Attachment to Coordinator Paper: (2) Note on Capital Gains Taxation and Taxation of Indirect Asset Transfers

October 15, 2015

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Overview

1. Executive Summary

1.1. The issue of indirect transfers of interests in mining and oil and gas related assets, as well as in other sectors, is receiving increasing attention, particularly in developing countries. The concern often expressed is that by use of the principle of separate legal personality, and the residence of companies and similar entities, what is in substance the sale of an asset located in a developing country, can be effected in a way that taxation of profits from the sale is avoided. What is often said to be "in substance" the sale of an asset in the developing country (attracting tax on the profits) is transformed into an offshore sale of a foreign holding company (which may hold the developing country asset directly or through other foreign companies), usually to an offshore buyer. The claim is then usually made that the developing country lacks the jurisdiction under the domestic law to tax such an "extraterritorial" event not involving tax residents. The further claim is made that even if domestic law allowed taxation, a treaty between the developing country and the country of the transferor company preserves no taxing right for the developing country.

1.2. In examining the issues involved in the taxation of indirect transfers, the first consideration should be the basic policy issue of whether the country taxes gains made on the direct transfer of capital assets at the time of the transfer or only tax the profits over time as income is generated by those assets. If the direct transfer of assets is taxed, a further policy decision is whether the country desires to tax the indirect transfer of capital assets. If a country determines, as a general policy matter, to tax indirect transfers, it must also decide on the scope of the transfers to tax. For example, certain business reorganizations are often exempt from immediate taxation, even if done directly and within the country. The note will therefore also consider whether immediate tax on certain similar transactions in the extractive industries should be imposed, whether done directly or indirectly.

1.3. Where a country determines immediate taxation should be imposed on a particular indirect transfer, the final set of issues relate to how this should be done, given that the transferor and the transferee are often foreign tax residents, and the transaction is conducted outside the country where the assets are located. The issues involved from the policy and administration viewpoint include those of: how to ensure an awareness of such transactions when they occur; who should bear the tax obligation; and how that can be achieved fairly but with a degree of certainty that the tax will be paid. Issues also arise regarding applicable tax treaties, if any, and their impact on the taxing rights over such transfers. How a tax treaty may interact with either general or specific provisions in domestic law seeking to address perceived abuses in this area – including the issue of "treaty override" rules – must also be considered. This note gives examples of responses to this issue and practical guidance on other potential responses.

2. Purpose

2.1. This note is intended to provide options for policy-makers and administrators in developing countries as to the taxation of indirect transfer of assets within the extractive industries, as well as to offer guidance on the pros and cons of such options in particular circumstances. It also seeks to assist countries in limiting the negative aspects of options.

2.2. More specifically, the note explores the issues involved in deciding whether a tax should apply to capital gains in the extractive industries and, if so, under what circumstances. It further explores, in cases where there is such a tax, some of the policy and administration issues involved in covering so-called "indirect transfers" – whereby extractive assets are not themselves transferred (as in Figure 1 below), but companies or other entities (often resident offshore) holding the assets directly or through further entities are transferred (as in the simple example at Figure 2). The issue of concern in indirect transfers is that they may be motivated and the structure designed primarily to avoid capital gains tax on the transfer by having the transfer occurring at the level of a company in a low or no-tax jurisdiction, rather than in a country where the extractive assets are located. On the other side of the coin, taxing indirect transfers can raise difficult issues in compliance and enforcement that may be relevant to whether they are taxed at all, and certainly, if they are, to the way in which that is achieved.

2.3. The issues are basically: (i) whether gains from direct transfers of extractive assets should be taxed; (ii) whether gains from *indirect* transfers of the same extractive assets should be treated (by the country where the mine or other extractive assets are located) in the same way as in a direct transfer of extractive assets; and (iii) if so, how tax on such a gain can be effectively implemented from the perspectives of administrations and taxpayers.

2.4. The term "transfer", whether direct or indirect, is used for convenience in this note, and is intended to cover not just sales where money changes hands, but also many other forms of disposals, of interests in extractive assets, e.g. "swaps" (including asset for share transactions) and "farm-out" arrangements"[1]. Similarly, the reference to extractive assets refers not just to physical assets, but also to the rights appertaining to their use, such as exploration and development rights. Some countries specifically provide for information relating to the extraction (such as survey information) to be treated in the same way.

2.5. A particular issue for many policy-makers and administrators is how a policy decision to tax indirect transfers of valuable extractive industry interests can be effectively implemented. Implementing such a regime involves information and administrative (including enforcement) considerations for administrations. For taxpayers, it raises issues of their liability to taxation in a country that is neither their country of residence nor where a transfer occurred, as well as issues of whether they will be taxed, but not be entitled to the corresponding benefits of a deduction under the tax law.

[1] See the discussion in: J Calder., Administering Fiscal Regimes for Extractive Industries: a Handbook, Washington, D.C, International Monetary Fund, 2014, p.87.

2.6. Annex I to this note gives a "decision tree" of major policy decisions that arise in this area, with an indication of where each of the issues is discussed in this paper. Annex II is a note on some symmetry issues.

Fig. 1: A Direct Transfer

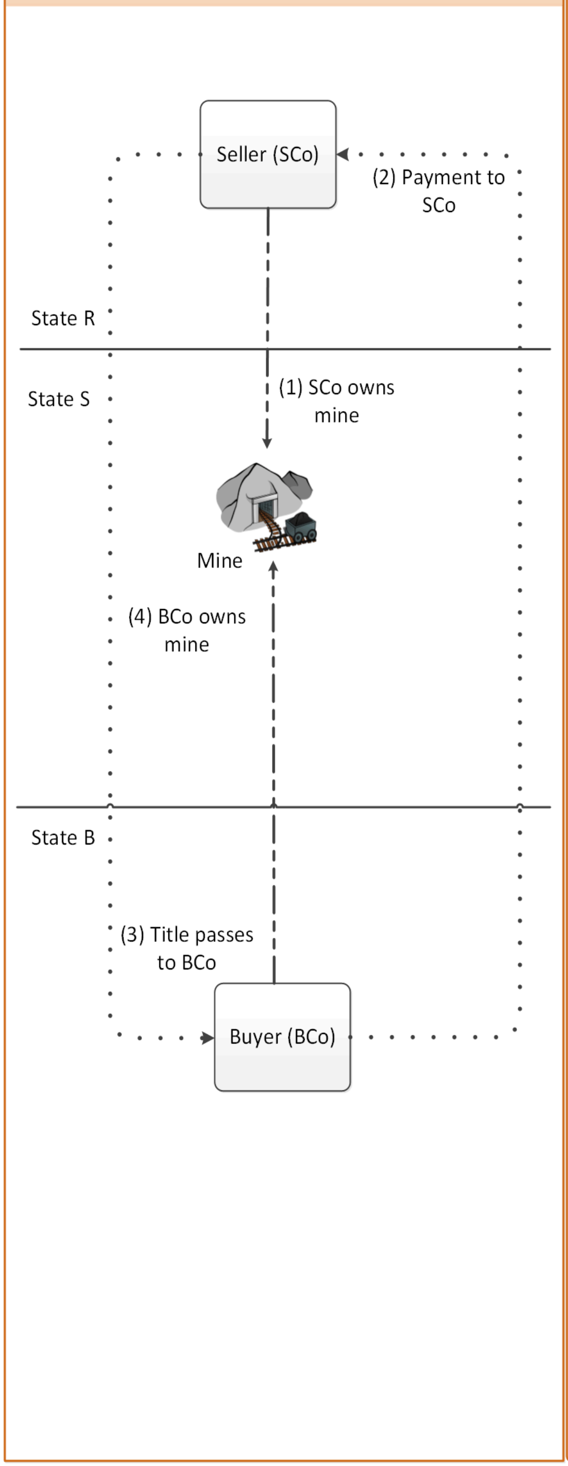
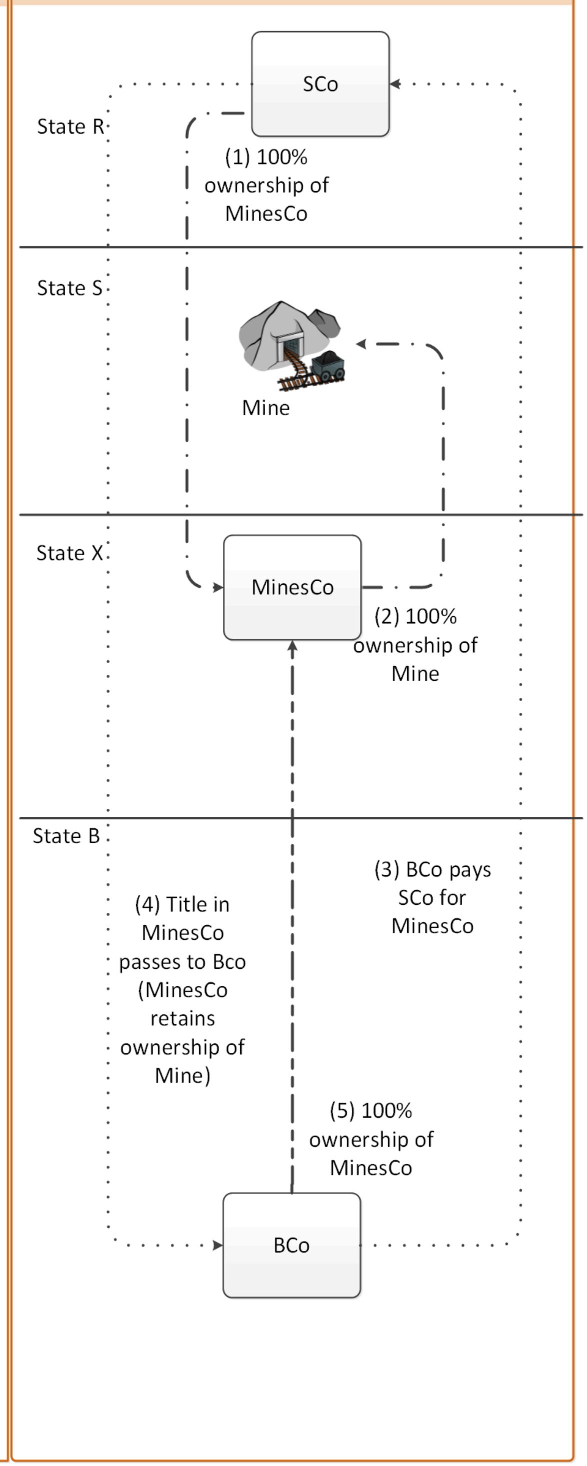


Fig. 2: One Form of Indirect Transfer



3. Status

3.1. This note is for guidance only. It is intended to survey and address the issues in some detail, help build awareness of them, provide options that may assist developing countries, and put those faced with these issues in a better position to make policy and administrative decisions.

4. Terms Used

UN Model = *United Nations Model Double Taxation Convention between Developed and Developing Countries* (2011)[2].

OECD Model = *OECD Model Tax Convention on Income and on Capital* (2014)[3].

CGT = capital gains tax used generally in this note to include taxation of a capital gain either through a separate specific capital gains tax regime or through the general income tax system.

GAAR = General Anti-Avoidance Rule (or General Anti-Abuse Rule), a rule in tax statutes or sometimes as evolved through judicial decisions (such as "substance over form" approaches), empowering a revenue authority to deny taxpayers the benefit of an arrangement that they have entered into for an impermissible tax-related purpose (usually only where this is a main purpose or the sole purpose, differentiated for example from non-tax business or commercial purposes). It is general in nature and description because it is meant to be able to address abuses not specifically identified.

SAAR = Special Anti-Avoidance Rule (or Specific Anti-Abuse Rule), a rule in tax statutes empowering a revenue authority to deny taxpayers the benefit of a particular known and defined arrangement. It has a very limited scope of application and allows only limited discretion to the tax authorities (such as through a "purpose test") compared to a GAAR.

5. The Issues

5.1. Should capital gains be taxed?

5.1.1. A threshold policy issue is whether to tax gains made when an asset is disposed of *directly*, such as by sale or other transfer. Such a tax is referred to as a capital gains tax (CGT) in this note, although in some countries such gains are subject to a distinct capital gains tax (whether comprehensive[4] or more specific) and in others, the capital gain will be taxed under the general income tax provisions, rather than as a separate tax on capital items only.

5.1.2. In a CGT, what is taxed is the *gain* made from the disposal, not the full amount received as proceeds. For a CGT to operate in a particular case, the *person* making the gain will have to be subject to

[2] Available at http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

[3] Available at http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2014_mtc_cond-2014-en#page1

[4] In practice, no CGT is completely comprehensive – the term is used here to mean a relatively comprehensive system of taxation of capital gains.

the tax, the *type of asset* disposed of and the *type of disposition* will have to be covered by the tax and the *type of gain* made will have to be of types covered by the tax.

5.1.3. Policy reasons for or against taxing capital gains comprehensively will inevitably include reasons related in practice to passive assets rather than active assets. While some of these reasons may not be relevant to the extractive sector assets, they are helpful in understanding the wider issues when deciding whether or not a comprehensive tax on capital gains should be introduced. Assuming a capital gains tax is introduced, they assist in assessing whether in the case of certain "active" assets there should be an exception.

5.2. Arguments for taxing capital gains

5.2.1. In policy terms, there are many reasons why capital gains might be taxed, and not all of them will be directly relevant to transfers of extractive assets or even other corporate assets. Reasons commonly given *for* taxing capital gains when realized include the following:

(i) The need for base broadening – with a trend to wider tax bases and lower rates among many countries. The benefits from ownership of property and other forms of capital may not otherwise be as comprehensively taxed as income and consumption and expanding the tax base in this direction may also have lower economic costs than a rise in tax rates on income items;[5]

(ii) The concern that if there is no CGT (or even taxation at a lower rate), taxpayers would rather acquire assets generating capital gains, because of the difference in tax treatment between ordinary income and capital gains, thus distorting economic decisions. This lead to a lack of "horizontal equity" between two persons earning the same amounts, one through a capital gain and one through ordinary income, such as wages or business profits. In fact, a CGT may reduce an incentive to invest in those most likely to produce capital gains.[6] Without CGT, there is a lack of neutrality in the system that prefers capital returns over normal income and creates incentives towards conversion of normal income into capital gains, or encourages converting, or appearing to convert, the former into the latter. Horizontal equity requires that individuals in similar economic circumstances should bear a similar tax burden irrespective of the form the accretion of economic benefits takes. In other words, taxpayers should bear similar tax burdens, irrespective of whether their income is received in the form of wages, or capital gains. In this context, the exclusion of capital gains from the income tax base fundamentally undermines the horizontal equity of the tax system;

(iii) The concessionary treatment of capital gains as compared to income gains can also lead to speculation and inflation of preferred classes of investments (such as the housing sector). This leads to inefficient allocations of resources, as well as the waste of human capital in re-

[5] A Tax System for New Zealand's Future, Report of the Victoria University of Wellington Tax Working Group ("New Zealand Tax Working Group Report"), 2010, p. 16. Available at http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf

[6] New Zealand Tax Working Group Report, supra fn. 5, p. 63.

characterizing income as capital gains and in combatting such attempts. The application of scarce resources to tax planning and tax avoidance is a dead-weight loss to society;

(iv) The richest persons (including corporates) will be most likely to make significant capital gains. To tax capital gains reflects their greater ability to pay tax and addresses the conversion of income into capital. Not taxing capital gains results in a lack of horizontal equity which arises because one taxpayer is likely to have proportionately more capital returns, while the other earning the same amount is likely to rely more on normal income. Vertical equity requires that taxpayers with greater ability to pay taxes should bear a greater burden of taxation. It is commonly accepted that capital gains accrue disproportionately to higher income individuals. Thus, including capital gains in taxable income contributes to the progressivity of the income tax system, while enabling government to pursue other tax policy objectives, premised on widening tax bases and reducing standard tax rates[7];

(v) A comprehensive CGT represents a "safety net" that taxes economic gains that would avoid taxation as normal income. It thus implements a more comprehensive concept of taxable "income" than might apply on normal concepts, such as in case law. In some countries, the law might in fact already reflect this more comprehensive approach to "income tax"; and

(vi) Taxing such gains will speed up the point when income is returned.

5.3. Arguments against taxing capital gains

5.3.1. Reasons commonly given for *not* taxing such gains when made include the following:

(i) A tax on capital gains inappropriately taxes illusory income, since a large component of any "gain" is due to inflation for assets held over many years;

(ii) Not taxing capital gains may encourage investments by allowing them to occur at a lower economic cost, which in turns creates jobs and encourages economic growth;

(iii) A comprehensive CGT may be difficult to administer and the potential savings and investment distortions and other efficiency implications that may arise from a *partial* CGT is economically harmful;

(iv) The complexity (including difficulties in identifying all possible disposal events) of many comprehensive CGT regimes, especially for developing countries, with high compliance costs (for taxpayers)[8] and to administer them (for the revenue administration)[9]. One US Senator

[7] See also Hungerford, TL The Economic Effects of Capital Gains Taxation, Congressional Research Service, June 18, 2010 ("The Economic Effects of Capital Gains Taxation"), at p.7ff, https://fas.org/sgp/crs/misc/R40411.pdf.

[8] See for example, J Clements, C Lammam and M Lo, The Economic Costs of Capital Gains Taxes in Canada, 2014, Fraser Institute, Canada, ("The Economic Costs of Capital Gains Taxes") at p.10, http://www.fraserinstitute.org/uploadedFiles/fraser-ca/Content/research-news/research/publications/economic-costs-of-capital-gains-taxes-in-canada-chpt.pdf

[9] See for example The Economic Costs of Capital Gains Taxes, supra fn. 8 at p. 11.

stated in 2012 that: "[W]e must consider complexity. Experts tell us that about half the U.S. tax code – more than 20,000 pages – exists solely to deal with capital gains."[10];

(v) Taxing business related capital gains is purely a timing issue. If gains are taxed, the purchaser obtains a tax basis in the assets equal to the price paid, which provides a tax deduction over time against the purchaser's future income. If the gain is not taxed, no such increased tax basis arises and future income and taxes due are higher. The overall tax paid over time is the same;

(vi) Capital gains taxes are in a sense "voluntary" taxes, unlike taxes on ordinary income. Only when a taxpayer chooses to dispose of assets may tax be payable in respect of those assets. Economic decisions as to disposal of assets will therefore be influenced and potentially distorted by such a tax. This arises since there will be an incentive to retain some investments, even if more profitable or productive opportunities exist, with the result that the economy loses the extra output that would have resulted from the reallocation of capital occurring in the absence of the CGT. This is the so-called "lock-in effect" of capital gains tax[11];

(vii) Not taxing capital gains can keep a country competitive with other countries that do not tax such gains, and create a competitive advantage over those that do;

(viii) Economic double taxation arises if capital gains on the sale of shares and other interests in entities directly or indirectly owning business assets are taxed. The value of the shares and other interests reflects expected future profits of the extractive activities and the future profits will be taxed as they arise. That would also be the case if the business assets consist of extractive licences, mining and petroleum extractive assets;

(ix) The double taxation argument may not be valid in the case of speculative profits realized on the disposal of those shares and interests which may not reflect actual profits to be earned by the extractive activities. Governments should also be cautious of the risk that the tax base of the company or entity holding the extractive assets could run the risk of being eroded. The latter may for example in some situations occur due to a debt push down of the interest charges on loans acquired to fund the takeover of the shares or interests by the buyer; and

(x) Taxes on gains from sales of investment assets are in effect a double-tax. The income earned to make the investment was already subject to an income tax and thus taxing the income from the investment, taxes the investor a second time.

[10] US Senate Finance Committee Chairman Max Bausus, 20 September 2012, http://crfb.org/blogs/capital-gains-and-tax-reform
[11] See for example The Economic Costs of Capital Gains Taxes, supra fn. 8 at pp. 4 and 11 and The Economic Effects of Capital Gains Taxation, supra fn. 7 at p. 4~~.~~

5.4. If capital gains are taxed, what should be taxed and how should that be done?

5.4.1. A country's domestic tax laws could tax capital gains through:

(i) A **stand-alone CGT** on the gain made through the transfer: the CGT could be a comprehensive CGT where the disposal of any kind of assets would be subject to taxation. But also, a specific CGT could be configured, aiming to tax only certain assets or transactions. A comprehensive CGT could have exemptions or "rollovers" delaying the point of taxation for certain types of assets or in certain types of events. Such exceptions can distort economic decisions in favor of certain types of assets, but a country may regard that as appropriate to encourage investment in that area. Certain transactions where no cash or other readily marketable property is involved can be harmful to efficient and cost effective corporate repositioning of assets. In such cases, a country might consider it appropriate, as a means of not discouraging economically beneficial transactions, to exempt or defer tax, where such relief is not seen as abusive of the CGT system. The benefits may be that businesses will be more efficient, and profitable, and therefore able to generate more value (including additional jobs and additional tax revenues). For example, certain reorganizations between related parties are often exempt, or tax is deferred, until there is a disposal to an unrelated party. Even if such an approach is taken, it may only apply in circumstances where the restructuring will not lead to reduced CGT liability at a later stage.

With respect to the extractive industries, it would in practice be very rare for a tax system to exempt gains from the sale or other disposal of assets used in resource extraction, particularly the exploration and extraction rights and the extractive facilities, from the operation of CGT. However, rules that apply to other businesses, and tax principles that apply to reorganizations or the facilitation of efficient investment are also highly relevant and important to resource extraction. This issue is specifically considered in paragraphs 9.5 and 10 in the context of indirect sales.

If there are different tax rates between capital gains and ordinary income, or if the rules operate differently a country should appreciate that there will be clear incentives to attempt to earn capital gains versus ordinary income, or *vice versa*.

(ii) A **corporate income tax (CIT) that encompasses capital gains:** Assuming that the gains from the sale of a capital asset are encompassed within the meaning of taxable income under the regular domestic CIT, they will be taxable as long as the seller is a company considered to be a tax resident or if it is an international company operating through a permanent establishment in the country. Under this scenario, the gain would be integrated in the general income tax base and the corporate income tax rate would apply.

Countries wishing to relieve the tax burden (such as part of the general investment climate, or because they believe transfers of such assets may encourage more motivated, better equipped sellers) could allow for tax exemption for certain transactions or tax deductions directly related with the transfers, provided certain requirements are met. These exemptions should be carefully considered since they do reduce the overall tax base. The current trend in income tax systems is for a wider tax base combined with lower rates.

Nevertheless, in some countries, the overall fiscal regime that applies to a particular extraction activity may be uniquely crafted pursuant to negotiations. In such cases, additional requirements may be imposed by the government, such as specific obligations to construct or improve infrastructure, train workers, or pay amounts not required from other businesses. As a part of the negotiations, a country may also agree to exempt the extractive investment from certain provisions if it feels, in the overall design of the fiscal regime, such exemptions are warranted and may promote investment. In such cases, one could envision an exemption from capital gains taxes if, as part of an overall negotiation, the country feels it has compensated itself in other ways in the fiscal regime it adopts.

5.4.2. Whatever approach is taken, transparency and a well thought through policy approach is the best way of encouraging other countries to allow a credit for the tax paid. Even under a tax treaty other countries will only consider themselves bound to allow a credit for source country taxation ‘‘in accordance with the provisions of” the tax treaty. Even then, there would be scope for different measurements of the gain. For this reason, openness about the taxation of capital gains, including in treaty negotiations (where a summary of the tax system is often useful and can be recorded as handed over in negotiations) and when changes are made to tax rules, is an important component of balancing the need for revenue with the need to have an investment climate encouraging investment for development.

5.4.3. Of course it does not necessarily follow that a transfer involves a gain, and sometimes the transfer outside the country of extractive activities will involve an indirect sale of ownership interests in many countries (such as in the *Zain* case in Uganda noted in Box 4 below). In such cases there will need to be a fair assessment of the amount of the gain connected to the particular country and then whether and how the gain is taxable under domestic law.

5.5. Should gains in the extractive industries have “special” treatment?

5.5.1. Arguments that gains from asset sales in the extractive industry should be entirely exempt from capital gains taxation usually relate to their use in an active trade or business as opposed to a passive investment activity.

5.5.2. Some countries might consider that unrelieved capital gains taxation might be inappropriate to the class of actively used assets to encourage investments in certain circumstances. For example Australia has an active assets capital gains tax reduction of 50%, but only for small business. Canada also has certain exemptions for certain types of active businesses, but again only for small business. South Africa does not tax capital gains on the disposal by individuals of small businesses under certain circumstances.

5.5.3. An exemption might be possible for gains made on extractive industry assets generally, particularly where returns might, at least in early years, be more marginal, but such exemptions are not at all common in practice. The lack of exemptions is supported by public expectations that such gains should in principle be shared with the country through taxation, and the basis that if a main reason for not having a CGT is to encourage investment, the reasoning may not hold in the case of the perception that projects that would go ahead even without this measure.

5.5.3. More likely than a special provision exempting the extractive industries from a country's capital gains tax is that countries *without* a general capital gains tax will have a provision bringing gains in that sector into the tax base. Kenya for example had suspended the operation of their CGT since 1985, but introduced legislation imposing a 10 per cent final tax on residents (20 per cent non-final on non-residents) for gains on the transfer of shares or property interests in oil and gas, mining or prospecting companies in 2012. In 2015 Kenya re-introduced the suspended CGT to tax capital gains generally, but while the general rate is 5%, the rate for the extractive industries is 30% for residents and 37.5% for non-residents with permanent establishments. The taxable gain is the net gain derived on the disposal of an interest in a person, if the interest derives its value from immovable property in Kenya. "Immovable property" means a mining right, an interest in a petroleum agreement, mining information or petroleum information.[12]

5.5.4. Other countries which do not have a general tax on capital gains often have special extractive industry legislation, such as New Zealand's provisions that in effect disregard the normal distinction between capital and income returns on asset transfers so that capital gains are treated as income. The New Zealand provisions cover, for example, information obtained as a result of exploratory or prospecting activities. However, there are some exceptions in the case of transfers of shares in closely held corporations.

5.5.5. One important factor in the general taxation of capital gains in the extractives industry is probably the widespread public view that transfers of large scale extractive facilities should bring a return to the government, especially as profits are often seen as "a long way down the road" or may not materialize due to economic circumstances or (sometimes) profit shifting arrangements.

5.5.6. In any event there will be a timing difference between the time value of money advantages developing countries gain from early receipt of consideration for capital assets, and the later receipts of consideration for outputs from the capital assets that may be especially significant for developing countries.

[12] See Kenya Revenue Authority CGT Guidelines at paragraph 13: http://www.kra.go.ke/notices/pdf2014/Capital-Gains-Tax-Guidelines.pdf

***Box 1*: One Non-Government Organisation's view on the Timing of Receipts Issue**

The view expressed below may be valid based on the assumption that the purchaser in the transaction giving rise to the capital gains tax can deduct the purchase price (including capital gains realized by the seller) from taxable income arising from extractive activities:

"It is often argued that it is politically unfeasible in developing countries not to tax billion dollar sales of the right to exploit national resources. One of the very few ways that a government can extract revenue from extractive sector projects that will not generate a profit for years or even decades is to impose a tax on capital gains.

The early injection of substantial revenue from capital gains taxes is obviously very welcome. In some cases it is seen as a major victory over powerful international companies and a redress to generous tax concessions offered in the original contracts. The significance of capital gains tax payments is often not well understood. In most countries, the capital gains tax is deductible against future assessments of taxable income. This means that a capital gains tax is not an additional source of government revenue. It does enable the government to bring forward some future revenue. But it also generates additional deductions against company taxable income. Securing early revenue in advance of production delays the onset of profit based taxes (IRPC) and pushes back the date when government revenues will become significant. The resulting offset in medium-term government revenues is considered, if it is even considered at all, a small price to pay for substantial early revenue."

'Taxing "Capital Gains" in Mozambique's Extractive Sector', Centre for Public Integrity, May 2014

(http://www.cip.org.mz/cipdoc/307_Spinformacao_2014_04_en.pdf)

5.5.7. Rather than a wholesale exemption for the extractive industry from a capital gains tax, far more likely is a tailoring of the application of such a tax to the unique aspects of the industry itself. Thus, as in the example provided earlier regarding certain corporate restructurings, other transactions and restructuring of asset ownership may also deserve similar exemption or deferral from a potential taxable gain. For example, in many industries, exchanges of assets, used in a trade or business, which are similar in nature are not taxable immediately. The notion is that each taxpayer has simply continued its investment in the assets of its business, and no cash proceeds have been realized. In such a case, many countries exempt the exchange of like-kind assets from taxation until the asset received is ultimately sold.

5.5.8. Similarly, most countries encourage investors and businesses to join together in conducting a business or making an investment. For example, generally the transfer of assets into a corporation in exchange for an ownership interest (i.e. shares of stock) is not a taxable event. Similarly, the transfer of assets to a partnership to operate a joint business activity is not generally taxable to the partners. Countries examining the scope of taxable events under a tax system that otherwise taxes sales or transfers of assets need to carefully consider application of those taxes to these types of activities.

5.6. What are “farm-out” and “farm-in” agreements and how should they be treated?

5.6.1. One distinctive characteristic of the extractive industry is that investors often spread their risks by carrying out large natural resource operations jointly[13]. Often these joint ventures are formed after one party has already engaged in substantial activities to acquire licenses and conduct exploration activities. As a result of such activities, the value of the initial investment in the extraction project may have substantially increased, while the scope of the ongoing investment required, and hence financial exposure, has similarly increased. To attract other investors to share in the costs, risks and obligations of developing the project, the initial investor will need to transfer a portion of the project to the new investor, while retaining a smaller portion but with reduced obligations and risks. In most cases, no cash is paid. How a country’s tax system treats the formation of a joint venture to develop an extractive project will have consequences on the decision of whether or not to go forward with the development opportunity, and if so, how.

5.6.2. In the extractive industries, one way to involve additional investors is via what is termed a “farm-out” agreement. Particularly common in the oil and gas industry, these are agreements where an owner of an oil or gas interest (the “Farmor”) agrees to assign part of its interest to another party (the “Farmee”) in exchange for certain obligations in connection with development of the oil or gas interest. Sometimes the obligations may include the provision of certain services. More generally, they simply require the new investor to pay a share of all of the ongoing costs of exploration and development. In the purely service context (by far the least relevant in large joint venture farm-outs) sometimes these services include drilling a well to a certain depth, in a certain location, in a certain time-frame and the agreement also typically stipulates that the well must obtain commercial production. After this contractually agreed service is rendered, the Farmee is said to have “earned” an assignment. This Assignment comes after the services are completed, and is sometimes subject to the reservation of an overriding royalty interest in favor of the Farmor.[14] From the Farmee’s perspective these are known as “farm-in agreements”.

5.6.3. More typically with respect to extractive industry projects of large scope, introduction of co-venturers simply results in the new investor taking on the responsibility to fund a share of ongoing costs. Generally, these conventional farm-out agreements do not involve cash, or the retention of an overriding royalty. To the extent cash is received, it is generally taxable to the recipient. Where a royalty or overriding royalty is retained, there is no tax due at the time of the farm-out, but tax is paid as income from the royalty, or overriding royalty, is received. The U.S. has long considered the pooling of capital in connection with oil and gas activities as not-taxable under its “pool of capital” doctrine as explained in Box 2 below. Even where the pool of capital doctrine does not apply, tax rules relating to partnerships provide a similar avenue for effecting joint ventures without tax on formation.

[13] J Calder., Administering Fiscal Regimes for Extractive Industries: a Handbook, Washington, D.C, International Monetary Fund, 2014, p.87.

[14] Austin W Brister, “Farmout Agreements: The Basics, Negotiations and Motivations”, 2013, http://www.oilandgaslawdigest.com/ogagreements/farmout-agreements-basics-negotiations-motivations/

5.6.4. A major consideration in allowing additional partners to join in the ongoing exploration and/or development of natural resources in a non-taxable fashion is to maximize the chances for full development and provide an efficient way of achieving risk sharing. Given the size and extent of the risks involved in large natural resource developments[15], policies that facilitate risk sharing will be viewed very favorably by investors. In contrast, policies that in effect place restrictions or additional costs on commonly employed transactions that facilitate risk sharing can make a prospective investment significantly less attractive.[16]

Box 2:* From the United States Internal Revenue Service Oil and Gas Handbook:

1. Frequently promoters, accountants, lawyers, geologists, operators, and others receive an interest in an oil and gas drilling venture in return for services rendered. These services may have been rendered in acquiring drilling prospects, evaluating leases, packaging the drilling program, or, in general, administrative services such as formation of partnerships, filing with Securities and Exchange Commission (SEC), and other functions.

2. It is a common practice for the promoter or sponsor of a drilling package to acquire part or all of the interest in the drilling venture in return for services. GCM 22730, 1941–1 CB 214, provided that the receipt of an interest in a drilling venture in return for capital and services furnished by a driller and equipment supplier was not taxable on receipt. This ruling provided for the "pool of capital" doctrine that is widely quoted in oil and gas tax law. The same reasoning has been extended to geologists, petroleum engineers, lease brokers, accountants, and lawyers who receive an interest in an oil or gas drilling venture in return for services rendered. This doctrine resulted from the court decision in *Palmer vs. Bender*, 287 U.S. 551 (1933); 1933–1 C.B. 235; 11 AFTR 1106; 3 USTC 1026.

3. The "pool of capital doctrine" is widely accepted by accountants and lawyers and is still quoted to justify the tax-free receipt of property for services. Subsequent changes in the tax laws, and subsequent court cases, have significantly limited the use of GCM 22730. [...]

8. While the pool of capital doctrine is still viable in specific factual circumstances, it does not equate to a special exemption from IRC 83 for the oil and gas industry. Generally, for the pool of capital doctrine to apply, all of the following must occur:
   A. The contributor of services must receive a share of production, and the share of production is marked by an assignment of an economic interest in return for the contribution of services.
   B. The services contributed may not in effect be a substitution of capital.
   C. The contribution must perform a function necessary to bring the property into production or augment the pool of capital already invested in the oil and gas in place.
   D. The contribution must be specific to the property in which the economic interest is earned.
   E. The contribution must be definite and determinable.
   F. The contributor must look only to the economic interest for the possibility of profit.

**At 4.41.1.2.3.1 (Services Performed for Oil and Gas Property Interest), available at: www.irs.gov/irm/part4/irm_04-041-001.html*

[15] See, for example, International Energy Agency Special Report on World Energy Investment Outlook 2014 Special Report at page 32, for a list of the risk factors investors face.
[16] Given that over the life of the project the same amount of taxes should be collected, the timing benefits to the countryceiving some of this revenue at an earlier period must be weighed against a permanent loss of revenue if a project does not go policy choices.

6. Taxation of gains from "indirect transfers" as an option

6.1. It is a policy decision that each country must consider whether or not it should address gains made from indirect transfers. If a country decides to tax indirect transfers the question is how that should be done, taking into account the tax policy aspects addressed in this note. There are increasing expectations, including from the broader population, that if direct transfers of a mine or other extractive facilities are subject to taxation on the gains made, an indirect transfer should have the same effect in revenue terms, despite the lack of any change in the direct ownership of the assets, and the separate legal entity status of distinct companies in the chain of ownership. In tax policy terms the position is often taken that the soundness of the system for taxing direct transfers of interest requires the taxation of indirect transfers that otherwise have the same characteristics – since otherwise those with the means to do so will simply structure transfers indirectly. The value of extractive facilities is no doubt one reason for the particular focus on indirect transfers of such facilities and one of the ways a multinational can extract profits from the extractive industry is by way of the sale of shares. It is fair to say, however, that the information and other compliance and enforcement issues in taxing indirect transfers are not often discussed in detail in such debates, although legislation can be drafted in a way that seeks to deal in some fashion with these issues, as noted below.

6.2. Apart from the compliance and enforcement issues, another argument given for not taxing indirect transfers is that the production of income from the domestic mine or oil and gas assets continues to be subject to taxation, and thus, no tax revenue is lost to the country. While there is a timing difference on the collection of tax revenues, the absolute amount does not change. This is because if the gain is taxable, in order to avoid double taxation, the domestic asset values need to be increased for tax purposes by the amount of that gain, giving rise to higher ongoing depreciation and depletion deductions and a corresponding reduction in future tax receipts. Given the fact that the total amount of taxes ultimately paid, if the tax value of the domestic asset values are increased, will not change, a country needs to balance the revenue timing benefit versus the complexity of compliance and enforcement that arise from seeking to tax such indirect sales. Another argument against the taxation of indirect transfers is an often expressed view that because of the separate legal entities involved, taxing such transfers happening in a foreign country and which do not involve any domestic residents as a party to the transfer, in effect constitutes extraterritorial taxation of foreign economic activity by foreign people. It should also be borne in mind that taxing indirect transfers affects the price of the transaction as the seller will factor the tax to be paid into the selling price of the shares.

Box 3: An Example from Norway

As a starting point, capital gains/capital losses arising from the transfer of assets located on the Norwegian continental shelf are taxable/deductible.

However, in practice, most asset deals are exempt from tax based on provisions in section 10 of the PTA. According to section 10, an approval from the MOF is required with regard to the tax effects of a transfer of assets that are under the petroleum tax regime provided that consent to the transfer is needed from the MPE. Consent from the MPE is needed upon a direct or indirect transfer of a licence and where the assets will follow the transfer of the licence.

This is applicable if all fixed offshore installations pertaining to a licence are transferred (even if the licence itself is not transferred).

Under regulations adopted based on the section 10 of PTA, capital gains arising from the transfer of assets that are allocated to the petroleum tax regime are not taxable and losses non-deductible (neither when calculating ordinary petroleum tax nor special tax). Moreover, the buyer will take over the seller's tax balances (including the basis for uplift) and other tax positions and stand in the shoes of the vendor. There are also specific provisions in the regulations dealing with transfers where one of the parties covers future explorations costs, or where the seller covers future abandonment costs pertaining to the assigned interest. Broadly, the regulations state that it will be the party who will eventually bear the costs that may deduct those costs and claim a refund of the tax values of those costs when they accrue (i.e. according to the same system that would apply to the seller if the licence was kept).

The rationale for these rules is that the Norwegian state's tax revenues from upstream activities should be unaffected by a transfer. Consent from the MOF is also required for an indirect transfer such as a share deal implying a change of control. Such deals are, in practice, straightforward from a tax perspective as there are no withholding taxes regardless of where the shareholder is a resident.

Deloitte, "Oil and Gas Taxation in Norway" (2014) page 6, http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Energy-and-Resources/gx-er-oil-and-gas-taxguide-norway.pdf

6.3. The contrary view is that a certain degree of extraterritoriality is supported in international law and is often explicitly part of domestic law[17]. It is usefully expressed in the Indian Government's *Draft Report on Retrospective Amendments Relating to Indirect Transfer Expert Committee*[18] (2012) which noted that:

> "In the case of Electronics Corporation of India Ltd. (ECIL), the Supreme Court referred the matter, being of substantial public importance, to a Constitution Bench after making the following observations:

[17] See for example the influential *Statute of Westminster*, Section 3: "It is hereby declared and enacted that the Parliament of a Dominion has full power to make laws having extra-territorial operation". Though a UK Act of Parliament, this Act established the legislative independence of what were then the self-governing Dominions of the British Empire from the United Kingdom, http://www.legislation.gov.uk/ukpga/Geo5/22-23/4/section/3

[18] At para 4.1.1, http://www.finmin.nic.in/the_ministry/dept_revenue/draft_report_IT.pdf

- The operation of the law can extend to persons, things and acts outside the territory of India.

- Reliance was placed on the decision of the Privy Council in the case of British Columbia Electric Railway Co. Ltd. v. King [1946] AC 527, 542 (PC) wherein it was stated that - "A Legislature which passes a law having extra-territorial operation may find that what it has enacted cannot be directly enforced, but the Act is not invalid on that account, and the courts of its country must enforce the law with the machinery available to them."

- The provocation for the law must be found within India itself. Such a law may have extra-territorial operation in order to sub serve the object and that object must be related to something in India. It is inconceivable that a law should be made by Parliament in India which has no relationship with anything in India. However, the matter was not pursued by the applicant, being a public sector company and therefore it is still an open issue. The decision did clarify one issue that, on the grounds of non-enforceability in India, a law cannot be held as invalid. The reference was, however, made on the second issue i.e. whether there was sufficient nexus with India or not."

6.4. Some countries take positions that judicial or legislative anti-abuse rules - such as a general anti-avoidance rule (GAAR) - apply to indirect transfers. For example, the People's Republic of China's State Administration of Taxation has recently issued new administrative guidance on application of their General Anti-avoidance Rule (GAAR) to re-characterize an indirect transfer of certain properties as a direct transfer of the same[19]. Those favoring GAARs point to the need to cover types of conduct (abuses) and discourage them rather than merely address specific types of such abusive conduct, providing a "road map" for tax avoidance.

6.5. One issue that may arise when GAARs are relied on in the case of indirect transfers is that of whether there is a "treaty override" occurring. The circumstances when GAARs may or may not be in compliance with tax treaties are discussed in the Commentaries to Article 1 of both the UN and OECD Models. By using domestic law to address certain indirect sales as "abusive" it follows of course that the scope of the anti-abuse rules would be necessarily limited to what constitute abusive transactions in the terms of the relevant legislation (including any requirements of proof that fall upon the tax administration), and this might not always be seen by a country as sufficient for properly achieving the goals of taxing capital gains derived from extractives. If officials are not confident that such anti-abuse rules will be applied by courts to indirect transfers in the same way as for direct transfers, more specific domestic legislation would be necessary to achieve this result. Such specific domestic legislation does

[19] See Baker & McKenzie, Breaking News: China Issues Long Awaited Indirect Transfer Regulation Replacing Notice 698, Feb. 2015, http://www.bakermckenzie.com/files/Publication/fb4c9971-e2a6-444e-a095-f89f2474ce1e/Presentation/PublicationAttachment/1b355717-dacb-4e84-9188-a15b64ff29ff/al_china_indirecttransferregulation_feb15.pdf

not necessarily have to be a special anti-abuse (or anti-avoidance) rule (a SAAR), and can cover broader types of transactions.

6.6. As recognized in the Commentaries to Article 1 of both the UN and OECD Models, issues of "treaty override" may also arise in the case of specific legislation, however, countries proposing or having legislative provisions dealing with indirect transfers therefore need to at least consider their relationship to treaty obligations and of course it is always advisable to notify negotiation partners of legislation addressing such issues and to keep treaty partners advised of changes in such legislation. In particular, even if local courts accept that the domestic law must be followed (either because it is compatible with the treaty or must be applied by the court even if inconsistent) there is no guarantee that the other country will accept this – especially in the latter case - and give credit for the taxes paid as a result of the judgment.

Box 4: A Case from Uganda: the Relationship between Tax Treaties and Specific Anti-Avoidance Provisions

In September 2014 an Appeals Court in Uganda ruled in favor of the Uganda Revenue Authority (URA) in the Zain case. Shares in a Netherlands company (Zain Africa BV) that owned 100% of a Ugandan telecommunications provider were transferred between two Netherlands companies (from Zain BV to Bharti A BV) and it was argued that even if taxation was allowed under domestic law, under the Netherlands – Uganda tax treaty Uganda had no taxing right preserved (there was no equivalent to the UN or OECD Article 13(4)). Uganda's tax authorities successfully applied Section 88(5) of Uganda's Income Tax Act to preserve its taxing right. This provides that:

> "Where an international agreement provides that income derived from sources in Uganda is exempt from Ugandan tax or is subject to a reduction in the rate of Ugandan tax, the benefit of that exemption or reduction is not available to any person who, for the purposes of the agreement, is a resident of the other contracting state where 50 percent or more of the underlying ownership of that person is held by an individual or individuals who are not residents of that other Contracting State for the purposes of the agreement."

The Court ruling overturned an earlier High Court decision that Uganda had no jurisdiction to tax. It does not finally dispose of the case but the matter was sent back to the URA to consider whether and if so what amount of gain was sourced in Uganda and taxable.

Daniel K. Kalinaki, The East African, (13 September 2014) "Court gives URA nod to seek taxes on sale of Zain assets in Uganda", http://www.theeastafrican.co.ke/news/URA-taxes-on-sale-of-Zain-assets-in-Uganda/-/2558/2451578/-/item/0/-/6hm2he/-/index.html

6.7. There are other reasons often favoring specific anti-avoidance provisions (SAARs) rather than relying on a GAAR, including the fact that in recent years there has been a great deal of such legislation in Africa to attempt to counter indirect transfers in the extractive industries.[20] These reasons include

[20] Kennedy Munyundi and others, "Tax Policy Trends in Africa – Commentary on the Major Tax Developments in 2013 and 2014", Bulletin for International Taxation, March 2015, 154 at 158-9.

that SAARs can be more precise about who must bear the compliance obligations, and what the obligations are. A SAAR can, for example, focus on related party transfers, minimum shareholdings and off-stock exchange transfers to limit the impact on transactions that are not considered to be high risk. Finally, it need not depend on a "purpose" test (which can be difficult to prove for whoever bears the onus of proof, creates uncertainty for both administrations and taxpayers and can involve a great deal of discretion on the part of officials), but more "scientifically" make an indirect transfer taxable irrespective of the purpose of the transfer, by for example treating it as equal to a direct transfer.

6.8. Any such legislation needs to be seen (like a GAAR) in the context of a country's tax treaty network. Tax treaties cannot give a taxing power that does not exist in domestic legislation, but they can either allow it to continue to be exercised or can prevent it from being exercised. It is therefore important that a country's tax treaties preserve the right to apply the domestic legislation in that treaty relationship. It is also strongly advisable that all treaties consistently preserve these rights, otherwise there would be an inducement to use "treaty shopping" techniques to have the transfer occur in a state against which the domestic legislation of the other state is overridden by treaty rules (i.e. where no taxing right is preserved). This issue is discussed further below.

7. The Issue of Symmetry

7.1. Whatever approach is taken to the application of a general or specific capital gains tax provision, a factor in the policy decision is the possibility of *asymmetries of treatment*.[21] From the revenue perspective, a country will not want to allow a purchaser current or future deductions based on its purchase cost of an asset, and yet be unable to tax capital gains derived by the seller of the asset. This will be an issue where a transfer is either untaxed or concessionally taxed (as compared with income gains). On the other hand, it may deter economic activity if the seller's capital gains are taxed, but no deductions are available to the purchaser for the cost of acquiring the asset in the form of depreciation or cost-basis in the asset that can be deducted when calculating taxable income (including capital gains) in the future. Importantly, if the gain is treated as a capital gain and is either untaxed because the country does not have a CGT, or concessionally taxed under the CGT, then there will be asymmetric tax treatment as between the transferor and transferee as the transferee's cost represented by the gain is likely to deducted at the normal the corporate tax rate.

7.2. For example, in a case where an indirect transfer is re-characterized as a direct transfer, the built-in gains in the assets held by the underlying domestic corporation will be essentially taxed to its shareholder-seller. In this case, symmetry may be regarded as being maintained between the seller and the purchaser, since the purchaser's basis in the shares in the domestic corporation would be the purchase price paid to the seller, for which the seller realized capital gain. However, without a specific statutory rule, the basis in the assets owned by the domestic corporation would remain unchanged (i.e., not stepped-up for the amount of capital gains already taxed in the seller), and this can be regarded as an asymmetry. In contrast, some countries address an indirect transfer by deeming a transfer and then a

[21] See Annex II with numerical examples illustrating the significance of the issue of symmetry.

re-acquisition by the underlying domestic corporation of assets owned and liabilities owed by that corporation immediately before the underlying ownership changed,[22] thus confirming a liability to domestic tax. In those cases symmetry will be maintained since the domestic corporation acquires a cost-basis in the assets deemed to be acquired which can be deducted in the future for tax purposes. Implications for the countries deeming a transfer and re-acquisition by the underlying domestic corporation are that the corporation would not have access to the consideration for the actual transfer of shares or other indirect interests to pay the tax and the increased future deductions by the corporation will negatively impact taxes payable in future on its reduced taxable income.

7.3. If countries frame their indirect transfers legislation relatively narrowly, to deal with what are perceived as abusive cases (less likely to involve unsuspecting buyers and sellers and more likely to involve a purpose of avoiding tax on a transfer) they may be less willing to grant symmetrical benefits to the buyer. In such cases there is probably an intention to bring about a result that the buyer will ensure the right amount of tax is paid on the gain - especially since the buyer may otherwise be a beneficiary from the seller not paying taxes on the transfer - through paying a lower price albeit with lower deductions over time. The impact on unsuspecting buyers should, however, be borne in mind in framing any legislation, possibly with an ability to obtain symmetrical benefits if the buyer can prove lack of awareness of or negligence as to the abusive purpose/ lack of reasonable commercial purpose etc.

7.4. Countries will also take different views on how to ensure symmetry since this can be done by either (i) taxing gains to the seller but allowing a deduction for the buyer based on the purchase price, or (ii) not taxing the seller and not granting deductions to the buyer. The former might be preferred by those desiring payments as early as possible, and with less concern as to the budgetary implications of the “lumpiness” of revenues and difficulty in predicting such payments. The latter approach might be preferred by countries confident that any profit will be properly recorded and will be taxed in practice, which regard such profits as more readily calculated and more predictable over time and which desire to preserve such revenues for future needs.

8. Indirect Transfers and Corporate Structuring and Restructuring

8.1. There may be many non-tax business reasons for a corporate restructuring, such as adapting to changes in markets, the way in which the business is conducted, or in management approaches. Restructuring could, for example, be undertaken in preparation for a share market float, to prepare for a transfer of some or all of the business, or to raise capital. Such a restructure can lead to disposals and could lead to an “indirect transfer” of an asset in another country.

8.2. Some countries provide capital gains relief for dispositions arising from certain corporate restructures, such as between related companies. South Africa’s roll-over relief for asset-for-share transactions, amalgamation transactions and intra-group transactions is an example in this regard[23]. A

[22] For example, Tanzania, Income Tax Act 2004 (as amended) S.56.

[23] Sections 42, 44 and 45 of the Income Tax Act of 1962.

policy issue is whether, and if so why, there should be any different result if the same type of exempt "direct" transfer were done as an indirect transfer.

8.3. In relation to its Public Notice 7 on indirect transfers (considered below), for example, China addresses these issues by providing relief for internal group restructures that meet specified requirements, i.e. (i) a more than 80% equity relationship exists between the transferor and the transferee, (ii) the tax burdens in China for any subsequent indirect transfer would not be less than that for the same or similar indirect transfer were it be conducted instead of the indirect transfer at issue, and (iii) the consideration paid by the transferee only consists of equity of the transferee or its affiliates.[24]

8.4 Even in reorganizations or acquisitions involving unrelated parties, a question arises as to whether such transactions should trigger "indirect" taxation events wherever the acquired entity has subsidiaries or other business operations. For example, when one publicly listed major enterprise combines with another via a merger transaction, clearly not motivated as a means of avoiding local taxation, countries may often decide to limit their "indirect" transfer jurisdiction. This is discussed further below.

9. What are the Double Tax Treaty Aspects?

9.1. Tax treaties are generally regarded as not creating taxing rights that do not exist in domestic law, but they can prevent or limit the operation of domestic law where that is for the benefit of taxpayers of the countries entering into those treaties. This means that if domestic law of a country provides for the taxation of offshore indirect transfers, any tax treaty between that country and the country of residence of the seller of the interest will need to be examined to see if it allows the domestic law to operate as intended or restricts its operation to the advantage of a taxpayer. The consequences of this relationship between tax treaties and domestic law is that;

(i) If there is no domestic law in place taxing gains from indirect transfers, the treaty will not address the deficiency by creating a taxing right;
(ii) Any treaty right for the country where the assets indirectly sold are located will merely represent an unexercised right to taxation unless and until the domestic law is amended to tax indirect transfers;
(iii) A treaty right to tax need not have all the detail of the domestic law, but as it needs to be at least as wide in operation as the domestic law it should be broadly expressed (as in the UN and OECD Model Conventions discussed below); and
(iv) The treaty may limit the operation of domestic law to the extent that the right preserved is narrower than domestic law or no taxing right is preserved, and any attempt to change that by amending domestic law may be a treaty override contrary to the terms of the treaty.

[24] See Baker & McKenzie, supra fn. 19 at page 12.

9.2. Assuming domestic law on taxation of indirect transfers is in place or is being kept open as a possibility, the question is then whether the treaty limits such an exercise of taxing rights and thereby overrules the legislation to some degree. To consider that issue, the provisions on Capital Gains (often Article 13) of a specific tax treaty have to be studied:

Box 5: Capital Gains under the Model Tax Conventions

Capital Gains under the UN Model: Article 13

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. 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 may be taxed in that State. In particular:

(a) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.

(b) For the purposes of this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding fifty percent of the aggregate value of all assets owned by the company, partnership, trust or estate.

5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of __ per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.

6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

... and under the OECD Model: Article 13

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

5. Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.

Definition of "Immovable Property in Article 6 of the UN Model (and in the OECD Model):

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, 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; ships, boats and aircraft shall not be regarded as immovable property.

10. Article 13 (Capital Gains) and Indirect Transfers

10.1. Assuming the sort of indirect transfer illustrated in Figure 2 at Paragraph 2.6 of this note, how will the basic provisions of Article 13 addressed above apply?

Paragraph 1 would obviously not apply, as there is no alienation of the immovable property itself, at least directly. The general anti-avoidance rules in tax treaties, as provided for in the Commentaries to Article 1 of the UN and OECD Model Conventions, may in some countries allow for coverage of indirect transfers, but this will rarely be clear, and may be regarded as an interpretation no longer open under Article 13 where there is a specific provision on indirect transfers, because of the presence of paragraph 3. This reflects the common legal principle that specific coverage with limitations implies that a more general coverage is not intended. In contrast, where a domestic anti-abuse rule re-characterizes an indirect transfer of an immovable property as a direct transfer of the same, paragraph 1 directly applies, as long as such domestic anti-abuse rule is not in violation of applicable tax treaties.

Paragraph 2 would not apply, as the shares sold are not effectively connected to the permanent establishment, comprised by the extractive facility.

Paragraph 3 would obviously not apply, as it relates to ships and aircraft.

Paragraph 4 specifically applies to address indirect transfers of immovable property. The UN version of the paragraph differs, as noted above, from the OECD version. This paragraph (often referred to as the "land-rich" entities provision) is considered in more detail in paragraph 13.1.

Paragraph 5 would only apply to shares in "land-rich" companies that are not covered under paragraph 4. However, the paragraph only applies to shares in a company resident in the country seeking to tax the transfer and in the illustrated indirect transfer the .underlying mine or other facility is located in another country.

Paragraph 6 merely confirms that unless the country where the extractive facility is located has a taxing right preserved by the preceding paragraphs, only the residence state of the seller of the shares can tax profits made, and that will usually be another country.

11. Shaping an Effective Land-Rich Entities Regime in Domestic Law and in Article 13(4) of Tax Treaties

11.1. There are many choices involved in relation to a specific "indirect transfer" provision in a tax treaty, and of course the results of those choices will have to be negotiated with other countries, many of whom will have different views. The choices include:

(i) Whether to have a specific indirect transfers provision at all:

a. As noted above, unless there are domestic law provisions giving taxing rights or negotiators want to ensure that any such future legislation will not be rendered ineffective in a treaty relationship, there is little point negotiating for a provision such as this where the other negotiating party does not seek it. The other side will almost inevitably seek some concession from your preferred text in return for a treaty provision that may not advance your country's policy interests and revenue base.

b. The advantage of a specific provision is that there is a clear coverage of indirect transfers – unless there are court decisions on the coverage of indirect transfers under paragraph 1 in a country (something that is likely to be very rare). It reduces the risk of an interpretational difference between two countries that leads to both claiming competing taxing jurisdiction under Paragraph 1, and possible unresolved double taxation. This could negatively impact the investment climate.

c. A potential disadvantage of a special provision is that, because of the specific requirements before it can apply (noted in more detail below) it can not only reduce the likelihood of a purposive, anti-avoidance approach to paragraph 1 by the courts, but can also serve as a (not easily amended) "road map" for tax avoidance by mitigating the effect of the specific requirements.

(ii) Whether there should be an exception for immovable property used in an extractive business:

a. The UN Model provides at Paragraph 4(a) of Article 13 that:

"Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities."

b. It is not entirely clear what the central phrase "used … in its business activities" means. On one view, any holdings of mines and other facility, as well as mining leases and other related immovable property leases would inevitably fall outside the scope of the indirect transfer provision, as they are actively being used in business activities. On another view, however, more is required, since merely holding an asset, for example, is not a use in *one's own* (as a distinct legal entity) business activities. Further, Company A owning Company B that holds an asset does not mean that Company A is *using* Company B's asset in *its* (i.e. Company A's) business activities. On this view, there has to be direct active use, not just a passive holding. In other words, indirect holdings are explicitly addressed by this paragraph, but "indirect use" through the mining operator further down the chain is not treated as a *use* in its business activities by the company higher up the chain, perhaps several companies removed.

c. The Commentary does not address the interpretation of this provision, added as part of the UN Model as amended in 1999 and published in 2001, in any detail, but some support for the latter view can be found in the Commentary comments that: "[Paragraph 4] is designed to prevent the avoidance of taxes on the gains from the transfer 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 transfer of shares in such a company." And that: "[i]t also decided to exclude from its scope such entities whose property consists directly or indirectly principally of immovable property used by them in their business activities."[25]

d. On the other hand, those opposed to the latter interpretation would point out that the paragraph may have little meaning if it were the correct interpretation, as a company rarely if ever *itself* uses the assets of its subsidiaries in its operations. They would also point to the discussion of the same issue in the OECD Commentary at paragraph 28.7: "Also, some States consider that the paragraph should not apply to gains derived […] where the immovable property from which the shares derive their value as immovable property (such as a mine or a hotel) in which a business is carried on." On this view, indirect transfers which in effect look through the separate entity structure should also look through that structure to find use of an asset in business by the company situated in the country claiming taxing rights. It should be noted, however, that in order for a company to fall within this paragraph 4(a) exception, more than 50% of its assets is required to be used in business in the country claiming taxing rights. For example, when 40% of assets are immovable properties used in business in the country claiming taxing rights and other 20% are immovable properties not so used, the company is not within this exception and thus subject to taxation in such country. If such a provision is used there needs to be a common understanding between the treaty partners about the scope of the provision, and its particular impact on the extractive industries.

(iii) Whether gains on such a transfer should be deemed to be sourced locally:

a. While some provision such as Article 13(4) is needed to *preserve* the taxing right in a tax treaty, the specific rule deeming such gains as locally sourced should be placed in domestic law. The treaty will not, in the view of most countries, provide a taxing right that does not exist in domestic law.

b. Where there is domestic legislation, it should provide that the gains made are sourced locally when the immovable property is located locally. The gains could be taxed or could be limited to the proportion of the gains that reflects the proportion of the value of shares sold corresponding to the proportion of local immovable property to other assets.

c. In tax treaty terms, the domestic legislation will not, of course, by itself ensure that the gain is treated as taxable in the country of the immovable property asset under the treaty, and require the treaty partner to, for example, give credit for that tax paid. The

[25] UN Model Tax Convention (2011), page 233, paragraph 8; http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf.

treaty partner may, for example regard the gain as sourced in its country and fully taxable under the treaty there, or as sourced in a third country. To avoid double taxation based on source (and double non-taxation, where a taxing right might be claimed by the treaty partner but not exercised) it is therefore important to consider specifically addressing such transfers in treaties, such as in some form of Article 13(4) provision which specifically allows the country of the asset a taxing right. Of itself it will not prevent a third country with which no treaty exists from claiming source taxing rights under its own law.

(iv) Whether an indirect transfer provision should extend beyond transfers in shares:

a. If the indirect transfers provision is confined to the transfer of company shares, it would be easy to avoid it (such as by using a unit trust, and selling units), although this also may depend on the entity-classification rule of countries (for example, if trusts, partnership or estates are treated fiscally transparent and thus looked-through, such avoidance attempt may not be successful). The UN Model was thus revised in 1999 (published in 2001) to extend the rule to trusts, partnerships and estates, though estates might not be relevant particularly to extractives. The OECD Model has an option at paragraph 28.5 of the Commentary to cover "shares or comparable interests". There seems to be increasing use of these sorts of extensions, and recently the OECD/G20, in its 2014 BEPS Deliverable on Action 6, recommended amending Article 13(4) to cover "shares or comparable interests, such as interests in a partnership or trust". This is a clause blending the above UN and OECD Model provisions, as suggested by an earlier version of this attachment.[26]

b. The specific rule extending taxing rights beyond transfers of shares to cover other interests would need to be reflected *both* in the treaty provision preserving the taxing right and in the specific domestic legislation - to ensure that the treaty right is implemented in practice.

(v) What valuation method should be used:

a. Paragraph 4*(b)* of Article 13 of the UN Model provides that: *(b)* For the purposes of this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the company, partnership, trust or estate. This is merely repeated in the Commentary on that Article, without elaboration of how it is to be applied in practice.

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[26] *OECD, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances Action 6: 2014 Deliverable,* at pp.78-79, *("*BEPS Action 6: 2014 Deliverable*"). Available at: http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-9789264219120-en.htm. See also* OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report ("*BEPS Action 6: 2015 Final Report*").* at pp71-72, *http://dx.doi.org/10.1787/9789264241695-en*

b. The OECD Commentary on Article 13 provides at paragraph 28.4 that: "paragraph 4 allows the taxation of the entire gain attributable to the shares to which it applies even where part of the value of the share is derived from property other than immovable property located in the source State. The determination of whether shares of a company derive more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all the property owned by the company without taking into account debts or other liabilities of the company (whether or not secured by mortgages on the relevant immovable property).

c. It seems that practice on whether countries use Fair Market Value (reflecting current value in the market) or Book Value (reflecting the price initially paid) as the valuation method is very varied. Some countries have a blended requirement that allows the latter to be used in some circumstances unless there is any reason for a shareholder to suspect that it does not fully reflect the underlying value of the immovable property, as compared with other assets. Many, probably most, countries do not seem to include intangibles in the calculation, perhaps in part because of the difficulty of accurately calculating this. However, such interpretation might be problematic in countries where intangibles are treated as a "property" or "asset" under domestic laws, especially when they use Fair Market Value as the valuation method, since sometimes the Fair Market Value of intangibles can be significant, and exclusions of those intangibles may be regarded as overly broadening taxing rights of such countries contrary to the terms of the applicable treaties.

(vi) Whether there should be an exception for shares quoted on a stock exchange:

a. This is sometimes used as a mechanism to reduce compliance costs for taxpayers (and administration costs for tax authorities) in cases where there is a genuine share market transaction, since there can be less tax-avoidance risks involved. It would usually be defined to include at least the stock exchanges of the two treaty countries, and in the case of domestic legislation operating even without a treaty, the legislating country's stock exchange(s). As regards stock exchanges in third countries, countries may not be willing to broadly cover all stock exchanges in any countries, and instead want to confine to certain reputable and reliable stock exchanges. In this regard, tax treaty practices in defining "recognized stock exchange" in LOB (limitation on benefits) clauses may serve as a useful reference. They typically either simply define the term as stock exchanges agreed between the competent authorities or else list certain stock exchanges, usually in the two countries as well as other stock exchanges agreed between the competent authorities.[27] Sometimes the term is used but left undefined[28]

[27] Costa Rica-Mexico Double Tax Treaty (2014), Article 24 (4).
[28] Singapore-Sri Lanka Double Tax Treaty (2014) Article 14(4).

and sometimes it may list stock exchanges in countries with which either of two treaty countries have strong economic connections (such as regional stock exchanges or a major international stock exchange)[29].

b. The specific exception for such on-market transfers would only need to be reflected in the domestic legislation if there is a taxing right such as under Article 13(4), since it narrows rather than extends the treaty right. For example, Public Notice 7 of China, though an administrative regulation, exempts transactions through public securities markets. In contrast, Japan sets a higher threshold for percentage of shares that needs to be held by the transferor in the case of listed shares, which is 5%, as opposed to 2% for the other shares,[30] and this can also be seen as one variety of this exception. The U.S. also has a 5% threshold for the same percentages, which is only applicable to listed shares.

(vii) Should there be a "reorganizations clause"?

In paragraph 28.7 of the OECD Model Convention Commentary to article 13.4 it is noted that (emphasis added):

> Also, some States consider that the paragraph should not apply to gains derived from the alienation of shares of companies that are listed on an approved stock exchange of one of the States, to **gains derived from the alienation of shares in the course of a corporate reorganization** or where the immovable property from which the shares derive their value is immovable property (such as a mine or a hotel) in which a business is carried on. States wishing to provide for one or more of these exceptions are free to do so.

The rationale behind this type of provision is not to grant an exemption for such transactions, but simply to neutralize, by means of a deferral system, the taxation on the unrealized gains existing at the time the reorganization takes place.

Examples of such a clause include the following:

> **Article 13.4 of the Belgium - Congo (Dem. Rep.) Double Tax Treaty (2007):**
> Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value from immovable property situated in the other Contracting State may be taxed in that other State. This paragraph shall not, however, apply to gains derived from the alienation:
> (a) of shares listed on a recognized stock exchange of a Contracting State, or

[29] Ethiopia-Netherlands Double Tax Agreement (2012) Article 3(1).
[30] Edwin T. Whatley and Shinichi Kobayashi, "Taxation of Indirect Equity Transfers: Japan", 17 Asia-Pacific Tax Bulletin, 2 (2011), 138.

(b) of shares sold or exchanged in the framework of a corporate reorganization, of a merger, of a division or of another similar operation, or

(c) of shares deriving more than 50% of their value from immovable property in which the company exercises its activities, or

(d) of shares owned by a person who holds directly or indirectly less than 25% of the capital of the company whose shares are alienated.

Article 14.4 of the Hong-Kong - Malaysia Double Tax Treaty (2012):

Gains derived by a resident of a Contracting Party from the alienation of shares of a company deriving more than fifty (50) per cent of its asset value directly or indirectly from immovable property situated in the other Contracting Party may be taxed in that other Party. However, this paragraph does not apply to gains derived from the alienation of shares:

(a) quoted on such stock exchange as may be agreed between the Parties; or

(b) alienated or exchanged in the framework of a reorganization of a company, a merger, a scission or a similar operation; or

(c) in a company deriving more than fifty (50) per cent of its asset value from immovable property in which it carries on its business.

Before 2003 reorganization clauses were not so relevant, however some countries had taken them into account, as for example:

Protocol to the Treaty between Spain and Mexico (1992):

8.(a) With respect to paragraph 3 of Article 13[31], gains derived from the alienation of shares in a company that is a resident of Mexico shall be determined without including capital contributions made during the period in which the shares are held and the profits accrued during the same period on which the issuing company has already paid income tax.

(b) The tax charged, under paragraph 3 of Article 13, in the State of residence of the company the shares of which are alienated shall not exceed 25% of the taxable gains.

(c) Where, owing to a reorganization of companies which are owned by the same group of shareholders, a resident of a Contracting State alienates property as a consequence of a merger or division of companies of or an exchange of shares, then the recognition of the gain arising on the alienation of such property shall be deferred, for purposes of the income tax in the other Contracting State, to the moment in which a subsequent alienation which does not meet the requirements provided for in this paragraph for the deferment of the gains is effected."

[31] "13.3. Gains from the alienation of shares that represent a participation of at least 25% of the capital of a company resident of a Contracting State and held during at least the 12-month period preceding such alienation, may be taxed in that State."

(viii) What should be the percentage of the gain taxed:

The provisions in the UN and OECD Models allow, when the company meets the requisite test for domestic immovable property holdings, for taxing of the whole gain, not just the percentage of it relating to immovable property in the taxing jurisdiction, but some countries provide a moderating effect in their domestic laws so that only that percentage is taxed.

(ix) How can abuses be addressed within Article 13(4):

a. Some countries provide that the gain will be taxable if the percentage test for immovable property was met at any time in the year before transfer – this is to prevent manipulation of indirect assets held temporarily when the transfer occurs. In fact, the OECD 2014 BEPS Deliverable on Action 6 notes this issue:[32]

> 32. Article 13(4) allows the Contracting State in which immovable property is situated to tax capital gains realized by a resident of the other State on shares of companies that derive more than 50 per cent of their value from such immovable property.
>
> 33. [*omitted*]
>
> 34. There might also be cases, however, where assets are contributed to an entity shortly before the transfer of the shares or other interests in that entity in order to dilute the proportion of the value of these shares or interests that is derived from immovable property situated in one Contracting State. In order to address such cases, it was agreed that Article 13(4) should be amended to refer to situations where shares or similar interests derive their value primarily from immovable property at any time during a certain period as opposed to at the time of the alienation only.
>
> 35. The following revised version of paragraph 4 of Article 13 incorporates these changes:
>
> > 4. Gains derived by a resident of a Contracting State from the alienation of shares ***or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived*** ~~deriving~~ more than 50 per cent of their value directly or indirectly from immovable property***, as defined in Article 6,*** situated in ***that*** ~~the~~ other State ~~may be taxed in that other State~~.

b. The question has sometimes arisen about whether Article 13(4) may still apply, if the company holding the immovable property borrows money just before the share transfer to dilute the percentage of assets constituted by immovable property. Some countries take the view that as the OECD Commentary states at paragraph 28.4 that debt should

[32] BEPS Action 6: 2014 Deliverable, supra fn. 26, at pp. 78-79; cf. BEPS Action 6: 2015 Final Report, at pp. 71-72.

not be taken into account in the valuation of the property of the company, the money borrowed should not be taken into account to dilute the percentage of immovable property interests. Others more specifically address this, as many do not see the implication as flowing necessarily from the OECD Commentary. This part of the OECD Commentary is not quoted in the UN Model Commentary, in any case.

(x) What are the possibilities for limiting the compliance difficulties in taxing capital gains:

a. One of the difficulties is that of how a shareholder will know if the test of indirectly held immovable property subject to taxation on indirect transfers has been met in a particular country. As it is often not clear whether the information could be effectively requested from the company, especially at a particular point of time, and as knowledge of immovable property held is not enough, the taxpayer would need to know where it is held. Even access to balance sheets may not indicate all of the assets of a company, or whether they are properly classed as "immovable" under relevant legislation. For these sorts of reasons, a number of countries such as Australia (10 per cent) and the US (5 per cent, but only for listed shares) have *de minimis* standards in their domestic law so that small shareholders (portfolio investors) are not burdened by this requirement. South Africa has a 20 per cent threshold test for the taxpayer and related parties' total holdings. These sorts of provisions may be especially relevant in the case of non-corporate vehicles, where less information is usually publicly available, though controlling interests may be more common.

b. As noted above, some countries such as China do not apply the laws where the shares are openly traded on certain stock exchanges, such as those in the treaty countries, thus reducing compliance and administration costs.

c. South Africa only applies its legislation to non-residents where 80 per cent or more of the market value of the holdings (shares in the case of a company) derives from South African immovable property (otherwise than held as trading stock), and where the non-resident (together with related parties) holds directly or indirectly 20 per cent or more of the shares in the company or ownership or right to ownership of another entity.

d. What percentage is appropriate as applicable to extractive industry would have to be determined, by also taking into consideration the practice in the industry. For example, if the industry practice is basically one single investor wholly or substantially owns one mine, setting a high threshold percentage would still work in terms of effectively taxing indirect transfer of extractives. If, in contrast, it is the industry practice that several different investors sometimes invest in the same mine by setting up a joint venture, and that they transfer their interest to third parties or among them, a high threshold percentage may not suffice. Treatment of farm-out and farm-in agreements may also have to be examined in this context.

e. Recognizing that the percentage of assets may vary over time, some countries allow shareholders to take the proportions from the most recent accounts (i.e. not on the day of the transfer) unless they have reason to believe that the accounts will not reflect the reality on the day of transfer. Malaysia, for example, allows the taxpayer to submit the audited accounts of the company for the financial year which is closest to the date of the transfer. In the United States, if there is a transfer between two balance sheet dates, the US corporation must nevertheless be able to demonstrate whether it is a US Real Property Holding Company (the US legislative term for a "land-rich company") on the date of transfer. A US corporation can rely on the most recent balance sheet (*i.e.* quarterly, monthly, *etc*.) and determine whether there was a material shift in value or whether an additional relevant date was triggered in between the balance sheet date and the date of transfer by the foreign taxpayer.

(xi) What is the importance of the domestic meaning of "immovable property":

a. Countries seeking to tax indirect transfers resulting in capital gains, and having treaty clauses similar to Article 13(4) need to take stock of their domestic law meaning of the term "immovable property". This is especially because the term "immovable property" is not defined in Article 13. This means that it either (i) looks to domestic law unless the context requires otherwise (in the terms of Article 3(2) of both the UN and OECD models); or else (ii) follows the definition in Article 6. The definition in Article 6 is not expressed (unlike the Article 3 definitions) to apply for the purposes of the Convention as a whole, but unlike the definitions of dividends, interest and royalties, it is also not expressed to apply only for the purposes of the Article (i.e. Article 6). Therefore, the fact that there is a definition of immovable property in article 6 and it is not explicitly confined to article 6, the definition may be considered as a relevant part of the treaty context.

b. Most countries regard the Article 6 definition as applying to Article 13, by inference. This takes us back to the meaning in domestic law, but ensures that, whatever domestic legislation says, would mean that "rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources" are covered by the definition.

c. To guard against an interpretation that the term "immovable property" takes its meaning from domestic law only, with no "supplementation" from the Article 6 definition, countries should consider either (i) making specific reference to the Article 6 definition in Article 13, or (ii) reflecting the Article 6 definition coverage, as a minimum, in domestic law. The latter would be an easier option for many countries as they can make it unilaterally. They might also consider it helpful to specifically clarify in domestic law the tax treatment of rights relating to the mining/oil or gas production, including reconnaissance and/or exploration related rights as well as the extraction (i.e.

development) licenses themselves, and possibly surveys and other non-public information pertaining to the immovable property.

11.2. It should be noted that the reference is to the domestic law "meaning" of immovable property" and in some countries it might not be considered necessary to specifically define "immovable property" because the meaning of the term is sufficiently clear. In contrast, as noted in Box 7 below, Australia has legislated that the term "immovable property" encompasses the term "real property" more commonly used in Australian law.

***Box 6:* The meaning of "immovable property in South Africa:**

The capital gains tax provisions *inter alia* apply to the following assets of a person who is not a resident:

- immovable property situated in the Republic held by that person
- any interest or right of whatever nature of that person to or in immovable property situated in the Republic
- rights to variable or fixed payments as consideration for the working of or the right to work mineral deposits, sources and other natural resources.

An interest in immovable property situated in the Republic includes any equity shares held by a person in a company or ownership or the right to ownership of a person in any other entity or a vested interest of a person in any assets of any trust, if—

(*a*) 80 per cent or more of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of disposal thereof is attributable directly or indirectly to immovable property held otherwise than as trading stock; and

(*b*) in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20 per cent of the equity shares in that company or ownership or right to ownership of that other entity.

(*Paragraph 2 of the Eighth Schedule to the Income Tax Act, 1962*)

***Box 7:* An Australian Definition of "real property":**

A capital gains tax asset is *taxable Australian real property* if it is:

(a) Real property situated in Australia (including a lease of land, if the land is situated in Australia; or

(b) a mining, quarrying or prospecting right (to the extent that the right is not real property), if the minerals, petroleum or quarry rights are situated in Australia.

(Section 855-20 Income Tax Assessment Act 1997).

Note: the International Tax Agreements Amendment Bill 2014 was approved by the Australian Parliament on 24 September 2014. It clarifies that the term "immovable property" encompasses "real property" to the extent that an Australian treaty provides that immovable property has the meaning it has under domestic law.

Box 8: **IMF Recommendations on the Philippines:**

Transfers of exploration permits, mining agreements, and interests in mining companies

58. **The Mining Act allows for the assignment (transfer) of exploration permits to another person.**[37] Gains realized on the transfer of an exploration permit or mining agreement are subject to income tax as business income or capital gains, most likely as capital gains since a mining company will not hold permits as inventory. Any gain realized on the transfer by a company of an exploration permit or mining agreement will thus likely be subject to 30 percent tax. In contrast, if mining rights are held indirectly through an interposed company, the increased value of the rights could be realized by way of a sale of shares in the interposed company with the tax rate on this gain being 10 percent.[38]

59. **A non-resident company is liable to tax on gains realized on the sales of real property in the Philippines and sales of shares in a Philippine company as both are treated as Philippine-source income wherever the sale may be completed.[39]** There is no specific rule for mining interests, however, and a sale of mining interests by a non-resident might be able to escape tax if sold directly and almost certainly would escape tax if it were sold indirectly by way of a sale of shares in a foreign upper tier company that owned a Philippine company that owned the mining interests. A solution to this problem commonly used elsewhere is to expand the definition of real property for income tax purposes to include any mining interests or any interests in any trust, company, partnership or any other entity or arrangement where at least 50 percent of the value of the interest is attributable to direct or indirect interests in real property (included deemed real property in the form of mining rights). If this rule were adopted, gains from the sale of shares in companies that directly or indirectly owned mining rights would be taxed at 30 percent as gains from the sale of real property rather than at 10 percent as gains from the sale of shares.

60. **Unfortunately, Philippines has entered into a number of tax treaties that require it to give up its right to tax residents of the treaty partner country on gains from the sale of mining rights where those rights are held via a small chain of companies.** The Philippines has a very extensive tax treaty network and it will be almost impossible to renegotiate the treaties to extend Philippines taxing rights over gains related to Philippine mining interests. However, future treaties should adopt a broad definition of real property for purposes of the capital gains article to include all direct and indirect interests in mining rights. If there are opportunities to amend existing treaties, these should be used to address the definition of real property in existing treaties.

61. **Philippines authorities currently have no direct enforcement powers over non-residents with respect to collection of income tax on gains from direct or indirect sale of Philippine mining rights.** However, it is likely that Philippine authorities only learn of any indirect transfers of Philippine mining rights (i.e., selling of interest in the company that owned the company with the mining rights) through international mining industry information channels and not through any government data collection. A simple enforcement mechanism to ensure collection of tax on both direct and indirect sales would be to provide an automatic security interest for the [Bureau of Internal Revenue] in respect of any unpaid tax on gains on the direct or indirect sale of mining interests. If this rule were in place, the parties to the transaction itself would ensure tax is paid to protect the interest of the buyer and the sale price of the seller.

62. **An alternative approach that the authorities may want to consider would be taxing the deemed gain of the local company holding the mining rights.** Under this approach, if there is a 5 or 10 percent or more change in the underlying ownership of the entity holding the mining right, the entity is treated as: (1) disposing of its proportionate interest in its mining right and immediately reacquiring that interest; (2) receiving for the disposal consideration equal to the market value of the proportion of the mining right treated as disposed of; and (3) incurring a cost in respect of the re-acquisition of an equal amount.

[37] Mining Acts s. 25; [38]National Internal revenue Code (NIRC) ss. (B)(5)(c), (A)(7)(c); [39] NIRC s. 42(A)(5) for real property; NIRC s. 42(E) for shares.

(*IMF Country Report No. 12/219, Philippines: Reform of the Fiscal Regimes for Mining and Petroleum (August 2012)*)

***Box 9:* A Case in Point: Peru**

Taxing Transfer of Shares in "Land-rich" Companies

By Law no 29663 of February 15 2011,capital gains of non-residents of Peru from the indirect transfer of ownership or participations in Peruvian companies is treated as sourced in Peru and taxable in Peru.

The indirect transfer is deemed to occur if shares from a non-resident company are transferred and that company owns shares of a resident company, directly or through other companies, as long as (i) over the 12 months prior disposal the market value of the domiciled company's shares held by the non-domiciled company directly or through other companies equals 50 per cent or more of the market value of shares of the non-domiciled entity, or (ii) the non-domiciled entity resides in a tax haven.

Peruvian resident companies must report any indirect transfers to the Peruvian Tax Administration by foreign affiliates. If the transferor is not a resident, the domestic company will be jointly and severally liable for any capital gains tax arising from the indirect transfer.

There was criticism that very small transactions would be caught by the legislation, provided that the transfer resulted in capital gain for a non-resident company owning the shares.

In July of 2011 Law 29757 provided some relief. An indirect transfer would only be taxable if the transaction represented a transfer of 10 per cent or more of the non-resident company's interest in its investment in Peru. The 10 per cent threshold is determined by amalgamating any disposals over a 12-month period (to reduce the chances of transfers little by little over a twelve month period).

Law 29757 also addressed issues of the *amount* of the taxable capital gain. In general, the basis of shares acquired before the February 16 2011 effective date of Law 29663 would be the greater of: (1) the market value of the shares as of February 15, 2011; or (2) the acquisition cost or the value of the equity if acquired without consideration. Market value, if the shares were listed on a stock exchange, would be the stock exchange price at the close of February 15, 2011, or the last published quotation.

For shares not listed on a stock exchange, the value of the shares at the time when they were added to the company's balance sheet is used, based on an audited balance sheet of the non-resident company. The balance sheet could not be dated earlier than February 15, 2010.

Other changes were new provisions that:

(i) limited the deemed Peruvian sourced income to the proportion of the value of the shares sold which represents the indirect Peruvian interests (i.e.) the gain on the shares as a whole would not be taxed where part of the value relates to unrelated investments.

(ii) those paying or crediting income as a result of the indirect transfer of shares are deemed to be withholding agents, and in such case the company whose shares are indirectly sold is not jointly or severally liable.

12. Other Approaches to Tax Indirect Transfers – in Compliance with Tax Treaties

12.1 There are at least two other approaches that can effectively tax indirect transfers without violating tax treaties. First is the use of a GAAR in domestic tax law that re-characterizes, for domestic tax law purposes, an indirect transfer of shares in a domestic corporation as a direct transfer of the same, where only the latter is taxable under the domestic tax law. For example, Public Notice 7 of China is based on a GAAR in its domestic tax law and re-characterizes an indirect transfer as a direct transfer in certain circumstances (see the box below for more details). Under this approach, countries can effectively tax indirect transfers, regardless of the proportion of values in shares that are derived from immovable properties. Countries that want to tax indirect transfers even in non-extractive industries may prefer this approach for this reason.

(i) As regards the relationship with tax treaties, if such re-characterization under the domestic tax law is respected for tax treaty purposes as well, Article 13(5) of the UN Model will, to the extent permitted thereunder, authorize taxing rights to the country seeking to tax the transfer. As regards GAARs, Paragraphs 22 and 22.1 of the OECD Commentary state as follows (*emphasis added*):

> 22. Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including "substance-over-form", "economic substance" and **general anti-abuse rules** have also been analyzed, particularly as concerns the question of whether these rules conflict with tax treaties, which is the second question mentioned in paragraph 9.1 above.
> 22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, **there will be no conflict**. For example, to the extent that the application of the rules referred to in paragraph 22 results in a re-characterization of income or in a re-determination of the taxpayer who is considered to derive such income, **the provisions of the Convention will be applied taking into account these changes**.

(ii) The guiding principles to qualify as a GAAR under the OECD Commentary are found in Paragraph 9.5 of the Commentary on Article 1, being that:

> (a) *a main purpose* for entering into certain transactions or arrangements was to secure a more favorable tax position; and
> (b) obtaining that more favorable treatment in these circumstances would be *contrary to the object and purpose of the relevant provision*.

(iii) OECD/G20 2014 BEPS Deliverable on Action 6 reinforces this position and states that if these conditions are satisfied, there will be no conflict with tax treaties.[33] Paragraphs 20-27 of the UN Commentary on Article 1 basically follow the OECD Commentary.

(iv) Hence, as long as the OECD/UN Commentaries are followed, and those guiding principles are satisfied, GAARs would be respected for tax treaty purposes.[34] Countries have to make sure that these principles are satisfied, and this would affect the scope of indirect transfers that can be covered by this approach. For example, in order for an indirect transfer to be considered abusive, it would be generally necessary that the percentage of shares transferred be sufficiently high. Furthermore, if countries desire to effectively tax the indirect transfer of shares in domestic corporations the sale of shares to related persons and sales over a period of time should be aggregated. Also, industry practices should be examined in order to decide on the level of an appropriate threshold percentage to effectively tax indirect transfers in the extractive industry.

(v) In what circumstances such guiding principles are regarded as satisfied can largely depend on how strictly the court in each country reviews the conformity of GAARs with those principles, and establishing such conformity may be burdensome for tax administrations in some countries. In addition, this GAAR approach may be considered too uncertain for taxpayers due to the subjective standard to be used, particularly if one of the requirements is dependent on a future event (e.g., tax implications of a future transaction), and this may impede otherwise desirable business transactions. For these reasons, countries may prefer other approaches.

12.2. Where an indirect transfer of shares in a domestic corporation is successfully re-characterized as a direct transfer of the same, attention should be paid to the issue of potential double taxation. While, as a result of re-characterization, the transferor is treated as having directly transferred shares in a domestic corporation, it does not follow that the transferee is treated as directly acquiring and owning those shares for tax purposes in the future as well. As a matter of fact/form, the transferee owns the shares in the offshore holding company, which in turn owns the shares in a domestic corporation, and such fact/form can be respected in deciding the tax consequences in a future transaction. This can be problematic particularly when the offshore holding company sells the shares in the domestic corporation, since in this case, unless the GAAR (or relevant enforcement regulation thereunder) specifically addresses the issue of basis in the shares owned by the offshore holding company, double taxation can potentially arise. This is because the offshore holding company by itself neither owns newly-acquired shares in the domestic corporation nor paid taxes for the transfer in the first transaction, and hence, its basis in the shares may be treated as unchanged despite the fact that taxes for built-in gains in those shares are effectively already paid by the former shareholder of the offshore holding company. It appears theoretically consistent to give the offshore holding company a stepped-up

[33] BEPS Action 6: 2014 Deliverable, supra fn. 26, at 92; cf. BEPS Action 6: 2015 Final Report at p. 79 ff.
[34] But see Qiguang Zhou, "The Relationship between China's Tax Treaties and Indirect Transfer Anti-avoidance Rules", 74 Tax Notes Inernational 543 (May 12, 2014) (Criticizing the OECD/UN interpretation as too general).

basis in the shares; however, since a GAAR would be generally triggered only in abusive cases under the afore-mentioned guiding principles, some countries may not be willing to do so.

Box 10: A Case in Point: China

General anti-abuse rule in domestic law, with a specific enforcement regulation for indirect transfer[35]

Under Article 47 of the Corporate Income Tax Law of China introduced in 2008, if taxable income is reduced as a result of arrangements with no reasonable commercial purpose, the tax authorities can make adjustments.

According to State Administration of Taxation Order 32 published in 2014, a general administrative guidance on the application of Article 47, two major features of a tax avoidance arrangement are required to justify its denial under Article 47, being that: (a) its sole or main purpose is to obtain tax benefit; and (b) its legal form is not commensurate with its economic substance.[36]

Additionally, Public Notice 7 was released in 2015 as an enforcement regulation to specifically handle indirect transfers.[37] This new regulation replaces previous rules under Circular 698 issued in 2009. Under Public Notice 7, an indirect transfer will be re-characterized as a direct transfer of "China Taxable Property" if the following requirements are *all* satisfied:

(a) a non-resident entity transfers equity or other similar interests in an offshore holding entity that directly or indirectly holds China Taxable Property;

(b) the result of the transfer is in substance the same as or similar to the direct transfer of the China Taxable Property;

(c) the transfer is made by the non-resident entity through arrangements lacking reasonable commercial purpose; and

(d) the non-resident entity avoids corporate income tax liability.

"China taxable Property" is defined as meaning: (a) property of an "establishment or place", a domestic concept corresponding to a permanent establishment under treaties, in China: (b) real property in China; (c) equity interests in Chinese resident entities; and (d) other property directly held by a non-resident entity and the transfer of which brings about corporate income tax liability. This definition was expanded from the one in Circular, under which only equity interests in Chinese resident entities were covered. In the case of (b) and (c) above, buyers owe obligations to withhold 10% from the purchase price.

[35] See Baker & McKenzie, supra fn. 19.

[36] See Ernst and Young, "China Tax & Investment Express: China released Administrative Measures for General Anti-avoidance Rules (GAAR)" (Dec. 19, 2014), available at http://www.ey.com/Publication/vwLUAssets/EY-CTIN-2014002-ENG/$FILE/EY-CTIN-2014002-ENG.pdf.

[37] The original language in Chinese is available at http://www.chinatax.gov.cn/n810341/n810755/c1491377/content.html. See e.g., Baker & McKenzie, supra note 20 for an unofficial English translation.

***Box 10 A:* A Case in Point: China – Public Notice 7 Factors**[38]

Public Notice 7 lists the followings as factors to be taken into consideration for the purpose of determining the existence of "reasonable commercial purpose":

(a) whether the value of the offshore holding entity's equity is mainly directly or indirectly derived from China Taxable Property;
(b) whether the assets of the offshore holding entity mainly comprise direct or indirect investments in China, or whether the revenue of the offshore holding entity is mainly sourced directly or indirectly from China;
(c) actual functions performed by or actual risks assumed by the offshore holding entity and its affiliates holding directly or indirectly China Taxable Property is sufficient to prove economic substance
(d) duration of the offshore holding entity's shareholders, business model and relevant organizational structures;
(e) tax implications of the indirect transfer outside of China;
(f) whether the investment and transfer of China Taxable Property could have been effected directly, as opposed to indirectly,
(g) applicable tax treaties or arrangements applicable in China with respect to the indirect transfer; and
(h) other relevant factors.

The following three categories of transactions are exempted from the re-characterization: (a) intra-group reorganizations satisfying certain requirements; (b) gains that would have been exempt even in the case of a direct transfer; and (c) transactions through public stock exchanges. The categories (a) and (b) above are addressed by Public Notice 7, but not under Circular 698.

Public Notice 7 includes a provision for voluntary reporting of transactions to the tax authority by buyers, sellers and underlying Chinese entities. This is a change from Circular where buyers were required to report transactions. If buyers report transactions, they are potentially entitled to exemption from, or reduction of, future penalties. If sellers report transactions, they can be exempted from additional annual 5 % punitive interest. Tax authorities are also specifically authorized to make information requests to buyers, sellers, underlying Chinese entities and advisors.

12.3. Another approach to effectively taxing an indirect transfer is to impose tax on the underlying domestic corporation that holds immovable properties, instead of the shareholder which transferred the offshore holding company which in turn owns the underlying domestic corporation, by deeming all built-in gains in properties of such domestic corporation as realized when there is a change in its shareholding over a certain percentage. The built-in gains to be taxed can be limited to those derived from immovable properties, but countries can also choose to tax all of them. For example, Tanzania taxes an underlying domestic corporation for all of the built- in gains, if its ownership changes more than 50% (see Box 11 below for more details).

[38] See Baker & McKenzie, supra fn. 19.

(i) Tax treaties are generally applicable to protect only non-residents from taxation. It may be arguable that this domestic legislation is effectively taxing capital gains that are protected under Article 13. However, countries generally have broad discretion as to how to structure realization events for capital gains under their domestic legislation. For example, some developed countries have Fair Market Value based taxation system for listed stock or other financial instruments that have a Fair Market Value. Also, the amount of capital gains can be different between a direct transfer and an indirect transfer since the bases in the assets can be different. Hence, this accelerated realization of built-in gains itself would unlikely cause a conflict with tax treaty obligations.

(ii) Another tax treaty obligation countries should pay attention to is Paragraph 5 of Article 24 (Non-discrimination) of the OECD/UN Models. This paragraph forbids giving less favorable treatment to a resident corporation owned by non-residents. Hence, if the domestic legislation under this approach is applicable only to domestic corporations owned by non-residents, it can be considered invalid by violating Article 24(5). In order to avoid this concern, countries would have to apply this regime regardless of whether shareholders are residents or non-residents.

(iii) In contrast, Paragraph 5 of the UN Commentary on Article 24 includes the following alternative provision of Article 24(5), in consideration of the tax compliance problems arising from foreign ownership of domestic corporations in developing countries (*emphasis added*):

> 5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are subjected other similar enterprises the capital of which is wholly or partly owned or controlled, directly or indirectly, **by residents of third countries**.

(iv) Unlike Article 24(5) of the OECD/UN Models, discrimination only between non-residents is prohibited under this alternate provision. There are several treaties that adopt this or similar provision,[39] and under those treaties, countries that have adopted this alternate provision in their tax treaties can limit the scope of domestic legislation under this approach to cases where foreign ownership is involved.

12.4. As long as a change in ownership over a specified percentage happens, this approach fully taxes built-in gains regardless of the percentage of shares transferred indirectly, and the amount of tax can be

[39] See for example the Norway-Qatar Treaty, as well as several treaties signed by Kuwait and United Arab Emirates. For example, Art. 26(3) of Mongolia-UAE treaty states: "Enterprises of a Contracting State, the capital of which is wholly or partly owned or which is controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any obligations connected therewith which is other or more burdensome than the taxation and connected obligations to which other similar enterprises the capital of which is wholly is or partly owned or which is controlled directly or indirectly by one or more residents of any third state are or may be subjected."

quite burdensome in light of the percentage of shares actually transferred. There are several options to mitigate this problem, which are not necessarily mutually exclusive.

(i) Firstly, as regards the minimum threshold percentage of shares that need to be transferred, countries may consider setting a relatively high percentage (e.g., 50% in Tanzania or 20% in South Africa) as compared to those used for domestic legislation pursuant to Article 13(4) of the OECD/UN Models (e.g., 5% for listed shares and 2% for non-listed shares in Japan). Such higher threshold may not be sufficient to deal with indirect transfers where several different shareholders set up a consortium to jointly invest in one project, for example in order to diversify the risks involved, and only some of them indirectly transfer their ownership rights. Again, industry practice should be examined to determine an appropriate threshold percentage.

(ii) Alternatively, countries may choose to deem built-in gains as realized only to the extent corresponding to the percentage of shares transferred, though this can make the rule too complicated for both tax administrations and taxpayers.

(iii) Another option is to deem, not only built-in gains, but also built-in losses as realized, and thereby, reduce the net taxable gains. In order to prevent attempts to avoid taxes by accelerating loss realization, countries would want to limit such deemed loss realization to the extent not exceeding the amount of gains deemed realized.

12.5. While this approach would be easier for tax administration to actually collect taxes, since the taxpayer is a domestic corporations located within its jurisdiction, this at the same time can cause another potential problem, that of cash flow. The domestic corporation will need to finance the taxes due, even though the corporation itself does not receive any cash or other consideration for the transfer. In some cases, the domestic corporation may be obliged to dispose some of its assets only to pay taxes, and this can ruin the business rationale of the transaction. In practice, this problem can be avoided if the transferor and transferee agree to reduce the consideration for the share transfer to the extent of taxes due on the domestic corporation, and after the transfer, the transferee contributes cash to the domestic corporation so that it can pay taxes. However, this practical solution may not always work particularly when less than 100% of the total shares in the domestic corporation are indirectly transferred, in which case the transferor would not be willing to bear all of the tax burdens in the form of reduction in consideration it can receive.

12.6. Double taxation can also arise under this approach, and it can be more problematic here than other approaches. As mentioned in the above, Article 24(5) of the OECD/UN Models would require domestic tax laws under this approach to cover domestic corporations owned by residents. As a result, where a resident transfers shares in a domestic corporation, and the requirements for deemed gain recognition are satisfied, both the domestic shareholder and the underlying domestic corporation would have to realize gains immediately. This is different from other approaches where double taxation potentially arises only when the relevant shares/assets are transferred in the future. One solution would be to grant the shareholder a tax credit equivalent to the amount of taxes paid by the underlying domestic corporation as a result of deemed gain recognition.

Box 11: A Case in Point: Tanzania (deemed realization of gains by the underlying entity whose shares are indirectly transferred)

Under the Income Tax Act of Tanzania, an entity will be deemed to have realized gains in its assets, if its ownership changes, directly or indirectly, by more than 50 % (change of control) during a 3-year period. As a result, if the underlying entity is a *resident*, it has to pay taxes for all of the gains deemed as realized, while a *non-resident* underlying entity is liable for taxes only to the extent derived from "domestic assets", including immovable properties in Tanzania.

This regime effectively triggers taxation by Tanzania, where "domestic assets" in Tanzania are indirectly transferred through transfer of shares in an offshore holding entity. One distinct aspect of this regime as contrasted with the Peruvian approach above is that the underlying entity, not the shareholder who transferred its shares, is treated as realizing gains and thus liable for taxes. This unique nature was introduced by an amendment to the Income Tax Act in 2012. Before this amendment, the transferor, not the underlying entity, had been the taxpayer, and reducing enforcement difficulties and practical challenges by making the underlying entity directly liable for taxes appears to have been the main purpose of this amendment.[40]

The Tanzanian Income Tax Act intentionally has no exemption for intra-group reorganizations, apparently due to potentially significant tax avoidance risks.[41]

13. Issues of Identification

13.1 The most pressing issue is how does one even know about the indirect transfer, especially a transfer effected in a foreign jurisdiction (as it often will be):

(i) It is possible that information may come to light in an automatic exchange of information (though developing countries at this stage do not have many such arrangements) or by a spontaneous exchange from another country, but this is not likely to happen often either. Where treaty relationships exist information could be sought from treaty partners, but that would usually only happen after there was an initial awareness of the transfer, and at least some of its details.

(ii) Officers in the revenue collection agency should keep up to date with industry news and conducting regular internet searches for sets of key words such as the names of mines, the word "mine" and the country name have some value, but are necessarily reliant on luck. Commercial databases may assist as might details of foreign takeovers required under domestic law or notifications of changes required under extractives legislation. In one Chinese case a public announcement was found on the website of the buyer, announcing the completion of the

[40] Presentation by Mr. Charles Bajungu of the Tanzania Revenue Authority to the UN Tax Committee (October 2014). Available at http://www.un.org/esa/ffd/wp-content/uploads/2014/11/10STM_PresentationBajungu.pdf
[41] Presentation by Mr. Charles Bajungu, supra fn. 40.

acquisition of the Chinese company, but without mention of the intermediate holding company, a Hong Kong special purpose vehicle with little substance.[42]

(iii) Other potential pointers to an indirect transfer might include changes in enterprise names, changes in directors, and changes in tax auditors.[43] It has been noted that companies that have been listed on international stock exchanges, subsequent to structuring, are more prone to detection, and that accountants may be required to "provision" for a potential tax liability of the selling entity.[44]

(iv) Some countries have imposed reporting obligations (i) on underlying domestic companies to report to authorities when they are indirectly sold or where there are major changes in their shareholding or (ii) on shareholders of such companies (usually only those in a control situation – because the requirements can cast heavy obligations on the shareholder to know what business the company is conducting, and can present an issue of extraterritorial exercise of jurisdiction particularly when over-widely imposed) to report to authorities a transfer indirectly affecting local property.

(v) To be effective, even requirements to notify of major shareholding changes (say of those above 10 per cent) would need to provide that changes over a period of time (12 months or longer in some cases) to prevent several transfers of 9 per cent in a short being time not having to be reported. The above-mentioned OECD/G20 2014 BEPS Deliverable on Action 6 in relation to 50% threshold to determine whether the value of a company is primarily derived from real property or not suggests one potential approach to this issue.

(vi) Further, reporting requirements on ownership of interests would need to apply at more than one level, to ensure that the reporting requirements are not avoided by having the changes occur further up a string of companies. The intention of such "indirect" transfers being covered would need to be clear in the legislation.

14. Enforcement Issues

14.1 If there is a taxable disposition, how can the tax debt be enforced in practice? The indirect transfer generally takes place outside the jurisdiction where the property (such as a mine) is located and usually neither the buyer nor the seller is a resident.

(i) While both the UN and OECD Models now contain optional Assistance in the Collection of Tax Debt Articles for countries wanting to provide for this in bilateral tax treaties, and there is a multilateral OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax

[42] Cadwalader, Wickersham and Taft LLP, "Circular 698: The China's Anti-tax Avoidance Measures for Offshore SPVs" , 23 August 2010, Available at: http://www.cadwalader.com/CN/assets/client_friend/CWT_C&FMemo_SAFECir698%29.pdf ("Cadwalader, Wickersham and Taft ")

[43] Cadwalader, Wickersham and Taft, supra fn. 42.

[44] Cadwalader, Wickersham and Taft, supra fn. 42.

Matters on the subject, this is not yet something most developing countries have provision for in their bilateral or multilateral relationships.

(ii) One approach taken has been to deem, where there is a change in ownership of an underlying domestic corporation holding assets over a certain percentage (50 per cent in Tanzania as seen above; 10 per cent in the case of Peru, as also seen above), that there has been a disposal and re-acquisition of exploration and development rights by such underlying domestic corporation. This would lead to a domestic capital gains event (the responsible taxpayer will have to be made clear), and countries can enforce against a resident taxpayer. Depending on the legislation there might be necessary re-approvals required such as for export licenses (though such re-approvals would unlikely be necessary, if such deemed disposal and re-acquisition are made only for tax purposes).

(iii) Alternatives include joint and several liabilities of the seller and buyer for the tax debt, or else a tax obligation on the indirect buyer of the assets (such as withholding obligation to withhold a specified percentage from the purchase price, which may or may not be sufficient to cover all taxes due on the seller). The theory is that publicizing an indirect transfer regime will put the buyer (exercising due diligence) on notice and the buyer takes necessary actions, for example, making sure that the seller will pay all taxes due and, in cases where the underlying domestic corporation as opposed to the seller becomes the taxpayer, the transfer price will reflect that. There may have to be legislation imposing obligations on the mine etc. operator (such as in the capacity of as a withholding agent in respect of interest or dividends payable to shareholders / owners of the operating company) and imposing a specific lien upon the facility in the event of non-payment.

(iv) One alternative is allowing non-payment by certain time after the payment becomes due, to be a factor in denying export licenses for the minerals, oil, gas etc. produced by the facility. This sort of provision is a very serious step, and it would need to preserve normal taxpayer rights under domestic law for contesting a tax debt.

(v) However, this sort of response may not be possible (or only with the risk of substantial damages) because of contractual obligations, including stability (or “stabilisation”) clauses that essentially “freeze” the applicable law for the life of the project or reimburse for costs resulting from regulatory change or because of governing Investment Protection Agreement with Fair and Equitable Treatment[45] or “Umbrella” clauses[46], for example. Any consideration of a regime to address indirect transfers and any risks in relation to meeting Investment Protection Agreement

[45] See generally, for example: UNCTAD, “Fair and Equitable Treatment”, (2012) *UNCTAD Series on Issues in International Investment Agreements II*. Available at http://unctad.org/en/Docs/unctaddiaeia2011d5_en.pdf

[46] “Umbrella clauses” such as to the effect “Each Contracting Party shall observe any obligation it may have assumed with regard to investments”, which gives an additional treaty basis to claims that contractual terms have not been abided by”. See for example Yannaca-Small, K. *Interpretation of the Umbrella Clause in Investment Agreements*, in “International Investment Law: Understanding Concepts and Tracking Innovations: A Companion Volume to International Investment Perspectives”, OECD (2008). Available at: http://dx.doi.org/10.1787/9789264042032-3-en

obligations should consider any possible effect of these obligations in any case. As always addressing abuses of the system must be balanced with not creating too much complexity for the country, given the scope of the benefits it perceives and without increasing uncertainty or investment risks for basically compliant taxpayers. When stability clauses became an issue for Ghana, a seven person team was set up to review stabilisation clauses, renegotiate them where necessary and develop procedure for granting stability clauses in future.[47]

(vi) One particular aspect of this is that any tax payable in the country of the mine or other facility may not be viewed as properly creditable in a treaty partner – they may view the gain as sourced offshore. While any indirect transfers legislation should specifically indicate that the gain is treated as domestically sourced, to prevent issues in the courts, other countries may not accept that, leading to possible double taxation that will have some impact on the investment climate.

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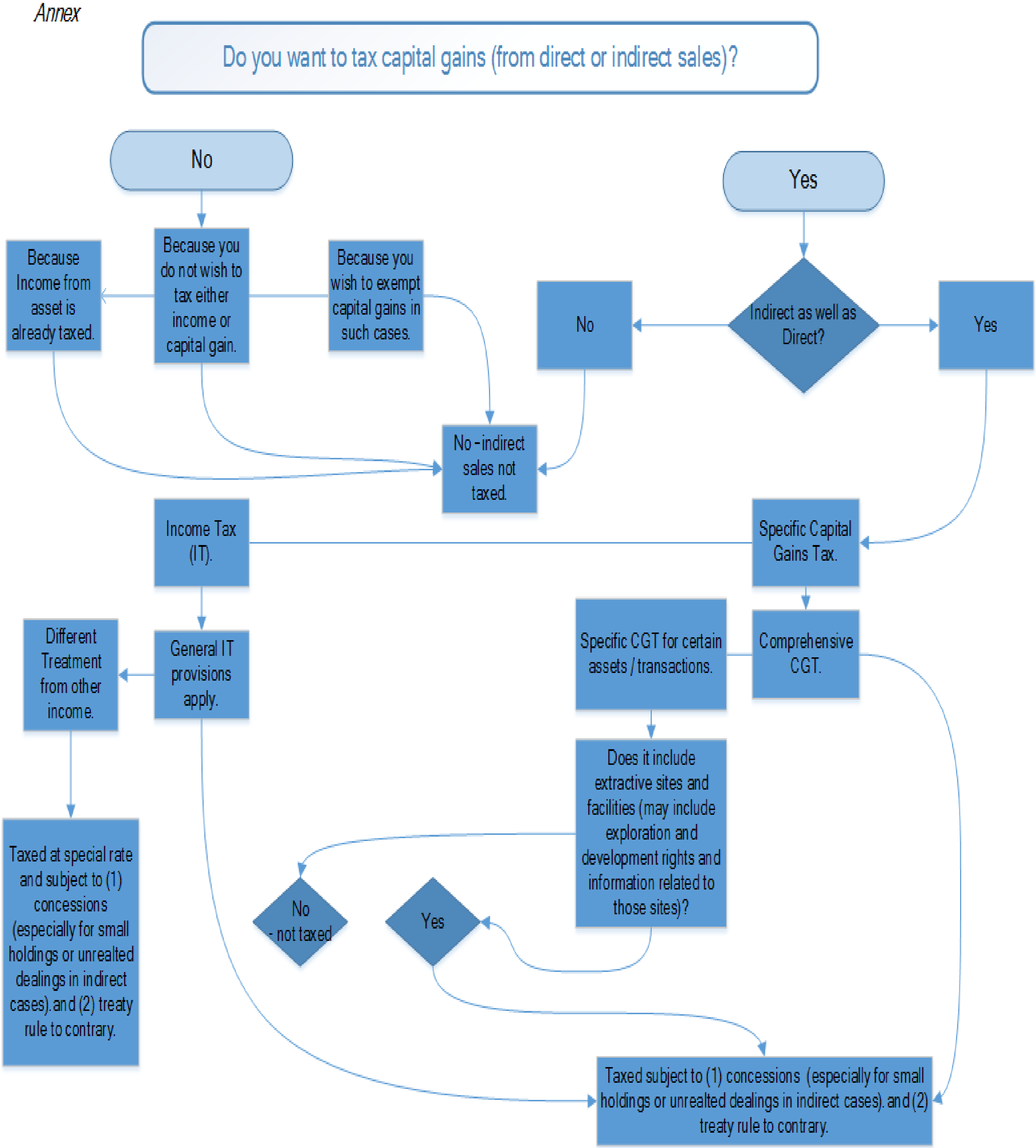
[NB - the first Annex below will be linked to paragraph numbers in the final text]

Annex I

Annex



Annex II: Symmetry in Capital Gains Taxation

Capital gains taxation rules are as important to the buyer as they are to the "taxpaying" seller. When a seller is taxable on its gain, measured by its sales price over its remaining cost basis in an asset, the buyer takes as its beginning tax basis the same price (in its case, its purchase price) for measuring future income or capital gains. Unless this occurs, the structure of the tax law itself will impose double taxation, contrary to basic taxation principles. While this "symmetry" is clearly understood as an important principle for in-country, direct sales of operating assets, its impact is equally important in the case of indirect sales that may take place outside of the country.

To fully appreciate the importance of symmetry in this context it is critical to understand the economic analysis underlying sales transactions, and in particular, for purposes of this note, sales transactions involving extractive assets and operations. Consider the following fact pattern: Opco owns and operates an oil well in Country X. Opco is a resident of Country X and is owned by Holdco, which is a resident of Country Y.

Opco's well is expected to generate net cash (cash revenues less cash operating/capital expenses) of 100 for each of the next ten years. For tax purposes, Opco's well is fully depreciated and there are no other differences between net cash and taxable income during the ten year period. Assuming a Country X tax rate of 50%, Opco expects to generate after-tax net cash of 500 over ten years (100 x 10 = 1,000 – 50% tax rate = 500), Country X will receive 500 in tax revenues over the same ten year period.

Assume Buyer has expressed an interest in buying Opco's well. To reach an agreement Buyer and Opco will have to arrive at a mutually agreeable sales price. Putting aside for the moment financial principles that deal with the present value of money,[48] Opco would demand an after-tax sales price of at least 500, which is the expected after-tax cash from retaining the well. Likewise, Buyer will only be willing to pay a sales price that is at least equal to the after-tax cash that it expects to receive from the well. Thus, the tax treatment of the transaction will have a significant impact on whether Opco and Buyer will be able to reach a mutually agreed upon price. In general, if the tax rules of Country X allow for symmetrical treatment, then there would be no tax impediment to Opco and Buyer reaching a deal.

Symmetry – Seller's Gain Taxed / Buyer Deducts Purchase Price

Under these rules, assume for simplicity that Buyer is willing to pay 1,000 to Opco for the well. Buyer's economic analysis of this decision would be as follows. Assuming the well generates the same net cash of 100 over ten years, the Buyer's future depreciation deductions (that were not available to Seller) will offset taxable income generated from the well, and as a result Buyer's future net after tax cash generated is 1,000. Under these simplified facts, Buyer "breaks even" on this investment.

[48] Which are very important principles and are essential to understanding the impact of tax depreciation rules on the incentives for investors to risk and invest capital.

	Cash	Tax Calculation
Income	1,000	1,000
Tax Deduction		(1,000)
Taxable Income		0
Tax	0	0
After Tax Cash	1,000	

Seller, on the other had will accept the 1,000 knowing that it is fully taxable at 50% because the after tax cash to seller will be the same 500 that Seller expected to receive from continuing to own and operate the well. Country X receives the same 500 in revenue that it would have received absent a sale.

Symmetry – Seller's Gain Not Taxed / No Deduction For Buyer (typical offshore indirect sale)

In this case, for Buyer to again have a "break-even" investment, it would be willing to pay only 500 for the well because that is the expected after-tax cash generated from operation of the well. Under these rules, Buyer basically steps into the shoes of Opco and has the same after-tax result that Opco would have had: 1,000 of before tax cash generated less 500 of tax paid nets 500 of after tax cash. Seller is willing to accept the 500 because it is not subject to tax and therefore Seller's after tax cash from the sale is also 500. Country X will receive 500 in revenues and is in the same position as before.

These two fact patterns are instructive, because they demonstrate, contrary to assertions frequently made, that a Seller can avoid local country tax through an offshore sale and that such a sale deprives developing countries of tax revenues.[49] Notice that in this case Opco bears the full brunt of the Country X tax. Buyer's calculation of the sales price it is willing to pay to Opco is based on the after-tax cash flow that is expected from the well. In other words, even though the well generates 1000 of revenues, Buyer is only willing to pay Opco 500 after deducting the expected tax payments of 500. Country X also is kept whole and will still receive 500 of revenue.

Nonsymmetrical Treatment – Seller's Gain Taxed / No Deduction For Buyer

Under these rules, Buyer will only be able to break-even by paying Opco 500 for the well because – as explained above – that is the expected after-tax cash flow from the well. For Opco, a payment of 500 is insufficient because the sale would be subject to 250 of tax by Country X (500 x 50%), and therefore, Opco's after tax cash is only 250 (500 – 250), which results in effective tax rate of 75%, i.e. double taxation.

Some may argue that this tax regime is favorable for Country X because it will receive 750 of tax revenues (250 from Opco as a result of the sales transaction plus 500 from Buyer as a result of the ongoing operations of the well). However, it is unlikely that this windfall to Country X will ever materialize. As stated previously, the sales transaction will only take place if Opco and Buyer can arrive at an agreeable price. Under this tax regime, the likelihood of that happening is extremely unlikely. As a

[49] OECD, Part 1 of a Report to G20 Development Working Group on the Impact of BEPS In Low Income Countries, July 2014, http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf

result, the sales transaction will not take place and Opco will remain operator of the well. In the long run this may be detrimental Country X if Buyer would have been a more efficient operator or would have been more willing to make additional investments.

Nonsymmetrical Treatment – Seller's Gain Not Taxed / Buyer Deducts Purchase Price

Under these rules, Country X would subsidize the sales transaction between Opco and Buyer. For the reasons explained above, Buyer would be willing to pay 1000 for the well. Seller would receive a windfall in this case because the after tax cash to Seller would also be 1000 if the sale is not subject to tax. Country X would receive 0 tax revenues under this regime.

In conclusion, a tax regime that provides symmetrical treatment for the Seller and the Buyer will protect the country's revenue and will not present an economic impediment to investors seeking to maximize efficiencies.

Even if a system is designed to create symmetry, there is still a question as to which approach is the best, i.e. tax gains to Seller but allow a deduction for Buyer or do not tax gains to Seller but likewise do not allow deductions based on the purchase price to Buyer. This ultimately becomes a question of timing. For example, under the Opco example above, if the gains are taxed, then Country X receives a lump sum of 500 in year 1 and then nothing in future years. If the gains are not taxed, Country X continues to receive a steady stream of 50 in revenues for the next ten years. Which is best for Country X? Obviously, many factors come into play but one item that public finance experts may consider is whether Country X's budgeting and spending processes are sufficiently disciplined to account for one-time acceleration of expected revenues. Would one year's spike in revenues be mistaken for a continuing trend or would other pressures force the revenues to be spent, effectively mortgaging the future? Alternatively, would it be better from a budgeting perspective to maintain a steady stream of income throughout the future years? These are the considerations a country will need to weigh in making its policy decision on this important issue.