The **BEPS** Monitoring Group

Comments on the Public Discussion Draft on

THE TAXATION OF OFFSHORE INDIRECT TRANSFERS – A TOOLKIT

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Jeffery Kadet and Sol Picciotto, with contributions and comments from Tommaso Faccio and Pooja Rangaprasad.

We appreciate the opportunity to provide these comments, and are happy for them to be published.

October 2017

SUMMARY

We welcome this discussion draft, which deals with an important issue of particular interest to developing countries, and was only partly dealt with in the G20/OECD project on base erosion and profit shifting (BEPS).

We agree with the argument it makes that principles of inter-nation equity clearly support the right of the country where an asset is located to tax the gains on its transfer, even if the seller and/or acquirer are not resident in that country. The country is of course free to decide whether and at what rate to tax such gains, taking account of the effects of such taxation on investment in the development of such assets. This right should therefore not be restricted by tax treaties, and we support the proposals in the BEPS project for inclusion in all treaties of a provision equivalent to article 13(4) of the model treaties. This can most effectively be done if all countries sign the Multilateral Convention on BEPS and adopt its article 9(4). This Toolkit should be amended to clearly and unambiguously urge all countries to do so.

In our view, the proposals should extend to indirect transfers of all kinds of assets, without limitation to immoveable assets. This is in accordance with the global consensus that profits and gains should be taxed in the jurisdiction where the economic activities giving rise to them are

located. The reference to article 13(5) of the UN model in the DD is therefore misleading, and should be amended, to provide countries that choose to tax a wider range of gains the necessary guidance to address movable assets such as shares.

We make a number of other comments which we hope would help improve the DD.

A. General Remarks

1. Background and Principles

We applaud the effort and thought that went into this Discussion Draft (DD) of a toolkit for the taxation of offshore indirect transfers (OITs). This is an important area not covered by the G20/OECD Base Erosion and Profit Shifting (BEPS) project that has simply cried out for the attention that this DD is now giving it.

In particular, we agree with the DD that offshore indirect transfers (OITs) are a significant issue for many developing countries. OITs are also a significant issue for many developed countries as well. Some specific country actions taken over a number of years are evidence of this, including the 1980 enactment of the U.S. Foreign Investment in Real Property Tax Act. Hence, this toolkit once finalized will be an important aid and resource for all countries.

We agree with the analysis in section B of the DD (p.18) that principles of inter-nation equity clearly support the right of the country where an asset is located to tax the gains on its transfer, even if the seller and/or acquirer are not resident in that country. The country is of course free to decide whether and at what rate to tax such gains, taking account of the effects of such taxation on investment in the development of such assets.

It is therefore inappropriate that this right should be constrained by tax treaties, especially as they were generally executed when parties to their negotiation had little appreciation of what practical taxing rights they were giving up. It should therefore be a high priority to remove tax treaty provisions that constrain this right. A major step in this direction would be adoption of a provision equivalent to article 13(4) of the model conventions in all treaties. This was agreed as part of the G20/OECD project on Base Erosion and Profit Shifting, and is proposed in article 9(4) of the Multilateral Convention on BEPS. We therefore urge all countries to sign the MC-BEPS and accept this article. We are disappointed that of the 71 countries which have so far signed the MC-BEPS, 37 have made reservations against article 9(4). Unless these reservations are withdrawn, this important anti-BEPS measure, which is particularly important for developing countries, would be implemented only partially.

The Toolkit acknowledges that some countries seek to tax some moveable asset transfers. In our view this is justified, and should be achieved by inclusion in all treaties of a provision based on article 13(5) of the UN model convention. This inclusion in all treaties would allow countries that currently do not tax moveable transfers to be free to do so in the future.

We strongly suggest that the toolkit include in discussion and within the Conclusions section three clear recommendations.

- That all countries signing the MC-BEPS should accept its article 9(4) for all their covered treaties;

- That all countries should renegotiate their non-covered treaties to include article 13(4) of the UN model; and
- That all countries should renegotiate all their existing treaties to include article 13(5) of the UN model.

Within this comment letter, we provide our thoughts on how this toolkit may be made even better.

2. Overall Conclusion on Model

We agree with the conclusion that Model 1 is the better of the two approaches discussed, treating the transfer as a deemed disposal by the local entity that directly owns the asset in question, even though it takes the legal form of an offshore transfer of shares or other direct or indirect ownership interest by a non-resident. The fact that existing domestic rules relevant to tax residents apply and its practicality of enforcement make it a usable tool for any country, whether developed or developing. We applaud this clearly stated and sensible conclusion.

3. Reaction to Taxpayer Concerns and Complaints

We can imagine that there may be some number of comments on this DD that represent taxpayer complaints that the DD's recommendations and/or the variety of approaches applied by different countries will complicate their lives and increase uncertainty. Such comments should be summarily ignored as disingenuous. Most typically, taxpayer efforts to achieve non-taxable offshore indirect transfers involve careful planning and structuring specifically meant to overcome appropriate and legitimate local taxation on realized economic gains. Such structuring seldom would be conducted in the absence of the anticipated tax reductions. With this in mind, we believe that no concern should be given to the risk, described on page 23, of "amplifying the uncertainty that taxpayers face in arranging their affairs." When taxpayers do not intentionally try to sidestep legitimate local taxation on realized gains, their outcome will normally be very certain.

B. SPECIFIC COMMENTS

1. Need for Expanded Coverage beyond only Immoveable Property

All of the language and discussion in the DD in relation to both Model 1 and 2 assume that a country will only want to cover OITs that involve an indirect interest in immoveable property, although the discussion of the definition of 'immoveable property' includes both a minimal and an extended definition. In our view, the same considerations apply to indirect transfers of assets which may be considered moveable property. A number of countries do tax transfers of interests in resident companies or partnerships and would want to include language to include OITs that are indirect transfers of such assets. This is recognized in the DD, including in the Conclusions on page 58 where it is acknowledged that some countries tax 'intangibles such as corporate stock issued in regard to a domestic company but held by a non-tax resident'.

We strongly suggest that additions be made to Model 1 and 2 so that countries desiring such broader coverage will be properly served by this new Toolkit. In our view, it should clearly recommend that countries desiring such broader coverage should renegotiate their treaties to

include a provision based on Article 13(5) of the UN model, which allows the source country to tax indirect transfers of a substantial shareholding in any company resident in that state.

2. Avoid References to a 'Uniform Approach'

The Executive Summary states:

> **There is a need for a more uniform approach to the taxation of OITs.** Countries' unilateral responses have differed widely, in terms of both which assets are covered and the legal approach taken. Greater coherence could help secure tax revenue and enhance tax certainty.

The Conclusions on page 58 also expresses concern about 'uncoordinated measures that jeopardize the smooth and consensual functioning of the international tax system'.

We agree that a more uniform approach that discourages new loopholes that taxpayers can exploit could well be helpful. However, considering both the sovereignty of countries and their varying conditions and concerns, we believe that expressing in the Executive Summary and Conclusions this 'more uniform approach' goal, which in the end may not be achieved, is misleading to readers on what they will find within the DD. In our view, it is the final paragraph in the Executive Summary that does briefly describe the real achievement of the DD, which is several workable best-practices options that countries may consider in light of their particular circumstances and needs. We believe that there is no need to refer to any unattainable 'uniform approach". In this regard, in addition to the final paragraph in the Executive Summary, we note that the DD comments on page 10:

> … [The toolkit] does not set out a single, definitive approach suitable in all circumstances. The aim rather is to identify practicable options, with a particular view to the circumstances of developing countries. It does, however, make some tentative recommendations.

The DD does set out two concrete Models and a definition of immoveable property. It provides a number of options that countries may consider. This is laudable and should be described as such in the Executive Summary and Conclusions, which unfortunately are probably as much as the majority of readers will read in this understandably long and excellent document. Hence, we believe that the Executive Summary and Conclusions should not make mention of a 'uniform approach' goal that may not be reached.

3. Addition to Purchaser Tax Consequences

On page 14, various purchaser tax consequences are noted. We suggest that the following be added at the end of footnote 12:

> Indeed, it will often happen in the case of indirect transfers of appreciated depreciable property that the purchase price will reflect an economic discount related to the lost future depreciation deductions since the tax basis of the indirectly acquired asset will not be stepped-up to the purchase price actually being paid by the indirect acquirer.

4. Misleading Revenue Effects

The discussion at the top of page 16 on the revenue impact on capital gains from basis adjustments seems to us very misleading. We believe that it would cause a typical reader to ask, why do we bother to impose any tax on capital gains?

The discussion states, in part:

> … the total nominal (undiscounted) revenue raised from the capital gains tax over time will be zero: that is, the same as if there had been no sale, or no capital gains tax. …

The reason for this "zero" result is the basis adjustment in the asset that is equal to the price paid for the asset. This basis adjustment will then mean an offset in determining gain on a future sale.

We of course agree with the basic accounting and tax computations that allow a basis increase for any purchase price paid. However, this ignores the actual tax that is collected from gains on assets that appreciate.

Take as a simple example a piece of raw land. (We use raw land to avoid complicating the discussion with depreciation.) Owner A, who acquired it for 100, sells it to Owner B for 150, who in turn sells it to Owner C for 300. There is cumulatively 200 of gain (300 minus 100). If this is an asset that by its nature will not likely decrease in value (raw land being in short supply) and is not depreciable, then there is little chance that there will be any reversal of this 200 gain. The basis adjustment will of course prevent this 200 gain from being taxed a second time, but it will not reverse the tax collected on that 200 gain.

With the above in mind, we suggest that the discussion of the revenue impact should be amended to indicate these real revenue effects.

5. Gains as Reflecting Accumulated Undistributed and Future After-Tax Earnings

On page 18, the DD notes the counterargument that gains may reflect earnings that the location country has either chosen not to tax or that are, as yet, unrealised gains and will not be taxed until some realisation event occurs. The discussion includes the sentence:

> The gain, that is, reflects earnings that the location country has in a sense simply chosen not to tax.

While we understand what this sentence is meant to convey, we believe that it will be too simplified for many readers. We suggest that it be changed to:

> The gain, that is, reflects economic earnings that the location country has either chosen not to tax or the events that would result in a taxable event have not yet occurred.

6. Need for Additional Balance in Discussion

Throughout the DD, there are many references to natural resources and sometimes telecommunication license rights as examples in discussions, but few references to more traditional real property assets. While real property is of course included within the discussion starting on page 55 where defining immovable property is covered, it seems to us that more references to real estate generally within the DD's discussion would provide readers a more complete and balanced understanding.

7. Matters Concerning Article 13.5 of the U.N. Model Tax Convention

On page 25 in the Assessment section, the following is stated:

> … It would seem that Article 13(5) [of the U.N. Model Tax Convention] is generally not needed as long as the definition of "immovable property" in both any applicable treaty under Article 13(4), and especially in domestic law, is sufficiently broad.

This sentence appears incorrect and misleading to us. Article 13(5) allows location country taxation on gains from any alienation of shares, other than those covered by Article 13(4), where the seller holds directly or indirectly some minimum percentage ownership in the capital of the company. The focus of Article 13(5) is on the level of ownership regardless of what assets the company might own and the activities it might conduct. Such a company, of course, may own little or no immovable property and may conduct significant and varied businesses and investments both within and outside the location country. Even with the broadest of definitions of immoveable property, there will often be no taxation under Article 13(4) for situations where Article 13(5) would apply. Therefore, to suggest that Article 13(5) is not needed if there is a sufficiently broad definition of immovable property is simply incorrect. We therefore strongly suggest that this sentence be deleted from the DD.

8. Concern with Taxpayer Burden

On page 52 is the following in regard to a withholding mechanism:

> … As noted, the withholding tax can only be collected as an estimate of the seller's final income tax liability (as the actual quantum of the seller's gain is unlikely to be known by the purchaser) and so withholding necessarily increases the compliance burden for the purchaser (who is subject to the withholding obligation) and the seller (who needs to file a tax return and determine any outstanding balancing amount or refund after claiming a credit for the amount of the tax withheld)—*although this burden could be manageable*. … [Emphasis added.]

The tenor of this should definitely be changed. OITs are a real problem for many countries. Taxpayers who enter into transactions to sell or buy properties in an indirect manner often do so with an intention to lower their tax obligations (and perhaps other costs as well, e.g. real estate transfer taxes and other costs), and do so with full knowledge of their intention and their specific structuring. To include this kind of language, "*although this burden could be manageable*", is making an excuse for something that absolutely needs no excuse. We suggest the following language as an alternative.

> … As noted, the withholding tax can only be collected as an estimate of the seller's final income tax liability (as the actual quantum of the seller's gain is unlikely to be known by the purchaser). While any imposition of a taxation approach that includes a withholding tax will create a compliance obligation for the purchaser (who is subject to the withholding obligation) and the seller (who needs to file a tax return and determine any outstanding balancing amount or refund after claiming a credit for the amount of the tax withheld), this is not an added burden that merits concern. This reflects the fact that the seller and buyer are the parties that intentionally structured their indirect OIT and typically have done so with the primary intention of avoiding income tax obligations

and/or other transaction costs, e.g. real estate transfer taxes, need to apply for new licenses, etc. …

We agree with the content of the remainder of this paragraph on page 52 regarding a 'prudent third party purchaser'. However, it will be recognized that some reasonable percentage of third party purchasers are either less than fully prudent or are actively complicit in attempting to structure a transaction that will avoid tax and other costs on the seller, thereby sharing in the seller's savings through a lower purchase price. Again, for this reason, the tenor of this paragraph must reflect the reasonableness of withholding and return filing obligations and not make excuses for them.

9. Concern with Potential Double Taxation

In various places within the DD there is mention of how an advantage is that one Model or the other will avoid double taxation in particular situations. See for example the bullet points on this on pages 47 and 55. While we do not dispute that avoiding double taxation is desirable, we believe that the DD should be less concerned regarding any potential double taxation risks. This is because OIT structures have normally been specifically created to avoid any taxation. Often, such structures have been set up specifically as an exit strategy when an investment was first made with a goal of avoiding tax on a contemplated future disposition. One has only to look at some of the structures used in publicly disclosed transactions involving countries such as India and China to see the truth and reality of this. Taxpayers, especially those seeking double-non-taxation, should not receive sympathy when their structures backfire and they end up with some amount of unrelieved double taxation.

10. Concern with Certain Wording Used in the Illustrative Cases

It seems inappropriate and belittling to developing countries a) to state on page 28 that in all three cases, the country in which the underlying asset was located lost in court, especially given that in the Uganda – Zain Case, this is not actually the case; and b) to suggest on page 29 that countries responding to defeat in court by quite sweeping policy changes result in more incoherence and uncertainty in international taxation than already exists, *for no apparent gain* (emphasis added).

We have already commented earlier herein on the issue of uncertainty. This reference to 'incoherence and uncertainty' should be deleted.

We recognise that the phrase "no apparent gain" is simply referring to the fact that the three governments concerned might not yet have received any additional taxes from their efforts. Irrespective of this, these cases represent material issues to the countries involved (as clearly outlined in the previous paragraphs: 5% of total government revenue in the Zain case and 2% of central government revenue in the Vodafone case). More importantly though, as future events unfold, both Uganda and India through their future actions may realize significant sums in regard to these cases. In any case, this paragraph on page 29 should be rewritten to avoid the implication it now provides to readers that these efforts are damaging, and in the end, not worthwhile. At a minimum, the last sentence on page 29 should be deleted.

We may add that if criticism is to be made, it should also be directed at the companies that resort to protracted legal and political campaigns, including resorting to external private arbitration, to

prevent a state from exercising its legitimate right to tax gains from assets deriving their value from within its territory.

11. Concern with the Separate Legal Entity Distinction

From page 48:

> This approach undermines the separate legal entity distinction between the local asset holding entity and its relevant tiers of parent entities. [See also first bullet point on page 55.]

That this concern is mentioned is understandable since much of international taxation is, regrettably in our view, based on the separate entity principle. However, as this principle is also the basis for many BEPS structures and at the heart of each structure specifically created to avoid tax on OITs, this concern should be summarily dismissed.

12. Need to Add Consideration of Non-Income Taxes, Fees, and Other Costs

The focus here is on immoveable property. Some countries will have national or local transfer costs (e.g. transfer taxes, registration fees, etc.) that will apply to actual transfers of some immoveable property. As some such costs may be based on the actual transfer price, the amounts can be significant and may encourage OITs even where the OIT is covered by an income tax charge.

The DD should make clear that the Model 1 'Change in Control' provision described in Box 4 on page 44 should be enacted in a manner that will make it effective not only for a country's income tax but also for all transfer taxes and other costs and fees that accompany any transfer of immoveable property.

Where Model 2 is applied, then it seems clear that there would be no ability for a national or local government to collect these transfer taxes and other costs and fees. As this may be a very important loss to national and local revenues, this should be included as a disadvantage of Model 2 on page 55.

13. Addition Needed to Reflect Statute of Limitation Concerns

For both Model 1 and Model 2, there should be discussion in the DD noting that amendments should be made to appropriate statute of limitation rules providing that any normally applicable statute of limitations will not start to run until after notification and filing of applicable information and tax forms required by any change in control.

14. Additional Mechanisms to Highlight OITs

A suggestion that could be more strongly made in the DD is that registers of real property, natural resources, and other assets should be expanded to include not only the title owner of the applicable property, but also all higher tier owners that have indirect interests in the property. The required updating for any changes in indirect ownership would be an additional mechanism to alert applicable tax authorities of possible OIT taxable events.

We suggest expanding the second paragraph in the 'Enforcement/collection rules' section on page 51 of the DD. Presently, through the parenthetical, the focus is on extractive licenses rather than on real property more generally.

15. Guidance on Domestic Law Anti-Avoidance and Treaty Override Tailored to OITs

Taxpayers that invest in some business or asset typically consider their exit strategy at the time of the initial investment. Such taxpayers structure their affairs in advance, often using multiple legal entities not for commercial or legal concerns, but rather with some tax motivation in mind. Importantly, they have the advantage of structuring whatever will arguably avoid tax obligations and reporting under whatever objective local country rules are in place. As a result of this, there is a very "unlevel playing field". This "unlevel" situation means that the only truly usable tools will often be the principal purpose test where a treaty applies and domestic law anti-avoidance rules that grant reasonable discretion to tax authorities.

On page 55 is the following:

> Even with appropriate domestic legislation, under this model the taxing right of the location Country L could (*unless there was a treaty override*) still be limited by an applicable tax treaty, if the relevant treaty does not include an article similar to Article 13(4) of the OECD or UN Model MTC. [Emphasis added.]

What is truly needed for developing countries is specific guidance for amending their domestic tax rules so that OIT transactions are directly addressed, whether through appropriate treaty overrides or through other anti-avoidance rules. Such rules should make taxable any OIT that is not caught by the domestic objective rules (whether Model 1 or Model 2) and is not legitimately covered by a tax treaty provision.

16. Amendment of Appendix B

On page 61 is the following:

> For example, the payment for the sale of an asset could be timed to occur after the entity engaged in the U.S. trade or business had been liquidated, so that the capital gain would be realized when the foreign resident had no U.S. business to be connected to.

We suggest that this sentence be deleted. See §§864(c)(6) and (c)(7) of the Internal Revenue Code.

17. A Further Minor Item

Within the Executive Summary, the first sentence in the last paragraph should read: "The report outlines two main approaches for enforcing *the* taxation of OITs by the country in which the asset is located—provisions for which careful drafting *is required*."

C. Responses to Specific Questions Raised

The announcement of the DD set out the following nine questions. Our above comments cover many of these questions in some detail. We have only added additional responses below where we have something additional to say.

1. Does this draft toolkit effectively address the rationale(s) for taxing offshore indirect transfers of assets?

> **Response:** Yes.

2. Does it lay out a clear principle for taxing offshore indirect transfers of assets?

Response: Yes.

3. Is the definition of an offshore indirect transfer of assets satisfactory?

Response: Yes. The broad definition is excellent.

4. Is the discussion regarding source and residence taxation in this context balanced and robustly argued?

Response: Yes. We approve particularly of the clear statement that neutrality between direct and indirect transfers is important.

5. Is the suggested possible expansion of the definition of immovable property for the purposes of the taxation of offshore indirect transfers reasonable?

Response: Yes. It is both reasonable and appropriate. See also section B.1 above stating that the toolkit should also provide for countries that tax transfers of moveable assets such as interests in resident companies or partnerships.

6. Is the concept of location-specific rents helpful in addressing these issues? If so, how is it best formulated in practical terms?

Response: Yes.

7. Are there other implementation approaches that should be considered?

Response: Yes. See section B above.

8. Is the draft toolkit's preference for the 'deemed disposal' method appropriate?

Response: Yes. See section A.1. above.

9. Are the complexities in the taxation of these international transactions adequately represented?

Response: For the most part, yes. See various suggestions in section B above.