra note 49, at 81; and R. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 12, at 319.

meeting rooms, presence on the premises of a client, in hotels, on ships entering and exiting the jurisdiction);

- The exceptions in Article 5 (4) of the OECD Model Convention, especially if interpreted literally, offer a wide margin for carrying out activities within a jurisdiction without exposure to tax.[53] If combined with the more and more frequent possibility of avoiding having a business presence or dependent agent in a territory, the per PE approach and the legal independence of companies within a group may create a considerable margin for minimizing taxation in the source country.

Second, while the problem of dependent and independent agents in Article 5 (5) and (6) of the OECD Model Convention has existed from the very outset of the work of the League of Nations and the OEEC, it has been exacerbated by the economic and technological changes of the past three decades, as described below:

- In a world with better telecommunications, connecting the PE dependent agent to the conclusion of contracts "in the name/on behalf of" the enterprise does not make much sense. At the time of the League of Nations or the OEEC, it was probably assumed that the agent was, more or less, immobile. However, since the 1990s, it has become easy to avoid this requirement, either by concluding the contract outside the country of source or by making the principal ultimately sign the contract.[54] Moreover, a person who has only dependent agents in a country who are not empowered to conclude contracts or who are independent (or are a combination of both) can avoid having a PE as long as the fixed place of business test is not met;[55]

[53] Ibid., note 73, where it is pointed out that while "the exception does not cover firms whose very business is the activity in question, it is not clear if there is an overall preparatory or auxiliary limit on the exceptions, and nowadays the listed activities include significant value-adding elements — purchasing, warehousing, delivery, advertising, collection of information, and market research."

[54] B. Arnold, "Threshold Requirements for Taxing Business Profits Under Tax Treaties," supra note 49, at 91.

[55] Ibid., 91-93.

- Reliance on legal (as opposed to economic) dependence often led subsidiaries to be considered "independent" creatures of other companies in the same group. As long as their activity was remunerated at arm's length and they were not dependent agent PEs according to Article 5 (5) of the OECD Model Convention, substantial business profits could be stripped from the country of source provided that they were attributable to a non-resident company, which could be located in a low-tax country,[56] take advantage of hybrid structures[57] or benefit from ring-fenced regimes[58] to reduce taxation;
- Article 5 (4) is also relevant in this context: a subsidiary or another person could carry on auxiliary and preliminary activities without such activities being accumulated and attributed to those of other persons who are related somehow to the same group of companies within the same jurisdiction, especially if they take place in different locations.

In this context, as early as the 1990s and even before, fragmentation of activities or commissionaire-like agreements that permitted foreign companies to have a substantive economic business presence in a country without having a PE there could easily exist. The problem was perceived to be so acute that, already in 1991, Skaar wrote the following:

> The effects of the PE concept in international fiscal law have changed, in particular during the last few decades. Rather than protecting the tax base in the source State, the PE principle today has become instrumental in ensuring avoidance of source-state taxation for some economically important business operations.[59]

As explained below, the reaction of the OECD was to preserve the status quo with some very limited changes and, therefore, the PE principle continued to act in favour of residence countries to limit the taxing rights of source countries.

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[56] For example, Ireland.

[57] For example, hybrid structures in the Netherlands.

[58] For example, special regime for principals in Switzerland.

[59] A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle*, supra note 30, at 559.

3.4.2 OECD reaction: 1992-2005

While the evolution of the OECD work on the subject of PEs during the period 1992-2005 is complex, it did not result in significant changes compared with the preceding period. It can be summarized as follows:

- In 1992, a new paragraph 18 — still valid at the present time — was added to the Commentary on Article 5 (3) of the OECD Model Convention, to point out that contracts could be artificially split up to avoid the 12-month test and that anti-avoidance rules could be applied for these purposes or specific clauses could be included in tax treaties. The new paragraph marked a relevant change of perspective — it was an explicit recognition that some of the paragraphs in Article 5 of the OECD Model Convention could be abused. However, the change affected only the computation of the time threshold in Article 5 (3), and abuse had to be considered within the context of: (a) respect for business structures and groups; and (b) the per PE principle and geographical and commercial coherence test, which severely limit the possibilities of regarding two or more separate presences in a country as a PE;
- The 1994 change to paragraph 32[60] of the Commentary on Article 5 of the OECD Model Convention constituted a step towards a less formalistic interpretation of Article 5 (5) of the OECD Model Convention (dependent agent PE), but only with regard to intervention in the negotiation of contracts, and not with regard to the elimination of the problem of commissionaires, even if the paragraph was ambiguous enough to be interpreted by some countries in a non-formalistic way. Therefore, the change did not represent any relevant move to abandon or substantially modify the dependent agent PE threshold;

[60] In the 1994 update to the OECD Model Convention, it was provided that "the phrase 'authority to conclude contracts in the name of the enterprise' does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise."

- The controversial 2002-2003 revision[61] to the Commentary on Article 5 of the OECD Model Convention did not add much with regard to the problem of (artificial) avoidance of PEs even if it did represent a (limited) move in favour of more source-country taxation. Rather, it could be said the changes limited even further the scope of anti-avoidance rules in the context of Article 5 of the OECD Model Convention with regard to the problems of commissionaires and fragmentation and, thereby, the possibility for source countries to react against these structures:[62]

  (a) Changes to Article 5 (1), 5 (3) and 5 (4)

  Even if a less formal interpretation and some changes in anti-avoidance intent are evident (for example, the factual disposal test, or supervision of activities in Article 5 (3)), the basic principles of the PE concept remained untouched or were even reinforced. For instance, the geographical and commercial coherence test was imported from Article 5 (3) to Article 5 (1) of the OECD Model Convention, and the controversial examples of the painter and the consultant or the coordination office aim to illustrate how it should be applied. Moreover, the new paragraph 27.1[63] of the Commentary on Article 5 (4) and

[61] See OECD, *Issues arising under Article 5 (Permanent Establishment) of the Model Tax Convention* (Paris: OECD, 2002).

[62] The Commentaries on Article 1 of the OECD Model Convention represented a dramatic shift, since it was recognized that domestic anti-abuse or anti-avoidance doctrines could be applied. As a result, the Commentaries on Article 1 and Article 5 of the OECD Model Convention are not fully aligned in this regard. There are two different anti-avoidance standards in connection with Article 5 and Article 1, respectively: the first only admits an “exclusively-tax-motived standard” whereas the second picks up a “main purpose test.”

[63] See paragraph 27.1 of the Commentary on Article 5 of the OECD Model Convention, where it is provided that “Places of business are not ‘separated organisationally’ where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.”

the introduction of the term "combination of activities" did not contribute much to eliminating the formalistic reading of Article 5 (4) and, certainly, did not help the effort to deal effectively with the fragmentation of activities in the source country. Rather, it could be interpreted as a limit to the application of anti-avoidance rules against fragmentation: if read correctly, it means that activities of several taxpayers cannot be combined and activities of the same taxpayer can be considered together only if they are carried out in the same place of business and are not separated organizationally. As a matter of fact, even some examples on business restructuring contained in the 2002 OECD Report on Issues in International Taxation[64] are supportive of limiting tax avoidance doctrines or legislation to affect exclusively tax-motivated transactions.[65]

(b) Changes with regard to dependent agent PEs

Even though the underlying philosophy of the dependent agent PE was explained for the first time in the above-mentioned 2002

[64] OECD, *Issues in International Taxation: 2002 Reports Related to the OECD Model Tax Convention* (OECD: Paris, 2002).

[65] Ibid., at 100, where the following example was provided: "A non-resident parent company owns a resident subsidiary that hitherto has been engaged in selling both automobiles and spare parts. The spare parts storage facility is now to be hived off and treated as a separate branch of the parent company. The activities of the storage facility will be limited to the storage, relocation, and distribution of the spare parts, which will be ordered 'directly' from the parent by the customers. Specifically, this means that: (a) the settlement of the transactions, with regard to both contracting and accounting, is to be effected exclusively by the parent in its name and for its account; (b) ancillary activities such as settling warranty claims, installing, performing customer service, and advertising are not performed by the storage facility; and (c) the necessary staff is provided under a lease contract, and the facility's own staff is engaged merely in instructing and supervising." It was concluded that in this example the source country had lost taxing rights because the new activities carried out by the branch fell squarely under Article 5 (4). Also, it was recognized that Article 5 (4), letters a) through d), "are always exempt and are not subject to examination for whether or not they are truly preparatory or auxiliary." Even if this could give rise to tax planning, it was argued that, as long as the transaction was not "exclusively" tax-motivated, the taxing rights should be allocated to the residence country.

Report, the main limitation of Article 5 (5) was already clear: signing of contracts is not an adequate substitute for fixed place of business as it is not a measure of economic presence in the source country. This led to the acknowledgement that "signing," as such, was not a crucial element of the test under Article 5 (5). In this regard, the threshold was lower for cases where final signature — rubber stamp — was reserved for the non-resident (all the elements of the contract having been negotiated by someone in the source country). Also, it was recognized that splits to avoid "habitually contracting" needed to be addressed with anti-avoidance rules. This was evidence of the inappropriateness of the dependent agent PE test as a measure of presence in a country. On the other hand, the independence of the same companies of a group was reinforced by the changes in the Commentary on Article 5 (6) of the OECD Model Convention and by the new paragraph 38.1 therein, although the issue of commissionaires or business models that did not need agent PEs (or fixed places) was not addressed.

- The reaction of the OECD to the Philip Morris case was another example of a formalistic interpretation and limitation of the scope of anti-avoidance norms as opposed to a substantive interpretation in the context of Article 5 of the OECD Model Convention. In that case,[66] the Italian Supreme Court (Corte di Cassazione) linked the dependence/independence test to the circumstances of the group as a whole, and not to the subsidiaries considered in isolation. The OECD dismantled that approach, which could have represented a fundamental change regarding the evolution of the PE concept.[67] The changes of 2005 in the OECD Commentary on Article 5 (paragraphs 33, 41, 41.1 and 42) basically made clear that: (a) companies of a group were to be considered separately and, therefore, the PE test must be applied to each of them; and (b) where a company

[66] Decisions of the Italian Supreme Court (Corte di Cassazione) of 7 March 2002, No. 3667 and No. 3368.

[67] See United States Council for International Business, "OECD Work on the PE definition," available at www.uscib.org/docs/OECD_Note_PE_Definition.pdf; see also L. Schoueri and O. Günter, "The Subsidiary as a PE," (2011) Vol. 65, No. 2 *Bulletin for International Taxation*, 69 ff.

> provides services to another company of the same group on the former's premises and with its own personnel, that company cannot be considered to be a PE of the company receiving the services unless its premises are at that company's disposal or it acts as a dependent agent of that company.[68]

The OECD position in these years (1992-2005) was basically in line with the main principles of Articles 5 and 7 of the OECD Model Convention as designed at the outset. Even if some elements of change can be found in the Commentaries (that is to say, they are more anti-abuse oriented and offer a less literal interpretation of Article 5), it cannot be said that artificial avoidance or even avoidance of PEs in the source country was the most important issue for the OECD during this period. Further, these elements have given rise to conflicting interpretations in some countries. Rather, with limited exceptions, the changes in the Commentary on Article 5 of the OECD Model Convention moved in the direction of making the underlying philosophy of Article 5 and its principles more robust to counteract substantive interpretations, anti-avoidance theories or corrections that could favour source countries. This occurred despite the fact that it was already evident in these years that PE was probably not the right test for aligning economic presence and taxation in the source country.

3.4.3 OECD work on attribution of profits to PEs and OECD Transfer Pricing Guidelines

Although transfer pricing and attribution of profits to PEs are not the subject of the present chapter, a brief reference to these topics is useful because evolution in these areas in the period 1995-2010 was a very relevant issue. On the one hand, the discussions reinforced the PE principle and limitation of source-country rights but, on the other, they contributed to a change in the landscape of PEs for taxpayers and tax administrations alike. The latter have realized the potential for

[68] See R. Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37, at 374, where it is pointed out that "the changes reinforce the separate legal entity status of associated enterprises and indicate that it is not generally possible to pierce the corporate veil and attribute the acts of one associated enterprise to another on the basis of a deemed agency or place of business."

challenging some tax-oriented structures through the PE concept and the former have also noticed that conflict in this area can be significant.

As explained in section 3.2 above, the current transfer pricing system — derived from the original work of Carroll and developed in the OECD Transfer Pricing Guidelines — has fostered the attribution of (residual) value to residence countries. The freedom of contract between associated companies and the independence of companies within a group also helps to obtain this result. In fact, conversion of full-fledged manufacturers into toll manufacturers, and full distributors into commissionaires, very much relies on the possibility of associated companies being able to shift risk through legal contracts between companies of the same group. Preference in the 1995 OECD Transfer Pricing Guidelines for traditional methods of valuation (for example, cost-plus) has promoted this result: the local subsidiary is remunerated on a cost-plus basis that permits the allocation of the most relevant part of the profit to a foreign parent or associated company, usually located in a favourable tax environment (without that company having a PE in the source State), that has contractually assumed the relevant risk from which profits will follow. With the revision of Chapters I-III, and especially Chapter II, of the OECD Transfer Pricing Guidelines in 2010, a hierarchy of methods was eliminated — now there is a "most appropriate method" rule — although a certain preference for traditional methods over transactional profit ones (for example, profit-split) was retained.[69]

In this context, Chapter IX of the OECD Transfer Pricing Guidelines (2010) on business restructuring has supported separating business profits from presence in a jurisdiction because business restructurings that were well executed from a transfer pricing perspective could not be challenged even if local entities were transformed into limited risk distributors, toll manufacturers or commissionaires.

[69] See, for instance, C. Silberztein, "The 2010 Up-Date to the OECD Transfer Pricing Guidelines" and G. Maisto, "OECD Revision of Chapters I-III and IX of the Transfer Pricing Guidelines: Some Comments on the Hierarchy of Methods and Re-characterization of Actual Transactions Undertaken," in D. Weber and S. Van Weeghel, *The 2010 OECD Up-Dates: Model Tax Convention and Transfer Pricing Guidelines* (Alphen aan den Rijn: Kluwer Law International, 2011).

The only limits to this (the disregard principle or domestic GAARs) are not very effective as they clash with the PE thresholds in Article 5 of the OECD Model Convention, which operate in favour of residence countries/separate companies within a group.[70]

It remains to be seen whether the OECD Action Plan on BEPS will correct this bias in the international transfer pricing system (for example, with more frequent use of profit splits) or, rather, whether it will foster it in another form (for example, by relying on economic ownership of intangibles). The fact is that the PE principle and the transfer pricing rules, together, have operated in parallel and as mutually reinforcing tools in favour of the interest of residence countries.

The OECD work on attribution of profits to PEs (mainly addressed in the 2008[71] and 2010[72] Reports), which has evolved since 2001, has also had an impact on current developments and on the attitudes of taxpayers and tax administrations.[73] Two main features of the reports on attribution of profits stand out. First, because a PE is part of an entity, there is no possibility of contractual allocation of risks within the same corporation, unlike between associated companies. Risks follow functions and these are located where significant people in a corporation carry out their job; capital and assets are to

[70] Paragraph 9.182 in Chapter IX of the OECD Transfer Pricing Guidelines (2010) manifestly recognizes this: "Provided functions, assets and/or risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNE group to restructure in order to obtain tax savings. However, this is not relevant to whether the arm's length principle is satisfied at the entity level for a taxpayer affected by the restructuring." See also, for instance, Example (A) in paragraph 9.188 in Chapter IX of the OECD Transfer Pricing Guidelines.

[71] OECD, *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, 2008) (2008 Report).

[72] OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, 2010) (2010 Report).

[73] The 2008 and 2010 Reports have an important impact on the interpretation of Article 7 of the OECD Model Convention (1963-2008 versions and 2010-2014 versions, respectively). As a result, these Reports project their effects upon both existing and new tax treaties.

be allocated to where the significant people functions are performed.[74] Second, the reports gave support to the dual taxpayer approach, especially for dependent agent PEs. Under this approach, if the dependent agent PE assumes functions, assets or risks beyond those attributed to the dependent agent company (associated company of the same group), those additional profits are also taxable in the source State in the hands of the enterprise having the PE. The dual taxpayer approach is not inherent to the Authorised OECD Approach (AOA); in addition, it could be applied in the context of the traditional attribution of profits to PEs,[75] but probably the OECD work in this regard was eye-opening for some tax administrations, which tried to use it to correct the bias in favour of residence countries in the international context.

As a consequence, the OECD reports on attribution of profits to PEs have worked in two divergent ways that may help to explain why conflicts around PE structures have proliferated recently:

- For tax advisers, the new approach provided an important tax planning tool: if significant people functions are located in favourable tax jurisdictions, this would mean that a relevant portion of a company's profits would go with them (risks follow functions, and functions are identified with significant people

[74] See paragraph 15 in Part I (General Considerations) of the 2010 Report: "Accordingly, the authorised OECD approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risks are performed by people in the PE and also attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE."

[75] As a matter of fact, the 2008 Report — which also recognizes the dual taxpayer approach — is attributed an important function with regard to Article 7 of the 2008 OECD Model Convention (and previous versions of that Article), which follows the traditional approach to attribution of profits to PEs. For examples of the use of the dual taxpayer approach in cases involving subsidiaries and PEs of the same group or commissionaire agreements, see Australian Taxation Office, *Attribution of Profits to a Dependent Agent PE*; or the HM Revenue & Customs (United Kingdom), "Transfer Pricing: Transactions and Structures: business structures: marketing and distribution — commissionaires: overview," in *International Tax Manual*, INTM441040.

within the company).[76] Constant travelling by these individuals into and out of the source country, as long as that does not create a PE, has only the effect of removing more profit from that jurisdiction if "services" are provided to resident companies. This approach tends to ignore that a company is much more than "significant people" and that all parts of the firm, especially employees but also other associated companies and subcontractors, contribute to profits.[77] Combined with the PE thresholds and the freedom of contract to allocate risks between associated companies, the final result is that it is relatively easy to remove profits from the country of sale or manufacture of a product (through contract-manufacture agreements combined with fragmentation and/or commissionaire agreements if the country is also a relevant market) provided significant people are in the right place.[78]

- For tax administrations, the OECD reports (together with the functional analysis in the OECD Transfer Pricing Guidelines), by emphasizing risks and significant people functions, offer an important tool to challenge traditional fragmentation and commissionaire-like agreements.[79] Some tax administrations have established that where functions and risks are de facto, not de jure, in a source country, a PE may exist.[80] Relaxation

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[76] See R. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 12, 326.

[77] Ibid., 330-332. Contrary to the usual assumption, according to this scholar the profits from services provided by significant people should be located where they are used (given that in modern corporations it is increasingly difficult to know the place of provision of services). The OECD Model Convention, however, does not allow this.

[78] Ibid., at 337.

[79] R. Collier, "BEPS Action Plan, Action 7: Preventing the Artificial Avoidance of PE Status," supra note 11, 640.

[80] See HM Revenue & Customs (United Kingdom), "Transfer Pricing: Transactions and Structures: business structures: marketing and distribution — commissionaires: practicalities," supra note 25. The following excerpt illustrates the point: "The principal, through the UK commissionaire, is participating in the selling activity in the UK; the selling activity is the source of the profits of the PE. In the example, the profits included in the accounts for the principal are derived from the inventory and debtor functions and risks

of some of the criteria for interpreting PE thresholds after 2003 has contributed to this outcome. Intuitively, one may think that the solution to the problem of undertaxation of groups in the country of source should be provided at the level of the subsidiary by increasing its profits. If this is not possible, and emphasis on contractual freedom of associated companies renders it more difficult, the only way of correcting the undesirable result is by attributing to a PE of the parent in the source country all or part of the residual value obtained by the parent company from activities in the source country.[81] In fact, it seems that both strategies have been considered by tax administrations as mutually reinforcing: sometimes the PE argument is used as an instrument (that is reinforced by the ambiguous Commentary on Article 5 of the OECD Model Convention) to reach a more balanced result in the transfer pricing area.[82] Even if, in theory, other solutions could be more desirable, the current interpretation of PE by the

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and the residual profit. Attribution of profit between a principal and a PE in another country involving the transfer of function and risk cannot be dictated by a legal agreement alone — there must be a detailed consideration of whether in fact the risks and functions lie with a PE or the principal overseas. Once the functions and risks have been allocated between the PE and the home territory of the principal, appropriate profits can be allocated to those functions and risks. It will be simpler to establish a reward for the activities, which relate to ownership of the assets, such as managing and insuring stock. A cost-plus method could be used, leaving the balance of the profits from the overall selling activity to be allocated to the PE."

[81] See R. Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37, 345 ff.; and R. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 12, 291 ff.

[82] See J. Müller, "Attribution of Profits to a PE: A Business Perspective" in D. Weber and S. Van Weeghel, *The 2010 OECD Up-Dates: Model Tax Convention and Transfer Pricing Guidelines*, supra note 69, where it is pointed out that "You always know when you have a subsidiary. PEs, especially dependent agent PEs, can appear out of nowhere. In various countries inside and outside of the OECD, the opening move of an aggressive tax authority will be to claim the existence of a PE. For example, some tax authorities argue that entities carrying no risk must be dependent agents for those entities carrying the risk instead. To date many of these disputes end up in transfer pricing settlements, where it is acknowledged by the taxpayer that the local entity does in fact carry some risk, and therefore should receive an increased compensation."

> OECD limits its more active use, although this has not stopped some tax administrations from using it aggressively.[83]

As currently devised, transfer pricing instruments and attribution of profits to PEs have been part of the problem of avoidance of source-country taxation. They have exacerbated the effects of Article 5 of the OECD Model Convention, even if the work on attribution of profits to PEs (or even transfer pricing) has opened the eyes of some

[83] See R. Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37, 376-380, for a criticism of the Authorised OECD Approach to dependent agent PEs. In this article, the author concluded by proposing the following solution: "If a PE is avoided on legal form grounds even though not independent, it is necessary to have recourse to the associated enterprises article to capture the profits in the country of the alleged PE. The second problem relates to . . . use of legal form based on separate legal entities and the respect for transactions to shift the residual more or less at will (taking care to relocate a bit of brainpower at the same time) . . . If PEs could be created on an economic substance approach (based on independence for the boundary of the firm) with real profits attributed to them for significant activities in a country regardless of playing with risks between associated enterprises, the residual might end up where it seems to belong. Alternatively if transactions between associated enterprises were less sacrosanct than they are now and a realistic value approach were taken to allocation of residual profits, again it would be more likely that profits align with reality" (p. 380). Moreover, the author proposes to solve the current problems in the following manner: "(1) the independence criterion should be used to conceptualize the firm and its boundaries, the recognition of separate legal entities in international taxation and the concept of the firm based on common ownership has been the source of much confusion since independence has been relegated to a secondary role to legal form (treaty provisions could be re-interpreted to reverse the current situation); (2) the use of legal form to oust economic substance needs to be recognized and addressed … independence can be made concrete by treating associated enterprises in the sense of common ownership as PEs of each other unless it is established that they are legally and economically independent. In this way legal form would not stand in the way of substance, but rather assist it. It would again be possible, though more daring, to reach this result by treaty reinterpretation. The PE definition could be regarded as incorporating a concept of independence. Both the fixed place of business and the agency PE provisions could be interpreted in this light. The provision on associated enterprises not constituting a PE would only apply if the enterprises are in fact independent."

tax administrations, with both instruments now being used as tools to challenge some of the commissionaire and fragmentation structures. As they are not helpful for either party, conflicts in the PE field and transfer pricing areas also demonstrate the need to find a satisfactory solution for tax administrations and taxpayers. In part, BEPS is about finding a consensus that currently does not exist. But that may be a very difficult task if only very limited movements in the direction of source countries (as proposed in the OECD Public Discussion Draft on BEPS Action 7) are accepted.

3.4.4 More recent works (2011-2012) by OECD on Article 5 and PEs

It will be recalled that prior to the adoption of the OECD Action Plan on BEPS, the OECD published two drafts (2011[84] and 2012[85]) on the concept of PE. They provided clarification on a vast array of issues, some of them closely related to Action 7. The reaction to these documents was not positive from the business perspective,[86] but from a BEPS viewpoint it was not satisfactory either as the legal independence of group companies was reinforced. This facilitated tax strategies with respect to business restructuring and supported the continued defence of the traditional understanding of anti-abuse and transfer pricing rules to combat the fragmentation of activities, without really changing the threshold for taxation at source or the formal interpretation of it in the Commentary on Article 5 of the OECD Model Convention. It can even be said that an attempt had been made to halt aggressive interpretations by some tax administrations of some forms of business restructuring or fragmentation. It seems that this work will continue after the final document on Action 7 is released, but it will likely reflect the limited move in favour of source countries envisaged in Action 7.

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[84] OECD, *Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention* (Paris: OECD, 2011).

[85] OECD, *Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention* (Paris: OECD, 2012).

[86] See R. Collier, "BEPS Action Plan, Action 7: Preventing the Artificial Avoidance of PE Status," supra note 11, 640-641, where it is reported that there were concerns about lowering the PE threshold and a feeling that the bright-line test for PEs was being diluted.

3.5 Conclusion: standard for (artificial) avoidance of PEs in the OECD Model Convention

The historical evolution of the PE concept shows that since its inception, it has comprised two opposing elements. It is a threshold permitting source-State taxation, but it also encompasses limitations in favour of residence-State taxation. As a consequence, the PE has created a dissociation between the idea that a source State should tax "substantial participation" within its economic life and the taxation rights that can be claimed upon that participation: if there is no fixed place of business or dependent agent with authority to habitually conclude contracts, there will be no source taxation for business profits, regardless of the level of economic penetration in the source State. In an economy based on immobile factors, there seemed to be more alignment between the PE tests and economic presence in the State of source; at the present time, however, changes in the economy, communication or business models (especially in the digital economy) have contributed to making the lack of alignment between economic presence and PEs more acute.

Several conceptual assumptions contribute to a separation of "business presence" and taxation in the source country, leading to a distancing of PEs from the main goal of Action 7 in the OECD Action Plan on BEPS (to end artificial segregation of taxes and business activities). First, there is the so-called per PE principle and the configuration of PEs and business presences of a taxpayer or a group of companies, horizontally (within the same country) and vertically (from the source to the residence country) independent of each other. The PE tests and application of the PE concept to a stream of income and not to a taxpayer make it possible to have a considerable economic penetration in the source State without being taxed at source. This result can be obtained as long as none of the streams meets the thresholds of Article 5 of the OECD Model Convention. The per PE principle and the geographical (as well as the commercial coherence) test, as applied especially with regard to Article 5 (1), (3) and (4) (for the combination of activities), maximize this effect. The legalistic interpretation of Article 5, on the possibility of combining different activities of the same taxpayer or a group, as well as Article 5 (7), which enables a strict separation of companies of the same group even if they are not in fact independent, has increased the residence bias.

Second, the system of attribution of profits admitted in the OECD Model Convention, the OECD Transfer Pricing Guidelines and the OECD reports on attribution of profits have also helped create further distance between economic activity in the source State and taxable income therein:

- Profits can be attributed to a PE only for the activities (risks and personal functions) specific to it without attracting other presences in the State of the same taxpayer or others of the group, even if they can be closely connected;
- The special importance of risks and significant people functions in the attribution of profits to PEs make it easy to move people elsewhere in order to reduce source taxation;
- The traditional view of companies within a group as independent parties and the remuneration of subsidiaries as service providers have had the effect of transferring the "residuum" of the profits of the group to the State of residence, thereby reducing the tax base in the State of source.

Third, when conceptually adhering to the PE, the drafters of the OECD Model Convention made a deliberate choice between two competing goals: facilitating trade and reducing administrative burdens to international trade, on the one hand, and preventing tax avoidance on the other. The history of PE reveals the clear "bias" towards free trade and the respect of business models associated with it, as well as the limited role that was assigned to the prevention of artificial tax avoidance as a mechanism to restore source-country rights (a tool of last resort). By making that choice, the anti-avoidance threshold was placed very high, at a level where only the most aggressive, exclusively tax-driven structures, could be challenged. As the evolution of the OECD Model Convention shows, this threshold has not been corrected over time. In this regard, the OECD Public Discussion Draft on BEPS Action 7 seems to abide by the traditional principles and has very limited effects on the alignment of economic activity and taxing rights in source countries, even if it represents a tentative move in favour of more source taxation.

The OECD Discussion Draft does not leave much scope for anti-abuse rules to combat artificial avoidance in the context of Article 5 of the OECD Model Convention. This is because the nature of the historical configuration of the PE concept as currently supported by the OECD cannot be changed: if this concept, for the reasons mentioned above, produced a disconnect between the economic presence and taxation rights of the source country, it would not be possible for the notion of artificial avoidance of PEs to make a consistent contribution to an alignment of those concepts in a manner not suggested by the PE notion itself. Full alignment of the source-country economic presence and taxation rights can be achieved only through changes in the concept of PE or by using other tools, not by reinterpreting it or by forcing the acceptance of anti-avoidance rules.

Not all countries have readily accepted this status quo. Ambiguity and lack of clarity in the Commentary on Article 5 of the OECD Model Convention have fostered attempts to rebalance the alignment of economic presence and taxable rights with regard to PEs by, more or less, aggressive interpretation of the Commentary on Article 5 of the OECD Model Convention. In this respect, the Commentary — unclear or contradictory as it may be after evolving over half a century — allows room for manoeuvre, but States should know that "interpretations" of Article 5 and its Commentary that assume too aggressive an approach may place them in an awkward situation from an international perspective.

These conclusions basically mean that focusing on artificial avoidance of PEs may not be of much help to those developing countries that seek more source taxation. Moreover, to the extent that the outcome of Action 7 assumes the historical pillars of the PE concept and corrects only some extreme cases so as to give source countries more, albeit very limited, taxing rights, it will not contribute to the achievement of a more balanced result. As a consequence, developing countries should focus on avoidance of PEs rather than on artificial avoidance of PEs if they would like to increase their power to tax the economic activity taking place within their borders. The following sections explore the options available to them, although the concept of PE in the United Nations Model Convention is studied first.

4. United Nations Model Convention and (artificial) avoidance of PE status

4.1 Differences between the United Nations and OECD Model Conventions

The differences between the United Nations and OECD Model Conventions regarding the PE concept are well known, and the present chapter will mention them only very briefly:

- Article 5 (3) of the United Nations Model Convention has two paragraphs:[87]
  - Article 5 (3) (a) of the United Nations Model Convention is broader than Article 5 (3) of the OECD Model Convention as it covers assembly projects and supervisory activities — even if a similar interpretation of Article 5 (3) of the OECD Model Convention is suggested by the Commentary on Article 5 — and the time limit for a PE to exist is shorter, 6 months instead of 12.
  - Article 5 (3) (b) of the United Nations Model Convention permits the source State to tax the provision of services in its territory, provided they refer to a project or connected projects lasting for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the year concerned (a similar provision is included as an alternative in paragraphs 42.11-42.48 of the Commentary on Article 5 of the OECD Model Convention).

  A controversial issue, however, is whether the geographical and commercial coherence requirements apply to projects under both subparagraphs (a) and (b) of Article 5 (3) of the United Nations Model Convention. Paragraph 11 of the Commentary

[87] See B. Arnold, "Commentary on Article 5 of the OECD Model Convention," in IBFD, *Global Tax Treaty Commentaries*, supra note 12, at 36, where it is pointed out that there is a much stronger argument in favour of Article 5 (3) (a) of the United Nations Model Convention being a deeming provision (that is to say, it does not have to meet Article 5 (1) requirements) than Article 5 (3) of the OECD Model Convention.

on Article 5 of the United Nations Model Convention explicitly accepts paragraph 18 of the Commentary on Article 5 of the OECD Model Convention, which means that the geographical and commercial coherence test will also apply with regard to Article 5 of the United Nations Model Convention. However, the effects of such a paragraph should probably be limited to Article 5 (3) (a), as the main reason for the existence of Article 5 (3) (b) is precisely to avoid the geographical coherence test.[88] The key limit for this subparagraph is "the same or a connected project," that is to say, commercial coherence;[89]

- Article 14 of the United Nations Model Convention refers to independent personal services, which may be taxed at source if they are connected with a fixed base or physical presence in the source country. This Article may have some interaction (and pose interpretative problems) with both deeming provisions in Article 5 (3) of the United Nations Model Convention. However, it extends the source-country rights to cover not only the remuneration of the enterprise, as in Article 5 (3) (b) of the United Nations Model Convention, but also the remuneration of the individual providing services to that enterprise. The differences between the PE and the fixed base concepts for some countries are also arguments for the retention of Article 14 of the United Nations Model Convention in tax treaties;
- Article 5 (4) of the United Nations Model Convention, unlike Article 5 (4) of the OECD Model Convention, excludes delivery of goods from the preliminary and auxiliary activities of subparagraphs (a) and (b). In this regard, paragraph 17 of the

[88] Ibid., at 67, where it is suggested that the main goal of Article 5 (3) (b) of the United Nations Model Convention is to overcome the problems of the geographical coherence test.

[89] On the interpretation of "the same or a connected project," see paragraph 12 of the Commentary on Article 5 of the United Nations Model Convention; see also "Article 5: the meaning of 'the same or a connected project,'" presented at the ninth session of the United Nations Committee of Experts on International Cooperation in Tax Matters, Geneva 21-25 October 2013 (E/C.18/2013/CRP.2), available at http://www.un.org/esa/ffd/wp-content/uploads/2014/09/9STM_CRP2B_Article5.pdf; and paragraph 42.41 of the Commentary on Article 5 of the OECD Model Convention.

Commentary on Article 5 (4) of the United Nations Model Convention, explains that "[t]he deletion of the word 'delivery' reflects the majority view of the Committee that a 'warehouse' used for that purpose should, if the requirements of paragraph 1 are met, be a permanent establishment." It would seem, however, that the United Nations Committee of Experts on International Cooperation in Tax Matters (United Nations Committee of Experts) acknowledges that little income can be attributed to this activity;[90]

- Article 5 (5) of the United Nations Model Convention covers, in addition to the normal dependent agency PE, a person not having authority to conclude contracts but habitually maintaining (in a contracting State) a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of an enterprise of the other contracting State. There seems to be some intent to challenge commissionaire agreements with this provision where the Commentary observes that: "Some countries believe that a narrow formula [on Article 5 (5)] might encourage an agent who was in fact dependent to represent himself as acting on his own behalf." It is interesting to note that the Commentary on Article 5 (5) of the United Nations Model Convention still reflects that the former United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters, with regard to the 1999 version of the United Nations Model Convention, noted that: (a) "if all the sales-related activities take place outside the host State and only delivery, by an agent, takes place there, such a situation would not lead to a permanent establishment"; and (b) "if sales-related activities (for example, advertising or promotion) are also conducted in that State on behalf of the resident (whether or not by the enterprise itself or by its dependent agents) and have contributed to the sale of goods or merchandise, a permanent establishment may exist."[91] The independent agent of Article 5 (7) of the United Nations Model Convention may be interpreted as an

[90] See paragraph 21 of the Commentary on Article 5 of the United Nations Model Convention.

[91] See paragraph 26 of the Commentary on Article 5 of the United Nations Model Convention.

exception to this paragraph, which makes its effect very limited, especially if it is considered that associated companies are, in principle, regarded as independent. This may explain why the United Nations Committee of Experts pointed out, with regard to Article 5 (4), that having a warehouse for delivery would lead to little income being attributed to it;

- An insurance provision (excluding reinsurance) is provided in Article 5 (6) of the United Nations Model Convention whereby a PE is deemed to exist if the foreign enterprise collects premiums in the territory of the other State or insures risk there through a dependent agent;
- Article 5 (7) of the United Nations Model Convention (the independent agent provision equivalent to Article 5 (6) of the OECD Model Convention) adds a sentence considering that the agent loses independence "when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their financial relations which differ from those which would have been made between independent enterprises;
- Article 7 (1) of the United Nations Model Convention follows a limited force of attraction principle whereby the profits of a PE also encompass, apart from those connected with its activities, those attributable to: (a) sales of goods or merchandise of the same or similar kind as those sold through the PE; and (b) other business activities carried out in the PE State of the same or similar kind as those effected through the PE. This is viewed as an objective rule, as it is shown by the observation of some States that the limited force of attraction rule should not apply where an enterprise "is able to demonstrate that the sales or business activities were carried out for reasons other than obtaining treaty benefits," which "recognizes that an enterprise may have legitimate business reasons for choosing not to carry out sales or business activities through its permanent establishment."[92]

Finally, the current work of the United Nations Committee of Experts on the possibility of adding a technical service article in

[92] See paragraph 7 of the Commentary on Article 7 of the United Nations Model Convention.

tax treaties is very relevant because, ultimately, it would considerably lower the threshold for taxation of activities in the host State.[93]

4.2 Standard for avoidance of PEs in the United Nations Model Convention

An element that can be observed in the United Nations Model Convention is the notion that by lowering the PE threshold, the source country has more taxing rights and, as a result, fewer profits escape taxation there. Especially relevant in this regard are the insurance provision, the warehouse agent PE provision and the service PE rule.

Article 5 (3) (b) of the United Nations Model Convention deserves a special mention. If adopted, this Article reduces the problems of fragmentation of fixed places of business because the geographical coherence test is not relevant as this PE-deeming rule is tied to the concept of physical presence and the "same or a connected project" test (commercial coherence). Like Article 5 (3) (a) of the United Nations Model Convention, the rule, however, is vulnerable to avoidance through artificial splitting of the project/connected projects so as not to meet the time threshold among associated companies. Consequently, one relevant issue in this context is whether the requirement that the services be connected to the same or a connected project really makes sense within a test that assumes physical presence as a proxy of economic penetration in a country.[94] In addition, the Commentary on Article 5 of the United Nations Model Convention mentions that "measures to counteract abuse would apply equally

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[93] See "Note from the Coordinator of the Subcommittee on Tax Treatment of Services: Draft Article and Commentary on Technical Services," presented to the Tenth Session of the Committee of Experts on International Cooperation in Tax Matters, Geneva 27-31 October 2014 (E/C.18/2014/CRP.8), available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/10STM_CRP8_TechnicalServices1.pdf.

[94] See, on this issue, paragraph 12 of the Commentary on Article 5 of the United Nations Model Convention; and "Note from the Coordinator of the Subcommittee on Tax Treatment of Services: Draft Article and Commentary on Technical Services," supra note 93.

under Article 5, paragraph 3, subparagraph (b)"[95] and accepts rules analogous in this respect to those in paragraph 18 of the Commentary on Article 5 of the OECD Model Convention.

In terms of preventing abuse, two differences with the OECD Model Convention also stand out: Article 5 (7) of the United Nations Model Convention and the force of attraction principle. Contrary to how it may appear at first glance, Article 5 (7) of the United Nations Model Convention does not add much, if properly interpreted, to Article 5 (6) of the OECD Model Convention. The provision has a number of interpretative problems and its conditions can be easily avoided by having more than one principal (either related or unrelated) or, better still, by avoiding agency arrangements in the jurisdiction altogether (which is not difficult to achieve).[96] In fact, it may be argued that countries are worse off if this provision is included because it may make the application of anti-abuse provisions more difficult: it would be enough to establish remuneration at arm's length of the agent in order to argue its independence and hence reduce the possibilities of bringing profits accruing to non-resident entities to the tax base of the source country. Unless "arm's length" is interpreted in a non-conventional form, this provision does not guarantee that the source country will increase its taxing rights over groups of companies and related parties. For instance, if cost-plus is accepted as the method for remunerating activities of a subsidiary in the source country, this will allow the residual value of activities in the jurisdiction to go to the country of residence of the principal. This would mean that as long as the subsidiary does not assume risks and functions regarding, for instance, sales in the same country by the parent, the attribution of profit to it may be very limited.

Moreover, the consequences of a non–arm's length remuneration could be brought into question. For instance, the subsidiary may be a dependent agent. However, this finding would not guarantee that the parent/associated company would be taxed within the source country — that is to say, as long as the PE tests were not met (fixed place,

[95] See paragraph 11 of the Commentary on Article 5 of the United Nations Model Convention.

[96] See R. Vann, "The UN Model and Agents: "Wholly or Almost Wholly," (2011) *Sydney Law School Legal Studies Research Paper*.

physical presence or habitually concluding contracts or having stock to deliver merchandise). In this context, the wording of Article 5 (7) of the United Nations Model Convention, in connection with Article 9 thereof, suggests that simply adjusting transfer pricing paid to the subsidiary in the source country would be enough. Again, this may not be very satisfactory from the source country's perspective, unless a non-conventional approach to transfer pricing is applied. This stance seems to be incompatible with the Authorised OECD Approach to attribution of profits, which basically supports a dual taxpayer approach as opposed to the single taxpayer approach that seems to be at the heart of Article 5 (7) of the United Nations Model Convention.[97]

[97] In this vein, see M. Butani and P. Jain, "Permanent Establishment Concept — An Indian Perspective," (2014) *Asia-Pacific Tax Bulletin*, 247 ff. These authors have criticized the trend in Indian case law of adopting a single taxpayer approach which, after the Supreme Court decision in the Morgan Stanley case (*DIT v. Morgan Stanley and Co. Inc.* (2007) 292 ITR 416 (SC)), may lead to the acceptance of arm's length remuneration for Indian subsidiaries of foreign companies with the residual value accruing to non-resident entities, as it is deemed that there is no PE in such cases. The Morgan Stanley case referred to the tax treaty between the United States of America and India (1989) which had a provision on independent agents in line with Article 5 (7) of the United Nations Model Convention. Other authors, however, have taken the view that, on a closer reading, the decision in the Morgan Stanley case is in line with the dual taxpayer approach: see, for example, H. Pijl, "Morgan Stanley: Issues Regarding PEs and Profit Attribution in Light of the OECD View," (2008) Vol. 48, No. 5 *Bulletin for International Taxation*, 174 ff. It must be noted that the decision is somehow ambiguous, even if the majority position, later confirmed by other decisions in India, seems to be in favour of the single taxpayer approach: "The object behind enactment of transfer pricing regulations is to prevent shifting of profits outside India. Under Article 7(2) not all profits of MSCo would be taxable in India but only those which have economic nexus with PE in India. A foreign enterprise is liable to be taxed in India on so much of its business profit as is attributable to the PE in India. The quantum of taxable income is to be determined in accordance with the provisions of I.T. Act. All provisions of I.T. Act are applicable, including provisions relating to depreciation, investment losses, deductible expenses, carry-forward and set-off losses etc. However, deviations are made by DTAA in cases of royalty, interest etc. Such deviations are also made under the I.T. Act (for example: Sections 44BB, 44BBA etc.). Under the impugned ruling delivered by the AAR, remuneration to MSAS

The limited force of attraction under Article 7 of the United Nations Model Convention has an evident anti-avoidance connotation but, apart from the interpretative and administrative problems it presents, its effects are very limited.[98] First, it is conceivable that a company could organize its business to carry out only auxiliary activities in a jurisdiction with the core activities being performed through independent agents, the PE thus being avoided. Second, it would be sufficient to turn the PE into a company and the principle of limited force of attraction could then be short-circuited.[99] This would make it possible to operate by fragmenting activities between subsidiaries in the jurisdiction, independent agents and other (non-resident) companies of the group that do not meet the PE threshold. The legal independence of companies of a group is therefore a serious limit to the force of attraction principle.

The reduced thresholds for PEs in the United Nations Model Convention make it more difficult to avoid the PE status because of the

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[the Indian Subsidiary] was justified by a transfer pricing analysis and, therefore, no further income could be attributed to the PE (MSAS). In other words, the said ruling equates an arm's length analysis (ALA) with attribution of profits. It holds that once a transfer pricing analysis is undertaken; there is no further need to attribute profits to a PE. The impugned ruling is correct in principle insofar as an associated enterprise, that also constitutes a PE, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise. In such cases nothing further would be left to be attributed to the PE. The situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. If such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered. Therefore, in each case the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits and that would depend on the functional and factual analysis to be undertaken in each case. Lastly, it may be added that taxing corporates on the basis of the concept of Economic Nexus is an important feature of Attributable Profits (profits attributable to the PE)."

[98] See J. Sasseville and R. Vann, "Commentary on Article 7 of the OECD Model Convention," in IBFD, *Global Tax Treaty Commentaries*, supra note 12.

[99] See A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle*, supra note 30, 339-340.

effects of Article 5 (3) (b) of that Model Convention, although there are doubts as to whether force of attraction could be applied with regard to services in view of the fact that said Article applies on a project-by-project basis. The same can be said of Article 5 (3) (a) of the United Nations Model Convention. In any event, the force of attraction in both cases could easily be avoided by using separate entities for different projects.[100]

The warehouse PE in Article 5 (5) (b) of the United Nations Model Convention also reduces the possibilities of avoidance of PE status. However, it is not difficult to avoid having a warehouse come within a jurisdiction or meeting the "habitually maintains" or "regularly delivers" test to escape the PE clause.

Finally, paragraph 35 of the Commentary on Article 5 (8) of the United Nations Model Convention states the following:

> Determining whether or not a permanent establishment exists on a separate entity basis may entail vulnerability to abusive arrangements. Depending on the domestic law of States, safeguards against purely artificial structures may be found through application of a rule according to which substance overrides form.

That statement does not add much to the interpretation of Article 5 (7) of the OECD Model Convention because, in the final analysis, the principle of separate entities can also be questioned by applying anti-abuse legislation, and the United Nations Model Convention has accepted the principles added after 2005 by the OECD as a reaction to the Phillip Morris case. Respect for legal business forms and free trade also seems to be part of the foundation of the PE concept in the United Nations Model Convention, which limits the margin for application of anti-avoidance doctrines or regulations. The observation in paragraph 35 cited above, therefore, seems to serve as a reminder or clarification. A certain deviation may be identified if the paragraph is interpreted to introduce domestic anti-avoidance standards that could overrule the OECD standard in Article 5 that only those "exclusively tax motivated" structures designed

[100] See J. Sasseville and R. Vann, "Commentary on Article 7 of the OECD Model Convention," in IBFD, *Global Tax Treaty Commentaries*, supra note 12.

to avoid having a PE may be challenged. It does not seem to be the case, however, because the main pillars of the PE concept and its evolution are also accepted in the context of the United Nations Model Convention, and, as such, this includes the principle of legal independence and separate consideration of PEs of companies within a group.

Therefore, despite the fact that the United Nations Model Convention clearly leans towards more recognition of source-country rights, and in this regard may reduce vulnerability of source countries to artificial avoidance of PE status, it has inherent limitations, in line with the OECD Model Convention. These also make it susceptible to the effects of the most common strategies of fragmentation/commissionaire-like agreements of company groups aimed at avoiding the presence of a PE in the source State. As a consequence, an effective strategy to counteract these types of behaviours should be considered also by those countries which use the United Nations Model Convention. Additionally, it is easy to avoid having a PE in the context of business models that do not use contrived or abusive structures and simply do not need much presence within the source State, but can still conduct relevant business activity within its borders. If States want to tax these activities, they may need to reconsider their strategies and tax treaty policies, because the PE concept will not help them much in this regard.

5. Strategies against (artificial) avoidance of PE status

5.1 Introduction

The most relevant issue for developing countries is likely how to identify a PE, and how to attribute profits to it, rather than develop sophisticated methods to counteract the most challenging tax avoidance strategies. Therefore, in any critical review of the possible routes that can be proposed for developing countries, special importance is attached to administrative concerns: theoretical solutions that are difficult to implement or enforce should be discarded. The term “difficult” is clearly relative and the correct strategy will ultimately depend on the specific situation of individual countries. As explained above, the preferred OECD solution for putting an end to PE tax planning appears to be the application of anti-avoidance rules or doctrines and/or transfer pricing legislation, combined with a slight move in favour of source countries in the OECD Public Discussion Draft on BEPS Action 7. The United Nations Model Convention combines reduction of thresholds for taxation in the source country with anti-avoidance doctrines. This may help developing countries, but it could be complemented with still other options.

For countries with less developed administrations, the best solution probably would be not to focus too much on artificial avoidance of PEs but to concentrate on avoidance of PEs within their jurisdiction and taxation of economic activity within their borders with tools other than the PE concept. This concept is not easy to use by less developed administrations and even if they have a clear idea and policy of what a PE is (which is not easy in view of the different international interpretations of this concept and the vagueness of the Commentary on Article 5 of the OECD Model Convention), the issue of attribution of profits to PEs may represent an insurmountable task for them or may be a source of conflict that they cannot manage in an efficient manner. For these reasons, solutions that shy away from the PE concept may be far easier to apply for some administrations; or at the very least they could act as a complement. In this context, Action 7 and the Public Discussion Draft thereon are directed more towards limited modification of the PE concept, and this may not be a solution for countries that want to align taxation and economic activity.

Moreover, in the current international context of competition among jurisdictions, legal certainty is a very important asset. This should be taken into account seriously by developing countries. Being too aggressive with regard to foreign investors may be profitable for tax administrations in some cases, but it may incur collateral damage in terms of reputation, particularly with regard to attracting and keeping other investors. Therefore, any initiative developing countries may adopt should have legal certainty as a precondition and as a goal. This requires that any solution be accompanied by clear administrative measures and legislation, and drafted as part of a process that ensures a certain level of quality and transparency.

Lastly, there is no "best" solution to help developing countries tax economic activity that is carried on within their territory, but there is indeed a set of options that may assist them in trying to find their own framework and policy, depending on the situation regarding their tax systems and administrations. This means that a combination of all or some of the solutions proposed below might be considered.

5.2 Tax treaty policy

5.2.1 Introduction

As explained above, much of the separation between economic activity and taxation in the State of source can be attributed to the specific configuration and interpretation of PE as a concept, with a strong bias in favour of residence taxation. Evolution of business models has also made it easy for some enterprises which do not need a continuous or substantial presence in the State of source to avoid the PE threshold without any trace of artificiality. These problems can be tackled only by changing the tax treaty policy of (developing) countries with a view to realigning economic presence and taxation in the source country.

This solution has an advantage over others, especially with regard to anti-avoidance norms or doctrines: if tax treaties are drafted clearly and can be easily administered, they may be much easier to apply than anti-avoidance rules or doctrines, or transfer pricing legislation, when they are used to try to increase attribution of income to local subsidiaries or PEs.

There are several options that could be assessed by developing countries. No preference is expressed in this regard, as every country should consider its tax treaty policy in the light of its particular situation.

5.2.2 Adopting the standard of Article 5 of the United Nations Model Convention

The option of adopting the standard of Article 5 of the United Nations Model Convention has the advantage that it represents a move away from the fixed place of business/dependent agent PE threshold in the direction of taxing at source significant economic presence, as provided for in subparagraph (3) (b). The specific features of Articles 5 and 7 of the United Nations Model Convention, as explained above, also help prevent some typical avoidance structures, and taxation of royalties at source may also help to generate additional income for developing countries.[101]

However, there are some disadvantages that need to be taken into account by developing countries:

- The similarity of Article 5 of the United Nations Model Convention to Article 5 of the OECD Model Convention may not ensure that the source country could tax all the relevant activities that take place within its borders;
- Article 5 (3) (b) of the United Nations Model Convention is neither easy to interpret nor to administer. Some of the most relevant problems are the following:[102]

    - The terms it uses (for example, furnishing of services, enterprise) have no clear-cut meaning and this may create differences in interpretation (for example, there is some dispute about whether "furnishing of services" may be taken to mean in-State provided services or services consumed within the source State; also, it is not clear whether secondment of employees falls under this Article or not);
    - The limitation of the Article to the "same or a connected project," while eliminating the geographical coherence test of Article 5 (1) and (3) of the OECD Model Convention, retains the commercial coherence logic, which reduces the possibilities for source States to tax economic activity taking place within their borders. Coherence with the physical presence test would call for eliminating the reference to same or connected projects;

[101] Royalties taxation at source is considered in the following section.

[102] See B. Arnold, "The Taxation of Income from Services under Tax Treaties: Cleaning Up the Mess — Expanded Version," (2011) Vol. 65, No. 2 *Bulletin for International Taxation* (online version); B. Arnold, "The New Services Permanent Establishment Rule in the Canada-United States Tax Treaty," in A. Cockfield, ed., *Globalization and its Tax Discontents* (Toronto: University of Toronto Press, 2010), 280 ff.; C. Devillet, "Note on Article 5: the meaning of 'the same or a connected project'," presented at the ninth session of the United Nations Committee of Experts on International Cooperation in Tax Matters, Geneva, 21-25 October 2013, (E/C.18/2013/CRP.2).

- The meaning of "same or a connected project" is not clear even if the factors in paragraph 42.11 of the Commentary on Article 5 of the OECD Model Convention can be considered as a point of reference, and further clarification is being pursued by the United Nations on this difficult issue;
- It is relatively easy to avoid conditions that fall within Article 5 (3) (b) of the United Nations Model Convention. First, presence of the service provider for more than 183 days needs to be detected, which may not be that simple. Associated companies may divide the "project" so as to avoid meeting that threshold and, even if they do meet it, in line with the Commentary to the United Nations Model Convention which provides for the accumulation of any relevant period of time by applying a rule similar to that given in paragraph 18 of the Commentary on Article 5 of the OECD Model Convention, the association of companies needs to be detected and artificiality of the split needs to be proved. Difficulties in application and ease to avoid this type of PE is, however, a feature that service PEs share with other PE clauses;[103]
- Attribution of profit issues are not easy either with regard to Article 5 (3) (b) of the United Nations Model Convention. Some countries have abandoned this provision because of the difficulty in deciding what profits can be attributed to this form of PE and because of disputes with their tax treaty partners. The interaction of subparagraph (b) with the limited force of attraction principle in Article 7,[104] or even Article 14 of the United Nations Model Convention, is not clear either when all of these clauses are incorporated in a tax treaty;

➢ Article 5 of the United Nations Model Convention, by adopting a very similar anti-avoidance threshold to Article 5 of

[103] The main issues which are mentioned in paragraphs 42.12 and 42.13 of the Commentary on Article 5 of the OECD Model Convention are not exclusive of service PEs.

[104] See C. Devillet, "Note on Article 5: the meaning of 'the same or a connected project'," supra note 102.

the OECD Model Convention, is also vulnerable to the most important strategies of tax planning adopted nowadays, and, especially to fragmentation of activities/commissionaire agreements. As explained above, Article 5 (7) of the United Nations Model Convention does not add much to and may even hinder the application of other anti-avoidance devices, or may permit the erosion of tax bases in the source country if the single taxpayer approach is adopted (for instance, as decided by the Indian Supreme Court in the Morgan Stanley case).

If Article 5 of the United Nations Model Convention is the preferred option, developing countries may want to consider reducing the time period triggering the application of Article 5 (1) or 3 (for example, to 90 or 60 days), eliminating the reference to project or connected projects in Article 5 (3) (b) or eliminating the second sentence in Article 5 (7) of the United Nations Model Convention. In view of the above-mentioned disadvantages, and the fact that the PE definition in the United Nations Model Convention is still very similar to that of the OECD, developing countries may also want to consider adopting other measures.

5.2.3 Withholding taxes on services/royalties and other similar measures

Although services or royalties taxation is not the subject of the present chapter,[105] it undoubtedly affects the topic studied here. The option of applying withholding taxes to technical services is currently being examined by the United Nations Committee of Experts.[106] Whatever source rule is chosen, and this is an issue that should be carefully considered, a withholding tax upon services is easy to apply and has the advantage that it changes the function of Article 5 of the United Nations and OECD Model Conventions: having a PE in the

[105] See chapter II, Taxation of income from services, by B. Arnold; see, on royalties, A. Martín Jiménez, “Commentary on Article 12 of the OECD and United Nations Model Conventions (including technical services),” in IBFD, *Global Tax Treaty Commentaries*, supra note 12.

[106] See “Note from the Coordinator of the Subcommittee on Tax Treatment of Services: Draft Article and Commentary on Technical Services,” supra note 93.

source country would be the way to avoid the withholding tax (that is to say, businesses that want net taxation can easily move away from withholding taxes and have a PE). The same is true for withholding taxes on royalties, which are already permitted by Article 12 of the United Nations Model Convention. In addition, withholding taxes allow tax administrations to monitor deductions of expenses paid to non-residents and, therefore, base erosion (although in presumptive systems used by some countries, this information may not be relevant).

Such a withholding tax at source for (technical) services/royalties, which requires clear source rules, also has disadvantages that should be carefully considered. First, if fixed at high rates, it may be an entry barrier to the market as it can discourage foreign enterprises from conducting business within a country; or the tax may be shifted to local companies with the effect of increasing the costs of access to technology or high-value services. Low withholding tax rates may help to overcome this disadvantage. Moreover, having the possibility of levying withholding taxes in a tax treaty does not mean that they have to be levied: if tax treaties permit the source country to tax royalties or services at source, the source country can always decide whether to levy the tax or to give tailored incentives in specific sectors (for example, imports of technology) without being limited permanently (until termination) by a tax treaty.

Second, a well-known problem of withholding taxes is that they are usually levied on a gross basis. Although an elective system of net taxation (non-final withholding tax) can be offered as an alternative to provide a fairer result for the taxpayer, it imposes compliance burdens on taxpayers and withholding agents, as well as on tax administrations, to process the refunds and assess the deductibility of expenses. There are, however, several ways of making the system easier to apply for taxpayers and administrations:

- Withholding taxes may be fixed at a rate that takes into account a (presumptive) profit margin. Foreign investors and tax administrations often prefer this simpler system (some taxation at low rates) rather than having to overcome the hurdle of submitting and processing further applications for refunds. The margin and rates need not be the same for all productive sectors, which makes the system fairer;

- Withholding taxes may be fixed at higher rates and presumptive deductions granted and expressly provided for under domestic law or tax treaties. For instance, the Protocol to the tax treaty between China and Spain (1990)[107] provides, with regard to certain types of royalties, that the withholding tax rate of 10 per cent will be applied only on 60 per cent of the gross amount paid. Once again, presumptions may apply for all services or only for certain types;
- A withhold and refund system may be designed and deduction permitted only for certain expenses (for example, those incurred in the source country, or some of the most relevant expenses), with regard to all types of services or only some of them.

As most of these systems require legislation that cannot be accommodated easily within a tax treaty, a treaty could set a limit (for example, 10 per cent of the gross income) and the system could be implemented within the limit of the treaty through national legislation.

Countries should also consider that levying withholding taxes on royalties may create problems of differentiating royalties and technical services. If withholding taxes are levied for both royalties and technical services, that problem is eliminated (provided the withholding tax rates are the same for both categories); but a new one may arise, that is, how to distinguish technical services and royalties, on the one hand, from different services, on the other.

Obviously, withholding taxes on deductible payments (for example, service fees or royalties) cannot be applied where there are treaties in force that follow the OECD Model Convention. In this case, denial of base-eroding deductions or special surtaxes on payments causing base erosion may be an alternative. The configuration of these alternatives should be considered carefully so that they do not affect legitimate transactions, infringe upon domestic constitutional principles or cause double taxation. At the same time, it should be ensured that these measures are compatible with international obligations in

[107] Agreement between the Government of the People's Republic of China and the Government of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital, of 22 November 1990.

tax treaties (for example, Article 24 of the United Nations and OECD Model Conventions on non-discrimination).

It should be kept in mind that some structures may not be affected by these measures: for instance, typical commissionaire agreements for the sale of goods in market countries, or toll manufacturers that act as service providers. In such cases, other options (for example, lowering PE thresholds or rethinking transfer pricing policies) would need to be considered. In addition, where there are withholding taxes on services or royalties, it may not be unusual to find that there has been an increase in the selling price of goods to domestic subsidiaries. In these cases, recharacterization of transactions would be a useful tool.

5.2.4 Lowering the PE threshold through adoption of specific clauses designed to recognize a significant presence as a PE or to counteract avoidance of it

5.2.4.1 Introduction

Whereas withholding tax or other similar measures on service fees/royalties may be more general in scope and effect, there might be better-targeted solutions for certain sectors or activities. These are based on the reduction of the PE threshold and are considered below. In fact, the solutions presented in the OECD Public Discussion Draft on BEPS Action 7 mostly pursue a limited reduction of the PE threshold that is designed to counteract the most obvious cases of (artificial) avoidance of PE in the source country. As explained above, they fall short of aligning economic activity and tax base in the source State. To achieve this, developing countries may want to consider other clauses that will reduce the PE threshold.

The different types of clauses examined below do not exclude the use of other categories and all or some of them can be used in combination. An example of their cumulative use is provided in section 5.2.4.6 below.

5.2.4.2 Clauses for exploration and exploitation of natural resources

Some countries use specific clauses to capture income from extractive industries, where vast amounts of money are at stake,[108] thus reducing

[108] The following countries are reported to use these clauses: Australia,

the PE threshold with respect to Article 5 (1) of the United Nations and OECD Model Conventions. An example can be found in Article 5 (6) of the tax treaty between Ireland and Spain (1994):[109]

> 6. A person engaged in a Contracting State in exploration of the seabed and its subsoil or in exploitation of natural resources situated there, as well as in activities which are complementary or auxiliary to such activities, shall be deemed to exercise such activities through a permanent establishment in that State. However, this provision shall not apply where these activities are carried on in the other Contracting State for a period not exceeding 30 days.

This type of clause — which may have several variations in drafting — overcomes two problems: (a) the fact that these activities are often carried out by using mobile devices that may not be regarded as PEs under Article 5 (1) because they are not fixed; and (b) fragmentation of activities among companies engaged in the same project in order to avoid meeting the time threshold of the PE in the country concerned (this is why the clause refers to "a person engaged" and establishes a very short period of time which triggers the effects of the clause, that is to say 30 days).

Such clauses often pose interpretative problems. In the abovementioned example, questions arise as to: (a) how "engaged" is defined and what types of activity are covered; and (b) whether complementary or auxiliary activities are within their scope, how they are defined and what types of activities are not complementary. Interpretative issues may, however, be mitigated by protocols or mutual agreement procedures, but, as there are several types of these clauses in the international tax arena, preference should be given to those that are less difficult to interpret and administer. The interaction with articles on technical services in tax treaties should also be considered because quite often activities that are captured by these clauses will also fall within the technical services

Ireland, Japan, Norway, the Russian Federation, the United Kingdom and the United States. See B. Arnold, "Commentary on Article 5 of the OECD Model Convention," in IBFD, *Global Tax Treaty Commentaries*, supra note 12.

[109] Convention between Ireland and the Kingdom of Spain for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, of 10 February 1994.

provisions. If this occurs, the clause would be a way out of the withholding tax often levied on a gross basis. It should be noted that the source rules may need to be coordinated to cover payments made by non-residents to non-resident companies if these payments are not captured by the technical services provision where the payer criterion is used.

5.2.4.3 Clauses against fragmentation of contracts/projects

The clauses against fragmentation of contracts/projects are also common in the international tax arena and often apply with regard to Article 5 (3) of the United Nations Model Convention. That is to say, where they are included, they also cover provisions equivalent to Article 5 (3) (b) of that Model Convention, and sometimes even other deeming provisions included within Article 5 (3), for example, clauses on the provision of services by individuals. A common example of these clauses is the following, which is included at the end of Article 5 (3) of the tax treaty between Chile and Spain (2003):[110]

> For the purposes of computing the time limits referred to in this paragraph, activities carried on by an enterprise associated with another enterprise within the meaning of Article 9 shall be aggregated with the period during which activities are carried on by the enterprise to which it is associated if the activities of both enterprises are identical or substantially similar.

It should be noted that the potential effects of this clause in favour of source-country rights are more important if, as is the case with regard to Article 5 (3) of the tax treaty between Chile and Spain, the service clauses are not linked to a particular project and simply provide for a physical presence test regarding the provision of services.

The clause is easier to apply than paragraph 18 of the Commentary on Article 5 of the OECD Model Convention, as it is not necessary to resort to anti-avoidance provisions for accumulating periods in order to determine whether there is a PE. Moreover, it has a more far-reaching effect: periods may be accumulated regardless of whether there is avoidance or

[110] Convention between the Kingdom of Spain and the Republic of Chile for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital, of 7 July 2002.

not or whether the splitting of the contract is done in the context of the business model of the group of companies, or even whether the splitting is done between resident and non-resident associated companies.

The clause has, however, several disadvantages:

- Tax administrations should have the resources to detect the presence of associated companies within their territory for more than the time threshold established in the treaty in order to accumulate the periods of presence of all associated enterprises. For implementation purposes, establishing obligations in this regard on the persons that act as clients can be considered (for example, notification of projects lasting for more than the time threshold, withholding tax obligations, obligation to request the attendance records of employees from the contractor or other companies of the same group, potential liabilities of the clients);
- The application of the clause to "substantial or identical activities" of the different companies providing the service leaves room for debate over when this condition is met;
- The reference to Article 9 includes only associated enterprises — one in a contracting State and another in the other contracting State. It may not be fully effective in cases where the splitting is likely to take place between two or more non-resident companies, a situation that is not covered by Article 9 of the OECD Model Convention. In order to avoid this problem, some treaties provide a definition of associated companies, for example, Article 5 (4) (c) of the tax treaty between the United Kingdom and Australia (2003)[111] or Article 5 (5) of the tax treaty between Japan and Australia (2008);[112]
- Subcontracting by associated companies to non-associated companies should also be covered, although it may be interpreted

[111] Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains, of 21 August 2003.

[112] Convention between Japan and Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, of 31 January 2008.

that the period for subcontractors should be imputed to the principal contractor;

- The clause obviously does not address the fragmentation of the activities which are covered by Article 5 (1) or (3) of the United Nations and OECD Model Conventions. The limited force of attraction principle in Article 7 of the United Nations Model Convention can help in this regard, although, it has very important limits, as explained above.

These types of clauses have been proposed in the OECD Model Convention with regard to the alternative service PE provision in paragraph 42.45 of the Commentary on Article 5 of the OECD Model Convention, or are being considered by the United Nations with regard to Article 5 (3) (b) of the United Nations Model Convention.[113] The main difference between these clauses and the one used as an example is that they refer to the "same or a connected project" and, therefore, their ability to expand source-country taxation is much more limited. This is because they do not use a mere "physical presence test" and the scope of the service PE provision is limited by commercial coherence.

A similar clause is one of the alternatives (the other dealing with the splitting-up through anti-avoidance provisions) proposed in the OECD Public Discussion Draft on BEPS Action 7, to combat the splitting-up of contracts with regard to Article 5 (3) of the OECD Model Convention. The effects of the OECD proposal would be much more limited from the perspective of the source country if a service PE paragraph was not included. In the OECD context, the clause simply functions as a device for computation of the 12-month period, which helps counteract abuse through the accumulation of time periods spent on the same project/site by associated companies. However, unlike in the above-mentioned example, it does not require a physical presence test (and an anti-avoidance clause for computation of this test) to be added to the PE definition.

[113] See C. Devillet, "Note on Article 5: the meaning of 'the same or a connected project'," supra note 102 (in particular, draft paragraph 12.5 of the Commentary on Article 5 of the United Nations Model Convention).

5.2.4.4 Clauses on substantial equipment

Australia often includes a clause in tax treaties deeming a PE to exist if a foreign enterprise has substantial equipment in the source country. For instance, Article 5 (3) (b) of the tax treaty between the United Kingdom and Australia (2003) provides that a resident of the other contracting State will have a PE if that resident:

> maintains substantial equipment for rental or other purposes within that other State (excluding equipment let under a hire-purchase agreement) for a period of more than 12 months.

Once again this is a clause that relies on physical presence — in this case, the equipment — within a country to extend the scope of Article 5 (1) of the United Nations and OECD Model Conventions.

Developing countries should assess whether it is worth including this type of clause in their tax treaties, for a number of reasons:

- If tax treaties include a withholding tax at source for royalties (including fees for the use of equipment within the definition of royalties) and/or services, or clauses on the exploitation or exploration of natural resources, or other services equivalent to those falling under Article 5 (3) (b) of the United Nations Model Convention, income from “substantial equipment” may already be covered and taxed in the source country. It should be taken into account, however, that these clauses may also apply to leasing of equipment that has a service rather than a letting nature (that is to say, fully manned equipment) that may not be covered by royalty clauses, for instance;
- Under the current approach to attribution of profits, where significant people functions play a very important part, the presence of equipment only in a State (unless fully manned) may not attract a very relevant tax base to the source country. This is a disadvantage of the clause. In cases of fully manned equipment, however, it may be of some help to capture activities taking place within the territory of the source country;
- These clauses are not free from either interpretative problems, such as the meaning of “substantial equipment,” or the interaction with Article 8 of the United Nations and OECD Model Conventions.

5.2.4.5 Anti-fragmentation and commissionaire clauses

Clauses against the most common avoidance structures of PE status have been used in tax treaties for a long time by some countries. In this respect, the Australian experience — one of the first countries which had judicial decisions on these types of tax planning transactions — is a useful example.[114] Australia adds three different types of clauses:

- A deemed PE for non-residents having contract-manufactures/maquila services in the other country, which may have two forms. It is either included in the equivalent of Article 5 (3)[115] or Article 5 (6) of the OECD Model Convention (in the latter case to facilitate the application of the independent agent exception);[116]
- Article 5 (4) is drafted so that it is clear that the preliminary and auxiliary conditions apply to the whole paragraph and not only to subparagraph (f);
- The equivalent of Article 5 (5) of the United Nations and OECD Model Conventions does not refer to the controversial "in the name of" and mentions only "on behalf of" in connection with

[114] See R. Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37.

[115] See, for example, Article 5 (3) of the tax treaty between the United Kingdom and Australia (2003): "An enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if: … c) a person acting in a Contracting State on behalf of an enterprise of the other Contracting State manufactures or processes in the first-mentioned State for the enterprise goods or merchandise belonging to the enterprise."

[116] See, for example, Article 5 (7) of the tax treaty between Finland and Australia (2006): "Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 8 applies — is acting on behalf of an enterprise and: a) has, and habitually exercises, in a Contracting State an authority to substantially negotiate or conclude contracts on behalf of the enterprise; or b) manufactures or processes in a Contracting State for the enterprise goods or merchandise belonging to the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for that enterprise, unless the activities of such person are limited to those mentioned in paragraph 6 and are, in relation to the enterprise, of a preparatory or auxiliary character."

> the conclusion of contracts. Whereas this change may have to do with specific features of agency law in Australia, it also certainly covers the case of commissionaire structures, which was an early worry in that country as proved by the inclusion of a commissionaire clause in Article 4 (8) of the tax treaty between Australia and the United Kingdom (1967).[117]

The above clauses may be a good option because they are rather comprehensive and define a PE threshold that substantially reduces the risks of abuse. In fact, the OECD Public Discussion Draft on BEPS Action 7 has adopted a similar, albeit more limited approach. Several options of anti-commissionaire clauses that would change the drafting of Article 5 (5) and (6) of the OECD Model Convention are being considered as well as options to limit the scope of Article 5 (4) of the OECD Model Convention. The OECD options, however, do not refer to cases of toll or contract manufacturing and simply focus on the material intervention of the intermediary in the process of concluding contracts for the non-resident company.

Because the above-mentioned clauses are to be included within a tax treaty, they will make it clear that the anti-avoidance standard of PEs is accepted in that treaty and will prevent any potential dissension. However, separate consideration of PEs (per PE principle) or groups of companies (in some cases — as in the OECD approach in the OECD Public Discussion Draft on BEPS Action 7 — this is also limited) is still

[117] See the Agreement between the Government of the Commonwealth of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland, of 7 December 1967, which stated the following: "Where an enterprise of one of the territories sells to a person in the other territory goods manufactured, assembled, processed, packed or distributed in the other territory by an industrial or commercial enterprise for, or at, or to the order of, that first-mentioned enterprise and: (a) either enterprise participates directly or indirectly in the management, control or capital of the other enterprise, or (b) the same persons participate directly or indirectly in the management, control of capital of both enterprises, then, for the purposes of this Agreement, that first-mentioned enterprise shall be deemed to have a permanent establishment in the other territory and to carry on trade or business in the other territory through that permanent establishment." See also note 116 for another clause of this type in the tax treaty between Australia and Finland (2006).

the rule. This leaves some room for avoidance that should be dealt with by domestic anti-avoidance doctrines or rules, or with other relevant clauses or modifications of treaty policy. This would be appropriate as these clauses do not contribute significantly to the alignment of economic presence and the taxable base in the source country, and the PE principle, as such, would continue to work in favour of residence countries. The issue of attribution of profits to PEs/associated companies also needs attention in these cases and may cause some conflict if transfer pricing continues to function in these situations to move profits away from the source country in favour of residence countries.

5.2.4.6 Combination of clauses in the PE article

All of the clauses, or a majority of those described, whether or not included in the United Nations Model Convention, that lower the PE threshold can be combined in the PE Article, thus substantially reducing the PE threshold. This reduction can also be mixed with withholding taxes at source for royalties and technical services fees, which would increase divergence from the OECD Model Convention and contribute to lowering the thresholds for taxation at source.

For example, Article 5 of the tax treaty between the United States of America and India (1989)[118] combines some variations of the clauses studied and a withholding tax at source for royalties and "included services" (services, ancillary and subsidiary, to any property included within the royalty definition or consisting of making available some knowledge or technical plans or design). This treaty, however, replicates the limitation of Article 5 (7) of the United Nations Model Convention and, therefore, independence may be presumed if the subsidiary of a non-resident company is remunerated at arm's length.

An interesting variation is also found in the tax treaty between the United Kingdom and India (1993),[119] which has two distinguishing

[118] Convention between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, of 2 September 1989.

[119] Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of India

features when compared with the tax treaty between the United States and India:

- Whereas Article 5 has a broad definition of PE very similar to that in Article 5 of the tax treaty between the United States and India, there is a very relevant difference in the independent agent provision which, as drafted in the tax treaty between the United Kingdom and India, excludes independence if the agent acts wholly, or almost wholly, for the non-resident enterprise or associated companies without adding the reference to arm's length remuneration found in Article 5 (7) of the United Nations Model Convention. This provision, which is also in line with OECD draft proposals on Action 7 in the Action Plan on BEPS and the independent agent clause, contributes to the elimination of some of the problems of Article 5 (7) of the United Nations Model Convention as arm's length remuneration is not a condition for establishing independence, and even arm's length remuneration of the agent would not preclude attribution of other profits to the PE of the foreign enterprise;
- Article 7 (3) of the tax treaty between the United Kingdom and India attributes to the source State a relevant portion of the profits obtained by the enterprise through contracts which the PE has negotiated, concluded or fulfilled.

These provisions have been used by the tax administration and courts in India to "pierce the veil" of some subsidiaries and attribute to India more than a cost-plus remuneration of the services provided by the Indian subsidiary to its United Kingdom parent.[120]

Countries must be sure, however, that they are able to apply and administer these complex PE (or attribution of profits) provisions also in connection with withholding taxes at source for royalties and technical services in general, or some services in particular (for example, "included services," as in Indian tax treaties).

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for the Avoidance of double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains, of 25 January 1993.

[120] See, for instance, Income Tax Appellate Tribunal-Delhi Bench "F" New Delhi, *Rolls Royce Plc. vs. Dy. Director of Income Tax*, 26 October 2007, (2008) 113 TTJ 446.

5.3 General Anti-Avoidance Rules and artificial avoidance of PE status

As described above, applying General Anti-Avoidance Rules (GAARs) or doctrines has been the preferred option for the OECD to counteract PE avoidance, together with respect for business models and the arm's length principle. In this regard, therefore, domestic anti-abuse rules and doctrines should take into account the standard of avoidance internationally accepted or followed by the tax treaty being applied, which may reduce their effectiveness.[121] In particular, with regard to PEs, their history shows that only exclusively artificial structures to avoid PEs can be challenged, which may not be in line with the general anti-avoidance standard of the Commentary on Article 1 of the OECD Model Convention or with the standards commonly accepted in domestic legal orders. That is to say, the anti-avoidance standard of Article 5 of the OECD Model Convention is not the same as that developed in the Commentary on Article 1 of the OECD Model Convention or Action 6 of the OECD Action Plan on BEPS. This is because the PE concept is designed to preserve residence-country taxation, which is seen as undesirable only when the PE is avoided based on exclusively tax-driven behaviours. Any business reason or model that avoids a PE is, therefore, protected even if tax reasons play a very relevant role in choosing it. Countries should be aware of this, as the configuration and inherent principles of Article 5 of the OECD Model Convention very much reduce the possibility of applying GAARs to strategies aimed at avoiding having a PE in the source State.

However, because less formal interpretations of Article 5 of the United Nations and OECD Model Conventions than the one proposed by the OECD are possible, there is some scope for using domestic anti-avoidance rules or doctrines. This could be achieved, for instance, by

[121] See R. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 12, 342, where it is suggested that substance over form rules "could be applied to transfer pricing avoidance strategies where nothing of economic substance happens, such as risk shifting by contract within the corporate group. In many cases, however, there is economic substance . . . corporate restructures often have commercial purposes as well as tax purposes. In that event the application of general anti-avoidance rules becomes more problematic."

adopting a more economic view of independence and groups of companies. In this context, GAARs should be preferred to administrative or judicial doctrines.[122] Although this is not the place to study the advantages and disadvantages of GAARs, which are often (somewhat unfairly) charged with creating uncertainty, it is sufficient to state that they have proved their effectiveness in developing countries, which already have experience in their application or are on their way to testing their usefulness.[123] Moreover, there are ways of reducing the charges of uncertainty against GAARs by regulating an appropriate administrative framework for their application.[124] Tax legislation, administrative instructions or circulars could address the main principles relating to the correct interpretation of GAARs, and could make any necessary corrective adjustments, at least, in the most severe cases. This strategy has several advantages: (a) it provides legal certainty to foreign investors; (b) it unifies the criteria used by different tax offices in a country; (c) it may, depending on its form, also have an important effect upon courts when interpreting tax treaties; and (d) subject to consultations with treaty partners (competent authorities), it also provides certainty in the application of tax treaties and reduces conflicts between jurisdictions. Uncertainty regarding PEs may also be reduced by making the administrative opinions on when there is artificial avoidance of PEs public, or, alternatively, by publicizing the decisions taken by administrative boards in charge of deciding whether there is avoidance of domestic rules on this issue. In addition, an advance ruling procedure could be established to determine whether or not some structures are PEs.[125]

It should be recalled, however, that GAARs are there to ensure that laws and treaties are not interpreted too literally, not to create

[122] See J. Freedman, "Designing a General Anti-Abuse Rule: Striking a Balance," (2014) *Asia-Pacific Tax Bulletin*.

[123] See C. Silvani, "GAARs in Developing Countries," *International Fiscal Association Research Paper* (Amsterdam: International Fiscal Association, 2013).

[124] See, J. Freedman, "Designing a General Anti-Abuse Rule: Striking a Balance," supra note 122.

[125] This kind of advance agreement on whether there may be a PE or not is also a risk-management tool that permits countries to concentrate on taxpayers that have not approached the tax authorities.

completely new rules. They cannot be used, therefore, to turn Article 5 of the United Nations and OECD Model Conventions into a completely new and different rule. If GAARs, or too aggressive interpretations thereof, are used to overrule the main principles and more conventional interpretation of the PE concept, the position of a country may suffer from the perspective of legal certainty and attraction of investment.

5.4 Diverted profits taxes

The United Kingdom has worked on the introduction of a 25 per cent tax on structures or arrangements that avoid having a PE within its borders (the diverted profits tax), having effect on 1 April 2015.[126] In its PE variant, the diverted profits tax will apply where goods are sold or services are provided in the United Kingdom by a non-United Kingdom company, if it is reasonable to assume that the structure is organized in order to avoid having a PE in the United Kingdom. Small or medium-size companies will not be subject to the tax, and an exemption will be provided for supplies of goods and services not exceeding 10 million pounds sterling for a 12-month accounting period.

This tax is, in fact, a substitute for GAARs in the United Kingdom or the reduction of PE thresholds, and does not seem easy to apply or to be effective. With as yet no experience on how it will function, and in view of how complex the tax and its application may be, other countries, especially developing countries, should probably not follow this path for the time being, but could monitor its development. Even if the tax seems to be designed not to formally breach the treaty obligations of the United Kingdom, it is a non-conventional move that departs from the consensus on Action 7. In fact, this unilateral move, if followed by other countries, may render Action 7 irrelevant. It is also likely that the diverted profits tax will ultimately be challenged, either because it breaches tax treaties or EU law, or because it is not easy to apply.

[126] See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/385741/Diverted_Profits_Tax.pdf. A somewhat similar base-protecting surtax was also proposed in B. Wells and C. Lowell, "Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin," (2011) Vol. 65, *Tax Law Review*, 604 ff.

5.5 Transfer pricing rules

Unless they are reformed or reinterpreted, transfer pricing rules undoubtedly have a role to play regarding the avoidance of PE status, albeit a limited one. Such an objective also seems to be one of the goals of the OECD project on BEPS. As explained above, the current framework of transfer pricing and attribution of profits to PEs and subsidiaries promotes, rather than prevents, the separation of economic activities from tax bases for source countries. As is the case with PEs, developing countries need a clear agenda with regard to the implementation and application of the arm's length principle that they currently do not have.[127] Consequently, transfer pricing rules, as they are today, are of limited use in the context of artificial fragmentation of operations or transactions undertaken to avoid having a PE in a jurisdiction. As noted earlier, the current conventional transfer pricing analysis can frequently be used as a shield to defend artificially fragmented structures, even if this result is questioned more and more by tax administrations.

Apart from the complexity of transfer pricing (and the need to have adequate legislation and experts within the tax administration), ineffective transfer pricing analysis may explain why tax administrations have avoided challenging business restructuring with transfer pricing rules. Instead, they have resorted to the threat of PE, either as a bargaining tool to obtain more reasonable attribution of profits to local subsidiaries or as a device of last resort, which is relatively easier to apply than transfer pricing. This is because if substantial risks are singled out in a jurisdiction, tax administrations presume that most of the benefits of the foreign company attributable to the source State are located in the PE and only a minor part is attributed to the head office (for example, on a cost-plus basis).

However, if improved, transfer pricing rules could help a source country retain a relevant part of the tax base that might otherwise be allocated to the residence country. Several options are being considered and developed either by international institutions or by some developing countries. As it is not the objective of the present chapter

[127] See, for instance, IMF, "Spillovers in International Corporate Taxation," supra note 27.

to deal with transfer pricing issues, suffice it to say that some examples are mentioned in the United Nations Practical Manual on Transfer Pricing for Developing Countries (United Nations Transfer Pricing Manual).[128] For instance, fixed profit margins are used in Brazil for distribution of products.[129] China adopts an approach aimed at correcting what is seen as overvaluation of purchases by local subsidiaries and undervaluation of functions — sales, marketing and distribution — and considering value location savings and other specific advantages and, in general, the contribution of local subsidiaries to global supply chains.[130] A similar approach is adopted by India to correct the profits of local subsidiaries by adequately valuing marketing intangibles or the contribution of local subsidiaries to the group's profits.[131] In the case of both China and India, cost-plus is deemed not to give a correct outcome in terms of valuation. Other examples are related to fixed margins for some sectors (for example, hotels and resorts). This is the case in the Dominican Republic[132] where fixed margins are applicable until enough experience and information on the relevant sectors is obtained. Other proposals from different perspectives to make more

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[128] United Nations, Department of Economic and Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2013), available at http://www.un.org/esa/ffd/wp-content/uploads/2014/08/UN_Manual_TransferPricing.pdf.

[129] Ibid., 358-374.

[130] Ibid., 374-388. See also R. Ainsworth and A. Shact, "UN Transfer Pricing Guidelines: China's Contribution to Chapter 10," (2014) Vol. 74, No. 12 *Tax Notes International*, 1147 ff. It seems that developed countries are also using similar approaches: see, for instance, P. Desai and S. Goradia, "Cross Border Outsourcing: Issues, Strategies and Solutions," supra note 19, where it is reported that the Canadian authorities are also using an aggressive approach to define "location savings" and attribute higher margins to local subsidiaries.

[131] United Nations, Department of Economic and Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries*, supra note 128, 388-409.

[132] See F. Velayos and A. Barreix, "Towards a New Form of International Taxation: the View from Latin America and the Caribbean," (2013) Vol. 41, No. 3 *Intertax*, 128 ff.

aggressive use of profit splits,[133] or even other BEPS actions,[134] could also be taken into account.

The main advantage of these new trends in transfer pricing rules and methodologies is that a broader tax base is allocated to subsidiaries located in developing countries. But this requires adequate legislation to be in place, as well as capability in transfer pricing analysis that not all countries have. For these reasons, the International Monetary Fund (IMF) has suggested that developing countries should develop a specific agenda for building transfer pricing capability while applying other transitional measures.[135] Within these measures, account should be taken of the fact that reduction in the thresholds for taxation either in the PE Article or through withholding taxes upon royalties and services may help these countries to capture some revenue linked with activities carried on within their territories. Moreover, developing countries should remember that transfer pricing rules should be effectively linked with the PE concept, as adopting a single taxpayer approach when local subsidiaries are regarded as PEs (as in India after the Morgan Stanley case or in Article 5 (7) of the United Nations Model Convention) may contribute to erosion of the tax bases of source countries.

It should not be forgotten that transfer pricing rules may also apply in the case of the restructuring of a business group which is aimed at compensating distributors or manufacturers for their loss of benefits, activity in the creation of intangibles, transfer of know-how, and so forth. However, rules in this respect are probably too complex to be applied by countries with limited resources and knowledge of transfer pricing, or which have less sophisticated tax legislation.

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[133] See IMF, "Spillovers in International Corporate Taxation," supra note 27, and R. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 12.

[134] See OECD, *Public Discussion Draft, BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-border Commodity Transactions* (Paris: OECD, 2014); or OECD, *Public Discussion Draft, BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* (Paris: OECD, 2014).

[135] IMF, "Spillovers in International Corporate Taxation," supra note 27, 33-34.

5.6 Administrative measures tailored to identify PEs

Finally, identification of PEs may be a challenge for those administrations with fewer resources. This means that, for less developed tax administrations, the priority is probably to have rules that would permit the early detection of PEs. In this connection, they may wish to consider implementing some of the following measures that would enable them to do so. For instance, India introduced, effective April 2012,[136] annual reporting obligations for liaison offices (conducting auxiliary activities in India), which seek to obtain information about: (a) the activity in India of the foreign entity to which the liaison office belongs and other entities of the same group operating in India (for example, sales and purchases and services to and from India; details of the products sold and agents used by the group in India; identification and activity in India of other companies of the same group or their liaison offices; other group entities operating from the same premises); (b) the human resources used by the liaison office and those visiting it (for example, number of employees and salaries); and (c) clients and projects located in India. The reporting form must be signed by the chartered accountant of the company in India or by the person so authorized on its behalf by the non-resident person. Similar information is to be provided to the Reserve Bank of India before setting up a liaison office. Developing countries may wish to consider establishing this obligation with regard to foreign entities with a fixed place of business within their territory that claim the benefits of Article 5 (4).

Reporting obligations, penalties and liabilities, may also be established for clients and subcontractors of non-resident companies claiming not to have a PE in the source country in specific sectors that are more vulnerable to tax avoidance (for example, large construction works and engineering projects, exploitation and exploration of natural resources, and distribution of specific foreign products). These could also be applied to specific service providers to non-resident entities (maquilas, distributors, and so forth) and/or subsidiaries of foreign companies. The scope of these reporting obligations should be limited to the information that can be provided by those subjects and should be aimed

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[136] Notification No. 5/2012 of 6 February 2012. The author wishes to express his gratitude to D.P. Sengupta, Principal Consultant, National Institute of Public Finance and Policy, New Delhi, for his assistance on this subject.

at discovering any relevant business activity performed by the foreign head office/group within the source country. Thus, for example, clients and subcontractors could provide information on specific contracts; distributors could do so regarding their activity, products distributed and links with other entities of the same group in the same jurisdiction; and subsidiaries could provide information about other activities of the group in the same jurisdiction that are similar to those requested in India for liaison offices. Withholding taxes in targeted sectors (construction, services, and so forth) may be even more effective than the present reporting obligations to detect PEs through the refund procedure.

Additionally, country-by-country reporting and transfer pricing documentation, currently being studied under Action 13 of the OECD Action Plan on BEPS, may be very relevant risk-management tools for developing countries with regard to PE issues and may even obviate the need to establish some specific reporting obligations. This is one of the reasons why not only the country of residence of the parent company of a group should have access to country-by-country reporting. If local authorities do not have access to such documentation, they may feel inclined to impose reporting obligations locally, possibly adding to the administrative burden of groups of companies. Any local documentation should be tailored to identifying the real activity of a group of companies and PEs within the jurisdiction of the source State and could be accompanied by fair penalties to be effective, but it should not create undue burdens for taxpayers.

Specific audit programmes may also be established for subsidiaries of foreign companies (for example, the accounts of the subsidiaries of foreign companies would easily reveal whether there was a shift of risks outside the jurisdiction) in general, or for specific sectors or transactions (for example, business restructuring). In this regard, a recent decision in India stated that LinkedIn profiles of employees of a foreign entity were relevant evidence that led to the conclusion, in the context of a tax audit, that there was a PE in India.[137]

Effective exchange of information with other administrations within the same country (for example, exchange controls, social

[137] Income Tax Appellate Tribunal, *GE Energy Parts Inc. v. ADIT*, 4 July 2014 (ITA No. 671/Del/2011).

security, visa authorities) is also crucial in this respect for identifying business activities taking place within a jurisdiction.

Specific administrative measures will depend on the situation of each country and should be proportionate and adequate to the goals they are intended to achieve; they especially should not create undue burdens for good-faith taxpayers.

Chapter VIII

Protecting the tax base in the digital economy

Jinyan Li*

1. Introduction

Protecting the tax base in the digital economy is Action 1 of the Organisation for Economic Co-operation and Development Action Plan on Base Erosion and Profit Shifting (OECD Action Plan on BEPS).[1] The reason is simple: "International tax rules, which date back to the 1920's, have not kept pace with the changing business environment, including the growing importance of intangibles and the digital economy."[2] Existing tax rules are rooted in clear-cut jurisdictional boundaries designed for businesses selling goods and services in bricks-and-mortar, physical locations. They are inapt in dealing with income arising from the digital economy, which renders physical form and location irrelevant. The digital economy is characterized by an unparalleled reliance on intangible assets, massive use of data (notably personal data), widespread adoption of multisided business models capturing value from externalities generated by free products, and

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[1] Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf. At the request of the G20 Finance Ministers, in February 2013, the OECD prepared a report outlining the BEPS issues, and in July 2013, followed up with an Action Plan, which was to address those issues in a coordinated and comprehensive manner. Specifically, it was to provide countries with domestic and international instruments that would better align rights to tax with economic activity. The Action Plan is organized around 15 actions, which are to be implemented by the specified deadlines during 2014-2015.

[2] G20 Leaders' Declaration (St. Petersburg, 6 September 2013), paragraph 20, available at https://g20.org/wp-content/uploads/2014/12/Saint_Petersburg_Declaration_ENG_0.pdf.

the difficulty of determining the jurisdiction in which value-creation activity occurs.

The digital economy threatens the tax base of the corporate income tax (CIT) and the value added tax (VAT) by facilitating base erosion and profit shifting (BEPS)[3] and potentially causing the tax base to disappear (base cyberization). BEPS is the result of tax planning designed to take advantage of gaps in the interaction of different tax systems to artificially reduce taxable income or shift profits to low-tax jurisdictions in which little or no economic activity is performed. The targeted BEPS structures are "artificial" in that they are undertaken primarily for tax purposes, not for business reasons. Digital enterprises, such as Amazon, Apple, Facebook and Google, which are flagship digital companies, are among the top BEPS practitioners. More profoundly, digital enterprises and other multinational enterprises (MNEs) can "legitimately" separate profit and profit-generating activities through new business models made possible by technological advances.

Base cyberization occurs when MNEs can sell goods and services into developing countries without the need for a local business presence or without falling within the jurisdictional threshold. It is the result of the collision of new business models coupled with an increasing proportion of unconventional value added activities and the existing tax rules designed to carve out the sovereign territory for taxation on some form of physical presence. The collision creates substantial challenges in taxing business transactions undertaken not only by major global technology conglomerates, but also other businesses that

[3] See OECD, *Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy* (Paris: OECD, 2014) (OECD Public Discussion Draft on BEPS Action 1), available at http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf; and OECD, *Addressing the Tax Challenges of the Digital Economy* (Paris: OECD, 2014) (OECD Action 1 — 2014 Deliverable). These reports were prepared by the Task Force on the Digital Economy, a subsidiary body of the Committee on Fiscal Affairs (CFA). Public comments on the OECD Public Discussion Draft on BEPS Action 1 were published on the OECD website. The voice of developing countries was largely absent.

are less wholly “digital” in nature.[4] Addressing BEPS is unlikely to solve the problem of base cyberization.

Developing countries are part of the growing digital economy. The BRICS[5] countries and other emerging markets are significant, if not equal, players in this economy, particularly in the sense of providing essential markets for goods and services delivered through e-commerce platforms. The reason is not only the existing size of the Internet population in these countries, but also the immense growth potential for these emerging markets. For example, China had, by the end of 2013, an Internet population of 618 million, which is only a 45.8 per cent penetration rate given the size of the total population.[6] The number of online shoppers is estimated to be less than half of the Internet population, at about 302 million, which is approximately equivalent to the population of the United States of America.[7] The potential for growth is, however, not limited to BRICS nations. For example, Africa’s middle class has reportedly tripled over the past 30 years, and the current trajectory suggests that it will grow to 1.1 billion in 2060, making it the world’s fastest growing continent.[8] This growth, coupled with the forecasted gross domestic product (GDP) growth of over 6 per cent, is expected to drive the growth of e-commerce as businesses seize upon opportunities arising from the growing number of digitally empowered consumers, who are opting to purchase goods via e-commerce channels.[9]

The tax base of developing countries is presumably more at risk than that of OECD countries. The CIT usually figures more

[4] International Monetary Fund, “Spillovers in International Corporate Taxation,” (2014), *IMF Policy Paper*, available at http://www.imf.org/external/np/pp/eng/2014/050914.pdf (IMF Spillovers Report), at 48.

[5] Brazil, Russian Federation, India, China and South Africa.

[6] China Internet Network Information Centre, *Statistical Report on Internet Development in China* (2014), available at http://www1.cnnic.cn/IDR/ReportDownloads/201404/U020140417607531610855.pdf, at 4.

[7] Ibid., at 8.

[8] Deloitte, “The Rise and Rise of the African Middle Class,” (2013), available at http://www2.deloitte.com/content/dam/Deloitte/au/Documents/international-specialist/deloitte-au-aas-rise-african-middle-class-12.pdf.

[9] E-commerce news, “Potential for retail growth in Africa,” (2014), available at http://www.bizcommunity.com/Article/196/394/112923.html.

prominently in developing countries than in developed countries in terms of its share of the total tax revenues.[10] The VAT generates the largest share of tax revenue in many developing countries.[11] As a result, any erosion of the tax base of the CIT and/or the VAT could have profound consequences on the revenue capacity of developing countries. Furthermore, the loss of tax revenue is presumably more urgent and real in developing countries as they are net importers of digital goods and services.

To combat this global phenomenon of digitization, a "global" reaction to the tax challenges of the digital economy has occurred. The OECD Project on BEPS, the work of the United Nations Committee of Experts on International Cooperation in Tax Matters (United Nations Committee of Experts) on BEPS and the participation of the international business community and the tax community are testaments to such movement. This movement presents a unique opportunity for developing countries to participate in the "globalization of tax policy" — developing international tax rules that can take into account their interests as source or market jurisdictions. Interestingly, the technological advances that enable the growth of the digital economy may further help developing countries improve overall efficiency in their tax administration and transform them into more modern tax systems.

The present chapter aims at exploring the options available for developing countries to protect their tax base in the face of the growing digital economy.[12] It draws on work of the OECD, a report by a European Commission Expert Group on Taxation of the Digital

[10] IMF, *Spillovers in International Corporate Taxation,* supra note 4, at 7.

[11] Richard M. Bird and Pierre-Pascal Gendron, *VAT in Developing and Transitional Countries* (Cambridge University Press, 2007).

[12] Because the digital economy issue cuts across all sectors of the economy and all forms of BEPS, the scope of the present chapter can potentially be very broad and overlap with that of other chapters in this publication, particularly Chapter II, Taxation of income from services, by Brian Arnold, and Chapter VII, Preventing avoidance of permanent establishment status, by Adolfo Martín Jiménez. To the extent possible, the present chapter will defer to these other chapters on general issues and principles and focus on digital services and unique permanent establishment (PE) issues arising from the digital economy.

Economy,[13] a study by Collin and Colin, "Task Force on Taxation of the Digital Economy,"[14] and literature on the taxation of e-commerce.[15] After a brief overview of the general features of CIT and VAT in section 2 below, the key features of the digital economy and the main challenges are discussed in section 3. Some policy options for developing countries are set out in section 4.

The main thrust of the present chapter is, first, BEPS issues are no less relevant to developing countries than to developed economies, with the issues of base cyberization having more profound consequences on the former. The loss of the tax base under the CIT is primarily associated with the erosion of the source-country taxation rule. The loss of the tax base under the VAT is largely due to issues of enforcement and tax collection. Developing countries are source countries. As such, the impact of tax base cyberization is more severe on these countries. To protect the tax base, developing countries need to develop some new tax tools for the new economy, ideally through multilateral efforts.

Second, an evolutionary approach to addressing the tax challenges is preferred as radically different tax models would be unlikely to receive international support and would violate one or more key policy objectives, such as neutrality and efficiency. The United Nations Model Double Taxation Convention between Developed and Developing Countries[16] (United Nations Model Convention) provides more tools for source taxation than the OECD Model Tax Convention

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[13] European Commission (EC), *Commission Expert Group on Taxation of the Digital Economy Report* (2014), available at http://ec.europa.eu/taxation_customs/taxation/gen_info/good_governance_matters/digital_economy/index_en.htm.

[14] Available at http://www.hldataprotection.com/files/2013/06/Taxation_Digital_Economy.pdf.

[15] Arthur J. Cockfield and others, "Taxing Global Digital Commerce," (2013); Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2002).

[16] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

on Income and on Capital[17] (OECD Model Convention). Examples are the lower threshold for physical presence or permanent establishment (PE) and withholding taxes on royalties. Extending the policy rationale of these broader source taxation rules to the context of the digital economy seems to be both consistent with the wider policy rationale of preventing BEPS and the right direction for formulating tax measures for the digital age. As for the VAT, there are already some precedents for developing countries to consider, such as requiring foreign online vendors to register for VAT if the sales in a country exceed a specified threshold.

Third, while recognizing the merits of the evolutionary approach, the global and intangible nature of the digital economy does call for some original thinking about where value is created for tax purposes and how States can share the new tax base fairly. New nexus rules or new ways of implementing existing principles, such as the arm's length principle, are necessary to ensure a fair sharing of the tax base among countries, especially between developed and developing countries.

Fourth, it is in the best interest of developing countries to participate in multilateral efforts to tackle the tax challenges of the digital economy. Economies of developing countries are increasingly tied to the global economy, as is their tax base. The global nature of the new economy defies any unilateral locally based or nation-centric tax policies or enforcement measures.

2. Tax base of developing countries

2.1 Corporate income tax

The tax base of the corporate income tax (CIT) is the net profit earned by corporations from various activities, such as trading, manufacturing and processing, retail, extractive and services. The tax rate is generally flat. Corporations are required to file tax returns and self-assess their tax liability.

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[17] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

Non-resident corporations are generally taxable only on income derived from domestic sources. Different jurisdictional nexus (or sourcing) rules apply to business profits and investment income (and capital gains). The foundation of the nexus rule for business income is the same under domestic law and tax treaties — a certain level of physical presence in the source jurisdiction is required, either directly or through the actions of a dependent agent.[18] The physical presence can be manifested by the existence of a physical place or physical presence of human service providers. Many developing countries have concluded tax treaties on the basis of the United Nations Model Convention. The effect of tax treaties is to modify domestic tax laws by limiting the tax jurisdiction of the source country. For example, the nexus rule for business profits is elevated to the level of a permanent establishment (PE), requiring a business presence that is "permanent" or "fixed," which is a higher threshold than the rule under domestic laws. Article 5 of the United Nations Model Convention also deems certain services activities to be equivalent to a PE if the activity satisfies a time requirement. A person acting on behalf of the non-resident corporation and habitually exercising an authority to conclude contracts in the name of the corporation is deemed to be a PE. Article 5 (4) further raises the threshold by not considering warehousing, marketing and other "preparatory or ancillary" activities to constitute a PE.[19] Article 5 (8) provides that a subsidiary of a foreign corporation shall not of itself constitute a PE of the parent company.

The nexus rule for investment income is generally the same under domestic laws and tax treaties — the residence of the payer or the "base-erosion rule." The base erosion rule traces the source of interest or royalty to the place of PE where the interest or royalty is

[18] OECD, Action 1 — 2014 Deliverable, supra note 3, at 39.

[19] Article 5 (4) refers to: "(a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise; (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display; (c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise."

deducted in computing profit attributable to the PE.[20] In the case of income from services, the nexus rule is the same as business profit. Some tax treaties have a specific provision on technical fees.

2.2 VAT

VAT is a broad-based tax on the consumption of goods and services. Although taxes are collected by businesses at different stages of production, distribution and sale of goods and services, the ultimate burden of VAT is intended to fall on the eventual consumers. Domestic businesses and certain foreign businesses conducting commercial activities in a given country are required to register for VAT purposes, collect VAT on their sales and claim a credit or refund for VAT paid on their business inputs. For various policy reasons, the supply of certain goods or services is exempt from VAT. Examples are necessities, financial services, basic health and education services, and importation of small-value items.

In order to collect VAT on cross-border supplies, tax authorities around the world generally adopt the destination principle.[21] Under this principle, VAT is levied in the jurisdiction of the final consumer. This means that exports are not subject to VAT (and the associated input tax is refunded to the exporter) and imports are taxed on the same basis as domestic supplies. In the case of imported tangible goods, VAT is generally collected from the importer at the same

[20] Article 11 (5) of the OECD Model Convention and Article 12 (5) of the United Nations Model Convention.

[21] OECD, *International VAT/GST Guidelines* (Paris: OECD, 2014). Some developing countries have not adopted the destination principle. China is one such country. The Chinese VAT system does not differentiate the place of taxation for business-to-business (B2B) and business-to-consumer (B2C) cross-border supplies of services and intangibles. VAT is payable on supplies of intellectual property rights and certain services if either the supplier or the recipient is inside China. China does not have specific tax rules dealing with cross-border supplies of digital content. For importation of intangible supplies, the Chinese VAT requires the importers to withhold VAT and settle tax payments with local tax authorities. In practice, the withholding rules are not strictly enforced against individual importers who do not maintain VAT registration in China.

time as customs duties. To ease compliance, many countries allow an exemption for relatively low-value goods.[22]

In the case of imported services and intangibles, however, applying the destination principle to supplies of services and intangible products is more difficult. The nature of services and intangibles is such that there are no customs controls that can effectively confirm their exportation and impose the VAT at importation. Currently, there are two approaches in dealing with the imposition of VAT to imported services: (a) self-assessment by the importer under a so-called reverse-charge mechanism; or (b) a requirement for non-resident suppliers to register for VAT purposes and to collect and remit the VAT. Under the reverse-charge mechanism, registered VAT businesses which import services from non-resident suppliers (that is to say, business-to-business or B2B) would have the onus of self-assessing the VAT (or charging themselves the VAT) and claiming an input credit for a tax refund. There is no net tax cost to the importer in such cases. However, if the importer is the final consumer and cannot claim any input credit, there is a risk that the importer would be motivated to abstain from its duty, and not self-assess and remit the tax to the government. It would be very difficult for the authorities to enforce the reverse-charge mechanism in such cases. That is why some countries, such as South Africa, introduced the registration requirement in respect of electronic services, including educational services, games and gambling, information system services, Internet-based auction service facilities, maintenance services in relation to a website or a blog, subscription services and the supply of e-books, films and music.[23] A non-resident supplier must register for South African VAT if electronic services are provided to residents in South Africa or where payment for such services originates from a South African bank.

[22] For further discussion of VAT, see OECD, Action 1 — 2014 Deliverable, supra note 3, 41-48.

[23] See press release by the National Treasury of South Africa, available at http://www.treasury.gov.za/comm_media/press/2014/2014032801%20-%20Press%20Release%20-%20Electronic%20Services%20Regulations.pdf; Nyasha Musviba, "South Africa's VAT changes: The impact on e-commerce," (2014), available at http://www.sataxguide.co.za/south-africas-vat-changes-the-impact-on-e-commerce/2/.

3. Tax base at risk in the digital economy

3.1 Global nature of the digital economy[24]

"Digital economy" can be described as "the global network of economic and social activities that are enabled by platforms such as the Internet, mobile and sensor networks."[25] The spread of information and communication technologies (ICT) across business sectors leads to the growth of the digital economy in both developed and developing countries.[26] The current spread of ICT (for example, broadband connectivity) is, as expected, higher in OECD countries (for example, universal for large enterprises and 90 per cent or more for smaller enterprises)[27] than in most developing countries. In East Asia, Singapore, the Republic of Korea, Hong Kong Special Administrative Region of China and Taiwan Province of China are among the most connected countries and areas in the world.[28]

Many developing countries have invested heavily in ICT infrastructure and in making ICT one of the key national industries in their

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[24] See Infocomm Development Authority of Singapore, Global Trends, The Emerging Digital Economy (June 2013), which defines the term "as social and economic activities that demonstrate the following characteristics: are enabled by internet/mobile technology platforms and ubiquitous sensors; offer an information-rich environment; are built on global, instant/real-time information flows; provide access 24/7, anywhere, i.e. are always-on and mobile; support multiple, virtual, connected networks," (available at http://www.globaltrends.com/monthly-briefings/60-monthly-briefings/192-gt-briefing-june-2013-the-digital-economy).

[25] Australian Government, Department of Broadband, Communications and the Digital Economy, "What is the digital economy?" available at http://www.dbcde.gov.au/digital_economy/what_is_the_digital_economy. See also Pierre Collin and Nicolas Colin, *Task Force on Taxation of the Digital Economy* (2013), available at www.hldataprotection.com/files/2013/06/Taxation_Digital_Economy.pdf.

[26] OECD, Action 1 — 2014 Deliverable, supra note 3, at 70.

[27] Ibid., at 70.

[28] World Economic Forum, Beñat Bilbao-Osario, Souitra Dutta and Bruno Lanvin, eds., "The Global Information Technology Report 2013: Growth and Jobs in a Hyperconnected World," available at http://unsdn.org/?p=5305.

attempt to diversify and transform their economies.[29] As latecomers to ICT and the digital economy, many developing countries have leapfrogged the "old" wired, fixed-line Internet technologies and embraced wireless, mobile networks, which are primarily driven by the maturation of smartphone technologies that allow for mobile computing and constant connectivity worldwide. From a luxury product used primarily in developed countries, mobile communication devices are becoming an integral part of life for many in the developing countries.[30] For example, the Asia-Pacific region is and will continue to be the largest regional mobile phone market, with 3.9 billion subscriptions in 2020 (up from 2.4 billion in 2010). China will continue to be home to the world's largest number of mobile phone subscriptions, with 1.3 billion subscribers in 2020 (up from 839 million in 2010). The number of mobile phone subscriptions in India was forecast to grow at an average annual rate of 5.7 per cent during the period 2011-2020, to approximately 1.1 billion in 2020. Mobile data traffic grew at a much higher rate in emerging countries than in most developed countries.[31] In China alone, mobile Internet users were about 500 million at the end of 2013,[32] which is more than 80 per cent of the total Internet population. Mobile devices are playing an increasing role in the mix of e-commerce, and purchases made on mobile devices may make up

[29] Ibid.

[30] World Trade Organization, *E-Commerce in Developing Countries: Opportunities and challenges for small and medium-sized enterprises* (Geneva: WTO, 2013) (WTO E-commerce Report), available at http://www.wto.org/english/res_e/publications_e/wtr13_e.htm. Jack Ma, the founder and chairman of Alibaba was quoted as saying: "in other countries, e-commerce is a way to shop, in China it is a lifestyle." See He Wei. "China set to overtake US in e-commerce," (2013) *China Daily*, available at http://usa.chinadaily.com.cn/business/2013-08/28/content_16927926.htm; see also Group of Companies, "E-commerce in China: Gain entrance into a completely different world," (2013), available at http://www.ptl-group.com/blogs/e-commerce-in-china-gain-entrance-into-a-completely-different-world.

[31] Visual Networking Index (VNI), Cisco Visual Networking Index: Global Mobile Data Traffic Forecast Update, 2013–2018, available at http://www.cisco.com/c/en/us/solutions/collateral/service-provider/visual-networking-index-vni/white_paper_c11-520862.html.

[32] China Internet Network Information Centre, *Statistical Report on Internet Development in China,* supra note 6, at 4.

25 per cent of the market by 2017.[33] Social media platforms in China and other emerging economies are an additional driver or facilitator of e-commerce activity.[34]

3.2 Developing countries as market jurisdictions

E-commerce is the best known element of the digital economy. It refers to "the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders."[35] E-commerce includes offline transactions that involve online ordering of goods and services and delivery through traditional channels, as well as purely online transactions involving digital goods and services. Depending on the parties, the activities can be classified as business-to-business (B2B), business-to-consumer (B2C), consumer-to-consumer (C2C),[36] or business-to-government (B2G). B2B commerce accounts for more than 90 per cent of global e-commerce,[37] although it accounts for less in developing countries.

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[33] Visual Networking Index (VNI), Cisco Visual Networking Index: Global Mobile Data Traffic Forecast Update, 2013–2018, supra note 31.

[34] The way social media like Facebook and LinkedIn make money is to create platforms for online advertising, much like Google. Their mode of e-commerce (advertising services) is thus distinct from Alibaba, Amazon and eBay, which actually provide platforms for the purchase and sale of physical goods. Mobile commerce has been growing steadily.

[35] OECD, *Guide to Measuring the Information Society 2011* (Paris: OECD, 2011). See also World Trade Organization, "E-Commerce in Developing Countries: Opportunities and challenges for small and medium-sized enterprises," supra note 30.

[36] C2C transactions are becoming more and more common. Businesses involved in this model play the role of intermediaries, helping individual consumers to sell or rent their assets by publishing their information on the website and facilitating transactions. An example of this would be eBay.

[37] OECD Public Discussion Draft on BEPS Action 1, supra note 3, paragraph 62. According to research conducted by the United States-based International Data Corporation (IDC), it is estimated that global B2B e-commerce, especially among wholesalers and distributors, amounted to US$ 12.4 trillion at the end of 2012. If the expansion in e-commerce continues at this rapid pace in developed markets, as is expected, B2B and B2C e-commerce trans-

For example, in Brazil and India, B2C e-commerce accounted for almost one half of total e-commerce.

In terms of e-commerce involving digital goods, services and intangibles, developing countries are net importers, especially as regards B2C transactions.[38] Cross-border B2C e-commerce has been growing in BRICS countries with the growth of the middle class and connectivity to the global networks in these countries.[39] China led all other countries in B2C and C2C purchases by the end of 2013.[40]

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actions will account for about 5 per cent of all intercompany transactions and retail sales by 2017: see World Economic Forum, Beñat Bilbao-Osario, Souitra Dutta and Bruno Lanvin, eds., "The Global Information Technology Report 2013 in a Hyperconnected World," supra note 28, at 3.

[38] The major exporters are developed countries such as France, Germany, the Netherlands, the United Kingdom of Great Britain and Northern Ireland and the United States of America. Brazil, China and the Russian Federation are among the top online retail importers. China was ranked number 1 in the Global Retail e-Commerce Index in 2013, Brazil was ranked number 8, and the Russian Federation number 13. See yStats.com, *Global Cross-Border B2C E-Commerce* (2014), available at http://www.ystats.com/product/global-cross-border-b2c-e-commerce-2014/; *ATKearney 2013 Global Retail Development Index*, available at http://www.atkearney.com/consumer-products-retail/global-retail-development-index.

[39] In 2013, the Internet penetration rate (number of Internet users per 100 population) was 51.6 per cent in Brazil, 45.8 per cent in China, 15.1 per cent in India and 61.4 per cent in the Russian Federation. World Bank (2014), "Internet users (per 100 people)," available at http://data.worldbank.org/indicator/IT.NET.USER.P2.

[40] In 2013, the gross merchandise value of e-commerce represented by B2B e-commerce and traditional e-retailing was almost RMB 10 trillion. For the next five years, the growth rate of online shopping, B2B e-commerce of large enterprises and SME B2B e-commerce is predicted to be 22 per cent, 12 per cent and 25 per cent, respectively. China's e-tail (B2C) market was the second largest in 2012 and 2013 and was forecast to surpass the United States in 2014. In particular, the proportion of mobile commerce is expected to grow from 8.5 per cent in 2013 to 24 per cent in 2017. See KPMG, "E-commerce in China: Driving a new consumer culture," (2014) No. 15 *China 360*, available at http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/China-360/Documents/China-360-Issue15-201401-E-commerce-in-China.pdf.

Specific reasons for cross-border online shopping include: greater selection of products online — popular categories of goods bought online include computer hardware, personal electronics, and apparel and accessories as well as automobile parts (particularly in the Russian Federation); higher level of consumer trust in quality, and time-saving; and perhaps most importantly, cost-saving.[41] One of the reasons for the price advantage is tax.[42] The popular international websites for B2C transactions are those hosted by companies in the United States, such as Amazon, and other developed countries.[43]

Similar growth trends exist in other developing countries. In 2014, for example, the Asia-Pacific region was expected to claim more than 46 per cent of global digital buyers and to spend more on e-commerce purchases than North America, and the potential to grow remains huge as Internet users currently account for only 16.9 per cent of the Asia-Pacific region's population.[44] Africa's e-commerce has been defined and accelerated by mobile networks. To promote e-commerce, entrepreneurs are reportedly contemplating circumventing the

[41] For further information, see Research on International Markets, "Russia B2C E-Commerce Report," (2012), *Market Report*, available at http://ystats.com/uploads/report_abstracts/998.pdf?PHPSESSID=8703349841ca7cebda9e9ee664281724; Market Watch, "Eastern Europe B2C E-Commerce Report 2013," available at http://www.reportlinker.com/p0191557/Eastern-Europe-B2C-E-Commerce-Report-2013.html; Deloitte, "Doing Business in Russia 2014," available at http://www.deloitte.com/assets/Dcom-Russia/Local%20Assets/Documents/Doing%20Business%20in%20Russia/Doing_business_in_Russia_2014.pdf.

[42] For example, in the Russian Federation, parcels are not subject to customs duties and import VAT if they do not exceed 31 kg in weight and 1,000 euros in value each month per recipient. In the case of intangibles (such as computer programs, e-books, music or video content), there is no concept of electronic import in the Russian Federation, allowing the content to be delivered to Russian users tax-free.

[43] Some of the websites are also hosted by Chinese companies, such as Alibaba.

[44] See "India, China to help APAC become largest e-commerce market in 2014," The Economic Times (online), 18 February 2014, available at http://articles.economictimes.indiatimes.com/2014-02-18/news/47451222_1_e-commerce-emarketer-emerging-markets.

barriers of road transportation by opting for air transportation, even drones.[45] In Latin America, social networks are propelling the boom in e-commerce in the region. Moreover, 74 per cent of Internet users in Latin America regularly use social media sites such as Facebook or LinkedIn.

Companies in developing countries take advantage of e-commerce in cross-border trade, especially B2B trade in goods. For example, Chinese companies sell into other countries.[46] Alibaba's top foreign markets are Australia, the United Kingdom of Great Britain and Northern Ireland, the United States, and, more recently, Brazil, the Russian Federation and the Middle East.[47] Exports by small and medium-size enterprises (SMEs) in developing countries are aided by B2B e-commerce. For example, 15,000 SMEs in India export a variety of Indian handcrafted products to 190 countries. That is "just the tip of the iceberg,"[48] as many small businesses still do not have their own website and are looking to the third-party B2B exchanges/marketplace platforms to gain access to new markets.[49] In 2012, Alibaba's third-party cross-border e-commerce platform attracted more than 80,000 Chinese suppliers, or about 5 per cent of Chinese export companies,

[45] See Research on International Markets, "The African Version of Amazon Will Emerge From Nigeria," (2014) *Market Report*, available at http://mashable.com/2014/03/18/nigeria-ecommerce-drones/. For further information, see "Africa B2C E-Commerce Report 2013," *Market Report*, available at http://www.ystats.com/product/africa-b2c-e-commerce-report-2013/.

[46] It was reported that five of the top fifteen websites on the worldwide web were Chinese: Baidu, Hao123.com., Sina Corp., Taobao and Tencent QQ. See http://en.wikipedia.org/wiki/Alexa_Internet. Other top 15 websites were: Amazon, Facebook, Google, Google India, LinkedIn, Twitter, Wikipedia, Windows Live, YouTube and Yahoo.

[47] Alibaba launched the world's largest initial public offering (IPO), raising over US$ 21 billion in September 2014. See Wall Street Journal, "What is Alibaba?" http://projects.wsj.com/alibaba/. Transactions on Alibaba's online sites totalled US$ 248 billion in 2013, more than those of Amazon and e-Bay combined, and the majority of Alibaba's transactions take place inside China.

[48] Ibid.

[49] See Goldman Sachs on India's Internet industry, available at http://evigo.com/14101-india-already-booming-e-commerce-market-continues-grow/.

creating an export volume of RMB 1.3 trillion, 20 per cent of total exports of SMEs in China.[50]

3.3 Key features of the digital economy

The digital economy challenges the tax base of market jurisdictions because it has features that render the existing tax rules inapplicable. In a digital economy, knowledge and information (data) is considered a main production factor, in addition to the three major production factors of an industrial, capitalist society — labour, capital and land. Digitization[51] of core economic activities, such as production, distribution and consumption of goods and services, turns tangibles into intangibles, physical things into digital bits and bytes.

The digital economy has given rise to a number of innovative business models, products and services, such as e-commerce, online app stores, online advertising, cloud computing, payment services, high frequency trading and participative networked platforms. Participants of the digital economy include Internet giants such as Facebook and Google as well as, more importantly, traditional businesses whose activities are linked and enhanced through the use of ICT by offering online platforms to facilitate traditional business activities, such as online sales, online payments, online auctions, online logistical solutions, online publication, online broadcasting, and so on. The lion's share of the digital economy occurs between businesses.

There is a variety of revenue models in the digital economy, including: (a) advertising-based model, under which the company offers content, services and/or products and provides a forum for advertisements and receives fees from advertisers (for example, Facebook and Google); (b) subscription model, under which the website that offers users content or services charges a subscription fee for access to some or all of its offerings (for example, Consumer Reports Online, The

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[50] See *Economic Daily*, "Tax Rebate and Exemption Help Cross-Border E-Commerce Upgrade," (2014), available at http://www.chinatax.gov.cn/2013/n2925/n2953/c673757/content.html.

[51] Digitization — the mass adoption of connected digital services by consumers, enterprises and governments — is regarded as a fundamental driver of economic growth in developed and emerging markets.

New York Times, and so on); (c) sales model, under which a company derives revenue by selling goods, information or services to customers (for example, Amazon.com and Gap.com); (d) licensing content and technology model, under which a company provides access to specialist online content (for example, publications and journals), algorithms, software, cloud-based operating systems, and so on, or a specialist technology such as artificial intelligence systems; (e) sale of user data and customized market research models, used by Internet service providers (ISPs), data brokers, data analytics firms, and enterprises requiring telemetrics and data gained from non-personal sources. In addition, some companies may charge a fee for enabling or executing a transaction; examples are eBay and E*Trade.

The new business models and revenue models share some common features that challenge the existing tax law and policy. These features can be described to include mobility, reliance on data, multi-sided business models, tendency of forming a monopoly or oligopoly, and volatility.[52] For the purposes of analysis, they can best be broken down into three separate issues: (a) dematerialization of what is being traded; (b) connectivity and mobility and its impact on where income-earning activities or functions are located; (c) the role of customers in value creation or a paradigm shift in how value is created.[53]

3.3.1 Dematerialization

The dematerialization of a product literally means less or no physical material is used to deliver the same level of functionality to the user.[54] In the context of digital economy, dematerialization refers to the transformation of any material object into something of virtual or digital quality. Anything that can be digitized can be delivered online or dematerialized. A common example is the online sale and delivery

[52] OECD, Action 1 — 2014 Deliverable, supra note 3, at 84.

[53] Comments of the BEPS Monitoring Group on the OECD Public Discussion Draft on BEPS Action 1, published on the OECD Website (BMG Comments).

[54] Iddo K. Wernick and others, "Dematerialization: Measures and Trends," (1996) Vol. 125, No. 3 *Journal of the American Academy of Arts and Sciences*, 171-198.

of information or entertainment products which used to be delivered in physical forms, such as books, newspapers, movies or television shows. Furthermore, advances in 3D printing technologies have the potential to transform manufactured goods (for instance, machines and spare parts) into intangibles (such as licence plans and specifications) that allow customers to manufacture the physical items whenever customers actually need them.[55]

Dematerialization is also manifested by the increasing value attributable to "intangibles." Even when a product remains tangible in form, such as a car or telephone, much of its functionality and value is driven by artificial intelligence. More pervasively, dematerialization occurs in the expansion of the scope of services. Services can be delivered digitally as opposed to face to face. Goods can be transformed into services, deliverable online. For example, in the early days, computer software had to be installed onto a computer locally by means of a physical disc. Today, many software applications assume the virtual form of a website (for example, Dropbox) that provide a service accessible over the Internet without the need for any local medium of delivery. The service can be about providing access to content (as a portal) or about providing access to executable code performing certain features. Conventional services can now be identified by the prefix "e" and can be delivered online. Examples are advertising, auction, banking and finance, broadcasting and publication, education, entertainment, health care, insurance, logistics services (such as transportation, warehousing and distribution) and travel.

New services arising from the digital economy are largely virtual or digital. Examples are the services of information technology (IT), ISPs, application service providers (ASPs), network operators and telecommunications, web-hosting and cloud computing. For example, through cloud computing, software, data and other resources are transformed into services, known as "X-as-a-Service" (XaaS). Customers are granted access to resources that are not stored

[55] 3D printing is defined as "additive manufacturing techniques to create objects by printing layers of material based on digital models": James Manika and others, *Disruptive technologies: Advances that will transform life, business, and the global economy* (McKinsey Global Institute: 2013). See also OECD, Action 1 — 2014 Deliverable, supra note 3, at 132-3.

on a single computer, but instead on many networked computers that are available to everyone who has access to that "cloud" of computing resources. Cloud computing often provides customers with a cost-effective alternative to purchasing and maintaining their own IT infrastructure, because the cost of the consumer resources is generally shared among a wider user base.[56]

Dematerialization in the digital economy does not, however, mean that everything is virtual. Human beings remain important as producers and consumers. Physical delivery of tangible goods remains a significant part of e-commerce. Also, some people may still want to test products before ordering online. However, the proportion of e-commerce involving "intangibles" or "digitized goods and services" is rising.

3.3.2 Connectivity and mobility

The Internet virtually connects everybody who has access to it using a computer or mobile device. Such connectivity diminishes the relevance of distance or physical barriers. Digitized information and

[56] OECD, Action 1 — 2014 Deliverable, supra note 3, at 80-1, describes the following as the most common examples of cloud-computing-services models: Infrastructure-as-a-Service (IaaS) providers offer computers — physical or (more often) virtual machines — and other fundamental computing resources. Platform-as-a-Service providers provide a computing platform and programming tools as a service for software developers. Software resources provided by the platform are embedded in the code of software applications meant to be used by end users. The client does not control or manage the underlying cloud infrastructure, including the network, servers, operating systems or storage, but has control over the deployed applications. Software-as-a-Service providers allow the user to access an application from various devices through a client interface such as a web browser (for example, web-based email). Content-as-a-Service: where rights are obtained and software is provided to allow content to be embedded by purchasers, content can be purchased as a service. Data-as-a-Service: data from multiple sources can be aggregated and managed by a service provider, so that controlled access to that data can be granted to entities that may be geographically and organizationally removed from each other, without each entity needing to develop or acquire the infrastructure necessary to prepare and process that data.

content can be communicated and delivered instantly from anywhere to everywhere, provided that the ICT infrastructure is available. Digital technology increases the speed and efficiency at which information can be processed, analysed and utilized.

Connectivity enhances the ability of companies to carry out activities remotely and to expand the number of potential customers that can be targeted and reached. It enables companies to generate revenue from customers located in foreign jurisdictions without having any old-fashioned business presence in those jurisdictions. Such connectivity also increases "the flexibility of businesses to choose where substantial business activities take place," and as a result, "it is increasingly possible for a business' personnel, IT infrastructure (for example, servers), and customers each to be spread among multiple jurisdictions, away from the market jurisdictions."[57] Digital businesses are, thus, intrinsically global; the "where" issue is neither here nor there.[58]

The potential benefits of e-commerce can be illustrated by the Dell business model.[59] Dell relied on e-commerce to support a virtual company. Orders for computers are placed with Dell by telephone or through the Internet. Through the process of just-in-time (or lean) manufacturing, waste is reduced and productivity improved by having the required inventory on hand only when it is actually needed for manufacturing. This reduces lead and set up times for building a computer. Dell orders the parts for a computer only when it has a firm order. It operates with little in-process and no finished goods inventory. Products are shipped as soon as they are manufactured. This approach also enables Dell to forgo having brick-and-mortar store fronts with inventory that must be kept on the books or that might become obsolete, thereby significantly reducing overheads. Items that are not built by Dell are shipped directly to the customer by the manufacturer. These features help Dell to reduce the costs of production and sales. This process allows Dell to custom design systems for its customer within

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[57] OECD, Action 1 — 2014 Deliverable, supra note 3, at 127.

[58] Borrowing from Bill Bryson, *Neither Here nor There: Travels in Europe* (Perennial, 1993).

[59] See Kenneth Kraemer and Jason Dedrick, "Dell Computer: Using E-commerce To Support the Virtual Company," (2001), available at http://digitalenterprise.org/cases/dell_text.html.

certain parameters as well as to offer a range of items rather than a single system. In short, digital connectivity enhances the mobility of a firm's business functions, customers and intangible assets.

3.3.3 Role of the consumer in value creation

In a digital economy, consumers are empowered and turned into "free workers" for digital companies. "Consumers are more empowered than ever before."[60] They are empowered as they have more choices, more convenience, more bargains and more say in how they want to be "served."[61] Unbeknown to them, consumers of the digital economy are also contributors to the value-creation process. They seem to create value in at least two ways: as part of an "ecosystem enabling a continuous, symbiotic and reciprocal relationship of value exchange"; and as a source of big data.[62]

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[60] Insider Whitepaper, "Rise of the Empowered Consumer: How to reach audiences in 2012," (2012), available at http://www.mediacomusa.com/media/2088012/mediacom%20the%20insider_the%20empowered%20consumer_whitepaper.pdf.

[61] Internet users who shop online tend to be middle class, more educated, younger and more autonomous. The rise of social media has also offered an instant global platform for sharing ideas. There has been a recent shift in the balance of power "from developed markets to the developing world and from institutions such as governments to individuals, who exercise their new power as consumers to gain information to their advantage." See Gregory Carpenter, "Power shift: The rise of the consumer-focused enterprise in the digital age," (2013), available at http://webcache.googleusercontent.com/search?q=cache:EXowVJi9HUMJ:https://www.kellogg.northwestern.edu/faculty/academics/~/media/Files/general/2013/Rise-of-the-Consumer-Focused-Enterprise.ashx+&cd=1&hl=en&ct=clnk&gl=us. A 2012 survey found that 70 per cent of customers use their smartphones to read reviews, 61 per cent to compare prices and products and 42 per cent to contact the retailer. More and more, these individuals are doing these activities while they are shopping. See also Stephanie Clifford and Claire Cain Miller, "The shrewd shopper carries a smartphone," *The New York Times*, 22 November 2012.

[62] Comments of the BEPS Monitoring Group on the OECD Public Discussion Draft on BEPS Action 1, published on the OECD Website (BMG Comments).

Unlike the relationship between suppliers and consumers in the traditional economy, the relationship is no longer one of a passive, discrete nature, but rather symbiotic and continuous, and creates real economic value. Such a relationship may be cultivated through the supply of a bundle of hardware, a stream of services, and new products or enhancements. An example of this is Apple, who has bundled the sale of hardware (for example, the iPhone) and software or services (for example, the App Store). These symbiotic relationships can also be the product of participative networked platforms, such as Wikipedia and YouTube. These platforms allow users to generate user-created content, such as product reviews, creative or how-to videos, and social media sharing, which add value by attracting an audience and provoking interactions between users and businesses. Frequent updating of content increases a website's visibility in search results, which drives the value of advertisement.

Consumers play a more important role in multisided business models or platforms, which are the modern versions of the ancient village market and matchmakers.[63] Prominent platforms include Alibaba, Amazon, eBay, Facebook and Google, each of which carries a global reputation and is virtually a mini-kingdom on its own. This business model is based on a market in which "multiple distinct groups of persons interact through an intermediary or platform, and the decisions of each group of persons affects the outcome for the other groups of persons through a positive or negative externality."[64] "In a multisided business model, the prices charged to the members of each group reflect the effects of these externalities. If the activities of one side create a positive externality for another side (for example more clicks by users on links sponsored by advertisers), then the prices to that other side can be increased."[65]

[63] Andrei Hagiu, "Multi-Sided Platforms: From Microfoundations To Design And Expansion Strategies," (2006), available at www.hbs.edu/faculty/Publication%20Files/07-094.pdf; and Andrei Hagiu and Julian Wright, "Multisided Platforms," (2011), available at http://faculty.chicagobooth.edu/workshops/marketing/past/pdf/MultiSidedPlatformsHagiu.pdf.

[64] OECD, Action 1 — 2014 Deliverable, supra note 3, at 13.

[65] Ibid., at 92.

Customers are an irreplaceable source of data generation. Data is intrinsically valuable. Big data means big value.[66] It is an important factor of production, alongside labour and capital.[67] Companies use the data collected to gather insights for product development, marketing and customer service. "Big data — large pools of data that can be captured, communicated, aggregated, stored, and analyzed — is now part of every sector and function of the global economy."[68] Big data creates value by, among other things, creating transparency, improving performance management, developing more precisely tailored products or services, improving decision-making, and improving the development process of new business models, products and services.[69] More potential value lies in the use of social media to enhance communications, knowledge sharing, and collaboration within and across enterprises.[70]

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[66] See the Boston Consulting Group, David Dean, Carl Kalapesi and John Rose, "Unleashing the Value of Consumer Data," (2013) which states: "Every second of the day, a wealth of data stream from a global maze of social networks, smartphones, point-of-sale devices, medical records, financial transactions, automobiles, energy meters, and other digital sources. Such big data, fueled largely by personal data about all of us, represent an asset class every bit as valuable as gold or oil." (available at www.bcgtelaviv.com/documents/file124851.pdf).

[67] McKinsey Global Institute, James Manyika, Michael Chui, Brad Brown, Jacques Bughin, Richard Dobbs, Charles Roxburgh and Angela Hung Byers, eds., "Big data: The next frontier for innovation, competition, and productivity," (2011), available at http://www.mckinsey.com/insights/business_technology/big_data_the_next_frontier_for_innovation; McKinsey iConsumer Research, Bertil Chappius, Ewan Duncan, Brendan Gaffey and Kevin Roche, "The next stage: Six ways the digital consumer is changing," (2012), available at http://mckinseyonmarketingandsales.com/sites/default/files/pdf/iconsumer_digital_consumer_trends.pdf; World Economic Forum, "Unlocking the Value of Personal Data: From Collection to Usage," (2013), available at http://www3.weforum.org/docs/WEF_IT_UnlockingValuePersonalData_CollectionUsage_Report_2013.pdf.

[68] Ibid.

[69] Ibid.

[70] It was estimated by the McKinsey Global Institute that by fully implementing social technologies, companies have an opportunity to raise the productivity of interaction workers — high-skill knowledge workers, including managers and professionals — by 20 to 25 per cent. See McKinsey Global

3.4 Tax challenges for developing countries

The above business models and features raise important questions about where and how much profit is earned for tax purposes. The dematerialization and mobility features of the digital economy are, fundamentally, at odds with the existing tax policymaking process and tax principles which were developed for the traditional economy.

3.4.1 National tax sovereignty

Existing CIT and VAT laws applicable to cross-border transactions are creatures of national tax sovereignty. Cross-border coordination is achieved through formal bilateral tax treaties in the case of CIT or the adoption of international norms or best practices in the case of VAT. There are no formal global tax institutions, legal instruments or processes for addressing cross-border tax issues. The OECD has been a de facto world tax organization in terms of developing the OECD Model Convention and its Commentaries, as well as guidelines on transfer pricing and other international tax issues. At best, these amount to "soft law" for OECD countries and would have, expectedly, no legal effect on non-OECD countries. The United Nations plays an increasingly important role in the area of international taxation but, similar to the OECD, it also has no tax law-making power.

The digital economy is borderless in nature. It offers opportunities for businesses (especially MNEs) to exploit differences between and among national tax laws in order to minimize their tax obligations in host or home jurisdictions. At the same time, different national tax laws may also cause double or multiple taxation of income arising from cross-border transactions.

3.4.2 Jurisdictional nexus

Jurisdictional nexus under existing tax laws of developing countries is based on physical and tangible connections between a taxpayer and a taxing country. These connections include residential ties or

Institute, "The social economy: Unlocking value and productivity through social technologies," (2012); McKinsey Global Institute, supra note 67.

territorial source of income. Under bilateral tax treaties, the jurisdictional threshold for business income is that of a permanent establishment (PE), which requires an element of "permanency" in the activity.

Since e-commerce requires little, if any, physical presence in the market jurisdiction, an offshore company can carry on business through a website in the market country without any physical presence. For example, a digital business can locate its website on servers outside the market country and deliver digital goods and services online, barring any legal or logistical issues as well as any Internet controls imposed by the host government. Social network providers may not need any physical presence in the market country to reach their users. Conventional sales outlets in the market country can be replaced with online licensing of software or specifications if the products can be produced through 3D printing. To the extent that some physical premises are required, an offshore company can take advantage of the exceptions under Article 5 (4) of the OECD Model Convention by tasking the local office with "preparatory and ancillary" functions, such as warehousing and delivery. Services that used to be provided in person can be provided online or provided in a manner that requires minimum presence in the market jurisdiction.

It is therefore possible for an offshore company to interact with customers (B2B or B2C) in a country through a website or other digital means (for example, an application on a mobile device) without maintaining a physical presence in that country. Remote servers are often not needed in the market country as they can be located anywhere where ICT infrastructure is available. Even if a physical presence is maintained in that country, it can avoid the PE threshold by taking advantage of the current rules. While some countries may be prepared to consider the location of a server that hosts the website of a non-resident company or a website to constitute a PE, such a position is quite controversial under the existing text of Article 5 of the United Nations or OECD Model Conventions. The dominant view is that a server located in a country for purely technical reasons would not by itself create the right to tax profits of a company using that server in its e-business, unless the business is that of providing paid Internet access to customers in the market jurisdiction, akin to that of ISPs.

3.4.3 Characterization of transactions

Dematerialization blurs the traditional distinction between "goods" and "services." A traditional sale of tangible goods can be transformed into a licence for downloading a digital file. The maturation and increasing use of 3D printing technology may further convert "goods" (sales profit) into "intangibles" (royalties or fees for technical services) if direct manufacturing for delivery evolves into a licence of designs for remote printing directly by purchasers.

Traditional royalties can be converted into services fees and can avoid withholding tax by transforming technical services or provision of software or other technologies into services delivered online. As stated in the OECD Action 1 — 2014 Deliverable, the character of payments for cloud computing and application hosting can be controversial in the context of tax treaties.[71]

The question for tax treaty purposes is often whether such payments should be treated as royalties (particularly under treaties in which the definition of royalties includes payments for rentals of commercial, industrial or scientific equipment), fees for technical services (under treaties that contain specific provisions in that respect), or business profits. More specifically, questions arise regarding whether Infrastructure-as-a-Service transactions should be treated as services (and hence payments characterized as business profits for treaty purposes), as rentals of space on the cloud service provider's servers by others (and hence be characterized as royalties for purposes of treaties that include in the definition of royalties payments for rentals of commercial, industrial, or scientific equipment), or as the provision of technical services. The same questions arise regarding payments for Software-as-a-Service or Platform-as-a-Service transactions.

Controversial characterization of payments is not unique to payments in an e-commerce context. Payments for the use of satellite, transponder, cable or optic fibre are characterized as "rental fees" in

[71] OECD, Action 1 — 2014 Deliverable, supra note 3, at 132.

some countries,[72] but "business profits" in others.[73] What is clear is that the traditional tax base under the royalty or technical service fee withholding taxes is ill-suited to capturing payments for new digital products or services.

3.4.4 Determination of profit

Current international tax norms are silent or unclear about attributing value created from the generation of data through digital products and services, such as the "free" information provided by customers to suppliers. For example, the tax base defined by Articles 5, 7 and 14 of the United Nations Model Convention and Articles 5 and 7 of the OECD Model Convention does not acknowledge the role that consumer data play in generating profit for MNEs, let alone capturing such profit.

In the digital economy, data gathered from various sources is often a primary input into the process of value creation. As pointed out by the OECD Action 1 — 2014 Deliverable, the "expanding role of data raises questions about whether current nexus rules continue to be appropriate or whether any profits attributable to the remote gathering of data by an enterprise should be taxable in the State from which the data is gathered, as well as questions about whether data is being appropriately characterised and valued for tax purposes."[74] The reliance of MNEs on intangibles accompanied by the increasing importance of data in the global value chains put additional pressure on transfer pricing rules.[75]

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[72] China, State Administration of Taxation, Circular [1998] No. 201, which was upheld by Chinese courts in *PanAmSat International Systems, Inc.* (2001). For further discussion of the PanAmSat case, see Ge Tan, "Tax Treaties' Interpretation and Application under the Challenges of the Digital Economy — Issues Raised by the PANAMSAT v. Beijing Tax Bureau," (2006) Vol. 16, No. 1 *Revenue Law* Journal, at 99; Jinyan Li, "The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base," (2012) Vol.66, No. 9 *Bulletin for International Taxation*, at 463-4.

[73] In India, for example, the courts held that such payments do not give rise to "royalty" for treaty purposes. See Asia *Satellite Communication Co. Ltd*. (332 ITR 340) (Del) and *Skycell Communications Ltd.* (251 ITR 53) (Mad).

[74] OECD, Action 1 — 2014 Deliverable, supra note 3, at 130.

[75] It is beyond the scope of the present chapter to discuss transfer pricing issues.

3.5 Loss of tax base

The tax base of developing countries is at risk in the digital economy for three primary reasons. First, the income or transaction is not captured by the existing tax laws because the business models require no physical presence or defy the characterization rules. Second, the new business models of the digital economy make it easier for companies to circumvent the existing tax rules and avoid source-country taxation (resulting in BEPS). Third, the tax base as defined under existing laws cannot be effectively administered due to the lack of enforcement mechanisms.

3.5.1 Base cyberization

Base cyberization is the broader and more fundamental issue because profit is not even in the tax base as defined by the existing jurisdictional rules. This issue goes to the fundamental assumptions underlying the design of the current system: physical presence of activities and the factors of production including land, labour and capital. As mentioned above, these assumptions do not apply to digital transactions or value derived from data sourced from customers.

3.5.2 BEPS

The BEPS issues are relevant to the extent that suppliers of goods and services in the digital economy still require physical presence in the market country, where a substantial portion of their profit is earned. For example, Google has offices in more than 60 countries, supports more than 130 languages or dialects and offers a personalized version of the search engine for more than 115 countries. Amazon has subsidiaries and/or fulfilment centres in over 22 countries in Africa, Asia, Australia, Europe, Latin America and North America.[76] Corporations conducting e-commerce may minimize assets and risks in market jurisdictions by using a subsidiary or PE to perform marketing or technical support, or to maintain a mirrored server to enable faster customer access to the products sold by the corporate group, with a principal company, often in the form of a holding company located in

[76] See http://www.amazon.com/Locations-Careers/b?ie=UTF8&node=239366011.

a low-tax jurisdiction or a tax haven, bearing the contractual risks and claiming ownership of intangibles generated by these activities.

BEPS occurs when a corporate group can avoid having a PE in the market country by using legal structures, such as commissionaires, or fragmentation of activities to avoid the time requirement, such as 183 days or six months.[77] In the case of a business selling tangible products online, a local subsidiary or PE may maintain a warehouse and assist in the fulfilment of orders and qualify for the exemptions under Article 5 (4). If a PE must be maintained, BEPS can also occur when business profit attributable to the PE is deliberately minimized by limiting the services provided through the PE. Alternatively, functions purported to be undertaken by local staff under contractual arrangements may not correspond with the substantive functions performed by the staff. For example, staff may not have formal authority to conclude contracts on behalf of a non-resident enterprise, but may perform functions that indicate effective authority to conclude those contracts. If purported allocations of assets, functions and risks do not correspond to actual allocations, or if less-than-arm's length compensation is provided for intangible property of a principal company, these structures may present BEPS concerns, particularly if emphasis is overly placed on the form or structure of transactions, and not their substance or actual reality on the ground.

BEPS issues are not unique to digital companies or e-commerce companies. All MNEs have adopted business models that incorporate ICT or e-commerce.[78] For example, Yihaodian is a Chinese company owned by Walmart. The subsidiary uses an app to allow smartphone users to shop online in 1,000 "virtual stores" accessible only on specific websites. To operate the "virtual" aspect of its business, Walmart has 1,500 employees in Silicon Valley (United States) "trying to

[77] In the absence of such structures, both the "legal profit" as defined under existing rules and "economic profit" as determined by the business activities would be taxed in the source country.

[78] *The Economist*, "The emporium strikes back: Retailers in the rich world are suffering as people buy more things online. But they are finding ways to adapt," 13 July 2013, available at http://www.economist.com/news/briefing/21581755-retailers-rich-world-are-suffering-people-buy-more-things-online-they-are-finding.

out-Amazon Amazon in areas such as logistics and making the most of social media."[79] Therefore, the global platforms used by digital companies or e-commerce companies and the reliance on data and intangibles presumably create more opportunities for BEPS.

3.5.3 Collection of taxes

Collection of taxes (CIT and VAT) is more complicated when the subject matter of cross-border transactions is digital or intangible, especially when no local intermediaries (either ISPs or financial institutions) are involved. The enforcement challenges are more immediate in respect of the VAT.

Enforcing the destination principle is difficult in the digital economy because non-resident vendors are generally not required to register for the collection of VAT purposes unless they carry on business in the destination jurisdiction. The collection of VAT on imported goods and services depends on self-assessment by the consumer. Self-assessment in B2B transactions is less problematic as the customer is often registered for VAT purposes and entitled to claim an input credit for the VAT. In contrast, self-assessment of VAT by individual customers is problematic as the amount of VAT owed might be small and the process for reporting and remitting the amount of tax lacking or inefficient. Cross-border movement of goods is subject to customs clearance, and thus creates no major issues. However, there is no equivalent fiscal frontier for the movement of digital goods and services. This is a particular concern in respect of B2C transactions, because it is unrealistic to rely on individual customers to self-report and remit the tax on online purchases from unregistered non-residents.

4. Options for developing countries

4.1 Opportunity for change

The tax challenges raised by the digital economy are global. Global solutions are therefore needed. Back in the 1920s when the current

[79] Ibid.

international tax system was developed, developing countries were not at the table. In spite of the subsequent efforts to modify the system to meet the needs of capital-importing countries, the system remains one that is largely made by developed countries for developed countries. Recent international efforts in combating BEPS provides an historical opportunity for developing countries, some of which are part of the G20, to actually have some real say in how international tax problems are resolved.

Because the digital economy brings about a fundamental shift in how business is conducted and value is created, it is necessary to investigate whether there should be a fundamental shift in thinking about the basis for allocating taxing rights. Developing countries should play an active role in the process of reshaping the international tax system. The United Nations is the ideal institution to lead this important initiative and to coordinate with the OECD.

In developing appropriate international tax rules to allocate taxing rights between countries in a fair manner, it may be helpful to revisit the fundamental theories and principles underlying the existing system. A digital economy may involve a shift in how business is done and how value is created, but it does not necessarily remove the need for an economic nexus between income and the taxing jurisdiction. Therefore, a digital economy may require new "tools" to allocate the global tax base among nation States. It remains important to keep in mind the fundamental theories and policy justifications in designing the new tools.

Developing country concerns with BEPS and base cyberization differ from those of OECD countries. To begin with, they are predominantly source countries. The tax base of the source country is defined differently under the United Nations and OECD Model Conventions, especially in respect of royalties and services. The BEPS debates have been focused primarily on the use of legally sophisticated structures to avoid the tax base defined under the OECD Model Convention, such as the use of commissionaire to avoid the classification of a dependent agency PE. The more common issue in developing countries is likely base cyberization, where the income is not captured by the existing rules, due to the design of the rules (not due to the use of artificial legal structures). Developing countries are thus advised to go beyond BEPS and to take advantage of the historical opportunity of a burgeoning multilateral process and address the fundamental base definition and tax enforcement issues that arise in a digital economy.[80] Specifically, the discussion should focus on how to change the tax rules that govern the digital economy, rather than on attempting to fit the digital economy into traditional tax rules.

4.2 Policy framework

The principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility continue to be a good starting point for a framework for evaluating options for addressing the tax challenges raised by the digital economy.[81] Under the principle of neutrality, even though the special features of the digital economy give rise to the tax issues, digital or e-commerce transactions should be taxed no differently from other forms of transactions. A tax designed to apply only to digital companies or e-commerce transactions would violate this principle.

It makes little sense to develop new rules to apply only to digital transactions. To begin with, ring-fencing the digital economy is very difficult to implement as the entire economy is increasingly digitized. Second, it violates the tax neutrality principle without any apparent policy or principled justifications. Third, the digital economy exposes the weaknesses in the fundamental design of the existing PE test and transfer pricing rules. Addressing these fundamental design issues would be more effective in the long run.

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[80] OECD, Action 1 — 2014 Deliverable, supra note 3, states that the BEPS problems are to be addressed by specific BEPS actions related to the PE, mismatch, transfer pricing, and so on, and provides no recommendations on addressing the broader issues. The Task Force on the Digital Economy will continue to work on the broader issues, evaluate how the outcomes of the OECD Project on BEPS affect the broader challenges and provide a supplementary report by December 2015. The OECD Action 1 — 2014 Deliverable clearly states that the digital economy should not be "ring-fenced" in tax policy.

[81] These principles are summarized in the OECD Public Discussion Draft on BEPS Action 1, Annex 1, along with other previous work of the OECD on e-commerce. These principles were endorsed by 29 OECD Member countries and 11 non-member countries at the Ottawa Ministerial Conference on Electronic Commerce (1998) (Ottawa Framework).

The principle of efficiency requires that the burden of tax compliance and administration be minimized as much as possible. The digital economy makes the administration of existing tax rules more difficult in respect of identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers. The existing rules were designed on the practical considerations of a bricks-and-mortar economy. It is thus important to ascertain the extent to which the new model of economy may have "altered the balance of those practical constraints."[82] "Tax administration is tax policy."[83] Interestingly, technological advances that propel the growth of digital economy may simultaneously provide novel mechanisms for tax administration and enforcement.

In addition to the above policy framework, developing countries should also consider some complementary principles, such as the principle of profit-value alignment. Under this principle, international tax rules should ensure that profits are taxed where economic activities occur and value is created; in particular, the location of real activities should take precedent over legal constructions. This principle is consistent with the purpose of the OECD Action Plan on BEPS.[84] It is also aligned with the interest of developing countries in asserting source-based taxation, especially in respect of services and royalties. The current OECD position generally favours characterizing payments as "service fees" as opposed to "royalty" or "technical fees"[85] and the OECD Model Convention does not allow the source country to tax royalties. The United Nations Model Convention has always allowed

[82] OECD Public Discussion Draft on BEPS Action 1, supra note 3, paragraph 206.

[83] Milka Casanegra de Jantscher, "Administering a VAT," in M. Gillis, C.S. Shoup and G.P. Sicat, eds., *Value Added Taxation in Developing Countries* (Washington, D.C.: World Bank, 1990), at 179. See also Richard M. Bird, "Administrative Dimensions of Tax Reform," (2004), *Asia-Pacific Tax Bulletin*, at 134.

[84] The G20 Leaders' Declaration (St. Petersburg, 6 September 2013) states that "international tax rules on tax treaties, permanent establishment and transfer pricing will be examined to ensure that profits are taxed where economic activities occur and value is created."

[85] See OECD, Action 1 — 2014 Deliverable, supra note 3, Annex A, "Prior Work on the Digital Economy," at 172-3.

withholding tax on royalties and many developing countries allow the source country to levy withholding tax on technical fees.

4.3 Nexus

The current definition of PE under the United Nations Model Convention allows a lower threshold than the OECD Model Convention, but remains anchored in the notion of a "physical presence" or human agents. A certain "physical footprint" is required.[86] Reform options are thus focused on the necessity of the physical footprint in the digital economy and/or its economic equivalent.

4.3.1 Modifying Article 5

Modifying Article 5 is a modest step in ensuring that the threshold for source-country taxation is low enough to capture some profit from e-commerce transactions. The exemptions under Article 5 (4) of the OECD Model Convention may be revised to reflect the fact that the use of a fixed place of business to purchase, warehouse and deliver merchandise may be a core activity for e-commerce businesses. Suggestions include eliminating Article 5 (4) entirely, eliminating subparagraphs (a)–(d), or making these exemptions subject to the overall condition that the character of the activity conducted be preparatory or auxiliary in nature, rather than one of the core activities of the enterprise in question.[87]

Article 5 (3) of the United Nations Model Convention may be modified by reducing the period of time required to give rise to a PE in respect of construction, assembly or installation projects, or supervisory and consultancy services. Even with further dematerialization, these types of services still need to be provided with some physical presence in the client's country. However, dematerialization can significantly reduce the amount of time required for the physical presence. Thus, the current six months or 183 days should be adjusted downwards significantly, especially in cases where a portion of the project is implemented in the service provider's home country or a third country.

[86] Ibid., at 149.

[87] Ibid., at 143.

Some BEPS structures designed to circumvent the PE status rely on a highly technical, legalistic interpretation of the definition of PE and taxpayers' contractual arrangements. Examples are the commissionaire arrangements and limited-function distributorship with a subsidiary in the market country. Developing countries can protect their tax base from erosion by adopting a purposive interpretation of the PE definition and a substance-over-form construction of taxpayers' contracts, or by invoking domestic general anti-avoidance rules. Through such interpretation approaches, it is probable and reasonable that a non-resident online seller of tangible goods or online provider of services might be treated as an entity with a PE in the market jurisdiction where the non-resident uses the sales force of a local subsidiary to negotiate and effectively conclude sales with prospective large clients (that is, B2B transactions).

The option of modifying Article 5 has the advantages of being evolutionary. It does not require any radical departure from the existing PE test and is applied to all forms of business activities. The disadvantage of this option is that it cannot deal with fully digitized, online businesses, which are discussed in the following section.[88]

4.3.2 Virtual PE or "significant digital presence"

Moving away from a physical footprint, a website or other forms of digital presence in the market jurisdiction can be considered to exhibit a sufficient nexus — a virtual PE — for sourcing the profit to that jurisdiction for tax purposes.[89] The virtual PE option seeks to

[88] The EC *Commission Expert Group on Taxation of the Digital Economy Report*, supra note 13, recommends that the realities of digital transactions be taken into account when defining exceptions to the PE (section 5.2.3.2). It agrees that a revision of the PE concept in itself may not have a big impact since the question remains how much taxable income can be allocated to such PE.

[89] The OECD Public Discussion Draft on BEPS Action 1 includes several potential options for alternative PE thresholds that were considered by the OECD Business Profits Technical Advisory Group (TAG) "for the sake of completeness" only. See OECD, Action 1 — 2014 Deliverable, supra note 3, paragraph 217.

address situations in which businesses are conducted wholly digitally.[90] A virtual PE thus includes any technological means that can enable contracts to be "habitually concluded on behalf of an enterprise with persons located in the market country."[91] A foreign enterprise providing on-site services or other business interface at the customer's location would satisfy the nexus requirement.

This option applies only to fully dematerialized digital activities.[92] Examples are where online or Internet sale of digital goods or services is the core or a substantial part of the business of the enterprise, requiring no physical stores, agencies or assets (except servers and IT tools), and the "legal or tax residence and the physical location of the vendor are disregarded by the customer and do not influence its choices."[93]

Indicia of a digital enterprise or e-commerce company's "significant digital presence" in a country include: a significant number

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[90] OECD, Action 1 — 2014 Deliverable, supra note 3, at 145-6.

[91] OECD, Public Discussion Draft on BEPS Action 1, supra note 3; EC, *Commission Expert Group on Taxation of the Digital Economy Report*, supra note 13. See also Pierre Collin and Nicolas Colin, *Task Force on Taxation of the Digital Economy*, supra note 25.

[92] OECD, Public Discussion Draft on BEPS Action 1, supra note 3, at 65: "The core business of the enterprise relies completely or in a considerable part on digital goods or digital services; No physical elements or activities are involved in the value chain other than the existence, use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialization of location-relevant data; Contracts are concluded exclusively remotely via the Internet or by telephone; Payments are made solely through credit cards or other electronic payments using on-line forms or platforms linked or integrated to the relative websites; Websites are the only means used to enter into a relationship with the enterprise; no physical stores or agencies exist for the performance of the core activities other than offices located in the parent company or operating company countries; All or the vast majority of profits are attributable to the provision of digital goods or services; The legal or tax residence and the physical location of the vendor are disregarded by the customer and do not influence its choices; or The actual use of the digital good or the performance of the digital service do not require physical presence or the involvement of a physical product other than the use of a computer, mobile devices or other IT tools."

[93] Ibid.

of contracts being concluded with customers in that country; the enterprise's goods or services being "widely used or consumed" in that country; clients in that country making substantial payments to the enterprise; or an "existing branch" of the enterprise in that country offering secondary functions such as marketing and consulting targeted at clients resident in the country that are strongly related to the core digital business of the enterprise.[94] As an alternative, it was suggested that an enterprise engaged in a fully dematerialized digital activity be deemed to have a significant digital presence if it "does a significant business in the country using personal data obtained by regular and systematic monitoring of Internet users in that country through the use of multi-sided business models."[95]

The economic rationale for such digital presence is that a non-resident company making profit from transactions with local customers takes advantage of local digital infrastructure in a manner that is analogous to its non-digital counterpart in a traditional economy making profit through a physical presence which is dependent on a market country's local infrastructure. Under the benefit theory of taxation, the company is expected to pay tax to contribute to the cost of that infrastructure just as it should be expected to share in the cost of the local digital infrastructure.

The main advantage of this option is that it helps ensure the alignment of taxing rights and economic source of profit without relying on any physical presence threshold. It is consistent with the fundamental theories underlying the current distribution of taxing rights between countries. The main drawback is that it would apply only to digital transaction and run afoul with the principle of neutrality. It would amount to "ring-fencing" the digital economy and would be difficult to administer.[96]

[94] OECD, Action 1 — 2014 Deliverable, supra note 3, at 145.

[95] Ibid.

[96] The EC, *Expert Group on Taxation of the Digital Economy Report*, supra note 13, rejects the concept of "digital taxable presence," which would include the collection, processing and monetizing of data as part of the taxable nexus. Section 5.2.3.1 of the report states that there is currently "no valid justification for such a fundamental change specifically for digital activities" and that "revenue concerns of the country where digital services and products are consumed should be adequately addressed via the VAT system."

4.3.3 "Significant business presence"

Replacing the PE test with a "significant presence" test has been suggested as an option.[97] The criteria for applying this test include: (a) relationships with customers or users extending over six months, combined with some physical presence in the country, directly or via a dependent agent; (b) the sale of goods or services by means involving a close relationship with customers in the country, including (i) through a website in the local language, (ii) offering delivery from suppliers in the jurisdiction, (iii) using banking and other facilities from suppliers in the country or (iv) offering goods or services sourced from suppliers in the country; and (c) supply of goods or services to customers in the country resulting from or involving systematic data-gathering or contributions of content from persons in the country.[98]

This proposal is not limited to digital businesses and emphasizes economic presence as opposed to physical presence. It still requires some significant presence in the market jurisdiction. It would not include many businesses involved in the digital economy. For example, a software designer supplying a program in digital form to customers all over the world from a single website in the language of its residence country would not be covered. A significant business presence test encompasses a fixed base PE, an agency PE as well as a website or other methods of value creation in the market country. Its goal is to ascertain the level of a non-resident company's engagement in the economy of the market country and the company's benefit from the infrastructure and business environment created by that country. It is consistent with the policy rationale of the current test. However, it is a radical change from the existing test, on which it could be difficult for countries to reach an agreement.

4.4 Attribution of profit

Merely revising the PE test will not suffice to protect the tax base of the market jurisdictions. The current profit attribution rules must also be

[97] Comments of the BEPS Monitoring Group on the OECD Public Discussion Draft on BEPS Action 1, published on the OECD Website (BMG Comments).

[98] Ibid.

revisited so that meaningful profit could be attributable to the market jurisdiction. Under the current rules, no, or minimal, profit could be attributable to a PE if a non-resident supplier has few people functions, assets or risks present in the market country.

The force of attraction principle under Article 7 of the United Nations Model Convention can be extended so that income earned by a non-resident company from any digital activity in the country would be taxable as long as the jurisdictional threshold is met.[99] Such a change would require some clarification of Article 7 of the United Nations Model Convention, which currently limits the principle to profit attributable to a PE, profit from sales of the same or similar kind as those sold through that PE, or other business activities carried on in the market jurisdiction of the same or similar kind as those effected through the PE. In essence, the expanded force of attraction principle would deem all online or digital activities as "same or similar" for purposes of Article 7.

4.5 Transfer Pricing

Allocation of profit to a PE or subsidiary of an MNE is currently governed by the arm's length principle and transfer pricing rules. The key features of the digital economy has put tremendous pressure on the existing transfer pricing rules, which were conceived to function in a different business environment. The policy question is whether "the transfer pricing rules based on the arm's length principle (ALP) are theoretically equipped to address [the BEPS problems]?" The OECD Action 1 — 2014 Deliverable does not list transfer pricing as a broader tax challenge of the digital economy. Critics of the OECD approach claims that "it is high time to acknowledge this core deficiency of the ALP and adopt tax solutions for the present." [100]

[99] See Walter Hellerstein, "Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments," (2014) Vol.68, No. 6/7 *Bulletin for International Taxation*, 346 at 349.

[100] Comments of the BEPS Monitoring Group on the OECD Public Discussion Draft on BEPS Action 1, published on the OECD Website (BMG Comments). See also "BEPS Monitoring Group Critiques OECD Report on Transfer Pricing Comparability Data and Developing Countries," (2014), *Tax Notes International*, at 153.

The separate entity, transaction-by-transaction, comparable approach endorsed by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[101] are difficult for developing countries to administer. As noted by China and India in Chapter 10 of the United Nations Practical Manual on Transfer Pricing[102] (2012), it is extremely difficult to find comparables in transitioning economies. Through BEPS structures, MNEs often treat subsidiaries in developing countries as limited-function entities and attribute profit to them for their so-called routine functions. Local contributions to the global value chains of these MNEs are often ignored. The tax base of developing countries would therefore suffer under the current transfer pricing rules, which fail to recognize the economic reality of MNEs operating as single-minded entities through coordination made possible by digital technology.

Despite the rigidity of the OECD rules, it would be in the interest of developing countries to work with the OECD in designing measures to address artificial transfer pricing manipulation. More importantly, developing countries should probably advocate a move to the use of a profit split or other profit apportionment methods based on the value chains used by MNEs. Value created by data, by people as consumers and producers, should be appropriately recognized, and value attributable to risks that are within the control of MNEs should not be inflated through internal contracts. If MNEs act as unitary business beings, they should be treated as such in tax law. A global profit split method based on some measurements of profit (for example, the use of data, sales, and so on) derived in each country in which an MNE has a significant business presence may be an appropriate option.

4.6 Characterization and withholding tax

Expanding withholding taxes to cover payments for digital transactions has been suggested as a possible option.[103] The current United

[101] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2010).

[102] *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2012).

[103] OECD, Action 1 — 2014 Deliverable, supra note 3, at 146.

Nations Model Convention allows a broader scope of withholding taxes than the OECD Model Convention, especially in respect of royalties. Developing countries may find this option of great interest because dematerialization has meant a conversion of traditional services into digital services, including technical services that fall within the scope of services giving rise to royalties. The base erosion occurs when payments fall outside the existing withholding tax system as well as when the payer of the service fees claims a tax deduction in computing its income (that is, B2B transactions).[104]

Deeming all B2B service fees as royalties would have several advantages. First, it is evolutionary and, thus, would be more easily accepted. The domestic law of some countries, such as China and India, treat payment of fees for ICT services as royalties.[105] The United Nations Committee of Experts has suggested adding a new provision in the United Nations Model Convention on technical services. Second, it is consistent with the principle of neutrality, as services delivered online would be subject to the same rules (as an alternative, all digital services could be deemed to be "technical services" or royalty-generating services) as services delivered through various physical media. Third, it would be administratively feasible. The existing mechanism of withholding can be used. As discussed above, it is difficult to characterize transactions in the digital economy in general and related-party B2B transactions in particular. Thus a general deeming rule

[104] As an alternative, to protect the tax base from B2B payment of service fees where the provider has no PE in the market country, the source country could deny the deduction of payment to the resident company — a "draconian" method that could be used in limited circumstances.

[105] In India, for example, the courts held that such payments do not give rise to "royalty" for treaty purposes. See Asia Satellite Communication Co. Ltd. (332 ITR 340) (Del) and Skycell Communications Ltd. (251 ITR 53) (Mad); China, State Administration of Taxation, Circular [1998] No. 201, which was upheld by Chinese courts in *PanAmSat International Systems, Inc.* (2001). For further discussion of the PanAmSat case, see Ge Tan, "Tax Treaties' Interpretation and Application under the Challenges of the Digital Economy — Issues Raised by the PANAMSAT v. Beijing Tax Bureau," (2006), supra note 72; Jinyan Li, "The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base," supra note 72, at 463-4.

has a catch-all effect that allows the effective collection of the widest base possible, although B2C transactions would not be subject to this deeming rule.

However, this option is not without disadvantages. It would be a shift in the "source rule" for services. Instead of the place of performance, the source rules would be similar to that in United Nations Model Convention Article 12 (5) (residence of payer) or United Nations Model Convention Article 12 (6). It would be a departure from the current OECD position that e-commerce payments should be characterized as business profits, not subject to withholding tax. A withholding tax might be a poor proxy for a tax on net income and the tax burden would be shifted to resident companies, increasing their cost of doing business. If the source-country tax is not recognized by the residence country, there is potential for double taxation. Like other options, there are administrative challenges.

4.7 VAT registration of offshore suppliers

To ensure the collection of VAT on purchases by domestic customers in B2B or B2C transactions from non-resident vendors which have no PE in the country would require the non-resident vendors to register and account for the VAT. South Africa has already introduced this requirement in respect of "electronic services" in B2B and B2C transactions.[106] The threshold for registration is the value of such sales exceeding R50,000.

Multilateral cooperation among countries could help make the requirement easier to enforce. Corporations, such as Amazon, eBay and Google would certainly have the technology and administrative means to comply with the requirement. In the United States, Amazon and other online vendors are required to collect and remit state-level sales taxes under the laws of a number of states in which they have a warehouse or distribution centre — the "Amazon tax."[107] There are

[106] See note 23.

[107] Amazon collects sales taxes on sales sold into over 20 states in the United States, see http://www.amazon.com/gp/help/customer/display.html?nodeId=468512. For further discussion, see Brian Baugh, Itzhak Ben-David

practical difficulties associated with requiring offshore suppliers to register, collect and remit VAT. Smaller suppliers may find the cost of compliance prohibitive.

5. Conclusions

The digital economy raises the same kind of tax challenges for developing countries and OECD countries. However, the adverse impact of these challenges is likely greater in developing countries as they rely more heavily on CIT and VAT and are net-importing countries. To protect the tax base, developing countries have options. Some options are more immediate, such as amending domestic law to require VAT registration of offshore suppliers of digital goods and services or extending withholding tax to technical services. Other options require more multilateral coordination, such as reforming the test for jurisdictional nexus or adopting a global profit split method. Ultimately, the tax base of developing countries is tied to the growing global digital economy.

and Hoonsuk Park, "The 'Amazon Tax': Empirical Evidence from Amazon and Main Street Retailers," (2014), Charles A. Dice Center Working Paper No. 2014-05; Fisher College of Business, available at http://ssrn.com/abstract=2422403.

Chapter IX

Tax incentives: protecting the tax base

Eric M. Zolt*

1. Overview

The present chapter seeks to provide an overview of key issues facing policymakers in deciding whether to use tax incentives to attract investment and how best to design and administer these incentives to minimize erosion of the tax base in developing countries. It focuses on three key questions:

(a) How can developing countries best design and administer tax incentives to increase their effectiveness?

(b) How do tax systems in developed countries influence the desirability or effectiveness of tax incentives in developing countries?

(c) How does the project launched by the Organisation for Economic Co-operation and Development (OECD) to deal with base erosion and profit shifting (OECD project on BEPS)[1] change the tax environment related to developing countries' tax incentives?

Before turning to these questions, the following are some initial observations.[2] Some contend that tax incentives, particularly for foreign direct investment, are both bad in theory and in practice. Tax

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[1] See Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/tax/beps-reports.htm; and OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf.

[2] Parts of the discussion in the present chapter rely on Alex Easson and Eric M. Zolt, "Tax Incentives," World Bank Institute (Washington, D.C.: World Bank Group, 2002), available at http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf.

incentives are bad in theory because they distort investment decisions. Tax incentives are bad in practice because they are often ineffective, inefficient and prone to abuse and corruption.

Yet almost all countries use tax incentives. In developed countries, tax incentives often take the form of investment tax credits, accelerated depreciation and favourable tax treatment for expenditures on research and development. To the extent possible in the post-World Trade Organization (WTO) world, developed countries also adopt tax regimes that favour export activities and seek to provide their resident corporations a competitive advantage in the global marketplace. Many transition and developing countries have an additional focus. Tax incentives are used to encourage domestic industries and to attract foreign investment. Here, the tools of choice are often tax holidays, regional investment incentives, special enterprise zones and reinvestment incentives.

Much has been written about the desirability of using tax incentives to attract new investment. The United Nations,[3] the International Monetary Fund (IMF),[4] the OECD[5] and the World

[3] See, for example, United Nations Conference on Trade and Development, *Tax Incentives and Foreign Direct Investment* (United Nations publication, Sales No. E.96.II.A.6); and *Tax Incentives and Foreign Direct Investment: A Global Survey* (United Nations publication, Sales No. E.01.II.D.5).

[4] See, for example, George E. Lent, "Tax Incentives for Investment in Developing Countries," (1967) Vol. 14, No. 2 *Staff Papers, International Monetary Fund,* 249; Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries," International Monetary Fund (Washington, D.C.: IMF, 2001); Alexander Klemm, "Causes, Benefits and Risks of Business Tax Incentives," International Monetary Fund (Washington, D.C.: IMF, 2009); David Holland and Richard J. Vann, "Income Tax Incentives for Investment," in Victor Thuronyi, ed., *Tax Law Design and Drafting* (Washington, D.C.: IMF, 1998), Vol. 2, 986-1020.

[5] See, for example, Organisation for Economic Co-operation and Development, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis*, Tax Policy Study No. 17, (2007); OECD, "Tax Incentives for Investment: A Global Perspective: experiences in MENA and non-MENA countries," in *Making Reforms Succeed: Moving Forward with the MENA Investment Policy Agenda* (Paris: OECD, 2008).

Bank[6] have produced useful reports that provide guidance to policymakers on whether to adopt tax incentives and how best to design them. The empirical evidence on the cost-effectiveness of using tax incentives to increase investment is inconclusive. While economists have made significant advances in determining the correlation between increased tax incentives and increased investment, it is challenging to determine whether tax incentives caused the additional investments. This is partly because it is difficult to determine the amount of marginal investment associated with the tax benefit — that is to say, the investments that would not otherwise have occurred "but for" the tax benefits. While foreign investors often claim that tax incentives were necessary for the investment decision, it is not easy to determine the validity of the claim. Governments often adopt tax incentives in a package with other reforms designed to improve the climate for investment, making it difficult to determine the portion of new investment that is attributable to tax benefits and the portion that relates to other pro-investor reforms. With these qualifications, it is sometimes easy to conclude that a particular tax incentive scheme has resulted in little new investment, with a substantial cost to the government. In other cases, however, tax incentives have clearly played an important role in attracting new investment that contributed to substantial increases in growth and development.

One place to start thinking about tax incentives is to consider what role governments should play in encouraging growth and development. Governments have many social and economic objectives and a variety of tools to achieve those objectives.[7] Tax policy is just one

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[6] See, for example, Robin W. Broadway and Anwar Shah, "Perspectives on the Role of Investment Incentives in Developing Countries," World Bank (Washington, D.C.: World Bank, 1992); Sebastian James, "Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications," World Bank Group (Washington, D.C.: WBG, 2013); Sebastian James, "Incentives and Investments: Evidence and Policy Implications," World Bank Group (Washington, D.C.: WBG, 2009); Alex Easson and Eric M. Zolt, "Tax Incentives," supra note 2.

[7] See, generally, Richard M. Bird and Eric M. Zolt, "Tax Policy in Emerging Countries," (2008) Vol. 26, *Environment and Planning C: Government and Policy*, 73-86; Richard M. Bird, "Tax Incentives for Investment in Devel-

option, and taxes are just one part of a complex decision as to where to make new domestic investment or commit foreign investment. Governments have a greater role than to focus on relative effective tax burdens. Governments need to consider their role in improving the entire investment climate to encourage new domestic and foreign investment, rather than simply doling out tax benefits. Thus, while much of the focus on tax incentives is on the taxes imposed by government, it is also important to examine the government spending side of the equation. Investors, both domestic and foreign, benefit from government expenditures. A comparison of relative tax burdens requires consideration of relative benefits from government services.

1.1 Definition of tax incentives

At one level, tax incentives are easy to identify. They are those special provisions that allow for exclusions, credits, preferential tax rates or deferral of tax liability. Tax incentives can take many forms: tax holidays for a limited duration, current deductibility for certain types of expenditures, or reduced import tariffs or customs duties. At another level, it can be difficult to distinguish between provisions considered part of the general tax structure and those that provide special treatment. This distinction will become more important when countries become limited in their ability to adopt targeted tax incentives. For example, a country can provide a 10 per cent corporate tax rate for income from manufacturing. This low tax rate can be considered simply an attractive feature of the general tax structure as it applies to all taxpayers (domestic and foreign) or it can be seen as a special tax incentive (restricted to manufacturing) in the context of the entire tax system.

Tax incentives can also be defined in terms of their effect on reducing the effective tax burden for a specific project.[8] This approach compares the relative tax burden on a project that qualifies for a tax

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oping Countries," in Guillermo Perry, John Whalley and Gary McMahon, eds., *Fiscal Reform and Structural Change in Developing Countries* (London: Canada: Macmillan in association with the International Development Research Centre, 2000), Vol. 1, 201-21.

[8] Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries," supra note 4.

incentive to the tax burden that would be borne in the absence of a special tax provision. This approach is useful in comparing the relative effectiveness of different types of tax incentives in reducing the tax burden associated with a project.

Commentators contend tax incentives may now play a larger role in influencing investment decisions than in past years. Several factors explain why tax considerations may have become more important in investment decisions.[9] First, tax incentives may be more generous now than in past years. The effective reduction in tax burden for investment projects may be greater than in the past, as tax holiday periods increase from two years to ten years or the tax relief provided in certain enterprise zones comes to include trade taxes as well as income taxes. Second, over the past several decades there has been substantial trade liberalization and greater capital mobility. As non-tax barriers decline, the significance of taxes as an important factor in investment decisions increases. Third, business has changed in many ways. Firms have made major changes in organizational structure, production and distribution methods, and the types of products being manufactured and sold. Highly mobile services and intangibles are a much higher portion of cross-border transactions than in past years.

Fewer firms now produce their products entirely in one country. Many of them contract out to third parties (either unrelated third parties or related "contract manufacturers") some or all of their production. With improvements in transportation and communication, component parts are often produced in multiple countries, which results in increased competition for production among several countries. In addition, distribution arrangements have evolved, where the functions and risks within a related group of corporations are allocated to reduce tax liability through so-called commissionaire arrangements. Finally, there has been substantial growth in common markets, customs unions and free trade areas. Firms can now supply several national markets from a single location. This will likely encourage competition among countries within a common area to serve as the host country for firms servicing the entire area.

[9] Alex Easson, "Tax Incentives for Foreign Investment, Part I: Recent Trends and Countertrends," (2001) Vol. 55, *Bulletin for International Fiscal Documentation*, 266.

While tax incentives can make investing in a particular country more attractive, they cannot compensate for deficiencies in the design of the tax system or inadequate physical, financial, legal or institutional infrastructure. In some countries, tax incentives have been justified because the general tax system places investments in those countries at a competitive disadvantage compared with other countries. It makes little sense, however, to use tax incentives to compensate for high corporate tax rates, inadequate depreciation allowances or the failure to allow companies that incur losses in early years to use those losses to reduce taxes in later years. The better approach is to bring the corporate tax regime closer to international practice rather than grant favourable tax treatment to specific investors. Similarly, tax incentives are a poor response to the economic or political problems that may exist in a country. If a country has inadequate protection of property rights, rigid employment laws or a poorly functioning legal system, it is necessary to engage in the difficult and lengthy process of correcting these deficiencies rather than provide investors with additional tax benefits.

The effectiveness of tax incentives is directly related to the investment climate (including investor confidence that a revenue authority will actually honour tax incentives without controversy) in a particular country.[10] While two countries could provide identical tax incentives (for example, a 10-year holiday for corporate income taxes), the relative effectiveness of the incentive in attracting foreign direct investment is substantially greater for the country with the better investment climate.[11]

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[10] Stefan Van Parys and Sebastian James, "Why Tax Incentives May be an Ineffective Tool to Encouraging Investment? — The Role of Investment Climate," International Monetary Fund, World Bank Group (Washington, D.C.: IMF, WBG, 2009), available at http://ssrn.com/abstract=1568296.

[11] Sebastian James, "Providing Incentives for Investment: Advice for Policymakers in Developing Countries," Investment Climate in Practice, No. 7, World Bank Group (Washington, D.C.: WBG, 2010). He estimates that tax incentives in a country with a good investment climate may be eight times more effective in attracting foreign investment than in countries with less favourable investment environments.

1.2 Different types of tax competition

Tax incentives are all about tax competition—how can a country attract investment that otherwise would have gone to a different region or country? Countries may seek to compete for different types of investments, such as headquarters and service businesses, mobile light assembly plants or automobile manufacturing facilities. The starting point in thinking about tax competition is to consider the reasons why foreign investors invest in a particular country. At a highly-stylized general level, there are three primary reasons to engage in cross-border investments: (a) to exploit natural resources; (b) to facilitate the selling or production of goods or services in a particular market; and (c) to take advantage of favourable conditions in a particular country (such as relatively low wages for qualified workers) to produce goods for export (either as finished products or as components). The competition for foreign investment will differ depending on the reason for the investment. For example, tax competition will exist among countries of a common customs union for the manufacturing or distribution facility that will service the entire region. In contrast, for export platforms, the competition will be among countries that have similar comparative advantages. As such, the competition for investment may be global, among countries in a particular region, or even among states within a particular country. The key point is that the design and the effectiveness of tax incentives will differ depending on the type of investment.

1.3 Additional investment incentives

Countries will compete for foreign investment using any means available to them. Non-tax incentives, such as training grants, low-cost loans or infrastructure improvements can be substitutes or complements to tax incentives. If challenges exist to using tax incentives (for example, due to agreements not to use particular types of tax incentives or because of the structure of the tax regime in the foreign investor's home country), then countries will likely make greater use of non-tax incentives.

A different form of investment incentives is tax-related, but not generally included in the list of types of tax incentives. These disguised tax incentives can include liberal safe harbours in transfer pricing rules, provisions that facilitate aggressive tax planning, and even tacit forms of lax tax enforcement. For example, the United States "check-the-box" regulations can be viewed as a tax incentive to allow United States multinational entities to compete more effectively with non-United States multinational entities by using hybrid entities to minimize foreign tax liability in high-tax countries.

1.4 Role of non-tax factors

Deciding whether and where to invest is a complex decision. It is not surprising that tax considerations are just one factor in these decisions. Commentators have listed several factors that influence investment decisions, particularly those of foreign investors.[12] A partial list of these factors is set forth in Box 1.

Box 1. Non-tax factors influencing investment decisions

1. Consistent and stable macroeconomic and fiscal policy.
2. Political stability.
3. Adequate physical, financial, legal and institutional infrastructure.
4. Effective, transparent and accountable public administration.
5. Skilled labour force and flexible labour code governing employer and employee relations.
6. Availability of adequate dispute resolution mechanisms.
7. Foreign exchange rules and the ability to repatriate profits.
8. Language and cultural conditions.
9. Factor and product markets — size and efficiency.

Most surveys of business executives conclude that taxes were often not a major consideration in deciding whether and where to invest. For most types of investments, there is a two-part decision. First, from a business perspective, which country would be the best choice

[12] Sebastian James, "Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications," supra note 6.

for achieving a particular investment objective? And second, from a tax perspective, how would activities be structured to minimize tax liabilities (both on a country basis and an aggregate worldwide basis)?

1.5 Review of empirical evidence

Several economic studies have examined the effect of taxes on investment, particularly foreign direct investment. While it is not easy to compare the results of different empirical studies, scholars have attempted to survey the various studies and to reach some conclusions as regards the effect of taxes on levels of foreign investment. Useful surveys are included in the "Ruding Report,"[13] Hines,[14] Mooij and Ederveen,[15] and Klemm and Van Parys.[16] These surveys note the difficulty of comparing the results of different studies because the studies contain different data sources, methodologies and limitations. The studies also report different types of elasticities in measuring the responsiveness of investment to taxes.

Part of the difficulty in determining the effect of taxes on foreign investment is getting a good understanding of the different types of foreign investment and the different sources of funding for foreign investment. Foreign investment consists of both portfolio and direct investment. While different ways to distinguish portfolio and direct investment exist, a common approach is to focus on the foreign investor's percentage ownership of the domestic enterprise. For example,

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[13] Commission of the European Communities (CEC), *Report of the Committee of Independent Experts on Company Taxation* (1992) (Official Publications of the EC, ISBN 92-826-4277-1).

[14] James R. Hines, Jr., "Tax Policy and the Activities of Multinational Corporations," in Alan Auerbach, ed., *Fiscal Policy: Lessons from Economic Research* (Cambridge, MA: MIT Press, 1997) and James R. Hines, Jr., "Lessons from Behavioral Responses to International Taxation," (1999) Vol. 52, *National Tax Journal,* 305.

[15] Ruud A. de Mooij and Sjef Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research," (2003) Vol. 10, No. 6 *International Tax and Public Finance,* 673-93.

[16] Alexander Klemm and Stefan Van Parys, "Empirical Evidence on the Effects of Tax Incentives," International Monetary Fund (Washington, D.C.: IMF, 2009).

if the foreign investor owns a greater than 10 per cent stake in an enterprise, the investment is likely more than a mere passive holding for investment purposes. Foreign direct investment can be further divided into direct transfers from a parent company to a foreign affiliate through debt or equity contributions and reinvested earnings by the foreign affiliate.

The different forms of foreign investment are also important, as each form may respond differently to taxes. Types of foreign investment include: (a) real investments in plant and equipment; (b) financial flows associated with mergers and acquisitions; (c) increased investment in foreign affiliates; and (d) joint ventures. Finally, commentators have noted that taxes may affect a decision as to the source of financing more than decisions as to the level of investment.[17] Investors have several alternatives on how to fund new ventures or expand existing operations. Taxes likely play a role in the choice of whether to make a new equity investment, use internal or external borrowing or use retained earnings to finance investments.

When the results of tax incentive regimes are examined seriously, there are successes and failures.[18] A good review of the results of incentives is set forth in a 1996 United Nations study.[19] The United Nations study concludes that "as other policy and non-policy conditions converge, the role of incentives becomes more important at the margin, especially for projects that are cost-oriented and mobile."[20] The OECD reaches a similar conclusion in finding that host country taxation affects investment flows and that it is an increasingly important factor in locational decisions.[21]

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[17] Alan Auerbach, "The Cost of Capital and Investment in Developing Countries," in Anwar Shah, ed., *Fiscal Incentives for Investment and Innovation* (Washington, D.C.: World Bank Group, 1995), Vol. 1.

[18] See Ngee Choon Chia and John Whalley, "Patterns in Investment Tax Incentives Among Developing Countries," in Anwar Shah, ed., *Fiscal Incentives for Investment in Developing Countries* (Washington, D.C.: World Bank, 1992).

[19] United Nations Conference on Trade and Development, *Tax Incentives and Foreign Direct Investment*, supra note 3.

[20] Ibid., 44-45.

[21] W. Steven Clark, "Tax Incentives for Foreign Direct Investment:

2. Tax incentives: benefits and costs, design and administrative considerations

This section examines the benefits and costs of using tax incentives as well as important considerations in designing, granting and monitoring the use of tax incentives to increase investment and growth. Tax incentives are often criticized on grounds that they erode the tax base without any substantial effects on the level of investment. It is not easy, however, to separate criticism of the tax incentive regimes that are actually adopted from criticism of all tax incentives. Advisers have recognized that certain well-designed tax incentives have been successful in increasing investment.

2.1 Benefits and costs of tax incentives

2.1.1 Benefits of tax incentives

If properly designed and implemented, tax incentives are a useful tool in attracting investments that would not have been made without the provision of tax benefits. Tax incentives are justified if they correct market inefficiencies or generate positive externalities. Some commentators view such tax incentives as desirable, in that without government intervention the level of foreign direct investment would be suboptimal.[22]

It is not surprising that governments often choose tax incentives over other types of government action. It is much easier to provide tax benefits than to correct deficiencies in the legal system or to dramatically improve the communications system in a country. Also, tax incentives do not require an actual expenditure of funds by the government. Some alternatives do, such as the provision of grants or cash subsidies to investors. Although tax incentives and cash grants may be similar economically, for political and other reasons, it is easier to provide tax benefits than to actually provide funds to investors.

Empirical Evidence on Effects and Alternative Policy Options," (2000) Vol. 48, *Canadian Tax Journal,* 1139.

[22] Yoram Y. Margalioth, "Tax Competition, Foreign Direct Investment and Growth: Using Tax Incentives to Promote Developing Countries," (2003) Vol. 23, *Virginia Tax Review,* 161.

New foreign direct investment may bring substantial benefits, some of which are not easily quantifiable. A well-targeted tax incentive programme may be successful in attracting specific projects or specific types of investors at reasonable costs compared with the benefits received. The types of benefits from tax incentives for foreign investment follow the traditional list of benefits resulting from foreign direct investment. These include increased capital transfers, transfers of know-how and technology, increased employment and assistance in improving conditions in less-developed areas.

Foreign direct investment (FDI) may generate substantial spillover effects. For example, the choice of location for a large manufacturing facility will not only result in increased investment and employment in that facility, but also at firms that supply and distribute the products from it. Economic growth will increase the spending power of the country's residents that, in turn, will increase demand for new goods and services. Increased investment may also increase government tax revenue either directly from taxes paid by the investor (for example, after the expiration of the tax holiday period) or indirectly through increased tax revenues received from employees, suppliers and consumers.

This positive view of the benefits of foreign direct investment has recently been challenged by Yariv Brauner.[23] Like other scholars, Brauner questions whether tax incentives actually increase the level of foreign direct investment. However, Brauner goes further and challenges whether foreign direct investment actually generates economic growth that is beneficial for development. Under this view, even if tax incentives succeed in attracting new investment, it is not clear, with many types of foreign investments, that the developing country benefits.

One can provide a general description of the types of benefits of additional investment resulting from tax incentives. It is difficult, however, to estimate the benefits resulting from tax incentives with any degree of certainty. Sometimes the benefits are hard to quantify. Other times the benefit accrues to persons other than the firm receiving the tax benefits.

[23] Yariv Brauner, "The Future of Tax Incentives for Developing Countries," in Yariv Brauner and Miranda Stewart, eds., *Tax Law and Development* (Cheltenham: Edward Elger Publishing, 2014).

2.1.2 Costs of tax incentives

In considering the costs of a tax incentive regime, it may be useful to examine four different types of costs: (a) revenue costs; (b) resource allocation costs; (c) enforcement and compliance costs; and (d) the costs associated with corruption and lack of transparency.[24]

2.1.2.1 Revenue costs

The tax revenue losses from tax incentives come from two primary sources: first, forgone revenue from projects that would have been undertaken even if the investor did not receive any tax incentives; and, second, lost revenue from investors and activities that improperly claim incentives or shift income from related taxable firms to those firms qualifying for favourable tax treatment.

Policymakers seek to target tax incentives to achieve the greatest possible benefits for the lowest costs. Ideally, the objective would be to offer tax incentives only to those investors who at the margin would invest elsewhere but for the tax incentives. Offering tax incentives to those investors whose decisions to invest are not affected by the proposed tax benefit merely results in a transfer to the investor from the host government without any gain. However, it is very difficult to determine on a project-by-project basis which of them were undertaken solely due to tax incentives. Similarly, it is hard to estimate for an economy as a whole what the levels of investment would be with or without a tax incentive regime.

For those projects that would not have been undertaken without tax incentives, there is no real loss of tax revenue from those firms. To the extent that the firms become regular taxpayers or that these operations generate other tax revenue (such as increased profits from suppliers or increased wage taxes from employees), there are revenue gains from those projects.

An additional revenue cost of tax incentives results from erosion of the revenue base due to taxpayers abusing the tax incentive regimes

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[24] Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries," supra note 4.

to avoid paying taxes on non-qualifying activities or income. This can take many forms. Revenue losses can result where taxpayers disguise their operations to qualify for tax benefits. For example, if tax incentives are available only to foreign investors, local firms or individuals can use foreign corporations through which to route their local investments. Similarly, if tax benefits are available only to new firms, then taxpayers can reincorporate or set up many new related corporations to be treated as a new taxpayer under the tax incentive regime.

Other leakages occur where taxpayers use tax incentives to reduce the tax liability from non-qualified activities. For example, assume that a firm qualifies for a tax holiday because it is engaged in a type of activity that the government believes merits tax incentives. It is likely quite difficult to monitor the firm's operation to ensure it does not engage in additional non-qualifying activities. Even where the activities are separated, it is very difficult to monitor related-party transactions to make sure that income is not shifted from a taxable firm to a related one that qualifies for a tax holiday.

2.1.2.2 Resource allocation costs

If tax incentives are successful, they will cause additional investment in sectors, regions or countries that would not otherwise have occurred. Sometimes this additional investment will correct for market failures. Other times, however, the tax incentives will cause allocation of resources that may result in too much investment in certain activities or too little investment in other non-tax favoured areas.

It is difficult to determine the effects of tax provisions in countries where markets are relatively developed. It is even more difficult to determine the consequences of tax provisions in developing countries where markets are not well approximated by existing competitive models. As such, where markets are imperfect, it is not clear whether providing tax incentives to correct market imperfections will make markets more competitive.[25]

[25] Richard George Lipsey and Kelvin Lancaster, "The General Theory of Second Best," (1956) Vol. 24, No. 11 *Review of Economic Studies*.

2.1.2.3 Enforcement and compliance costs

As with any tax provision, there are resource costs incurred by the government in enforcing the tax rules and by taxpayers in complying. The cost of enforcement relates to the initial grant of the incentive as well as the costs incurred in monitoring compliance with the qualification requirements and enforcing any recapture provisions upon termination or failure to continue to qualify. The greater the complexity of the tax incentive regime, the higher the enforcement costs (as well as compliance costs) may be. Similarly, tax incentive schemes that have many beneficiaries are harder to enforce than narrowly targeted regimes.

It is also difficult to get revenue authorities enthusiastic about spending resources to monitor tax incentive schemes. Revenue authorities seek to use their limited administrative resources to improve tax collection, so it is not surprising that they prefer auditing fully taxable firms rather than those firms operating under a tax holiday arrangement.

2.1.2.4 Opportunities for corruption

The existence of corruption can constitute a major barrier to foreign investment in a country. This does not, however, prevent foreign investors from benefiting from a corrupt system. Recent scholars have focused on the corruption and other rent-seeking behaviour associated with the granting of tax incentives. Several different policy approaches exist to designing the qualification requirements for tax incentives. Policymakers can choose between automatic and objective approaches versus discretionary and subjective approaches. The opportunity for corruption is much greater for tax incentive regimes, where officials have much discretion in determining which investors or projects receive favourable treatment. The potential for abuse is also greater where no clear guidelines exist for qualification.

The IMF, the OECD and the World Bank have projects that try to reduce corruption and provide assistance to countries to establish anti-corruption programmes.[26] One element of such programmes

[26] OECD, United Nations Office on Drugs and Crime (UNODC) and World Bank, *Anti-Corruption Ethics and Compliance Handbook for Business,*

should be the monitoring of foreign investment projects and, especially, the granting of investment incentives. If a tax incentive is subsequently found to have been improperly obtained, then, in addition to any other legal sanctions, the privileges should be withdrawn and any tax that has been avoided should be repaid.

2.1.2.5 Estimates of costs of tax incentives

Even where tax incentives succeed in attracting investment, the costs of the incentives may exceed the benefit derived from the new investment. This is difficult to substantiate, as problems exist in estimating the costs and benefits of tax incentives. One method of cost-benefit analysis is to estimate the cost (in terms of revenue forgone and/or direct financial subsidies) for each job created. Studies using this approach may not provide a true measure of efficiency, because they measure only the cost, and not the value, of the jobs created. The cost of jobs, however, varies widely according to the country and the industrial sector, and the more "expensive" jobs may bring with them greater spillover benefits, such as technology transfer.

All revenue estimates are based on a set of assumptions about responses of taxpayers to particular tax law changes. In assessing the performance of tax incentive schemes, the objective is to determine the amount of incremental investment resulting from tax incentives and to be able to determine the costs and benefits associated with attracting that investment.

This requires making assumptions about such items as: (a) the amount of investment that would have been made without the tax incentive programme; (b) the amount of "leakage" from the tax base due to taxpayers improperly claiming the tax incentives or from shifting income from taxable to related tax-exempt (or lower-taxed)

available at http://www.unodc.org/documents/corruption/Publications/2013/Anti-CorruptionEthicsComplianceHandbook.pdf; OECD, Asian Development Bank Organization for Economic Co-operation and Development, Anti-Corruption Initiative for Asia and the Pacific (see http://www.oecd.org/site/adboecdanti-corruptioninitiative/publications.htm); Vito Tanzi, "Corruption Around the World: Causes, Consequences, Scope and Cures," (1980) Vol. 45, No. 4 *Staff Papers, International Monetary Fund*.

entities; and (c) the tax revenue gained from either activities from taxpayers granted a tax incentive after the incentive expired or from the activities generating other sources of tax revenue.

Two methods to increase accountability and transparency of tax incentives are tax incentive budgets and general tax expenditure analysis. As discussed below, in many countries the tax authorities do not have sole responsibility or discretion in designing and administering tax incentive programmes. In many countries, different government agencies, such as foreign investment agencies or ministries of economy, have a role in designing investment regimes, approving projects, and monitoring investments. These agencies' major objective is attracting investments; they are often less concerned with protecting the tax base.

One approach that merits consideration is to set a target monetary amount of tax benefits to be granted under a tax incentive regime. This would require both the tax authorities and other government agencies to agree on both a target amount and a methodology for determining the revenue costs associated with a particular tax incentive regime.

A second method that merits serious consideration is to include tax incentives in a formal "tax expenditure budget." All OECD countries and several other countries require estimates to be prepared on the revenue impact of certain existing and proposed tax provisions. The goal of these budgets is to highlight the revenue consequences of providing tax benefits. This approach seeks to treat tax expenditures in a manner similar to direct spending programmes, and thus effectively equates direct spending by the government with indirect spending by the government through the tax system. While the scope of tax expenditure analysis goes beyond tax incentives, countries can choose to follow this approach for only certain types of tax incentives or for a broader class of tax provisions. For those countries that do not have a formal tax expenditure requirement, it makes good sense to go through the exercise in deciding whether to adopt or retain a tax incentive regime.[27]

[27] Sebastian James, "Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications," supra note 6.

2.2 Design considerations for tax incentives

2.2.1 Eligibility issues

Tax incentives are departures from the benchmark system that are granted only to those investors or investments that satisfy prescribed conditions. These special tax privileges may be justified only if they attract investments that are both particularly desirable and that would not be made without such tax benefits. Thus, the first question in designing a tax incentive system is "What types of investment are the incentives intended to attract?"

2.2.1.1 Targeting of incentives

Incentives may be broadly targeted — for example, they may target all new investment, foreign or domestic — or they may be very narrowly targeted, and designed with one particular proposed investment in mind. The targeting of incentives serves two important purposes: (a) it identifies the types of investment that host governments seek to attract; and (b) it reduces the cost of incentives because it reduces the number of investors that benefit.

This raises the question of whether a government should treat some types of investment as more desirable or beneficial than others. Should a government seek to attract tax incentives and target them at particular types of investments and not others, or should investment decisions be left solely to market forces? Justifiable doubt exists about the ability of politicians to "pick winners," particularly in countries where markets are less than perfect. Also, there are some types of investment that, while not prohibited altogether, may not deserve encouragement in the form of tax benefits. Ideally, incentives should be given only for incremental investment; that is, for investments that would not otherwise have occurred but for the tax benefits.

An initial question is whether the granting of tax incentives should be discretionary, or automatic once the prescribed conditions are met. In many cases it may be advisable to limit discretion. But if qualification for incentives is made largely automatic, it becomes necessary for the qualifying conditions to be spelled out clearly and in detail.

Many countries grant preferential tax treatment to certain sectors of the economy, or to certain types of activities. Sectoral targeting has many advantages: (a) it restricts the benefits of the incentives to those types of investment that policymakers consider to be most desirable; and (b) it also makes it possible to target those sectors that are most likely to be influenced by tax considerations. Among the activities commonly preferred are manufacturing activities, pioneer industries, export promotion, locational incentives and investments that result in significant transfers of technology.

Countries may elect to restrict investment incentives to manufacturing activities or provide for those activities to receive preferential treatment (for example, China, Ireland). This may reflect a perception that manufacturing is somehow more valuable than the provision of services, perhaps because of its potential to create employment, or a view that services (with some exceptions) tend to be more market-driven and therefore less likely to be influenced by tax considerations.

Some countries adopt a more sophisticated approach and restrict special investment incentives to certain broadly listed activities or sectors of the economy. These countries can restrict tax incentives to "pioneer" enterprises. Generally, to be accorded pioneer status, an enterprise must manufacture products that are not already produced domestically, or engage in certain other listed activities that are not being performed by domestic firms and that are considered especially beneficial to the host country.

Many countries also provide tax incentives to locate investments in particular areas or regions within the country. Sometimes the incentives are provided by regional or local governments, in competition with other parts of the same country. In other cases, the incentives are offered by the central government, often as part of its regional development policy, to promote investment in less developed regions of the country or in areas of high unemployment.

One benefit of foreign direct investment is the creation of new employment opportunities and, not surprisingly, incentives are frequently provided specifically to encourage job creation. Policymakers could provide for tax incentives for investment in regions of high unemployment, or they could tie the tax incentive directly to employment, with the creation of a stipulated number of new jobs as a qualifying condition for the tax holiday or other incentive.

Foreign direct investment often results in the transfer of technology. Even critics of tax incentives concede that they may be useful to promote activities such as research and development, if only as a way of correcting market imperfections. Countries attempt to attract technologically advanced investment in several ways: (a) by targeting incentives at technologically advanced sectors; (b) by providing incentives for the acquisition of technologically advanced equipment; and (c) by providing incentives for carrying out research and development (R & D activities).

Finally, the experience of many developing countries is that export promotion, and the attraction of export-oriented investment, is the quickest and most successful route to economic growth. It is therefore hardly surprising that competition to attract such investment is especially fierce, and investment incentives are frequently targeted at export-oriented production. Incentives targeted specifically at export-oriented investment may be more effective than other tax incentives, due to the higher degree of mobility of such investment.

2.2.1.2 Forms of tax incentives

Designing tax incentives requires two basic decisions: (a) determining the types of investment that qualify; and (b) determining the form of tax incentive to adopt. Tax incentives for investment take a variety of forms. Table 1 sets forth the most commonly employed tax incentives.

This section examines three different types of tax incentives: tax holidays, investment credits and allowances, and tax credit accounts. While the first two types of incentives are used frequently, the tax credit account approach has received too little attention from policymakers.

Table 1:
Prevalence of tax incentives around the world[28]

	Number of countries surveyed	Tax holiday/ tax exemption	Reduced tax rate	Investment allowance/ tax credit	VAT exemption/ reduction	R & D tax incentive	Super-deductions	SEZ[a]/Free Zones EPZ[b]/ Free port	Discretionary process
		Percentage							
East Asia and the Pacific	12	92	92	75	75	83	8	83	25
Eastern Europe and Central Asia	16	75	31	19	94	31	0	94	38
Latin America and the Caribbean	24	75	29	46	58	13	4	75	29
Middle-East and North Africa	15	73	40	13	60	0	0	80	27
OECD	33	21	30	61	79	76	18	67	27
South Asia	7	100	43	71	100	29	57	71	14
Sub-Saharan Africa	30	60	63	73	73	10	23	57	47

[a]Special economic zone (SEZ).
[b]Export processing zone (EPZ).

[28] Ibid.

2.2.1.3 Tax holidays

In developing countries, tax holidays are by far the most common form of tax incentive for investment. A tax holiday may take the form of a complete exemption from profits tax (and sometimes from other taxes as well), a reduced rate of tax, or a combination of the two (for example, two years exemption, plus a further three years at half-rate). The exemption or reduction is granted for a limited duration.

Tax holidays can vary in duration from as little as one year to as long as twenty years. In determining the length of the tax holiday, a clear trade-off exists between the attractiveness to investors and the revenue cost to the host country's treasury. Most studies have concluded that short tax holidays are of limited value or interest to most potential investors and are rarely effective in attracting investment, other than short-term, "footloose" projects. Substantial investments often take several years before they begin to show a profit, by which time the tax holiday may have expired. Short tax holidays are of the greatest value to investments that can be expected to show a quick profit and are consequently quite effective in attracting investment in export-oriented activities such as textile production. Since that sector is highly mobile, however, it is not uncommon for a firm to enjoy a tax holiday in one country and, when it expires, to move its entire operation to another country that is willing to give a new holiday. Consequently, the benefit of the investment to the host country may be quite limited.

Tax holidays have the apparent advantage of simplicity for both the enterprise and the tax authorities. The simplest tax holiday regime, and most investor-friendly, provides not only that no tax is payable during the holiday period, but also that taxpayers are not required to file information or tax returns. While this results in an absence of compliance or administrative costs, the better approach is to require the filing of a tax return during the holiday period. For example, if the enterprise is allowed to carry forward losses incurred in the holiday period or to claim depreciation allowances after the end of the holiday for expenditure incurred during the holiday, the enterprise will obviously need to file a return or at least keep appropriate records.

Additionally, tax holidays are especially prone to manipulation and provide opportunities for tax avoidance and abuse. Another disadvantage is that the revenue cost of tax holidays cannot be estimated in advance with any degree of accuracy, nor is the cost related to the amount of the investment or to the benefits that may accrue to the host country. Finally, tax holidays exempt profits without regard to the level or amount of profits that are earned. For potential investments that investors believe will earn above market returns, tax holidays will result in a loss of tax revenue without any benefits. Because of the high return, investors would have undertaken these projects even without the availability of tax incentives.[29]

2.2.1.4 Investment allowances and credits

As an alternative, or sometimes in addition, to tax holidays, some governments provide investment allowances or credits. These are given in addition to the normal depreciation allowances, with the result that the investor may be able to write off an amount that is greater than the cost of the investment. An investment allowance reduces taxable income, whereas an investment tax credit is set against the tax payable; thus, with a corporate income tax rate of 40 per cent, an investment allowance of 50 per cent of the amount invested equates to an investment credit of 20 per cent of that amount.

Investment allowances or credits may apply to all forms of capital investment, or they may be restricted to specific categories, such as machinery or technologically advanced equipment, or to capital investment in certain activities, such as research and development. Sometimes, countries limit eligibility to contributions to the charter capital of the firm. This approach may encourage investors to increase the relative amount of equity capital rather than related-party debt capital in the firm's initial capital structure.

One objection to the use of investment allowances and credits is that they favour capital-intensive investment and may be less favourable towards employment creation than tax holidays. They may also distort the choice of capital assets, possibly creating a preference for short-lived assets so that a further allowance or credit may be claimed on replacement.

[29] Vito Tanzi and Howell H. Zee, "Tax Policy for Emerging Markets: Developing Countries," International Monetary Fund (Washington, D.C.: IMF, 2000).

Investment allowances and credits seem preferable to tax holidays in almost every respect: (a) they are not open-ended; (b) the revenue cost is directly related to the amount of the investment, so there should be no need for a minimum threshold for eligibility; and (c) their maximum cost is more easily estimated. A recent study, however, finds that investment credit and allowances are significantly less effective in attracting foreign investment than tax holidays.[30]

2.2.1.5 Tax credit accounts

Vito Tanzi and Howell Zee propose an interesting approach to offering tax benefits to potential investors that allows taxing authorities to determine with great certainty the revenue costs of the tax incentive programme.[31] This approach provides each qualifying investor a specific amount of tax relief in the form of a tax credit account (say, for example, potential exemption for US$ 500,000 of corporate income tax liability). The investor would be required to file tax returns and keep books and records just like any other taxpayer. If the investor determines it has US$ 60,000 of tax liability in year one, it would pay no tax, but the amount in its tax account would be reduced to US$ 440,000 for future tax years. The tax credit account has the advantage of providing transparency and certainty to both the potential investor and the government.

The tax credit account may be regarded as a sort of hybrid: a cross between a tax holiday and an investment tax credit. It resembles a tax holiday, except that the tax exemption period, instead of being a fixed number of years, is related to the amount of taxes due on the income earned (for example, the exemption applies to the first US$ 500,000 of taxable income). This has two important advantages: the cost of the incentive to the host government is known, and there is no strong built-in advantage for those investments that make quick profits. The tax credit account also resembles an investment tax credit in that the amount of the credit is a fixed sum; where it differs is that the amount

[30] Alexander Klemm and Stefan Van Parys, "Empirical Evidence on the Effects of Tax Incentives," supra note 16.

[31] Vito Tanzi and Howell H. Zee, "Tax Policy for Emerging Markets: Developing Countries," supra note 29.

is not determined by the amount of the investment. It consequently does not provide a preference to capital-intensive investments.

2.2.2 Implementation issues

2.2.2.1 Initial compliance with qualifying conditions

The first administrative issue is determining whether an investor meets the qualifying conditions. Some incentive provisions require initial approval or some other positive decision. For example, officials may need to determine that the investment is in a priority sector or that prescribed employment or export targets will be met, or that environmental requirements will be complied with. Generally, tax authorities will require some form of written certification of qualification. A second type of qualifying condition requires what is essentially a factual determination: for example, that the foreign participation in a joint venture exceeds a stipulated percentage, that a certain number of new jobs have been created, that a particular capital investment falls within a category qualifying for accelerated depreciation, or that imported equipment can be classified as "advanced technology." Tax authorities sometimes carry out this verification: otherwise, they can be expected to require written confirmation from the appropriate authority or department. A third type of condition requires a valuation of assets. For example, investors may be required to establish that the amount invested exceeds the minimum stipulated amount needed to qualify for a tax holiday, or that an investment qualifies for a tax credit of a given amount.

2.2.2.2 Reporting and monitoring continuing compliance

Conditions are sometimes attached to incentives that are related to ongoing performance — for example, requirements that a given number of jobs are maintained, or that a certain percentage of production is exported, throughout the tax holiday period. Incentives of this type require continual monitoring. Although this imposes an additional administrative burden on authorities, it does have the merit of providing the host government with a reasonably accurate idea of how an investment is performing. Without a formal monitoring mechanism, investors have little reason to make realistic projections as to the number of jobs that will be created, or the volume of exports that will be produced, and some studies have shown large discrepancies between investor prediction and performance. However, it is important that administrative capabilities to conduct necessary monitoring are taken into account when incentive legislation is drafted so that unnecessary supervision is avoided.

2.2.2.3 Common abuses

Ongoing monitoring of investments is necessary not only to ensure continuing compliance with qualifying conditions but also to detect tax avoidance or evasion. Tax avoidance presents greater difficulties, because countries have different attitudes as to what constitutes avoidance, and what to do about it. For example, a tax holiday may be conditional upon employing a given number of persons. In some countries an investor could legitimately make up the qualifying number by hiring "employees" with minimal duties and at low wages. In other countries, this course of action might be considered an abuse of the legislation and result in the denial or withdrawal of the tax privilege.

Box 2 sets forth some of the more common abuses associated with tax incentives. The related discussion provides additional details of some of these abuses.

Box 2. Top ten abuses of tax incentive regimes

1. Existing firms transforming to new entities to qualify for incentives.
2. Domestic firms restructuring as foreign investors.
3. Transfer pricing schemes with related entities (sales, services, loans, royalties, management contracts).
4. Churning or fictitious investments (lack of recapture rules).
5. Schemes to accelerate income (or defer deductions) at the end of a tax holiday period.
6. Overvaluation of assets for depreciation, tax credit, or other purposes.

7. Employment and training credits — fictitious employees and phony training programmes.
8. Export zones — leakages into domestic economy.
9. Regional investment incentives and enterprise zones — diverting activities to outside the region or zone.
10. Disguising or burying of non-qualifying activities into qualifying activities.

2.2.2.4 Round-tripping

Round-tripping typically occurs where tax incentives are restricted to foreign investors or to investments with a prescribed minimum percentage of foreign ownership. Domestic investors may seek to disguise their investments to qualify for incentives for foreign investment by routing their investment through a wholly controlled foreign corporation. Similar practices have occurred in a number of transition economies, especially in connection with the privatization of State-owned firms, where the existing management has acquired ownership of the firm through the vehicle of an offshore company.[32]

2.2.2.5 Double dipping

Many tax incentives, especially tax holidays, are restricted to new investors. In practice, such a restriction may be ineffective or counterproductive. An existing investor that plans to expand its activities will simply incorporate a subsidiary to carry on the activity, and the subsidiary will qualify for a new tax holiday. A different type of abuse occurs where a business is sold towards the end of the tax holiday period to a new investor who then claims a new tax holiday. Sometimes the "new" investor is related to the seller, although the relationship is concealed. A more satisfactory approach for policymakers may be to use investment allowances or credits, rather than tax holidays, so that new investments, rather than investors, qualify.

[32] Round-tripping is not always undertaken in order to meet foreign ownership requirements; it may also be used to take advantage of favourable tax treaty provisions.

2.2.2.6 Transfer pricing

Transfer pricing has been described as "the Achilles heel of tax holidays,"[33] although it can be a problem with other forms of investment incentives as well. The tendency is to think of transfer pricing as a phenomenon that occurs internationally in transactions between related enterprises in different countries. Transfer pricing can also take place in a single country where an investor has two or more operations within a country or where the investor derives income from more than one activity. If one of those operations, or one type of income, enjoys a tax preference, profits will tend to be allocated to the preferred activity.

Transfer pricing is likely to take place where: (a) an investor undertakes two or more activities, one of which qualifies for an incentive (for example, manufacturing, exporting) and another does not; (b) an investor has operations in two or more locations, one of which is in a tax-privileged region and another is not; or (c) an investor owns two or more subsidiaries, one of which enjoys a tax holiday and another does not. In each of these cases the investor will wish to allocate as much profit as possible to the tax-exempt (or tax-privileged) entity or activity. In cases (a) and (b) there may be only a single entity, in which case there is no transfer pricing as such, but an equivalent result is achieved through the allocation of revenues and expenditures.

Substantial challenges exist for monitoring transfer pricing, especially for small or less-developed countries. One approach may be to use those tax incentives that are less prone to transfer pricing abuses. For example, in contrast to tax holidays, investment allowances or credits provide an exemption from tax of a given amount, rather than for a given period. Consequently, artificial transfers of profits to a firm that has been granted an investment allowance or credit may result in tax liability being postponed but not eliminated.

[33] Charles E. McLure, Jr., "Tax Holidays and Investment Incentives: A Comparative Analysis," (1999) Vol. 53, *Bulletin for International Fiscal Documentation,* 326-327.

2.2.2.7 Overvaluation

Overvaluation (or sometimes undervaluation) is a constant problem in any tax system. Tax incentives, however, may provide additional temptations to inflate the values of assets. For example, where a tax holiday is conditional upon a certain minimum amount being invested, the value of assets contributed to the new firm can be manipulated to achieve the target figure. Sometimes this is done legitimately. For example, firms may purchase machinery rather than lease property from independent lessors. Other times, however, an inflated value is attributed to the property contributed, especially in the case of intellectual property. In cases where investors also receive an exemption from customs duty for newly contributed capital, no compensating motivation exists to correctly state the value, and no reason exists for customs authorities to pay much attention to the declared value.[34]

2.2.2.8 Abuse of duty-free privileges

A common investment incentive takes the form of an exemption from customs duty on imported equipment. A danger is that, once imported, items may be resold on the domestic market. A partial solution is to restrict the exemption to those assets that are contributed to the charter capital of the enterprise. Even so, it may be necessary to verify periodically that the assets remain in the enterprise. Another approach is to restrict the exemption to assets such as machinery (which are less likely to be resold) and to exclude items such as passenger vehicles and computer equipment.

2.2.2.9 Asset stripping and "fly-by-night" operations

Many countries have experienced problems with "fly-by-night" operators that take advantage of tax incentives to make a quick, tax-free profit and then disappear to begin operations in some other country

[34] Sometimes there is a further problem. Foreign investment agencies have an incentive to boost their investment figures, so that there is some sort of common interest between the agency and the investor to inflate the amount of the investment. It is thus important for the tax administration to be involved in the valuation process.

that offers tax privileges. This problem most often arises with the use of tax holidays and export processing zones. A further problem sometimes occurs where a foreign investor acquires control of an existing local enterprise and instead of contributing new capital to modernize the enterprise, the investor strips it of its useful assets and simply disappears.[35]

Some countries have attempted to counter the "fly-by-night" problem by introducing "clawback" provisions. For example, a country can grant a tax holiday for a 5-year period, but only if the venture continues for a period of 10 years. If the venture is terminated before the end of the ten-year period, any tax "spared" must be repaid. The difficulty with such a provision is that the investor may have vanished before it is possible to claw back any of the forgiven tax liability.

2.2.3 Review and sunset provisions

The costs and benefits of tax incentives are not easy to evaluate and are hard to quantify and estimate. Incentives that may work well in one country or region may be ineffective in another context. Tax incentive regimes in many countries have evolved from general tax holidays to incentive regimes that are more narrowly targeted.

It therefore may make sense (a) to limit the duration of tax incentive regimes to reduce the potential costs of unsuccessful or poorly designed programmes by including a specific "sunset" provision as part of the original legislation; (b) to design incentive regimes to require information reporting by beneficiaries to investment agencies and to specify what government agency has responsibility for monitoring and enforcing qualification and any recapture provisions; and (c) to require an evaluation as to the costs and benefits of specific tax incentive regimes and to specify the timing of the evaluation and the parties responsible for conducting the review.

[35] This latter problem is not necessarily linked to the availability of tax incentives, although the ability to make a tax-free capital gain is an added attraction to the asset stripper.

2.2.4 Guidance for policymakers

No shortage exists on advice to policymakers on how to design and implement tax incentives. Richard M. Bird has put forth a relatively concise prescription.[36] He first recommends that policymakers keep tax incentives simple. Bird contends that attempts to fine-tune incentives to achieve detailed policy goals are likely to be costly to administer and unlikely to produce the desired result. Second, Bird recommends that the government keep good records on who gets what tax incentives, for what time period and at what costs in revenue forgone. This information is necessary to ensure transparency and accountability. Finally, governments must evaluate the effectiveness of tax incentives in achieving the desired results and be willing to terminate or modify those incentive programmes that fail to achieve their objectives.

The OECD has prepared a "best practice" guide to aid in the transparency and governance of tax incentives in developing countries.[37] Box 3 provides a summary of the OECD recommendations.

Box 3. OECD draft principles to enhance the transparency and governance of tax incentives for investment in developing countries

1. Make public a statement of all tax incentives for investments and their objectives within the governing framework.
2. Provide tax incentives for investment through tax laws only.
3. Consolidate all tax incentives for investment under the authority of one government body, where possible.
4. Ensure tax incentives for investments are ratified through the lawmaking body or parliament.
5. Administer tax incentives for investment in a transparent manner.

[36] Richard M. Bird, "Tax Incentives for Investment in Developing Countries," supra note 7.

[37] OECD, Draft Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries, available at http://www.oecd.org/ctp/tax-global/transparency-and-governance-principles.pdf.

6. Calculate the amount of revenue forgone attributable to tax incentives for investment and publicly release a statement of tax expenditures.
7. Carry out periodic review of the continuance of existing tax incentives by assessing the extent to which they meet the stated objectives.
8. Highlight the largest beneficiaries of tax incentives for investment by specific provision in a regular statement of tax expenditures, where possible.
9. Collect data systematically to underpin the statement of tax expenditures for investment and to monitor the overall effects and effectiveness of individual tax incentives.
10. Enhance regional cooperation to avoid harmful tax competition.

3. Impact of developed countries' tax systems on the desirability or effectiveness of tax incentives

The effectiveness of tax incentives is tied not only to taxes imposed in the country of the investment but also to the taxes imposed by other countries, most notably the home country of the foreign investor. Foreign investors focus on their aggregate worldwide tax liability, which requires consideration of the tax systems of those countries where they are required to pay taxes as well as the tax regimes of their country of residence. It is therefore important to consider the investor's home country's tax system in estimating the influence of tax incentives offered by the host country in attracting investment. Countries generally tax their corporate taxpayers on their foreign source income under one of two alternatives: (a) the "credit" method, whereby corporate taxpayers are taxed on their worldwide income and receive a foreign tax credit against their domestic tax liability for foreign income taxes paid on the foreign source income; or (b) the "exemption" or "territorial" method, whereby corporate taxpayers are generally taxed only on their domestic source income and can exempt certain foreign source income in computing their tax liability.

In theory, foreign investors from countries that adopt the credit method are less likely to benefit from tax incentives, as the tax revenue from the favoured activities may be effectively transferred to the investor's revenue service from the tax authorities in the host country. In practice, however, because foreign investors have different alternatives to structuring their foreign investments, the effect of the different tax approach is likely to be relatively small.

3.1 Simple model

One approach to understanding how a foreign investor's home country's tax system affects the attractiveness of developing countries' tax incentives is to begin with a simple model of foreign direct investment. This simple model of direct investment assumes the foreign investor invests directly in a developing country either through a branch or through a subsidiary that immediately repatriates any profits to the parent corporation.

Under a "territorial" system, for many types of income, the tax imposed by the host country would constitute a final tax on profits earned in that country. Because foreign source income is generally not subject to tax in the investor's country of residence, any tax advantages from tax incentives will flow directly to the foreign investor.

In contrast, under a "worldwide" tax system, the foreign investor is subject to tax in both the country of the source of the income and the country of residence. This potential double taxation is generally reduced through the resident country providing a credit for foreign income taxes paid on foreign source income. But what happens if the foreign investor receives a tax incentive that substantially reduces or eliminates the tax in the country of investment?

The 2000 UNCTAD Suvey on Tax Incentives and Foreign Direct Investment provides an answer to the question above:

> In order to assess the full tax treatment of FDI [foreign direct investment], it is necessary to look into the way home countries tax the income generated in host countries. Where an investor is subject to tax under a residence-based principle, the introduction of a tax incentive such as a tax holiday reduces or eliminates tax credit in the host country. It has the effect of increasing the tax revenues in the home country dollar for dollar.

> For an investor, the total tax burden remains unchanged, negating the benefits of tax incentives. Tax incentives simply result in the transfer of tax revenues from the host country treasury to the home country treasury.[38]

The following is a simple example based on the assumption that the corporate tax rate in South Africa is 30 per cent and the corporate tax rate in the United States of America is 35 per cent and that a United States corporation invests directly in a business in South Africa. If the South African business generates US$ 1 million in profits and repatriates the profits to the United States, the South African Revenue Service would collect US$ 300,000 in taxes and the United States Internal Revenue Service would collect US$ 50,000 (the United States would impose a 35 per cent tax on the foreign income but then allow a foreign tax credit for the US$ 300,000 tax paid to the South African Government). On the further assumption that the South African Government provided a tax holiday for this investment in South Africa while the South African tax liability on the US$ 1 million profits would be reduced to zero, the United States tax liability would be increased from US$ 50,000 to US$ 350,000 (the 35 per cent United States tax without any reduction for foreign income taxes paid). While the aggregate tax liability of the United States investor remained the same, the South African tax incentive results in an effective transfer of US$ 300,000 from the South African Government to the United States Government.

To address this concern, tax sparing provisions are often included in treaties between developed and developing countries. These provisions generally treat any source country tax that, but for the tax incentive, would have been paid as foreign taxes paid for purposes of computing the tax liability in the country of residence. These tax sparing provisions ensure that the investor gets the tax benefit from tax incentives (rather than the investor's home government).

Several developed countries (with the notable exception of the United States) have included tax sparing provisions in their treaties with developing countries. Some scholars contend that the failure of

[38] United Nations Conference on Trade and Development, "*Tax Incentives and Foreign Direct Investment: A Global Survey*," supra note 3.

the United States to provide tax sparing has severely limited the attractiveness for United States companies to invest in developing countries. In order to increase investment in less developed regions, they call for the United States to provide tax sparing in treaties with developing countries or adopt an exemption system for investment in certain countries.[39]

One view of tax sparing provisions is that they constitute a form of foreign assistance from developed countries to developing countries. In essence, the developed country is transferring an amount equal to the taxes they would have collected but for the tax sparing arrangement to the treasury of the developing country. The desirability of this form of foreign assistance rests on the effectiveness of tax incentives in providing benefits to developing countries compared with the benefits from other forms of foreign assistance. Thus, if one believes that tax incentives in developing countries are largely ineffective in promoting foreign investment or economic growth, then developed countries should provide foreign assistance in a form other than tax sparing provisions.[40]

A different view of tax sparing considers the sovereign rights of countries to determine the tax liability of operations conducted in their country.[41] Here, the focus is not on paternalistic transfers from the rich to the poor, but rather the right of any country to have its tax policy respected by other countries. Thus, treaty policy should respect

[39] Other scholars have proposed alternatives to the simple tax sparing approach outlined above by either allowing tax sparing but only after grossing the amount of income to include the value of the tax subsidy, or by allowing tax sparing only for the excess profits amounts and only if the source country exempts the taxation of normal returns. See Paul McDaniel, "The U.S. Tax Treatment of Foreign Source Income Earned in Developing Countries," (2003) Vol. 35, No. 2. *George Washington International Law Review*, 265; William B. Barker, "An International Tax System for Emerging Economies, Tax Sparing, and Development: It is All About Source," (2007) Vol. 29, *University of Pennsylvania Journal of International Law*, 349. While both approaches merit further consideration, the likelihood of them being adopted is small.

[40] OECD, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998).

[41] Luis Eduardo Schoueri, "Tax Sparing: A Reconsideration of the Reconsideration," in Yariv Brauner and Miranda Stewart, eds., *Tax Law and Development* (Cheltenham: Edward Elger Publishing, 2013).

the right of source countries to have exclusive jurisdiction to decide tax policy for activities conducted in their country.

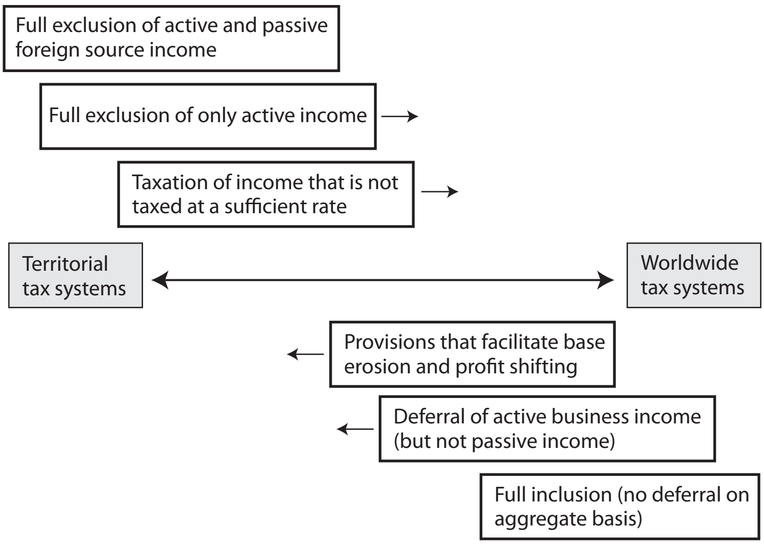
3.2 A more complex view

The question arises as to how much revenue is really being transferred from developing countries to the treasuries of developed countries, and how much foreign investment is being deterred by the absence of tax sparing provisions. The answer is probably very little. This is partly because many countries that previously had worldwide tax regimes have moved to territorial regimes. But even if a country (most notably, the United States) still retained a nominal worldwide regime, several features of the tax regime make it highly unlikely that the income earned outside the country of residence would be subject to current (or, in many cases, future) taxation.

For the reasons set forth below, the simple model of foreign direct investment likely substantially overstates the degree to which the economic benefits from tax incentives are actually diverted from the foreign investor to the tax coffers of the residence country. To see why this is the case, it is helpful to appreciate that territorial tax systems and worldwide tax regimes may be much less different from one another in practice than they appear in theory. Figure 1 shows the continuum between tax systems that are purely territorial and those that are purely worldwide tax regimes. The distinction between worldwide and territorial regimes is blurred as some worldwide regimes have territorial features and some territorial regimes (primarily through Controlled Foreign Corporation (CFC) provisions) have worldwide features.

Although the general rule is that a taxpayer subject to worldwide taxation (such as in the United States) is taxed currently on income earned abroad, the key exception is that taxation in the home country of foreign income earned through a subsidiary is deferred until the income is repatriated. While sometimes the deferral is temporary, in many cases corporations choose to “permanently reinvest” their funds outside the United States. Because of the opportunity to defer tax on foreign source active income simply by non-repatriation, United States corporations have accumulated an extraordinarily large amount of cash and other liquid securities outside the United States. Some commentators have estimated the amount to be more than US$ 2 trillion.[42] With such a large amount of money looking for productive investments, very little investment in other developed or developing countries will be made directly from the United States.

Figure 1:
Continuum of types of international tax regimes



But even without the availability of deferral of unrepatriated income, foreign investors could structure their investments in developing countries through other countries (including tax havens) so as to minimize the potential tax liability associated with foreign investments. So, for example, a large percentage of foreign investments in Africa from developed countries is routed through Mauritius, the Netherlands Antilles or Switzerland. To make matters worse, these countries have been successful in negotiating treaties with several African countries that have zero withholding rates on dividends and other types of distributions. As a result, many developing countries with extensive tax incentive regimes are not collecting revenue on the

[42] Martin A. Sullivan, "Economic Analysis: Designing Anti-Base-Erosion Rules," (2013) Vol. 70, *Tax Notes International,* 375.

income either when earned in their country or when it is transferred out of the country in the form of dividends or interest.

Additionally, as discussed earlier, the tax consequences for foreign investors depend on their worldwide tax attributes, not just their tax position in the country of investment. For those taxpayers whose countries of residence have worldwide tax systems with credits for foreign taxes paid, tax consequences will vary greatly depending on the availability of tax credits from taxes paid not only in the country which provided the tax incentives, but also from taxes paid in other foreign countries. For those taxpayers with substantial excess tax credits, the lack of tax sparing provisions does not prevent the foreign investor from obtaining the benefits of tax incentives for investments in developed or developing countries.

In sum, a strong argument can be made that the tax regimes of developed countries (even those with nominal worldwide tax systems) have little impact on the desirability or effectiveness of tax incentives in developing countries. Indeed, under certain circumstances, the potential availability of zero or low-taxed active income from foreign sources will often be very attractive to those tax directors in multinational corporations who seek to minimize the overall worldwide tax liability of the corporation. This results because tax directors can effectively "blend" other types of foreign income that are subject to tax rates above the tax rate of the country of residence with low-taxed income from developing or other countries to reduce the tax liability in the investor's home country.[43] While foreign investors will likely not choose to invest in a particular company simply for the purpose of gaining low-taxed active income, for many investors the availability of zero or low-taxed income from countries using tax incentives will be a positive factor rather than a negative one.

Interestingly, proposed changes to the tax regimes governing cross-border transactions of some developed countries may change the conclusion that developed countries' tax regimes have little impact

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[43] Edward D. Kleinbard, "Stateless Income," (2011) Vol. 11, *Florida Tax Review*, 699; Edward D. Kleinbard, "Stateless Income's Challenge to Tax Policy," (2012) Vol. 68, *Tax Notes International,* 499.

on the effectiveness of tax incentives. Mostly motivated by the success of multinational corporations in shifting income to low-tax jurisdictions while still maintaining substantial operations and sales in high-tax jurisdictions, some countries are considering imposing some type of minimum tax on foreign source income. While the types of minimum taxes being considered vary greatly both within and across countries, the basic notion is that the most desirable tax rate (for political and economic reasons) on active foreign source income is somewhere between zero and the full corporate tax rate imposed on domestic source income. For example, if the corporate tax rate imposed on domestic profits is 30 per cent, then income from foreign sources could be taxed at 15 per cent. Under tax systems that allow foreign tax credits, some or all of the foreign taxes paid could be used to offset the minimum tax imposed by the residence country. Depending on the form of minimum tax adopted, it may be that the desirability of tax incentives to foreign investors will be reduced.

4. How does the OECD project on BEPS change the tax environment for tax incentives in developing countries?

4.1 Overview

The OECD project on BEPS has the potential to significantly change the tax regimes for cross-border transactions in both developed and developing countries. It is ambitious in both its scope and time tables. The magnitude of the changes will depend largely on what form the project takes in addressing the key action items identified in the OECD Action Plan on Base Erosion and Profit Shifting (OECD Action Plan on BEPS)[44] and the willingness of countries to implement any proposed changes. From a high-level perspective, the OECD has three major options in proposing measures to limit base erosion and profit shifting:

- "Narrow approach", whereby the OECD proposes some ad hoc fixes to address the major perceived abuses of multinational entities;

[44] OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 1.

- "Broad approach", whereby the OECD adopts a more holistic approach to examine difficult issues and propose innovative solutions; and
- "Fundamental change approach", whereby several of the existing fundamental principles and policies that shape the international tax regime would be open for re-examination.[45]

For example, if the OECD recommends a series of narrowly targeted recommendations to curb some of the most notorious schemes by multinational taxpayers, it is unlikely this will result in major changes in the cross-border tax regime. In contrast, if the OECD project on BEPS recommends reforms that significantly change the allocation of profits between source and residence countries, then the project will have substantially more impact.

In the OECD Action Plan on BEPS, there are 15 action items. It is unlikely that the OECD would adopt a uniform approach in addressing the various items. For example, the OECD could adopt a "narrow approach" in addressing concerns about hybrid mismatch arrangement and adopt (although unlikely) a "fundamental change approach" to address the challenges of the digital economy. Once the OECD completes its work on this project, the question then becomes how countries will respond to the proposed recommendations. Without some type of coordinated effort among major countries, the chances for meaningful changes will be relatively small.

Even apart from the OECD project on BEPS, the notoriety around the aggressive tax planning by multinational entities has influenced the timing and scope of domestic efforts to reform tax regimes covering cross-border transactions. Many countries, including Ireland, the United Kingdom of Great Britain and Northern Ireland and the United States, have adopted or are considering reforms in the "shadow" of the OECD project on BEPS.

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[45] Yariv Brauner, "What the BEPS?" (2014) Vol. 16, *Florida Tax Review,* 55.

4.2 Relative change in tax burdens

The effectiveness and desirability of tax incentives have the potential to change substantially if the OECD project on BEPS succeeds in better matching reported taxable income with level of economic activity. This section examines two areas where tax changes resulting from the OECD project on BEPS could alter the relative attractiveness of tax incentives: first, the relative tax burdens between activities in a developing country that are not eligible and those that are eligible for tax incentives; and second, the relative tax burdens between activities conducted in developed and developing countries.

4.2.1 Relative tax burdens of activities that qualify or do not qualify for tax incentives

A key factor in considering the effectiveness and desirability of tax incentives is how much the tax liability is reduced because of tax incentives compared to the tax liability incurred by the foreign investor in the developing country under the regular tax regime. While the primary focus of the OECD project on BEPS is on how multinational entities reduce their tax liability in developed countries, it is important to appreciate that these corporations have used similar techniques in developing countries to shift taxable profits outside of the developing countries while still conducting substantial sales and manufacturing activities within the country.

As discussed below, the OECD project on BEPS has the potential to provide developing countries with additional tools that would aid in improving the ability of these countries to tax foreign investors. For example, it may set forth proposed measures to strengthen CFC rules or limit base erosion via interest deductions that would provide guidance to countries on how best to reform their tax rules to more effectively tax the income of foreign investors. Similarly, proposals that improve the quality of information available to tax authorities in developing countries have substantial potential to improve tax compliance. Here, improved rules regarding transfer pricing documentation and other OECD efforts with respect to country-by-country reporting will likely aid increasing both the level of tax compliance and the effective tax burden of doing business in a developing country.

The insight here is that increasing the relative tax burden of those activities not qualifying for tax benefits will increase the relative attractiveness of conducting activities that qualify for tax incentives. Phrased differently, foreign investors have two options for decreasing tax liability related to activities in a country — they can use base erosion and profit shifting techniques to avoid paying taxes, or they can seek tax incentives. By reducing the availability of techniques to shift profits outside the country, the relative attractiveness of tax incentives will increase.

4.2.2 Relative tax burdens in doing business in developing and developed countries

If the OECD project on BEPS succeeds in better matching economic activity with reported taxable income, then the cost of doing business in developed countries will increase.[46] This increase in tax burdens in doing business in developed countries will likely make the tax regimes of developing countries relatively more attractive. The key determination is whether tax reform changes resulting from the BEPS project increase the tax burdens of doing business in developed countries more than they increase the tax burdens of doing business in developing countries.

There are two primary reasons why the effective increase in tax burdens will be greater in developed than in developing countries. First, some of the proposed recommendations may be more easily adopted and implemented in countries that have the capacity to administer and enforce very complex rules to counter very complex structures to avoid tax liability. Second, if multinational enterprises can no longer conduct operations in developed countries and shift profits to low-tax jurisdictions, then the relative attractiveness of locating economic activity in developing countries will increase, especially with the availability of tax incentives.

4.3 Additional tools

One exciting aspect of the OECD project on BEPS is the potential to provide tax authorities with additional tools to improve tax collection

[46] International Monetary Fund, "Spillovers in International Corporate Taxation," (2014) *IMF Policy Paper.*

in developing countries. While it is still too soon to determine whether it will be successful, the work will likely produce results that will be useful to tax authorities in developing countries. For example, if the OECD provides a summary of "best practices" to address specific abuses, then this work may aid developing countries in reforming their domestic tax law to improve the effectiveness of their tax regime. Depending on how well the proposed recommendations work in the tax environment in developing countries, great potential exists to improve rules related to such items as hybrid arrangements, CFC rules and provisions to curtail excessive interest stripping.

Similarly, developing countries could be major beneficiaries if the OECD project on BEPS increases the quality of information available to tax authorities. Again, this assumes the information is in a form that can be useful to tax authorities. So, for example, country-by-country reporting requirements and rules that require taxpayers to disclose aggressive tax planning arrangements could prove extremely useful to tax authorities in developing countries.

One important area in which the OECD project on BEPS could be useful to developing countries is transfer pricing. While the OECD has stated that they will maintain the basic foundation of arm's-length pricing, it likely does not preclude the introduction of "formula apportionment methods" as part of a nominal arm's-length pricing regime.

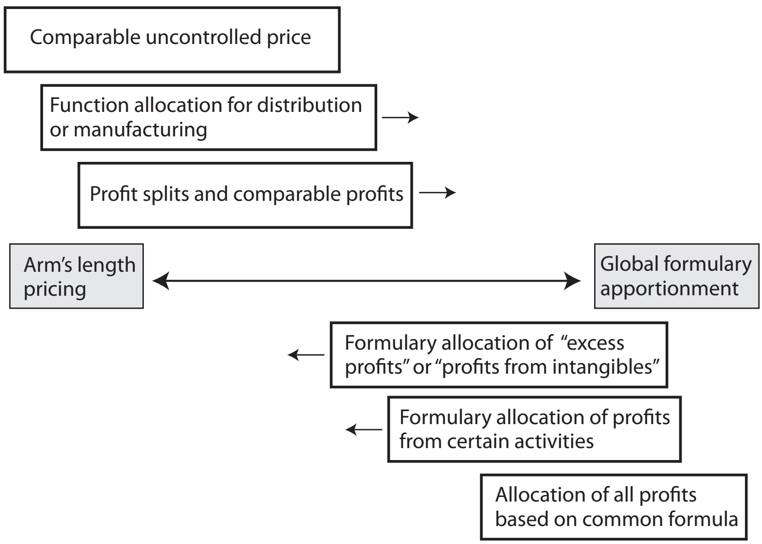
Here, the work of Reuven Avi-Yonah is useful in thinking about reform alternatives. He contends that the different types of transfer pricing arrangement are not a stark choice between arm's-length pricing and global apportionment but rather the choice of a point on the continuum that best works for a particular type of transaction (see Figure 2).[47]

The insight here is that changes in methods of determining transfer prices will likely change the allocation of taxable income among countries. In many instances, the move towards global apportionment–type methods will increase the taxable income

[47] Reuven S. Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation," (1995) Vol. 15, *Virginia Tax Review,* 89.

attributable to developing countries whose current share of total income may be less than the amount of income determined with respect to such factors as sales, employment or total assets. Changes that increase the potential tax liability for foreign investors will likely make tax incentives more attractive.

Figure 2:
Continuum of types of transfer pricing methods



5. Conclusion

Tax incentives can play a useful role in encouraging both domestic and foreign investment. How useful they may be, and at what cost, depends on how well the tax incentive programmes are designed, implemented and monitored. The present chapter has examined the costs and benefits of tax incentives, the relative advantages and disadvantages of different types of incentives, and important considerations in designing, granting and monitoring the use of tax incentives to increase investment and growth.

No easy answers exist to the questions of whether to use tax incentives and what form they should take. There are, however, some clear guidelines that may improve the chances of success of tax incentive programmes. First, the objectives of the tax incentive programme should be clearly set forth. Second, the type of tax incentive programme should be crafted to best fit the objective. Third, the government should estimate the anticipated costs and benefits of the incentive programme in a manner similar to other types of tax expenditure analysis. Fourth, the incentive programme should be designed to minimize the opportunities for corruption in the granting of incentives and for taxpayer abuse in exploiting the tax benefits. Fifth, the tax incentive regime should have a definite "sunset" provision to allow for a determination of the merits of the programme. Finally, the government should be required at a specific time to assess the success and failure of each incentive programme.

Chapter X

Transparency and disclosure

Diane Ring*

1. Introduction

1.1 Base erosion and profit shifting and tax information

Across the globe, countries increasingly express the concern that they are facing serious financial challenges from base erosion and profit shifting (BEPS). Without a stable and adequate tax base, countries lose the financial capacity to provide the infrastructure, social services and development opportunities important to their citizens. In response, the G20 and the Organisation for Economic Co-operation and Development (OECD) organized the project on BEPS. Much of the project is focused on substantive law — the rules and practices that can allow the tax base of a country to be eroded and profits to be shifted out of the country. But the project recognizes that improved substantive tax rules alone are not sufficient to guarantee the tax base of a country. Without adequate transparency and disclosure of tax information to the taxing authorities, even the most carefully designed substantive tax rules will fail to protect the base. Thus, an important part of BEPS work targets the more administrative issues of transparency and disclosure. Ultimately, the goal is to ensure that tax authorities have adequate and appropriate access to the information necessary for the effective administration of the tax law. As part of this mission, the OECD project on BEPS includes the development of standards for information reporting by multinational enterprises — referred to as "country-by-country reporting" (see section 3.3.2 below).

1.2 Broader context for tax information issues

BEPS work on transparency and disclosure is not occurring in a vacuum. Existing tools offer tax administrators different avenues for accessing

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information. Such tools include: bilateral tax treaties — based on the United Nations Model Double Taxation Convention between Developed and Developing Countries[1] (United Nations Model Convention) and/or the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital[2] (OECD Model Convention) — tax information exchange agreements (TIEAs), regional agreements, and the work of the Global Forum on Transparency and Exchange of Information for Tax Purposes (see sections 5.2–5.6 below). Additionally, there are new developments taking place outside the formal OECD project on BEPS, some initiated by individual countries, others by regional networks or other international bodies, including: intergovernmental agreements (IGAs) (see section 4.5 below), automatic exchange of information agreements, the Common Reporting Standard (CRS) for automatic exchange (see section 4.3 below), and increased attention to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (section 5.4 below).

1.3 Scope of the chapter

The purpose of this chapter is to provide developing countries with an overview of both the new developments in transparency and disclosure as well as existing options for obtaining information. Some of the new developments remain in progress and final recommendations have not yet been made. But the examination provided below of the key goals, concerns, advantages and disadvantages of various options (including existing methods and newly proposed ones) may help countries evaluate their own circumstances and determine which options make the most sense for them in their effort to curb BEPS. Given the newness of certain proposals (for example, actions taken under the OECD project on BEPS, including country-by-country (CbC) reporting), this chapter will devote more attention to reviewing the anticipated content and implementation of those options with which countries may be less familiar.

[1] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[2] Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

1.4 Pervasive questions in transparency and disclosure

Regardless of the specific mechanism for providing information to tax administrators, a number of universal questions arise: (a) What type of information must be provided? (b) How difficult will it be for the taxpayer to provide that information? (c) How will the information be provided? (d) What kind of technology and infrastructure will be needed by the taxpayers and the country to implement this system? (e) To whom will the information be distributed? (f) What are the permissible uses of the information? (g) Does the country have the capacity to meaningfully use the information? and (h) How will data protection and taxpayer privacy be ensured? The success, failure and impact of a given regime for providing tax information will depend significantly upon the responses to these concerns. That said, there is no single appropriate response to these questions. By examining each of the new emerging information regimes, as well as the existing ones, against the backdrop of these questions, a country can determine its own most effective path towards appropriately protecting its tax base.

2. Transparency and disclosure in the current tax world

2.1 Overview

Recent efforts to ensure that countries have access to the information needed to meaningfully and effectively implement their tax laws have focused on the goals of "transparency" and "disclosure." These terms appear in the OECD Action Plan on BEPS[3] and a variety of related documents and commentaries. These two terms are distinct from the related phrase "exchange of information"; thus, it may be useful to specify their meaning. All three play a critical role in guaranteeing that countries have the needed information.

2.1.1 Transparency

The term "transparency" reflects the idea that a country needs to understand how a taxpayer is conducting its business, structuring its

[3] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf.

operations and making investments in the country. To achieve this level of understanding, it may be necessary for the country to have a solid grasp of the activities, transactions and business structure of the taxpayer beyond the borders of its jurisdiction.

2.1.2 Disclosure

The term "disclosure" captures the idea that a country will need access to the information necessary to provide transparency regarding the activities of a taxpayer.

2.1.3 Exchange of information

The phrase "exchange of information" refers to the process (and mechanism) by which a country can obtain information regarding a taxpayer or the transactions of the taxpayer, typically from another country. The most well-known mechanisms for exchange of information are bilateral tax treaty provisions based on Article 26 of both the United Nations and the OECD Model Conventions, discussed in section 5.2 below.

2.2 Current need for information

As noted above, and discussed more extensively in section 5.1 below, the demand for taxpayer information by taxing authorities is not new. However, the current lack of transparency that many countries face (owing in part to insufficient disclosure) has become a significant problem. The growth in cross-border commerce by multinational enterprises (MNEs), both foreign and domestic, has created a crisis in information for several reasons, as outlined below.

2.2.1 Cross-border tax planning

Taxpayers with cross-border activities can engage in a wider array of tax planning techniques which can lead to base erosion and profit shifting. Substantive tax law changes that are designed to eliminate various arbitrage opportunities are one tool for attacking this problem. But substantive tax reform is insufficient given that arbitrage may be difficult to identify and fully eradicate. Adequate disclosure remains vital for the needed transparency regarding taxpayer activities.

2.2.2 Volume of cross-border business

Both the number of taxpayers engaging in cross-border business and the volume of business they conduct have been increasing. Thus, the scale of the base erosion and profit shifting at stake is significant. Correspondingly, the amount of information that countries must access, process and evaluate to stem the loss of tax base is also quite large. Mechanisms for providing information to countries must be tailored to promote the goal of transparency and understanding.

2.2.3 Role of developing countries in the global economy

Developing countries have experienced significant growth in inbound investment by foreign multinationals as well as in outbound activities of their own multinationals. Income generated by these MNEs forms a critical portion of the tax base and, as noted in section 2.2.1 above, is especially susceptible to base erosion and profit shifting tax planning.

For all countries facing such base erosion and profit shifting from multinationals, the ability to access and use tax information is vital. However, developing countries may find that they encounter serious barriers to securing needed information, compared with other jurisdictions. Not only do developing countries often experience a number of domestic constraints on their ability to access and use taxpayer information (see section 2.2.4.2 below), they also may find it more difficult to obtain information from other jurisdictions (see section 2.2.4.3 below). Additionally, to the extent that foreign multinationals pose a greater information transparency and disclosure risk than domestic ones, developing countries face a distinct challenge. These countries typically have a substantial amount of inbound investment relative to outbound and therefore have more foreign multinational taxpayers than domestic ones.

2.2.4 Informational challenges for developing countries

As noted in section 2.2.3 above, developing countries are especially dependent upon corporate taxation of MNEs for their tax base. To the extent that MNEs are able to engage in successful BEPS transactions, developing countries typically have fewer alternative tax bases upon which to draw (for example, individual taxes and consumption taxes).[4] Thus, BEPS problems can be particularly significant for these jurisdictions. The costs of BEPS to developing countries may be more severe and the impediments to overcoming BEPS may also be greater for these jurisdictions. Developing countries may experience a number of hurdles in securing information, transparency and disclosure from multinational businesses. A review of these barriers directs attention to the changes that may be needed and allows reform proposals to be measured against the list of challenges so as to see where and to what extent such proposals can help. The impediments can be grouped into roughly three categories: (a) domestic law; (b) domestic enforcement; and (c) international support.

2.2.4.1 Domestic law impediments

Some countries already have in place domestic law reporting requirements that provide relevant taxpayer information. Such reporting requirements can include the obligation of the taxpayer to provide information regarding: (a) foreign related entities and related-party transactions; (b) foreign financial assets and accounts; (c) discrepancies between tax reporting and accounting treatment; and (d) certain kinds of tax shelters or otherwise suspect transactions and structures. This information can be useful in helping a country determine whether to initiate an audit, and where and how to direct its attention in an audit. If a developing country does not have such reporting regimes in place, changes to domestic law reporting requirements may be one step in the process of enhancing transparency and disclosure. The final recommendations that ultimately emerge from the OECD project on BEPS regarding Actions 12 and 13 in the OECD Action Plan may play a guiding role for countries that are just starting to institute such reporting requirements (see sections 3.4 and 3.3 below, respectively).

The work of the Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum) identifies other fundamental domestic law features that can inhibit (or conversely, facilitate) transparency. The peer review process of the Global Forum

[4] See, for example, OECD, *Part I of the Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* (Paris: OECD, July 2014), at 11, available at http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf.

is intended to provide a mechanism for assessing the compliance of a country with "the international standard of transparency and exchange of information"[5] (see section 5.6 below). In evaluating a jurisdiction against this standard, the Global Forum reviews a number of key dimensions of the domestic law critical to transparency. One set of factors looks to the availability of information on the following topics: (a) ownership and identity information for entities and structures; (b) accounting records; and (c) banking information for account holders. Another set of factors looks at the rules and procedures governing access to that information. The expectation is that the designated tax authority in the country (the competent authority) has the power under domestic law to obtain such information and provide it under an exchange of information mechanism, while respecting taxpayer rights.[6] Although the focus of the peer review process and recommendations may be directed towards enhancing exchange of information with other countries, many of the same rules, practices and procedures that enable a country to participate actively in the exchange of information would improve the ability of a country to implement its own tax system and limit base erosion and profit shifting. The same availability of and access to information that enables a jurisdiction to be a global partner in sharing information with other countries would facilitate its own tax enforcement and revenue collection. Thus, engagement in the work of the Global Forum may be useful for developing countries, regardless of the amount of taxpayer information sought from their jurisdiction (see section 5.6 below).

2.2.4.2 Domestic enforcement impediments

All countries face the question of whether their administrative system is effective in using the information available. However, developing countries may face barriers to deriving maximum benefit from the

[5] Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2014: Report on Progress* (November 2014), at 16, available at http://www.oecd.org/tax/transparency/GFannualreport2014.pdf; see also ibid., *Progress Report to the G20 Finance Ministers and Central Bank Governors: Update on Effectiveness and On-going Monitoring* (September 2014).

[6] Ibid., Information Brief (November 2013), at 6-7, available at http://www.oecd.org/tax/transparency/global_forum_background%20brief.pdf.

information that they currently possess (or that they may be able to acquire in the immediate future).[7] These barriers can include: (a) limited audit staff; (b) audit staff without the required training and experience (for example, an ability to review foreign language documents, a detailed understanding of transfer pricing and tax law); (c) regular attrition of highly trained staff; (d) technological limitations to the ability to receive, manage, store and work with different types of data; (e) inadequate systems for identifying and matching taxpayers; and (f) existing culture of limited tax compliance.

Any recommendations on how to increase access to information and improve transparency and disclosure (for example, recommendations pursuant to Actions 11, 12 and 13 of the OECD Action Plan on BEPS) should be evaluated against the backdrop of such domestic enforcement impediments. For example, transparency and disclosure recommendations that could ease any of the current impediments might be particularly attractive to developing countries, even if other options were more effective for developed economies. To the extent that a particular recommendation would yield more limited benefits for a developing country owing to domestic enforcement constraints, adoption of that recommendation might be paired with a concrete support plan designed to build the capacity of the tax administration to use the information effectively so as to curb BEPS in its jurisdiction.[8]

2.2.4.3 International impediments

The success of a country in tackling BEPS will depend in part upon its ability to actively engage with the international community and obtain information from other jurisdictions. The most obvious examples of such engagement arise under exchange of information provisions in bilateral tax treaties (based on Article 26 of the United Nations and OECD Model Conventions) and under TIEAs (such as those based

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[7] See, generally, OECD, *Part I of the Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries*, supra note 4.

[8] See, for example, C20 Position Paper Background: Governance (7 August 2014), at 6, available at http://www.c20.org.au/resources/. It encourages research regarding the cost/benefit trade-off for automatic exchange of information and the impact on developing countries.

on the OECD Model Agreement on Exchange of Information on Tax Matters) (see sections 5.2 and 5.3 below). Therefore, the more limited the network of bilateral treaties and TIEAs of a country, the more constrained it may be in gathering needed information. In the same vein, bilateral tax treaties and TIEAs whose terms impose significant barriers to exchange (such as the level of information that the requester must provide, or the nature of the tax violation in the requesting State) effectively reduce the value of these agreements as meaningful tools for developing countries.

International mechanisms for sharing information across borders are important in their own right as independent and currently existing tools for responding to BEPS problems. But the availability of these mechanisms may also be important in the future as the OECD project on BEPS moves towards recommendations and action. Depending on how various action items related to transparency, disclosure and information are designed, the ability of a country to benefit fully from BEPS recommendations could depend upon its treaty network. For example, if the information gains anticipated from Action 13 (for example, a CbC reporting template) require a country to obtain that information from the home jurisdiction of the MNE parent, the question of "mechanism" would arise. If the envisaged mechanism is an exchange of information provision in an existing treaty, then developing jurisdictions, particularly those with more limited treaty networks (tax treaties and TIEAs) would find it harder to obtain the information and proceed with their efforts to stop base erosion and profit shifting. This issue is widely acknowledged, and is discussed more extensively in section 3.3.5.2 below.

2.3 Response to increased need for information

The focus of the global tax community on BEPS has included recognition of the centrality of information to tax administrations. As discussed below, the G20 also supports the OECD Action Plan on BEPS, including its attention to transparency, disclosure and information. The Action Plan operates against the backdrop of existing mechanisms for the provision of information. Its value added derives from its focus on the information-driven crisis points in BEPS. It targets the gaps created by the current system of providing information to tax authorities that leave countries susceptible to BEPS through related-party transactions, transfer pricing and cross-border arbitrage.

However, the BEPS setting is not the only context in which global tax actors continue to examine how tax administrations can be strengthened through transparency and disclosure. In some cases, individual countries have taken action that has triggered a more global response. For example, the United States implementation of the Foreign Account Tax Compliance Act (FATCA) regime, which requires foreign financial entities to disclose information regarding United States taxpayers to the United States tax authorities or face penalties, has led to the signing of IGAs (see section 4.5 below). Additionally, other countries increasingly seek to secure similar commitments for taxpayer information from foreign financial entities. In yet other cases, international bodies are promoting enhanced access to information through automatic information exchange (see section 4.2 below) and/or through the expansion of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (section 5.4 below).

Thus, while the need to acquire information is as old as the international tax system itself, the current climate for tax administrations differs from that of the past. The scale of information needed, its complexity and its importance have all grown dramatically. Although traditional information-based tools for facilitating tax compliance remain relevant and valuable, close examination of the ways in which transparency and disclosure can be enhanced is now a critical topic for countries. To that end, section 3 of this chapter reviews and analyses the work on transparency and disclosure carried out by the OECD project on BEPS. Section 4 then undertakes a similar examination of new developments in information-gathering occurring outside of the OECD project on BEPS. Finally, section 5 provides context for the new reforms and recommendations by revisiting more familiar tools and techniques currently available for enhancing transparency and disclosure.

As the review of each new and old information-related provision and practice reveals, there are no simple solutions to the complexity of today's information-rich (and information-dependent) environment. There may be substantial agreement on the importance of transparency and disclosure as broad concepts, but the effort to translate those principles into specific practices and regimes unmasks the challenges and concerns outlined in section 1.4 above. The assessment of a country of the right balance and mix among these risks, trade-offs and benefits may vary depending upon its domestic infrastructure, economic position, existing network of tax agreements and tools, and substantive tax system.

2.4 Summary of the current tax environment and its connection to transparency and disclosure

Multinationals with significant cross-border business activities form an important part of today's economy for all countries. The growth in cross-border commerce has increased the opportunity for tax planning and, correspondingly, the needs of countries for taxpayer information. Developing countries may confront a number of challenges as their tax administrators seek the information necessary for effective enforcement of the tax laws. The challenges include: (a) domestic law impediments (inadequate required reporting by multinationals regarding assets, accounts and transactions); (b) constrained domestic enforcement (owing to limited audit staff; inexperienced staff; attrition of trained staff; and insufficient technological capacity to receive, manage and store data, and to link taxpayers to data); and (c) international impediments (a limited treaty network and high treaty thresholds for requesting information). The OECD project on BEPS recognizes the centrality of tax information to meaningful tax administration and the action items discussed below explicitly seek to increase both the quality and the availability of relevant information. But in addition to the OECD project on BEPS, transparency and disclosure is the subject of other international efforts to curtail base erosion and profit shifting, including the rising number of IGAs, the support for automatic exchange of information, and the expansion of treaty networks.

3. BEPS and transparency and disclosure

3.1 Overview of BEPS action items related to tax information, transparency and disclosure

The OECD Action Plan on BEPS released in July 2013 included two significant action items related to the increased provision of information to countries by taxpayers:[9] Action 12: Require taxpayers to disclose their aggressive tax planning arrangements; and Action 13: Re-examine transfer pricing documentation (which includes the establishment of a common reporting template, referred to as "country-by-country reporting").

Currently, the most serious attention is being directed to Action 13 (transfer pricing and related issues), which includes the proposal for CbC reporting. This proposal, which has been ranked as being of "high" relevance to developing countries,[10] is discussed extensively in section 3.3 below. The companion information-reporting provision, Action 12 (aggressive tax planning), has a target deliverable date of September 2015 on the OECD Action Plan on BEPS timetable, and will likely be the subject of increased public discussion over the coming year. Action 12, reported as being of "medium" relevance to developing countries,[11] is more briefly considered in section 3.4 below.

One additional action item, Action 11, seeks to improve the understanding of countries (and of the global tax community) of the "scale and economic impact" of BEPS by establishing "methodologies to collect and analyse data on BEPS and the actions to address it." This action item, which has been listed as being of "high" relevance for developing countries,[12] has a target delivery date of September 2015, and is considered in section 3.2 below.

3.2 Action 11: collect and analyse data on BEPS

Although Actions 12 and 13 share with Action 11 the common mission of helping countries more effectively address BEPS problems through

[9] Other action items may, in a more limited manner, enhance transparency and disclosure through mechanisms not based on taxpayer provision of information. For example, Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance, focuses in part on "including compulsory spontaneous exchange on rulings related to preferential regimes."

[10] OECD, *Part I of the Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries*, supra note 4, at 31.

[11] Ibid., at 30.

[12] Ibid.

improved knowledge and understanding, their focus and "solutions" are different. Actions 12 and 13 target specific taxpayer conduct through enhanced reporting requirements for actual taxpayers. Both Actions 12 and 13 anticipate changing the kinds of information that taxpayers must provide to countries. The new information presumably would enable a country to evaluate a multinational taxpayer more effectively and accurately and identify conduct that is creating BEPS (either by aggressive planning or by cross-border related-party transactions and structures). In that way, Actions 12 and 13 function more as a support to and enhancement of the audit function.

3.2.1 Goals of Action 11

In contrast to Actions 12 and 13, Action 11 targets a more systemic goal — obtaining a comprehensive, overall picture of the BEPS problem. Action 11 is expected to "[d]evelop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis." For example, Action 11 would seek to calculate the resulting effects on overall tax receipts, total employment, geographic location of employment, investment in physical capital, investments in knowledge-based capital, tax competition, and so forth.[13] Once data and methodologies are in place to "measure" the problem, it is expected that indicators and tools to monitor the success of BEPS actions taken by countries will be developed under Action 11.[14]

The focus is on not only what is happening within a given country owing to BEPS, but also the "spillover" effects on other jurisdictions.[15] This newly collected information is expected to help

[13] OECD, *Request for Input, BEPS Action 11: Establish methodologies to collect and analyse data on BEPS and the actions to address it* (4 August 2014), at 3, available at http://www.oecd.org/ctp/public-request-for-input-beps-action-11.pdf.

[14] Ibid.

[15] See, for example, International Monetary Fund, "Spillovers in International Corporate Taxation," (2014) *IMF Policy Paper*, at 1, available at http://www.imf.org/external/np/pp/eng/2014/050914.pdf. It observes that "spillovers [from the international aspects of corporate taxation] are especially marked and important for developing countries."

policymakers and countries evaluate all of the changes implemented pursuant to the OECD Action Plan on BEPS. Thus, Action 11 will provide key diagnostic tools for determining whether the implementation of steps under other BEPS action items are meeting their goals.

3.2.2 Data collection under Action 11 and its impact

Some of the data will be collected on an aggregate basis (such as foreign direct investment (FDI) and balance-of-payments data), but the OECD Action Plan on BEPS also envisages that taxpayer-level data (financial statements, tax returns) will play an important role. We can expect that the taxpayer-level data portion of Action 11 will raise many of the same questions and concerns as Actions 12 and 13. Thus, the examination of these questions in section 3.3 below in the context of CbC reporting should be relevant and helpful to the anticipated discussion on Action 11. Future data collection and reporting under Action 11, though potentially influential in the longer term, will have less immediate relevance for those developing countries seeking to protect their tax base.

3.3 Action 13: transfer pricing–related documentation

3.3.1 Overview

Action 13 responds to the determination that transfer pricing is a crucial facet of BEPS and that tax administrators face a serious problem in responding to these BEPS issues because of information asymmetry between tax authorities and taxpayers. Tax authorities need the ability to evaluate the global value chain of an MNE and to obtain detailed data on the structure of its activities, operations and intragroup transactions. Taxpayers, too, may find current transfer pricing regimes unsatisfactory to the extent that varying transfer pricing documentation standards and practices across countries place an unnecessary and unproductive burden on reporting taxpayers.[16]

Action 13 calls for a re-examination of transfer pricing documentation, with attention devoted to two potentially competing goals:

[16] OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 3, at 23.

enhancement of transparency for tax administration, and sensitivity to taxpayer compliance costs. But perhaps more importantly, Action 13 seeks the establishment of rules that would require an MNE to "provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template."[17] This reporting template concept is known as "country-by-country reporting."

The prospect of a new reporting format with new information raised a number of questions that have dominated the discussion of CbC reporting. Briefly, the issues can be broadly identified as: (a) the kind of information required; (b) the burden on taxpayers; (c) the permitted recipients of the information; (d) the permitted uses of the information; (e) the ability of a country to use the information; (f) the protection of taxpayer data; and (g) the delivery mechanism.[18]

3.3.2 OECD introduction of Action 13

In January 2014 the OECD released a Discussion Draft on Transfer Pricing Documentation and CbC Reporting (Discussion Draft).[19] It identified the three core goals for transfer pricing documentation: (a) risk assessment: "to provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment"; (b) appropriate taxpayer pricing practices: "to ensure that taxpayers give appropriate attention to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns"; and (c) audit support: "to provide tax administrations with the information that they require in order to

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[17] Ibid.

[18] See, for example, OECD, *Memorandum on Transfer Pricing Documentation and Country by Country Reporting* (3 October 2013), available at http://www.oecd.org/ctp/transfer-pricing/memorandum-transfer-pricing-documentation-and-country-by-country-reporting.pdf.

[19] OECD, *Public Consultation: Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (30 January 2014), available at http://www.oecd.org/ctp/transfer-pricing/discussion-draft-transfer-pricing-documentation.pdf.

conduct an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction."[20]

With respect to these goals, the Discussion Draft sought input regarding: (a) whether the BEPS work on this action item should include additional forms and questionnaires (beyond the CbC template); and (b) the appropriate rules for the production of information and documents held by related parties outside the jurisdiction of the taxing authority undertaking the audit inquiry. The expected content of the CbC reporting template is discussed in more detailed in section 3.3.3.2 below.

3.3.3 Discussion Draft plan for transfer pricing and country-by-country reporting

The Discussion Draft envisaged a standardized reporting system for taxpayers, which has since been formalized and has three components: (a) the master file; (b) the CbC template; and (c) the local file.

3.3.3.1 Master file

The master file would contain "standardized information for all MNE group members." The goal of this information would be to provide a "reasonably complete picture of the global business, financial reporting, debt structure, tax situation and the allocation of the MNE's income."[21] The information to be provided would cover five categories: (a) the group organizational structure; (b) a description of business or businesses; (c) the intangibles held by the group; (d) the intercompany financial activities; and (e) the financial and tax positions of the MNE.

The relative brevity of the description of the master file belies the number of complicated choices and options imbedded in its design. The Discussion Draft flagged many of them. The preliminary decision is whether to have MNEs prepare the file for the group as a whole or by line of business, depending upon which would be most useful for tax administrators. Reporting by business line raised two

[20] Ibid., at 2.

[21] Ibid., at 5.

observations — the potential for flexibility in sharing different business line information with different countries; and the concern that countries would be unable to ascertain that the MNE had fully reported all income and activities. It has been emphasized that the master file information is intended to provide a high-level risk overview and should be used consistent with that function (and, for example, should not replace actual audits and more detailed taxpayer-specific analysis and inquiry).

3.3.3.2 Country-by-country template

The CbC template is expected to require taxpayer reporting on the following seven items: (a) revenue; (b) earnings before taxes; (c) cash tax; (d) current year tax accruals; (e) stated capital and accumulated earnings; (f) number of employees; and (g) tangible assets.[22] This information would be provided on a country-by-country basis (as opposed to entity-by-entity).

The template would be accompanied by a list of all group entities and permanent establishments (PEs), by country, along with business activity codes identifying their major activities. Taxpayers would have the flexibility to use either statutory account data or financial statement reporting packages to complete the template — if data usage is applied consistently across the group and across years. Information contained in the CbC template would provide tax authorities with a clearer picture of the relationship between reported profits, taxes paid and the underlying details of economic activity (for example, tangible assets, employees, employee expense).

Several questions pertaining specifically to the CbC template have been raised:

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[22] The reporting items were reduced to 7, from an original suggested 17 in the January 2014 Discussion Draft, following extensive taxpayer comments. See, for example, Kevin A. Bell, "Country-by-Country Template Won't Require Entity-by-Entity Financial Details, Andrus Says," BNA Transfer Pricing Report (10 April 2014), available at http://www.bna.com/country-bycountry-template-wont-n17179889500/; see also OECD Update on BEPS Project — Webcast Powerpoint (2 April 2014), available at http://www.oecd.org/ctp/OECD-BEPS-Webcast-2April.pdf.

(a) *Accounting approach*:

   (i) Whether the template should use bottom-up reporting — using local statutory accounts to build the file (the current recommendation); or

   (ii) Whether the template should require/permit top-down allocation of the consolidated income of the group among the countries; and

   (iii) How the choice between the two would impact the calculation of compliance costs or the determination that additional requirements would be needed.

To provide further clarity regarding the impact of these choices and decisions, the draft reported that Working Party 6 (WP6) currently believes that if top-down reporting were adopted, it should reflect the earnings and revenue from cross-border related-party transactions, but should eliminate revenue and transactions between related parties in the same country.

(b) *Burden and regulation*: Is a requirement of consolidated reporting within each country unduly burdensome on taxpayers? Under the top-down model of allocating the income of the MNE across countries, would additional guidance on appropriate sourcing, characterization of income, and allocation of deductions be required?

(c) *Taxes*: Should withholding tax paid be reported? Would that be particularly burdensome for taxpayers?

(d) *Cross-border related-party payments*: Should there be aggregate reporting of related-party cross-border payments? How detailed should this be? Would it be a significant burden if taxpayers were required to report intragroup interest, royalties and services fees?

(e) *Nature of business activities*: Would any business sectors require special treatment? Would this reporting be a significant burden on taxpayers? Are there other types of information for assessing economic activity that would be useful?

The information provided through the CbC template offers countries the ability to assess the transfer pricing and base erosion risk they face with the multinational and thus determine where and how to audit. But anticipating a serious concern of taxpayers, the draft cautions against countries effectively bypassing detailed audit work and using the CbC data to assert transfer pricing adjustments.

3.3.3.3 Local file

The third element in the Action 13 package of transfer pricing information is the local file. The expectation is that the local file would include jurisdiction-specific information that would complement the master file in helping the country ensure that the taxpayer complies with the arm's length principle and transfer pricing rules in its major transactions connected to that jurisdiction. Broadly, the local file would include more detailed information regarding relevant transactions between the MNE entity in the local jurisdiction and its related entities in other countries, such as financial details of the transactions, a comparability analysis for pricing, and "selection and application of the most appropriate transfer pricing method for the fiscal year in question."[23]

The Discussion Draft contains an annex delineating the anticipated local file information. The information is grouped into three categories:

(a) *Local entity*: The first concerns information regarding the local entity itself: its management structure, organization chart, identification of individuals to whom the local management must report (and the jurisdiction of their principal offices), and any recent participation by the local entity in a business restructuring.

(b) *Financial accounts*: The second category seeks financial information important to the application of transfer pricing analysis: the annual financial accounts of a local entity (audited, if available), schedules showing how financial data that was used in the transfer pricing method is linked to the annual financial statements, and summary schedules of the financial data of the comparables and the source of that data.

[23] OECD, *Public Consultation: Discussion Draft on Transfer Pricing Documentation and CbC Reporting*, supra note 19, at 6.

(c) *Controlled transactions*: The third category pertains to information regarding controlled transactions involving the local entity. A more specific list of information is enumerated here, which goes to the core of how the taxpayer applies the transfer pricing rules:

- Description of the transactions (for example, services, purchase of goods, loans) and the context in which that transaction took place (for example, business activity, financial activity, cost contribution arrangement);
- Aggregate charges for each category of transaction;
- Identity of the related parties involved and the nature of their relationships;
- Functional analysis of the taxpayer and the related entities regarding each category of controlled transactions (functions performed, assets used, assets contributed, intangibles involved, risks borne and changes compared to prior years);
- Identification and description of controlled-party transactions that might impact the transaction in question;
- Specification of the most appropriate transfer pricing method by category, the reasoning for the selection, which entity is the tested party (where relevant) and why, and assumptions made in using the method;
- If using a multi-year analysis, include an explanation why;
- Information regarding comparables — how selected, search strategy, application of method, and relevant financial indicators used in the analysis;
- Any adjustments to comparables, to the tested party;
- Conclusions regarding the arm's length status of related-party transactions based on application of the selected method.

3.3.4 Implementation issues under Action 13

Documentation and burden: Taxpayers are expected to price at arm's length based on contemporaneous information, and prior to engaging in the transaction, with confirmation completed before filing the tax return. But the Discussion Draft urges countries to consider the burden on the taxpayers when making documentation requests. For example, taxpayers that can reasonably demonstrate the absence of comparables (or their absence at an appropriate cost) should not be required to bear such a burden. At present, the Discussion Draft specifically does not recommend that transfer pricing documentation be certified by an outside auditor.

Timing: Given the diversity in country expectations regarding when documentation should be available (at the time of filing the return or by the time of audit) and how long taxpayers should have to respond to requests, the suggested best practice is for taxpayers to have both the master file and the local file ready by the time the tax return for the relevant year is filed (unless the jurisdiction practises contemporaneous auditing, which would require the information prior to the filing of the return). In countries for which final statutory financial statements and related CbC reporting data are not available until after the tax return is due, the best practice would allow for extension of completion of the CbC template to one year after the last day of the fiscal year of the MNE parent.

Materiality: Conscious of the need to balance the competing interests of countries (seeking access to transfer pricing information) and taxpayers (seeking a "reasonable" documentation burden), the Discussion Draft recommends documentation requirements with materiality thresholds based on the "size and nature of the local economy, the importance of the MNE group in that economy, and the size and nature of local operating entities, in addition to the overall size and nature of the MNE group."[24] For example, many jurisdictions offer simplified transfer pricing documentation rules for small and medium-sized enterprises. Nonetheless, such smaller businesses would be expected to provide data and documentation regarding material cross-border related-party transactions upon request and also to complete the CbC template.

Document retention: Again, balancing taxpayer burdens and the need of a country to access information, the Discussion Draft recommends that tax administrators take into account the difficulty in locating documents from prior years, and that they should make such requests only when there is a "good reason" relating to a transaction

[24] Ibid., at 7.

under review. To assist in the balance of burden and need, taxpayers should be permitted to store the documentation in a manner they deem appropriate (electronic, paper, and so forth) as long as it can be produced in a useable form to the tax authorities.

Documentation updates: Both the master file and the local file should be updated annually, although in many cases information (for example, functional analysis or description of business) may not change. The Discussion Draft offers a recommendation — on which it specifically seeks comments — to the effect that where operating conditions are unchanged, the tax administration may permit taxpayers to update their database searches for comparables in the local file every three years. However, financial data for the comparables would be updated annually.

Language: The expectation is that the master file would be prepared and submitted to jurisdictions in English. However, at a minimum, the local file should be prepared in the relevant local language. To the extent the tax authorities need a translation of portions of the master file, they can make that request to taxpayers and provide adequate time to secure the translation.

Penalties: The draft cautions against the imposition of documentation-related penalties (civil or criminal) where taxpayers have made a reasonable, good faith effort and/or do not have access to the information. But it is not a good defence to contend that some other related party bears the group responsibility for documentation. The decision not to impose these penalties would not prevent a jurisdiction from making the underlying transfer pricing adjustment in order to bring taxpayers into compliance with the arm's length principle. Two strategic observations regarding documentation-related penalties may guide the thinking of a country about designing a penalty regime:

(a) Differences in penalty regimes among countries may influence whether a taxpayer "favours" one jurisdiction over another in pricing. For example, if one jurisdiction imposes stronger penalties (compliance and/or underlying substantive pricing penalties) than another, the taxpayer may be more inclined to shift resources (and even transfer pricing profits) to the jurisdiction with the stronger penalty regime so as to avoid the imposition of large penalties;

(b) A documentation regime that includes benefits for compliant taxpayers may increase the actual compliance of a taxpayer with the documentation rules, resulting in a favourable outcome for the country. For example, if taxpayers who meet documentation requirements receive some measure of penalty protection or a shift in burden on some or all issues, there will be added taxpayer incentive for upfront conformity with the documentation requirements.

Confidentiality: As the prospect of increased disclosure of information becomes more likely, taxpayers are expressing greater concern regarding confidentiality. The draft urges tax administrations to protect taxpayers from public disclosure of trade secrets, scientific secrets and other confidential information. The need for protection should lead countries to carefully consider their requests for such information and to provide assurances to the taxpayer regarding confidentiality. To the extent that public court proceedings or judicial decisions will entail some measure of disclosure, confidentiality should be preserved to the extent possible and disclosure should be as limited as possible.

Implementation:

(a) *Changes to domestic law*: Tax law, including transfer pricing rules, are a function of domestic law. Thus, in order to achieve the benefits of increased uniformity under Action 13 (as well as the widespread adoption of best practices advocated by the Discussion Draft), countries will need to make changes to their own domestic law. Thus, for example, countries would need to enact transfer pricing and documentation rules that require their locally based MNE affiliates to produce information required for the master file, CbC template and local file (as detailed in the three annexes attached to the Discussion Draft). Given the general importance of consistency, and the need for master file information to be consistent across jurisdictions, countries should review their own domestic rules. The goal would be domestic rules that require production of information for the master file that conforms to the Discussion Draft annex (detailing the information in both the master file and the CbC reporting template).

(b) *Reporting oversight*: As part of the effort to ensure consistency, the draft recommends that the master file and the CbC template be completed under the supervision of the MNE parent corporation and then shared with each country in which the MNE has an affiliated taxpayer. Each jurisdiction could obtain the master file from the local entity in its jurisdiction. If that request is not met, the local jurisdiction could request the master file from the parent jurisdiction of the MNE pursuant to a treaty-based exchange of information provision.

(c) *Delivery mechanism*: The Discussion Draft recommends that the MNE parent make the master file and the CbC template available to the local affiliates, who will then share it with their local taxing authorities. But it notes other possibilities and contains a request for comments. Other delivery mechanism options for the master file and CbC template include: (a) direct local filing of the information by the MNE local affiliate; (b) filing of the information with the MNE parent jurisdiction, which would then share it with the jurisdictions of the local affiliates through a treaty information exchange mechanism; or (c) some combination thereof. Given that access to this new reporting format and information is at the heart of Action 13, many countries have strongly advocated that the delivery mechanism should be uncomplicated and widely available (see section 3.3.6.2.2 below). Taxpayers, however, have repeated their concerns that the delivery mechanism should include appropriate safeguards ensuring the protection of their information.

3.3.5 General questions regarding proposed Action 13 recommendations

3.3.5.1 Taxpayer burden

On balance, the current proposed recommendations regarding Action 13 (see section 3.3.3 above) reflect the concerns raised by multinational taxpayers and their advisers. Primarily, these concerns centre on an overarching theme that compliance with documentation is much more difficult than the OECD and governments understand. Taxpayers enumerated a variety of challenges and barriers to their immediate, low-burden compliance with the master file, CbC template and local file approach. These difficulties included: existing reporting systems not aligned to the requested information; different reporting and measurement approaches within different parts of a multinational and across multinationals; difficulty in securing the information in a timely fashion; the need to rework data from affiliates into a consistent reporting format; the cost of gathering requested data; the burden arising from uncertainty in definitions and applications (for example, what counts as an employee). Not surprisingly, given the objections articulated, taxpayers raised the most questions about the CbC template.

Despite this general critique, taxpayer responses to the release of the recommendations under Action 13 seem to vary considerably. MNEs have pursued one or more of the following steps: (a) reported that their operations are significantly out of step with the data sought; (b) used the OECD comment period to press for modifications; (c) tested their ability to comply with the master file, CbC template and local file structure; and (d) explored new information management systems to facilitate their compliance with anticipated reporting requirements. Some taxpayers may already be collecting much of the master file and CbC template information in order to comply with existing, country-specific reporting requirements imposed by jurisdictions which currently require reporting on the worldwide activities of their MNEs, including information on certain foreign subsidiaries.

3.3.5.2 Delivery mechanism

Among the most controversial issues raised by the Action 13 steps is how the required information (master file, CbC template, local file) will be delivered. For example, will taxpayers be required to file the information only with the jurisdiction of the MNE parent corporation — with the expectation that countries will request the information via treaty information exchange provisions? If so, what kind of presentation of, or demonstration of need for, the information would be required? Alternatively, would taxpayers be required to file directly in each jurisdiction in which they are a taxpayer (for example, an affiliate or a permanent establishment (PE))? Would some but not all information be filed directly with the taxing jurisdiction of the local affiliate?

Taxpayers have generally urged that required filings be made to the country of the MNE parent corporation. The primary argument advanced for the single central filing (at least of the master file and the CbC template) is the concern that some jurisdictions might not adequately protect information. If the data is provided only to the parent jurisdiction and then shared via treaty request, there would be additional protection because countries requesting information pursuant to a treaty must ensure and commit to specified confidentiality requirements.

The significance of the taxpayer concern about confidentiality turns on two points: the legitimacy of the concern over protection of taxpayer information, and the sensitive nature of the data. First, appropriate protection of taxpayer data is an accepted norm, although there are differences in exactly what is protected, when it is protected and how. Model exchange of information provisions (for example, Article 26 of both the United Nations and OECD Model Conventions) make reference to the expectations regarding taxpayer privacy, and expound further upon the application of the standard in the accompanying commentaries. However, sharing the master file and CbC template via treaty poses challenges for requesting jurisdictions, particularly developing countries (see section 3.3.6 below).

Second, regardless of the broader subject of taxpayer privacy, to the extent that information in the master file and the CbC template is generally publicly available for these multinationals, the argument in favour of filing those documents only with the jurisdiction of the parent may be weakened. For example, in the case of publicly traded entities, how much of the information is publicly reported in compliance with securities (or other) regulations? Are there other public sources for that information? If so, how much weight should be given to arguments about uncertain protection of the data? Alternatively, should the public availability of data be less relevant in the debate if the "public" information is cumbersome to gather? This argument would be grounded on the assumption that difficult-to-assemble data were in reality "less public" and thus there would be a real impact on these taxpayers if their well-organized reporting to the tax authorities were inadvertently made public. Should privately held multinationals be treated differently if their publicly available entity information is more limited?

The importance of this issue to both countries and taxpayers has led the OECD to defer a recommendation on the delivery mechanism in order to provide more time to evaluate concerns and consider possible options.

3.3.5.3 Use of information

Related to the delivery mechanism concern (see section 3.3.5.2 above) is the separate question of which files a country may access and what it may appropriately do with the information. Taxpayers typically have several concerns about what jurisdictions might do with information compiled by taxpayers.

Replace audit: One concern articulated by taxpayers is that countries, particularly those that may be resource-constrained, will use the master file and the template data as the basis for an actual transfer pricing allocation. For example, if such a jurisdiction draws the conclusion that inadequate income (and thus tax) is being reported in its jurisdiction relative to the value chain, functions and reporting of income worldwide, the tax authorities might simply stop at that stage and make a transfer pricing adjustment. The OECD has stated that the purpose of the master file and the CbC template is to facilitate risk assessment and decisions about where to allocate audit resources — not to replace the audit. However, the early revisions to the January Discussion Draft (see section 3.3.3 above) include an even more explicit statement that the master file and CbC template are understood to be a high-level view and are not expected to displace an audit of the taxpayer.

Shift to formulary: In a similar vein, taxpayers are also concerned that countries may use this information (master file and CbC template) to shift informally to a formulary approach to transfer pricing, despite formally being committed to an arm's length approach. In part, countries might be inclined to use the information in this way if they find it difficult to locate comparables for the traditional application of the arm's length method. Again, developing countries, in particular, may face this challenge (see section 3.3.6 below). Although substantive reforms to transfer pricing rules are not part of Action 13, this taxpayer concern reveals the connection between administration, documentation and substantive law.

Assist beyond transfer pricing: Should countries use some of this high-level information, in particular the CbC template, to assist more broadly in efforts to combat base erosion and profit shifting? The OECD plan to treat the CbC template separately supports the view that the template can and should play a broader role in helping jurisdictions make their high-level assessments of risk. The final form of the template and the specific columns of information provided will impact how countries can effectively use the filings to reach beyond transfer pricing concerns to other causes of base erosion.

Format and function: Taxpayers have raised a variety of questions regarding exactly how to report data properly, especially under the CbC template. Examples include how to handle various accounting differences within the multinational group, how to define "employees" and how to treat PEs. Depending on the intended and appropriate uses of the data, it may be possible to determine the best, or the appropriate, responses to these questions. For example, the decision to require reporting of only the number of employees and not their compensation likely reflects a conclusion that the burden of trying to ascertain what counts as compensation for all employees across entities and jurisdictions is not necessary for a high-level risk assessment given the burden it might impose. "Number of employees" in each jurisdiction might be an adequate and less burdensome measure of the MNE presence in a country. Similarly, the flexibility permitted in sourcing financial data presumably reflects the view that a steady comparative picture of the MNE activities across countries and years is the core of the high-level risk assessment intended by the master file and CbC template. However, the decision as to whether to report information from the bottom up or the top down (see section 3.3.3.2 above) has been viewed by some as critical to the meaningful role of the template in providing even a high-level risk assessment. From this viewpoint, bottom-up reporting would effectively replicate (and obscure) any BEPS already in place and thus fail to signal the real risk to the tax authorities; only top-down reporting would be able to reveal even the high-level risk of BEPS problems for the jurisdiction.

3.3.5.4 Data protection and authorized public disclosure

In addition to the concern expressed by countries regarding how the master file and template will be reported and shared (see section 3.3.5.2 above) is a general focus on data protection and a special focus on the potential for authorized public disclosure. On a broad level, taxpayers fear that some jurisdictions will not follow agreed and accepted standards for data protection, either because of inadequate internal rules and oversight mechanisms or because of a more intentional decision to share information with other agencies or domestic competitors. As discussed in section 3.3.5.2 above, a recommendation that MNEs file the information only with the parent jurisdiction, who shares it only with countries committed to data protection consistent with the model treaties, provides a measure of certainty regarding data protection. As the OECD explores various alternatives for filing and sharing this information, taxpayers will continue to press for assurances of confidentiality. Suggestions for enhancing confidentiality have included a mechanism for reviewing country compliance with confidentiality protocols, a reporting system for taxpayers experiencing confidentiality problems and possible penalties for jurisdictions that fail to appropriately protect taxpayer data.

In the context of BEPS, data protection has an additional dimension beyond the above-discussed concern that countries might either: (a) carelessly allow unauthorized access to private commercial or tax information; or (b) intentionally share information with State-owned competitors or with favoured domestic competitors. Specifically, taxpayers also worry that reporting to governments under Action 13 will serve as a prelude to authorized public disclosure of certain tax information. Not only have there been explicit demands for public disclosure of some Action 13 material (particularly the CbC template), but a disclosure trend can be observed in recent public disclosure projects, including recently enacted United States Securities and Exchange Commission reporting rules and other similar projects in extractive and financial industry sectors (see section 4.4 below). The increased public awareness of the role and conduct of multinationals in the economy and the import of BEPS issues has led to calls for public disclosure of some, or all, of the information that would be provided by businesses to tax authorities under the BEPS initiatives.[25] From a perspective that citizens should be able to assess and evaluate the conduct of their own government with MNEs, and should be able to ensure that the country and the treasury are properly protected, public release of some or all of the master file and template data would likely be sought. Public release of basic tax information could serve as a check on corruption, inadequate enforcement and/or inadequate substantive tax rules.

Following the release of the 2014 BEPS Deliverables, including on Action 13, the BEPS Monitoring Group issued a review of the progress on the BEPS action items to date. With regard to the question of disclosure of Action 13 to the public, the group concluded:

> In view of the very general nature of the information required by the CbC report template, there seems no valid reason why these reports should not be published. The [BEPS] report rightly stresses the need for tax authorities to preserve strict confidentiality of information which may be commercially confidential. However, the CbC report as now designed would not normally include such information. Publication should therefore be the norm, subject perhaps to allowance for exceptional cases. There is widespread public interest in such greater corporate transparency, which has led to mandatory publication requirements especially in the EU and the US of such reports in specific sectors (extractive industries and financial services). Finally, this data would constitute an invaluable information resource, which should be treated as public domain. At present, corporate data, even if they originate from state legal requirements e.g. for publication of company accounts, are in practice extremely difficult to access. Hence, both researchers and even government bodies such as tax authorities, are dependent on private providers of data-bases. This is particularly damaging to developing countries, both because of the high cost of subscriptions, and because the coverage of developing countries in such databases

[25] See, for example, C20 Position Paper Background: Governance, supra note 8, at 5 (advocating a "commitment to make public country-by-country reporting the global standard" assuming that "[e]nsuring this information is made public would enable tax administrators in the poorest countries to easily access this information and address base erosion and profit shifting").

> is poor. The G20 should take a lead in making this important standard a worldwide expectation, and ensure that the data is publically available to support corporate transparency and facilitate tax enforcement everywhere in the world.[26]

Other organizations have similarly urged increased public reporting. For example, Christian Aid, in commenting on the January 2014 OECD Discussion Draft for Action 13, stated that it is "firmly of the belief that the Country by Country (CbC) report be made public," citing the opportunity to hold both governments and multinationals more accountable on the basis of such tax information.[27] The Trade Union Advisory Committee to the OECD (TUAC) similarly supported public disclosure of certain MNE taxpayer information in order to facilitate informed public discussion.[28]

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[26] BEPS Monitoring Group, *OECD BEPS Scorecard* (7 October 2014), available at https://bepsmonitoringgroup.files.wordpress.com/2014/10/oecd-beps-scorecard.pdf.

[27] Christian Aid Submission, *OECD BEPS project: Discussion draft on Transfer Pricing Documentation and CbC Reporting* (February 2014), available at http://www.oecd.org/ctp/transfer-pricing/volume1.pdf.

[28] See TUAC, *OECD Public Consultation on Draft Revised Guidance on Transfer Pricing Documentation and Country-by-Country Reporting: Comments by the TUAC* (21 February 2014), available at http://www.oecd.org/ctp/transfer-pricing/volume4.pdf. It states that "[p]ublic disclosure would resolve a number of outstanding issues, including the above mentioned problem of access to information for developing countries. It would also help inform other stakeholders, who are affected by the activities and operations of MNEs, including workers, local communities, civil society groups and of course citizens at large. The content of the public filing could cover a selected number of reporting items which in our view would not threaten or violate business confidentiality rights. Items could include: (i) organisational structure, (ii) important drivers of business profit, (iii) supply chain for material products and services, (iv) service arrangements between members of the MNE group, (v) business restructuring transactions during the fiscal year, (vi) geographic distribution of the top 5/10% highest compensated employees, (vii) geographic distribution of employees and other supervised workers expressed in number of full-time employments, and (viii) MNE's important financing arrangements with unrelated lenders. … Regarding reporting on tax and incomes, reporting should include (i) consolidated group accounts and (ii) tax due and tax paid in each country. The public filing should at least

Business organizations, in contrast, strongly urge careful protection of taxpayer data and reject the idea that public disclosure of some of the Action 13 information (such as the CbC report) could be an appropriate response. The Business and Industry Advisory Committee to the OECD (BIAC) contended that the master file and the CbC report "should only be provided by taxpayers to their home (headquarter) tax administrations, to then be shared through existing exchange of information channels with the necessary confidentiality requirements."[29] Rather than contemplate some form of limited public disclosure, BIAC sought enhanced measures to safeguard taxpayer information (including "anti-infringement procedures" to protect taxpayers from unauthorized disclosure, the viewing of certain information only at the taxpayer site, and legally binding confidentiality agreements between taxpayers and tax administrations).[30] The International Alliance for Principled Taxation similarly recommended that "the CbC report be filed with the parent company's home country tax authority as the Discussion Draft contemplates, but that it then be shared with other tax authorities only through a formal EOI channel (whether spontaneously or upon request), so that confidentiality obligations will apply to the recipient governments."[31] In addition to the concerns about the public disclosure of trade secrets and related information, multinationals and their representatives have expressed concern that public disclosure of tax information could easily be misinterpreted and used (inappropriately) for political purposes.

The OECD has repeatedly asserted that the Action 13 information is intended only for governments and only for the purposes of making risk assessments for BEPS. Given the importance of this issue

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include reporting on a single ratio between tax charge and declared profits to give some indication on the potential presence of risk for transfer pricing manipulation and other aggressive tax planning schemes."

[29] BIAC, *OECD Discussion Draft on Transfer Pricing Documentation ("TPD)" and Country by Country ("CbC") Reporting* (21 February 2014), available at http://www.oecd.org/ctp/transfer-pricing/volume1.pdf.

[30] Ibid.

[31] International Alliance for Principled Taxation, *Comments on Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (23 February 2014), available at http://www.oecd.org/ctp/transfer-pricing/volume2.pdf.

(access and use of information) and the widely differing views on what information should be made available to whom, and on what terms, implementation of Action 13 will continue to generate significant debate. The Action Plan recommendations for the delivery mechanism (that is to say, to whom the master file, CbC template and local file will be delivered), which are expected in late 2015, will likely generate further discussion.

3.3.5.5 Independent country action

One important thread paralleling the entire BEPS process is the distinct possibility that countries may pursue unilateral responses to their BEPS problems. Such action could be in advance of broad agreement on BEPS steps or contemporaneous with it. Additionally, as noted in section 3.3.5.1 above, some countries already impose fairly extensive reporting obligations on their own multinationals, as well as on other entities doing business in their jurisdiction. The risk or possibility of independent unilateral action by countries on BEPS problems is relevant throughout the debates on specific BEPS recommendations. For example, in measuring and evaluating the burden imposed on taxpayers by the requirements under the master file, CbC template and local file, it is fair to consider the reduction in burden that corporations may experience through such a unified and streamlined reporting system. Similarly, taxpayers themselves may reassess their resistance to the OECD project on BEPS given the risk of multiple, country-specific reporting requirements that might arise should the project not move forward with some success. Such individual country requirements seem all the more possible given that countries could use the Action 13 proposed master file and template as a baseline in crafting their own reporting legislation. This "risk" of independent action by countries may be greatest with respect to those jurisdictions that have some leverage in the market. In contrast, a developing country that perceives itself as having more limited negotiating power vis-à-vis multinationals may be less inclined to impose independent reporting requirements perceived as "unfriendly" to business. Effectively, countries could be competing based on their relative lack of disclosure. Those developing countries might find it advantageous if a uniform standard of reporting is broadly adopted (along the lines of BEPS Action 13).

There is, however, another completely separate dimension of independent country action in the context of the OECD project on BEPS: how will countries effectuate their support for and participation in the BEPS recommendations? Presumably, a multilateral commitment mechanism of some type will be needed. Additionally, countries will need to modify their domestic law consistent with the various accepted recommendations that emerge from the multistage BEPS process. These realities are not unique to Action 13. But the effort to resolve the delivery mechanism question (for the master file and CbC template) will be one important piece of the BEPS implementation process.

3.3.6 Developing country issues regarding Action 13

Although all countries share many of the same concerns, questions and goals regarding the reporting recommendations under Action 13, developing countries may have a distinct perspective. In terms of both the overall mission of Action 13 and the implementation-specific decisions, developing countries should evaluate the BEPS project against their own circumstances.

3.3.6.1 Overall perspective

The broad mission of Action 13, to improve a country's risk assessments for BEPS (through the master file and CbC template) and to facilitate transfer pricing audits (through the local file), is likely important to developing countries with limited audit and other resources. First, to the extent that developing countries must decide where to direct their most sophisticated audit resources, they would want to identify their most serious BEPS problems. A high-level assessment tool (master file and CbC template) delivered by each MNE operating in the jurisdiction would provide the country with a solid basis for making that preliminary risk assessment and assigning audit resources.

Second, if the package (the master file, CbC template and local file) becomes the standard for MNEs, then developing countries will be able to rely on a unified format as they make both high-level risk assessment decisions and as they evaluate taxpayer-specific transactions among related entities. Both their own MNEs, as well as foreign multinationals conducting business in their jurisdiction, will be utilizing the same format and standards, thereby producing more uniform information that may be more readily subject to comparison. Again, for a jurisdiction with limited resources, this enhanced uniformity in reporting (assuming it carries the requisite content) should allow the tax administration to process and evaluate the information more effectively — and train new tax professionals.

Third, assuming that broad support for Action 13 recommendations is ultimately achieved, and that this support is manifest in some kind of commitment across countries, then developing countries should benefit from the "global" obligation imposed on MNEs to prepare this information. If many countries, including countries with more enforcement resources, are seeking the information, presumably taxpayers will more readily comply. Moreover, this compliance would likely be not only in name (for example, providing documents labelled "master file" and "template") but also in spirit (providing materials meeting the expectations articulated for each of these documents). Thus, use of the BEPS process to enhance information reporting and document production by MNEs offers certain advantages for resource-constrained jurisdictions.

3.3.6.2 Implementation-specific perspective

Although the driving purpose behind Action 13 would be compatible with and would help facilitate most developing country audit and enforcement goals, the details regarding the actual implementation of Action 13 are critical to their real-world impact. Both the final content of the master file, the CbC template and the local file, and the manner in which this information is provided to countries, will ultimately determine whether the potential value of Action 13 is realized.

3.3.6.2.1 Content

Several of the design questions that have arisen in the context of crafting the master file, CbC template and local file may be particularly relevant for developing countries.

Reporting entities: First, given that developing countries may find they have many permanent establishments (PEs) operating in their jurisdiction, it will be important to clarify how that kind of presence in a jurisdiction will be handled for reporting purposes. Presumably, to the extent that the CbC reporting is country-based, the data from the PEs should be picked up. But clarification on this point may be valuable. For example, the enumerated listing of entities operating in the jurisdiction should include not only local subsidiaries of the foreign multinational, but also the foreign corporations with a PE in the jurisdiction.

Accounting: Second, as initially noted in sections 3.3.3.2 and 3.3.5.3 above, countries in general, but developing countries especially, might prefer the top-down allocation of group income to the extent that they are concerned that use of the local statutory accounts to construct a bottom-up reporting may disguise underlying BEPS problems. If the local statutory accounts reflect inappropriate pricing and profit shifting, that reality might be built into the template responses and effectively obscure the base erosion and profit shifting. This concern is not unique to developing countries. But the template may play a more pivotal role in the tax enforcement process of a developing country if it lacks other reporting mechanisms or information that could signal a risk for BEPS with regard to a particular taxpayer.

Verification: Third, although attention has been given to the source of data used in constructing the files, less attention has been focused on verification of the information. Of course, verification of data is always an issue for tax authorities. If there are expectations regarding the ability of a country to verify information, it would be useful to outline them more specifically. This concern may be most prominent in the local file context because that information would likely be circulated to a more limited pool of tax authorities. In contrast, the master file and CbC template would likely receive wider circulation. It is not clear, however, whether a jurisdiction that finds the master file or template inaccurate would be expected to unilaterally share that information with other countries in possession of the file or template.

Language: Fourth, the current proposals anticipate that the master file (and the CbC template) would be prepared in English but that the local file would be prepared in the local language of the jurisdiction. Certainly, it is likely to be more efficient for the developing country that the master file be in English rather than the language of the MNE parent jurisdiction (assuming that language is not English). However, the personnel constraints that developing country tax administrations face include the limited pool of English-speaking tax professionals with sufficient international tax training to effectively review the files, make risk assessments and then pursue taxpayer audits where appropriate. If more information is made available in the language of the developing country, the number of tax professionals in government available to work on audits, reviews and examinations may increase.

Burden: Fifth, the dominant taxpayer critique of Action 13 reporting (master file, CbC template and local file) has been that of the burden it imposes on taxpayers (see section 3.3.5.1 above). Although the question of burden is important, and requested information should be useful and reasonable in context, the balance of benefit and burden may look different from a developing country perspective. Taxpayers have urged that they not be asked to provide difficult-to-gather data that a country would be unable to use. This objection is not levelled solely at developing countries, but it is one that is heightened where a country has limited resources and is ultimately constrained in its ability to process information meaningfully. However, despite this claim, which might suggest that the benefits to developing countries would be less than the burden to the taxpayer, a broader look at the benefits and burden question might produce a different conclusion. Developing countries are often understood to be highly dependent upon income taxes, specifically corporate income taxes, for their revenue base. There are a number of factors contributing to this fiscal picture and although it may shift in the long term, at present there is a serious cost to the fiscal welfare and stability of these countries when they are unable to collect corporate income tax otherwise due. Additionally, developing countries have fewer internal resources to engage in extensive monitoring and reviewing of multinational taxpayers and their tax planning. Thus, the benefit to these jurisdictions in having MNEs provide relatively uniform, comprehensive information of both a qualitative and quantitative nature that assists in risk assessment and in audit is distinctly valuable. That said, the BEPS project is a group effort by countries to respond to BEPS. However, in making a group-wide assessment of the burden imposed on taxpayers by Action 13 compared to the benefit for tax administrations, it will be important to bear in mind that the benefit should not be measured solely from a developed country perspective.[32]

3.3.6.2.2 Delivery

Just as the question of to whom information will be provided and how is very significant for taxpayers, it is equally critical for developing countries. As suggested in section 3.3.6.1 above, Action 13 will play little meaningful role if countries cannot predictably and effectively access the information in the master file, CbC template and local file. Given that many of the key advantages of this information package for developing countries derive from the resource-savings opportunities it provides (see section 3.3.6.1 above), it is important that countries have easy access to the information in a timely fashion. To the extent that the delivery mechanism imposes costs, the value of the entire process for developing countries is diminished.

For example, if the master file and template is provided only to the jurisdiction of the MNE parent, with the expectation that other countries can seek that information through an exchange of information request, several barriers are created. First, the developing country must pursue the process of requesting the information, presumably pursuant to a treaty (bilateral treaty or TIEA). This step requires the efforts of a tax professional sufficiently familiar with the process, the

[32] Various international groups have urged that the OECD project on BEPS appropriately incorporate the views and needs of developing countries. See, for example, C20 Position Paper Background: Governance, supra note 8, at 2 (recommending "an inclusive and transparent process that ensures developing countries benefit from these tax reforms"), available at http://www.c20.org.au/resources/; G20 Leaders' Declaration (St. Petersburg, 6 September 2013), at 13 ("Developing countries should be able to reap the benefits of a more transparent international tax system, and to enhance their revenue capacity, as mobilizing domestic resources is critical to financing development"), available at https://g20.org/wp-content/uploads/2014/12/Saint_Petersburg_Declaration_ENG_0.pdf; G20 Leaders' Communiqué (Brisbane, 16 November 2014), at 2 ("We welcome deeper engagement of developing countries in the BEPS project to address their concerns. We will work with them to build their tax administration capacity and implement AEOI"), available at https://www.g20.org/sites/default/files/g20_resources/library/brisbane_g20_leaders_summit_communique.pdf.

rules and possibly a foreign language. Second, it is not clear what information the requesting jurisdiction must provide to make this request. One of the long-standing problems with treaty-based exchange of information provisions has been the requirement imposed on requesting jurisdictions to provide upfront details regarding the underlying taxpayer and the matter being investigated. This requirement would contradict one of the core functions of Action 13 — allowing countries to make more meaningful BEPS risk assessment early in the process. Yet depending upon the precise treaty provision under which the country is making the request for information, it might need to know much more information in order to request the master file and template. Not only would this be difficult to accomplish in some cases, it will inevitably require more audit resources simply to secure the information intended to provide the risk assessment tools. Developing countries will be able to take these steps for fewer taxpayers, thus decreasing the beneficial impact of Action 13.

Second, tax administrations generally are seeking to make the audit process more contemporaneous. Working through a treaty mechanism to obtain the master file and CbC template, particularly if the requesting country must provide detailed supporting information, would only extend the audit process.

Third, developing countries are less likely to have MNEs with the parent located in their jurisdiction. As a result, a much larger portion of their enforcement work to combat BEPS would require the preliminary step of seeking master files and CbC templates from other countries. In contrast, developed countries typically have more multinationals headquartered in their jurisdictions and would (under a system of filing only in the parent country) have the information automatically available. Moreover, these developed countries would likely be especially, though not exclusively, interested in BEPS on the part of their own major multinationals. Thus, although all countries would (under this approach) be required to seek information via treaty, the burden would be most significant for developing countries which are resource-constrained, dependent upon corporate income taxes and have few domestic multinationals.

3.3.6.2.3 Domestic

The proposed steps under Action 13 raise several questions for countries to consider from a domestic perspective. As with some of the observations above, these points may not apply uniquely to developing countries, but they may resonate strongly with them. First, assuming that countries adopt the recommendations under Action 13 in some final form, domestic legislation would be required to fully implement the recommendations. To the extent that countries have not yet implemented significant reporting requirements for MNEs, they would likely need to do so now. Given the importance of obtaining the information, developing countries would want to ensure their ability to enact the required legislation.

Second, taxpayers have expressed the concern that countries, especially developing countries, may be inclined to bypass a real audit, and use the master file and CbC template to impose a transfer pricing adjustment based on a more formulary approach. Some taxpayers have urged that the OECD secure commitments from countries affirming that they will not forgo the arm's length method, even informally. It is unclear what such a commitment would look like and whether and how the final recommendations under Action 13 would incorporate it. But it does make sense for jurisdictions, including developing countries, to review their own positions and commitments on the subject.

Third, taxpayers have also repeatedly raised confidentiality as an objection to widespread filing of the master file and CbC template. Regardless of the delivery mechanism(s), countries receiving access to information will likely be expected to demonstrate their ability and willingness to comply with norms of confidentiality and privacy regarding taxpayer information. If the current domestic law of a country is not consistent with the typical expectations reflected in, for example, Article 26 of either the United Nations or OECD Model Convention, the country may wish to preemptively evaluate the changes that would be necessary to domestic law for compliance.

Fourth, Action 13 itself does not impose documentation or transfer pricing penalties. That remains the province of the individual countries. The Discussion Draft recommends against documentation penalties for good faith compliance that falls short of the required disclosures. But the Discussion Draft anticipates the need for both documentation and mispricing penalties in some cases. As countries examine their own documentation and substantive pricing penalties, it is important to bear in mind the risk that taxpayers will "favour" jurisdictions with more severe penalties: taxpayers might devote more resources to documentation compliance in such jurisdictions and, where in doubt on pricing, shift profits to the jurisdiction with higher penalties (to avoid the imposition of such penalties). Given that developed countries frequently have well-established transfer pricing documentation and substantive penalties regimes, developing countries should carefully evaluate their own penalty regimes with these observations in mind.

3.3.6.3 Options

Assuming that developing countries secure workable access to the master file and the CbC template under the final delivery mechanism, there remains the question of how they can best use this information. Given the resource constraints faced by many developing countries, targeted capacity-building might enhance the ability of these countries to use the information received from all three formats (master file, CbC template and local file) in a strategic manner. For example, training for developing country tax auditors could focus on the information included in these files and how to use that information to make overall risk assessments and, where appropriate, to pursue taxpayer-level audits. Using "case studies" of hypothetical taxpayers with corresponding master files, CbC templates and local files would help developing countries not only receive the information but begin to use it effectively and more immediately to tackle base erosion and profit shifting.[33] Real-time technical assistance and capacity-building could also be pursued through the "Tax Inspectors Without Borders" programme[34] currently being piloted by the OECD, which provides

[33] See, for example, African Tax Administration Forum, *A Practical Guide on Information Exchange for Developing Countries* (2013), at 46-47 (outlining an abbreviated version of the case study concept in the context of requesting information).

[34] See, generally, OECD website at http://www.oecd.org/tax/taxinspectors.htm.

expertise to developing-country tax administrations during the course of real-time audit and enforcement.[35] The G20 has noted its support for this programme.[36]

3.3.7 Summary of Action 13

Action 13 in the OECD Action Plan on BEPS addresses the challenge of transfer pricing documentation and the need to understand the activities of an MNE across the globe. The action item introduces three new reporting mechanisms: (a) the master file (standardized information for the entire MNE group regarding business activities, finance, debt structure, taxation and allocation of income); (b) the CbC reporting template (a template completed by each multinational providing data on a country-by-country basis on seven key questions); and (c) the local file (jurisdiction-specific information on the local entities, their financial accounts, financial data of comparables for transfer pricing analysis and detailed information on related-party transactions).

The goal of this reporting is to assist countries in: (a) risk assessment; (b) enforcement of transfer pricing requirements; and (c) audit. The proposed reporting under Action 13 has raised a number of implementation issues: (a) burden on the taxpayer; (b) timing of the provision of information; (c) scaling of documentation requirements to reflect the materiality of the taxpayer and the transactions (based on

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[35] OECD Task Force on Tax and Development, *Final Report on the Feasibility Study into the Tax Inspectors Without Borders Initiative* (5 June 2013), at 1 ("Experts would be deployed to work directly with local tax officials on current audits and audit-related issues concerning international tax matters, and to share general audit practices. In addition to improvements in the quality and consistency of audits and the transfer of knowledge to recipient administrations (tax administrations seeking assistance), broader benefits are also anticipated including the potential for more revenues, greater certainty for taxpayers and encouraging a culture of compliance through more effective enforcement"), available at http://www.oecd.org/ctp/tax-global/TIWB_feasibility_study.pdf.

[36] G20 Leaders' Declaration, supra note 32, at 13 ("we welcome the OECD Tax Inspectors without Borders initiative, which aims to share knowledge and increase domestic capacities in developing countries in the tax area").

the size and nature of the local economy, and the size and nature of the MNE and its activities both globally and locally); (d) expectations regarding document retention and updates; (e) language requirements for reporting; (f) nature and impact of documentation penalties; (g) confidentiality; and (h) actual implementation (domestic law changes, oversight of taxpayer reporting, mechanism(s) for delivering information — centralized to MNE parent, locally or other options). Among some of the most important concerns that have emerged regarding the design and implementation challenges are: (a) burden: the gap between how MNEs manage their group reporting and the expectations under Action 13; (b) delivery mechanism: the need to ensure taxpayer confidentiality while also ensuring meaningful access to reported information, especially by developing countries; (c) use of information: the expectation that the CbC template will not lead countries to bypass audit and directly impose a transfer pricing adjustment, and the expectation that countries will not abandon an arm's length approach.

Developing countries may want to devote particular attention to the following key issues in Action 13: (a) the broad goal of Action 13 (to improve information necessary for tax authorities to make valid risk assessments) may be especially valuable to resource-constrained developing countries which must decide where and how to allocate scarce audit resources; (b) similarly, if the Action 13 reporting package (master file, CbC template and local file) becomes the MNE standard, the increased reporting uniformity should also help developing countries conserve and best direct their tax and audit resources; (c) the choice of reporting language can also directly impact the ability of developing countries to access information; thus, reporting at least the local file in the local language may be very important; (d) if MNEs provide the information directly to the home jurisdiction of the parent with the expectation that other countries then request some or all of the information, the actual availability of the data will be diminished for developing countries that have a smaller treaty network and/or limited tax enforcement staff to make the treaty-based inquiries for all information sought; (e) the ability to ensure confidentiality under domestic law will be vital regardless of the precise delivery mechanism; and (f) the capacity-building support that would benefit the developing country in making the most of information available under the Action 13 reporting package.

3.4 Disclosure of aggressive tax planning: BEPS Action 12

Action 13 is not the only part of the OECD project on BEPS seeking increased information from taxpayers. Action 12 targets aggressive tax planning arrangements and seeks taxpayer disclosure regarding these structures. As noted in section 3.1 above, this topic has a delivery date of September 2015.

3.4.1 Goals of Action 12

Based on the view that countries can more effectively tackle base erosion and profit shifting if they receive timely and relevant information, Action 12 seeks to require disclosure regarding aggressive planning. Paralleling the work currently being undertaken on Action 13, the work on Action 12 will include the design of a reporting standard and a mechanism for sharing information among taxing jurisdictions. Many of the same concerns raised under Action 13 for both taxpayers and governments will also arise, including: taxpayer burden, consistency, country-specific needs, and value of qualitative and group-wide information. The OECD Action Plan on BEPS anticipates that the recommendations under Action 12:

> will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of "tax benefit" in order to capture such transactions. The work will be co-ordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations.[37]

Given the thematic and structural overlap between Actions 12 and 13, the conclusions reached regarding questions such as taxpayer burden and the format for delivering the master file and CbC template under Action 13 will likely impact the future recommendations under Action 12.

[37] OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 3, at 22.

Although all countries should be concerned about the impact of aggressive tax planning structures and transactions on their tax base, many developing countries may find that their more immediate BEPS threat comes from "straightforward" profit shifting. In that case, the recommendations under Action 13 may have more significant, immediate relevance to such countries. That said, if developing countries currently experiencing BEPS through more traditional transfer pricing mechanisms successfully curb this loss of tax revenue, they may find that taxpayers shift to more sophisticated techniques for reducing their tax bill. At that point, Action 12 would take on a greater role in the response of developing countries to BEPS.

3.5 Summary of the OECD project on BEPS and transparency and disclosure

The OECD Action Plan on BEPS includes two action items directly bearing on transparency and disclosure. Action 12, which will be delivered in 2015, seeks to require disclosure of aggressive tax planning. Many of the issues and concerns that have emerged in the formulation and evaluation of Action 13 over the past year will likely become important again in the context of Action 12. Perhaps of greater importance for developing countries at present are the recommendations under Action 13 pertaining to documentation of transfer pricing and the multinational group. This action item has been the subject of extensive debate and comment and its three-part reporting package (master file, CbC template and local file) could play a very significant role in developing country tax enforcement. Additionally, Action 11 might play a role in the future to the extent that its anticipated collection of broad-level data regarding the success of strategies targeting BEPS provides guidance on future reform.

4. Other new developments in transparency and disclosure

4.1 Overview

The OECD project on BEPS is the most expansive effort to address base erosion and profit shifting, including through transparency and disclosure. But it is not the only venue for such action. Other work on transparency, disclosure and exchange of information is taking place at the national, regional and global levels — including at the OECD. A review of these efforts helps provide a more complete picture of the tools being developed to enhance the ability of countries to enforce their tax laws in a global economy.

4.2 Automatic exchange of information

4.2.1 Overview

Before the OECD project on BEPS began, countries were struggling with the question of how to improve access to taxpayer information and thus improve tax enforcement. Although global taxpayers are not new and exchange of information provisions have existed in bilateral tax treaties for decades, the explosion of cross-border commercial activity and investment by businesses and individuals has increased the need of tax authorities for information from locations outside their jurisdiction. Existing exchange of information provisions in bilateral tax treaties have been insufficient, in part because they generally call for exchange of information upon request. But that process can be slow, burdensome and difficult for requesting countries (see section 5.2 below). Many in the international tax community have advocated for automatic exchange of information — a process and commitment between or among jurisdictions to regularly send country-specified types of tax-related information regarding the taxpayers of that country. Others, however, have resisted on various grounds, including: domestic traditions of bank secrecy, administrative burden, the inability of the recipient to meaningfully process large quantities of information, and privacy concerns. Perhaps less often acknowledged is the reason to resist automatic exchange of information related to tax competition. Countries which impose low taxes on outsiders investing in or through their jurisdiction would see little upside to helping the home country impose tax and thereby negate the "value" of "investing" in that low tax jurisdiction.

4.2.2 Current practices

At present, neither Article 26 (Exchange of information) of the United Nations Model Convention nor Article 26 of the OECD Model

Convention requires automatic exchange (see section 5.2 below). However, the United Nations Commentary on Article 26 offers alternative language that would include automatic exchange of information as part of the commitment of the State.[38] The OECD Commentary on Article 26 similarly considers automatic exchange of information as one of the mechanisms available for countries to adopt.[39] The OECD Model Tax Information Exchange Agreement, which formally uses the upon request mode of exchanging information, envisages in its Commentary that countries could use the document for automatic exchange of information subject to agreement by the two States.[40] The Multilateral Convention on Mutual Administrative Assistance in Tax Matters provides for automatic exchange of information between members pursuant to terms mutually agreed to by those States (see section 5.4 below).

The European Union (EU) Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation (repealing Directive 77/799/EEC)[41] requires mandatory automatic exchange of information, effective 1 January 2015. The Directive mandates automatic exchange of information in specified categories: employment income, directors' fees, life insurance products, pension, ownership and income from immovable property. The EU Council Directive 2014/48/EU of 24 March 2014 (amending Directive 2003/48/EC) on taxation of savings income in the form of interest payments[42] generally requires member countries to report interest income paid to an individual beneficial owner resident in another member State.

[38] Paragraph 29.2 of the Commentary on Article 26 of the United Nations Model Convention.

[39] Paragraphs 9 and 9.1 of the Commentary on Article 26 of the OECD Model Convention.

[40] OECD, *Model Tax Information Exchange Agreement* (Paris: OECD, 2002), available at http://www.oecd.org/tax/exchange-of-tax-information/2082215.pdf. See paragraph 39 of the Commentary on Article 5.

[41] Available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:064:0001:0012:En:PDF.

[42] Available at http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0048&from=EN.

4.2.3 Challenges

Successful automatic exchange of information requires several elements: (a) a common standard regarding information reporting; (b) due diligence by financial institutions; (c) an exchange process; (d) a legal framework through which to execute the exchange; and (e) compatible technical systems.[43] Primary challenges in moving from the idea of automatic information exchange to the reality of widespread committed implementation have included: historic bank secrecy provisions, disagreement on the types of information, reciprocity, confidentiality, taxpayer identification, data security, format and feasibility. The first challenge, bank secrecy, has been under attack since approximately 2009. Over the past five years, most countries have substantially limited or eliminated domestic rules on bank secrecy that barred their own financial institutions from providing client information (to the local government or foreign governments) and/or barred the country from providing that information to another country pursuant to an exchange of information request.

4.2.4 OECD, the G20 and automatic exchange

The remaining challenges have been the focus of global work over the past two years. As of April 2013, the G20 has formally supported the "progress made towards automatic exchange of information which is expected to be the standard, and urge[d] all jurisdictions to move towards exchanging information automatically with their treaty partners, as appropriate."[44] The G20 had given the OECD a mandate to prepare standards and guidance on automatic exchange of information. In February 2014, the OECD released the first part of this project, the "Standard for Automatic Exchange of Financial Account Information:

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[43] OECD, *Automatic Exchange of Information: What it is, How it works, Benefits, What remains to be done* (Paris: OECD, 2012), available at http://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-of-information-report.pdf.

[44] Communiqué, G20 Meeting of Finance Ministers and Central Bank Governors (Washington, 18-19 April 2013), available at https://www.banque-france.fr/fileadmin/user_upload/banque_de_france/Eurosysteme_et_international/The-Final-Communique-of-G20_FM_CBG_Meeting-in-Aprill_2013.pdf.

Common Reporting Standard,"[45] which the G20 approved: "We endorse the Common Reporting Standard for automatic exchange of tax information on a reciprocal basis and will work with all relevant parties, including our financial institutions, to detail our implementation plan at our September meeting."[46]

As a follow-up to its February 2014 document, the OECD released its more comprehensive "Standard for Automatic Exchange of Financial Account Information in Tax Matters" in July 2014.[47] The July report included: (a) the text of a Model Competent Authority Agreement (CAA) for automatic exchange of certain tax information; (b) the Common Reporting Standard (CRS); and (c) Commentary intended to facilitate uniform implementation of the agreement and standard. Exchange of information under this system requires that each country take two basic steps.

First, countries must implement any domestic law changes necessary for: (a) requiring financial entities to gather and report the designated information; and (b) ensuring appropriate protection of taxpayer data. Second, countries (through their competent authorities) must agree to the exchange on an automatic basis and must set the terms of that exchange (for example, the CAA). The report urges that this agreement be executed under the legal framework of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (see section 5.4 below) because it allows for more than one country to enter into such a competent authority agreement, potentially reducing the amount of negotiating a country must do. Alternatively, the competent authority agreement could be executed under a bilateral tax treaty between two countries.

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[45] OECD, *Standard for Automatic Exchange of Financial Account Information: Common Reporting Standard* (Paris: OECD, 2014), available at http://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-financial-account-information-common-reporting-standard.pdf.

[46] Communiqué, G20 Meeting of Finance Ministers and Central Bank Governors, supra note 44.

[47] OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (Paris: OECD, 2014), available at http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-information-in-tax-matters.htm.

Much of the discussion and debate surrounding implementation of automatic exchange of information concerns the same questions that arose in considering the work under BEPS Action 13: the information to be provided, the level of burden imposed, the usefulness of the information and the protection of taxpayer data. One notable difference is that automatic exchange of information places the reporting burden on third-party financial entities, not the taxpayer.

In October 2014, 51 countries signed a Multilateral Competent Authority Agreement committing to automatic exchange of information based on the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. Some States signed as "early adopters" committing to exchanges by September 2017. Others will seek to implement automatic exchange by 2018. As a support to the automatic exchange process, the Global Forum on Transparency and Exchange of Information for Tax Purposes plans to establish a peer review process to ensure effective implementation of the new agreement.

To the extent that the recommendations regarding automatic exchange of information in the July 2014 OECD report form the baseline for automatic exchange of information relationships, developing countries must carefully evaluate whether its contents and structure would adequately meet their informational needs for the foreseeable future. In section 4.3 below, the Common Reporting Standard and the Model Competent Authority Agreement are outlined briefly and then analysed from a developing country perspective.

4.3 Common Reporting Standard and Model Competent Authority Agreement

4.3.1 Overview

The underlying goal of the OECD automatic exchange of information project is to put in place a system that: (a) enables the sharing of taxpayer information that is necessary for effective tax enforcement; and (b) does so in a manner that is sufficiently uniform and standardized that information can be efficiently provided, shared and processed. The OECD commented that it drew "extensively" on the intergovernmental response to the United States financial reporting requirements (the Foreign Account Tax Compliance Act (FATCA)) in designing the CRS (see section 4.5 below for further discussion of the intergovernmental agreements). Under this system, certain financial entities have an obligation to report specified information on account holders to the tax authorities in their own jurisdiction. That jurisdiction would then share the account information with the country in which the account holder is a resident. The expectation is that the emerging standard and system would be a minimum standard of sharing information between jurisdictions. Countries could, of course, decide to exchange additional information.

4.3.2 Common Reporting Standard

The CRS details the entities that must report, the type of information to be reported, the types of accounts for which information must be reported and the due diligence required of the reporting financial entities.

Reporting entities: Under the CRS, the following types of financial institutions are required to participate in reporting financial information of taxpayers: custodial institutions, depository institutions, investment entities and specified insurance companies (unless there is low risk of evasion).

Information provided: The types of financial information to be provided by the reporting financial entities include: interest, dividends, account balance or value, income from certain insurance produces, sales proceeds from financial assets, and other income generated by assets held in the account or payments made with respect to the account.[48]

Covered accounts: The accounts ("reportable accounts") for which reporting must be made by the reporting financial entities include accounts held by individuals and entities (including trusts and foundations). To limit evasive tax planning, the reporting financial entities must look through passive entities and report on the controlling persons. In terms of providing identifying information regarding the account, the financial entity must report the "name, address, jurisdiction(s) of residence, TIN(s) and date and place of birth (in the

[48] Ibid., at 15.

case of an individual) of each Reportable Person that is an Account Holder."[49]

Due diligence: To ensure meaningful and effective provision of information, reporting financial entities must perform a specified level of due diligence aimed at securing accurate information regarding the identity of the account holder. Different standards of diligence are applied depending upon when the account was created, its contents, its value and other information known to the financial entity.

4.3.3 Model Competent Authority Agreement

The CAA is drafted as a bilateral agreement between two jurisdictions to commit to the automatic exchange of financial account information. Pursuant to the agreement, the countries agree to have domestic rules requiring financial institutions to report accounts and follow due diligence procedures consistent with the CRS and the terms of the specific CAA. Additionally, the signatories confirm that they have: (a) the appropriate safeguards to protect the confidentiality of taxpayer data; and (b) the infrastructure necessary for effective exchange (including mechanisms for "timely, accurate, and confidential information exchanges, effective and reliable communications, and capabilities to promptly resolve questions and concerns about exchanges or requests for exchanges").[50]

4.3.4 Developing country analysis

4.3.4.1 Overview

A range of developing countries have expressed interest in automatic exchange of information. Income tax evasion poses a serious fiscal challenge for many developing countries which rely substantially on the income tax base. Current methods for obtaining information located outside the jurisdiction can be costly or unavailable. Treaties generally permit exchange of information only upon request (a process that can be burdensome in terms of time, money and expertise).

[49] Ibid., at 29.

[50] Ibid., at 21-22.

Moreover, many developing countries have a more limited treaty network (even including TIEAs), and may not have treaties with key tax haven jurisdictions (used by their residents to avoid the developing country income tax). Thus, some developing countries are among those who have committed to early adoption of the CRS (see section 4.2.4 above)

4.3.4.2 Advantages of the Common Reporting Standard and the Competent Authority Agreement

The overall automatic exchange of information project advances the potential for meaningful income tax enforcement. Widespread dissemination of relevant taxpayer information to the appropriate taxing authorities enhances real enforcement and, more broadly, alerts taxpayers to the risks of tax evasion. As noted in section 4.3.4.1 above, current information exchange mechanisms can be too burdensome to serve as a regular component of tax enforcement. Automatic, bulk provision of the information enumerated in the CRS would significantly reduce the costs of acquiring that information through existing mechanisms. Additionally, the automatic nature of the delivery reduces the opportunity for pressure, leverage and corruption in tax administration.

The scope of taxpayers whose accounts are covered by the CRS further increases the value of the information exchange. The decision to include entities and not just individuals, and to reach trusts and other often opaque holding structures, expands the coverage of this automatic exchange of information system beyond that of some other programmes.

4.3.4.3 Limitations of the Common Reporting Standard and the Competent Authority Agreement

The advantages of the CRS and CAA described above essentially reflect the reduced costs and difficulties of acquiring information compared with obtaining it via an existing bilateral treaty. But the ability to participate in the CRS and CAA is currently contingent upon: (a) meeting the standards necessary to commit to providing — not just receiving — information (required reciprocity); and (b) getting the key jurisdiction to sign a CAA (participation).

4.3.4.3.1 Reciprocity

The CAA is premised on reciprocity between or among signatories. Although countries may sign a CAA in advance of being ready to participate, the agreement takes effect only when they are in fact prepared to share information reciprocally.[51] The only option for non-reciprocal participation in the CRS and CAA is provided for countries which do "not need to be reciprocal" (for example, because one of the jurisdictions does not have an income tax).[52] This has been characterized by some commentators as intended to facilitate automatic exchange of information from tax havens. There is no current model or provision allowing for non-reciprocal automatic exchange of information with (or more precisely, to) a developing country (that is to say, providing information to that developing country without receiving information in return). The absence of such an alternative may render the current CRS and CAA out of reach of developing countries that cannot currently commit to or meet the standards for domestic collection of the required tax information (that is, the domestic law provisions and enforcement of data collection from reporting financial entities) and the processing and transmission of the information (inside the tax administration). These developing countries could benefit from the receipt of information under automatic information exchange, however. The only requirement they would need to meet would be the protection of taxpayer data. Even if the developing country were not yet able to make maximum use of the bulk data it receives, the country could nonetheless begin to improve tax enforcement with the information.

If non-reciprocity with developing countries were permitted, it could be managed in a gradual manner. The country could commit to meeting established benchmarks for domestic information collection and processing. While the country was meeting the benchmarks, it could receive information under the CRS and CAA, with the goal being full and reciprocal participation. The loss for the other country during this period of time would likely be minimal. Developing countries are typically not the financial destinations of major tax evaders,

[51] See, for example, OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, supra note 47, at 27.

[52] Ibid., at 223.

and developed countries would likely receive little significant information from this automatic exchange of information. Thus, the cost of helping developing countries improve tax collection while building their internal capacity to fully participate in automatic exchange should not be unduly high.

4.3.4.3.2 Participation

Even with adequate infrastructure to participate in automatic exchange of information under the CRS and CAA, developing countries must actually be able to persuade partner countries to sign these agreements. The bilateral version offered as the main example of a CAA would be less effective for many developing countries. It would have to be negotiated on a bilateral basis with each country and could be completed only with current treaty partners (bilateral tax treaties or TIEAs). The alternative, multilateral version of a CAA provided in annex 1 of the July 2104 OECD document (signed by 51 countries in October 2014) has its legal basis in the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (see section 4.2.4 above).[53] This multilateral version offers two key advantages to developing countries — only a single agreement to negotiate and a wide pool of potential signatory partners. There are, however, three problems.

First, with the availability and prominence of the bilateral version, there may be inadequate motivation for some countries to pursue the multilateral one. Second, even if countries do participate in a multilateral CAA, it is not clear that they would be required to invite a developing country to sign. Specifically, some developing countries that have been unable to sign treaties with tax havens may be concerned that tax havens would also refuse to participate in a CAA with them. Yet these havens are key jurisdictions from which a developing country may need to acquire tax information, and unlike developed countries the developing country may have little leverage to persuade or entice the participation of the tax haven. Finally, unlike the United States FATCA regime, which inspired the CRS and CAA, it is not clear what sanctions would apply to non-participants. The absence of sanctions may be a concern for developing countries that are trying to get tax havens to join them in a CAA.

[53] Ibid., at 215.

4.4 Industry-specific reporting requirements (natural resources, financial services)

Industry-specific CbC reporting has also been a focus of increased transparency for countries. For example, United States securities law regulations now require extractive industries to report various payments made to foreign governments by businesses engaged in extractive industries (exploration, extraction, processing and export of oil, natural gas or minerals, or the acquisition of a licence to engage in such activity). These payments, which must be reported on a country-by-country basis, include "taxes, royalties, fees (including licence fees), production entitlements, bonuses, and other material benefits." [54] Implementation of these new requirements (enacted into law in 2010), however, awaits Securities and Exchange Commission implementing regulation.

On a more global scale, the Extractive Industries Transparency Initiative (EITI) seeks to promote a two-pronged reporting approach for transparency in extractive industries[55] under which businesses report what they pay to each jurisdiction, and the governments report what they receive.[56] However, work on industry-targeted disclosure has not been limited to extractive industries. Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC)[57] seeks disclosure by covered financial institutions of information on a country-by-country basis, including: profit or loss before tax, tax paid, subsidies received, average number of employees. Member States of the EU must enact rules domestically to require the reporting.[58]

[54] United States Securities Exchange Act of 1934, section 13 (q).

[55] Extractive Industries Transparency Initiative Fact Sheet 2014, available at http://eiti.org/files/2014-03-26%20Factsheet%20English_0.pdf.

[56] EITI countries and country reports are available at http://eiti.org/countries.

[57] Available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:EN:PDF.

[58] See, for example, United Kingdom of Great Britain and Northern Ireland reporting rules which came into effect in January 2014, with the first

In some cases, efforts to combat corruption prompted the push for transparency and disclosure initiatives. Where transparency and disclosure serve an anti-corruption role, the public release of disclosed information can be important. Not surprisingly, the nature and scope of any public disclosure of taxpayer data has generated debate and objection in the business community.

Although the issue of public disclosure of taxpayer information has been raised by some advocates in the context of BEPS (see section 3.3.5.4 above), the OECD does not anticipate that Action 13 files would be made available to the public. But corruption concerns have surfaced as a possible factor in the limited collection of income tax in some countries, and public disclosure of at least some information in the master file, CbC template and/or local file could play a role in improving tax enforcement.

4.5 Intergovernmental agreements and related developments

In 2010, the United States enacted the Foreign Account Tax Compliance Act (FATCA).[59] Prompted by the number of United States taxpayers using offshore financial accounts to avoid United States income tax, the new legislation effectively requires a wide range of financial institutions (foreign and domestic) to provide data to the United States regarding its taxpayers who hold accounts at those institutions. The FATCA legislation imposes due diligence and reporting burdens on these third-party entities, and failure to comply can result in negative United States tax consequences for the financial institutions' own United States source income.

In an effort to streamline compliance for foreign financial entities required to report under FATCA, and to address various

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reporting required by 1 July 2014. See also final United Kingdom regulations, available at http://www.legislation.gov.uk/uksi/2013/3118/made, and final United Kingdom guidance, available at https://www.gov.uk/government/publications/capital-requirements-country-by-country-reporting-regulations-2013-guidance/capital-requirements-country-by-country-reporting-regulations-2013-guidance.

[59] United States Internal Revenue Code, sections 1471-1474.

disclosure and confidentiality concerns, a number of countries entered into intergovernmental agreements (IGAs) with the United States that provided specific guidance on the type of information that their own domestic financial institutions would gather on United States taxpayers and detailed how that information would be provided to the United States.[60] These IGAs were negotiated under the legal framework of the existing bilateral tax treaty of each country with the United States. Given the increasing number of IGAs being signed with the United States, other countries have expressed interest in receiving the same type of tax-related information on the foreign financial accounts of their own residents, and have pursued a broader IGA format.[61]

4.6 Summary of other developments in transparency and disclosure

In addition to the OECD project on BEPS, there are several other global efforts to limit base erosion and profit shifting. The OECD and G20 have been advocating introduction of automatic exchange of information including a "Common Reporting Standard" for the information that should be exchanged. The OECD released its comprehensive standard in July 2014 (including the CRS itself), a Model Competent Authority Agreement and a Commentary (to facilitate uniform implementation). The CRS specifies which financial entities must report taxpayer information, which information must be reported and which accounts are subject to reporting. Exchange of information as a tool for transparency and disclosure avoids the burdens of pursuing exchange upon request. But it still requires an agreement to the exchange. The proposed implementation of a multilateral CAA through the Multilateral

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[60] Ultimately, the United States provided two model intergovernmental agreements that formed the basis of its negotiations with other countries, IGA Model 1 and Model 2.

[61] See, for example, letter dated 9 April 2013, signed by the finance ministers of France, Germany, Italy, Spain and the United Kingdom announcing their pilot programme to automatically exchange information (a "multilateral exchange facility"), available at http://taxnews.lexisnexis.co.uk/TaxNewsLive/Members/BreakingNewsFullText.aspx?id=4335&css=1&xml=0. The signatories encouraged other European Union member States to join them in their pilot programme based on IGAs signed with the United States pursuant to FATCA.

Convention on Mutual Administrative Assistance in Tax Matters would obviate the need to enter into many bilateral arrangements. This would be an advantage for countries with few current treaties and limited resources for tax administration. In October 2014, over 50 countries signed a multilateral CAA to implement automatic exchange of information (see section 4.2.4 above). However, even this path (use of the Multilateral Convention) would not guarantee that crucial jurisdictions would join a developing country in exchange of information. Another barrier for developing countries is the "reciprocal" nature of the CAA. Exchanges would start only after both countries complied fully under the agreement. Phasing in reciprocity would allow developing countries to receive valuable tax information and tackle base erosion straight away, while building their internal capacity to comply with all aspects of the CAA. Other potentially interesting initiatives for transparency and disclosure include: (a) efforts such as the Extractive Industries Transparency Initiative, which encourages industry-based reporting of tax payments (with both business and government reporting payments and receipts); and (b) bilateral and regional efforts to replicate the kind of information exchange being promised under IGAs that have been signed in the wake of the new United States reporting requirements for financial entities.

5. Existing mechanisms supporting transparency and disclosure

5.1 Overview

Significant attention has been directed to transparency and disclosure in recent years, but these concepts are not new to the tax system. For example, tax treaties have included exchange of information provisions for decades, which although more limited in scope and effect than some of the transparency and disclosure projects currently under way, have nonetheless sought to enhance access of a tax administration to vital taxpayer data. A brief review of these existing mechanisms which support and facilitate tax transparency and disclosure provides: (a) a better understanding of what may be needed in new mechanisms; and (b) the role that these current agreements or structures can play in supporting any new developments in transparency and disclosure.

5.2 Article 26 of the Model Conventions

Both the United Nations Model Convention and the OECD Model Convention include an Article 26 (Exchange of information) that outlines the primary terms governing exchange of information between the two signatories: the duty to exchange, the duty to protect taxpayer information, the grounds upon which a request for information can be declined and the grounds which do not form an appropriate basis for refusal to exchange information. The United Nations and OECD versions of Article 26 (and their respective Commentaries) differ in some regards and on balance share several common deficits, but their common features are reflected in the bilateral tax treaties of many countries. Moreover, as referenced below, changes have been made to Article 26 of both Conventions in an effort to increase the likelihood of meaningful exchange of information.

5.2.1 Standard governing requests

As noted earlier, Article 26 of neither the United Nations nor the OECD Model Convention requires automatic exchange of information. Thus, countries requesting information must meet certain thresholds for documenting their request (in other words, "no fishing expeditions"). This step limits jurisdictions to requesting information only about taxpayers and activities for which they already have some knowledge. Moreover, the specific threshold requirements imposed by existing bilateral tax treaties decrease the likelihood that information will be requested. Recent changes to Article 26 of the United Nations Model Convention decreased the impact of these "thresholds." For example, changes to Article 26 (1) in 2011 sought to extend the scope of exchange of information by providing that information should be exchanged if it is "foreseeably relevant for carrying out the provisions of [the] Convention or to the administration or enforcement of the domestic laws of the Contracting States." The phrase "foreseeably relevant" replaced the earlier term "necessary."[62] The Commentary on Article 26 of the United Nations Model Convention offers some alternative language for the new

[62] Paragraph 4 of the Commentary on Article 26 of the United Nations Model Convention characterized the change to "foreseeably relevant" as one that was not substantive. Rather, it was intended to "remove doubts" and "clarify" the prior language.

phrase "foreseeably relevant," but these options are intended to allow treaty partners to choose language that they find clear in specifying the goal of "effective" exchange of information.[63]

Despite the expanded scope of exchange of information under the "foreseeably relevant" language of Article 26, it is important to note that automatic exchange of information entirely eliminates even a broad test for demonstrating the connection between the requested information and the investigation of the taxing authorities. The automatic receipt of specified bulk data effectively would place no such constraints on jurisdictions seeking information in the designated categories. Additionally, the current "upon request" process requires an allocation of the potentially limited resources of the requesting country, which would be alleviated under automatic exchange of information.

5.2.2 Bank secrecy

Historically, States have declined to comply with a request for information under Article 26 on the grounds that compliance would violate domestic law, specifically, bank secrecy rules. Where countries had such domestic law provisions severely limiting (often under significant penalty) the ability of a financial institution to share information with the government regarding a client, and/or limiting the ability of the government to share such information with another country, domestic law regularly trumped the operation of Article 26. In 2011, Article 26 of the United Nations Model Convention was revised to provide that certain domestic laws may not be used as a defence in complying with an exchange of information request. Thus, the new language in Article 26 (5) states: "In no case shall the provision of paragraph 3 [outlining appropriate grounds to refuse a request] be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person."[64]

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[63] Article 26 of the OECD Model Convention also uses the phrase "foreseeably relevant."

[64] Article 26 of the OECD Model Convention also bars refusal on the grounds of bank secrecy.

5.2.3 Information sought not needed by requested State for own purposes

A further 2011 change to Article 26 of the United Nations Model Convention sought to eliminate an additional argument that a State might use to decline to provide requested information: that the State asked to produce the information has itself no need or use for the information in administering its tax law. Article 26 (4) now provides that: "If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information-gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes." Anticipating that some States might try to argue that they are not legally capable of providing information that they do not need for a tax purpose (despite the language in Article 26 (4)), the United Nations Commentary on Article 26 offers alternative language. This alternative phrasing requires that each Contracting State must undertake to ensure that its competent authority will have the requisite power under domestic law to secure the information needed for tax treaty information exchange purposes. In some cases, domestic legislation, rulemaking or administrative changes may be necessary to ensure that power.[65]

5.2.4 Format

Article 26 exchange of information provisions do not require that information be provided in a certain format. But more uniformity in the content and format of information provided by taxpayers to the government might, increasingly, lead to the government of a requesting State receiving information in a desired format. For example, the recommendation under BEPS Action 13 would notably enhance transparency and disclosure by requiring that taxpayers collect, generate and provide information in a specified format to the tax authorities. This rule, implemented in each jurisdiction through domestic legislation (master file, CbC template and local file reporting requirements), would shift the burden to the taxpayers, who have a distinct ability to access their own information. To the extent that reporting for the

[65] See paragraph 26.3 of the Commentary on Article 26 of the United Nations Model Convention.

master file, CbC template and local file is fairly uniform and consistent over time, across countries and across taxpayers, the information may be easier for tax authorities to use. For resource-constrained developing countries, this uniformity could facilitate training and decrease audit burdens.

5.2.5 Article 26 of the Model Conventions: summary

Existing bilateral tax treaties still constitute a relevant tool in encouraging transparency and disclosure. First, they can provide the legal basis or framework for an agreement between competent authorities to exchange information on an automatic basis (as can TIEAs or the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (see sections 5.3 and 5.4 below)). Second, they may explicitly permit requests regarding persons neither resident nor engaged in economic activity in the State from which information is sought. An automatic exchange of information arrangement would be unlikely to include data regarding such persons. Third, the "residual" ability under Article 26 provisions to seek information upon request remains useful if a country finds that it requires information beyond the scope of that provided automatically.

Although bilateral treaty provisions based on Article 26 of either the United Nations or the OECD Model Convention are inadequate in meeting the full range of transparency and disclosure needs of tax administrations today, they continue to provide possible access to information not likely available through automatic exchange of information or through the taxpayer reporting envisaged by BEPS Action 13 recommendations.

5.3 Tax Information Exchange Agreements

TIEAs are stand-alone agreements, typically negotiated between countries that have not negotiated a bilateral tax treaty, that focus exclusively on exchange of information. The expectation is that even countries that do not have a bilateral treaty may still seek to exchange tax information. The TIEA provides the legal basis and structure for doing so. The OECD Model TIEA, not surprisingly, is very similar to Article 26 of the OECD Model Convention (and the United Nations

Model Convention). The primary differences between the OECD Model TIEA and Article 26 include the following: (a) TIEAs can be bilateral or multilateral; (b) TIEAs focus on exchange "upon request"; (c) TIEAs cover specific taxes; and (d) TIEAs provide more detail regarding the information that the requesting State must provide to initiate its request.

For countries pursuing increased transparency and disclosure in tax, TIEAs provide a legal framework and context to agree to exchange information automatically. That is, although TIEAs call for exchange "upon request," they permit contracting States to expand their cooperation through agreement by the competent authorities. Thus, just like comprehensive bilateral treaties in the case of Article 26, TIEAs can serve as the legal foundation for countries to commit to automatic exchange. To the extent that some developing countries have a more limited network of comprehensive tax treaties but do have a network of TIEAs, such a role for TIEAs could become important.

5.4 Multilateral Convention on Mutual Administrative Assistance in Tax Matters

The Multilateral Convention on Mutual Administrative Assistance in Tax Matters, which originally was developed by the OECD and the Council of Europe in 1988, was amended in 2011 to welcome all countries as participants.[66] At present over 60 countries have signed the Convention, including developing countries. The Convention must be signed and ratified by a country in order for it to apply — and countries can make individual reservations to the basic terms of the Convention. As a result, reliance on the Convention depends upon whether the countries in question have ratified it and whether they have made any relevant reservations to significant terms. But, as a multilateral framework, the Convention offers a potentially valuable legal foundation for countries looking to pursue enhanced transparency and disclosure among a group of nations in a relatively simultaneous and efficient way.

[66] OECD-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, available at http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf.

With respect to exchange of information, the Convention includes a comprehensive consideration of: (a) prerequisites to exchange; (b) what can be exchanged; and (c) the mechanism for exchange. As drafted, the Convention envisages exchange of information upon request, spontaneously and automatically (according to procedures and terms mutually agreed to by two or more parties).[67] The Commentary on the Convention emphasizes the value of standardization in automatic exchange, noting savings in time and workload, but observes that these advantages accrue primarily when large numbers of countries participate in the standardization process. The Multilateral CAA that was signed by 51 countries in October 2014, committing to automatic exchange of information, is grounded in the legal framework of the Convention, with the advantages and concerns for developing countries noted in sections 4.3.4.2 and 4.3.4.3 above.

5.5 Regional agreements

In addition to bilateral tax treaties, TIEAs and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, regional agreements exist which could serve as the legal basis and framework for exchange of information among the signatory States. Examples of such regional agreements include: (a) the 2008 West African Economic Monetary Union (WAEMU) Income and Inheritance Tax Convention (Article 33); (b) the South Asian Association for Regional Cooperation (SAARC) Limited Multilateral Agreement on Avoidance of Double Taxation and Mutual Administrative Assistance (Article 5); and (c) the Agreement Among the Member States of the Caribbean Community (CARICOM) for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Profits or Gains and Capital Gains and for the Encouragement of Regional Trade and Investment (Article 24). However, a major limitation of regional agreements is their membership. Both the requesting State and the country from which it is seeking information must be members of the applicable regional agreement. To the extent that the taxpayers of a country conduct business or hold their assets and accounts in other jurisdictions, the regional agreements offer little assistance. Moreover, their relatively abbreviated exchange of information provisions do not

[67] Ibid., Articles 6 and 7.

detail the expectations regarding the delivery mechanism for information and do not call for automatic exchange.

5.6 Global Forum on Transparency and Exchange of Information for Tax Purposes

5.6.1 Overview

In the late 1990s, many countries became concerned with the effects of tax havens and preferential tax regimes which impeded effective tax enforcement by virtue of their lack of transparency and their lack of information exchange. As a response, the predecessor of the current Global Forum on Transparency and Exchange of Information for Tax Purposes was formed in 2000 under the auspices of the OECD. The Global Forum has 126 members (as at May 2015)[68] including developed and developing countries, and OECD and non-OECD members.

The Global Forum has pursued two projects relevant to transparency and disclosure: (a) the development of the Model Tax Information Exchange Agreement (TIEA) (see section 5.3 above); and (b) the development and implementation of the peer review process (the essentiality of the legal and regulatory framework of the assessing countries to transparency and exchange of information). The peer review process, which began in 2009, is undertaken in two phases (Phase 1 and Phase 2), although they can be combined. The review evaluates a country by reference to its capacity for and actual performance in providing information upon request. Thus, the peer review process explores the degree to which a country is compliant with commitments under treaty provisions comparable to Article 26 of the United Nations and OECD Model Conventions, or to the Model TIEA. Additionally, following the signing of the Multilateral CAA for automatic exchange, the Global Forum announced its intent to establish a peer review process to ensure compliance with the exchange commitment (see section 4.2.4 above).

The current peer review process examines the domestic laws and practices of a country along a number of dimensions to assess whether: (a) the ownership and identity of entities and arrangements

[68] See http://www.oecd.org/tax/transparency/.

are available to the competent authority; (b) reliable accounting records are maintained for such entities; (c) account holder banking information is available; (d) the competent authority has the power to obtain and provide information pursuant to an exchange of information request; (e) appropriate safeguards apply to persons in the requested country; (f) all relevant partners are covered by the network of information exchange mechanisms of the jurisdiction; (g) adequate confidentiality mechanisms exist to protect information received; (h) the rights and safeguards of taxpayers and third parties are respected; and (i) information is provided in a timely manner for requests made under its exchange of information mechanisms.

Input is sought from all members of the Global Forum during the process of reviewing a specific country.[69] Members complete an extensive questionnaire about their own practical experience in working with the country under review. The review is performed by an assessment team (two expert assessors from peer jurisdictions, along with a coordinator from the Global Forum secretariat). The report of the team is presented to the 30-member Peer Review Group (PRG), and upon approval becomes a formal report of the PRG. At that stage, the entire membership of the Global Forum is asked to approve the report. To date, over 100 countries have participated in the peer review process and have been the subject of a completed and published report. As part of the review process, recommendations are made to countries for ways in which to improve their ability to participate and cooperate in exchange of information. Over 80 countries have introduced or proposed domestic law changes in order to implement the more than 400 recommendations that have emerged from the peer review process.[70]

5.6.2 Developing countries and the Global Forum

From the perspective of a developing country, a number of observations can be offered regarding the work of the Global Forum. First, the promotion of TIEAs can be beneficial to jurisdictions not currently in

[69] Global Forum on Transparency and Exchange of Information for Tax Purposes, *Information Brief* (Paris: OECD, 2013), at 6-7, available at http://www.oecd.org/tax/transparency/global_forum_background%20brief.pdf).

[70] Ibid., at 4.

a position to negotiate many bilateral treaties. Second, to the extent that the peer review process improves the general transparency of domestic banking, tax and regulatory rules of other jurisdictions, developing countries may gain. Assuming that developing countries would have had little leverage to instigate these transparency changes on their own, they may now find that their information requests made to other jurisdictions are more efficiently managed.

Third, a peer review of a developing country itself may provide support for the internal efforts of the tax administration to encourage and effectuate domestic law (and practice) changes consistent with active participation in exchange of information. This will be most true where the developing country receives any needed and requested technical assistance on the more detailed facets of managing information and requests.[71] Fourth, the current benchmark for the peer reviews is exchange upon request (which still imposes burdens on developing countries (see section 4.3.4.1 above)). But the domestic law and infrastructure standards that the peer review process promotes would also be essential if and when countries ultimately adopt some version of automatic exchange of information. Finally, to gain the maximum benefit from enhanced compliance by other countries, developing countries need to be in a position to request information (until automatic exchange takes hold) and to make effective use of such information. Additional work by the Global Forum in providing relevant assistance to developing countries, consistent with the G20 emphasis on ensuring that all States benefit from improved exchange of information, would help guarantee that developing countries are not just providers of information but also knowledgeable "consumers" of exchanged information.[72]

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[71] See, for example, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2013: Report on Progress*, at 23 (outlining technical assistance opportunities), available at http://www.eoi-tax.org/keydocs/f6eb5861601672f34b5e25e8a4f57380#default.

[72] See, for example, Communiqué, G20 Meeting of Finance Ministers and Central Bank Governors (Moscow, 20 July 2013), available at http://en.g20russia.ru/events_financial_track/20130719/780961553.html ("All countries must benefit from the new transparent environment and we call on the Global Forum on Exchange of Information for Tax Purposes to work with the OECD task force on tax and development, the World Bank Group and others to help developing countries identify their need for technical assistance and

5.7 Summary of existing support for transparency and disclosure

Transparency and disclosure are not new to the international tax system. The versions of Article 26 of both the United Nations and the OECD Model Conventions call for exchanging information "upon request" and in recent years, changes made to the provision have enhanced the likelihood of effective and useful information exchange taking place. Among the most important reforms are: (a) elimination of domestic bank secrecy rules as a justification for denying a request for information; (b) reduction of the threshold that the requesting State must meet to demonstrate that the information requested is "foreseeably relevant for carrying out the provisions of [the] Convention or to the administration or enforcement of the domestic tax laws of the Contracting States"; and (c) elimination of the argument that requested information need not be provided because the requested State itself does not need the information. Additionally, the work of the Global Forum, particularly in the peer review process, has the potential to help countries seeking to improve their own transparency and disclosure laws (which will improve both their own enforcement capacity and their ability to participate globally in transparency and disclosure projects). Moreover, to the extent that the peer review process improves the transparency and disclosure capacity of countries from which a developing country is seeking information, the developing countries need not expend resources to encourage such reform in its partners.

6. Summary observations regarding the role of tax transparency and disclosure in preventing base erosion and profit shifting

Base erosion and profit shifting are critical problems for all countries, but especially for developing countries that rely significantly on the corporate income tax. Although many reforms will be important for a successful global response to this challenge, increased transparency

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capacity building"); Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2013: Report on Progress*, supra note 71, at 25.

and disclosure regarding multinational businesses are essential. Countries face a number of barriers to achieving this level of transparency and disclosure. First, domestic law may not currently require adequate reporting regarding financial accounts, cross-border related-party transactions, foreign financial assets or foreign business activities. The final recommendations emerging from the OECD project on BEPS, in particular those grounded in Actions 12 and 13, may prove especially useful as guides for countries exploring domestic reform. Additionally, the Global Forum peer review process provides a mechanism for both assessing and facilitating domestic improvements in transparency and disclosure.

Second, countries may face domestic enforcement impediments to their effective acquisition and use of information. Developing countries that are resource-constrained (for example, limited audit staff, limited international tax expertise, limited technological resources) might find it difficult to seek and acquire the information necessary to effectively audit all of the major multinational businesses operating in their jurisdiction. To the extent that proposed reforms can ease any of these constraints or burdens, they may be particularly useful to developing countries. Conversely, if reforms require resources or treaty relationships not currently available to many countries, their formal adoption will likely have less impact on resource-constrained States.

Third, effective responses to BEPS will require engagement with the broader tax community. Information can be sought directly from taxpayers, but often important information will be needed from other countries. Thus, the crucial question is whether a State has treaty relationships (bilateral, TIEA or other) with the countries from which it is most likely to need information. If the transparency and disclosure reforms rely less on bilateral relationships and more on multilateral approaches, jurisdictions with more limited treaty networks can more readily enjoy the benefits of the new reforms.

Among the most prominent proposals for transparency and disclosure reforms currently under way are the documentation reforms envisaged in Action 13 of the OECD Action Plan BEPS (focused on improved reporting for transfer pricing documentation and the global activities of a multinational group). The proposed reporting package under Action 13 includes: (a) the master file (standardized global information regarding the multinational group); (b) the CbC template (which reports seven information items on a country-by-country basis for the group, along with identifying information on entities operating in each jurisdiction); and (c) the local file (more country-specific details regarding activities, assets, income and related-party transactions). The reporting package is expected to help tax administrators assess risk and focus audit efforts. This assistance is especially valuable for resource-constrained countries seeking to allocate scarce audit resources to their more serious and relevant BEPS problems. A number of important issues continue to be debated regarding Action 13. For example, depending upon how the information is delivered, it may be either more or less accessible to jurisdictions. If the master file and CbC template are provided only to the residence jurisdiction of the MNE parent (then to be shared via exchange of information requests), developing countries with limited treaty networks, or limited resources to pursue treaty requests, or both, would face a burden in retrieving the information. At the same time, taxpayers have voiced concerns over their own potential documentation burden, the risks of inadequate data protection and the possibility that countries could use the information in unintended ways (for example, as a replacement for audit).

The OECD project on BEPS is not the sole avenue for potential reforms in transparency and disclosure. The OECD and the G20 have advocated for increased use of automatic exchange of information. To further this goal, in 2014 the OECD released a proposed Common Reporting Standard (CRS) along with a Commentary for automatic exchange of information. In October 2014, 51 countries signed a Multilateral Competent Authority Agreement under the Multilateral Convention on Mutual Administrative Assistance in Tax Matters committing themselves to automatic exchange. As with the work foreseen under Action 13, reforms that increase uniform provision of information more directly to States can be distinctly advantageous for developing countries trying to maximize the impact of their available tax administration resources. A critical question is the legal framework under which the automatic exchange will occur. The multilateral mechanism for sharing information (assuming it includes countries from which information would likely be sought) would best serve States with limited treaty partners. Moreover, allowing developing countries temporary access to automatic exchange on a non-reciprocal basis would enable these countries to start tackling base erosion immediately, with relatively little risk to other countries.

Finally, countries can continue to explore the use of existing bilateral treaties and TIEAs to seek taxpayer information. The United Nations and OECD Model Conventions both incorporate new standards that reject bank secrecy as a ground for refusing to share information and reduce the burden of the requesting State to show the precise use of the information sought.

Ultimately, transparency and disclosure of information remain vital to the effective enforcement of tax laws in a global economy. All countries should be attentive to the existing techniques for obtaining needed information, and should evaluate active reform proposals for their relevance, effectiveness and required capacity-building. Transparency and disclosure have centre stage in international tax policy reform, and the goal is to ensure that the outcomes of this focus meaningfully reduce the base erosion and profit shifting faced by jurisdictions around the world.

Designed by the Graphic Design Unit - DPI - United Nations

ISBN 978-92-1-159109-5