United Nations Handbook
on Selected Issues in

Protecting the Tax Base
of Developing Countries

Second Edition

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Edited by
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Preface

The 2030 Agenda for Sustainable Development lays out an ambitious set of commitments to end poverty and hunger, and to achieve sustainable development in its three dimensions through promoting inclusive economic growth, fostering social inclusion and protecting the environment. Its implementation will require financing from all sources to ensure delivery of the Sustainable Development Goals.

The Addis Ababa Action Agenda on Financing for Development provides a global framework for financing sustainable development by aligning all financing flows and international and domestic policies with internationally agreed economic, social and environmental priorities. As such, it is an integral part of the 2030 Agenda, supports and complements it, and helps to contextualize its means of implementation targets with concrete policies and actions.

The Addis Agenda notes that public policies and the mobilization and effective use of domestic resources, underscored by the principle of national ownership, are critical to achieving sustainable development. While additional domestic resources will be generated first and foremost by economic growth, improved tax policies and administration will help realize more efficient and effective resource mobilization.

To this end, the Addis Agenda calls for improving the fairness, transparency, efficiency and effectiveness of tax systems, including through broadening the tax base and fighting tax avoidance and evasion. Given the globalized nature of trade, investment and finance, however, there are limits to what can be achieved by domestic policies alone. Accordingly, the Addis Agenda also emphasizes the importance of international tax cooperation and notes that it should be universal in approach and scope and should fully take into account the different needs and capacities of all countries.

In line with the commitments of the Addis Agenda and its call for more inclusiveness in international tax cooperation, progress has been made both in terms of institutional arrangements and policy guidance to support developing countries in coping with the challenges posed by international tax avoidance and evasion, in order to increase tax revenues for investment in sustainable development.

Given the important role that the United Nations Committee of Experts on International Cooperation in Tax Matters plays in the development of international tax norms, with its special emphasis on the needs of developing countries, the Committee's effectiveness and operational capacity was strengthened by increasing the frequency of its meetings from one to two sessions per year, one held in New York and the other in Geneva.

In addition, in order to enhance intergovernmental consideration of tax issues at the United Nations, the engagement of the Committee with the Economic and Social Council has been increased through the holding of an annual special meeting of the Council on international cooperation in tax matters back-to-back with the Committee session in New York.

These arrangements have been instrumental in reaching important milestones in the work of the United Nations on international tax cooperation, including in the fight against international tax avoidance and evasion. Specifically, these include updates to the *United Nations Model Double Taxation Convention between Developed and Developing Countries* and the *United Nations Practical Manual on Transfer Pricing for Developing Countries*, as well as the adoption of the United Nations Code of Conduct on Cooperation in Combating International Tax Evasion.

Following the release by the Organisation for Economic Co-operation and Development (OECD) of a final set of reports and recommendations to curtail tax base erosion and profit shifting (BEPS) by multinational enterprises (a broad range of tax planning techniques aimed at shifting profits to low or no-tax locations), G20 leaders called upon the OECD to develop a mechanism to implement measures to address BEPS issues with the involvement of all interested non-G20 countries. This resulted in the establishment of the Inclusive Framework on BEPS, which enables all interested countries and jurisdictions, including developing countries, to participate in the norm-setting and implementation of such measures.

In a landmark development, the International Monetary Fund, the OECD, the United Nations and the World Bank established an inter-agency Platform for Collaboration on Tax to increase their cooperation on international tax matters and strengthen their tax capacity-building support to developing countries. The Platform was tasked with the development of a series of toolkits to help developing countries implement measures to address BEPS issues. In addition, the Platform is to organize, on a biennial basis, a global conference to enhance the international dialogue on tax matters. The first conference of the Platform will be held at United Nations Headquarters in New York from 14 to 16 February 2018 on the theme "Taxation and the Sustainable Development Goals".

Against this background, the Financing for Development Office of the United Nations Department of Economic and Social Affairs has been implementing a capacity development programme in international tax cooperation, which aims to strengthen the capacity of the ministries of finance and the national tax authorities in developing countries to develop more effective and efficient tax systems that support the desired levels of public and private investment, and to combat tax evasion.

One area of focus of this programme is strengthening the capacity of developing countries to increase the potential for domestic revenue mobilization through enhancing their ability to effectively protect and broaden the tax base. The main tool developed in this area was the *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*. First released in 2015, the *Handbook* soon became a reference aid providing practical guidance to tax professionals in developing countries in this regard.

This second edition of the *Handbook* has been updated and expanded to take into account new and emerging issues and the latest international developments in the area of protecting the tax base for developing countries. We hope it will continue to serve as a useful tool in helping tax officials in developing countries assess and implement the most suitable options for protecting and broadening their tax base, as well as effectively engage and participate in the ongoing policy discussions in this area, with a view to supporting domestic resource mobilization to foster sustainable development.

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Introduction

In recent years, increasing attention has been paid to the issue of tax base erosion and profit shifting (BEPS), which refers to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations, with the effect of reducing tax revenues available to governments for investment in sustainable development.

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

In February 2013, at the request of the G20 Finance Ministers, the Organisation for Economic Co-operation and Development (OECD) released a report outlining BEPS issues, which was followed, in July of the same year, by an action plan designed to address these issues in a coordinated and comprehensive manner. Specifically, the OECD Action Plan on BEPS was to provide countries with domestic and international instruments aimed at ensuring that profits were taxed where the economic activities generating the profits were performed and where value was created.

The OECD Action Plan recognized that BEPS could also affect developing countries, although the impact on them might be different owing to the specificities of their legal and administrative systems. The Action Plan also called for a prominent role for the United Nations in providing the perspective of developing countries.

In response, the United Nations Committee of Experts, at its ninth session (Geneva, 21-25 October 2013), established the Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries (Subcommittee on BEPS) and mandated it to draw upon its own experience and engage with other relevant entities, particularly the OECD, with a view to monitoring developments on BEPS, communicating on such issues with officials in developing countries and facilitating the input of the views and experiences of these countries into the relevant ongoing work of the United Nations and the OECD.

In follow-up, the Subcommittee on BEPS prepared a paper with a view to providing information and seeking the views of developing countries on the issue (available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/BEPS_note.pdf) and, in parallel, circulated a questionnaire asking for feedback on the relevant experiences of developing countries (available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/BEPS_questionnaire.pdf).

Overall, the feedback received from developing countries confirmed the importance of the United Nations efforts to reach out to them, and it was recognized that BEPS had an impact on their domestic resource mobilization, resulting in forgone tax revenue and higher costs of tax collection. Moreover, they identified several issues among those that fell within the scope of the OECD Action Plan on BEPS that were most relevant to them, and outlined additional areas of concern regarding BEPS that were not covered under the Action Plan, including the taxation of capital gains of non-residents and income from services, as well as tax incentives (full country responses are available at http://www.un.org/esa/ffd/tax-committee/tc-beps.html).

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

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

The work of the project addressed a number of topics that developing countries reported to be of particular interest and relevance to them, while focusing the capacity development dimension on three important areas: (a) the engagement and effective participation of developing countries in relevant international policy discussions; (b) the assessment of relevance and viability of potential options to protect and broaden their tax base; and (c) the effective and sustained implementation of the most suitable among these options.

The core modality for carrying out this project was the development of practical papers intended to simplify, summarize and systematize relevant information and materials, including those produced by the United Nations Committee of Experts, as well as within the OECD project on BEPS. To this end, these papers aimed to provide information geared towards the needs of developing countries, including through the provision of practical examples tailored to the realities of these countries.

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

Upon finalization and compilation, the papers were issued as the *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*, which was launched during the third International Conference on Financing for Development (Addis Ababa, 13-16 July 2015).

Since the Addis Ababa Conference, the OECD work on BEPS and the work of the United Nations Committee of Experts on issues relevant to protecting and broadening the tax base of developing countries have been marked by further significant advances in the effort to curtail tax base erosion and counter international tax evasion and avoidance. In October 2015, the OECD released a final set of reports and recommendations addressing BEPS; subsequently, at the request of the G20 leaders, the OECD established the Inclusive Framework on BEPS to enable all interested non-G20 countries and jurisdictions, including developing countries, to participate in the norm-setting and implementation of measures to address BEPS issues. The United Nations Committee of Experts, on the other hand, continued to analyze substantive issues related to BEPS concerns of developing countries, with a view to reflecting and addressing them in the upcoming revision of the *United Nations Model Double Taxation Convention between Developed and Developing Countries*.

This second edition of the *Handbook* updates the chapters contained in the previous edition to take into account the final outputs of the OECD project on BEPS, as well as the latest developments in the work of the United Nations Committee of Experts in the area of tax base protection for developing countries. It also includes two new chapters, which deal with base-eroding payments of rent and royalties and general anti-avoidance rules (GAARs). Similar to the method adopted in developing the first edition of the *Handbook*, the work done to produce the present revision reflects the input and feedback received from developing countries, members of the United Nations Committee of Experts and other relevant stakeholders, including those participating in three workshops (Panama City, 4-5 June 2015; Berlin, 1-3 December 2015; and Nairobi, 21-24 March 2017), which were held specifically to discuss the experience and concerns of developing countries with respect to BEPS.

The e-version of this publication is available at (http://www.un.org/esa/ffd/publications/handbook-tax-base-second-edition.html).

Contents

Chapter I

Protecting the tax base of developing countries: an overview

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

1. Introduction

1.1 General background

One of the most significant policy challenges facing developing countries is establishing and maintaining a sustainable source of revenues to fund domestic expenditures. While this problem has many facets, one of the most important is protecting the domestic tax base. In recent years, increasing attention has been paid to the fact that many multinational enterprises (MNEs) appear to have been able to pay effective tax rates well below what one would expect from the headline rates in the countries in which they operate. Several widely publicized cases of well-known companies paying low or no taxes have highlighted these issues and brought the questions of tax avoidance and evasion into the public political debate. In response to these developments, the Organisation for Economic Co-operation and Development (OECD), at the request of the G20, began analytical work to try to determine exactly the techniques that corporations were able to use to dramatically reduce their effective tax rates. The results of this work were the OECD Report "Addressing Base Erosion and Profit Shifting" [1] (OECD Report on Addressing BEPS) and the subsequent "Action Plan on Base Erosion and Profit Shifting" (OECD Action Plan on BEPS).[2] The Final

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

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

Reports on the 15 Actions listed in the Action Plan were presented to and accepted by the G20 in October 2015.[3]

1.2 History of the OECD work on BEPS

1.2.1 OECD Report on Addressing BEPS

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

- International mismatches in entity and instrument characterization, so-called hybrid arrangements, which take advantage of differences in domestic law to create income that escapes taxation altogether or is taxed at an artificially low rate;
- The use of treaty concepts limiting taxing jurisdiction to prevent the taxation of digital goods and services;
- The use of debt financing and other intragroup financial structures;
- Various aspects of transfer pricing dealing with risk, intangibles, and the splitting of ownership within a group, which allow income to be taxed in a country other than the country in which the value from economic activities is created;
- The lack of effective anti-avoidance measures such as general anti-avoidance rules (GAARs), controlled foreign corporation (CFC) regimes, thin capitalization rules and anti-treaty shopping rules; and
- The availability of harmful preferential regimes.

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

As a result of this "diagnosis," the OECD Report on Addressing BEPS concluded that what was needed was a comprehensive "global action plan" to deal with the many interrelated strands that lead to

[3] OECD, BEPS 2015 Final Reports (Paris: OECD, 2015), available at http://www.oecd.org/ctp/beps-2015-final-reports.htm.

BEPS. Accordingly, the OECD developed a comprehensive plan that was ultimately endorsed by the G20 leaders in 2015.[4]

1.2.2 OECD Action Plan on BEPS

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

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

(2) Neutralize the effects of hybrid mismatch arrangements;

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

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

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

(6) Prevent treaty abuse;

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

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

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

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

(13) Re-examine transfer pricing documentation;

(14) Make dispute-resolution mechanisms more effective;

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

The items listed in the OECD Action Plan on BEPS that are most relevant to developing countries are discussed in more detail in the following sections of this chapter. However, some preliminary observations can be made at this point. The substantive items in the OECD Action Plan on BEPS can be grouped into two basic categories. The first

[4]Ibid.

category includes transactions and arrangements where the interaction of domestic tax rules of two or more countries create the possibility of double non-taxation or taxation at a low rate. These situations are described as resulting from the lack of "coherence" of existing international tax rules. The OECD Action Plan on BEPS observes that much attention has been paid in the development of international tax standards to measures intended to avoid double taxation. However, the interaction of rules that allow income to escape tax altogether or to be taxed at a low rate have been for the most part ignored, and this has generated a number of techniques that allow for BEPS. These typically involve situations where a country allows a deduction for a payment with the expectation that the payment will be taxed in another jurisdiction but where this is in fact not the case. A similar problem arises where countries treat an entity differently, one viewing it as transparent and taxing the participants and the other viewing it as a taxable entity. Here again, there is a lack of coherence between the two national tax systems.

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

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

The basic focus in the OECD Action Plan on BEPS calls for adjustments to current international tax rules that would reduce the ability of companies to generate non-taxed or low-taxed income by modifying existing rules. However, the Plan states that: "[w]hile actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income." [5]

Subsequent to the initial publication of the OECD Action Plan on BEPS, the OECD issued a number of Discussion Drafts and Reports on various Action Plan items, which culminated in the publication of the Final Reports in 2015.[6] In 2016, the OECD project on BEPS moved into its implementation phase. The new institutional arrangements for monitoring and implementing the BEPS recommendations are discussed in section 13 below.

1.3 Developing country perspectives

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

Protecting the domestic tax base against BEPS is necessary if developing countries are to attain revenue sustainability. Capacity development in this area is essential to move towards that goal. The

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

[6] OECD, BEPS 2015 Final Reports, supra note 3.

OECD work has much to offer developing countries in terms of identifying issues and suggesting possible techniques to deal with the problem of BEPS, but it is important to keep in mind the special needs and perspectives of developing countries regarding these issues: among others, the state of development of the tax system, the administrative resources available to deal with these matters, the nature of the trade and commercial relations with trading partners, and regional considerations. Each country must evaluate its own situation in order to identify its particular issues and determine the most appropriate techniques to ensure a sound tax base.

1.4 United Nations response

In light of the importance of the issue of BEPS for developing countries and the necessity for further study and examination, the United Nations Committee of Experts on International Cooperation in Tax Matters (United Nations Committee of Experts) established the Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries, which was mandated to inform developing country tax officials on these issues and facilitate the input of developing country views and experience into the work of both the United Nations Committee of Experts and the wider work of the OECD Action Plan on BEPS.[7]

In addition, the Financing for Development Office (FfDO) of the United Nations Department of Economic and Social Affairs undertook a project to supplement and complement this work from a capacity development perspective. This project focused on a number of issues of particular interest to developing countries and include, but are not limited to, the matters covered by the OECD.

In particular, the FfDO project has decided to focus its efforts on the following topics:[8]

[7] Further information on the United Nations Committee of Experts is available at http://www.un.org/esa/ffd/tax-committee/about-committee-tax-experts.html.

[8] This project does not deal with the BEPS aspects of transfer pricing as those matters have been considered by the Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing, as part of its work on the revision of the *United Nations Practical Manual on Transfer Pricing for Developing Countries.*

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

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

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

The first edition of the present *Handbook* was published in 2015 as the initial output of the FfDO project.[9] This second edition

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[9] *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (New York: United Nations, 2015), available at http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf.

updates the chapters in the first edition to take account of the developments in the OECD project on BEPS since 2015, and also contains two new chapters, dealing with base-eroding payments of rent and royalties and controlling tax avoidance through general anti-avoidance rules (GAARs). The chapters were developed by individual authors, informed by the OECD work on the topics and a review of the existing literature. Most importantly, the work reflects the input of developing countries, through both the various activities of the United Nations Committee of Experts and workshops held specifically to catalogue the experience and concerns of developing countries with respect to BEPS. The present publication will be used to provide background material for subsequent workshops organized by FfDO to better inform developing countries on the issues involved and the techniques available for domestic base protection.

2. Neutralizing the effects of hybrid transactions

2.1 What are hybrid transactions?

In many cases, the same cross-border transaction may be treated differently in two jurisdictions. Domestic tax rules are typically developed without significant consideration of how the transaction may be treated in another jurisdiction where a foreign party is involved. This "hybrid" nature of the transaction may result in income escaping taxation in both jurisdictions. It may arise in a number of ways, with respect to the overall treatment of the transaction or just some particular elements. For example, one country may view a payment as having taken place, whereas the other country may not find a payment, or there may be differing views as to which taxpayers have made or received a payment. Similarly, an entity may be treated as transparent in one jurisdiction and as a separate entity in the other jurisdiction. As a result, the overall tax revenues that the two countries were expecting from a transaction may be reduced. The transaction may have resulted in "stateless" income that is not taxed in any jurisdiction. In addition, situations can arise in which the same amount is deducted twice, due to the differing treatment of a legal entity or disagreement as to who is the owner of an asset, with both countries granting a depreciation deduction for the same asset. These "hybrid" results can come about because of differences in domestic law or differences in the application of tax treaties.

2.2 Hybrid situations

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

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

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

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

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

B as dividends. When the shares are repurchased by Company A, Company B may realize a gain. Both the dividends and the gain on the sale of the shares may qualify for the participation exemption under the tax system of Country B.

2.3 Possible responses and developing country perspectives

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

2.4 OECD Final Report on BEPS Action 2

The scope of the OECD Final Report on BEPS Action 2[10] on neutralizing the effects of hybrid mismatch arrangements is more limited than the approaches discussed above, dealing only with specifically defined "hybrid instruments" and "hybrid entities." The Report's basic approach with respect to hybrid instruments is to have as a primary domestic rule

[10]OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report_9789264241138-en.

the denial of the deduction of a hybrid payment that is not taxed in the other jurisdiction. This, of course, requires the payer country to have adequate information with respect to the treatment of the payment in the recipient country. In cases where the payer country does not have domestic legislation denying the deduction, it is recommended that the recipient country deny an otherwise applicable exemption regime. Similar principles are suggested in the case of other hybrid transactions.

3. Limiting the deduction of interest and other financing expenses

3.1 General

The use of borrowing (leverage) was identified in both the OECD report on addressing BEPS[11] and the Final Report on BEPS Action 4[12] as a technique that facilitates BEPS. The issue comes up because most jurisdictions recognize interest expense on borrowing (the "rental" cost of money) as a deductible expense. When applied to corporations, this basic rule encourages the use of debt financing rather than equity financing for corporate structures because interest deductions reduce the tax base while distributions of corporate profits in the form of dividends do not. In addition, it gives an incentive to "load" debt into companies operating in high-tax countries and arrange for the interest payments to be received by an entity in a low- or no-tax jurisdiction. This problem is especially troublesome where the loan is provided by a related shareholder or a related finance company organized in a low-tax jurisdiction. Furthermore, not only can the amount of the loan be excessive, but there is also an incentive to have an excessively high interest rate on the loan. From the point of view of developing countries, where much inward investment is financed through debt, this can result in serious problems of BEPS.

[11] OECD, *Addressing Base Erosion and Profit Shifting*, supra note 1.

[12] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report_9789264241176-en.

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

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

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

> *Example B*: Company P, resident in Country P, pays tax at a rate of 20 per cent in Country P and wishes to make an investment in Country DC, which has a tax rate of 40 per cent. It has determined that it will need to finance this investment by external financing. It can structure the investment in Country DC so that all the financing expense falls in Country DC and is deducted there while the interest receipts are taxed at a lower rate in Country P or in a third country.

3.2 Possible responses

3.2.1 Recharacterization of debt as equity

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

3.2.2 Thin capitalization rules

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

3.2.3 Earnings stripping rules

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

3.2.4 *Transfer pricing aspects*

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

3.2.5 *Allocation of worldwide interest expense*

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

3.2.6 *Withholding tax on interest*

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

3.3 Developing country perspective

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

3.4 OECD Final Report on BEPS Action 4

The OECD Final Report on BEPS Action 4 deals with limitations on the deduction of interest to prevent base erosion. It recommends best practices in the form of a version of the earnings stripping approach described above. Under the recommended "fixed ratio" approach, the deduction of current interest expense would be limited to a fixed percentage of the debtor corporation's earnings before interest, taxes, depreciation and amortization (EBITDA). The Report suggests a range of percentages between 10 per cent and 30 per cent of EBITDA, and suggests several factors which a country might take into account in setting the percentage. For example, if Company DC has 100 of EBITDA and pays out 40 in interest expense, the Country DC law may limit the current deduction to 30, disallowing 10 of the 40 payment. The Action 4 proposals would allow a carry-forward mechanism to ensure that the disallowed interest expense could be deducted subsequently if additional EBITDA were generated in later years. The Report also suggests that it would be appropriate for countries to allow a larger current deduction if the worldwide group of which the DC company was a member had a higher ratio of net interest expense to earnings on a consolidated worldwide basis. This supplementary worldwide group rule presents some obvious difficulties — in particular, the need for detailed financial information about the worldwide group.

4. Base protection issues involving permanent establishments

4.1 General considerations

Under the laws of many countries, and under both the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention)[13] and the OECD Model Tax Convention on Income and on Capital[14] (OECD Model Convention), the concept of "permanent establishment" (PE) plays a key role in determining the taxing jurisdiction, and hence the tax base, of the country. With respect to business activities, the existence of a PE is necessary to allow the source country to tax the business income derived by a resident of the other country, and may also require the residence country to exempt the income. Thus, the exact content of the definition of PE is of crucial importance. The various definitions of PE, both in domestic laws and in the United Nations and OECD Model Conventions, differ substantially. For example, under Article 5 (5) (b) of the United Nations Model Convention, an agent who holds a stock of goods from which he regularly fills orders can constitute a PE even in the absence of the power to conclude contracts in the name of the principal. Under the OECD Model Convention, Article 5 (5) (prior to its amendment pursuant to the Final Report on BEPS Action 7[15]), authority to conclude contracts is

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

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

[15] OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report* (Paris: OECD, Paris, 2015), available at http://www.oecd-ilibrary.org/taxation/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report_9789264241220-en.

necessary for the actions of an agent to constitute a PE for the principal. Similarly, under Article 5 (3) (b) of the United Nations Model Convention, the furnishing of services for a certain period of time in connection with the same or connected projects may constitute a PE, even in the absence of a fixed place of business. Under the OECD Model Convention, a fixed place of business is required.

A distinction should be made between the broad question of which activities should constitute a PE as central in determining taxing jurisdiction and the narrower question of how to deal with structures that are "artificially" set up to avoid PE status while at the same time giving the taxpayer substantial economic presence in the taxing jurisdiction. The OECD Final Report on BEPS Action 7 is clearly focused on the latter issue; its mandate is to develop changes to the definition of PE to "prevent the artificial avoidance of PE status." [16]

Developing countries are, of course, concerned with the "artificial" avoidance of PE status and establishing mechanisms to deal with such avoidance. However, they are also concerned with the appropriateness of the PE definition generally and the extent to which it unduly restricts source-based taxation of activities that involve substantial economic activity in the domestic jurisdiction. The issue arises most importantly in the context of the taxation of the digital economy and the taxation of services, and is discussed below in sections 5 and 9, respectively. The focus here is principally on dealing with structures that can be viewed as "artificial" regardless of the basic PE definition. [17]

4.2 Commissionaire arrangements

In recent years, a number of companies have reorganized their international structures by centralizing a number of functions dealing with intangibles, product promotion, inventory management and the like in

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

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

individual companies, often located in low-tax jurisdictions, and converting sales subsidiaries that had previously handled all aspects of the purchase and sale of goods in the source country into so-called "low-risk" distributors. In many cases, these business restructurings had the effect of reducing substantially the amount of revenue attributed to the source jurisdiction. Under the prior structure, where the "full-fledged" distribution subsidiary bought the goods from a related party and sold them in the source jurisdiction, the full amount of the sales profit was taxed in the source country. However, where the operations are rearranged with the local company acting only as a sales agent, it is possible to argue that only a small sales commission would be taxable in the source State. This position relies on Article 5 (5) (a) of the United Nations Model Convention and Article 5 (5) of the OECD Model Convention, which require that for a PE to be present in these circumstances, the agent must have "authority to conclude contracts" in the name of the related person supplying the goods. This requirement has been interpreted to require that the agent must have the legal authority to bind the supplier — that is to say, at the end of the contract negotiations, the agent must have the legal authority to create binding obligations on the supplier in order for a PE to exist, regardless of the extent of the agent's activity in the market jurisdiction.

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

4.2.1 Possible responses

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

4.3 Preparatory and auxiliary services

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

4.3.1 Possible responses

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

4.4 OECD Final Report on BEPS Action 7

The OECD Final Report on BEPS Action 7 [18] makes a number of recommendations for changes in the OECD Model Convention. With

[18] OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report*, supra note 15.

respect to commissionaire arrangements, the requirement that an agent have legal authority to conclude contracts in the name of the principal will be eliminated. A PE will be deemed to exist if an agent who is not independent habitually plays the principal role leading to the conclusion of contracts that are routinely approved without material modification by the non-resident company. This new rule does not apply to independent agents acting in the ordinary course of their business; however, an agent that acts exclusively or almost exclusively for a closely related enterprise cannot qualify as an independent agent. A definition of "closely related enterprise," based on control or the ownership of more than 50 per cent of the beneficial interests in an entity, will be added to Article 5 (6) (b).

With respect to the exception for preparatory or auxiliary activities, the Final Report would limit that exception to situations where each activity considered separately and the overall activity of the fixed place of business or agent are preparatory or auxiliary. It would also provide rules to prevent the fragmentation of activities, requiring those activities, even if carried out in separate closely related enterprises, to be considered together in determining whether a PE exists.

4.5 United Nations actions

The United Nations Committee of Experts recently approved changes in the United Nations Model Convention that are similar to those proposed in OECD Action 7. These changes are being reflected in the 2017 update of the United Nations Model Convention.

5. Protecting the tax base in the digital economy

5.1 General

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

5.2 Avoiding taxable presence

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

5.2.1 Possible solutions and developing country perspectives

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

5.3 Income characterization

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

5.4 OECD Final Report on BEPS Action 1

The OECD issued the Final Report on BEPS Action 1 on addressing the tax challenges of the digital economy in October 2015.[19]

The Final Report discusses many of the issues raised in the previous sections but makes no specific recommendations.

6. Transparency and disclosure

6.1 General

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

In addition, in order to assess tax on its resident companies and individuals, a jurisdiction needs to have access to information concerning the foreign assets and activities of its resident taxpayers. For developing countries, these issues primarily concern the taxation of resident individuals, and there have been a number of important international developments moving in the direction of automatic exchange of information (AEOI). This work has been carried out by the OECD

[19] OECD, *Addressing the Tax Challenges of the Digital Economy Action 1—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en.

in cooperation with the G20.[20] AEOI will be implemented through a multilateral competent authority agreement[21] prepared under the multilateral Convention on Mutual Administrative Assistance in Tax Matters.[22]

6.2 Transfer pricing documentation

Both the United Nations Practical Manual on Transfer Pricing for Developing Countries[23] and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[24] contain substantial guidance on the structure and application of transfer pricing documentation rules. Ideally, such documentation would allow tax administrations to carry out transfer pricing risk assessments, to ensure that the taxpayer has applied the appropriate transfer pricing methodology, and to assist in the audit of transfer pricing cases. However, currently it is very difficult for countries, and developing countries in particular, to obtain information about the global activities of MNEs operating in their jurisdiction, where their profits are reported, and where and how much tax they pay. This information would allow tax administrations to assess whether the income reported and the taxes paid in their jurisdiction were appropriate in the light of the global activities of the MNE. For example, it would allow tax authorities to identify where base-eroding payments are

[20]OECD, "OECD Secretary-General Report to G20 Leaders, Brisbane, Australia," (November 2014), available at http://www.oecd.org/tax/transparency/OECD-secretary-general-report-tax-matters-brisbane-november-2014.pdf.

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

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

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

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

received or to determine whether the "low-risk" return shown by a local distributor was appropriate in light of the residual profit being reported elsewhere.

6.2.1 Country-by-country reporting

The OECD Final Report on BEPS Action 13[25] proposes a requirement that MNEs provide country-by-country (CbC) information in the context of transfer pricing documentation. CbC information can be useful as a risk-assessment tool to help a tax administration make decisions about the allocation of its auditing and investigative resources. This aspect is particularly important for developing country tax administrations, given their lack of resources. However, it is clear that the importance of CbC reporting goes well beyond transfer pricing issues because CbC reporting provides insight into the relations between the various parts of an MNE. It can assist the countries involved in determining whether the income and tax allocations of the group seem to make sense in general terms.

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

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

[25] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 — 2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report_9789264241480-en.

6.2.3 Developing country perspective

From the perspective of developing countries, the information that would become available from increased reporting requirements would certainly be useful in properly assessing MNEs doing business in their jurisdictions. However, there are a number of important policy issues to be considered. First, a country must have the appropriate domestic legislation for it to gather the required information from its taxpayers. In addition, to the extent that foreign multinationals prepare master files and CbC templates under the guidance of the home office, there must be some mechanism for other countries, in particular developing countries, to obtain the information contained in master files and CbC templates. Under the current framework, such information can be obtained only through a treaty mechanism (a bilateral general tax treaty, a tax information exchange agreement or a multilateral convention). For developing countries that have limited treaty networks and have not signed the multilateral Convention on Mutual Administrative Assistance, access to CbC information will be difficult. In addition, even where a treaty is in place, the actual mechanics for obtaining the information may present practical problems. The requirement for a treaty exchange mechanism was adopted in response to business concerns about the confidentiality of the information involved, but it poses a substantial limit to the effectiveness of CbC reporting for developing countries.

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

6.3 Automatic exchange of information

In addition to the work on transparency and disclosure undertaken in connection with the OECD project on BEPS, the G20 and the Global Forum on Transparency and Exchange of Information for Tax Purposes have been active in developing a new international standard for AEOI. The basic structure of this project is that participating countries would require local banks and financial institutions to obtain information on financial accounts, which they would make available to the local tax authorities; they, in turn, would provide that information on an automatic basis to other countries (that is to say, without the need for a specific request). Under a mandate from the G20, the OECD has developed a Common Reporting Standard (CRS), establishing the information to be reported, and a Model Competent Authority Agreement (CAA), outlining the mechanism for implementing the exchange. The CRS identifies the entities that are required to report, the type of information to be reported and collected, and the kinds of accounts on which reporting is necessary. It is accompanied by a Commentary, which sets out the information technology modalities allowing the information to be transmitted automatically. Under the CAA, participating countries would agree to pass the necessary domestic legislation in order to obtain the required information and to have appropriate safeguards to ensure the confidentiality of taxpayer information.

6.3.1 Developing country perspective

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

7. Preventing treaty abuse

7.1 General

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

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

> A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable tax treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.[26]

There are a number of techniques for dealing with treaty abuse, including:

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

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

- General anti-abuse rules (GAARs) and "limitation on benefits" (LOB) articles in treaties;
- Purposive interpretation of tax treaty provisions.

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

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

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

7.3 Treaty-based rules

7.3.1 Specific anti-avoidance rules in treaties

Existing treaties contain a number of specific rules that are aimed at denying treaty benefits in particular situations that have been identified as abusive. The use of "beneficial ownership" rules can restrict treaty benefits where the recipient of the income is not the "true owner" of the income and is only functioning as an agent, conduit or nominee. The "special relationship" provisions of the interest and royalties articles allow the tax authorities to reclassify certain payments that are not made at arm's length. Special provisions are often used that are aimed at personal services companies used by entertainers and athletes to avoid source-country tax.[27] Similarly, special provisions in Article 13 of both the United Nations and OECD Model Conventions allow countries to tax gains from the sale of shares of real estate holding companies to prevent the use of such companies to avoid taxation on gains on the underlying real estate.[28]

7.3.2 General anti-avoidance rules in treaties

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

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

While a treaty GAAR can be a useful tool, in some circumstances, too broad an application of a GAAR can create undesirable legal uncertainty and impede investment. In addition, the existence of a GAAR in some treaties, but not in others, can make the application of other techniques in treaties lacking a GAAR more difficult.

The United Nations Committee of Experts has approved the addition of a GAAR to the United Nations Model Convention as part of the 2017 update. The new GAAR is discussed in section 7.7 below.

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

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

7.3.3 *Limitation-on-benefits rules*

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

7.4 Limiting treaty abuse through treaty interpretation

Artificial arrangements that have been structured to take advantage of treaty benefits can sometimes be dealt with through an appropriate approach to treaty interpretation. Under Article 31 of the Vienna Convention on the Law of Treaties,[29] treaties are to be interpreted in good faith and in the light of the object and purpose of the treaty. Viewed from this perspective, structures without a business purpose or lacking in substance can be ignored in applying the treaty even where the treaty does not have a GAAR. The effectiveness of this approach depends on the general approach of the courts in the relevant country to statutory and treaty interpretation.

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

One common form of improper treaty use involves so-called treaty shopping. In these situations, the taxpayer interposes an intermediary

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

company (I) between the source country (S) and the residence country (R) to take advantage of the treaty benefits of the treaty between the intermediary country and the source country. The taxpayer "shops" to find a treaty between the source country and the intermediary country that has the lowest tax "price" in terms of treaty benefits.

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

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

7.6 OECD Final Report on BEPS Action 6

The OECD Final Report on BEPS Action 6[30] focuses on the need to

[30] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-

have a "minimum level of protection" against treaty abuse. This minimum standard can be met by including:

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

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

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

7.7 Developing country perspective

A detailed LOB clause such as that set out in the OECD Final Report on BEPS Action 6 may be difficult for many developing country tax administrations to deal with. The LOB rules are complex and are intended to cover a number of sophisticated financing transactions that typically may not be an issue for developing countries. Nonetheless, some kind of simplified LOB focusing on a limited number of objective criteria to ensure that the taxpayer, in addition to technically being a resident,

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benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en.

also has substantial contacts to the jurisdiction might be a possibility. Whether or not specific treaty anti-avoidance rules are necessary would depend on a variety of factors, including the general approach of the courts to avoidance transactions.

A GAAR might also be considered. The United Nations Committee of Experts has approved the addition of a GAAR to the United Nations Model Convention identical to the GAAR to be added to the OECD Model Convention pursuant to the recommendations in the Final Report on BEPS Action 6. The new GAAR reads as follows:

> Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

The Commentary on the new GAAR was finalized at the April 2017 meeting of the United Nations Committee of Experts and is largely similar to the Commentary on the OECD GAAR. A detailed LOB provision has also been added to the United Nations Model Convention, as is the case with the OECD Model Convention.

8. Preserving the taxation of capital gains by source countries

8.1 General

Foreign direct investment in developing countries can be structured as a locally organized subsidiary or as a branch of a foreign corporation. In both cases, the shares of the corporation may be held by an offshore holding company. If the operating assets in the country are sold, whether they are owned by the foreign corporation or a local subsidiary, the country will typically have the right to tax any capital gain on the assets, both under its domestic law and under a tax treaty.

Similarly, if dividends are paid by a domestic corporation, withholding tax would generally be applicable to the dividends. However, if instead of selling the assets directly, the foreign investor sells the shares of the domestic subsidiary or the shares of the foreign subsidiary with the branch operation in the country, source-country tax may be avoided. A similar result would apply if the shares of the domestic corporation were held by a holding company and the shares of the holding company were sold. Thus, the accrued gain attributable to the underlying assets that have accrued in the source country would escape taxation by the source country on the transfer. This gain may represent appreciation in the underlying assets or retained earnings that would have been taxed to the shareholder had they been distributed to the shareholder as a dividend. These elements of gain will escape taxation by the source country if the shares are sold unless the domestic law of the source country has a special provision to reach such gains. Even if the domestic law has the appropriate provisions, in some circumstances tax treaty provisions may prevent taxation of the gain.

8.2 Domestic law provisions

8.2.1 Shares in domestic companies

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

8.2.2 Administrative issues

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

8.3 Multiple taxation of the same economic gain

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

8.4 Shares of a foreign corporation

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

8.5 Treaty aspects

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

9. Services

9.1 General

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

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

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

9.2 Employment income

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

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

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

9.3 Entertainment and athletic services

Some entertainers and athletes can make large sums of money in a short period of time. Developing countries that wish to tax income derived by non-resident entertainers and athletes must ensure that the provisions of their domestic law and tax treaties allow them to tax such income irrespective of the legal structure of the arrangements. Article 17 of the United Nations Model Convention allows the country in which entertainment or sports activities take place to tax the income from those activities. Countries must also have provisions in place to deal with techniques used by non-resident entertainers and athletes to avoid source-country tax. Common avoidance schemes in this regard involve the assignment of income by a non-resident entertainer or athlete to another person, usually related to the taxpayer, or the use of an entity of which the non-resident entertainer or athlete is a shareholder and employee. Article 17 (2) of the United Nations and OECD Model Conventions allows the imposition of tax in these circumstances.

9.4 Business services

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

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

As discussed in section 4 above, there are several ways in which taxpayers can structure their affairs to avoid having a PE or fixed base in a country. In some situations, non-resident service providers can provide services in a developing country at various locations in the country without any one place being used for more than six months; similarly, a non-resident service provider may attempt to avoid having a PE or fixed base by using the fixed place of business of a client or a related enterprise. Although the Commentary on Article 5 of both the United Nations and OECD Model Conventions indicates that a PE may exist in this situation,[31] the tax administration of the developing country may not have the necessary information-gathering resources to discover the facts required to show that there is a PE or fixed base. In other situations, a non-resident can avoid having a PE or fixed base by fragmenting its activities among related enterprises, or by using related non-resident enterprises to carry out connected projects. Under Article 5 (3) (b) of the United Nations Model Convention, any services performed for the same or a connected project are aggregated for purposes of counting the number of days on which services are provided in the source country. There is no rule, however, to take into account services provided by related enterprises with respect to the same or connected projects. The same concern applies to construction projects under Article 5 (3) (a) of the United Nations Model Convention. Specific anti-avoidance rules in domestic law or tax treaties might be useful in this regard, although the application of such rules requires effective information-gathering by the tax authorities of the developing country.

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

The OECD Final Report on BEPS Action 7 [32] suggests that the fragmentation of construction activities among related enterprises can be dealt with by the new GAAR to be added to the OECD Model Convention. However, the Final Report also provides a specific anti-avoidance rule in the Commentary for those countries that prefer to deal with the problem through a specific rule. Similarly, the United Nations Model Convention was amended in 2017 to include a GAAR and an optional specific anti-avoidance rule in the Commentary to deal with the fragmentation of construction activities. Moreover, Article 5 (3) (b) was revised to delete the "same or connected project" requirement. As a result, if a non-resident performs services in a country for 183 days or more, the non-resident is deemed to have a PE in the country irrespective of whether the services are provided for the same or connected projects.

A multinational enterprise with a group company carrying on business in a developing country may use another group company resident in a low-tax country to provide various services to the company in the developing country. These services, which often include legal, accounting, management and technical services,[33] may not require employees of the non-resident service provider to be present in the developing country for long periods of time. It is difficult for developing countries to counteract this type of tax planning even with effective anti-avoidance rules in place. Some countries have insisted on a shorter period than 183 days in order to minimize this limitation on their ability to tax.

9.5 Technical services

Some developing countries have special rules in their domestic law and tax treaties, dealing with income from technical services. Under these rules, such services are subject to a final gross-based withholding tax at a flat rate and the resident payer for the services is required to withhold tax from the payments to the non-resident service provider.

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[32] OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report*, supra note 15.

[33] The treatment of technical services is discussed in more detail in the following section.

The types of services to which the rules apply often include managerial, technical and consulting services, but these are not defined precisely.

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

The erosion of a source country's tax base by payments for technical services and the inability of the source country to tax such payments have led some countries to add specific provisions to their domestic laws and tax treaties to allow them to tax payments for technical services on a gross basis.[34] A 2011 survey by the International Bureau of Fiscal Documentation (IBFD) found that 134 of the 1,586 tax treaties concluded between 1997 and 2011 contained a separate article dealing with fees for technical services.[35] Several other treaties extended the provisions of Article 12 dealing with royalties to include payments for certain technical services. Under the separate articles, income from technical services is treated like royalties: source-country tax is allowed on a gross basis at a fixed rate but is limited to fees for technical services "arising" in the source country, which usually means that the services must be performed in the source country. As noted above, typically these separate articles dealing with fees for technical

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

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

services refer to “managerial, technical or consultancy services” without defining that expression.

The United Nations Committee of Experts has been working since 2008 on the provisions of the United Nations Model Convention dealing with the taxation of income from services. The Committee approved the addition of a new Article 12 A to the United Nations Model Convention in 2017; the new article allows source countries to tax fees for technical services on a basis similar to the taxation of royalties (that is to say, on a gross basis at a limited rate without any threshold requirement, even if the services are provided outside the source country). If developing countries are successful in negotiating the inclusion of this new article in their tax treaties, they will be able to protect their domestic tax base from erosion through payments to non-residents for technical services.

10. Rents and royalties

10.1 General

While the OECD Final Reports on BEPS actions deal with some issues involving intangibles and payments for intangibles, they do not focus directly on the BEPS issues which can arise in connection with rents and royalties. From a developing country perspective, rental and royalty payments can raise significant problems in connection with protecting the tax base. Like interest and services, they offer the possibility of a deductible payment on the part of the payer, reducing the domestic tax base, while the payment in the hands of the recipient may be subject to no or limited taxation. In addition, differing domestic law treatment of rents and royalty payments may offer the possibility of structuring “hybrid” transactions to take advantage of those differences.

10.2 Definitional issues

While domestic law definitions vary substantially, the core concept behind the notion of rent or royalty is a payment for the right to temporary use of tangible property (rents) or intangible property (royalties). There are a number of difficult definitional issues arising from this basic concept. First of all, while payments may nominally be for the temporary use of the property, they may in fact constitute partial payments for the actual transfer of the property as well as an implicit interest charge for the payments over time. Where the tax treatment of dispositions of property and the payment and receipt of interest differ from the treatment of royalties, taxpayers will have an incentive to structure transactions to obtain the most advantageous tax results. Similarly, the return from an intangible may be "embedded" in the sale price of a produced good while the taxpayer could achieve a different tax result by arranging for the intangible to be licensed to a related party which does the manufacturing. In addition, the line between the payment for the use of "property" and the provision of technical services may be difficult to draw. Thus the design of domestic law provisions dealing with rents and royalties must take into account the possible "substitution" of rent or royalty payments for other, differently treated, payments.

10.3 Jurisdictional basis for the taxation of rents and royalties

Countries typically claim the right to tax rents or royalties which have a "source" in the jurisdiction. Source may be determined by looking at the place of use of the property or by the tax status of the payer of the rents or royalties. Typically, if a resident taxpayer or the PE of a non-resident taxpayer deducts the rent or royalty payment, the payment will be deemed to have a source in the residence country, thus allowing that country to recapture some of the tax revenue lost by virtue of the deduction. In this context, it is important to ensure that the taxing right provided to the residence country in its treaties is implanted in the domestic law provisions imposing a tax on the rental or royalty payments.

10.4 Structure of the tax

Rents and royalties earned by non-residents, which are not connected with a PE, are typically taxed to the recipient on a gross basis at a relatively low rate without any particular threshold and are subject to a withholding tax obligation on the part of the payer. The rate is often reduced or eliminated in treaties. Where the royalty payment is deducted by a resident taxpayer or the PE of a non-resident taxpayer and taxed in the hands of the recipient at a low rate, there is significant possibility of base erosion. The level of royalty payments also involves transfer pricing issues.

10.5 "Mixed" contracts

Many contractual arrangements involve a combination of different elements: sales combined with the use of tangible or intangible assets, services combined with the use of equipment, and rentals of immovable property (for example, land, farms, houses, hotels) combined with rentals of movable property (for example, equipment, furniture, animals). If the different elements of a mixed contract are treated differently under domestic law or tax treaties, it will be necessary for the tax authorities to determine the amount of the payments under the contract that are properly attributable to each of the elements. Moreover, the parties to the contract, regardless of whether they are related, may be tempted to split the contract into several elements or to price some of the elements in order to avoid or reduce tax. Therefore, it is important for the tax authorities to identify the various elements of a mixed contract and ensure that the price for each element is correct.

10.6 "Mismatch" structures and intermediary companies

Often mismatches between the characterization of a transaction under the domestic law of two countries are used to take advantage of the differing treatment of royalties and other payments. For example, if one country determines ownership on a strictly legal basis and the other looks to the economic substance of the transaction, a payment of "royalties" may be deducted in one jurisdiction while being treated as a financing transaction involving interest payments and depreciation in the other jurisdiction. In addition, the ownership of intangibles, having no physical location, can be easily transferred to related entities, which can create base erosion problems when intermediate companies based in low-tax jurisdictions are involved.

11. Tax incentives

11.1 General

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

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

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

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

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

11.2 Cost/benefit analysis of tax incentives

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

- Forgone tax revenues;
- The costs of administration and enforcement;
- Possible misallocation of economic resources;
- Opportunities for corruption.

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

11.3 The role of tax sparing

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

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

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

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

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

12. Statutory general anti-avoidance rules in domestic law

12.1 General

Abusive or aggressive tax avoidance arrangements erode a country's tax base and undermine public confidence in the integrity of the tax system. Abusive or aggressive tax avoidance poses serious problems for all countries' income tax systems. Countries use a variety of methods to control such tax avoidance, including specific anti-avoidance rules, judicial anti-avoidance doctrines, purposive interpretation of tax legislation, and robust enforcement efforts. However, these methods, even when combined, have often proved inadequate to deal effectively with abusive tax avoidance. As a result, many countries have adopted general anti-avoidance rules (GAARs) that potentially apply to all types of payments, receipts, taxpayers and transactions, including cross-border transactions. The purpose of a GAAR is to stop taxpayers from carrying out abusive tax avoidance arrangements that reduce a country's tax base, but at the same time not discourage legitimate commercial transactions. Thus, a GAAR must distinguish in some way between abusive tax avoidance transactions and legitimate commercial transactions.

The adoption of a GAAR is usually controversial. Taxpayers and their advisers typically raise several arguments against the adoption of a GAAR—in particular, that a GAAR is unnecessary because the tax authorities have other weapons to deal adequately with abusive tax avoidance, and that a GAAR causes so much uncertainty for taxpayers that it discourages legitimate commercial transactions. Nevertheless, many countries have concluded that a GAAR is necessary, and that the inevitable uncertainty associated with a GAAR can be minimized by providing administrative guidance on the application of the rule.

12.2 Major tax policy considerations in designing a statutory GAAR

The major tax policy issues that a country must resolve in adopting a GAAR include the following:

- A GAAR should be sufficiently broad to apply to all types of abusive tax avoidance transactions. The breadth of a GAAR is its fundamental advantage over specific anti-avoidance rules.
- A GAAR must distinguish between abusive tax avoidance transactions and legitimate commercial transactions. This distinction is usually made by reference to the principal purpose of a transaction.
- Any purpose test for a GAAR should be objective. Thus, the purpose or purposes of a transaction should be determined on the basis of objective facts and circumstances rather than the subjective intention or motives of the taxpayer. The testimony of the taxpayer as to the reasons for entering into the transaction may be relevant but is inevitably self-serving and should not be determinative.
- The relationship between a GAAR and other provisions of domestic tax law (in particular, specific anti-avoidance rules) should be determined on a case-by-case basis. Although it is tempting to provide that a GAAR prevails over all other provisions of domestic tax law, such an approach is inappropriate. Sometimes the GAAR should prevail over other provisions—for example, where transactions are designed to avoid the application of those other provisions. Sometimes, however, other provisions should prevail over the GAAR—for example, where transactions are carried out to obtain tax incentives in accordance with the purpose of those incentives.

- A GAAR should apply as a provision of last resort after all the other provisions of domestic tax law. Thus, if a transaction does not comply with the provisions of the law other than the GAAR (that is to say, the tax benefits of the transaction are denied pursuant to those provisions), the application of the GAAR is unnecessary. A GAAR should not be applied routinely, but as an extraordinary provision to stop egregious tax avoidance transactions.
- If a GAAR applies, the tax consequences should be determined to disallow the tax benefits that would otherwise have resulted from the transaction in the absence of the application of the GAAR. For this purpose, it is generally insufficient simply to ignore the abusive transaction. The tax authorities should be given broad discretion to determine the tax consequences—such as denying deductions, attributing income or other amounts to persons, and determining the character of amounts—for the taxpayer and for other persons who may be affected by the application of the GAAR.
- Taxpayers and other persons affected by the application of the GAAR should have the right to appeal all aspects of the application of the GAAR by the tax authorities.

12.3 The major features of a statutory GAAR

Typically, a GAAR applies if a transaction that results in tax benefits is carried out for the purpose (or principal purpose) of obtaining those tax benefits and those benefits are contrary to the object and purpose of the tax legislation. Thus, there are usually 4 major features of a GAAR:

- The definition of a transaction, scheme or arrangement;
- The definition of a tax benefit;
- A purpose test that requires the principal or one of the principal purposes of a transaction or arrangement to be determined; and
- An exception, additional condition or saving provision to ensure that the GAAR does not apply to transactions or arrangements that do not abuse, frustrate, defeat or contravene the underlying purpose or policy of the relevant provisions of the tax legislation.

Typically, countries use terms such as "transaction," "arrangement" or "scheme" as the basic building block for identifying the target of their GAARs. These terms are usually defined very broadly. Some countries define the relevant term comprehensively and explicitly and other countries leave it largely undefined, relying on the tax administration and the courts to give it a broad meaning. Most importantly, the GAAR must apply to a series of transactions, since most aggressive tax avoidance arrangements involve multiple connected transactions. A series of transactions for this purpose should be defined broadly to include any transaction that is related or connected to, or carried out in contemplation of, another transaction or transactions.

A GAAR applies only to transactions, arrangements or schemes that would result in the avoidance or reduction of tax in the absence of the application of the GAAR. For this purpose, many countries use the term "tax benefit" and define that term broadly to mean any avoidance, reduction or deferral of tax payable. Some countries also include in their definition of tax benefit the avoidance, reduction or deferral of amounts related to tax payable, such as interest and tax instalments. The requirement of a tax benefit is not intended to form a high threshold or difficult condition for application of the GAAR.

Most GAARs contain some type of purpose test: in effect, if none of the primary purposes of a transaction or arrangement is obtaining a tax benefit, the GAAR should not apply. However, if the primary purpose or one of the primary purposes is to obtain a tax benefit, the GAAR applies unless, with respect to most GAARs, the transaction or arrangement is consistent with the underlying policy of the tax legislation. Most countries use a sole or main purpose test, which requires the tax authorities and the courts to weigh the purposes of a transaction in order to determine its main purpose. The onus of proof may be an important factor in this determination. Some countries put the onus on the taxpayer by explicitly providing in the GAAR that the purpose test is met unless the taxpayer establishes that the primary purpose of the transaction was something other than obtaining the tax benefit. A few countries, and the GAARs in the United Nations and OECD Model Conventions, use a "one of the main purposes" test. Such a test is relatively easily satisfied. If a transaction results in a significant tax benefit, it seems unlikely that none of the main purposes of the transaction was obtaining that benefit. Therefore, it is especially important, if a one of the main purposes test is used in a GAAR, that an exception should be provided for transactions that have the reduction of tax as one of their main purposes but are in accordance with the object and purpose of the tax legislation.

As discussed above, any purpose test should be determined on the basis of the objective facts and circumstances rather than the subjective intention of the taxpayer. The purpose test in most countries' GAARs applies on an objective basis by referring to the purpose of a transaction rather than the purpose of the person carrying out the transaction.

Most statutory GAARs do not apply to all transactions or arrangements that are carried out primarily for the purpose of obtaining a tax benefit; they provide an exception for transactions that are consistent with and not contrary to the object and purpose of the tax legislation. This exception is an important safety valve for transactions that have the primary purpose of reducing tax but are nevertheless legitimate commercial transactions — most commercial transactions have important tax consequences that taxpayers would be foolish to ignore but many of these transactions, and the tax benefits they produce, are consistent with the underlying purpose of the tax legislation. In the absence of some type of exception to the GAAR for transactions that reduce tax but are not contrary to the underlying purpose of the tax legislation, the tax authorities would be required to exercise their discretion, without any statutory guidance, to ensure that the GAAR does not apply to such transactions.

The exception or safety valve for tax avoidance transactions that are not contrary to the purpose of the tax legislation can be worded in a wide variety of ways. Some countries refer explicitly to the object and purpose of the legislation; other countries refer to transactions that involve a misuse or abuse of the legislation or that are artificial in some way. For some countries, the exception is implicit in the GAAR as a matter of interpretation. Whatever approach is used to provide such an exception or safety valve, it is often difficult for the tax authorities and the courts to determine with any certainty the purpose of the relevant provisions of the tax legislation; this problem of interpretation is an especially difficult one for countries that do not provide any explicit statement about the purpose of provisions of the tax legislation in the legislation itself or in explanatory notes accompanying the legislation.

12.4 The relationship between a GAAR and the provisions of tax treaties

A fundamental principle of the law of treaties is that, in the event of a conflict between the provisions of a treaty and the provisions of domestic law, the provisions of the treaty must prevail. This principle is enshrined in Article 26 — pacta sunt servanda — of the Vienna Convention on the Law of Treaties.[36] The application of this principle would appear to suggest that if an abusive tax avoidance arrangement results in treaty benefits, those treaty benefits must be granted even where the arrangement is subject to a country's domestic GAAR. Before the changes to the Commentary on Article 1 of the OECD Model Convention in 2003, this was arguably the result. For this reason, some countries enacted special legislation to ensure that their domestic GAARs apply in the event of a conflict with the provisions of a tax treaty (a so-called treaty override), and other countries have insisted on the inclusion of specific anti-avoidance rules in their tax treaties.

In 2003, the Commentary on Article 1 of the OECD Model Convention was substantially revised to indicate that for most OECD member countries, there is no conflict between domestic anti-avoidance rules and the provisions of tax treaties; therefore, the provisions of tax treaties should not be interpreted and applied to prevent the application of domestic anti-avoidance rules. Moreover, the Commentary stated explicitly that tax treaties were not intended to facilitate tax avoidance and that it was not necessary for specific anti-avoidance rules to be included in tax treaties or for the application of domestic anti-avoidance rules to be protected in tax treaties. The Commentary on Article 1 of the United Nations Model Convention was revised in 2011 to adopt the OECD position on the relationship between domestic anti-avoidance rules and the provisions of tax treaties.

The 2003 revisions to the Commentary on Article 1 of the OECD Model Convention and the 2011 revisions to the Commentary on Article 1 of the United Nations Model Convention raise an issue about whether the revised version of the Commentary should apply to a tax treaty entered into before the Commentary was revised. Not surprisingly, taxpayers and their advisers generally take the position

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[36] Vienna Convention on the Law of Treaties, supra note 29.

that only the version of the Commentary applicable at the time the treaty was entered into should be relevant for purposes of interpreting the treaty. However, the OECD takes the position that the current version of the Commentary generally applies to all tax treaties regardless of whether they were concluded before or after the Commentary was revised.

In 2017, Article 29 (9) (a GAAR) was added to both the United Nations and OECD Model Conventions.[37] This rule provides that treaty benefits can be denied if one of the principal purposes of a transaction is to obtain those benefits, unless granting those benefits is in accordance with the object and purpose of the treaty. In effect, the interpretive guiding principle added to the Commentary on Article 1 of both the United Nations and OECD Model Conventions, in 2011 and 2003, respectively, has been moved into the text of the Conventions. As a result, for countries that have domestic GAARs, the question is whether their domestic GAARs are consistent with the GAAR in their treaties and, if not, what the consequences would be.

12.5 Administrative aspects

A domestic GAAR raises several special administrative issues. First, as mentioned above, the determination of the tax consequences where the GAAR applies requires the tax authorities to have broad discretion to take appropriate measures to deny the tax benefit that would otherwise result from a transaction — it is not sufficient for the tax consequences to be determined simply by ignoring the transaction. In addition, it may also be necessary for the tax authorities to make relieving adjustments for the taxpayer and other persons. Second, the GAAR must be applied by the tax authorities even in a self-assessment system. Third, some countries have adopted special review or approval processes for the application of their GAARs in order to ensure consistency and minimize uncertainty. These review or approval processes usually require the application of the GAAR to be approved by a committee of senior tax officials. Fourth, the application of the GAAR may result

[37]For further discussion, see chapter XII, "The role of a general anti-avoidance rule in protecting the tax base of developing countries," by Brian J. Arnold.

in the imposition of a financial penalty. While such a penalty is very controversial, it can serve as an effective deterrent for aggressive tax avoidance arrangements. These arrangements impose significant costs on a country's tax system in terms of the administrative resources necessary to combat tax avoidance; therefore, the imposition of a financial penalty where a transaction is found to be subject to the GAAR may be a reasonable cost to levy on taxpayers who engage in abusive tax avoidance transactions.

13. Institutional developments

13.1 General

The various recommendations developed in the OECD project on BEPS have had an important impact on the institutional architecture of the international tax world. To effectively implement the various changes in substantive tax rules proposed in the project, countries have recognized the need to take action on a coordinated basis. In addition, there has been greater recognition of the need to provide capacity development assistance to developing countries to meet the special challenges that such countries face in protecting their tax base. As a result, new institutional arrangements have been established that may be useful to developing countries in taking forward the work of base protection.

13.2 The Inclusive Framework

In February 2016, following the October 2015 release of the Final Reports on BEPS, the OECD announced a "new framework" for country participation in the continuing BEPS work and in the updating of international tax rules: the Inclusive Framework.[38] The goal of the Inclusive Framework is to enable all interested jurisdictions to "participate as BEPS Associates in an extension of the OECD's Committee

[38] "All interested countries and jurisdictions to be invited to join global efforts led by the OECD and G20 to close international tax loopholes," (23 February 2016), available at http://www.oecd.org/ctp/all-interested-countries-and-jurisdictions-to-be-invited-to-join-global-efforts-led-by-the-oecd-and-g20-to-close-international-tax-loopholes.htm.

on Fiscal Affairs (CFA).” Participation in the Inclusive Framework, however, requires that the BEPS Associates commit to implementing the four minimum standards emanating from the Final Reports: (a) tackling harmful tax practices, (b) confronting treaty shopping, (c) implementing country-by-country reporting, and (d) improving dispute resolution. The Framework foresees the development of a monitoring process to follow the progress of participating countries in implementing the BEPS recommendations. Since the announcement of the Inclusive Framework, over 100 countries and jurisdictions have indicated an interest in participating.

13.3 Platform for Collaboration on Tax

In April 2016, in recognition of the capacity-building needs of many developing countries, the International Monetary Fund (IMF), the OECD, the United Nations and the World Bank announced their joint engagement on a “Platform for Collaboration on Tax.” The accompanying “Concept Note” emphasized that the collaboration among these major international organizations aims to offer support and assistance to developing countries.[39] As part of its work, the Platform will develop toolkits to give guidance and assistance to developing countries in dealing with many of the topics discussed in the present *Handbook*, including the taxation of services, limitations on the deduction of interest, rent and royalties and the taxation of capital gains. The Platform will coordinate its work with the Inclusive Framework. The participating international organizations will continue to fulfil their own mandates.

13.4 The Multilateral Instrument

A number of the steps necessary to implement the various BEPS recommendations will require changes in countries’ tax treaties. It is clearly impractical for a country with a large treaty network to attempt to renegotiate quickly all of its existing treaties to include these developments. Therefore, in order to handle existing treaties, Action 15 of

[39]International Monetary Fund, OECD, United Nations and World Bank, “The Platform for Collaboration on Tax: Concept Note,” (April 2016), available at https://www.imf.org/external/np/sec/pr/2016/pdf/pr16176.pdf.

the OECD Action Plan on BEPS proposed the creation of a single multilateral instrument ("the MLI") to update existing bilateral treaties in order to accommodate these developments in treaty practice.

In November 2016, the OECD released the text of the MLI.[40] The objective of the MLI is to provide a single instrument that a country can sign to update, at a single stroke, its suite of treaties with respect to the BEPS treaty changes — that is, without having to renegotiate each treaty individually. If a country decides to sign the instrument, potentially all its existing treaties could be amended at the same time. Countries that have chosen to participate in the OECD project on BEPS and the Inclusive Framework, discussed above, have agreed to meet certain minimum standards; signing the MLI is one way of implementing these minimum standards.

The MLI must be flexible enough to effect amendments to over 3,000 treaties based on different treaty models, reflecting different compromises, some already containing versions of the amending provisions (for example, an LOB clause), of varying scope and age, some with protocols, in a variety of languages, and between countries that have different views about how much and which parts of the BEPS work they want to implement (from simply the minimum standards, to all the recommendations). These considerations present a serious drafting challenge; the MLI therefore offers countries the opportunity to make elections, options and reservations in order to determine which treaties will be affected, and by which of the clauses in the MLI.

Even where a country signs the MLI, the MLI does not necessarily apply to all the country's tax treaties. Countries can choose which treaties will be modified by the MLI by notifying the OECD when it signs the MLI. Thus, a country can choose to modify some of its treaties through the MLI, but other treaties only through bilateral negotiations. Importantly, a country's tax treaties will be modified by the MLI only if the country and its treaty partner agree to the same modifications. Thus, if a country agrees to a certain provision of the MLI but its treaty partner does not agree to that provision, their treaty will not

[40] OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (24 November 2016), available at http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm.

be modified. Similarly, if a country chooses one option provided in the MLI but its treaty partner chooses a different option, the treaty will not be modified. In these circumstances, the countries are expected to resolve their differences through bilateral negotiations.

Developing countries need to consider carefully the implications of signing the MLI, and in particular which treaties will be covered and how the various elections, options and reservations available to signatories should be handled.

14. Conclusion

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

Chapter II

Taxation of income from services

Brian J. Arnold*

1. Introduction

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

The OECD has been careful to involve developing countries in the BEPS initiative and, not surprisingly, these countries have indicated their enthusiastic support for the project. Obviously, their tax bases are equally, if not more, susceptible to base erosion and profit shifting as the tax bases of developed countries. Moreover, many developing countries have less capacity in terms of administrative resources and expertise to deal with base erosion by multinational enterprises than developed countries.

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

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

Although base erosion and profit shifting are equally important for both developed and developing countries, they affect them in different ways. The OECD Action Plan on BEPS does not identify the provision of services as a means of eroding the tax base of countries that requires action. Some of its action items, such as the digital economy and the artificial avoidance of permanent establishment status, may touch on the provision of services. In contrast, developing countries have become increasingly concerned about the erosion of their domestic tax bases by multinational enterprises through payments by residents for management, consulting and technical services provided by related non-resident companies. The United Nations Committee of Experts on International Cooperation in Tax Matters (United Nations Committee of Experts) has been considering the taxation of services for several years and in 2015 approved the addition of a new article to the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention)[3] dealing with fees for technical services.[4] Therefore, because of the importance of services for developing countries, the present chapter examines the taxation of income from services in the context of the BEPS initiative from their perspective.

As noted above, it is relatively easy and common for multinational enterprises to reduce the tax payable to a source country in respect of a group company resident and doing business in that country through payments for services rendered to that company by other non-resident group companies. The payments are generally deductible in computing the income of the company resident in the source country but may not be taxable by the source country in the hands of the non-resident service provider. For example, even if payments for services performed by the non-resident company are taxable under the domestic tax law of the source country, an applicable tax treaty along

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

[4] United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, Report on the eleventh session (19 – 23 October 2015), chapter III, section G, available at http://www.un.org/ga/search/view_doc.asp?symbol=E/2015/45&Lang=E. The new article on technical fees is discussed below in section 4.11.4.

the lines of the United Nations Model Convention would prevent the source country from taxing such payments unless the non-resident has a permanent establishment (PE) or fixed base in the source country. The same type of base erosion may occur with respect to developed countries; however, if the flow of services is relatively equal between the two countries, the erosion of the tax base of the source country may not be a serious concern because that country's tax revenues are increased in its capacity as the country of residence.

The present chapter begins with a brief discussion of the taxation of income from services performed by non-residents under the domestic law of developing countries. It emphasizes that protecting the tax base of developing countries involves both the provisions of domestic law and tax treaties. The chapter then provides an overview of the provisions of the United Nations Model Convention dealing with income from services. This overview is intended to provide the necessary background to determine which provisions of the United Nations Model Convention may be problematic in terms of base erosion through the provision of services. These overviews of the provisions of the United Nations Model Convention and domestic law dealing with income from services are followed by a detailed discussion of the opportunities for base erosion through the performance of services by non-residents and the possible responses by developing countries to prevent such base erosion. It is organized on the basis of various types of services including the treatment of fees for technical services. This chapter does not deal with digital services, which are the subject of a separate chapter.[5] The potential responses of developing countries to the problem of base erosion include changes to tax treaties—including the new article on fees for technical services added to the United Nations Model Convention in 2017 (Article 12 A)—and domestic law and some type of coordinated international action. This chapter does not make any recommendations for action by developing countries to protect their tax bases against base erosion; it simply identifies possible actions and provides some brief comments on their advantages and disadvantages. It also contains a discussion of the possible constraints on the taxation of income from services imposed by the provisions of

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

the General Agreement on Trade in Services[6] (GATS) and Article 24 of the United Nations Model Convention on Non-discrimination. The chapter ends with a brief conclusion.

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

2.1 Introduction

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

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

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

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

[8] However, several Latin American countries that tax generally on a territorial basis extend their taxes to services provided outside their countries by non-residents to residents of their countries.

country earn foreign source income from services and on the extent to which the services are geographically mobile. Countries that tax on a territorial basis could eliminate some of these problems by moving to a worldwide system or by extending the concept of domestic source income to include at least some services rendered outside the country.

For countries that tax on a worldwide basis (that is to say, residents are taxable on both their domestic and foreign source income), income derived by residents from services performed abroad is ordinarily taxed like any other business income on a net basis at the generally applicable rate. The residence country ordinarily allows a credit against residence country tax payable for any tax paid to the foreign country in which the services are performed in order to eliminate double taxation. Thus, under a worldwide system income from foreign services is taxable at the higher of the tax rate in the country of residence or the tax rate in the source country (that is the country in which the services are performed or used); as a result, there appear to be limited opportunities for the avoidance of residence country tax. However, residents of a country that taxes on a worldwide basis can establish controlled foreign corporations (CFCs) to provide services outside that country. Since a foreign corporation is generally considered to be a taxable entity separate from the person(s) who own(s) the shares of the corporation, a CFC is not subject to tax on its income in the country in which the controlling shareholders are resident, unless the income earned by the CFC is sourced in that country.[9] Many developed countries (and some developing countries)[10] have rules, referred to as controlled foreign corporation (CFC) rules, to limit the use of CFCs to defer or avoid residence country tax.[11] Some countries apply their CFC rules to income from services provided to residents of the

[9] If a treaty applies with terms similar to those of Article 7 (Business profits) of the United Nations Model Convention, the CFC would be subject to tax in that country only if the income was attributable to a permanent establishment.

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

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

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

2.2 A framework of analysis

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

(a) There must be some connection or nexus between a non-resident's service activities or income and a country before the country can tax the non-resident.[14] This initial question of jurisdiction to tax or nexus is a question of domestic law and is probably determined primarily on the basis of the practical ability of a country to enforce any taxes imposed on non-residents as much as some theoretical justification for taxing them.

(b) For many countries, the type of services involved must be determined because different rules apply to different types of services. For this purpose, the major types of services

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

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

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

are employment, professional services, technical services, international transportation services, entertainment, insurance, construction and other business services.

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

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

(e) The next stage involves the rules that apply for the purpose of computing the income from services derived by a non-resident from a country that is subject to tax by that country. These rules are the detailed computational rules for determining the non-resident's net income. Generally, they will be the same for resident and non-resident taxpayers, although some special rules may be appropriate to reflect the different circumstances of residents and non-residents.[16] These computational rules are different

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

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

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

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

The six stages in this framework of analysis are intimately connected. For example, a threshold requirement, such as a PE or fixed base, or gross basis taxation through a withholding tax, may be adopted because it makes the collection of tax more effective. Not all of the stages may be involved with respect to all types of income from services taxable by a particular country under its domestic law. For

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

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

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

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

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

In this section, the domestic laws of developing countries with respect

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

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

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

Second, in several countries the rules vary depending on the type of services involved. Some countries treat income from services derived by non-residents in the same way as other business income derived by them, although even these countries often have special rules for certain types of specialized services, such as international shipping and transportation, insurance, construction and entertainment. Surprisingly, even for countries that treat income from services differently from other business income, few of them have any statutory definition of services.[21] Some South American countries have judicial or administrative pronouncements concerning the meaning of services. In general, the meaning is quite broad and includes a wide range of activities performed by one person for the benefit of another person in consideration for a fee.[22]

[21] Similarly, the GATS does not define the term "services." The Russian Federation's tax code contains a statutory definition of services as actions with intangible results consumed in the course of the actions that confer benefits to the customer. The definition excludes actions with tangible results provided to the customer, financial rental, licences of intellectual property and assignment of rights. Despite the definition, there is considerable uncertainty about the meaning of services. See Dzhangar Dzhaichinov and Petr Popov, "Russia," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, 579 – 591.

[22] See, for example, Sergio André Rocha, "Brazil," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, 155-167, at 158; Sandra Benedetto and Liselott Kana, "Chile," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit*

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

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

Countries take different positions with respect to whether income from automated activities, such as the provision of access to a database, online gaming or gambling and communications, are treated as services, royalties or other income.[25] Some countries take

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fiscal international, supra note 7, 191–208, at 195; Rodrigo Castillo Cottin and Ronald Evans Márquez, "Venezuela," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, 747–759, at 749.

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

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

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

the position that services must involve activities performed by individuals while other countries do not consider intervention by individuals to be necessary.

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

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

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[26] See, for example, Kolozs Borbála and Kőszegi Annamária, "Hungary," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 341; Luis Felipe Muñoz and Ricardo Quibrera Saldaña, "Mexico," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 482; Dzhangar Dzhaichinov and Petr Popov, "Russia," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 583 – 584; Pavlo Khodakovsky and Anna Pogrebna, "Ukraine," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 687.

[27] See Alejandro Almarza, "Argentina," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 65 – 66; Yishian Lin, "Chinese Taipei," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 193 – 194; Esperanza Buitrago and Mauricio Marin, "Colombia," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 231 – 232 and 238; Lenka Fialkova, "Czech Republic," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 254 – 255; Saurav Bhattacharya and Dhaval Sanghavi, "India," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 353; Marcial Garcia Schreck, "Peru," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7,

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

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

- the services are performed in connection with or through a PE in the country;
- the services are used or consumed in the country;[29] and

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at 547; Tracy Gutuza, "South Africa," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 601; Jose M. Calderón, "Spain," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 628; Luis Aisenberg and Alejandro Horjales, "Uruguay," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 735 and 750; and Rodrigo Castillo Cottin and Ronald Evans Márquez, "Venezuela," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 748 and 751.

[28] See, for example, Sergio André Rocha, "Brazil," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 156 – 157; Tracy Gutuza, "South Africa," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 595; Shivaji Felix, "Sri Lanka," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 647.

[29] For instance, in the Bolivarian Republic of Venezuela, Colombia, India, Peru, Ukraine and Uruguay. In Peru, income from technical assistance and digital services are sourced in Peru if they are "economically utilized" there,

- payments for services are deductible by residents of that country or by non-residents with a PE in that country.[30]

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

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

With respect to the rules for the computation of income from services derived by non-residents that is subject to tax by source countries, the critical issue is whether the source country tax is imposed on a gross or net basis. If the tax is imposed by way of a final withholding tax on the gross payments to non-residents, no computational rules are necessary. The withholding tax is generally imposed at the time the amount is paid (or shortly thereafter) on the full amount paid without the deduction of any expenses incurred in earning the income. If the tax is imposed on the net income earned by non-residents, generally the same computational rules (amounts deductible, timing, etc.) apply that apply to business income earned by residents of that country. However, several South American countries as well as India

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which is the case if the recipient of the services deducts the payment for the services in computing its income subject to Peruvian tax.

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

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

impose a withholding tax on a presumptive amount of income derived by non-residents.[32] The presumed amount is a percentage of the amount of the gross payments to the non-resident. The justification for this presumptive tax base is to provide some standard relief for the expenses that might typically be incurred by non-residents in providing the services. The presumptive tax base eliminates the need for taxpayers to keep track of their actual expenses and for the tax authorities to verify those expenses. The same result can be achieved—although not as transparently—by reducing the rate of withholding tax so that the tax imposed approximates the tax that would be payable if a non-resident's actual net income were taxable at the ordinarily applicable rates.

Although many developed countries provide an election for non-residents to pay tax on a net basis with respect to certain income from services, developing countries do not generally do so due to inadequate administrative resources.[33] Similarly, few developing countries use a non-final interim or withholding tax as a collection device for taxes on income from services derived by non-residents, although

[32] Argentina and Uruguay use this presumptive income approach extensively. See Alejandro Almarza, "Argentina," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 74–76; and Luis Aisenberg and Alejandro Horjales, "Uruguay," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 739. The approach is also used in several other countries (including the Bolivarian Republic of Venezuela, India and Peru) although it is applied to a narrower range of payments for services. For example, in India non-residents providing construction, air transportation, shipping, prospecting or extraction of oil services are, respectively, taxable on 10, 5, 7.5 and 10 per cent of the amounts receivable for such services. See Saurav Bhattacharya and Dhaval Sanghavi, "India," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 359–360.

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

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

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

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

The rates of final withholding taxes on income from services vary considerably from country to country depending on the type of services. Rates are generally low (5 – 10 per cent) on payments for international transportation but can be as high as 35 per cent in some South American countries. The most common rate appears to be 15 per cent.[36] As noted above, in some countries a relatively high rate of withholding tax is applied to a percentage of the relevant payment for services. For example, in the Bolivarian Republic of Venezuela only one-half of

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[34] See Saurav Bhattacharya and Dhaval Sanghavi, "India," in International Fiscal Association, "Enterprise Services," in *Cahiers de droit fiscal international*, supra note 7, at 362 – 363.

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

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

the gross amount of payments for technical services is subject to tax at the rate of 34 per cent, resulting in an effective tax rate of 17 per cent.[37] Argentina uses this presumptive approach for most types of income subject to the nominal rate of withholding tax of 35 per cent. Since varying percentages of income are subject to tax, the effective tax rates range from 12.5 per cent to 31.5 per cent.[38]

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

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

3.1 Introduction

This section contains a brief description of all of the provisions of the United Nations Model Convention that deal with income from services.[39] The purpose of this overview is to provide sufficient background information about the provisions to allow the identification of those that potentially permit the erosion of the tax base of developing countries. The identification of the provisions that are problematic in this regard is essential in order to properly target any possible responses to the problems. The potential application of Article 24 of the United Nations Model Convention to prevent the discriminatory treatment of non-residents earning income from services is discussed subsequently.

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

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

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

3.2 Business profits derived from services provided by enterprises

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

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

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

These legal fictions effectively ensure that the profits attributable to a PE are determined in accordance with the arm's length principle that applies to transactions between related or associated enterprises under Article 9 of the United Nations Model Convention. Article 7 (3) of the United Nations Model Convention allows that any expenses incurred by an enterprise for the purposes of the PE be deductible in computing the profits of the PE irrespective of whether the expenses are incurred in the PE State or exclusively for the purposes of the PE. However, Article 7 (3) clarifies explicitly that notional expenses or internal charges for royalties, interest or fees for services made between a PE and the head office or other parts of the enterprise are not deductible or includible in computing the profits attributable to the PE. In summary, the profits attributable to a PE under Article 7 of the United Nations Model Convention are the net profits computed in accordance with the arm's length principle as if the PE were a separate entity.

In general terms, a PE is defined in Article 5 (1) of the United Nations Model Convention to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on. The general practice of countries is that a place of business is not considered to be "fixed" in a temporal sense unless it lasts for a minimum of six months.[40] Accordingly, income derived by a non-resident enterprise from services performed in the source country are generally taxable by that country only if the non-resident has a fixed place of business in the source country at its disposal for a minimum of six months and the services are provided through that fixed place of business. Under Article 5 (5) (a), a non-resident enterprise is also considered to have a PE if the enterprise has a dependent agent that has and habitually exercises an authority to conclude contracts on its behalf. The dependent agent PE rule is unlikely to have much significance for service businesses because an agent must habitually conclude contracts binding on the enterprise, not just perform services on its behalf.[41]

3.3 Construction services

Under Article 5 (3) (a) of the United Nations Model Convention, a building site, construction, assembly or installation project or supervisory activities in connection with such a site or project constitutes a PE if the site, project or activities last more than six months. It is unclear whether Article 5 (3) (a) is a deeming provision or whether construction sites and projects must also meet the requirements of a fixed place of business under Article 5 (1).[42] However, the preferred view is that

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

[41] Article 5 (5) of the OECD Model Convention will be amended to deal with commissionaire arrangements. See OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report* (Paris: OECD, 2015) (hereinafter "OECD Final Report on BEPS Action 7"), available at http://www.oecd.org/ctp/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm.

[42] If Article 5 (3) (a) is a deeming provision, construction activities taking place in different geographical locations would be aggregated for the

construction and other related activities must be conducted through a fixed place of business to be a PE.[43]

3.4 Providing services for 183 days or more

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

3.5 Insurance

Under Article 5 (6) of the United Nations Model Convention, a PE is deemed to exist where a non-resident enterprise collects insurance premiums or insures risks in the source country, unless such activities

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

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

are conducted by independent agents. Article 5 (6) does not require the activities to occur through a fixed place of business in the source country or for any minimum period of time. It is sufficient if the specified activities — collecting premiums — take place in the source country or if the risks that are insured are in the source country.

3.6 Income from shipping, inland waterways transportation and air transportation

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

3.7 Income from independent personal services

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

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

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

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

In general, a fixed base for purposes of Article 14 has the same meaning as a fixed place of business under Article 5 (1) although some countries consider the two expressions to have different meanings. The computation of the profits attributable to independent personal services performed through a fixed base under Article 14 is generally considered to be subject to the same principles as the computation of profits attributable to a PE under Article 7.[44] However, Article 14 and its Commentary do not contain detailed rules concerning the attribution of profits to a fixed base similar to the rules in Article 7 and its Commentary. If Article 14 is subject to the same principles as Article 7, the source country would be entitled to tax only the net profits derived from independent services by an individual resident of the other contracting State.

Article 14 of the OECD Model Tax Convention on Income and on Capital was deleted in 2000 with the result that income from services generally (that is to say, other than such income dealt with in specific articles) is dealt with exclusively under Article 7. The deletion of Article 14 with several consequential changes (the most important of which is the inclusion of a provision in Article 5 equivalent to Article 14 (1) (b)) is provided as an alternative in the Commentary on Article 5 of the United Nations Model Convention.[45]

3.8 Income from employment

Under Article 15 (Dependent personal services) of the United Nations Model Convention, income from employment derived by an individual

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

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

resident of one State from employment exercised in the other State may be taxed in that other State (the source country) in any one of the following three situations:

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

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

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

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

Under Article 16 of the United Nations Model Convention, fees derived by non-resident directors and remuneration derived by non-resident top-level managers of a company resident in the source country may be taxed by the source country. The only condition for source country tax under Article 16 is that the company paying the fees or remuneration must be a resident of the source country in accordance with Article 4. It is not necessary for the services to be performed by the directors or managers in the source country. Similar to Article 15, there are no limitations on source country tax under Article 16.

3.10 Entertainers and athletes

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

3.11 Pensions and social security payments

Under Article 18 of the United Nations Model Convention, social security payments (that is to say, public pensions) are taxable exclusively by the country making the payments.[46] Private pensions are taxable exclusively by the country in which the recipient is resident under Article 18 (alternative A) or alternatively under Article 18 (alternative B) by both the country in which the recipient is resident and the country in which the payer of the pension is resident or has a PE.

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

Alternative B reflects the fact that contributions to the pension plan by both the employer and the employee may have been deductible in computing the income subject to tax by the source country (in the case of a PE, only if the contributions were effectively connected with the PE). Since that country's tax base is reduced by the deductions for the pension contributions, it seems reasonable to allow that country to tax the recipient of the pension payments to offset the prior deductions. The country in which the employment services that resulted in the pension were rendered is irrelevant for purposes of both versions of Article 18.

3.12 Income from government services

Under Article 19 of the United Nations Model Convention, the right to tax salary, wages and other remuneration and pensions in respect of employment services provided by an individual to the government of a country is ordinarily allocated exclusively to the country paying the remuneration. However, if a government employee is a resident and a national of the other contracting State and the services are provided in that State, the remuneration is taxable exclusively by that State. Similarly, pension payments made by a contracting State are taxable exclusively by the other State if the recipient individual is a resident and a national of the other State.[47] Article 19 does not apply to salaries and pensions paid by a contracting State in connection with a business carried on by it.[48]

3.13 Other income

Under Article 21 of the United Nations Model Convention, income not dealt with in any other article is taxable exclusively by the residence country subject to a throwback rule if the taxpayer carries on business through a PE or a fixed base in the source country.[49] However, under Article 21 (3), a source country is entitled to tax items of income derived

[47] See Article 19 (2) of the United Nations Model Convention.

[48] See Article 19 (3) of the United Nations Model Convention.

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

by a resident of the other State if those items of income are not dealt with in another article of the treaty and arise (that is to say, have their source) in the source country. Consequently, the only condition for source country taxation of other income under Article 21 (3) is that the income must have its source in that country. No rules are provided in Article 21 or in the Commentary for determining the source of income.

Article 21 (3) is potentially applicable to income from services although that should not frequently happen because such income will usually be dealt with in another article. In some circumstances, the scope of application of the other provisions depends on the domestic laws of the source country.[50]

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

4.1 Introduction

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

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

country should also consider the deductibility of amounts paid by residents (and non-residents) to non-residents for services in computing income subject to domestic tax. To the extent that such amounts are deductible, they reduce or erode the domestic tax base. If the payments are subject to source country tax in the hands of the non-resident recipients of the payment, the domestic tax base will be eroded only to the extent of the difference, if any, between the reduction in tax as a result of the deduction and the tax imposed on the non-resident service provider. For example, in principle, there will be no erosion of the domestic tax base if non-residents are subject to tax on their net income at the same rates applicable to resident taxpayers.[51] However, the domestic tax base may be eroded if non-resident service providers are not subject to tax or are subject to a final gross-basis withholding tax that is levied at a rate less than the ordinary rate applicable to resident taxpayers. For example, if the ordinary tax rate is 35 per cent and the rate of withholding tax on services is 15 per cent, the domestic tax base will be eroded to the extent of 20 per cent of the gross amounts paid to non-residents for services. The erosion of the domestic tax base is greatest where the amounts paid to non-residents for services are deductible but the non-resident service providers are not subject to any domestic tax for some reason.

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

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

for foreign source business income earned through a PE. If the country of residence taxes the income, it will usually provide a credit for any source country tax on the income. The country of residence will not generally tax income from services earned by a foreign subsidiary of a resident enterprise except if the CFC rules apply.

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

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

4.2 Employment income

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

The taxation of non-residents on income from employment exercised in a source country usually applies irrespective of whether the employer is a resident or non-resident of the source country (or if the employer is a non-resident, irrespective of whether the non-resident has a PE or fixed base in the source country to which the employment is connected), irrespective of the duration of the employment in the source country or the amount of income derived and irrespective of whether the non-resident employee's remuneration is deductible by the employer against the source country's tax base.[52] In summary, under Article 15 of the United Nations Model Convention a source country is prevented from taxing a non-resident on employment income only if the non-resident is employed by a non-resident employer that does not have a PE or fixed base in the source country, or if it has a PE or fixed base, the employee's remuneration is not deductible in computing the profits attributable to the PE or fixed base and the non-resident employee is not present in the source country for 183 days or more in any 12-month period.

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

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

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

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

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

First, the source country's tax base may be eroded where a non-resident is employed by a resident employer to perform services outside the source country. Assuming that the source country taxes on a worldwide basis, the non-resident employee's remuneration will be deductible in computing the employer's worldwide income subject to tax, but the employee's remuneration will not be taxable by the source country because the employment is not exercised in the source country.[53] An important exception under Article 16 of the United Nations Model Convention may apply where directors and top-level managerial officials are involved.

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

Second, the tax base may be eroded where non-resident employees perform services in the source country on behalf of a non-resident employer that avoids having a PE or fixed base in the source country. In this situation Article 15 (2) of the United Nations Model Convention would prevent the source country from taxing the non-resident's employment income unless the employee is present in the source country for more than 183 days in any 12-month period. If, however, the non-resident employer has a PE or fixed base in the source country, the source country would be entitled to tax not only the profits attributable to the employer's PE or fixed base, but also the employee's remuneration borne by the PE or fixed base. There are several ways, including the use of artificial structures, in which non-residents can avoid having a PE or fixed base in the source country.[54]

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

[54] Avoiding PE status is the focus of BEPS Action 7. See OECD Final Report on BEPS Action 7, supra note 41; and chapter VII, "Preventing avoidance of permanent establishment status," by Adolfo Martín Jiménez.

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

Article 15 (2) (a) for employees.[56] Therefore, the real difference between the treatment of non-resident employees and non-resident independent contractors is that the latter may carry on activities in the source country for up to six months without becoming subject to source country tax, whereas employees of resident employers or non-resident employers with a PE or fixed base are taxable by the source country irrespective of how long they spend in the source country. The same distinction may exist under some countries' domestic law.

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

Neither the United Nations nor the OECD Model Convention provides a definition of employment or independent services. Article 14 (2) of the United Nations Model Convention provides an inclusive definition of professional services, but that definition simply refers to "independent" activities without defining what the term "independent" means. Under Article 3 (2), the terms "employment" and "activities of an independent character" in the case of Article 14 or "business" in the case of Article 7, have the meanings for purposes of the treaty that they have under the domestic law of the source country unless the context requires otherwise.[57] Most countries distinguish between employment and independent services for various legal purposes, including tax.

Where a country's domestic law allows the formal contractual arrangement to be ignored and the nature of the services to be determined based on the substance of the relationship between the service provider and the customer, the provisions of the treaty will respect the application of domestic law in this regard.[58] However, the deci-

[56] Under Article 5 (3) (b) of the United Nations Model Convention, an enterprise must perform services in the source country for 183 days or more and only working days (not all days of presence) are counted for this purpose.

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

[58] See paragraph 1 of the Commentary on Article 15 of the United

sion to disregard the formal contractual arrangements must be based on objective criteria and the Commentary on the United Nations Model Convention provides important guidance and examples in this regard.[59] Even if the formal contractual relationship is adhered to under domestic law, a contracting State may deny the benefits of the exemption in Article 15 (2) in abusive cases in accordance with the Commentary on Article 1 dealing with the improper use of tax treaties.[60]

A related difficulty with the legal meaning of employment for purposes of tax treaties is the international hiring-out of labour.[61] Under this practice, international human resource agencies hire out individuals to enterprises resident in other countries. The individuals purport to be employees of the agency and the agency purports to provide services to the enterprise resident in the source country, but does not have a PE in the source country. The Commentary on Article 15 contains a provision that countries might consider including in their tax treaties to deny the exemption in Article 15 (2) where the individual renders services to a person, other than the formal employer, who supervises or controls the manner in which the services are performed and the services are an integral part of the business carried on by that person.[62]

Nations Model Convention, quoting paragraphs 8.5 – 8.7 of the Commentary on Article 15 of the OECD Model Convention.

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

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

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

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

The provisions of Article 15 of the United Nations Model Convention dealing with employment income do not apply if the provisions of Articles 16, 17, 18 or 19 apply. With the possible exception of Article 17 dealing with entertainment and athletic services, which is analysed separately below, these Articles do not raise any serious concerns about base erosion or profit shifting.

4.3 Government service

Under Article 19 of the United Nations Model Convention, income from government services, including pensions, is generally taxable by the country that pays the remuneration, so there is no erosion of that country's tax base assuming that the country actually taxes the income. Article 19 applies only to non-resident individuals employed by the government of the source country; it does not apply to non-residents providing independent services to the government. Accordingly, the same issues with respect to the distinction between employment and independent or business services discussed in section 4.2 above also apply to non-residents providing services to the government. However, since the legal relationship is with the government, the opportunities for tax avoidance are limited. The only circumstance in which the government paying the employee or former employee is not entitled to tax the income is if the employee is a resident and national of the other country and the services are performed in that country. Therefore, with respect to income from government service, the source country simply has to ensure that such payments are taxable under its domestic law in order to protect its domestic tax base.

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

With respect to the remuneration of directors and top-level managerial officials, under Article 16 of the United Nations Model Convention, the country in which the company paying the remuneration is resident is entitled to tax the remuneration. It is irrelevant whether the services are provided inside or outside the source country. In terms of base erosion, any remuneration paid by a resident company to its non-resident directors and senior managers will likely be deductible in computing its income. However, that deduction may be offset by the tax on the director or top-level managerial official (assuming, of course, that the non-resident director or official is taxable on the remuneration under domestic law). Therefore, countries that wish to tax non-resident directors and senior managers of resident companies on their remuneration, irrespective of where the services are performed, must ensure that the provisions of their domestic law impose tax in these circumstances and that any tax treaties that they enter into contain a provision comparable to Article 16 of the United Nations Model Convention. However, such countries must recognize that, in the absence of a tax treaty, the imposition of tax on the remuneration of non-resident directors and senior managers of resident companies from services performed outside the country may result in double taxation.[63] Such countries should also recognize that, where a tax treaty applies, they give up the first right to tax directors and senior managers of companies resident in the other contracting State on any remuneration from services performed in the their countries.

4.5 Pensions

Pensions paid to non-residents may reduce a source country's tax base because the non-resident recipients are not subject to tax and the payers of the pensions claim deductions for such payments (or for prior contributions to the pension plan) in computing their income for source country tax purposes. Source countries that are concerned about the potential base erosion with respect to pensions should ensure that pensions paid to non-residents by resident employers, by non-resident employers with a PE or fixed base in the source country, and by the government are subject to domestic tax. Moreover, they must ensure that any tax treaties they enter into do not limit their ability to tax such pensions (that is to say, the treaties should contain Article 18 (alternative B) of the United Nations Model Convention).[64]

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

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

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

4.6 Entertainment and athletic services

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

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

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

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

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

In the absence of special domestic rules, the tax consequences of such an arrangement would be that the salary derived by the non-resident entertainer or athlete would be subject to source country tax because the employment is exercised in the source country. If the source country has entered into tax treaties based on the United

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

4.7 Business, professional and other independent services

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

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

However, for many other developing countries, the taxation of income from business, professional and other independent services derived by non-residents under domestic law is significantly different from the taxation of such income allowed under the provisions of the United Nations Model Convention. Many of these countries also tax income from such services under their domestic law if the services are consumed or used in the source country or the payments for the services are deductible against the country's tax base by a resident payer or a non-resident payer with a PE or fixed base in the country. Moreover, several countries tax income from such services on a gross basis unless the non-resident service provider has a PE or fixed base in the country. Under the provisions of Articles 7 and 14 of the United Nations Model Convention, non-resident service providers are taxable exclusively by the country in which they are resident, unless the services are provided through a PE or fixed base in the source country or, in the case of professional and other independent services provided by an individual, the individual stays in the source country for at least 183 days in any 12-month period. If the source country is entitled to tax income from services derived by a non-resident service provider under Article 7 or Article 14 (1) (a), it is entitled to tax any income "attributable" to the PE or fixed base. Such income may include income earned outside the source country (foreign source income) as long as it is attributable to the PE or fixed base.[65] However, the consumption or use of services in the source country and the deduction against the source country's tax base of the payments for services to non-residents are insufficient to justify taxation by the source country under the provisions of the United Nations Model Convention. In effect, the source country's entitlement to tax under Article 7 or Article 14 is subordinated to the residence country's right to tax unless a substantial minimum threshold requirement (PE, fixed base or 183 days of presence) is met. Moreover, even if the conditions of Article 7 or Article 14 for taxation by a source country are met, the source country must impose tax on a net basis.[66] As a result, if a country taxes non-resident service providers on a gross basis, it is required under any applicable tax treaties to allow non-residents to file tax returns, claim deductions for any expenses incurred in earning the income and pay tax only on their net income.

Therefore, developing countries that tax income from services derived by non-residents significantly differently from the provisions

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

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

of Articles 7 and 14 of the United Nations Model Convention should consider whether they wish to limit their taxing rights by entering into tax treaties.

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

There are several ways in which taxpayers can structure their affairs to avoid having a PE or fixed base in a country.[67] In some situations, non-resident service providers can provide services in a developing country at various locations in the country without any one place being used for more than six months. Or a non-resident service provider may attempt to avoid having a PE or fixed base by using the fixed place of business of a client or a related enterprise. Although the Commentary on Article 5 of the United Nations Model Convention

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[67] See chapter VII, "Preventing avoidance of permanent establishment status," by Adolfo Martín Jiménez; and OECD Final Report on BEPS Action 7, supra note 41, which makes several recommendations for changes to Article 5 of the OECD Model Convention to prevent the avoidance of PE status.

indicates that a PE may exist in this situation,[68] it is necessary for the tax administration of the developing country to have the necessary information-gathering resources to discover the facts required to assess tax. In other situations, a non-resident can avoid having a PE or fixed base by fragmenting its activities among related enterprises. Some of these situations can be dealt with by anti-avoidance rules in domestic law or by the inclusion of specific anti-avoidance rules in tax treaties.[69]

To avoid having a PE under Article 5 (3) (b) of the United Nations Model Convention, a non-resident service provider may simply limit its service activities in the source country to a period or periods of less than 183 days in any 12-month period. Thus, a multinational enterprise with a group company carrying on business in a developing country may use another group company resident in a low-tax country to provide various services to the company in the developing country. These services, which often include legal, accounting, management and technical services,[70] may not require employees of the non-resident service provider to be present in the developing country for long periods of time. It is difficult for developing countries to counteract this

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

[69] See OECD Final Report on BEPS Action 7, supra note 41, for the changes recommended to Article 5 of the OECD Model Convention. In addition, the draft Commentary on Article 5 indicates that the splitting of contracts to avoid the 12-month threshold in Article 5 (3) (6 months in Article 5 (3) (a) of the United Nations Model Convention) will be prevented by the new general anti-abuse rule to be added to the OECD Model Convention. See OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Paris: OECD, 2015) (hereinafter "OECD Final Report on BEPS Action 6"), available at http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm. However, for those countries that wish to deal with contract splitting expressly, the draft Commentary (paragraph 18.1) provides an alternative, specific anti-avoidance rule that these countries may include in their treaties.

[70] The treatment of technical services is discussed in more detail in section 4.11 below.

type of tax planning even with effective anti-avoidance rules in place. Some countries have insisted on a shorter period than 183 days to minimize the limitation on their ability to tax. A non-resident can also avoid having a PE under Article 5 (3) (b) by using related non-resident enterprises to carry out connected projects. Under Article 5 (3) (b) any services performed for the same or a connected project are aggregated for purposes of counting the number of days on which services are provided in the source country. There is no rule, however, to take into account services provided by related enterprises with respect to the same or connected projects. Specific anti-avoidance rules in domestic law or tax treaties might be useful in this regard,[71] although the application of such rules requires effective information-gathering by the tax administration of the developing country.

4.8 Construction

Under the domestic law of most developing countries, construction activities conducted by non-residents in the developing country are usually subject to tax by that country, although in some countries they may be taxable only if they last for a minimum period of time. Under Article 5 (3) (a) of the United Nations Model Convention, a source country is entitled to tax income from construction activities in the source country only if they last for six months or more and are related to a single project. Thus, non-resident construction companies can avoid having a PE in a developing country by fragmenting a project into multiple projects that last less than six months or by having the projects carried out by different related entities. Some developing countries have negotiated a shorter time threshold for construction projects in their tax treaties. Anti-avoidance rules in domestic law or tax treaties might be useful in counteracting other strategies for avoiding PE status.[72]

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

[72] See chapter VII, "Preventing avoidance of permanent establishment status," by Adolfo Martín Jiménez. See also OECD Final Report on BEPS Action 6, supra note 69, and OECD Final Report on BEPS Action 7, supra note 41.

4.9 Insurance

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

4.10 International shipping and air transportation

In general, profits from international shipping and air transportation are earned outside any particular country's territory. As a result, the imposition of tax on such profits is difficult for any country other than the country in which the enterprise is resident or is effectively managed. For this reason, under Article 8 of both of the United Nations and OECD Model Conventions the exclusive right to tax such income is given to the country in which the enterprise has its place of effective management. Article 8 (2) (alternative B) of the United Nations Model Convention allows a country to tax shipping activities (not air transportation) within the country if those activities are more than casual. The tax must be levied on a net basis.

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

4.11 Fees for technical services

4.11.1 Introduction

The United Nations Committee of Experts has been working since 2008 on the provisions of the United Nations Model Convention dealing with the taxation of income from services, including income from technical, managerial, consulting and other similar services (referred to here for convenience as "technical services").[73]

In 2011, the Committee agreed to work on the development of a new article and Commentary dealing with the taxation of fees for technical services. At the 2015 meeting of the Committee, it approved the text of a new article, which will be added to the United Nations Model Convention in 2017. The text of the new Article 12 A is reproduced in appendix 1 and discussed in section 4.11.4 below.

4.11.2 The treatment of technical services under domestic law

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

[73] The work on services has been carried out by the Subcommittee on Tax Treatment of Services (with Ms. Liselott Kana of Chile as Coordinator), which was established in 2009. The various reports prepared by the Subcommittee are available at http://www.un.org/esa/ffd/wp-content/uploads.

The definition of technical services is similarly problematic under the provisions of bilateral tax treaties dealing with fees for technical services, as discussed in the following section.

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

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

The current United Nations Model Convention does not contain any specific provisions dealing with income from technical services provided by a resident of one State in the other contracting State or to customers in the other contracting State. In general, income from business services is covered by Article 7 or 14. Under Article 7 (1), a country is entitled to tax a non-resident's business profits only if the non-resident carries on business in the country through a PE. A PE is defined in Article 5 to be a fixed place of business which lasts for a minimum period (generally, six months) and under Article 5 (3) (b) a non-resident is deemed to have a PE in the source country if it furnishes services in the source country for 183 days or more in any 12-month period in respect of the same or connected projects. The fixed place of business rule is easily avoided by some non-resident service providers by moving from place to place before the threshold is met. Under Article 14 of the United Nations Model Convention, income derived by a non-resident from professional or other independent services performed in the source country is taxable by that State only if the income is attributable to a fixed base in the source country that is regularly available to the non-resident or if the non-resident is present in the source country for 183 days or more in any 12-month period. It is generally accepted that the source country must tax income under Article 7 or 14 on a net basis.

Article 12 of the United Nations Model Convention dealing with royalties does not apply to fees for technical services because the definition of royalties in Article 12 (3) is limited to payments for the use of, or the right to use, intellectual property, equipment or information. However, according to the Commentary, Article 12 could apply to services under a mixed contract if the services are "of an ancillary and largely unimportant character." [74]

This overview of the provisions of the United Nations Model Convention that are potentially applicable to income from technical services shows that it is relatively easy for a non-resident enterprise to avoid source country tax on such income especially where the services are provided to a related enterprise resident in the source country. As long as the non-resident service provider does not have a PE or fixed base in the source country or stay in the source country for 183 days or more, the income is not taxable by the source country under Article 7 or 14. The income might be covered by Article 21 if it is not considered to be dealt with by Article 7 or 14; however, in most situations income from technical services would be considered to be business profits or income from professional or independent services so that Article 21 would not apply.[75]

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

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

[75] See supra note 50 with respect to Brazil's position concerning the application of Article 21 to income from technical services.

The erosion of the source country's tax base by payments for technical services and the inability of the source country to tax such payments has led some countries to add specific provisions to their domestic laws and tax treaties to allow them to tax payments for technical services on a gross basis.[76] According to an International Bureau of Fiscal Documentation (IBFD) study carried out in 2011,[77] 134 out of 1,586 bilateral tax treaties concluded in the period 1997–2011 contained a special provision dealing with "managerial, technical and consulting services" without defining such services. Some countries, such as India, extend Article 12 dealing with royalties to include payments for services that are ancillary or subsidiary to the application of intellectual property or that make available technical knowledge, skill, know-how or processes, or that involve the development of a technical plan or design.

Under the separate articles, income from technical services is treated like royalties. Source country tax is allowed on a gross basis at a fixed rate that varies; sometimes the rate is higher than the rate on royalties and sometimes lower. Typically, source country tax is limited to fees for technical services "arising" in the source country, which usually means that the services must be performed in the source country. As noted above, typically these separate articles dealing with fees for technical services refer to "managerial, technical or consultancy services" without defining that expression.

The distinction between technical services and professional and business services that involve technical expertise is unclear. For example, engineering services would often be considered technical services; however, the independent activities of engineers are included in the definition of professional services for purposes of Article 14 of the United Nations Model Convention.[78] Thus, income from engineering

[76] In some cases, the definition of royalties is amended to include technical fees; in other cases, a separate article dealing with technical fees is added to a tax treaty. See S. B. Law, "Technical Services Fees in Recent Tax Treaties," (2010) Vol. 64, No. 5 *Bulletin for International Taxation*, at 250–252.

[77] See Wim Wijnen, Jan de Goede and Andrea Alessi, "The Treatment of Services in Tax Treaties," (2012) Vol. 66, No. 1 *Bulletin for International Taxation*.

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

services, at least those performed by individuals, would be taxable by a source country only if the engineer has a fixed base in that country or stays in that country for 183 days or more in any 12-month period.

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

4.11.4 New Article 12 A of the United Nations Model Convention dealing with fees for technical services

The new Article 12 A dealing with fees for technical services is patterned on Article 12 of the United Nations Model Convention dealing with royalties. It allows a contracting State to impose a gross-based withholding tax at an agreed rate on the gross amount of payments for technical services made by residents of that State, or by non-residents carrying on business through a PE or fixed base in that State to non-resident service providers of the other State. The new article does not require any threshold for the taxation of fees for technical services and is not limited to services provided in the source country.

The first paragraph of the new article is similar to Article 12 (1) of the United Nations Model Convention. It allows a contracting State to tax fees for technical services if they arise in the other contracting State and are paid to a resident of the first State. Paragraph 3 provides an exhaustive definition of "fees for technical services" for purposes of the new article and paragraphs 5 and 6 provide rules to determine the circumstances in which fees for technical services arise in a country.

Paragraph 2 of the new article is a key provision, which allows fees for technical services to be taxed also by the country in which they arise; however, if the fees are paid to a resident of the other country who is the beneficial owner of the fees, the source country's tax is limited to the percentage of the gross amount of the fees agreed to by the contracting States pursuant to bilateral negotiations. If the source country imposes a tax in accordance with paragraph 2 of the new article, the residence country is required by Article 23 of the United Nations Model Convention to eliminate any double taxation by exempting the fees from residence country tax or providing a credit for the source country tax.[79]

Paragraph 2 of the new article applies "notwithstanding Article 14." Thus, although payments for technical services to a service provider who is a resident of a contracting State are not taxable under Article 14 if the service provider does not have a fixed base in the source country or is not present in the source country for 183 days or more, such payments are subject to tax under the new article. A similar result applies with respect to Article 7 of the United Nations Model Convention. The new article has priority over Article 7 as a result of Article 7 (6). Therefore, even if a non-resident service provider does not have a PE in the source country, any fees for technical services paid to the service provider by a resident of the source country or a non-resident carrying on business through a PE in the source country are subject to tax by the source country under paragraph 2 of the new article. In effect, for tax treaties containing the new article, the existence of a PE or fixed base in a country determines whether fees for technical services are taxable on a net or gross basis, rather than whether the source country is entitled to impose tax on such fees at all. If a non-resident service provider receives fees for technical services from the source country, those fees are taxable by the source country on a net basis if the fees are earned through a PE or fixed base in the source country, but are otherwise taxable under the new article on a gross basis.

Paragraph 2 is subject to Articles 8, 16 and 17. Therefore, if any of those provisions applies to payments for technical services, that

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[79] The obligation to eliminate double taxation applies even where the services are performed in the residence country.

provision would take priority over the new article. However, any fees for technical services outside the scope of those provisions (for example, fees for entertainment activities performed outside the source country) would potentially be taxable under the new article.

Paragraph 2 limits the rate of tax imposed by a country on fees for technical services only if the recipient of the fees is a resident of the other contracting State and the beneficial owner of the fees. If the recipient of the fees is not the beneficial owner, the fees would be taxable in accordance with the domestic law of the source country without any limit imposed by the treaty.

Paragraph 3 of the new article defines the term "fees for technical services" to mean payments in consideration for managerial, technical or consultancy services. The terms "managerial," "technical" and "consultancy" are not defined and the Commentary explains that they are intended to have their ordinary meaning. The Commentary also indicates that the definition is intended to preclude any reference to the domestic law meaning of "fees for technical services" or the domestic law meaning of any of the terms used in the definition in paragraph 3. Thus, countries are precluded from expanding their taxing rights with respect to fees for technical services by altering their domestic law.

The definition of "fees for technical services" in paragraph 3 provides three specific exclusions:

(a) Payments to an employee by an employer;
(b) Payments for teaching in or by an educational institution; and
(c) Payments for services for the personal use of an individual.

The exclusion of payments to employees means that employment income is covered exclusively by Article 15 of the United Nations Model Convention. Thus, payments to a non-resident employee by an employer for employment services performed outside the country in which the employer is resident or carrying on business through a PE or fixed base are not taxable by that country even if the services are of a managerial, technical or consultancy nature.

The exclusion of payments for technical services for the personal use of an individual reflects common sense. Otherwise, certain payments for personal services might be inappropriately subject to withholding tax. For example, an individual resident in one country might pay a non-resident medical specialist for medical treatment. In the absence of the exclusion, the payments would be fees for technical services subject to tax by the country in which the individual is resident. Although it is unlikely that countries would impose withholding tax on such payments under their domestic law, the new article prevents the imposition of such a tax.

The Commentary on the new article explains that the definition of fees for technical services is intended to apply only to services that involve the application of specialized knowledge, skills and expertise and not to routine services. The Commentary provides several examples that attempt to show the types of services that are covered by the definition. These examples indicate that although an enterprise may use technical knowledge, skills and expertise to develop services that it sells to customers, those services may not constitute technical services within the definition in paragraph 3. For example, a financial institution may apply its technical knowledge, skill and expertise to develop various financial services that it provides to its customers on a routine basis. Payments for such services would not be fees for technical services because the financial institution is providing standardized, routine services, rather than technical services to its clients. On the other hand, if a financial institution provided customized research, analysis and advice to a particular client in connection with a merger or acquisition, payment for those services would likely be within the definition of fees for technical services in paragraph 3.

Despite the explanation and examples provided in the Commentary on the new article, the definition of fees for technical services is vague and uncertain, and is likely to be the source of many disputes between taxpayers and tax authorities. Such disputes may require recourse to the mutual agreement procedure in the treaty.

Paragraph 4 of the new article is a so-called throwback rule similar to the rules in Articles 10 (4), 11 (4) and 12 (4). If the beneficial owner of fees for technical services carries on business through a PE or fixed base in the other State and the fees are effectively connected to the PE or fixed base (or with activities referred to in subparagraph (c) of Article 7 (1) of the United Nations Model Convention), the provisions of Article 7 or 14 apply. In such a case, the source country is entitled to tax the net profits attributable to the PE or fixed base, but the rate of tax is not limited.

Paragraphs 5 and 6 of the new article provide rules governing the source of fees for technical services or, in terms of the wording of paragraphs 1 and 2 of the new article, the circumstances in which fees for technical services arise in a State. Under paragraph 5, fees for technical services arise in a State where the payer is a resident of that State or where a non-resident has a PE or fixed base in that State and the fees are borne by the PE or fixed base.[80] Thus, fees for technical services may arise in a State even where the services are provided outside that State as long as the payments are made from that State. Under paragraph 6, fees for technical services are deemed not to arise in a State if the payer has a PE or fixed base in the other State or in a third State and the fees are borne by that PE or fixed base. The effect of this negative source rule is that a State cannot impose tax on fees for technical services paid by residents of that State where the fees are deductible in computing the profits of a PE or fixed base in another State. In this situation, the fees relate to a business carried on outside the country in which the payer is resident and as a result, a sufficient link does not exist between the fees for services and that country to justify the imposition of tax by that country on the fees.

The Commentary on the new article provides alternative source rules that countries may use in their treaties. For example, paragraph 5 might be revised to include only fees for technical services performed in a country or consumed or used in a country. In this case, paragraph 6 would be unnecessary.

Paragraph 7 deals with fees for technical services that are excessive because of a special relationship between the payer and the beneficial owner of the fees. It is similar to Articles 11 (6) and 12 (6) of the United Nations Model Convention.

The Commentary on the new article indicates that the adoption of the new article was controversial. A significant minority of the

[80] The words "borne by" mean that the fees are deductible in computing the profits attributable to the PE or fixed base. Similar wording is used in Articles 11 (5), 12 (5) and 15 (2) (c) of the United Nations Model Convention.

members of the Committee of Experts was strongly opposed to the new article and their arguments against the inclusion of the new article in any bilateral tax treaties are included in the Commentary. In addition, the Commentary contains an alternative provision that these members argue is preferable to the new article for developing countries that wish to extend their taxing rights with respect to fees for technical services. Under this alternative, which is similar to a provision included in several of India's treaties, Article 12 applies to "fees for included services," which include fees for technical services that are closely connected to the transfer of property that produces royalties subject to Article 12.[81]

In contrast, the majority of the members of the Committee of Experts favoured a second alternative provision, which is also included in the Commentary. Under this second alternative, a country would be entitled to impose a gross-based withholding tax on all fees for services paid by residents and non-residents carrying on business in the country through a PE or fixed base, not just fees for technical services. However, a country's entitlement to tax would be restricted to services performed in the country except for related party services, which would be taxable whether performed inside or outside the country. This alternative does not rely on a definition of fees for technical services, which, as noted above, is inevitably vague and uncertain. However, it captures the types of services that are most likely to seriously erode the tax base of developing countries — namely, services performed by a person that is a resident in one contracting State to a related person that is a resident or carrying on business through a PE or fixed base in the other State.

If developing countries are successful in negotiating the inclusion of the new article in their tax treaties, such countries will be able to tax income from technical services earned by non-residents and protect their domestic tax base from erosion through payments for technical services. Although payments for technical services to non-residents by residents of a developing country or non-residents with a PE or a fixed base in the developing country will be deductible against its tax base, that country will be entitled to tax such payments. Practically, however, there are several obstacles for developing

[81] See section 4.11.3 above.

countries to overcome in order to effectively tax income from technical services derived by non-residents:

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

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

5.1 Introduction

In considering possible responses to base erosion through services performed by non-residents, developing countries should ensure that they do not adopt measures in their domestic law that contravene the provisions of the GATS[82] or the non-discrimination article in their tax treaties. In general, neither the GATS nor non-discrimination articles based on Article 24 of the United Nations Model Convention impose serious constraints on the taxation of income from services derived by non-residents. The following discussion provides an overview of the provisions of the GATS and Article 24 of the United Nations Model Convention potentially applicable to income from services.

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

5.2 The General Agreement on Trade in Services

For countries that are members of the World Trade Organization (WTO), any measures of domestic law must comply with the provisions of the GATS.[83] For purposes of the GATS, the term "services" is not defined except to include "any service in any sector" and to exclude services performed by governments.[84] However, services would appear to have a broad meaning for purposes of the GATS as illustrated by the "Services Sectoral Classification List" used during the negotiation of the GATS.[85] In general, the GATS applies to measures by member countries "affecting trade in services"[86] and "trade in services" is defined to mean the supply of a service in any of the following four modes:

- From the territory of one member country into another;
- In the territory of a member country to a consumer of any member country;
- By a service supplier of one member country through commercial presence in another member country;
- By a service supplier of one member country through natural persons in another member country.[87]

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

- Services supplied in the country;
- Services supplied outside the country but consumed in the country;

[83] See, in general, Catherine Brown, "Tax Discrimination and Trade in Services: Should the Non-discrimination Article in the OECD Model Treaty Provide the Missing Link between Tax and Trade Agreements?" in Arthur J. Cockfield, ed., *Globalization and Its Discontents: Tax Policy and International Investment* (Toronto: University of Toronto Press, 2010), at 257–279.

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

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

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

[87] There is considerable overlap among these provisions.

- Services supplied by a non-resident through a commercial presence[88] in the country, whether the services are consumed inside or outside that country; and
- Services supplied by a non-resident through individuals (for example, employees) in the country, whether the services are consumed inside or outside that country.

The GATS requires most-favoured-nation (MFN) treatment with respect to services and service suppliers of member countries.[89] MFN treatment means that services and service suppliers of one country must be treated no less favourably than services and service suppliers of any other country.

The requirement to provide MFN treatment for services and service suppliers of other countries does not appear to cause any problems for most countries with respect to the taxation of non-residents on income from services under domestic law. As long as a country taxes all non-resident service suppliers in the same manner, the country has complied with its MFN treatment obligations under the GATS. Thus, a country is entitled to impose a gross-basis withholding tax on all non-resident service providers receiving payments for technical services provided to residents of the country. However, if a country provides benefits, such as reduced rates of withholding, to the residents of countries with which it negotiates tax treaties, those benefits would violate the MFN treatment required by the GATS, except for a specific exception in the GATS. Article XIV (e) carves out from a country's MFN obligations any difference in treatment that "is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement." Thus, if a country provides a reduced rate of withholding tax on payments for technical services or other treaty benefits for

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

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

income from services, there can be no violation of the country's MFN obligations under the GATS.[90]

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

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

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

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

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

However, it is less clear whether a developing country that imposes a gross withholding tax on non-resident service suppliers providing services outside that country would be in violation of its obligations to provide national treatment under the GATS. First, Article XIV (d) applies only with respect to "direct taxes" and, in the absence of a clear domestic law meaning of the term "direct taxes," it is unclear whether a tax levied by a country on services provided abroad and generally shifted to domestic consumers constitutes an indirect tax.[91] Second, the footnote to Article XIV (d) indicates that whether taxable items are "sourced or located" in a country for purposes of its tax law is determined under that country's domestic law. Therefore, in those countries that consider income derived from services consumed or used by residents of that country or non-residents with a PE or fixed base in that country to be sourced in that country, there should be no violation of the GATS. If, however, a developing country imposes tax on fees for services performed outside the country by non-residents even where the fees are considered to be sourced in another country, under that developing country's domestic law, the tax would violate the national treatment under the GATS unless it is necessary to ensure the imposition or collection of tax in the country or to prevent tax avoidance or evasion. It is unclear what "the imposition or collection of taxes in the Member's territory" in the footnote is intended to mean. Since all of a country's taxes would appear to be imposed and collected in its territory, the reference to taxes in a country seems to

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

be meaningless. The exception for measures to prevent tax avoidance and evasion is potentially broad and a gross withholding tax imposed on fees for services performed outside a country could be justified on that basis.

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

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

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

First, Article 24 (3) prevents a contracting State from taxing a PE of an enterprise of the other contracting State less favourably than it taxes its own enterprises carrying on the same activities. This provision prevents a country from taxing non-resident service providers that are carrying on business through a PE in the country less favourably than resident service providers. Thus, if resident service providers are subject to tax on their net profits, non-resident service providers (that are resident in treaty countries) must be taxable on the same basis.[92] However, Article 24 (3) does not apply to "connected requirements" such as information reporting and enforcement measures. Therefore, payments for services to a non-resident may be subject to withholding at source even though resident service providers are not subject to withholding.[93] However, pursuant to Article 24 (3) non-resident

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

[93] Arguably, paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 65 of the Commentary on Article 24 of the OECD Model Convention, contains a statement that may

service providers must be entitled to file returns, pay tax on their net profits attributable to the PE and claim a refund to the extent that the amount withheld exceeds the tax.

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

Second, Article 24 (4) requires a contracting State to allow the deduction of interest, royalties and "other disbursements" paid by its resident enterprises to residents of the other contracting State under the same conditions as if the amounts were paid to its own residents. The term "other disbursements" is sufficiently broad to include payments by residents of a country to non-residents for services. Thus, a country cannot deal with base erosion by denying the deduction of payments to non-residents for services if it allows the deduction of such payments to residents. Some countries disallow the deduction of payments for certain services to residents of tax havens. Such a measure would not be effective if the country enters into a tax treaty with a tax haven that contains a provision similar to Article 24 (4) of the United Nations Model Convention. However, Article 24 would not prevent a country from denying a deduction of amounts paid by a resident to a non-resident where the resident does not withhold tax properly in accordance with the law.

Third, Article 24 (5) prohibits a contracting State from taxing a resident enterprise that is owned or controlled, directly or indirectly, by residents of the other contracting State differently (that is to say, through other or more burdensome taxation) from other resident enterprises. This provision applies to both taxation and connected requirements, such as information reporting and enforcement measures.

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contradict this conclusion: "permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely." However, this statement relates to the taxation of the profits of a permanent establishment and not to connected requirements.

Thus, if an enterprise resident in one contracting State establishes a company in the other State to provide services, that company must be treated in the same manner for tax purposes as other similar companies resident in that State.

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

For those countries that have a specific article in their treaties dealing with fees for technical services (such as the new Article 12 A added to the United Nations Model Convention), taxation of such fees in accordance with that Article cannot be discriminatory in violation of Article 24.[94]

6. Conclusion

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

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

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

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

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

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

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

It should be emphasized that in these three situations base erosion and profit shifting are acceptable if they result from deliberate tax policy choices made by developing countries. If a developing country decides not to tax certain income from services derived by non-residents as a deliberate tax policy decision or enters into a tax treaty with another country or countries in which it gives up its right to tax such income under domestic law, any base erosion or profit shifting that may result cannot be considered inappropriate.

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

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

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

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

Appendix

United Nations Model Convention: New Article on fees for technical services

Article 12 A

FEES FOR TECHNICAL SERVICES

1. Fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, notwithstanding the provisions of Article 14 and subject to the provisions of Articles 8, 16 and 17, fees for technical services arising in a Contracting State may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the fees is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent of the gross amount of the fees [the percentage to be established through bilateral negotiations].

3. The term “fees for technical services” as used in this Article means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made:

(a) To an employee of the person making the payment;

(b) For teaching in an educational institution or for teaching by an educational institution; or

(c) By an individual for services for the personal use of an individual.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the fees for technical services are effectively connected with:

(a) Such permanent establishment or fixed base; or
(b) Business activities referred to in (c) of paragraph 1 of Article 7.

In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. For the purposes of this Article, subject to paragraph 6, fees for technical services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the fees, whether that person is a resident of a Contracting State or not, has in the first-mentioned Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the fees was incurred, and such fees are borne by the permanent establishment or fixed base.

6. For the purposes of this Article, fees for technical services shall be deemed not to arise in a Contracting State if the payer is a resident of that State and carries on business in the other Contracting State through a permanent establishment situated in that other State, or performs independent personal services through a fixed base situated in that other State and such fees are borne by that permanent establishment or fixed base.

7. Where, by reason of a special relationship between the payer and the beneficial owner of the fees for technical services or between both of them and some other person, the amount of the fees, having regard to the services for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the fees shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Chapter III

Taxation of non-residents' capital gains

Wei Cui*

1. Introduction

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

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

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

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

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

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

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

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

[5] See section 5 below.

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

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

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

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

give guidance to developing countries — tend to be brief, or even silent, on these design issues.

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

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

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

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

2.1 The economic substance of capital gains

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

Reflecting on the types of assets that are likely to give rise to capital gains is important for two reasons. First, it helps a source country to determine for which categories of assets it is important to reserve rights in terms of taxing capital gains. This issue will be discussed further in section 4 below,[8] but it is already immediately clear that immovable property, even if defined to include mining and mineral rights, is not the only type of asset that can yield substantial gain. In fact, from all that is known, it may not even be the most important class of assets.[9] Second, it enables an appreciation of the economic nature of capital gains. Essentially, in a competitive asset market, assets experience gain because of an increased expectation of the streams of income that they will generate. In effect, between the time the owner acquires the asset and the time he or she sells it, the market (that is to say, potential buyers) has come to expect the asset to generate more future income in present value terms. This increased expectation could be due to greater certainty in the future flow of income, an acceleration of the timing of the return, an increase in the absolute value of the future return or its value relative to other assets available for investment. Indeed, gain could arise due to the lack of competition

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

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

as well: an initial buyer with special access or bargaining power may be able to obtain an asset cheaply and "flip" it to other buyers.

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

Capital gains that arise in the ways just described can be contrasted with some other forms of gains. One kind of nominal capital gain results from inflation: in an inflationary context, even depreciating equipment can sell for a greater nominal amount of cash than the purchase price. Another kind of gain is income that has already been earned on the asset but that has been added to or reinvested in (capitalized into) the original asset. For example, if a corporation has retained earnings and does not distribute such earnings to shareholders, the price of its shares will go up simply because the shareholders have deferred the realization of their income, not because the corporation's business has better prospects than before. If a shareholder sells his or her shares, the gain realized may simply be the income that he or she could have realized as dividend if the corporation had made a distribution.[10]

In general, the design of an income tax may need to provide special treatment for these latter forms of nominal capital gain. In the

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

case of inflation, its presence should ideally be taken into account in determining whether the taxpayer has any taxable gain. In the case of accrued earnings realized through a sale of the asset, it may be important to treat the gain from the sale similarly to other ways of realizing already-accrued earnings (for example, dividends).[11] However, it is crucial to recognize that capital gains often come about not because income has already accrued, but because of a changed expectation of what income will accrue.

This conceptual discussion has a direct bearing on a common scepticism about the wisdom of taxing foreigners on capital gains. Because transfers of domestic assets by foreigners may be difficult to detect, and a tax on such transfers may be difficult to enforce, it is sometimes asked why the source country should attempt to do so. The asset itself is still located in the source country, and most of the income it generates — in the form of rent, dividends and other periodic payments — can be more easily subjected to tax (for instance through withholding). What does the source country lose by not taxing the gains non-residents derive by transferring ownership of the asset? Why tax upon transfer of ownership of an asset, and not just when income is received by the owner?[12]

There is a resolution to this scepticism. As already explained, generally, the value of an asset is determined by the stream of income it is expected to generate. If such income is going to be taxed at known rates, then the value of the asset should also reflect the tax. For example, if an asset generates $10 of income in each period, and a 20 per cent tax is imposed on the $10 of income no matter who owns it, then the after-tax income generated by the asset will be $8 per period. The value of the asset to a private owner will then be determined by the $8 return, and

[11] In the bond example in note 10, if the interest rate stays the same, the increases in the value of the bond in year one and year two should both be treated as interest.

[12] Notably, the recent IMF Spillovers Report expresses this scepticism: "Conceptually, there are arguments as to whether or not it is appropriate to tax [capital] gains at all: they presumably reflect accumulated and expected earnings, so it may not be necessary or appropriate to tax them if those earnings have been, or will be, adequately taxed in other ways." See IMF Spillovers Report, supra note 7, at 29.

not the $10 return.[13] If, despite the lower price, buyers are willing to pay in view of the expected tax on income, then the seller still realizes a gain and the seller's ownership of the asset has generated a form of income for him or her that is not captured by the tax imposed on future income. Indeed, in this example, since the burden (economic incidence) of the tax on dividends has already shifted onto the seller by being capitalized into asset value, it is clear that only a tax on capital gains can reach the additional income realized by the seller in the form of gain. Thus insofar as gains arise as a result of changes in expectations, there is a unique role for the tax on capital gains — one that cannot be played by the tax on investment income such as dividends.[14]

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

In light of the preceding arguments that capital gains taxation is not redundant, and, moreover, that capital gains may arise not only in connection with immovable property, it is striking how little source countries are expected to tax non-residents on capital gains under prevailing international norms. Most importantly, many developed countries do not tax capital gains realized by non-residents on the disposition of shares of domestic (that is to say, resident) companies, with the exception of companies that hold domestic real estate. There are a number of different reasons for the adoption of this policy, most of which are not necessarily relevant or persuasive in the context of developing countries. For example, developed countries generally prefer residence-based taxation, vis-à-vis themselves[15] and develop-

[13] This reflects the idea that a tax on the income generated by an asset may be "capitalized" into the value of the asset. Economists have offered many empirical confirmations of the capitalization of different types of taxes into the value of different types of assets, for example, real estate and company shares.

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

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

ing countries. In the European Union, there has even been a coordinated move towards residence-based taxation, removing the tax on dividends, interest and royalties derived from related companies.[16] Independently, there has also been a desire to align the treatment of shareholder capital gains with the policy of exempting dividends paid both to residents and non-residents.[17]

For developing countries that are capital importers and that have decided to maintain the classic corporate income tax, the above reasons generally have been considered — and frequently found to be outweighed by other considerations. Two practices of developed countries are, however, relevant. First, some of them have historically eschewed capital gains taxation of non-residents because of its perceived administrative burden. The United States of America, for example, originally abandoned taxing non-residents on capital gains realized on the sale of United States securities in 1936 for administrative reasons.[18] Canada narrowed its range of capital gains taxation for foreigners recently, in 2010, partly for the same reason.[19] This shows that enforcing the tax may be challenging for developed and developing countries alike. Second, even in countries where the alienation of shares of domestic companies by non-residents generally goes

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

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

[18] See Stanford G. Ross, "United States Taxation of Aliens and Foreign Corporations: the Foreign Investors Tax Act of 1966 and Related Developments," (1967) Vol. 22, *Tax Law Review*, 279, 293 – 295.

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

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

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

One possible explanation for this inconsistency is that the administrative cost of taxing share transfers should be equal between a company that holds domestic real estate and a company that holds a domestic operating business. The need to tax share transfers to prevent avoidance of a tax on direct asset transfers also arises equally for immovable property and for assets of operating businesses.[20] Finally,

[20]This rationale extends to the disposition of interest in other entities that are treated as legal persons. See David A. Weisbach, "The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corpo-

as discussed above, there is no clear difference between immovable property and business assets in their ability to generate capital gains. What is different is that foreign ownership of domestic immovable property has traditionally been politically more sensitive than foreign ownership of other domestic assets. It may be this political significance — rather than anything to do with revenue potential, the ease of tax administration or the need to rationalize tax systems — that has elevated immovable property to the status of an "especially taxable" asset class in the international tax arena. This is not to say that foreign ownership of domestic real estate is not politically sensitive in developing countries. Indeed, it may be so sensitive that it is prohibited outright — in which case the issue of taxing non-residents on capital gains from selling domestic real estate also becomes irrelevant.

Although this source of political legitimacy for the taxation of non-residents on capital gains may still possess political appeal in various countries, tax systems in the twenty-first century typically rely on a wider range of justifications, having to do with budgetary needs, efficiency, fairness and administrative requirements. These justifications may well point to the taxation of a wider range of capital gains realized by non-residents.

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

3.1 Gross-income versus net-income approaches

Under their domestic laws, countries may tax income earned from sources within them by non-residents on either a net- or a gross-income basis. Under net-income-based taxation, non-resident taxpayers are treated in many ways like residents: they file income tax returns on a periodic basis; report income from different sources and of different types, as well as expenses that are associated with the various items of income and allowable as deductions; and are subject to tax rates generally applicable to domestic individuals or corporations. Under

rate Tax," (2007) Vol. 60, *Tax Law Review*, at 215; Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," (2014) Vol. 33, *Virginia Tax Review*, 649.

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

The decision to tax a particular type of income either on a gross- or net-income basis could depend on such administrative considerations alone. For example, if a non-resident has a sufficient physical presence in the source country that periodic contact with the country's tax administration for purposes of filing a return and cooperating with audits is possible, then net-income taxation may be regarded as justified. Such a physical presence might be an office — possibly one that does not operate any business or at least not the business that generates the relevant taxable income — or a regular agent (even an agent that is independent).[21] However, for at least the past half century, it has been more common to tax on a net-income basis only business income attributable to a physical presence that is akin to a PE, whereas, short of a PE, income derived by a non-resident is either not taxed (if it is business income) or taxed on a gross-income basis (if it consists of particular types of investment income). Moreover, net-income taxation has become associated with active business income and gross-income taxation with passive investment income.

Some of these long-standing conventions have recently come under critical scrutiny: questions have been raised especially regarding whether the concept of PE should still undergird the taxation of

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

business profits.[22] In any case, capital gains realized by non-residents have always fitted uneasily within the above conventions. On the one hand, capital gains are often a form of passive investment income. On the other hand, the computation of the amount of gain will almost always require the taxpayer to submit information about the original cost of the investment and not just the amount of the gross proceeds. In contrast to dividends, interest and royalties, it is difficult to collect tax on capital gains through final withholding. But once the non-resident taxpayer is already required to file a tax return (because it has crossed the administrative threshold), it can be fairly asked whether net-income-based taxation may be more sensible. This may mean allowing offsetting capital losses from the country against the capital gain; it may also mean permitting other types of expenses to be deducted. At the same time, it may require a higher tax rate to be applied.

Countries differ widely in this regard in their approaches to taxing non-residents on capital gains. China and Japan, for example, require the reporting of a taxable capital gain by a non-resident, but still apply a reduced rate to such capital gains and do not allow offsetting losses. This can be viewed as being at one end of the spectrum. The United States, by contrast, treats capital gains on the disposition of certain real estate-related (FIRPTA[23]) property realized by foreigners as though they are simply business income, and allows other losses realized in connection with a United States trade or business of the foreigner to be offset against such capital gain. This can be viewed as being on the opposite end of the spectrum from China and Japan.[24]

There are important arguments in favour of allowing foreigners to reduce their taxable capital gains by their capital losses from the source country. To begin with, recognizing gains but ignoring losses may discourage investors from taking risks. Moreover, taking losses into account allows a more accurate measurement of the income of the non-resident that has been realized in the country, and imparts

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

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

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

greater legitimacy to taxing capital gains.[25] However, allowing loss offsets does reduce the revenue potential from taxing non-residents on capital gains. Moreover, because the tax on capital gains is difficult to enforce, non-residents who do not have offsetting losses might demonstrate less compliance than those who do.[26]

Whether a gross- or net-income approach is taken also has consequences for the computation of the amount of capital gains on each transaction. For example, should fees paid to lawyers, accountants and investment bankers by the seller be allowed to reduce the amount recognized as the proceeds from sale, and should such fees paid by the buyer be included in the cost of their investment that can be deducted in the future? If the law treats capital gains as a form of passive income, just like dividends and interest, and applies a reduced tax rate to such income earned by foreigners, then the appropriate answer is no: any expense similar to expenses that cannot be deducted from dividends or interests should also not be deductible. This means that from the perspectives of the source country and the residence country, the amount of the capital gains realized on a sale can be very different.[27] From the residence country's perspective, the amount of capital gains may depend on all kinds of expenses that should either be capitalized into the cost of the disposed asset or deducted from the income realized (thereby reducing the amount of capital gain), as well as on any depreciation or other allowance that has been given in respect of the investment (which may increase the amount of capital

[25] Under the United Kingdom of Great Britain and Northern Ireland's recently introduced regime of taxing non-residents on the disposal of residential properties in the United Kingdom, allowable losses may be taken into account, and for non-residents who need to file annual tax returns, they must remit tax payment only by 31 January of the following year instead of within 30 days after the disposal. See Trevor Johnson, "U.K. Tax Update: Nonresidents' Capital Gains—The Pendulum Swings, but Too Far?" (2015) Vol. 78, *Tax Notes International*, 747.

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

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

gains or trigger the recapture of income). From the source country's perspective, unless the capital gains are attributable to a PE, none of the expenses and allowances may be taken into account. This need not in itself cause alarm — it should be remembered that the difference originates in the source country treating the capital gains as a form of passive investment income, subject to a simplified method of collection.[28]

3.2 Special issues in taxing transfer of interests in entities

Taxing share sales creates the possibility of excessive taxation of the appreciation experienced by the assets held by the target company (whether immovable properties, operating businesses or some other type of assets): the appreciation may be taxed at both the corporate and the shareholder levels. In fact, the problem arises even for business entities (for example, partnerships) that are not themselves subject to tax: the sale of the assets of a partnership and the sale of the partnership itself are both ways of realizing a gain from the appreciation of partnership assets. Both need to be subject to tax to prevent taxpayer manipulation.[29] However, this means that the same economic gain might be taxed more than once. If such excessive taxation is to be avoided, then potentially complex measures — involving conforming the "inside" and "outside" tax cost base (or "basis") of assets and shares — may have to be applied to ensure that a gain that has been taxed at the shareholder level is not taxed again at the entity level (and vice versa).

Such measures are adopted in domestic contexts by some sophisticated tax systems (such as those implemented in Australia and the United States) within regimes for group consolidation or

[28] See paragraph 4 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraph 12 of the Commentary on Article 13 of the OECD Model Convention, where it is stated that "as a rule, capital gains are calculated by deducting the cost from the selling price. To arrive at cost all expenses incidental to the purchase and all expenditure for improvements are added to the purchase price." However, the same paragraph acknowledges that "the Article does not specify how to compute a capital gain, this being left to the domestic law applicable."

[29] See David A. Weisbach, "The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax," supra note 20.

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

One approach suggested later in the present chapter (see section 6) in connection with the taxation of indirect share transfers is to treat such transfers as dispositions of underlying assets. That approach would go some way towards reducing the risk of excessive taxation, as it would adopt a net-income-based approach to taxing non-residents on capital gains.

3.3 Should publicly traded shares be exempt?

Enormous gains may be realized on stock markets, raising the question of whether such gains realized by foreigners on domestic stock exchanges, for example, under "qualified foreign institutional investor" regimes operated in countries like China and India, should be taxed. It used to be said that because trading on stock exchanges tends to have very high volume and frequency, it would be impossible to keep track of the gains and losses realized by investors on exchange trades. But with advancing technology and increasing uses of such technology by financial intermediaries, tracking information on gains or losses realized by investors (including foreign investors) may become less difficult.[30] Moreover, it is possible to require such financial intermediaries, and not the sellers, to act as withholding agents. Therefore, the decision whether to tax stock exchange gains may hinge more on policies regarding attracting foreign investment than on administrability.

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

In addition, trading gains are more likely to reflect risk-taking rather than economic rent, and the case for allowing offsetting losses is thus rather strong.

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

For foreign listed companies, there is an important argument against source-country taxation of the transfers of their publicly traded shares, even if the companies hold substantial assets in the country. The argument is that listed companies are unlikely to be formed for tax avoidance purposes, but will almost invariably possess economic substance. The distinction between publicly traded and non-publicly traded companies is thus obviously relevant to the policy of taxing share sales, when that policy is motivated by anti-avoidance considerations. But this implies a criticism of the United Nations Model Convention, which, like the OECD Model Convention, does not distinguish between listed and non-listed companies among companies that hold substantial immovable property in the source country:[31] the source country is allowed to tax the capital gains realized on the sale of all such companies in accordance with Article 13 (4).[32]

3.4 Whether to tax foreign exchange gains

Measurements of capital gains or losses are sometimes affected by foreign exchange gains or losses.[33] For example, local assets purchased

[31] Article 13 (4) of the United Nations Model Convention. See further discussion in section 5 below.

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

[33] See paragraph 4 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraph 11 of the Commentary on

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

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

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

Administering a tax on capital gains realized by non-residents faces three fundamental challenges. First, if the sale and purchase of the asset occur between two non-residents, the execution of the transaction and the flow of funds may all take place outside the source

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

country, making such transactions difficult to detect.[34] Second, even if a transaction is detected, if the non-resident seller refuses to pay the tax and becomes delinquent, unless such a seller has other assets in the source country, it could be very difficult to complete tax collection. Third — and this is a point that has received little discussion in the existing literature — it may be difficult to organize tax administration around taxing capital gains. The non-resident taxpayers typically have little or no interaction with the tax authority of the source country. The timing and volume of transactions may be unpredictable, as may be the revenue intake from levying the tax. Such irregularity may be felt to be especially severe if tax administration in the source country is decentralized.

However, none of these challenges need be insuperable.

4.1 Detection

4.1.1 Reporting by transacting and third parties

Generally, there are three legal mechanisms that enable tax authorities to detect offshore (direct or indirect[35]) transfers of domestic assets or shares: self-reporting by the transferor, reporting by the transferee (whether or not accompanied by withholding) and reporting by third parties.

As regards transferor self-reporting, the source country may impose penalties on non-reporting transferors to foster compliance. However, if the chances of detection of taxable transactions are very low, the expected cost of a penalty for non-reporting may also be too low to be effective. If most taxpayers do not comply and the tax authority fails to detect most instances of non-compliance, imposing a heavy penalty on the few detected cases will also seem unfair. It thus seems surprising that, at least until recently, many countries have solely or

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

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

largely relied on seller reporting for taxing capital gains.[36] In response to a recent survey conducted by the United Nations Committee of Experts on International Cooperation in Tax Matters, a number of countries, both developed and developing, confirmed the relevant challenges for detection of taxable transfers.[37] For this reason, the Australian government has announced that "to further improve the integrity of the foreign residents' regime in relation to the disposal of Australian real property interests … a 10 per cent non-final withholding tax [will] apply to the disposal by foreign residents of certain taxable Australian property from 1 July 2016." [38]

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

[36] As recently as 2015, when the United Kingdom amended the Finance Act to subject non-residents to tax on the disposal of residential properties in the United Kingdom, the Government eschewed a proposed system of deduction at source whereby the solicitor for the seller would deduct the amount of tax. Instead, the amended Finance Act only required the transferor individual to file a non-resident capital gains tax return within 30 days of the completion of the disposal. See Trevor Johnson, "U.K. Tax Update: Nonresidents' Capital Gains — The Pendulum Swings, but Too Far?" supra note 25.

[37] See Committee of Experts Paper, supra note 7, at 36-39. The countries confirming difficulties with detection include Australia, Azerbaijan, China, Japan, Malaysia, Mexico, Norway, Russia, South Africa and Zambia. India and the United States, by contrast, did not report such problems because they require transferee withholding.

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

government still has to make all the efforts to collect the tax.[39]

Besides explicit sanctions, market dynamics may also create incentives to comply with transferee reporting requirements.[40] For example, when taxing capital gain, the source country generally needs to keep track of the tax cost or basis of the assets transferred. If the capital gains realized on a transfer have been subject to tax, the cost basis of the shares transferred should be adjusted ("stepped up" in the case of gain) for purposes of future source-country taxation. Conversely, one can imagine a rule that provides that if a transfer has not been taxed (other than in a case where the capital gains on a transfer are affirmatively exempted from tax, for example, under an applicable treaty), then the basis of the transferred shares would, for the purpose of source-country taxation, remain the same. That is to say, the transferee would not obtain a basis in the shares it acquires equal to the consideration it pays unless the acquisition has been taxed.

This is different from the normal use of the concept of cost basis: the cost basis of an asset is normally determined in respect of a particular owner of the asset. However, the notion can be modified so as to keep track of the relationship of the asset to the taxing authority: which portion of the value of the asset has been subject to tax by the source country (in whomever's hands)? With such a rule in place, the failure to report a taxable transfer would result in the risk that the transferee, in the future when it acts as a transferor, would be taxed on gain that accrued to and was realized by previous owners. Of course, for this to have an incentive effect, there must be an expectation that the future transfer itself will be reported or detected. Another complication is that both the tax authority and the non-resident taxpayer may also have difficulty determining what the original basis was in

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

[40] See Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 20.

the hands of previous owners.[41] Nonetheless, the risk of the conversion of a seller tax liability into a potential tax liability of the buyer (as a future seller) may well be unacceptable to many buyers. They would then either seek indemnity from the seller, or require, as a matter of contract, the seller to report the sale to the tax authorities and, in addition, to pay tax if required by law.[42]

With regard to third-party reporting, for certain types of property, such as immovable property, shares in companies, mineral and other licences, and sometimes even ships and aircraft (because of regulatory requirements), the country in which they are located may operate ownership registration systems. The transfers of ownership will be recorded in such systems and tax authorities may require those who maintain the systems to report the transfers.[43] In addition, third parties in the transfers of financial claims, that is to say, lessees, borrowers and companies issuing shares, often receive notice of the transfers under either legal or contractual requirements. It may be possible to enlist such parties in reporting taxable transfers, even if they are not party to the transfer.

However, such a requirement could have limits if third-party contractual rights to notice are not always required in the market.[44] Moreover, should both the purchaser/transferee and third parties be required (in the sense of having an obligation backed up by penalties)

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

[42] Dynamics in the tax service market may also contribute to compliance. For further discussion, see Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 20, at 680-681, 690-691 and 694. Because the penalties for non-reporting under China's policy of taxing indirect transfers of domestic company shares are very low, most compliance with that policy that has taken place in China since 2009 may have resulted from buyer and adviser monitoring.

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

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

to report a transaction? Third-party reporting requirements often will call upon market participants to share information which they would not otherwise share.[45] Finally, third-party reporting will not by itself solve the collection problem.[46] Therefore, where it is possible to rely on transferee/buyer reporting, third-party reporting should arguably not be used, unless such reporting (for example, to a regulatory authority) would take place in any case.

4.1.2 Exchange of information among tax authorities

Some recent discussions of the detection problem refer optimistically to the exchange of information among tax authorities.[47] It seems exceedingly unlikely, however, that the seller's resident country will have more information about an isolated transaction than the source country where the transferred asset is located.

The question can also be raised whether the new country-by-country (CbC) reporting regime promoted by the OECD project on Base Erosion and Profit Shifting (BEPS) is relevant to the detection of taxable transfers among non-residents. The OECD Final Report on BEPS Action 13 provides a template for multinational enterprises (MNEs) to report annually, and for each tax jurisdiction in which they do business, supplies information to help assess "high-level transfer pricing risks and other base erosion and profit shifting related risks."[48]

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

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

[47] See Committee of Experts Paper, supra note 7, at 36-39; IMF Spillovers Report, supra note 7, at 71; and Lee Burns, Honoré Le Leuch and Emil Sunley, "Transfer of an Interest in a Mining or Petroleum Right," in Philip Daniel and others, eds., *Resources without Borders* (Washington: International Monetary Fund, 2014), section 4.1.

[48] See OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—Final Report* (Paris: OECD, 2015), available at http://dx.doi.org/10.1787/9789264241480-en. As at October 2016, 49 countries had signed the Multilateral Competent Authority Agreement (MCAA) for the automatic exchange of CbC reports.

Under the CbC reporting regime, each MNE group required to file CbC reports needs to provide a "master file" depicting (among other things) the MNE group's organizational structure as well as its intercompany financial activities. In addition, "local files" for each country in which the MNE does business would furnish "information relevant to the transfer pricing analysis related to transactions taking place between a local country affiliate and associated enterprises in different countries and which are material in the context of the local country's tax system." [49] While the primary aim of the CbC reports is to expose risks of profit shifting through whatever intercompany transactions there are within an MNE group, changes in corporate structures and intragroup financial claims may indirectly reveal taxable asset transfers (including indirect transfers, discussed in section 6.2 below).

However, there are various reasons to believe that the impact of CbC reports on the practice of taxing capital gains realized by non-residents will be of secondary significance (at best). First, only MNEs with an annual consolidated group revenue equal or exceeding €750 million or equivalent are required to file CbC reports. Source countries may directly receive "master files" and "local files" only from MNEs that have consolidated subsidiaries in their countries. It is far from clear that this framework captures a population of taxpayers who routinely realize the kinds of capital gains that source countries may want to tax. For instance, although investment funds are not automatically exempt from CbC reporting requirements, how to apply the annual revenue threshold and the accounting consolidation requirement to investment funds remains unclear.[50] Moreover, the CbC reports that countries may exchange under the Multilateral Competent Authority Agreement contain only aggregate information and would not be informative with respect to particular transactions, whereas capital gain taxation crucially depends on the identification of particular transactions. Finally, information on corporate structures (including offshore holding structures) is the type of information that many countries' tax administrations are already able to obtain from

[49] Ibid., paragraph 22.

[50] See OECD, *Guidance on the Implementation of Country-by-Country Reporting: BEPS Action 13* (Paris: OECD, 2016). Investee entities may generally not be included in the consolidated group of a fund if ordinary financial accounting practice does not require such inclusion.

taxpayers directly, either pursuant to domestic legislation or in administrative practice, and it is not clear that the leverage provided by the CbC reporting regime is really needed.

4.2 Collection

From a collection and revenue protection perspective, transferee withholding is clearly a more powerful tool than transferee reporting. Canada, India and the United States each require the transferee in a taxable direct (and, in the case of Canada and India, indirect) transfer to withhold from gross proceeds paid to the transferor, regardless of whether the transferee is domestic or foreign.[51] Each also makes the amount required to be withheld the personal tax liability of the transferee if it fails to withhold. Note that when the transferee is made personally liable for failing to withhold a tax that was in the first instance imposed on the transferor, the implicit penalty of the no-basis-step-up treatment (which is possible even under transferor reporting) has merely been made explicit.

In countries with weak legal norms, a view may be held that the failure of the transferor to pay tax on a transfer creates a de facto personal liability for the transferee anyway, as the tax authority could always "go after" the asset located in the country and therefore expropriate its value from the present owner of the asset. Unless the transferee (new owner) is legally made liable for the tax that the transferor fails to pay, however, this kind of expropriation is against the rule of law, and is both unnecessary and unproductive for tax administration. Moreover, even when transferees are made liable for failures to withhold, it is important to observe legal distinctions. For example, if it is the tax on the capital gains realized on the alienation of

[51] The United States rule, Internal Revenue Code section 1445, requires withholding of 10 per cent from gross proceeds. IRC § 1445 (2013); the Canadian rule, Income Tax Act section 116, requires a significantly higher (25 per cent) rate of withholding, but allows the transferor to prepay or post collateral with the government based on the amount of capital gains. See Income Tax Act, R.S.C. 1985, c. 1. The Indian rule, Section 195 (1) of the Income Tax Act, 1961, requires withholding simply of the amount of the tax owed, without addressing the issue of how the transferee would know how much tax is owed. See Income Tax Act (195/1961) (India).

a domestic company's shares that is at stake, it makes little sense to demand payment from the domestic company itself. To do so would erase the distinction between shareholder and corporate liabilities that lies at the core of an indefinite range of transactions (for example, with creditors, customers and employees) that the company may be engaged in. This would clearly be counterproductive.[52]

Several limitations of the withholding approach should be noted, however. First, if the transferee is a non-resident, the imposition of a withholding obligation alone does not necessarily enhance the transferee's likelihood of compliance. And delinquent non-resident transferees create collection problems similar to those encountered in respect of delinquent non-resident transferors.[53] Second, withholding on capital gains also cannot generally be expected to be accurate with respect to the ultimate tax liability and therefore is likely to trigger either an application for refund or examination by a tax authority. The overall compliance burden for taxing capital gains, therefore, will be increased by withholding. It also bears mentioning that any obligation to withhold could only sensibly be formulated with respect to the gross amount paid and not the capital gains realized by the payee, because it is only infrequently that a seller would tell a buyer how much profit the seller has made.[54]

4.3 Voluntary compliance

In other areas of tax administration, a key to success in collection, beyond adequate sanctions and effective enforcement powers, is the inducement of voluntary compliance among taxpayers. It would be surprising if this were not the case in levying tax on non-residents.

[52] For these reasons, several suggestions regarding collection techniques made in the IMF Spillovers Report (for instance, treating the target resident company as the agent of the non-resident, so that it will be liable if the tax is not paid by the non-resident, or deeming the resident company to have made the transfer, so that it is liable for the tax) should be viewed with caution. See IMF Spillovers Report, supra note 7.

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

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

However, there has been little government or scholarly research on voluntary compliance on the part of non-residents. For example, while, intuitively, a lower rate of tax should produce greater voluntary compliance, it is not known how low the tax rate would need to be to produce sufficient compliance. Another suggestion is to increase the contact of non-residents with the tax authority and with other compliant taxpayers. For example, allowing losses and expenses to be taken into account in computing taxable gain may make the contact of non-residents with the source country less "one-shot" in character. Finally, it may be useful to focus on improving compliance among multinationals and foreign investors that deal with the source country on a regular basis. A culture of compliance among such taxpayers (and their advisers) may be an important step towards creating a culture of compliance among non-resident taxpayers in general.

4.4 Organization of tax administration

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

In the United States, for example, an Internal Revenue Service (IRS) publication from 2010 states that a study of the collection of FIRPTA tax was only "planned" and data was "not yet available."[55] Moreover, the "planned" study was based only on returns filed by

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

transferees who had withheld tax from the gross proceeds of sales of United States real estate interest (including shares of United States companies that hold United States real estate) by foreigners.[56] No data seems to be separately available to the IRS on transferor self-reporting of sale of United States real property interests, and there is no sign of any data on audits (if any) of transferors or transferees. In fact, the United States did not attempt to measure non-resident taxpayer compliance until 2008, and even the new attempt to do so is designed only for individual taxpayers.[57]

For developing countries that aim to preserve their tax base consisting of income belonging to non-residents to a greater extent than OECD countries, effective tax administration strategies may therefore have to be developed indigenously. One possible approach is to centralize tax administration in this area so as to allow specialization and economy of scale: the number of taxable transactions as well the revenue outcome will diminish if averaged over too many tax administrators, whereas a small number of specialized tax administrators may be able to deal with a relatively large number of taxable transactions because of the one-shot nature of the taxpayers involved.[58]

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

[57] See United States Internal Revenue Service, "The Tax Gap and International Taxpayers," (2008), available at http://www.irs.gov/Businesses/The-Tax-Gap-and-International-Taxpayers. See also, United States Government Accountability Office, "IRS May Be Able to Improve Compliance for Non-resident Aliens and Updating Requirements Could Reduce Their Compliance Burden," GAO-10-429 (2010), available at http://gao.gov/products/GAO-10-429. The IRS has not developed estimates for the extent of non-resident alien tax non-compliance.

[58] However, in China, where enforcement of the tax on capital gains of non-residents realized on transfers of domestic company shares (including indirect transfers, as discussed in section 6 below) has intensified in recent years, a decentralized approach seems to have emerged: tax administration staff in local offices take initiatives to find offshore share transfers (which is not hard to do if listed companies are involved and material transactions

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

Article 13 of the United Nations Model Convention allocates non-exclusive taxing rights to the source country in respect of gains on immovable property (paragraph 1), business assets forming part of a PE (paragraph 2), ownership interest in entities that derive value principally from immovable property (paragraph 4) and shares that represent substantial participation in a resident company (paragraph 5). It assigns exclusive taxing rights to the place of effective management in respect of gains on ships or aircraft operated in international traffic and boats engaged in inland waterways transport (paragraph 3).[59] It then provides that the gain from the alienation of other property not specifically enumerated shall be taxable only in the residence State of the alienator (paragraph 6). The threshold decisions of whether capital gains should be taxed and, if so, of how they are to be taxed, are left to the domestic law of each contracting State.[60]

The United Nations Commentary on Article 13 repeatedly refers to the "correspondence" between the taxation of gain and the taxation of income, and uses this correspondence to explain the purpose

are required to be disclosed by stock exchanges), and sometimes collect revenue that is sizeable for that particular office, even if not for the country's tax administration as a whole. There is no systematic study of this practice, but a sense of it can be gleaned from practitioners' reports. See, for example, Jinji Wei, "Chinese Tax Implications of Indirect Share Transfers," (2014) Vol. 23, No. 7 *Tax Management Transfer Pricing Report*.

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

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

of paragraphs 1 and 2 of the Article.[61] Nonetheless, in the restrictions it imposes on source-country taxing rights, the United Nations Model Convention does not generally adhere to this correspondence: instead of being a consistent implementation of the principle of similar taxation of income and gain (given their economic equivalence), Article 13 of the United Nations Model Convention is very much a compromise. The most salient symptom of this compromise is the structure of the Article. While the language of the United Nations Model Convention, following Article 13 of the OECD Model Convention, proceeds to delineate source-country taxing rights for specific types of property, and then to provide for exclusive resident-country taxation for properties not specifically enumerated, the United Nations Commentary on Article 13 acknowledges that "[most] members from developing countries advocated the right of the source country to levy a tax in situations in which the OECD reserves that right to the country of residence."[62] It therefore mentions an alternative provision allowing source-country taxation of gains "from the alienation of any property other than those gains mentioned in paragraphs 1, 2, 3 and 4."[63] This alternative language, adopted with modification in many actual treaties, leads to some obvious interpretive tensions surrounding the Article, as discussed below.

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

5.1 The definition of "immovable property"

"Immovable property" for purposes of Article 13 is defined by reference to Article 6, which, in the United Nations Model Convention, has "the meaning which it has under the law of the Contracting State in which the property in question is situated." Article 6 (2) of the United

[61] See section 3 above.

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

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

Nations Model Convention explicitly states that the term "immovable property" "shall in any case include … rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources." This broad formulation is likely to capture the rich variety of "bundle[s] of infinitely divisible rights" [64] that may be associated with immovable property and transferred at a gain.[65]

5.2 Movable property part of a permanent establishment

Article 13 (2) gives the source country taxing rights on gains from the alienation of movable property forming part of the business property of a PE (or pertaining to a fixed base available for the purpose of performing independent personal services). The United Nations Commentary explicitly notes that "the term 'movable property' means all property other than immovable property … . It includes also incorporeal property, such as goodwill, licenses, etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment [or fixed base] is situated." [66] This is an important observation, because tangible movable properties — such as machines and equipment — tend to experience depreciation and thus have limited

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

[65] Nonetheless, Professor Richard Krever has argued that "there are remarkably wide variances in the different definitions" used in different jurisdictions, and that "civil law jurisdictions with limited [natural] resources" tend to adopt the narrowest definitions. He warns that "treaties often fail to operate as broadly as domestic legislation, and domestic legislation itself may struggle to keep up with new and innovative forms of de facto property owners, including the use of rights, options, or derivatives." Therefore, he suggests that "countries seeking to retain domestic taxing rights through Article 13 must ensure, first, that domestic law is sufficiently robust to capture all gains related to real property realized by resident and non-resident taxpayers and, second, that Article 13 in their tax treaties is equally broad." Ibid., at 223 – 224.

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

potential for capital gain. It is instead the intangible components of a business, including contracts with customers, employment contracts with skilled personnel, brand names, know-how (whether patented or not) and so forth, that give rise to capital gains on the sale of a business.

This broad definition of movable property under Article 13 (2) raises a crucial interpretive issue: is movable property that does not form part of the business property of a PE of a non-resident thereby carved out from the scope of taxation under Article 13? Consider the vulture fund that has sold a portfolio of non-performing loans at a handsome gain. The loans may be viewed as movable property for the purpose of the fund business, or depending on the fund's structure, they may be held as investment assets but nonetheless are "movable property" in the sense defined above. The fund may have no PE in the country where the business borrowers are located. Does Article 13 (2) imply that the vulture fund's gain is not taxable in the country of the debtors? [67] Since whatever is not immovable property will be regarded movable property, unless there is a subsequent paragraph in Article 13 that prescribes a specific rule (for example, for ships, aircraft and shares), one might infer that capital gains taxation (without PE) is precluded by paragraph 2. If under the same treaty, interest on loans (and rent or royalty from leases, licences and other agreements covered by the "Royalties" article) remain taxable in the source country, a sharp inconsistency between the treatment of income and of gain from the same asset would result.

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

5.3 Entities holding immovable property directly or indirectly

Article 13 (4) of the United Nations Model Convention provides taxing rights over "gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the

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

property of which consists directly or indirectly principally of immovable property situated in a Contracting State" to that State.[68] The United Nations Commentary notes that the provision:

> is designed to prevent the avoidance of taxes on the gains from the sale of immovable property. Since it is often relatively easy to avoid taxes on such gains through the incorporation of a company to hold such property, it is necessary to tax the sale of shares in such a company .... In order to achieve its objective, paragraph 4 would have to apply regardless of whether the company is a resident of the Contracting State in which the immovable property is situated or a resident of another State .... In order to fulfil its purpose, paragraph 4 must apply whether the company, partnership, trust or estate owns the immovable property directly or indirectly, such as, through one or more interposed entities.[69]

However, it does not appear that countries have generally enacted the anti-avoidance measures permitted by Article 13 (4). For example, as discussed in section 6.2 below, surprisingly few countries—in the OECD[70] or in the developing world—have enacted domestic

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

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

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

law for taxing transfers of foreign companies (indirect transfers). The mere language of Article 13 (4), therefore, sheds little light on the practice of anti-avoidance legislation.

Finally, Article 13 (4) of the United Nations Model Convention carves out from source-country capital gains taxation transfers of interests in entities whose property consists directly or indirectly principally of immovable property used by them in their business activities (but not an immovable property management company, partnership, trust or estate). The reason for this carve-out, presumably, is that entities that use immovable property in their business activities are not formed for purposes of avoiding the tax on the sale of immovable property. However, relatively few treaties involving developing countries have adopted this carve-out; nor has Article 13 of the OECD Model Convention adopted a similar one. An obvious reason is that there are important types of companies which derive their value predominantly from real property, for example, hotel and resort operators, operators of shopping malls and even of restaurants and cinemas, and, of course, companies that extract natural resources. The appreciation in the value of the shares of such companies is likely to reflect the appreciation of the underlying real property, and it is not at all obvious why the source country should give up taxing rights over such shares. This carve-out can also be regarded as a special case in the inconsistent treatment between PEs and subsidiaries of non-residents, mentioned in section 2.2 above and further discussed in the next section.

5.4 Substantial participation in a company

The Commentary on Article 13 of the United Nations Model Convention notes that "some countries hold the view that a Contracting State should be able to tax a gain on the alienation of shares of a company resident in that State, whether the alienation occurs within or outside that State." It then claims that "for administrative reasons the right to tax should be limited to the alienation of shares of a company in the capital of which the alienator at any time during the 12-month period preceding the alienation, held, directly or indirectly, a substantial participation." [71] This position is reflected in Article 13 (5) of the United

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

Nations Model Convention, where the percentage deemed to constitute substantial participation is to be established through bilateral negotiations. Article 13 (5) allows that the substantial holding (which leads to taxability) may be "indirect," partly as an anti-avoidance device.[72]

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

The Commentary on the United Nations Model Convention also points out arguments against taxing listed shares (that it is "costly," and that "developing countries may find it economically rewarding to boost their capital markets by not taxing gains from the alienation of quoted shares."[73]) It goes on to suggest language for carving out traded shares from the scope of taxation under paragraph 5. The cost of taxing exchange-traded shares and the policy of boosting domestic stock markets, however, seem to be issues better addressed through domestic law. There seems to be little need or justification for negotiating a reciprocal agreement with individual treaty partners.

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

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

5.5 Residual taxing power

Article 13 (6) of the United Nations Model Convention, like Article 13 (5) of the OECD Model Convention, gives the residence State exclusive taxing rights over assets not covered by the preceding paragraphs of the Article. However, as mentioned, the Commentary has noted the preferences of developing countries to retain taxing power over assets not specifically enumerated. Such preferences are also reflected in the treaty practice of many countries—and not just developing ones.[74] This is not surprising insofar as the previous paragraphs of Article 13 do not capture all the important elements of the capital gains tax base for the source country (see the discussion at the beginning of section 2 above), and insofar as ceding such residual taxing rights would create disparate treatment between income and gain from the same asset.

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

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

almost as though Article 13 (5) is deleted in its entirety.[75]

Interpreted in this way, the approach to drafting in Article 13 would strike many readers as unusual (and unnatural). Even source-country tax authorities want to refrain from "overlooking" distinctions made in the previous paragraphs of Article 13 if residual taxing power is reserved under Article 13 (6). An alternative approach to applying Article 13 (6) is to deem what is reserved to be taxing rights over types of property (as opposed to types of gain) not referred to in a previous paragraph.[76] Thus, shares of resident companies are a type of property already covered by Article 13 (5), and the alienation of shares below the threshold would not be taxable even under Article 13 (6). The question is then what is the "type of property" previously referred to in the Article. For example, does Article 13 (2) refer to all movable property, or only movable property used in a business, or, even more narrowly, only movable property used in a business conducted by a PE? Here, one faces an interpretative dilemma. On the one hand, the reading of Article 13 (2) as referring to all movable property would render the class of "property other than that referred to" in a previous paragraph nearly empty. On the other hand, reading it as referring to "movable property used in a business conducted by a PE" would mean erasing the distinctions drawn in (and therefore the point of) that paragraph.

Therefore, the uneasy compromise that the United Nations Model Convention has tried to delineate between Article 13 of the OECD Model Convention and the positions of developing countries seems to have led to an interpretive impasse.

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

Section 4 of the present chapter identified detection of taxable transfers and enforcement against delinquent taxpayers as the main challenges

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

[76] This interpretation is made explicit in some treaties, through such language as: "Gains derived by a resident of a Contracting State from the alienation of *any property other than that referred to* in paragraphs 1 through 5 and arising in the other Contracting State may be taxed in that other Contracting State."

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

6.1 Treaty shopping

One obvious strategy for avoiding the capital gains tax is to set up holding companies that otherwise serve little or no business purpose in jurisdictions with treaties that contain favourable provisions on the taxation of capital gains.[77] Even for countries that generally tax transfers of shares of domestic companies (whether all transfers or transfers of substantial ownership, in accordance with Article 13 (5) of the United Nations Model Convention), some of their treaties may exempt such transfers. Still fewer treaties may exempt the transfer of shares of real estate holding companies (contrary to the provisions of Article 13 (4) of the United Nations Model Convention).[78] Moreover, a

[77] It was recently reported that in 2010, a non-resident company (Heritage Oil) sold a 50 per cent stake in two oil exploration blocks in western Uganda to a Ugandan company. Evidence from the Panama Papers leak shows that Heritage Oil not only knew of the impending tax but had planned aggressively to avoid it, by redomesticating the holding company from the Bahamas to Mauritius to take advantage of the latter's tax treaty with Uganda (which lacks any indirect transfer provision for real estate assets). Ajay Gupta, "Taxing Indirect Transfers of Real Estate Assets," (2016) Vol. 82, *Tax Notes International,* 820.

[78] The carve-out for companies that use domestic real property in their businesses contained in Article 13 (4) of the United Nations Model Conven-

developing country may not always be able to negotiate the retention of residual taxing rights under Article 13 (6).

Since a separate chapter in this publication deals with the abuse of treaties, there is no need to dwell on the issue here.[79] However, one comment is worth making in connection with Article 13. Unlike some of the other distributive articles in tax treaties (regarding, for example, interest, dividends, royalties and, increasingly frequently, other income), which generally deploy the concept of beneficial owner as a way of preventing treaty abuse, the capital gains article generally does not refer to beneficial owners. This by no means implies that a more permissive attitude towards treaty shopping is intended with respect to capital gains. Instead, it merely reflects the fact that the drafting of the article uniformly refers to capital gains "derived by" residents of a contracting State, and never employs the phrase "paid to." It is indeed this latter phrase that led to the (perceived) need to stress the qualification of the payee as a beneficial owner in the other distributive articles.[80]

6.2 Indirect transfers[81]

6.2.1 The growing prevalence of taxation of indirect transfers

As discussed in section 2.2 above, if the transfer of an asset is taxable, but the transfer of ownership interest in an entity that holds

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tion is not often adopted, but where it is, it also gives rise to incentives for treaty shopping.

[79] See chapter VI, "Preventing tax treaty abuse," by Graeme S. Cooper.

[80] A rare anti-avoidance provision specifically addressing capital gains is found in Article 14 (6) of the Convention between the Government of the Italian Republic and the Government of the Republic of Ghana for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion, of 19 February 2004: "The provisions of this Article shall not apply if the right giving rise to the capital gains was created or assigned mainly for the purpose of taking advantage of this Article."

[81] The present section is based on Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 20.

the asset is not taxable, then the tax on the transfer of the asset can be indefinitely deferred (thus essentially avoided) by using a holding entity. This logic applies no matter how many layers of holding entities are involved and regardless of whether the holding entity (or entities) is (are) domestic or foreign. This is why Article 13 (4) of the United Nations Model Convention permits the country where immovable properties are located to tax foreigners even on transfers of foreign entities, if such entities principally hold, directly or indirectly (for example, possibly through multiple layers of holding companies), the immovable properties. However, it is relatively uncommon for countries to adopt domestic law provisions for taxing non-residents on the disposition of shares of foreign companies, whether generally or for real estate holding companies.

There are several possible explanations for this. First, many developed countries where anti-tax-avoidance policies are most established have chosen not to tax non-residents on capital gains, on grounds unrelated to tax avoidance.[82] Second, using offshore holding companies to make an investment in a given country may be tax-inefficient for investors from that country (unless domestic investors can evade home-country taxes by going offshore). Thus for any asset market where domestic investors are dominant, it may be unlikely for that asset market to move offshore. This is probably the reason why the United States (unlike Australia, Canada and Japan) has not adopted rules for taxing indirect transfers of United States real property interests: any foreigner investing in United States real estate will want to use investment structures that future United States buyers would not reject.[83] Third, and more generally, there may be other legal factors that either pull the legal structures for foreign investment onshore or push them offshore.[84] Where such other considerations favour using onshore structures, the attraction of offshore structures (in terms of helping to avoid the capital gains tax) may be outweighed.

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[82] See supra note 15; and Stanford G. Ross, "United States Taxation of Aliens and Foreign Corporations: the Foreign Investors Tax Act of 1966 and Related Developments," supra note 18.

[83] See Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 20, 664-666.

[84] Ibid., 666-671.

In the past few years, a number of non-OECD countries, including Chile, China, the Dominican Republic, India, Indonesia, Mozambique, Panama and Peru, adopted the policy of taxing foreigners on the sale of interests in foreign entities that hold, directly or indirectly, the shares of resident companies.[85] While the background to these policy developments may be very diverse,[86] what is likely common among them is the use of active offshore markets to channel investments into these jurisdictions, making tax avoidance through indirect transfers a natural strategy.

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

The current approaches to taxing indirect transfers illustrate a well-known dichotomy in legal design for anti-avoidance, namely the use of specific anti-avoidance rules (SAARs) versus general anti-avoidance rules (GAARs). The crucial distinction is that under a SAAR, the content of the legal rule applicable to the relevant circumstances is specified ahead of time, so that it is clear what the outcome of applying the rule will be. By contrast, GAARs tend to be statements of principle, and how the legal standard is applied can be known only after the fact. India's policy illustrates the SAAR approach. The 2012 amendment of the Income Tax Act of India provided that "any share or interest in a company or entity registered or incorporated outside India shall be deemed to be … situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India." Therefore, the transfer of such shares would result in the realization of income accruing or arising in India and taxable to a non-resident transferor.[87] In contrast, China determines the taxability

[85] For Mozambique, see IMF Spillovers Report, supra note 7, at 70; for the other countries, see Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 20, 654-656.

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

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

of an indirect transfer on the basis of an ex post determination. Under the relevant administrative guidance,[88] in cases where "an offshore investor makes abusive uses of organizational forms or arrangements indirectly to transfer the equity interest in a Chinese resident enterprise, and such arrangements are without a reasonable business purpose and entered into to avoid enterprise income tax obligations," tax agencies are authorized to "re-characterize an equity transfer according to its business substance, and disregard the existence of the offshore holding company which is used for tax planning purposes." That is to say, only a tax authority can determine the taxability of an indirect transfer, and such determination is to be made explicitly on the basis of a finding of tax avoidance motives.[89] The statutory basis of this determination has been attributed to the GAAR in China's Enterprise Income Tax Law.[90]

Using the GAAR to deal with potentially abusive indirect transfers has turned out to be unsatisfactory in China in many respects, for

[88] Guoshuihan [2009] No. 698 (often referred to as "Circular 698"), Notice on Strengthening the Management of Enterprise Income Tax Collection on Proceeds from Equity Transfers by Non-resident Enterprises (promulgated by State Administration of Taxation (SAT), China, 2009). Circular 698 has largely been supplanted by SAT Public Notice [2015] 7, issued on 6 February 2015. Public Notice No. 7, relying on the statutory GAAR, extends China's policy of taxing indirect transfers to non-resident companies' gains on indirect transfers of movable property and immovable property, in addition to ownership interests in Chinese resident companies.

[89] This, ironically, implies that there is no legal basis for requiring transferors to report indirect transfers. Circular 698, a piece of informal administrative guidance, purported to impose such a legal obligation. The SAT changed this position when it issued Public Notice No. 7 in 2015, which eliminated the obligation of transferors to report indirect transfers to the Chinese tax authorities.

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

the fundamental reason that indirect transfers of shares of Chinese companies occur too often. Many of the entities used in offshore structures for investing into China neither serve substantial functions nor display a bona fide, operational business purpose. In this context, the determination that many of the holding companies serve no genuine business purpose, or that whatever business purpose they serve pales in comparison to the potential tax savings through indirect transfers, can be made in a much more routine fashion than case-by-case examinations permit.[91] Furthermore, overreliance on GAARs creates too many opportunities for negotiation between taxpayers and authorities. An industry of tax advisers on indirect transfers has emerged, whose routine tool of trade is to persuade foreign parties who have made indirect transfers first to hire them to report the transfers, and then to pay them literally to "negotiate" with Chinese tax authorities on the taxability of the transfers, often regardless of whether the position of non-taxability has any merit.

These phenomena are consistent with the theory that, when a type of transaction which the law wishes to regulate occurs often, it is socially optimal to spell out the content of the law ahead of time, thus minimizing the costs of interpreting the law for regulated subjects, legal advisers and enforcement personnel.[92] Thus SAARs are likely to be a superior way of dealing with the majority of indirect transfers, while a GAAR should be reserved for the relatively rare cases that are not properly dealt with by SAARs.

However, the existing SAARs adopted by various countries for taxing indirect transfers — in Australia, Canada and Japan for real property holding companies, and in India for all companies that hold sufficient assets in India — are subject to several objections. One is that many of them do not exempt publicly traded companies, even though such companies are unlikely to be formed for tax avoidance purposes

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

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

(and therefore taxing the transfers of their shares are unnecessary for maintaining the integrity of source-based taxation).[93] Another objection is that, typically under these rules, transfers of shares of foreign entities by non-residents are treated as giving rise to items of per se taxable income: any capital gains on such transfers are explicitly stipulated to have a domestic source.

In Canada, for example, if foreign company A derives more than 50 per cent of the fair market value of its shares directly or indirectly from real or immovable property situated in Canada, then the shares of A constitute "taxable Canadian property," and any capital gains realized on the disposition of shares of A are deemed to arise in Canada. Assuming that A is wholly owned by another foreign company, B, and B has no assets other than the shares of A, the shares of B would also constitute "taxable Canadian property." Any capital gains realized on the disposition of the shares of B are therefore also taxable income in Canada, and are legally distinct from the capital gains that have accrued to or been realized on the shares of A. If the capital gains on the disposition of the shares of A (by B) have been taxed in Canada, that does not prevent the capital gains realized on the disposition of the shares of B (by its shareholder(s)) from being taxed in Canada (or vice versa).

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

[93] See section 3.3 above. China's policy of taxing indirect transfers was refined in 2015 to exempt the transfers of shares of publicly traded non-resident companies as a result of SAT Public Notice No. 7. See supra note 88.

is still different from taxing the gain on the transfer only to the extent attributable to gains realized on the underlying Indian assets.[94]

6.2.3 *Multiple taxation and other implementation issues*

Are governments justified in their indifference to these problems? One view is that the decision on how many layers of intermediate companies are interposed between the domestic asset and ultimate investors is in the control of the taxpayers, as are decisions to make dispositions at different levels. If governments are wary of convoluted and opaque offshore structures to begin with, they will have no motivation to go out of their way to make sure that tax is neutral with respect to the choice of organizational structure in offshore corporate groups.[95]

While this argument is probably correct in itself, there is an important competing consideration. As discussed in section 4 above, taxing foreigners on capital gains raises significant challenges for enforcement. If the tax on indirect transfers leads to arbitrary tax consequences because of unmitigated multiple taxation, taxpayers may respond not by simplifying offshore corporate structures, but by non-compliance and evasion. If a government wants to maintain the credibility of its anti-avoidance regime without committing indefinite resources to enforcement, it should try to maximize voluntary compliance. Rationalizing the rules for taxing indirect transfers — including by mitigating the multiple taxation of the same economic gain — would seem to be one strategy for increasing voluntary compliance.

Notably, China's policy for taxing indirect transfers, though problematic in terms of adopting an approach of case-by-case determination, in fact suggests a solution to the problems characterizing the existing SAARs. In China, indirect transfers become taxable only after they have been determined by tax authorities to be, in economic substance, direct transfers. The layers of offshore holding companies,

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

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

instead of creating separately and distinctly taxable assets under Chinese law, must be disregarded. This implies that if the shares of a Chinese company are treated as having been disposed of indirectly through the transfer of an offshore entity, the fact that the indirect transfer has been subject to tax should be reflected by adjusting the tax cost or basis for the Chinese company's shares.[96] This eliminates the possibility of taxing the same economic gain multiple times as a result of multiple layers of indirect transfers. Moreover, the tax on an indirect transfer would necessarily always be proportional. The source country will get to tax only any gain represented by the excess of: (a) the portion of the purchase price paid on the indirect transfer that is allocable to the shares of the target company in the source country regarded as transferred indirectly; over (b) the tax basis, for purposes of the source country, of such shares of the target company.[97]

Overall, it seems possible to improve on all existing practices for taxing indirect transfers by taking the SAAR approach (if indirect transfers occur frequently), while modifying it to incorporate the Chinese approach of treating all indirect share sales as sales of the underlying domestic assets.[98] To implement this approach consistently can be technically complex, and adjusting the tax basis of assets held by an entity to reflect the transfers of interests in the entity by its owners (so as to avoid multiple taxation of the same economic gain) has only recently become feasible for entities with a large number of

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

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

[98] This is discussed as the "ex ante, look-through" approach in Wei Cui, "Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion," supra note 20, section V.

owners in the United States through specialized accounting software.[99] However, if publicly listed entities are excluded from a tax on indirect transfers, such that most taxable indirect transfers involve only entities with few owners, the complexity may be manageable. And the exclusion of shares of publicly listed entities from a tax on indirect transfers is independently justifiable, as they are unlikely to be used mainly for tax avoidance purposes.

One final issue that deserves mention is that the policy of taxing indirect transfers, when implemented by a number of source countries, increases the likelihood that a single share transfer may be taxable in multiple source countries, for example, because subsidiaries in different countries are indirectly transferred when a holding company is sold. The tax authorities in the different source countries may have different assessments of the amount of gain attributable to their country, which may lead to taxation of the same gain by multiple source countries.[100] Notably, there is currently no international arrangement for source countries to coordinate their taxes in such situations[101]—not even in a post-BEPS environment, given that the OECD project on BEPS did not identify taxation of non-residents' capital gains as being an important factor in dealing with base erosion.

6.3 Issuance of new shares and corporate reorganizations

Sometimes, taxpayers may try to avoid a tax on the sale of shares (whether direct or indirect) by having the target company issue new shares to new investors. This may or may not be accompanied by a distribution of the proceeds from the new share issuance to existing shareholders. When it is, there is a barely disguised share sale. But even when it is not, there can be an effective transfer of the value of the company

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

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

[101] The author is grateful to Mr. Peter Barnes, Senior Fellow, Duke University, for providing this information.

from existing to new shareholders.[102] Such tax planning tactics may be used within purely domestic contexts as well, and they need to be dealt with whether used domestically or in cross-border transactions.

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

7. Taxing former residents on capital gains

The present chapter has mainly focused on capital gains taxation from a source-country perspective. This section briefly touches on an issue that properly belongs to the topic of resident country taxation.[103] When the residence of a taxpayer changes on emigration, the taxing rights of the former residence State are reduced to those of a source State. In order to preserve the right to tax gains accrued while the taxpayer is a resident, many countries impose an "exit tax" (also referred to as a "departure tax") and/or a "trailing tax." Under an exit tax, assets owned by an emigrant are deemed to be alienated at market value and reacquired at a cost equal to that value. For instance, under the Australian domestic law exit tax rules, a person ceasing to be resident is deemed to dispose of assets other than taxable Australian assets (on which even non-residents are taxed) at market value.

The last few years have witnessed an expansion in the adoption of exit taxes in OECD countries. In Japan, a law became effective

[102] This issue is highlighted in Lee Burns, Honoré Le Leuch and Emil Sunley, "Transfer of an interest in a mining or petroleum right," in Philip Daniel and others, eds., *Resources without Borders*, supra note 47.

[103] For a more detailed discussion, see Jinyan Li and Francesco Avella, "Article 13: Capital Gains," supra note 74, section 2.1.8; Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis,* supra note 17, Part IV, chapter A, section 2.1.

on 1 July 2015, to require permanent residents with Japanese-source financial assets of at least 100 million yen (US$ 840,000) to pay an exit tax on any appreciation of the assets if they leave Japan to take up residence elsewhere.[104] The legislation was driven by concerns that wealthy Japanese individuals were moving to countries with no capital gains tax and selling assets that had experienced significant appreciation while they were held in Japan. Similarly, Spain introduced an exit tax at the beginning of 2015, applicable to taxpayers who have been Spanish tax residents for at least 10 out of the 15 years prior to their departure from the country, and who hold large fortunes—specifically, substantial shareholdings the market value of which exceeds €4,000,000 (or €1,000,000, if the total shareholdings exceed 25 per cent of the relevant company). Unrealized gain on such holdings is subject to tax, regardless of the location of the investments.

In the absence of coordination between the treaty States, a problem regarding the potential double taxation of the accrued gain may arise. This occurs when the property is actually alienated and the current residence State taxes the entire gain, computed by reference to the historical cost basis, which includes the gain that has been subject to the exit tax in the former residence State. Countries with exit taxes, such as Australia, Canada, the Netherlands and the United States, may include special provisions in their tax treaties to resolve the problem of double taxation. This is usually realized by allowing the taxpayer to use a tax cost for the asset in the new residence State equal to its market value at the time of the change in residence.[105]

Trailing taxes are taxes levied after a change of residence on assets that would normally not otherwise be taxed in the hands of a non-resident, but that are usually taxed under domestic law if alienated within a given period following the change of residence (generally five to ten years). A country may provide for both a trailing tax

[104] William Hoke, "Cabinet Proposes Exit Tax on Departing Permanent Residents," (2015) Vol. 77, *Tax Notes International,* 317. Persons subject to the exit tax include anyone who has been a resident of Japan for at least 5 years during the 10 years immediately before the date of departure.

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

and an exit tax if a taxpayer has an election to be subject to the exit tax or remain liable to tax for the full gain realized on actual alienation following the change of residence.[106] Special treaty provisions may also be needed to preserve the taxing rights of the former residence State and prevent double taxation.

8. Conclusion

Throughout the discussion in the present chapter, it has not been assumed that revenue from taxing non-residents on capital gains is indispensable to many developing countries.[107] Such an assumption could very well turn out not to be true. For example, in many of the developing countries that recently led efforts to combat base erosion by taxing indirect transfers — for example, China, India, Indonesia, Peru and others — revenue from international taxation in general (not to mention from capital gains taxation of non-residents in particular) is likely to represent a very small portion of overall tax revenue. The pursuit of such base protection measures is thus likely to be motivated by other policy considerations, for example, for maintaining the integrity and fairness of the tax system. Insofar as the administrative apparatus of a developing country can handle such taxation in the normal course of its operation, there should be little that is out of the ordinary.

A core contention of the present chapter is that many of the conventional arguments for limiting the taxation of non-residents

[106] The exit tax introduced in Spain in 2015 has this feature. Taxpayers can request to defer their exit tax liability if they move to any country which has a double taxation agreement with Spain and an information exchange clause. Moreover, if the taxpayer moves, for any reason, to another country in the European Union or the European Economic Area, the gain will be declarable and taxable in Spain only if they either sell the shares within 10 years of leaving Spain, or if they discontinue residency in the European Union or the European Economic Area.

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

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

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

Chapter IV

Limiting interest deductions

Peter A. Barnes*

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

The OECD project on BEPS put the issue of interest squarely into focus. Action 4 of the OECD Action Plan on BEPS[1] is titled "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments." The description of Action 4 stated, in part, that the action aimed to

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

The OECD *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report* (hereinafter "OECD Final Report on BEPS Action 4") "analyses several best practices and recommends an approach which directly addressed

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

the risks"[2] of base erosion through excessive debt and deductions for interest expense.

This chapter examines many of the issues that arise in designing tax rules to address the deductibility of interest payments, with a special focus on the challenges faced by tax administrators in developing countries. The chapter begins with a discussion of the issues involved, before summarizing the OECD recommendations regarding Action 4. As discussed more fully below, developing countries face many of the same challenges with respect to interest payments as developed countries, albeit with fewer resources to audit taxpayers and enforce the laws, and a greater need to attract investment capital. Accordingly, developing countries may choose to adopt more bright-line rules with respect to the tax treatment of interest payments than developed countries, where often complex and overlapping limitations and exceptions apply. The OECD recommendations may be too complex for adoption in their full form by developing countries, but close examination of the OECD recommendations is helpful in understanding the issues involved and the tests that can be considered to create a workable limitation on the deduction of interest expense.

1. Background

1.1 Debt and equity

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

- A debt instrument, classically a loan (from a bank, for instance) or a bond (issued by a government or corporate borrower), entitles the holder to receive a fixed, periodic return, typically called interest. The holder does not have an ownership interest in the borrower, so the holder does not share in profits of the borrower.

[2] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report* (Paris: OECD, 2015) (hereinafter "OECD Final Report on BEPS Action 4"), at 11, available at http://www.oecd-ilibrary.org/taxation/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report_9789264241176-en.

But, for the same reason, the holder ranks ahead of the owners of the borrower in the event of a default or bankruptcy;

- Equity, in whatever form issued, represents an ownership interest in the underlying entity.

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

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

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

The treatment of a payment as interest should depend not on the label assigned to the payment, but, rather, to the character of the instrument that gives rise to the payment. The OECD Final Report on BEPS Action 4 specifically states that it does not recommend "a definition of interest that is applied by all countries for all tax purposes,"[3]

[3] Ibid., paragraph 33.

so there will necessarily be variations among countries as to whether a particular instrument generates interest payments or not. Still, there is wide agreement that payments treated as interest by a particular country and payments "economically equivalent to interest" should be subject to appropriate limitations. The OECD Final Report on BEPS Action 4 lists some of the instruments that may generate payments economically equivalent to interest.[4]

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

1.2 Use of debt by taxpayers

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

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

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

(a) Using debt, the initial investor increases the pool of available capital by bringing in additional sources of capital that want the comparative safety of being paid before equity investors receive a return;

[4] Ibid., at 29-30.

(b) Debt allows the owners to expand the business without diluting control. If expansion can be funded only through new equity, the original owners will have a reduced stake in the larger enterprise;

(c) Economic studies have shown that the use of debt can bring discipline to the operation of an enterprise, resulting in long-term improved profitability and operation.

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

Third, an enterprise will typically require a line of credit to provide or to support working capital.[5] This line of credit may be drawn upon, or it may simply be available for a future need.

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

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

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

1.3 Related-party debt in capitalizing an enterprise

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

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

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

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

1.3.1 Tax considerations

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

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

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

- Does Beta have sufficient taxable income against which to deduct the interest payments to Acme such that the deduction for interest expense is economically valuable? If no deduction is available in the current year, will the deduction be available in a future year? The answer to the latter question requires consideration of both future earnings of Beta and the rules of Country Y on the carry-forward of losses;

- Does Country Y impose a withholding tax on the interest payment to Acme, and, if so, what is the rate? How does the economic impact of that withholding tax compare with the potential economic benefit of the income tax deduction to Beta for the interest payment?
- What is the tax treatment of Acme in Country X? Is the interest taxable to Acme? At what rate? How does the tax treatment of the interest received by Acme in Country X compare with the tax treatment of a dividend received by Acme in Country X?
- If there is a withholding tax imposed by Country Y on dividends or interest, or both, can that withholding tax be claimed as a credit against the tax in Country X, or are there other considerations (for example, excess foreign tax credits for Acme) that make the withholding tax imposed by Country Y a deadweight cost?

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

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

1.3.2 Non-tax considerations

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

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

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

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

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

1.3.3 Summary

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

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

1.4 Branch operations

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

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

2. Non-tax concerns regarding excessive debt

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

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

Government restrictions may be explicit. For example, there may be specific debt/equity limits imposed by law at the time the business is created and, in some cases, on an annual or periodic basis going forward. Alternatively, the government restrictions may be applied in a more flexible fashion, such as through reviews by financial regulators requiring financial institutions to seek approval (and demonstrate financial soundness) before paying dividends or making certain acquisitions. Indeed, financial institutions subject to strict review by government regulators have asserted that these non-tax limitations on debt levels are sufficiently rigorous that interest paid on any debt allowed by the non-financial regulators should automatically qualify for deduction for tax purposes, because the debt cannot be said to be "excessive."

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

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

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

3. Tax considerations regarding thin capitalization and related concerns

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

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

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

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

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

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

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

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

3.1 Determining whether a taxpayer has excessive debt

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

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

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

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

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

3.1.1 Debt/equity ratios

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

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

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

3.1.2 Interest as a share of a prescribed financial ratio

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

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

Determining "excessive interest" by means of a financial ratio or by using the more traditional test of a debt/equity ratio are not mutually exclusive approaches. The United States of America, for instance, combines the two tests under section 163 (j) of the United States Internal Revenue Code. That provision, generally referred to as the "earnings stripping" provision of the Code, applies to United States companies that pay interest to foreign lenders, often related parties. A portion of the United States taxpayer's interest expense is disallowed if the taxpayer breaches a debt/equity limitation and also the interest expense exceeds 50 per cent of adjusted taxable income. (The United States rules were recently amended because of perceptions that the rules are too generous to taxpayers in certain limited situations, where a United States resident company "inverts" and thereafter is owned by significant non-United States shareholders.)

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

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

3.1.3.1 Debt/equity ratios

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

Under financial accounting, the equity of an enterprise is often based on historical measures, such as the initial equity investment plus retained earnings. This may undervalue the asset side of the enterprise. For instance, if the enterprise has assets that have appreciated in value, or if the enterprise has substantial goodwill, then the ratio of debt to equity may be overstated if the debt is measured at current values but equity is measured based on historical data or pursuant to a formula.

On the other hand, if the enterprise seeks to measure its equity on a fair market value basis, that valuation can be costly and complicated. Valuations also potentially create controversy between the taxpayer and tax authorities.

Fluctuating interest rates: Determining whether an interest deduction is allowable based on compliance with a maximum debt/equity ratio has one interesting and often overlooked shortcoming: the approach does not take into consideration the rate of interest paid on the debt. And yet, the interest rate can be keenly important in determining whether a particular amount of debt is "reasonable" or "excessive."

Specifically, in a low-interest rate environment, an enterprise may be able to prudently carry a higher level of debt than it could in a higher interest rate environment. For instance, the amount of income required for a company (or an individual) to comfortably support a loan may be very different based on whether the loan carries an interest rate of 4 per cent or an interest rate of 12 per cent.

Interestingly, countries have been reducing the levels of debt for which interest is deductible in recent years, even though interest rates have fallen and therefore the amount of interest required to carry a fixed amount of debt has likewise fallen. These reductions are sound only if the consensus view of the maximum amount of appropriate interest expense has declined even more sharply than the decline in interest rates.

Financial institutions: One challenge in determining appropriate debt/equity ratios in the case of financial institutions is the fact that such institutions differ significantly in their business models. These differences arise with respect to both funding (for example, banks that rely on deposits versus banks that rely on short-term borrowing in the commercial paper markets) and the assets in which they invest (for example, readily marketable securities or credit card receivables versus capital goods leased to customers). These differences in funding and in assets are reflected in the marketplace; different financial institutions have significantly different debt/equity ratios.

For a tax rule, this creates the challenge of whether to try to apply a single rule to all institutions (for example, a permissible ratio of 6:1 or 3:1) as a bright-line test, or whether to seek to permit different ratios based on different business models.

Determining the disallowed interest: A mechanical, but sometimes challenging, issue is how to determine the amount of interest that should be disallowed in the event a taxpayer exceeds a permissible debt/equity ratio. Presumably, the best approach is a form of proration, in which interest is disallowed based on the degree to which the enterprise exceeds the debt/equity limitation. But that test may be easier to describe than to apply.

3.1.3.2 Prescribed financial ratios

As an alternative to capping the allowable interest expense based on a ratio of debt to equity, some countries limit deductible interest to a stated percentage of the enterprise's earnings before tax, or other financial measurements. As with a measurement based on a debt/equity ratio, this approach has both strengths and weaknesses.

Base erosion: The approach has one primary virtue — it directly limits base erosion. A taxpayer cannot deduct interest in excess of the limitation amount. By contrast, a test that uses debt/equity ratios has only an indirect limitation on base erosion. For instance, depending on interest rates, two enterprises with the same, permissible debt/

equity ratios will have different levels of interest expense—and one enterprise's deductible interest expense may be much higher than the other enterprise's level of interest expense.

The approach does not ensure that every enterprise will have positive income and pay taxes; the enterprise may be limited in its interest deduction but have other expenses that generate a loss, or a low taxable income. If the concern is that an enterprise may have excessive debt and excessive interest expenses that improperly erode or reduce the tax base, however, then this approach tackles the concern directly.

Fluctuating interest rates: Unlike limitations based on debt/equity ratios, a tax rule that denies (or defers) interest deductions based on a prescribed financial ratio automatically causes taxpayers to adjust their behaviour as interest rates fluctuate. This approach creates positive incentives for an enterprise to reduce its debt and accompanying interest expense when interest rates are rising. In this way, such a rule reinforces the goal of non-tax regulations that generally seek to drive an enterprise to reduce its debt level in such a situation.

Disallowed interest expense: In the case of a rule that disallows interest in excess of a certain prescribed financial measure, determining the disallowed interest is generally easy—it is the amount of interest expense in excess of the limitation.

3.1.3.3 Net interest or gross interest? Net debt or gross debt?

One important issue is veiled in the discussion above: In seeking to determine whether a taxpayer has excessive interest, such that some portion of the interest expense should be disallowed:

- Should the debt/equity test be based on gross debt (treating cash as an asset) or net debt (such that gross debt is reduced by cash); and
- Likewise, should the calculation whether an enterprise incurs interest expense in excess of a prescribed limitation be made on the basis of gross interest expense or net interest (gross interest expense minus interest income)?

There is, of course, no single right answer. And both approaches are readily administrable, since the data required to apply either approach lies in the financial statements and tax return information.

There are differences in the two approaches, however. For instance, a taxpayer may have high debt, but also high cash balances. Should interest payments on the debt be viewed as excessive and base-eroding, or does the fact that the company has available cash (which may be earning interest income) dampen any tax concern about base erosion?

The key point for tax administrators and taxpayers to recognize is that the question whether to adopt a test that uses gross debt and gross interest or net debt and net interest expense will have a major impact on what ratios or financial limitations should be adopted.

3.1.3.4 Tax treatment of disallowed interest

Assuming that a taxpayer has "excess" interest in a taxable year, the question arises whether the excess amount should be permanently disallowed as an interest deduction, or whether the interest should be carried forward and allowed as a deduction in a future year, when the taxpayer fully satisfies the limitations on interest expense.

Because of business cycles, some measure of carry-forward may be appropriate. The interest expense would be allowable in the future year only to the extent the enterprise incurs interest expense in the future year that is less than the amount otherwise allowable in that future year. Such a carry-forward rule would, of course, create administrative challenges for both government tax examiners and taxpayers.

In the event there is not a carry-forward rule, then a question arises as to how to characterize the disallowed interest payment. Should the payment be treated as a dividend in the current year? If so, would the applicable withholding tax be the rate of withholding on dividends, rather than the rate on interest? What is the tax impact of the recharacterization in the recipient's country?

These issues can all be answered, but they require that explicit rules be issued in order to minimize tax disputes.

3.1.3.5 Summary

As a matter of policy, it is appropriate — and consistent with international norms — to deny a deduction for interest expense that is "excessive" by some measure. This tax policy parallels and reinforces non-tax limitations on the amount of debt that an enterprise may incur. There are two primary methods for determining whether interest is excessive: measuring the debt/equity ratio, or measuring the interest expense as a percentage of some financial measure such as pre-tax income. Each method has strengths and weaknesses, but each approach can be usefully adopted.

3.1.3.6 OECD Final Report on BEPS Action 4

As part of the BEPS exercise, the OECD and G20 considered in detail how countries could determine whether interest expense is "excessive" and therefore should be non-deductible for tax purposes. The OECD Final Report on BEPS Action 4 provides a proposed approach for countries to adopt, as well as a discussion of alternative measures that exist today, including the benefits and challenges of some of these alternative measures.

The OECD proposed approach — referred to in the report as the "recommended approach" or "best practice approach"—is likely to be too complex for many developing countries to adopt, and, indeed, for many developed countries. But the foundational elements echo the analysis discussed above and could be adopted without undue complexity for either taxpayers or tax administrators. Moreover, the OECD analysis serves as an extremely valuable resource for the issues discussed previously in this chapter.

3.1.3.7 OECD recommended approach

In simple terms, the OECD approach is as follows:

Step one: Countries may allow an entity to deduct all of its interest expense, so long as the expense falls below a de minimis monetary threshold. This de minimis rule would reduce the administrative burden on both taxpayers and tax administrators without allowing a significant erosion of the country's tax base.

Step two: An entity would be allowed to deduct its net interest expense up to a benchmark ratio of net interest to EBITDA.

- ➢ The ratio of net interest to EBITDA would be calculated on the basis of tax accounting data, not financial accounting. Thus, all necessary information should be available on the entity's local country tax return.

- The best practice approach suggests that the allowable benchmark ratio would be at a level of 10 per cent to 30 per cent of the entity's EBITDA. Interest expense would be deductible up to the amount determined by multiplying EBITDA and the benchmark ratio adopted by that country.
- The Final Report gives guidance on how a country could reasonably determine the benchmark ratio (that is, towards the 10 per cent lower end of the proposed corridor, or the 30 per cent higher end of the corridor). Once determined, the benchmark ratio would apply to all taxpayers in that country.

As discussed more fully below, this approach, standing alone, would give a country a reasonable, albeit "rough justice" method for limiting interest expense.

Step three: The recommended approach provides for a further test that would allow a taxpayer to deduct a higher level of interest expense. This test compares a fixed ratio of the taxpayer (as determined in step two) to the ratio of the global group's net interest expense to EBITDA. Furthermore, a country could adopt an "uplift" to the global ratio of as much as 10 per cent.

The rationale for this alternative test is well-founded: If a group of companies have a certain ratio of debt to equity globally, then the group is not abusive (and does not engage in improper base erosion) when a particular entity in the group is leveraged at a ratio approximating the global group's leverage ratio. But this additional test creates a challenge and entails difficult consideration:

- The challenge for both taxpayers and tax administrators is how to assemble and audit the global group financial information required to apply a group ratio rule. Necessarily, the group ratio is likely to be determined on the basis of financial accounting data, rather than tax data. The Final Report recognizes that no country currently adopts a rule like the one proposed and states that further work will be necessary to provide guidance to countries; that additional work is now under way.
- The difficult consideration lies in how this group rule should affect the limitations, if any, of a wholly domestic taxpayer. If an entity is allowed to leverage itself up to the level of its global

group, then an entity that is either a stand-alone company or a member of a wholly domestic group would always qualify under this rule since the leverage ratio of the entity would be identical to its group ratio.

Limitations on interest expense generally are proposed for two reasons: to prevent erosion of the tax base and to discourage excessive leverage in a company for prudential reasons unrelated to tax. Therefore, it may be prudent to provide for some cap on the allowable leverage, even if the leverage of an entity in a specific country is at or below its group level.

Step four: The OECD recommended approach suggests that countries consider allowing a taxpayer to carry forward and/or carry back disallowed interest expense. In addition, or alternatively, the proposed approach puts forward that countries could allow taxpayers to calculate their EBITDA (for both a specific entity and a group) on the basis of a three-year average.

These suggestions are intended to "smooth" the calculation, so that a taxpayer is not disadvantaged because of volatility in earnings, including volatility that leads to a loss year.

Finally, the recommended approach recognizes that countries may wish to adopt targeted rules to prevent artificial arrangements and to address the special considerations of financial services and insurance companies. The OECD is continuing to study the group ratio rules and how these limitations on interest deductions should be applied to financial services companies.

The OECD Final Report on BEPS Action 4 provides a thorough, useful analysis of the issues that each country must consider in establishing rules to prevent base erosion through excessive interest deductions. However, the report makes clear how complex countries' decision-making will be in considering limitations on deductions for interest.

3.2 Interest allocable to exempt or deferred income

In addition to a disallowance of interest on excessive debt — however "excessive" may be defined — a related issue arises in connection with income that is either exempt from taxation or on which the tax is deferred. The issue arises most frequently when a taxpayer earns income sourced outside of the home country and the income receives favourable tax treatment in the home country.

This is a challenging topic that could usefully be discussed at length elsewhere; in many countries, there has been a long, high-octane debate on how best to allocate interest that may be attributable to deferred or exempt income, especially foreign source income such as dividends from foreign corporations. But at least a few concerns need to be noted.

The issue is not limited to developed countries. It affects developing countries as well:

- For instance, many developing countries tax their multinational corporations on worldwide income. But, income earned outside the home country may be deferred for a period of time, before home country tax is imposed. If a resident company incurs interest expense within its home country, should some portion of that expense be allocated to the investments and income earned from those investments outside the home country? And, if so, should a portion of the current interest expense be disallowed (or deferred) until the foreign income is taxable in the home country? If the answer is yes, how should the allocable expense be determined?
- In countries with a territorial tax system, where active earnings outside the home country of a taxpayer are not subject to home country tax, a similar issue arises. Should some portion of the home country interest expense be allocable to this exempt income and disallowed permanently?

The concern for developing countries will increase as more multinational corporations grow within developing countries and outbound investment from developing countries increases. In the near future, existing multinationals resident in developing countries will be joined by a dramatically increasing number of home country peers.

In determining how to allocate interest expense to outbound investment, countries have struggled to balance appropriate tax rules with a public policy desire to encourage and support home country champions as they invest abroad. As a result, there is no single approach that has garnered consensus support.

There are several options:

(a) Countries can impose no (or very modest) limits on the deduction for interest expense on debt incurred to support outbound investment. This approach is not "pure," but garners support on the well-grounded theory that a home country benefits when companies headquartered in that country have strong investments outside the country. Having the headquarters of a multinational enterprise (MNE) in a country typically brings with it well-paying jobs for executives, business opportunities for suppliers, philanthropy and other benefits. But—and this is an important caution—such an approach can be viewed as favouring MNEs over companies that operate purely domestically, since the rate of tax paid on the foreign income may be lower than the rate incurred by domestic companies that earn all of their income in the home country;

(b) Countries can impose a proxy charge to account for interest expense that may be attributable to exempt or deferred income. For instance, some countries exempt certain foreign income from home country tax but limit the exemption to, say, 95 per cent of the income. Local country tax is imposed on 5 per cent of the income as a proxy for disallowing expenses attributable to earning that foreign income. This approach is applied by several countries with respect to dividends paid by non-resident corporations to resident corporations that hold a substantial interest in the foreign corporations;

(c) Finally, a country may seek to allocate and apportion interest expense between home country income (which currently is typically subject to full tax) and income that is exempt or deferred. The interest expense attributable to that exempt or deferred income will, likewise, be denied as a deduction or the deduction will be deferred until the income is taken into account for tax purposes.

There are precedents for each of these options, but no clear consensus on the most appropriate approach. As corporations resident in developing countries increasingly engage in outbound investment, each country will need to determine which rules for interest allocation best serve its national development goals and its sense of fairness.

3.3 Is all interest equal?

As discussed previously, debt (and the associated interest expense) may arise from any of several different business needs:

- A need for initial capital to form the business, or to fund subsequent expansion, in which case the debt and interest can be viewed as a substitute (or companion) for equity;
- Debt may be incurred for a specific purpose, such as a mortgage obtained to purchase a piece of real property or a loan associated with the purchase of a piece of capital equipment. When a business obtains goods from a supplier on extended terms, the business may pay interest if the payment is delayed beyond a certain period (such as 30 or 60 days). In this case, the debt can (sometimes) be traced to the specific asset, and the asset often serves as security for the debt;
- Debt may be in the form of a line of credit, or other generalized borrowing, as a source of funding for the ongoing operations of a business. This debt may, of course, be closely analogous to debt incurred as part of the initial capital of the business, or debt incurred to purchase property or equipment.

It is frequently said that "money is fungible," which suggests that all debt is equivalent, if not fungible. Under this view, all interest expense should be considered as a single item of expense for determining whether some or all of that interest should be deductible in determining taxable income. But this view is not the only approach that may be adopted.

For instance, tax rules may treat debt incurred on initial capital differently (and, generally, less favourably) from debt incurred for the ongoing operations of a business, either for the purchase of goods or services or for a line of credit. If an enterprise is deemed to have excess debt related to its formation (for example, a debt/equity ratio that exceeds a stated level), then some of the interest on that debt may be disallowed. But, interest attributable to specific purchases of goods or services would be viewed as ordinary business expenses and fully deductible.

In determining whether to treat all interest alike (as a single expense item) or whether to treat some interest differently from other interest in terms of deductibility, there are several factors to consider:

(a) *Ease of administration*: Treating all interest expense as a single item is generally easier for both taxpayers and tax administrators. Otherwise, taxpayers and tax officials must analyse the sources of debt and separate interest payments into different categories for purposes of tax deductibility. Further, if interest expenses are treated differently for tax purposes, depending on the source of the debt, taxpayers will be encouraged to favour certain kinds of debt (for example, debt associated with the purchase of specific real property, equipment or goods) and disfavour other kinds of debt (most frequently, debt that would be a substitute for equity);

(b) *Perceptions of "base erosion"*: On the other hand, some kinds of debt may be perceived as more susceptible to abuse than others. As discussed further in section 3.4 below, and previously in section 1.3, an investor in a company may invest 1,000 of equity and no debt, or some combination of equity (say, 400) and debt (600). Interest paid on this initial debt—which is often, although not always, paid to a related person—may be viewed as being created artificially and seen as more likely to be an improper "base erosion" payment than interest paid to an unrelated party in connection with a mortgage on real property;

(c) *Policy*: Allowing full deductibility for interest on purchases of real property, capital goods and supplies encourages business operation and expansion. The same argument could be made for allowing full deductibility of interest paid on initial debt investment into the capital of a company, but the argument is generally more immediate and persuasive in the case of debt related to ongoing operations.

In weighing these factors, different countries reach, and will continue to reach, different conclusions. The OECD Final Report on BEPS Action 4 recognizes that countries may decide to exclude certain public-benefit projects from the limitations on deductions of interest.[6]

3.4 Interest paid to related parties

The most controversial — and most emotional — issue regarding the deductibility of interest payments arises in connection with the payment of interest to related parties. The example of Acme Corporation, Beta Corporation and Charlie Corporation was outlined above. Although interest payments to related parties most frequently arise in connection with the initial formation of a company — and the decision of how much investment to make with equity and how much (if any) to make with debt — the issue of related-party debt arises in other situations as well. Related parties are often suppliers and customers of one another, and payments in connection with their transactions may incur interest charges. Additionally, a related party may serve as a source of regular funding, either through fixed loans or a line of credit.

Related-party payments are a concern only when the related party receiving the interest is outside the country of the party that is paying the interest. If the two related parties are in the same country and each company is subject to local country tax, there should be no concern. When the related party receiving interest is located outside the country of the interest payer, however, the debt and associated interest payments are viewed as a major risk for improper "base erosion." This suspicion arises for several reasons:

(a) Although the decision on whether (and how) to extend a loan to a related party can be complex, as discussed previously, the related parties can work together to try to fashion a loan that has the most favourable tax result. In most cases, the payment of interest is more tax-advantaged to the borrower and lender, considered together, than an investment of equity. In some cases, the payment is very favourable, for instance, when the interest is deductible to the borrower and subject to low or no tax in the hands of the lender;

[6] OECD Final Report on BEPS Action 4, supra note 2, at 39-41.

(b) Related-party loans are not subject to market discipline, in the way that a debt from an unrelated party would be. The amount of the loan may be in excess of the amount that a third party would be willing to lend, or the loan may be for an extended period or subject to fewer conditions than a third party would demand;

(c) Importantly, there can be transfer pricing concerns with respect to the rate of interest paid and other terms of the loan.

Recognizing these concerns does not, however, suggest a single answer regarding whether interest paid on related-party debt should be subject to different (presumably, less favourable) tax terms than interest paid on debt to parties that are not related.

From the perspective of the country in which the interest expense arises, the key question is whether it is relevant that the recipient of the interest payment is related to the payer. The answer may be yes:

- There is a potential for transfer pricing abuse, and disallowing some or all of the interest paid to a related party is a preventive means of addressing that potential abuse;
- Even if the amount of interest paid is appropriate (and would be allowed if paid to a third party), there is a concern that the interest may not be properly taxed in the hands of the recipient. To prevent base erosion on a global basis, the country of the payer may limit the interest deduction.

On the other hand, treating related-party interest less favourably creates costs. In particular:

- As discussed previously, there are non-tax reasons as well as tax reasons why an investor may choose to invest partially with debt and not wholly with equity. If tax rules impose additional costs on the use of debt, that may affect investment decisions; not all investors will be willing to bear those additional tax costs;
- Enforcing special rules on related-party lending creates administrative costs because it can be difficult to define what a related party is for purposes of the rule. For instance, a nominal lender may be an unrelated party; however, the loan would not have

been made but for a deposit with the lender from a party related to the borrower. Or a party related to the borrower may offer a guarantee to the lender; such guarantees vary considerably, from formal and binding agreements to "comfort letters" that have no legal consequences. If special rules are applied to related-party lending, there will need to be anti-avoidance rules to prevent abuse.

Another factor to consider is whether the tax administration of a country can minimize the risk that related-party lending would abuse the tax system. The risk of related-party lending being on non-arm's length terms can be addressed by stronger transfer pricing enforcement, including the possibility of published permissible lending rates, although efficient and effective application of transfer pricing rules is a challenge for all tax authorities. Excessive base erosion can be addressed through limits on the deductibility of all interest expense, whether paid to a related party or unrelated parties, insofar as the rules are consistent with any applicable treaty limitations.

At bottom, the question for tax administrators is whether the potential abuse that can arise from related-party lending is sufficiently great that it warrants special rules, or whether the potential concerns can be minimized through other, less restrictive means. The United States recently grappled with this issue in connection with "inversions," which are a type of transaction in which a resident company of the United States becomes owned by a foreign shareholder. In these cases, the foreign shareholder often increases the debt of the company, reducing the tax base of the United States, while still complying with the debt/equity limitations in Section 385 of the United States tax code. The United States Treasury Department has issued rules to further limit the deductible interest in these situations.

3.5 Withholding taxes

Developing countries traditionally favour withholding taxes on payments of interest to non-resident lenders. The withholding tax is perceived as a tax cost to the non-resident lender, with the benefit of raising tax revenue that partially offsets the tax cost of the local interest deduction.

An example may be useful:

- Dart Corporation, resident in Country A, needs to borrow 1,000. It obtains a loan from Extra Corporation, resident in Country B, for 1,000 at an interest rate of 8 per cent, or 80 annually;
- Dart pays the 80 to Extra, subject to a 10 per cent withholding tax. Extra will receive 72 in cash, plus a credit for the 8 that Dart has withheld and remitted to the Country A tax authorities;
- Dart deducts the 80 worth of interest in determining its taxable income. The tax rate in Country A is 25 per cent, and Dart has sufficient income to fully benefit from the 80 deduction. Dart saves 20 in Country A tax because of the tax deduction;
- Country A receives 8 in withholding taxes on the payment to Extra, but gives up 20 in tax revenue it otherwise would have received from Dart. There is a negative tax rate arbitrage to the Country A treasury from this transaction, but the withholding tax has reduced the revenue loss from 20 to 12.

Historically, it was generally believed (and probably true) that most lenders could absorb the withholding tax as a credit against home country taxes that the lender would otherwise pay. Therefore, the withholding tax — 8 in our example — did not increase costs to the lender (or the interest rate that the lender would charge the borrower); rather, the economic burden of the withholding tax was transferred to the treasury of the country in which the lender was a taxpayer. In the example above, Extra would claim a foreign tax credit in Country B for the 8 in withholding taxes it had paid to Country A. Extra's total tax cost to Countries A and B would be unchanged but country B would receive 8 less revenue.

This traditional perspective has been eroding in recent years. Lenders are often able to minimize the taxation of interest income, such that withholding taxes are real costs. Accordingly, lenders regularly request a "gross up" for any taxes withheld, so that the borrower bears the cost of the withholding tax in the form of a higher interest charge.

The higher interest charge is, of course, generally tax deductible, which has the effect of increasing the tax deduction available to the borrower and reducing the borrower's home country taxes.

The decision whether to impose a withholding tax on cross-border payments of interest, and at what rate to impose withholding, requires juggling several factors.

Availability of local funds for lending: If a country has sufficient funds within its jurisdiction to meet all reasonable needs for borrowing, then it is more beneficial to impose a withholding tax.

When a company borrows funds from a lender within the same country, the interest paid on the loan is normally not subject to a withholding tax. In the few countries that impose withholding on domestic payments, the withholding tax is generally treated as a prepayment of tax that will be calculated on a net basis. The lender receives the interest income and will be subject to tax on a net basis. The ready availability of local funds for lending sets a market rate of interest that applies equally to lenders from offshore. Any withholding tax and gross-up requirement will not affect the economics of the transaction because the borrower has local lenders available as competition to the offshore lender.

On the other hand, if a country needs investment capital from offshore, a withholding tax will likely increase local borrowing costs, and a gross-up provision will increase that cost further. To return to the example, if Extra Corporation insisted on a gross up for its loan, Dart Corporation would remit 80 to Extra, plus 8.89 in withholding taxes to the local authorities. The gross up would yield an additional 0.89 in taxes to Country A, but at a cost of an additional tax deduction of 8.89 for Dart Corporation and a tax cost to Country A of 25 per cent of that amount, or 2.22.

Determining an appropriate withholding tax rate: When the local income tax rate (25 per cent for Country A in our example) is higher than the withholding tax rate (10 per cent in the example), a tax rate arbitrage arises that reduces tax revenues. It is natural to assume that the best way to avoid the arbitrage is to set the withholding tax at the same rate as the local income tax rate.

There is another perspective, however: the withholding tax rate arguably should be set at a level that mirrors the tax revenues that would be raised if the lender were a domestic company. In that case, a fairly low withholding tax rate may be appropriate as a proxy for a tax on net income.

The lender will often be a financial institution, which has an interest expense of its own associated with raising the funds that are lent to the borrower. In the example, assume that Dart Corporation borrows the 1,000 from Forest Corporation, a financial institution in Country A.

Because financial institutions often have high leverage ratios (for example, 6:1, or even 20:1), Forest Corporation will have substantial interest expense of its own arising from the 1,000 that it raised for the loan to Dart. This interest expense will reduce the net income taxable on the 80 of interest income that it received from Dart. For instance, Forest may have net taxable income of only 8 (80 of interest income, reduced by an assumed 72 of interest expense) from the Dart transaction. At a 25 per cent income tax rate, Forest will pay tax of 2 on its net income.

In such a case, even a 10 per cent withholding tax (which yielded 8 on the interest payment to Extra Corporation) would appear too high compared with the tax revenue derived from Forest Corporation on its domestic loan to Dart. When the corporate income tax in Country A is imposed on the small net interest income of Forest Corporation, the total tax revenue raised may be equivalent to a withholding tax on cross-border interest of only 1 or 2 per cent, well below the withholding tax rate generally imposed on cross-border interest.

Summary: One way in which to address the difficulty of determining an appropriate withholding tax rate on cross-border payments of interest is to adopt differential rates, and this is often the approach followed in tax treaties. When the lender of a loan is a financial institution, a treaty may impose lower withholding tax rates than when the loan is extended by a non-financial institution that may not have significant interest expense of its own. The challenge for a developing country in considering withholding taxes on interest is to balance the desire to minimize tax costs from the tax deduction for interest against the need to ensure that any withholding tax does not increase costs (through a gross-up or higher interest rates) or limit the availability of needed investment.

Significantly, the OECD Final Report on BEPS Action 4 specifically notes that a country's limitations on the deductibility of interest expense should not affect withholding taxes imposed on the payment to a non-resident lender.[7] If a country's rules impose a withholding tax, then the tax should be levied without regard to the domestic deduction.

4. Branch operations

The discussion above generally assumes that taxpayers are conducting business through separate corporations. In such a case, each corporation keeps its own books and records, and each corporation is expected to deal at arm's length with all related entities.

In many cases, multinational operations are conducted through branches, not separate corporations. Many of the tax issues relating to branches are substantially identical to the issues that apply to corporations. Interest expense is one issue where there can be differences.

Under Article 7 of most treaties based on the United Nations Model Double Taxation Convention between Developed and Developing Countries[8] (United Nations Model Convention) or the OECD Model Tax Convention on Income and on Capital[9] (OECD Model Convention), a corporation that has a taxable presence (a "permanent establishment," or PE, under Article 5) in another country is taxable in that other country on the profits "attributable to" the PE, determined by treating the PE as if it were a distinct and separate legal entity from the rest of the enterprise, engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE. The PE will maintain books and records of its income and expenses.

With respect to interest expense, however, there is some inconsistency:

- In some cases, the PE calculates its interest expense as if it were a separate legal entity from the parent, based on its own books and records;

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[7] Ibid., at 82-83.

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

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

- In other situations, however, the PE determines its interest expense as a share of the total interest expense incurred by the enterprise of which it is a part. Article 7 (Business profits) of the United Nations Model Convention specifically provides that, except in the case of a bank, a PE will not be allowed a deduction for any interest that is notionally charged to the PE by the head office (nor will the PE be considered to earn any interest that it notionally charges to the head office or another branch). Instead, the PE will be entitled to a deduction for its "allocable share" of interest expense incurred by the enterprise as a whole.[10]

If a branch is allocated a share of the interest expense incurred by the enterprise to which it belongs, that amount may, of course, be greater or smaller than the amount that would be determined by treating the branch as a separate entity. The argument in favour of allocation, however, is that the PE is not a separate legal entity and its assets and liabilities are therefore not separate from the assets and liabilities of the larger enterprise, at least in terms of exposure to creditors.

It is important for a country to make clear how interest expense of a PE will be determined in order to minimize tax disputes.

5. Relevance of tax treaty provisions

In fashioning rules that affect the taxation of interest to a recipient or that limit the availability of deductions for interest expense, countries do not have unfettered discretion, at least where they have entered into tax treaties with other countries. In the case of a treaty, countries mutually limit their taxing authority in order to foster trade and economic growth.

For instance, Article 11 of the United Nations Model Convention sets forth principles regarding the tax treatment of interest "arising" in

[10] For more information on this issue, see paragraph 3 of the Commentary on Article 7 of the United Nations Model Convention; and Jinyan Li, "Taxation of non-residents on business profits," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (New York: United Nations, 2013), available at http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf.

one State and paid to a resident of another Contracting State. Article 24 (4) of the United Nations Model Convention deals with the elimination of tax discrimination, including with respect to the deductibility of interest paid by an enterprise of a Contracting State to a resident of the other Contracting State.

The parameters of Articles 11 and 24 are often debated, and occasionally these provisions give rise to legal disputes. But the basic concepts of these treaty provisions are clear and do limit some actions that a country may wish to take with respect to the taxation of interest paid to or incurred by non-residents.

6. Conclusion

Loans and the free flow of credit are vital to international business and to economic growth. Interest payments are an ordinary business expense and generally will be deductible by the borrower in calculating both financial statement income and taxable income. The interest income generally will be taxable income to the lender.

However, as the OECD project on BEPS has recognized, debt can be a strong tax-planning tool. In some circumstances, interest payments may be considered excessive, to the extent that the relevant tax base is improperly eroded. Tax professionals have struggled for many years to determine when interest payments are excessive, such that tax deductions for those payments should be limited. The OECD project on BEPS and the work of many countries seeking to apply the lessons of this project promise to shine new light on this continuing challenge.

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Chapter V

Neutralizing effects of hybrid mismatch arrangements

Peter A. Harris*

The use of hybrid mismatch arrangements is one of the ways in which large multinationals can end up effectively paying tax at lower rates than the small domestically bound enterprises that multinationals often compete with. This is a major concern for most countries, including developing countries. Hybrid mismatch arrangements are not new in international tax.[1] Conceptually, it has always been possible to engage in such arrangements for the purpose of minimizing tax. What has changed is the proliferation of hybrid mismatch arrangements, the ease with which they can be achieved and their comparative importance. This change is largely a function of the increase in electronic commerce and globalization. Such arrangements are not "wrong" per se — they are simply a function of two countries having, typically unilaterally, decided not to tax a particular cross-border dealing or give some other favourable tax effect (such as a deduction). What might be considered wrong is the manner in which tax advisers and multinationals have in recent years aggressively sought out and exploited such arrangements.

Before discussing manners in which "hybrid mismatch arrangements" can be "neutralized," it is necessary to identify exactly what such arrangements are. This is not an easy task because the phrase hybrid mismatch arrangement is not logically bound from a tax perspective and so it is only possible to discuss a generally understood meaning.[2] It is

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[1] See Nathan Boidman and Michael Kandev, "BEPS Action Plan on Hybrid Mismatches: A Canadian Perspective," (2014) Vol. 74, *Tax Notes International, at* 1233.

[2] Organisation for Economic Co-operation and Development (OECD), *Neutralising the Effects of Hybrid Mismatch Arrangements — Action 2: 2014 Deliverable (*Paris: OECD, 2014) (hereinafter "OECD BEPS Action 2 — 2014 Deliverable"), available at http://www.oecd.org/tax/beps-2014-deliverables.htm, paragraph 41, defines a "hybrid mismatch arrangement" as "an arrange-

part of the purpose of the present chapter to identify that meaning and relate it to the fundamentals of income taxation.

The "hybrid" part of the phrase means that, in a particular case (taken to be an arrangement), two countries do not agree on the classification or characterization of some feature of the arrangement that is fundamental for income tax purposes. From this perspective, all of the fundamentals of income taxation can give rise to hybrid arrangements. In order to understand the scope for hybrid arrangements, it is thus necessary to investigate the fundamentals of income taxation.

The "mismatch" feature is different and suggests that the different ways in which two countries view the particular arrangement produce some sort of inconsistent outcome when looked at as a whole. From this perspective, not all hybrid arrangements give rise to mismatches, because in some cases the differing views of the two countries do not produce an inconsistent outcome. Similarly, not all mismatches in outcomes are a consequence of a hybrid arrangement.[3]

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ment that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more jurisdictions to produce a mismatch in tax outcomes." Like the earlier definition in OECD *Public Discussion Draft, BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* (Paris: OECD, 2014) (hereinafter "OECD Public Discussion Draft on BEPS Action 2"), available at http://www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf, paragraph 17, this is limited to "entities" and "instruments." OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* (Paris: OECD, 2015) (hereinafter "OECD Final Report on BEPS Action 2"), available at http://www.oecd-ilibrary.org/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report_9789264241138-en, does not repeat the definition, reinforcing the fragmentation of the suggested rules (a lack of conceptual linking). However, very similar terminology to the earlier definition appears in the first paragraph of the Executive Summary, at 11. Since the initial Discussion Draft, the OECD descriptions of "hybrid mismatch arrangements" no longer refer to "payments," however, subsequent discussion in OECD, BEPS Action 2—2014 Deliverable and the OECD Final Report on BEPS Action 2 suggests this is a further requirement.

[3] For example, in the OECD Final Report on BEPS Action 2, supra note 2, examples 1.10, 1.11, 1.26 and 1.35 appear to involve no hybrid element but rather a mismatch in outcomes; see annex I to the present chapter.

One of the complexities in seeking to establish rules to neutralize hybrid mismatch arrangements is identifying which arrangements give rise to inconsistent outcomes. By the very nature of a hybrid mismatch arrangement, this means that the countries in question need to look closely at how the tax law in the other country applies to the arrangement. Historically, countries (especially source countries) have not looked closely or sought to understand or apply the tax law in another country interested in a cross-border arrangement (see section 4 below). One core issue is whether it is realistic, even presuming high levels of cross-border cooperation between tax administrations, to believe that tax administrations, especially those of developing countries, can or will effectively interpret the tax laws of other countries.

Mismatches arising in the context of a hybrid arrangement may be one of two basic types. A mismatch may be harmful to the tax outcome of the taxpayer (when compared with a consistent treatment by both countries) or it may be beneficial to the taxpayer. Historically, tax treaties have, in a number of ways, dealt with styles of mismatch that are harmful to taxpayers. These include the reconciliation of residence of the taxpayer, often the source of income and transfer pricing adjustments (through corresponding adjustments) and even the provision of foreign tax relief (where otherwise both source and residence countries would exercise full taxing rights). Historically, the primary purpose of tax treaties has been to relieve international double taxation in order to facilitate cross-border investment.[4] In the face of globalization, countries are more clearly than ever in a market place for attracting investment, a market place that demands relief from double taxation, which is reflected in the proliferation of unilateral measures for such relief.[5] In this way, globalization fundamentally challenges the necessity of tax treaties.

[4]For example, see Hugh J. Ault, "Some Reflections on the OECD and the Sources of International Tax Principles," (2013) Vol. 70, No. 12 *Tax Notes International,* at 1195.

[5]These unilateral measures involve not only foreign tax relief as a residence State, but most importantly for present purposes the reduction of source-State taxation to realistic levels, for example, with respect to outbound withholding taxes. Many developing countries now have outbound domestic withholding taxes that are close to those that traditionally would have been agreed only under a tax treaty.

Current concerns with hybrid mismatch arrangements are with arrangements that are beneficial to taxpayers. While mismatches might also be harmful to taxpayers, it is likely that a well-advised taxpayer will plan to avoid such mismatches. As Action 2 in the Organisation for Economic Co-operation and Development Action Plan on Base Erosion and Profit Shifting (OECD Action Plan on BEPS)[6] highlights, the focus of current concerns (and the present chapter) is on multinationals that intentionally plan for hybrid mismatch arrangements to reduce their overall tax liability.[7] Action 2 essentially focuses on double non-taxation of income and claiming deductions simultaneously in more than one country against different items of income, that is to say, the OECD sees hybrid mismatch arrangements as essentially involving tax base issues.[8]

The tax results from use of hybrid mismatch arrangements are often comparable to those involving the use of tax havens and there is thus a clear synergy with the OECD project on harmful tax competition. The difficulty with hybrid mismatch arrangements is that they can and most commonly do involve countries that are not classically tax havens. Indeed, they commonly involve countries that are parties to a tax treaty, reinforcing the fact that the fundamental purpose of tax treaties has historically been to relieve international double taxation and not prevent international double non-taxation. Hybrid mismatch arrangements that are beneficial for taxpayers seek to simultaneously erode both taxation in the source State and taxation in the residence State. Accordingly, the present chapter is closely related to other chapters in the present publication.

The present chapter discusses hybrid mismatch arrangements in four sections. The first section seeks to determine the scope of

[6] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) (OECD Action Plan on BEPS), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf. Action 2 calls for the development of "model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effect … of hybrid instruments and entities."

[7] For a (very) limited exception to this, see the discussion in section 3.2.2.2 below regarding "dual inclusion income."

[8] See OECD Final Report on BEPS Action 2, supra note 2, paragraph 10, and particularly the references to "payments" being "included," or "deductible."

the issue by conceptualizing it. It does so by identifying income tax fundamentals and highlighting how they can give rise to hybrids and mismatches across borders. Some simplified case studies are used in the discussion to illustrate potential taxpayer benefits from hybrid mismatch arrangements. In this way, the present chapter seeks to explain as simply as possible why hybrid mismatches arise and their possible range.

The second and third sections look more particularly at the OECD proposals to deal with such arrangements under Action 2. The second section identifies which types of hybrids outlined in the first section are the subject of Action 2 and which are not. The third section considers how domestic law recommendations in the OECD *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* (hereinafter "OECD Final Report on BEPS Action 2") propose to deal with the targeted mismatches. In particular, it assesses the practicality of implementing the OECD proposals, especially from the perspective of a developing country.

The fourth section returns to the basics discussed in the first section and considers whether there are simpler steps that countries, especially developing countries, may take to alleviate the problems caused by hybrid mismatch arrangements. In particular, the OECD recommendations require an unprecedented level of integration between countries' tax systems and laws. Discussion in the section considers whether the problem of hybrid mismatch arrangements can be dealt with in ways that require lower levels of integration. The focus is on two anti-base erosion measures that a source State can take, but measures that may be taken by a residence State are also considered. Inevitably, there is no "one-size-fits-all" solution to the problems of hybrid mismatch arrangements and countries must make their own decisions based on their own capacity and economic needs.

1. Determining the scope of the problem

1.1 Income tax fundamentals

There are three essentials that all income tax laws incorporate and each of them (persons, earning activities and income) demonstrates a number of fundamental features that income tax laws must detail. Income tax laws are personal taxes and so must identify the "persons" to whom they apply. Persons are taxed with respect to their "income." However, not all amounts that "come in" or which may be allocated to a person fall within the ambit of a typical income tax. Inevitably (and through differing legislative mechanisms), only income that can be related to an "earning activity" (an activity that is not private) falls within the scope of an income tax. Within the scope of an earning activity, certain amounts positively enter into the calculation of income and some amounts are entered negatively, that is to say, for most countries income is a net concept (although there are exceptions, for example, sometimes for employment income).

All income tax laws must identify what constitutes a person (a tax subject or at least things to which earning activities and income can be attributed). As in many other areas, there are two options for an income tax law here: it can either follow general legal classification (for example, individuals and corporations as legal persons) or a disjointed approach can be adopted. Under the disjointed approach (which most countries follow), a person for income tax purposes might include some entities that are not persons for general law purposes or exclude as a tax person some entities that are persons for general law purposes. It is also possible for one person to be given two capacities for tax purposes, in which case the one person might be viewed as two persons for income tax purposes (such as the distinction between the personal capacity of a person and their capacity as a trustee of a trust). It is also possible for two or more persons to be given a single capacity for tax purposes, such as in the case of some tax consolidation regimes for group companies.

The rules that a country's income tax law adopts for identifying what constitutes a person must, in principle, be capable of characterizing every entity that is formed anywhere in the world. This is a function of globalization and the breaking down of trade barriers. It is possible for an entity formed anywhere in the world to do business in a particular country. So, as a source State, a country must be able to say whether the foreign entity is a tax person or whether the persons underlying the foreign entity are the tax persons. Similarly, globalization means that every resident of a country may invest in a foreign entity. Presuming the country taxes foreign source income of its residents, the country must be able to classify the type of foreign income derived from the foreign entity, and that will require a classification of whether the foreign entity is a person or not for tax purposes.

The various ways in which an income tax law may classify persons is fundamental to understanding the manner in which some hybrid mismatch arrangements operate, but there are other features of a person that can give rise to hybrid effects. In particular, an income tax law will characterize persons according to various types, for example, individual, partnership, trust or company. An income tax law will incorporate a situs test for persons, usually based on the concept of residence. An income tax law must also deal with the eventuality of a person beginning to exist and a person ceasing to exist. An income tax law might also identify the relationship of a particular person with another person or persons, such as in the case of related individuals, group companies or other closely held companies.

As for the activities through which income is earned, these are generally of three types: employment, investment and business, reflecting resources available for earning income. Income may be earned through the exclusive provision of labour — most employment falls into this category. Income may be earned through the exclusive provision or use of assets — often called "investment." Income may also be earned, in a myriad of combinations, through the use of labour and assets — most commonly referred to as "business." Just as it is possible that different countries classify persons differently, it is common for countries to classify earning activities differently. Further, earning activities also demonstrate some fundamental features. Earning activities must be allocated as being conducted by particular persons. These activities may be allocated a particular situs (often related to the location of the individual activities making up the earning activity). It may also be necessary to determine when an earning activity commences and when it ends.

Each earning activity constitutes the aggregate of the provision of resources on isolated occasions (transactions) within the scope of that activity. Thus, in the context of an employment, these are the occasions on which the individual renders services as an employee. In the context of an investment, it is the provision (transfer or use) of the investment assets. In the context of a business it is either or a combination of both.

Each isolated provision of resources (labour and assets) must be classified for income tax purposes and will demonstrate certain fundamental features. For example, in the context of the rendering of services, it will be necessary to identify the time when the services are rendered (usually during the period when the physical labour is performed) and where the services are rendered (usually where the individual is who is physically performing the labour or where the services are used or consumed).

The use of assets is more complex (than the rendering of services) and an income tax law is likely to have more detailed rules associated with assets. There is the need to identify what constitutes an asset (or two or more assets) for income tax purposes, including a negative asset in the form of a liability. There is also a need to classify different types of assets and liabilities because different tax consequences may be attached to the holding and sale of different types of assets and income derived from them. Third, assets must be allocated to particular persons (for example, ownership) and the earning activities of that person. Fourth, an income tax law is concerned with movements in the value of assets, whether while held (for depreciation purposes) or at least when they are disposed of (for purposes of calculating gains).

"Income" is the return derived from the provision of resources in the context of an earning activity calculated for a particular period, usually the tax year, less any assets used in the provision. In the context of a realization-based income tax (in practice the residual basis of all income taxes) this means the netting of amounts paid against amounts received in the context of an earning activity.

Payments are the building blocks of the calculation of income and, as with other income tax essentials, payments must be identified and have certain fundamental features. A "payment" is broadly the bestowal of value by one person on another person.[9] The ways in which a person may make a payment reflect the resources available to that person, that is to say, the provision of labour, the use of assets, the ownership of assets or a combination thereof. A payment may be made by one person transferring an asset, including cash, to another person. There is also a bestowal of value when one person gives up rights (an asset) that they have against another person (a liability). So

[9] Recommendation 12 of the OECD Final Report on BEPS Action 2, supra note 2, defines "payment" for the purposes of the Final Report. The limitations on this definition are discussed in section 2.2 below.

the reduction of a liability is also a payment. This type of payment involves the destruction of an asset by one person without the acquisition of an asset by another person. The third type of payment involves the opposite, where one person uses their resources to create an asset that becomes owned by another person, even though the first person never owned the asset created. The fourth type of payment involves the payer permitting another person to use an asset that the payer owns. The fifth type of payment is similar and involves one person providing services (labour) for the benefit of another person.

Often countries do not agree on the fundamental features of a payment and this disagreement gives rise to some common forms of hybrid mismatch arrangements. In particular, an income tax law must allocate payments to persons, earning activities, a location and perhaps to assets or liabilities. An income tax law must determine the quantum of the payment, especially when the payment does not involve a transfer of cash in the currency in which the tax base must be reported. An income tax law must determine the timing of the payment and, in particular, the tax period or periods in which the payment is to be recognized as having a tax effect.[10] Finally, an income tax law often places critical importance on the character of a payment (not to be confused with its form), that is to say, a label assigned to it which is usually determined by reference to the reason why the payment is made. The character of payments is particularly important in the context of allocating taxing rights between countries, and the source of a payment is viewed as one of the characteristics of a payment.

1.2 Hybrid mismatches in respect of payments and the fundamental features of payments

Disagreement between two countries as to any of the fundamentals of income taxation discussed in the previous section (the hybrid element)

[10] The OECD Action 2 recommendations are prescribed by reference to the making of payments. The making of a payment is defined by reference to "incurring" the payment under the laws of the payer jurisdiction and "deriving" the payment under the laws of the recipient jurisdiction; OECD Final Report on BEPS Action 2, supra note 2, paragraph 424. This split test highlights the potential for timing mismatches between the payer and the payee jurisdictions.

may be exploited by taxpayers in a way that gives rise to a mismatch of tax outcomes. However, as these fundamentals are cumulative in producing a tax liability, it is common that disagreement with respect to one of the essentials may give rise to disagreement with respect to another essential. For example, disagreement as to who or what constitutes a person may give rise to disagreement as to who owns an asset or who receives a payment with respect to use of the asset. Disagreement as to whether two persons are related may give rise to a disagreement as to the value at which a transaction between the persons should be quantified and the character of payments under it.

The reasons why countries disagree on the fundamentals of income taxation often pertain to one country accepting legal form and another adopting some type of substance approach, including one based on financial reporting (accounting standards).[11] The difference between following legal classification and adopting a disjointed approach for identifying persons was discussed above in section 1.1. Another common example involves disagreement as to whether a transaction transfers the ownership of an asset or not. At one extreme, a finance lease does not transfer legal ownership but might be considered in substance to do so. At the other extreme, a sale and repurchase agreement does transfer legal ownership but might be considered in substance not to do so. In the middle there can be legal mortgages (for example, securities lending arrangements) under which the legal title to an asset is transferred as collateral for a loan.

Most commonly (although not always) disagreements in identifying persons and earning activities (and the provision of resources) manifest themselves in disagreements as to the fundamentals of a payment. Therefore, the following discussion starts by considering how disagreement between two countries in the fundamentals of a payment may give rise to cross-border mismatch opportunities. This is done in the context of six case studies. Subsequent subsections proceed to develop other case studies demonstrating how disagreement in the fundamentals of a payment can be triggered by disagreement with respect to the identification of earning activities or of who or what is a person.

[11] For a similar observation, see Stephen Edge, "Base Erosion and Profit Shifting: A Roadmap for Reform — Tax Arbitrage with Hybrid Instruments," (2014) Vol. 68, No. 6/7 *Bulletin for International Taxation*, 318–320.

Hybrid mismatch 1 is a simple illustration of disagreement between two countries regarding whether a payment exists for tax purposes.

Hybrid mismatch 1
Identifying a payment—Deduction but no income

Z, a resident of Country A, owes money to Y, a resident of Country B. Z enters into an arrangement with its creditors whereby part of the debt owed to Y is written off. Under the Country B tax law, Y can deduct the amount of the debt that is written off. Under the Country A tax law, Z is not required to report any income.

If the reduction in the debt is looked at in isolation, there is a mismatch that gives rise to a cross-border tax benefit (deduction in Country B) with no pick-up in Country A (no income). In many cases, such a scenario is not abusive, presuming that Z has unrelieved (or cancelled) losses in Country A. However, the disagreement can result in untaxed funds if, from a tax perspective, Z has managed to set off all of the negative results that gave rise to the arrangement against income. This income might be in Country A or elsewhere, for example, through carry back of losses or setting losses against income from other activities, including those of related parties.

In this case study, Country B (country of creditor) sees value passing from Y (creditor) to Z (debtor) when Y forgives part of the debt. Country B also sees this "payment" as having a sufficient business purpose and grants a deduction for it. By contrast, Country A (country of debtor) does not recognize the payment received by Z in the form of a reduction in liability. The result is a cross-border mismatch. Hybrid mismatch 1 focuses on countries disagreeing as to the very nature of whether there is a bestowal of value (payment) that should be recognized for tax purposes. This case should not be confused with similar cases that focus on other income tax fundamentals, such as where both countries recognize a payment but characterize it differently, for example, Country A characterizes the forgiven debt as a payment of capital and does not tax it because Country A does not tax capital gains.

Hybrid mismatch 2 is a simple illustration of disagreement between two countries that recognize a payment, but disagree as to who (which person) should be treated as receiving it.

Hybrid mismatch 2
Recipient of payment—No income

Z, a resident of Country A, makes a payment that is deductible for Country A tax purposes. Country A considers that the payment is made to Y, a resident of Country B. Country B considers that the payment is made to X, a resident of Country A.

If the taxation of the recipient in their State of residence is looked at in isolation, there is a mismatch that gives rise to a cross-border tax benefit (deduction in Country A) with no pick-up as income of the recipient in a residence State. If Country A taxes the payment substantially at source (for example, by withholding) there may be little or no benefit. However, if that tax at source has been eroded (whether unilaterally or by tax treaty) then the cross-border benefit can be substantial. A common form of this type of mismatch is where the two countries do not agree on what constitutes a tax subject (hybrid entity). However, this style of hybrid mismatch is generic and not limited to the use of hybrid entities. For example, it can also arise where two countries disagree as to which of two related parties receives a payment.

In this case study, both Country A and Country B see a payment as being made by Z, but they do not agree on who receives the payment. So Country A grants a deduction for the payment but neither country taxes the receipt because neither country considers the recipient of the payment to be a resident. The case study notes that this is a problem particularly when source-State taxation of the payment has been eroded. The case study also notes that this style of mismatch is commonly triggered in the context of hybrid entities (one country considers an artificial entity as a tax subject but another country does not), discussed below.

Hybrid mismatches 1 and 2 are limited to the simple allocation of a payment to a person. As noted in section 1.1 above, payments also need to be allocated to earning activities, a location and perhaps to assets or liabilities. No further case studies are given with respect to these deeper allocation issues, but they can equally give rise to mismatches. For example, one country may view a payment as attached to one earning activity of a person (maybe a particular place of business) whereas another country views the payment as attached to another earning activity of the person (another place of business).

Hybrid mismatch 3 is a simple illustration of disagreement between two countries that recognize a payment, but disagree as to who (which person) should be treated as making it.

Hybrid mismatch 3
Maker of payment—Double-dip deduction

Y, a resident of Country B, receives a payment that is included in income. Country A considers that the payment is made by Z, a resident of Country A, and that the payment is deductible for Country A purposes. Country B considers that the payment is made by X, a resident of Country B, and that the payment is deductible for Country B purposes.

Presuming that both Z and X can deduct the payment against taxable income, there is a cross-border mismatch that gives rise to two tax benefits (deduction in Country A for Z and in Country B for X) with only one pick-up as income (for Y in Country B). If Country A taxes the payment substantially at source (for example, by withholding) there may be little or no benefit. However, if that tax at source has been eroded (whether unilaterally or by tax treaty) or if Country B grants Y foreign tax relief for that taxation at source (whether unilaterally or by tax treaty) then the cross-border benefit can be substantial. A common form of this type of mismatch is where the two countries do not agree on what constitutes a tax subject (hybrid entity). However, this is a generic mismatch issue and is not limited to the use of hybrid entities. For example, it can also arise where two countries disagree as to which of two related parties makes a payment.

In this case study, both Country A and Country B see a payment as being received by Y, but they do not agree on who makes the payment. The income tax fundamental at issue (allocation of payment) is the same as in example 2, but this is a different variation involving "double-dip" deductions. Thus, Country B includes the payment in calculating the income of Y, but both Country A and Country B grant a deduction for the payment to different entities, that is to say, two deductions, one income. Again, this type of mismatch is often triggered in the context of payments made by hybrid entities.

Hybrid mismatch 4 is a simple illustration of disagreement between two countries that recognize a payment, but disagree as to the quantum of the payment.

Hybrid mismatch 4
Quantifying payment—Large deduction but small income

Z, a resident of Country A, transfers an asset to Y, a resident of Country B, in return for a payment of 100 in cash, which is equal to the tax cost of the asset for Country A purposes. Z and Y are related and both Country A and Country B agree the market value of the asset is 150. Country A accepts the transaction at the price of 100 for tax purposes and considers that Z has no gain or loss. Because Z and Y are related, Country B applies a market value rule to the transaction and so considers the asset to have been purchased for 150. Country B proceeds to grant a deduction for that 150 (either through depreciation or on sale of the asset by Y).

There is disagreement between Country A and Country B as to the price considered paid for the asset for tax purposes. The discrepancy of 50 (difference between 100 and 150) results in a tax benefit (deduction in Country B) with no pick-up in Country A (no income or gain). In a reverse scenario (price considered received is higher than price considered paid), there is scope for application of corresponding adjustment rules in the transfer pricing provisions of tax treaties. While these rules protect taxpayers from many types of double taxation, in most countries they have no application in this scenario where the application of domestic rules results in undertaxation.

In this case study, there are two payments (bestowals of value); one being the transfer of the asset from Z to Y and the second being the cash payment from Y to Z. Both Country A and Country B agree as regards the quantum of the first payment (the asset). However, they disagree as to the quantification of the consideration paid for the transfer (the cash payment). Country A accepts the payment at its face value and calculates the gain/loss of Z from the transaction accordingly. By contrast, Country B deems Y to have paid an amount equal to the market value of the asset received. The result is that Country B grants a deduction (currently or in the future) for an amount that is more than was brought into account in Country A when calculating the gain or loss of Z. Again, this case should not be confused with similar cases that focus on other income tax fundamentals but also result in a smaller amount being brought into account in one country than is deducted in another country. One such similar case is where one country considers a payment received to be wholly capital in nature but the country of the payer considers it a mixture of revenue (for example financing expenses) and capital.

Hybrid mismatch 5 is a simple illustration of disagreement between two countries that recognize a payment, but disagree as to the time at which the payment should be recognized for tax purposes.

Hybrid mismatch 5
Timing payment—Early deduction but late income

Z, a resident of Country A, borrows money from Y, a resident of Country B. The loan is for a term of three years and the agreement requires Z to pay interest in one lump sum at the end of the three-year period. Country A permits Z to deduct the interest for tax purposes as it accrues, for example, one third of the interest in each of the three years. Country B does not tax the interest as income to Y until it is received in year three.

There is disagreement between Country A and Country B as to the time at which the interest should be recognized for tax purposes. This gives rise to a cross-border tax benefit because most of the interest is deductible in Country A in tax years before it is included in income in Country B. Commonly, this timing benefit is not resolved if Country A taxes the interest at source (for example, by withholding) because withholding is typically only at the point the interest is paid, that is to say, when, given these facts, Country B also taxes.

In this case study, Country A grants Z a deduction for interest payments as they accrue over the three-year term of the loan because Country A tax law follows financial reporting in this regard. By contrast, Country B requires Y to include the interest in calculating income when it is received (cash basis). The case study notes that source-State taxation of the interest often does not resolve the timing mismatch because that taxation (like taxation in the residence State in this case study) is most often imposed on a cash basis. This case should not be confused with similar cases that focus on other income tax fundamentals but also result in timing benefits across borders, for example, where two countries do not agree as to ownership of an asset and so simultaneously both grant depreciation deductions for the asset (see hybrid mismatch 9 below).

Hybrid mismatch 6 is a simple illustration of disagreement between two countries that recognize a payment, but disagree as to the character of the payment for tax purposes.

Hybrid mismatch 6
Characterizing payment—Deduction but specific tax relief

Z Co, a company resident in Country A, issues perpetual, subordinated, profit-sharing debentures to Y Co, a company resident in Country B. Country A characterizes the return payable on the debentures as deductible interest. Country B characterizes the return as dividends and grants a participation exemption (exemption for dividends paid between two companies) to Y Co with respect to receipt of the dividends.

There is disagreement between Country A and Country B as to characterization of the return payable on the debentures (interest or dividends). This gives rise to a cross-border tax benefit (deduction in Country A) with no pick-up in Country B (exemption granted). There are many variations of this style of mismatch. Some occur, as here, even though the two countries classify the investment in the same manner. Others occur because the two countries characterize the investment differently, for example, as debt or equity.

In this case study, Country A characterizes the payment as interest for tax purposes and so grants Z a deduction for it. By contrast, Country B characterizes the payment as a dividend, grants indirect foreign tax relief (cross-border dividend relief) and so does not tax Y with respect to the receipt. The result is a deduction in one country with no inclusion in income in the other country. This case should not be confused with similar cases that focus on other income tax fundamentals but also result in a deduction with no inclusion in income, for instance, as in hybrid mismatches 1 and 2.

1.3 Hybrid mismatches in respect of earning activities and the provision of resources

Disagreement between countries in identifying earning activities can also give rise to cross-border mismatches, as demonstrated in hybrid mismatch 7.

In hybrid mismatch 7, Country A characterizes the activities of Y as investment and Country B as business. This results in Country A not taxing and Country B also not taxing due to the provision of foreign tax relief. This case produces "double non-taxation" in a similar fashion to that in hybrid mismatch 6, but in this case Country B is providing direct foreign tax relief as opposed to indirect foreign tax relief (dividend relief). Similar cases arise where the residence State thinks that a person is engaged in an earning activity, for example, employment, and the source State thinks there is insufficient activity to constitute an earning activity (for example, private activity).

Hybrid mismatch 7
Earning activities—No source-State tax but foreign tax relief

Y, a resident of Country B, deals in securities in Country A. Country A does not consider that the activities of Y are sufficient to amount to conducting a business and so classifies them as an investment. As a result, Country A does not tax Y with respect to the dealings. By contrast, Country B considers that Y is conducting a business in Country A (for example, through a permanent establishment) and so grants Y foreign tax relief in the form of an exemption.

There is disagreement between Country A and Country B regarding the type of earning activity Y is conducting (investment or business). This gives rise to a cross-border tax benefit in that neither country taxes income derived from the dealing in securities. There are many variations of this style of mismatch. Some occur even though the two countries classify the activity in the same manner, as in hybrid mismatch 8 below.

Disagreement as to whether a source-State tax threshold such as permanent establishment (PE) is met can also give rise to a mismatch, as illustrated in hybrid mismatch 8.

Hybrid mismatch 8
Party to a contract—No income but foreign tax relief

Y, a resident of Country B, sells stock in Country A through a commissionaire arrangement. Under this arrangement, the commissionaire, Z, who is resident in Country A, sells the products of Y to third parties in the name of Z but on account of Y. Country A considers that Y is not bound by the contracts with third parties and so is not conducting the activity associated with these contracts. As a result, Country A does not consider Y to have a PE there and does not tax Y (but does tax Z on commission received from the sales). By contrast, Country B considers Y to be conducting business in Country A through an agent (Z) and so considers that Y does have a PE in Country A. As a result, Country B grants Y foreign tax relief in the form of an exemption for profits from the sales.

The mismatch in this example produces results similar to those in hybrid mismatch 7.

Here, the two countries agree as to the nature of the earning activity being conducted (business) and who is conducting it. However, the two countries do not agree in respect of whether there is sufficient activity to constitute a PE. This might happen due to disagreement as to which transactions are considered conducted or assets owned by the person (see hybrid mismatch 9). In hybrid mismatch 8, Country A and Country B do not agree as to who contracted with the customers of the goods of Y. As a result, Country A thinks the activity of Y is insufficient to constitute a PE, while Country B thinks it is sufficient and so grants foreign tax relief.

Hybrid mismatch 9 demonstrates a simple disagreement as to ownership of an asset, which gives rise to double dip depreciation.

Hybrid mismatch 9
Ownership of an asset—Double-dip depreciation

Y, a resident of Country B, leases by way of a finance lease an asset to Z, a resident of Country A. Country A considers the substance of the lease and treats it as a sale with debt financing. Accordingly, Country A grants Z tax depreciation and a deduction for notional interest paid to Y with respect to the debt financing. Country B accepts the form of the agreement as a lease and so treats Y as the owner and grants Y tax depreciation. Country B requires Y to include the rent payments received from Z in income, but also grants foreign tax relief with respect to them. In particular, Country B considers that the rent is derived through a PE in Country A.

Conceptually, it may be argued that an accurate rate of depreciation for a leased asset is equal to rent charged for the asset less a notional interest charge. In such a case, there might be little tax advantage. However, most countries grant tax depreciation at a rate in excess of economic depreciation and sometimes for more than 100 per cent of the cost of an asset. In such a situation, a mismatch such as in this case that gives rise to two sets of depreciation can give rise to substantial cross-border timing advantages, irrespective of whether there is also a mismatch in the tax treatment of the rent payments because the countries characterize them differently.

As in hybrid mismatch 8, hybrid mismatch 9 involves disagreement in the fundamentals of a provision of resources, in this case whether the provision of an asset is by way of transfer or lease. In this case study, Country A characterizes a finance lease as a transfer of an asset with debt financing. By contrast, Country B characterizes the finance lease as a lease. The result is that Country A considers Z to be the owner of the asset and Country B considers Y to be the owner of the asset and so both countries simultaneously grant tax depreciation to two different persons. Depending on the facts, it is possible for the reverse scenario also to give rise to tax benefits, that is to say, where Country A considers Y to be the owner of the asset and Country B considers Z to be the owner of the asset. If the asset is an appreciating asset, neither country may tax a gain arising on the disposal of the asset.

Hybrid mismatch 9 also demonstrates that disagreement as to ownership of an asset can trigger mismatches in the character of a payment, but such mismatches may also be triggered by simple disagreement as to the character of an asset. In hybrid mismatch 9, the disagreement as to ownership causes Country A to consider the payments under the finance lease to be a mixture of interest and capital (purchase price), whereas Country B considers the payments to be purely rent. Such a result can be caused where two countries do not agree as to the character of an asset, even if they agree as to its ownership. For example, if one country (Country A) considers a particular financial instrument to be debt and another (Country B) considers it equity, this can give rise to mismatches of the type illustrated in hybrid mismatch 6.[12]

[12] For an in-depth analysis of distinguishing between debt and equity in domestic and international tax law, see Wolfgang Schön and others, "Debt and Equity in Domestic and International Tax Law—A Comparative Policy Analysis," (2014), No. 2 *British Tax Review*, 146–217.

Hybrid mismatch 10 illustrates that disagreement as to the character of an asset can also give rise to cross-border tax benefits where the indirect foreign tax credit method (cross-border dividend relief) is used.

Hybrid mismatch 10
Characterizing an asset—Double-dip dividend relief

Y Co, a company resident in Country B, owns shares in Z Co, a company resident in Country A, such that Z Co is a subsidiary of Y Co. X, a resident of Country A, holds profit-sharing debentures in Z Co. Country A treats the profit-sharing debentures as shares for Country A tax purposes. As a result, Country A denies Z Co a deduction for interest paid on the profit-sharing debentures, but grants X dividend relief with respect to receipt of the interest in the form of dividend tax credits. By contrast, Country B considers that Y Co is the only shareholder in Z Co and so when Y Co receives a dividend from Z Co, Country B grants Y Co an indirect foreign tax credit for all of the Country A corporate tax paid by Z Co.

There is disagreement between Country A and Country B as to the character of the investment (shares or debt) held by X and the return payable on it (dividends or interest). This gives rise to two tax benefits in the form of crediting the same corporate tax paid by Z Co to both X (in Country A) and Y Co (in Country B). This style of arrangement is often referred to as a “tax credit generator.”

In this case study, there are two payments: payment of interest on the profit-sharing debentures held by X and payment of dividends on the shares held by Y Co in Z Co. The same corporate income tax paid by Z Co in Country A is credited to both X and Z Co and the duplication causes a mismatch benefit. For this style of disagreement to produce effective benefits, it is likely that the corporate tax rate of Y Co in Country B is comparatively high and/or Country B has a broad method of calculating the limitation on credit under its foreign tax credit system, for example, where it calculates the limitation on credit on a worldwide basis.[13]

[13] For different methods of calculating the limitation on credit, see Peter A. Harris, “Taxation of residents on foreign source income,” in *United*

1.4 Hybrid mismatches in respect of persons and personal characteristics

Countries may disagree as to whether an entity constitutes a person for tax purposes (hybrid entity) and this may give rise to disagreement as to whether a payment has been made, as illustrated in hybrid mismatch 11.

Hybrid mismatch 11
Identifying a person—Deduction but no income

Y, a resident of Country B, establishes Z Co in Country A. Y lends money to Z Co and Z Co pays interest in return. Country A considers Z Co to be a taxable person and thus grants a deduction for the interest paid. Country B considers Z Co to be transparent (not a taxable person) and thus does not recognize any loan transaction or payment of interest between Y and Z Co. Rather, Country B considers the activities of Z Co as a PE of Y in Country A and as a result grants Y foreign tax relief in the form of an exemption of the activities of Y in Country A.

There is a mismatch in the treatment between Country A and Country B. The arrangement gives rise to a cross-border tax benefit (deduction in Country A) with no pick-up in Country B (no income). In this sense the case study is similar to hybrid mismatch 1. The cross-border benefit may be minimized if Country A imposes a substantial source-based tax. Further, the benefit may be minimized if Country B adopts the foreign tax credit method of foreign tax relief. Tax planning of this variety presumes that the residence State (Country B) calculates the exemption for the Country A PE without a deduction for the interest. As such, the exemption will be larger than what Country A taxes to Z Co. A foreign tax credit would credit to Y only tax actually paid in Country A (although disagreement in calculating the Country A income can cause difficulties in calculating the limitation on credit).

In hybrid mismatch 11, Country B sees Z Co as part of the entity that is Y, whereas Country A considers Z Co and Y to be separate tax entities. This makes Z Co a "hybrid entity." The interest payment by

Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries, (New York: United Nations, 2013), available at http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf, chapter III, 109 – 171.

Z Co is recognized by Country A (paid between two persons), but not by Country B (paid by Y to itself). In this sense, hybrid mismatch 11 is similar to hybrid mismatch 1 and demonstrates how the classification of persons for tax purposes can impact on whether a payment is recognized. Hybrid mismatch 11 is also similar to hybrid mismatch 7 in that Country A sees the activities of Y as an investment (a loan), whereas Country B sees the activities of Y in Country A as business activities.

Mismatches of the type illustrated in hybrid mismatches 2 and 3 can also be triggered by disagreement between two countries as to whether an entity is a taxable person or not (hybrid entity). In hybrid mismatch 2, therefore, it may be that X is a hybrid entity established by Y. Country A does not recognize X and so considers the payment to be made to Y. Country B does recognize X and considers it to be the recipient of the payment. The tax effects are then the same as discussed in hybrid mismatch 2. Similarly, in hybrid mismatch 3, X may be a hybrid entity because Country A considers it to be a taxable person and Country B does not. Again, this may give rise to a double-dip deduction, as discussed in hybrid mismatch 3.

Mismatches of the type illustrated in hybrid mismatches 2 and 3 can also be triggered by disagreement between two countries as to whether an entity is a resident person, as illustrated in hybrid mismatches 12 and 13.

Hybrid mismatch 12
Residence of recipient—Deduction but no residence taxation

Z, a resident of Country A, pays for goods bought from Y. Y is formed under the laws of Country A and managed from Country B, but neither Country A nor Country B considers Y to be resident in their jurisdiction (different tests of residence). As a result, neither Country A nor Country B taxes Y with respect to the proceeds of sale.

There is a mismatch between Country A and Country B as regards the residence of Y. This gives rise to a cross-border tax benefit because the sales proceeds are likely to be deductible to Z in Country A with no pick-up in the taxation of Y because it is not resident anywhere (presuming the sale is not attributable to a PE in Country A or Country B, for example, goods shipped from a third country).

Hybrid mismatch 13
Residence of payer—Double-dip deduction

Z Co is a member of a multinational group of companies. It has been making losses. It is managed from Country A but formed under the laws of Country B. Both Country A and Country B consider Z Co to be resident in their jurisdiction. As a result, both Country A and Country B provide tax loss relief, including by way of setting the losses of Z Co against income derived by other group members resident in their jurisdiction.

There is disagreement between Country A and Country B as to the residence of Z Co. This gives rise to a cross-border tax benefit because the losses of Z Co are simultaneously used to reduce the income of more than one member of the corporate group.

Hybrid mismatches 12 and 13 help to demonstrate that much mismatch tax planning revolves around inconsistencies in the manner in which countries exercise their jurisdiction to tax. What constitutes a person and the fundamental features of the person are important where taxation on the basis of residence is at issue. As in hybrid mismatches 1, 2 and 11, in hybrid mismatch 12 there is a deduction but no effective pick-up in taxable income. Similarly, as in hybrid mismatches 3 and 9, in hybrid mismatch 13 a deduction is granted more than once for the same expenditure (that is to say, the expenditure producing the loss). Hybrid mismatch 10 is also similar to hybrid mismatch 13 in that the same tax benefit (credit in hybrid mismatch 10 and loss in hybrid mismatch 13) is used more than once.

2. What is covered by OECD Action 2

Categorization of hybrid mismatch arrangements in the OECD Final Report on BEPS Action 2 is very different from the above categorization. This is because Action 2 is targeted at only some types of cross-border mismatch arrangements that may give rise to cross-border tax benefits.[14] Exactly what is targeted by the Final

[14] Graeme S. Cooper, "Some Thoughts on the OECD's Recommendations on Hybrid Mismatches," (2015) Vol. 69, No. 6/7 *Bulletin for International Taxation*, at 335–336, notes that the Action 2 project is "directed at

Report is in some ways less clear than in the OECD *Public Discussion Draft, BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* (2014) (hereinafter "OECD Public Discussion Draft on BEPS Action 2") and the OECD *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2014 Deliverable* (hereinafter "OECD BEPS Action 2—2014 Deliverable"). Both of the earlier reports contained a section identifying and defining "hybrid mismatch arrangements." [15] Nevertheless, it is clear that the Final Report still targets only hybrid instruments and entities[16] and table 1.1. in the Final Report,[17] presenting a general overview of the recommendations, is the same as that in the OECD BEPS Action 2—2014 Deliverable. It would therefore seem that the Final Report is less concerned with identifying and conceptualizing links between what is covered by the recommendations and justifying their scope; rather, it is more concerned with detailing the potential application of those recommendations.

The OECD Final Report on BEPS Action 2 also reverts to the presentation in the OECD Public Discussion Draft, that is to say, it focuses (by way of its chapter headings) on the type of arrangement. This creates a dislocation with table 1.1, which like the 2014 Discussion Draft is presented with a focus on the mismatch outcome. However, the Final Report restructures the order in which it deals with different

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controlling corporate tax abuse in relation to only two or three areas .... The Recommendations Paper does not purport to address all mismatches. Rather, instead, it is clearly preoccupied with only a few key issues in the current international tax order."

[15] OECD *Public Discussion Draft on BEPS Action 2,* supra note 2, paragraphs 17–26; and OECD, BEPS Action 2—2014 Deliverable, supra note 2, Chapter 1.

[16] For example, see OECD Final Report on BEPS Action 2, supra note 2, paragraph 13. This is reinforced by OECD, *Public Discussion Draft, BEPS Action 2: Branch Mismatch Structures* (Paris: OECD, 2016) (hereinafter "OECD Public Discussion Draft on Branch Mismatches"), paragraphs 4 and 6, justifying separate treatment of branch mismatches because "they are not the result of differences in the tax treatment or characterisation of an instrument or entity" (available at https://www.oecd.org/tax/beps/Discussion-draft-Action-2-Branch-mismatch-structures.pdf).

[17] Ibid., table 1.1, at 20.

types of arrangements such that there is also broad consistency with the order of mismatch outcomes. As a result, the Final Report provides less explanation about why only certain types of hybrid mismatch arrangements are covered (and none concerning those which are not) and more detail about how the recommendations it has decided upon should work.

The following discussion seeks to gain some understanding of what is covered by the OECD Final Report on BEPS Action 2 by first looking at the previous explanation of a hybrid mismatch arrangement. It then considers the extent to which the features of that explanation are still apparent in the Final Report. The OECD Public Discussion Draft, BEPS Action 2: Branch Mismatch Structures (hereinafter "OECD Public Discussion Draft on Branch Mismatches") was released after the Final Report. It is not considered separately in the following discussion. The need for this separate report underlines the fragmented and narrow nature of the Final Report. All of the issues dealt with in the OECD Public Discussion Draft on Branch Mismatches fall within the broad conceptual framework outlined in section 1 above.

2.1 Hybrid mismatch arrangements

As noted, the OECD Final Report on BEPS Action 2 seeks to focus on particular tax outcomes arising in particular circumstances. It provides little to no conceptual justification regarding why the recommendations apply in certain circumstances and not in others. There are, nevertheless, clear links among the circumstances in which the recommendations apply to produce the prescribed outcomes. These circumstances typically involve disagreement about the fundamental features of financial instruments and the identification of tax subjects. One problem is that it is sometimes unclear what other aspects may be covered by the recommendations, for instance, other circumstances that produce the prescribed outcome. As Cooper notes, "constructing the rules around outcomes clouds as much as it reveals." [18]

Unlike the Final Report, the OECD Public Discussion Draft on BEPS Action 2 and the OECD BEPS Action 2—2014 Deliverable outlined

[18] Graeme S. Cooper "Some Thoughts on the OECD's Recommendations on Hybrid Mismatches," supra note 14, at 339.

the key elements of a hybrid mismatch arrangement, namely, the general circumstances on which Action 2 is focused. These elements are:

- The arrangement results in a mismatch in the tax treatment of a payment
- The arrangement contains a hybrid element
- The hybrid element causes a mismatch in tax outcomes
- The mismatch in tax outcomes lowers the aggregate tax paid by the parties to the arrangement[19]

This useful outline was removed from the Final Report, presumably because it was found to be too broad for the limited recommendations that the OECD wished to make. Nevertheless, the title of the Final Report includes hybrid mismatch arrangements, and the Report makes copious reference to them, even though they are now not defined per se. It is also clear that the recommendations continue to focus on these features, as does the discussion in the following subsections below.

While the OECD Final Report on BEPS Action 2 does not define hybrid mismatch arrangements, it does separately define "hybrid mismatch," "mismatch" and "arrangement."[20] "Arrangement" is considered in section 2.2 below, together with the concept of "payment." There is no separate definition of "hybrid" in the Final Report. However, discussion under the heading "Hybrid element" in the introduction makes it clear that "hybrid entities" and "hybrid instruments" are the target of the report.[21]

The definition of hybrid mismatch is particularly obscure and simply refers to certain paragraphs in certain recommendations. There is an element of circularity in some of these references.[22] All focus

[19] OECD *Public Discussion Draft on BEPS Action 2,* supra note 2, paragraphs 8 – 10; and OECD, BEPS Action 2 — 2014 Deliverable, supra note 2, paragraphs 41 – 44.

[20] OECD Final Report on BEPS Action 2, supra note 2, recommendation 12.

[21] Ibid., paragraphs 13 and 14. This is reinforced in the OECD Public Discussion Draft on Branch Mismatches, supra note 16, paragraphs 4 and 6.

[22] Ibid. For example, the definition of "hybrid mismatch" refers to recommendation 1.3, which refers to a financial instrument resulting in a "hybrid mismatch."

on the mismatch; none of them define or identify directly the hybrid element as such (although that can be discerned from the nature of the recommendation in question). It is not clear whether the OECD deems hybrid to have any particular meaning, for instance, with respect to inconsistent classification of payments, assets or entities. If the intended focus is purely on tax outcomes, then it would seem that a reference to mismatch arrangements would have been sufficient.

The OECD Final Report on BEPS Action 2 continues to focus on two key mismatches; deduction/no inclusion (D/NI) outcomes and double deduction (DD) outcomes. This is clear from the definition of mismatch in recommendation 12.[23] These two outcomes are the focus of the OECD recommendations. Both "D/NI outcome" and "DD outcome" are further defined in recommendation 12 and are considered in section 3.1.1 below. These definitions make it clear that a payment is a critical feature of a hybrid mismatch arrangement.

While there is much uncertainty about the scope of many of the recommendations in the OECD Final Report on BEPS Action 2, they are supported with 280 pages of worked examples (longer than many developing countries' income tax laws). These are supplemented with another 30 pages of discussion and examples in the OECD Public Discussion Draft on Branch Mismatches. While these examples reveal much about the scope of the proposals, they do not of themselves resolve ambiguities or the general lack of conceptual clarity in the recommendations. The table in annex I to the present chapter attempts to categorize many of the OECD examples by reference to the conceptual framework outlined in section 1 above, and through comparison with the 13 hybrid mismatch case studies discussed there.

The 13 hybrid mismatch case studies in the present chapter are intentionally spread across the potential types of disagreements that countries may have regarding income tax fundamentals (hybrid features). By comparison, the examples in the OECD Final Report on BEPS Action 2 and the Public Discussion Draft on Branch Mismatches continue to focus on hybrid mismatches regarding ownership of assets, character of assets and identification of persons. The Final Report now

[23] Ibid., at 123. This is also true of the OECD Public Discussion Draft on Branch Mismatches, supra note 16; for example, paragraph 3.

contains a number of pure examples of hybrid mismatches with respect to payments and that are not limited to mismatches triggered by other hybrid features (such as allocation and character of assets and identification of persons). However, the only examples in which the OECD recommendations address pure mismatches of payments are with respect to the character of a payment. Of course, even in hybrid categories where there are operative examples, many (possibly most) potential hybrid mismatches in these categories are not covered. This is because of the limited circumstances in which the OECD recommendations apply. This approach continues to raise fundamental questions about the intended scope of the recommendations. Examples are useful, but they are not a replacement for clear and comprehensive rules. The OECD examples are further analysed in annex II to the present chapter.

2.2 Arrangements and payments

The first of the key OECD elements in a hybrid mismatch arrangement (identified in section 2.1 above) requires that there be both an arrangement and a payment. Arrangement is defined in recommendation 12 of the OECD Final Report on BEPS Action 2 in extremely broad terms. The definition is of a type typically used in anti-avoidance legislation. It covers almost all courses of conduct (although not expressly unilateral conduct), whether or not legally enforceable, and has the usual extensions for amalgamation and fragmentation of arrangements.

All of the major recommendations in the OECD Final Report on BEPS Action 2 apply only where a payment is involved. Recommendation 12 contains a definition of payment, but rather than providing a comprehensive and exhaustive one, it merely refers to some examples which fall within the scope of such a definition. The Final Report itself contains more than one description of payment. At its broadest, the report suggests that a "payment is any transfer of value." [24] This is not as broad as the description given in section 1.1 above (bestowal of value), and because it requires a transfer it does not clearly apply in the creation of an asset (for example, issue of shares), reduction of liability and use of asset cases. This is confirmed in OECD example 1.14, where it is suggested that interest relief in respect of

[24] Ibid., paragraph 28.

an interest-free loan is not a payment.[25] This is particularly unusual because the definition of payment includes "accrual of money," and "money" is defined to include "any provision that would be paid for at arm's length." Similarly, the "release from a requirement under a financial instrument does not … constitute a payment." [26]

The OECD Final Report on BEPS Action 2 also contains a more limited description of payment. "Payment means a payment of money (which includes money's worth) made under the financing instrument and includes a distribution, credit or accrual." [27] The description goes on to include amounts "capable of being paid" and "any future or contingent obligation to make a payment" and certain notional amounts. The formal definition of payment in recommendation 12 is similar but not the same. As noted, it does not include the "means" element of this description nor the reference to future contingent obligations. The formal definition also specifically excludes "payments that are only deemed to be made for tax purposes." The precise meaning of these phrases is not clear. For example, it might be suggested that forgone interest is "capable of being paid" and is not "deemed to be made" because the bestowal of value is actually made. The confusion is because of the lack of a general definition of payment.

This confusion is reflected in the suggested treatment of a number of comparable examples. As noted, the forgone interest in

[25] Ibid., 217, paragraph 15, could be read in a number of ways, but this appears to be what is intended. The outcome seems inconsistent (or is at least form over substance) with the suggested treatment in example 1.13. See also 215, paragraph 8. In both cases the company deducts notional interest that is not included in income of the beneficiary. The only difference seems to be that in one case (example 1.13) the notional interest results in reclassification of part of the loan as equity.

[26] Ibid., paragraph 69. Examples 1.18 and 1.20 also suggest that the surrender of rights under a loan and the forgiveness of a debt are not payments. Confusingly, however, the commentary on example 1.20 suggests that "[a]lthough the forgiveness of debt is a transfer of value … it is not a payment under a financial instrument … . The discharge, satisfaction or release of the obligation itself should not be treated as a payment even though such release may give rise to a transfer of value between the parties." (At 229, paragraphs 3 and 4).

[27] Ibid., at 423.

OECD example 1.13 is not a payment, but that in example 1.14 is a payment (where the notional interest results in reclassification of part of the loan as equity). The result is that one is not a hybrid mismatch requiring adjustment and the other is. The explanation for this is more than a little obscure. Apparently, the notional interest is "capable of being paid" in example 1.14 but not in example 1.13. Further, the forgone interest in example 1.14 is not a "deemed" payment. The deemed payment exception "is only intended to exclude regimes, such as those that grant deemed interest deductions for equity capital, where the tax deduction is not linked to any payment obligation of the issuer." [28] This limitation can produce some arbitrary results and is further discussed in section 3.1 below.

There is similar inconsistency in the suggested treatment of OECD examples 1.15 and 1.16. The suggestion here seems to be that (in the context of convertible notes) whether there is a hybrid mismatch requiring adjustment depends on whether the note is mandatorily convertible or not. A problem for developing countries when looking at examples like these is the lack of any attempt at a conceptual justification for why these similar situations merit different treatment (other than the peculiar manner in which the OECD had worded its recommendations).

There is also confusion regarding the treatment of depreciation and amortization. Of itself, depreciation is not a payment, but it most commonly reflects an underlying payment (the cost of the asset in question). The OECD Final Report on BEPS Action 2 excludes depreciation from the scope of its recommendations on the basis of its not falling within the definition of "deduction" (discussed in section 2.3.2 below).[29] With reference to depreciation, it suggests that countries may wish to apply some of their recommendations to "all deductible items regardless of whether they are attributable to a payment." [30] Part of the confusion is that the recommendations are limited to payments and yet the Final Report proceeds with a complex example (6.1) suggesting denial of a deduction for depreciation. In making this suggestion, the example purports to be applying the recommendations.[31]

[28] Ibid., at 215, paragraph 8.

[29] Ibid., paragraph 145.

[30] Ibid., paragraph 192.

[31] Ibid., at 313 – 314.

Recommendation 12 of the OECD Final Report on BEPS Action 2 contains four related definitions; "payer," "payee," "payer jurisdiction" and "payee jurisdiction." The definitions of payer and payee simply refer to a person who makes or receives a payment. It seems that countries may still disagree as to who or what is realizing the making or receiving and (as discussed below) this can confuse the application of some recommendations. There is also a definition of person. This is not the same as in Article 3 (1) (a) of the OECD Model Tax Convention on Income and on Capital (OECD Model Convention)[32] and specifically includes a "trust." The definition is substantially different from the approach used in the domestic law of many countries and could give rise to confusing dislocations. For example, if domestic law does not consider a trust as a person (but rather the trustee) can a trust still be a payer? Can both the trust and the trustee each be a payer?

The payer and payee "jurisdiction" is any jurisdiction where the person "is a taxpayer." There is no definition of jurisdiction and it is unclear whether the intention is to cover subnational groupings (such as provinces and states), although presumably overseas territories (such as many tax havens) are jurisdictions. It is clear that a person can be a taxpayer by reason of having a PE in a particular jurisdiction. What is not clear is whether a person is a taxpayer only by reason of being subject to withholding tax—although, that seems to be the consequence of the definition of taxpayer, which includes being subject to tax on the basis of source. At best, the result is counter-intuitive. When a multinational makes a payment, the payer jurisdiction seems to be every jurisdiction in which the multinational pays tax (whether by withholding or assessment). Similarly, there may be numerous payee jurisdictions when a multinational receives a payment.

2.3 Hybrid element

As has been noted, while the OECD Final Report on BEPS Action 2 no longer generically defines the hybrid elements that it targets, they are set out in chapters 1 to 8, at least indirectly. As mentioned, the focus of the Final Report continues to be on hybrid financial instruments and

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

hybrid entities, with an extension to protect the related recommendations against imported mismatches.

2.3.1 Payments involving hybrid financial instruments

A primary focus of the OECD Final Report on BEPS Action 2 is on disagreement regarding the character of a payment made under a financial instrument. Recommendation 1 applies to "a payment under a financial instrument that results in a hybrid mismatch." Annex B to the Final Report contains 37 examples dedicated to financial instruments. While some of these examples consider issues regarding identification, quantification and timing of payments (which usually confirm there is no application of the recommendation), the most important examples involve the character of payments, ownership of assets and character of assets. Three of the OECD examples (examples 1.10, 1.11 and 1.35) seem to apply to a mismatch in tax outcome only (no hybrid feature), for instance, where the countries agree about all income tax fundamentals, identified in section 1.1 above. Another involves no hybrid element, but also no mismatch (example 1.26).

"Financial instrument" is defined in recommendation 1.2 (a) of the OECD Final Report on BEPS Action 2 as "any arrangement that is taxed under the rules for taxing debt, equity or derivatives under the laws of both the payee and payer jurisdictions and includes a hybrid transfer."

This is a difficult definition. First, "debt," "equity" and "derivatives" are not defined. Services, leasing, licensing, insurance and asset transfers are not intended to be covered.[33] However, under recommendation 1.2 (c) a country should treat provision of money for a "financing return" or "equity return" as a financial instrument. These terms are defined in recommendation 12 and are "intended to be in line with those used in international and generally recognised accounting standards" although there is no reference to such standards in the definitions.[34]

[33] Ibid., paragraph 64.

[34] Ibid., paragraph 63. Example 1.3.1 involves a share repurchase agreement where is it suggested this deeming rule applies to treat the agreement as a financial instrument.

"Hybrid transfer" is defined in recommendation 1.2 (b) of the OECD Final Report on BEPS Action 2 in inclusive terms. It is not clear what independent meaning it could have because the phrase "hybrid transfer" is not expressly limited to financial instruments. What is expressly included is essentially a transfer of a financial instrument which results in countries disagreeing as to who is the owner of the instrument.[35] There is a circularity issue with the definitions and it is unclear whether a hybrid transfer may involve another hybrid transfer (because a hybrid transfer is a financial instrument).

Despite these definitions, it is clear that countries may not agree about what is and what is not a financial instrument. This is acknowledged by the OECD Final Report on BEPS Action 2, which suggests that characterization as a financial instrument is "left to the laws of each country to determine."[36] The Final Report now contains examples where one country classifies an arrangement as a financial instrument but the other country does not.[37] Many countries will adopt a definition of financial instrument consistent with that used for financial reporting purposes. Even where all countries involved do this, there may still be disagreement as to whether there is a financial instrument or not.[38] Other countries may be more hesitant about adopting financial reporting standards, especially for purposes of determining their tax base.[39]

[35] Ibid. All of the examples involving hybrid transfers involve a mismatch of ownership of a financial instrument; for instance, see examples 1.31, 1.32, 1.33 and 1.34.

[36] Ibid., paragraph 65.

[37] Ibid. See examples 1.25 (finance lease) and 1.27 (interest component of purchase price).

[38] For example, the definition of financial instrument used in the International Financial Reporting Standards (IFRS) is a particularly difficult and complex one; International Accounting Standard 32, paragraph 11, available at http://www.ifrs.org/IFRSs/Pages/IAS.aspx.

[39] A common reason giving rise to disagreement in tax law characterization of a financial instrument is that either one or both countries do not follow financial reporting standards for purposes of distinguishing debt and equity. Some view blindly following accounting standards in tax law as being potentially harmful, for example, see Peter A. Harris, "IFRS and the Structural Features of an Income Tax Law," in Victor Thuronyi and Geerten Michielse,

The definition of financial instrument in the OECD Final Report on BEPS Action 2 refers to the treatment in "both the payee and payer jurisdictions." When there are only two countries involved, if one of the countries does not tax the arrangement as "debt, equity or derivative," then it appears that the definition cannot apply. However, as noted in section 2.2 above, in the case of multinationals there could be a lot more than two countries involved. How the definition applies where multiple countries are involved is not clear. It might be argued that many of these potential multiple jurisdictions will not tax the financial instrument (although where a PE is involved, there could be at least three). However, technically it may not be correct to suggest that the primary payer jurisdiction taxes a financial instrument. More correctly, it grants a deduction for a payment under the instrument. Read literally, the definition in recommendation 1.2 (a) of the OECD Final Report on BEPS Action 2 may never apply, leaving the potential application of recommendation 1.2 (c) (mentioned above).

Recommendation 1.2 (d) applies where "an arrangement … is not treated as a financial instrument under the laws of the counterparty jurisdiction." The OECD Final Report on BEPS Action 2 has many references to "counterparty jurisdiction," but there is no definition of this term. In particular, it is not clear whether there can be only one counterparty jurisdiction and, if so, how this jurisdiction might be determined. This is particularly confusing given the potential multiple payer and payee jurisdictions. Is every payer jurisdiction a counterparty jurisdiction for every payee jurisdiction? Is it possible for a payer jurisdiction to be a counterparty jurisdiction to another payer jurisdiction? The wording of these provisions is unfortunately unclear.

Returning to the operative rule in recommendation 1.1 of the OECD Final Report on BEPS Action 2, a payment is only covered if it is made under a financial instrument. This is another area where lack of clarity may lead to inconsistent treatments, as "[a] payment will be

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eds., *Tax Design Issues Worldwide* (Netherlands: Kluwer Law International, 2015), chapter 2, at 37–97. OECD Final Report on BEPS Action 2, supra note 2, examples 1.13 and 1.21, effectively illustrate the risks involved in following accounting treatment. These examples involve mismatches in a single country scenario (not cross-border) resulting from inconsistent accounting treatment adopted by members of the same corporate group.

treated as made *under a financial instrument* if the payment is either required by the instrument or is in consideration for a release from a requirement under the instrument. The release from a requirement under a financial instrument does not, however, constitute a payment for the purposes of the hybrid financial instrument rule."[40]

A payment for the transfer of a financial instrument is not a payment "made under it" even if amounts payable have accrued under the instrument.[41] However, "[a] payment made to acquire an instrument should … be treated as a payment made under that instrument if the acquisition discharges, in whole or part, obligations owed under the instrument."[42]

The examples of the OECD itself demonstrate the slipperiness of this attempt at distinction. Distinguishing between capital and revenue has been a problem for many years. In particular, many payments may diminish the value of an instrument without discharging any obligations under it. The point is that the distinction results in arbitrary line-drawing with no attempt at justifying the arbitrariness on a conceptual basis.[43]

Finally, recommendation 1 of the OECD Final Report on BEPS Action 2 also applies to "a substitute payment under an arrangement to transfer a financial instrument." Here, too, the interaction of this rule with the definition of "financial instrument" is problematic in that the definition itself includes hybrid transfers.[44] There is a definition of "substitute payment" in recommendation 1.2 (e). For present purposes, it is sufficient to note that this is a highly prescriptive rule that demonstrates the highly targeted and specific nature of the other

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[40] OECD Final Report on BEPS Action 2, supra note 2, paragraph 69.

[41] Ibid., paragraph 70.

[42] Ibid., paragraph 71.

[43] Ibid. For example, it is not clear on grounds of merit why recommendation 1 should apply to examples 1.18 and 1.19 but not to the similar examples of 1.20 and 1.36 (presuming that is what is being suggested). The commentary in paragraphs 69–71 is confusing and some of the discussion on the examples themselves seems inconsistent.

[44] That is, what is a substitute payment under an arrangement to transfer a hybrid transfer?

rules on financial instruments and their lack of comprehensive application. It seems likely that there will be practical difficulties in determining when a payment on a transfer represents a return on a financial instrument.

2.3.2 Payments involving hybrid entities

Chapters 3, 4, 6 and 7 of the OECD Final Report on BEPS Action 2 are devoted to payments involving disagreement regarding identifying entities and their residence. The primary focus here is on entities that are treated as tax subjects by one country but not by another (treated as transparent). Usually, this is a simple matter of mismatch in the character of a particular entity. However, it can involve the fragmentation and amalgamation of entities. So, in principle, a PE may be treated as a separate entity from the entity of which it forms a part (usually by the country where the PE is situated). Conversely, the tax treatment of a number of separate entities may be amalgamated for tax purposes, such as with the consolidation of corporate groups.

Chapter 3 of the OECD Final Report on BEPS Action 2 focuses on payments made within a fragmented entity, for instance, disagreement as to whether a payment has been made, as in hybrid mismatch 11 above. Chapter 4 focuses on payments received by a hybrid entity, such as agreement that a payment has been made, but disagreement as to who received the payment. Chapter 5 focuses on payments made by a hybrid entity, for example, agreement that a payment has been made, but disagreement as to who made the payment. Chapter 6 focuses on payments made by dual residents. Each is briefly considered in turn.

2.3.2.1 Disregarded hybrid payments

Recommendation 3 of the OECD Final Report on BEPS Action 2 applies to "a disregarded payment made by a hybrid payer." This recommendation is targeted at disagreements as to whether a situation involves two entities or one combined entity and whether to recognize that a payment has been made between them. From the perspective of the country recognizing a payment, this situation involves a payment that is simultaneously made by a hybrid entity and received by a hybrid entity.

Both "disregarded payment" and "hybrid payer" are defined in recommendation 3.2. The former is defined in terms of a "payment that is deductible under the laws of the payer jurisdiction and is not recognised under the laws of the payee jurisdiction." It is presumed that a deduction in any payer jurisdiction (of which there may be many) is sufficient to trigger the rule and that recognition in any payee jurisdiction (of which there may be many) is sufficient to disapply the rule. Again, these are matters in need of clarification.

"Deduction" is defined in recommendation 12 of the OECD Final Report on BEPS Action 2 in circular terms to mean "taken into account as a deduction or equivalent tax relief" in the payer jurisdiction. It seems that the payment must be directly deducted in calculating income and not simply deductible in calculating a net amount that is included in income (such as the cost of an asset when determining a gain on disposal). The report suggests that the "term does not cover the cost of acquiring a capital asset or an allowance for depreciation or amortisation." [45] This seems an arbitrary distinction to draw as the cost of acquiring an asset can be as effective in reducing tax as the payment of an immediate expense. There is no definition of "equivalent tax relief" in the Final Report. The only discussion of this phrase is with respect to the granting of corporate tax credits for the payment of dividends.[46] This suggests that the grant of a tax credit can be "equivalent tax relief." Whether a deduction for 100 per cent immediate depreciation (or 50 per cent, or any per cent) can also be equivalent tax relief is unclear (in substance, it clearly is).

There is also no definition of "not recognised" under the laws of the payee jurisdiction in the OECD Final Report on BEPS Action 2. The Final Report suggests that it involves the payee jurisdiction not treating the payment "as a payment" or not taking it "into account as a receipt for tax purposes." [47] Exactly what these phrases mean is also unclear. It seems a country could take a payment into account without taxing it (such as where the payment is attributed to a foreign entity). The examples suggest that the target is a mismatch in who is considered to receive a payment, but the recommendation is inadequate in articulating this target.

[45] OECD Final Report on BEPS Action 2, supra note 2, paragraph 121.

[46] Ibid., paragraph 31, and example 1.11.

[47] Ibid., paragraph 133.

"Hybrid payer" is defined in recommendation 3.2 of the OECD Final Report on BEPS Action 2 in terms of a situation "where the tax treatment of the payer under the laws of the payee jurisdiction causes the payment to be a disregarded payment." Read literally, this definition is confusing and possibly inaccurate. It is difficult to see how the tax treatment of a foreign payer in the recipient State could result in a payment being disregarded in the recipient State. It is clear from OECD examples 3.1 and 3.2 that the rule is targeted at the type of mismatch identified in hybrid mismatch 11 above. It is more the lack of recognition of the payer in the payee jurisdiction rather than any "tax treatment" that causes the payment to be disregarded. Recommendation 4 could have easily been described as involving a hybrid recipient (and so related to what the OECD describes as a "reverse hybrid"). The point is that the examples given may be viewed as involving both a hybrid payer and a hybrid recipient.

There is also a risk that there is no payment as defined in recommendation 12 of the OECD Final Report on BEPS Action 2 to trigger the definition of "hybrid payer" (see section 2.2 above), as a person must make the payment in order to trigger the definition. It seems conceivable (though not clear) that a person could make a payment to themselves (where they are both the payer and the payee) such as if a payment could be made by a PE to a head office. However, the suggestion in the Final Report that a payment requires a "transfer" and the definition of payment specifically excluding deemed payments "that do not involve the creation of economic rights between parties" suggests that there can be no payment from a PE to a head office (despite OECD example 3.2). This is confirmed by OECD Public Discussion Draft on Branch Mismatches.[48] Similar issues arise with respect to an "unincorporated body of persons" or "trust," the actions of which by definition cannot create economic rights.

2.3.2.2 Reverse hybrid payments

Recommendation 4 of the OECD Final Report on BEPS Action 2 applies to "a payment made to a reverse hybrid that results in a hybrid mismatch." This recommendation is targeted at payments received by hybrid entities (where both countries agree as to the identity of the

[48] Supra note 16, paragraph 34.

payer but not the payee). Unlike the disregarded payments scenario, in the reverse hybrid payments scenario, there is agreement that a payment has been made.

"Reverse hybrid" is defined in recommendation 4.2 of the OECD Final Report on BEPS Action 2 as "any person that is treated as a separate entity by an investor and as transparent under the laws of the establishment jurisdiction." This definition is unclear. "Investor" is defined in recommendation 12 in terms of a person holding voting rights or equity interests in another person. Leaving aside the definitions of "equity interest" and "voting rights," it is not clear in what sense an investor would "treat" a hybrid as a "separate entity" or why it should matter. It is presumed that the reference to investor is a typographical error and that the intention is to refer to an "investor jurisdiction," a term which is also defined in recommendation 12.

"Investor jurisdiction" is defined in recommendation 12 of the OECD Final Report on BEPS Action 2 as "any jurisdiction where the investor is a taxpayer." Similar to the definitions of "payer jurisdiction" and "payee jurisdiction," this seems to mean that a multinational investor may have any number of investor jurisdictions, including jurisdictions in which it has a PE or even where it is only subject to withholding tax. By contrast, a reverse hybrid must be a person and so the prevailing view is that a PE cannot be a reverse hybrid (reinforced by the OECD Public Discussion Draft on Branch Mismatches[49]). "Establishment jurisdiction" is also defined in recommendation 12 of the OECD Final Report on BEPS Action 2. It is the jurisdiction where the hybrid "is incorporated or otherwise established." While it seems there may be multiple investor jurisdictions, it is not clear whether there can be more than one establishment jurisdiction. This is critical because it is only the establishment jurisdiction that counts. That is, recommendation 4 cannot apply if the hybrid is treated as transparent only by any other jurisdiction. For example, a payment sourced and deductible in Country A is received by a hybrid incorporated in Country C with an investor in Country B. Country A considers the entity as transparent, Countries B and C recognize the entity, but Country C considers the entity as resident in Country A. It is not clear how recommendation 4 (or the imported mismatch rule) could apply in such a case.

[49] Supra note 16, paragraph 17.

"[T]reated as a separate entity" and "transparent" are not defined in the OECD Final Report on BEPS Action 2. Inevitably, these terms will give rise to difficult issues. They are terms used by tax administrators and professionals, but they are really the opposite ends of a spectrum rather than absolutes. Presuming it is treatment under tax law that counts (although this is not specifically stated), some entities are treated as separate for purposes of calculating their income, but the owners rather than the entity pay the tax on that income. In this case the entity is treated as a separate entity for the purpose of income calculation but not for purposes of tax payment. Some entities (such as partnerships) are treated as separate entities for purposes of imposing withholding tax obligations, but not for other purposes. Which purpose counts? All purposes? These elements of confusion are illustrated by the OECD Public Discussion Draft on Branch Mismatches, noting that "branch payees" are not "transparent" and so "do not fall within the literal language of the reverse hybrid rule."

Recommendation 4 of the OECD Final Report on BEPS Action 2 applies where the payment "results in a hybrid mismatch." This phrase is defined in recommendation 4.3 in terms of "if a mismatch would not have arisen had the accrued income been paid directly to the investor." The mismatch is a D/NI outcome (see definition of mismatch in recommendation 12). The definition of D/NI outcome in recommendation 12 is further considered in section 3.1.1 below.

"Accrued income" is defined in recommendation 12 of the OECD Final Report on BEPS Action 2 in terms of "income of the payee that has accrued for the benefit of that investor." There is no definition of income. It is presumed that it is only income attributable to the payment referred to in recommendation 4 that counts, but this is not expressly stated. It is also not clear whether income excludes the receipt of a payment as capital and, if so, which country's view as to whether a payment is income or capital counts. Contrast the above with the definition of "ordinary income" discussed in section 3.1.1 below.

There is no definition of "accrued for the benefit" in the OECD Final Report on BEPS Action 2, and its meaning is also unclear. In particular, it is not clear whether it should be linked (there is no express link) to the voting rights or right to an equity return that caused the investor to be an "investor" in the first place. It seems that income of a hybrid entity would not accrue for the benefit of an investor holding voting rights only. Whether such income could accrue for the "benefit" of an investor that is only "eligible" to participate in distributions of the entity (such as a discretionary trust) is not clear.

2.3.2.3 Deductible hybrid payments

Recommendation 6 of the OECD Final Report on BEPS Action 2 applies to "a hybrid payer that makes a payment that is deductible under the laws of the payer jurisdiction and that triggers a duplicate deduction in the parent jurisdiction that results in a hybrid mismatch." This recommendation is targeted at payments made by hybrid entities (where both countries agree as to the identity of the payee but not the payer). Here, too, both countries agree that a payment has been made.

A hybrid payer is defined in recommendation 6.2 of the OECD Final Report on BEPS Action 2 in very different terms from those used in recommendation 3.2. A hybrid payer must be a person, and a deduction in any payer jurisdiction (there may be many) is sufficient to trigger the rule. The definitions of these terms in recommendation 12 have already been considered. Recommendation 6.2 then sets out two scenarios in which there is a relevant hybrid payer depending on whether the payer jurisdiction is where the payer is resident or not. There is no definition of resident. Presumably it will be determined under the law of the payer jurisdiction in question, in which case there may be one jurisdiction in which the person is resident, more than one, or none. In the case where the payer is not resident in a payer jurisdiction, the payment must trigger "a duplicate deduction for that payer (or a related person) under the laws of the jurisdiction where the payer is resident (the parent jurisdiction)." [50] "Related person" is defined in recommendation 11 of the OECD Final Report on BEPS Action 2, but is not further pursued in the present chapter. It seems that recommendation 6.2 (a) of the Final Report regarding a payment made by a hybrid payer cannot be triggered where the payer claims a duplicate deduction in another non-residence country. For example, it cannot be triggered by a taxpayer claiming a deduction for the same payment in two different countries where the taxpayer has a PE. Further, it cannot be triggered by a related person claiming a deduction in any

[50] Ibid., recommendation 6.2 (a).

other jurisdiction than the jurisdiction where the payer is resident. This might happen where two countries disagree regarding which of the two related persons makes a payment.

In the case where the payer is resident in a payer jurisdiction, the payment must trigger "a duplicate deduction for an investor in that payer (or a related person) under the laws of the other jurisdiction (the parent jurisdiction)."[51] "Investor" was considered above in the context of reverse hybrid payments. Unusually, it seems that if a parent corporation is the true payer, then this rule cannot apply to a duplicate deduction in the country of a subsidiary as the subsidiary is not an investor in the parent (but may be related to an investor). There is no definition of "the other jurisdiction." It is not clear whether there can be only one other jurisdiction (that would not seem to make sense), whether the other jurisdiction is the residence country of the investor or whether it can be any jurisdiction in which the investor is a taxpayer (as in the definition of investor jurisdiction).

In order for recommendation 6 of the OECD Final Report on BEPS Action 2 to apply, the payment must trigger a duplicate deduction that results in a hybrid mismatch (the definition of hybrid mismatch in recommendation 12 was discussed in section 2.1 above). There is no definition of "trigger" or "duplicate." It is clear that recommendation 6 is targeted at DD outcomes. However, the definition of "DD outcome" in recommendation 12 (further considered in section 3 below) simply refers to a payment being deductible in more than one jurisdiction. It is not clear whether any significance should be attached to the use of the words trigger or duplicate in recommendation 6. For example, does a payment that is immediately deductible in the payer jurisdiction, but gives rise to deduction for amortization in the parent jurisdiction, trigger the amortization? Are the deductions duplicates?

2.3.2.4 Payments by dual residents

Recommendation 7 of the OECD Final Report on BEPS Action 2 applies to "a dual resident that makes a payment deductible under the laws of both jurisdictions where the payer is resident." In this recommendation there is no mismatch with regard to who makes or receives

[51] Ibid., recommendation 6.2 (b).

a payment, only with regard to the residence of the payer. Under recommendation 7.2 a person is a dual resident "if it is resident for tax purposes under the laws of two or more jurisdictions." As noted above, there is no definition of resident and it is presumed the domestic law of each country will be applied. As it is the payment that must be deductible, it seems that recommendation 7 cannot apply to other forms of double-dip deductions, such as for depreciation or amortization.

2.3.3 Imported mismatches

Chapter 8 of the OECD Final Report on BEPS Action 2 is devoted to "imported mismatches." Broadly, these are "indirect mismatches that arise when the effects of a hybrid mismatch arrangement are imported into a third jurisdiction." [52] Inevitably, imported mismatches involve an intermediate country and the issues raised seem to be little more than the usual issues pertaining to treaty shopping and the use of tax havens. The Final Report incorporates no explanation of the relationship between hybrid mismatch arrangements and these broader issues.

Recommendation 8 of the OECD Final Report on BEPS Action 2 applies to any "imported mismatch payment to the extent the payee treats that payment as set-off against a hybrid deduction in the payee jurisdiction." "Imported mismatch payment" is defined in recommendation 8.3 as "a deductible payment made to a payee that is not subject to hybrid mismatch rules." There is no definition of "hybrid mismatch rules," although it is presumed that these are derived from domestic law and based on the OECD recommendations. What is not clear is the extent of compliance with the recommendations that is required. That is, it is not clear whether weak compliance with the recommendations is sufficient to constitute particular domestic law rules as being hybrid mismatch rules. The Final Report suggests that the imported mismatch rule does "not apply to any payment that is made to a taxpayer in a jurisdiction that has implemented the full set of recommendations set out in the report." [53] This requirement is not expressly stated in the recommendations. In any case, the definition of imported mismatch payment could cover most any deductible payment.

[52] Ibid., at 11.

[53] Ibid., paragraph 234.

"Set off against" is used repeatedly in the OECD Final Report on BEPS Action 2 and its recommendations. However, there is no definition for this term. It is unusual to refer to income being set against deductions; it is usually deductions that are set against income. In any case, it seems clear that the rule requires an identification of the "hybrid deduction" as reducing the income from the imported mismatch payment. Difficulties with this identification process are noted in section 3.2 below.

Hybrid deduction is defined in recommendation 8.2 of the OECD Final Report on BEPS Action 2 under four primary headings which relate to the other recommendations in the report. The first heading is a deduction arising under a hybrid financial instrument. It would seem that this heading cannot apply to substitute payments covered by recommendation 1 because these are not made "under" a financial instrument. What is not clear is why they are not covered. The second heading is a deduction for a disregarded payment made by a hybrid payer (covered by recommendation 3). The third is a deduction for a payment made to a reverse hybrid (covered by recommendation 4). The fourth is a deduction for a payment made by a hybrid payer or dual resident (covered by recommendations 6 and 7). Recommendation 8.2 does not cross-refer to the other recommendations. This is unusual because phrases used in recommendation 8.2 are often defined only in those other recommendations.

Hybrid deduction is extended to include "a deduction resulting from a payment made to any other person to the extent that person treats the payment as set-off against another hybrid deduction." This is clearly designed to stop the use of multiple intermediate jurisdictions to avoid the imported mismatch rule. Unlike the primary rule in recommendation 8.1 of the OECD Final Report on BEPS Action 2, the extension of the definition of hybrid deduction does not specify the jurisdiction in which the hybrid deduction must be taken. It is presumed the relevant jurisdiction is the payee jurisdiction of the payment referred to in the extension. The extension to the definition of hybrid deduction is only effective to link payments between jurisdictions to the extent that each payment in a chain of payments is deductible. It seems the chain can be broken by inserting a payment that, while not deductible, is included in the cost of an asset that is then depreciated or amortized (see the discussion in section 2.2 above).

3. How Action 2 in the OECD Action Plan on BEPS proposes to deal with the problem of hybrid mismatch arrangements

The OECD Final Report on BEPS Action 2 targets a series of highly specific circumstances and incorporates suggested responses to those circumstances by particular countries. The suggested response depends on the type of outcome achieved in the circumstances. The circumstances, outcomes and suggested responses are tabulated in table 1.1 of the Final Report.[54] Table 1.1 is structured around four primary columns. Column 1 specifies the types of "mismatch" outcome targeted by the recommendations. As mentioned in section 2.1 above, this is the primary focus of the OECD Final Report on BEPS Action 2, although the Final Report is structured around the arrangements referred to in column 2. Column 2 specifies the types of arrangements covered by the recommendations and was essentially the focus of heading 2 above. Columns 3 and 4 deal with how the OECD suggests that countries should respond.

3.1 Defining mismatches: column 1 of table 1.1

Column 1 of table 1.1 of the OECD Final Report on BEPS Action 2 is entitled "mismatch." As noted in section 2.1 above, mismatch is defined in recommendation 12 as a DD outcome or a D/NI outcome. Both of these terms are further defined in recommendation 12. Column 1 includes both DD and D/NI outcomes, but in the context of imported mismatches it also includes "indirect D/NI." This term is not defined. Further, some of the primary recommendations include additional qualifications as to what constitutes a mismatch in the circumstances covered by the recommendations.

3.1.1 D/NI and DD outcomes generally

D/NI outcome is defined in recommendation 12 of the OECD Final Report on BEPS Action 2 in terms of a payment "to the extent the payment is deductible under the laws of the payer jurisdiction but is not included in ordinary income by any person in the payee jurisdiction."

[54] Ibid., at 20. Table 1.1 of the Final Report is a reproduction of table 1 of OECD, BEPS Action 2—2014 Deliverable, supra note 2, at 17.

The definition of deductible was discussed in section 2.3.2 above in the context of disregarded hybrid payments including the apparent exclusion of the cost of capital assets and allowances for depreciation and amortization. The potential for multiple payer jurisdictions was noted in section 2.2 and it is possible for a single payment to give rise to more than one D/NI outcome where a payment is deductible in more than one jurisdiction.

"Ordinary income" is defined in complex terms in recommendation 12 of the OECD Final Report on BEPS Action 2. The definition is circular; meaning "income that is subject to tax at the taxpayer's full marginal rate and does not benefit from any exemption … or other tax relief." For many countries, determining a taxpayer's "full marginal rate" will be problematic. For example, does it include reduced rates for savings income, reduced rates for capital gains, or income subject to final withholding tax? Specifically, the Final Report suggests that if "income from financial instruments" is taxed at lower rates, this would meet the full marginal rate test.[55] There seems little merit in such a distinction, which can lead to arbitrary results.[56]

At least in common law jurisdictions, ordinary income does not include capital gains and, in any case, capital gains are a net concept and a D/NI outcome is defined in terms of a payment, which is a gross concept. It seems clear that a payment included as consideration for the

[55] OECD Final Report on BEPS Action 2, supra note 2, paragraph 42. A similar comment is made at 183 in the context of example 1.3.

[56] This arbitrariness can be demonstrated with an example. Country A has a tax rate of 30 per cent and Country B has a similar tax rate, which is reduced to 5 per cent for income from financial instruments. Interest paid under a financial instrument from a person resident in Country A to a person resident in Country B produces no mismatch despite the deduction being worth 30 per cent and the pickup in Country B being only 5 per cent. Presume a similar interest payment from a person in Country B to a person in Country A, except that Country A taxes interest at 10 per cent but all other income from financial instruments at the full rate of 30 per cent. The OECD rules in this case seem to suggest that Country B should deny a deduction for the interest. The rationale for the difference in approach is not clear and underlies the point that "full marginal rate" is a dated concept in many modern income taxes. It also highlights the difficulties of the OECD recommendations when effective tax rates are not part of the consideration.

disposal of an asset is not included in ordinary income, at least where it is used for purposes of determining a net amount (for instance, a capital gain) that is included in income.[57] The same appears to be true of amounts received in respect of a liability such as a loan. The definition of ordinary income proceeds to confirm that a payment is treated as subject to tax at a full marginal rate despite the fact that "the tax on the inclusion is reduced by" foreign tax relief for "taxes imposed by the payer jurisdiction on the payment itself."[58] The requirement that the foreign tax be on the payment seems unfortunate and may lead to arbitrary results. Take an example of a payment received by a PE in Country A of a person resident in Country B. The profits of the PE are taxed by Country A at a preferential rate. As a result, the payment is not ordinary income for Country A purposes. Country B taxes the person at their full marginal rate on the profits from the PE but grants a foreign tax credit for the Country A tax. As the credit is given for Country A tax on profits rather than the payment, it seems that the payment is not included in the ordinary income of the recipient. If the payer is granted a deduction for the payment there is a D/NI outcome.

Returning to the definition of a D/NI outcome, there is such an outcome only to the extent of the mismatch. This phrase anticipates an apportionment where a payment is only partly deducted or partly included in ordinary income. That may seem appropriate but as it is focused only on the tax base, it can give rise to arbitrary results. In determining whether a payment gives rise to a D/NI outcome, effective tax rates are irrelevant. A payment may be deducted against income taxed at 45 per cent and included in income taxed at 3 per cent and that is not a D/NI outcome. However, where a payment is deducted against income taxable at 3 per cent and included in income taxed at a preferential rate of 35 per cent, then the whole payment gives rise to a D/NI outcome.

The OECD Public 2014 Discussion Draft on BEPS Action 2 made clear that "Action 2 is not intended to capture all arrangements that

[57] OECD Final Report on BEPS Action 2, supra note 2. Example 1.27 seems to demonstrate that sale proceeds of an asset are not considered to be included in ordinary income. Example 1.19 seems to demonstrate the same point.

[58] Ibid., at 167.

have the effect of lowering the aggregate tax burden of the parties to an arrangement."[59] The OECD Final Report on BEPS Action 2 does not make the same observation, but this underlying premise in the recommendations remains clear. The problem is that the OECD is not focused on lower taxation as such, but mismatches leading to lower taxation.[60] The OECD Public Discussion Draft on BEPS Article 2 recognized that some countries may intentionally create a mismatch that is "economically closer to a tax exemption or similar taxpayer specific concession."[61] As in the earlier discussion draft, the Final Report recognizes that such intentional mismatches are not "tax outcomes in the sense contemplated by Action 2."[62] There are many circumstances in which countries that are viewed as financial centres create intentional mismatches for exemption or concessionary purposes.

This lack of focus on tax burden means that the relationship between Action 2 and the general use of low-tax jurisdictions is unclear, or at least it is not specifically addressed in the OECD Final

[59] OECD Public Discussion Draft on BEPS Action 2, supra note 2, paragraph 22.

[60] Nathan Boidman and Michael Kandev, "BEPS Action Plan on Hybrid Mismatches: A Canadian Perspective," supra note 1, 1234–1235, make a similar point.

[61] OECD Public Discussion Draft on BEPS Action 2, supra note 2, paragraph 22.

[62] OECD Final Report on BEPS Action 2, supra note 2, paragraph 11; and OECD Public Discussion Draft on BEPS Action 2, supra note 2, paragraph 22. The example given is where a country has created a specific deduction "for invested equity" as under an allowance for corporate equity (ACE) system. For the ACE system, see Institute for Fiscal Studies, *Equity for Companies: A Corporation Tax for the 1990s* (London: Institute for Fiscal Studies, 1991); and James Mirrlees and others, *Tax by Design, The Mirrlees Review* (Oxford: Oxford University Press, 2011), 421–425, available at http://www.ifs.org.uk/publications/5353. Cryptically, in the OECD Final Report on BEPS Action 2, supra note 2, paragraph 11, continues by suggesting that "[s]uch rules … will, however, be considered separately in the context of the implementation of these recommendations." See also OECD Public Discussion Draft on Branch Mismatches, supra note 16, paragraphs 36 and 37, which seek to somewhat artificially distinguish between these types of notional payments and notional payments from a branch to a head office required by the Authorised OECD Approach under Article 7 (2) of the OECD Model Convention.

Report on BEPS Action 2. As noted above, the effect of a hybrid mismatch arrangement can be similar to using an intermediary in a third country (triangular arrangement). For many decades, tax planners have used companies in third countries to change the allocation, timing, quantity and character of payments ultimately passing from the jurisdiction of the investment to the jurisdiction of the investor. The novelty of hybrid mismatch arrangements is that they can do this without the use of a third country (even though they often do involve third countries).[63] Because intermediaries and hybrid mismatch arrangements are being used in the same manner, it may be suggested that rules designed to regulate them should be developed together to ensure a consistent treatment (see section 4.4 below).

The risk in the OECD recommendations of refusing to consider tax burden is that because commercial decisions take account of tax burden (rather than inclusions and deductions with respect to the tax base), the recommendations may actually become the source of tax planning.[64] For example, as noted in section 2.2 above, it seems there can be multiple payee jurisdictions for a particular payment. It also appears that inclusion in ordinary income in only one payee jurisdiction is sufficient to ensure that there is no D/NI outcome.[65] Simple tax planning to avoid a D/NI outcome may involve ensuring that the payment is included in ordinary income in a low-tax jurisdiction (such as by receiving the payment through a subsidiary or PE). This means that the effectiveness of the hybrid mismatch rules will only be as good as the effectiveness of anti-deferral rules (such as controlled foreign corporation (CFC) rules). As in the OECD Final Report on BEPS Action 2, anti-deferral rules are outside the scope of the present chapter. The definition of D/NI outcome in recommendation 12 of

[63] Peter A. Harris and J. David Oliver, *International Commercial Tax* (Cambridge: Cambridge University Press, 2010), 369 – 370.

[64] Graeme S. Cooper, "Some Thoughts on the OECD's Recommendations on Hybrid Mismatches," supra note 14, at 349 suggests that "[i]t would be more than a little ironic if the automatic anti-hybrid rules, with their disdain for any concern as to which jurisdiction has lost tax revenue, themselves became an engine for base erosion and profit shifting."

[65] "If the payment is brought into account as ordinary income in at least one jurisdiction then there will be no mismatch for the rule to apply to." OECD Final Report on BEPS Action 2, supra note 2, paragraph 149.

the OECD Final Report on BEPS Action 2 provides that "[a] D/NI outcome is not generally impacted by questions of timing in the recognition of payments or differences in the way jurisdictions measure the value of that payment." It is not clear what is supposed to be made of the word "generally." It is impossible to divorce issues of timing and quantification from the definition of D/NI outcome because deduction and non-inclusion in income are by definition affected by such matters. How far apart in timing must the deduction and inclusion in income be before there is a D/NI outcome; one year, two years or many years?

The definition of D/NI outcome seeks to address this difficulty by granting broad tax administration discretion. The definition proceeds to provide that "a timing mismatch will be considered permanent if the taxpayer cannot establish to the satisfaction of a tax authority that a payment will be brought into account within a reasonable period of time." [66] Example 1.22 of the OECD Final Report on BEPS Action 2 suggests that a reasonable period of time may be anything up to 15 years. Many developing countries have gone through tax reform processes designed to remove precisely this sort of broad tax administration discretion.

The definition of a D/NI outcome also generally excludes mismatches in value of a payment (quantification), although in this case there is no tax administration discretion granted. Confusingly, the Final Report on BEPS Action 2 also states that "[a] D/NI outcome can arise from differences between tax jurisdictions in the way they measure the value ascribed to a payment." [67] The next paragraph states "[w]hile there may be differences in tax outcomes that arise from the valuation of a payment or in translating a payment into local currency, these differences … will not give rise to a D/NI outcome." [68] While the examples given (OECD examples 1.13, 1.15, 1.16 and 1.17) demonstrate that the OECD may be clear about the outcome it wishes to achieve in particular cases, it is not clear that it is in a position to articulate the nature or expression of the rule it wishes to apply. Here, too, the merit of counteracting some of these examples and not others is also not clear.

[66] Ibid., at 121.

[67] Ibid., paragraph 385.

[68] Ibid., paragraph 386.

A DD outcome is defined in recommendation 12 of the OECD Final Report on BEPS Action 2 in terms of a payment that is "deductible under the laws of more than one jurisdiction." The definition of deductible was discussed in section 2.3.2 above in the context of disregarded hybrid payments including the apparent exclusion of the cost of capital assets and allowances for depreciation and amortization. There is substantial inconsistency between this definition and that of a D/NI outcome. There is no reference to the extent of the dual deduction or to payer jurisdiction. There is likewise no reference to timing or valuation. Some of these inconsistencies may be picked up in the suggested responses by countries (such as, "extent of"), but others, such as the rules for timing and valuation, are not. The drafting is imprecise and is likely to cause confusion.

3.1.2 Additional recommendation-specific rules

Most of the primary recommendations in the OECD Final Report on BEPS Action 2 contain further qualifications as to what constitutes a mismatch, D/NI outcome or DD outcome.

3.1.2.1 Payments involving hybrid financial instruments

In the context of financial instruments, recommendation 1.1 (c) of the OECD Final Report on BEPS Action 2 repeats that differences in recognizing the timing of a payment do not give rise to a D/NI outcome. The wording of this repetition is slightly different from the words used in the definition of "D/NI" outcome in recommendation 12. In particular, the qualification "generally" is not used in recommendation 1.1 (c) and it is not clear what significance should be attached to this. Further, for no obvious reason, the tax administration discretion (requiring the taxpayer to show that a payment will be brought into account within a reasonable period of time) is also repeated.

Recommendation 1.3 of the OECD Final Report on BEPS Action 2 contains an important qualification as to when a hybrid mismatch arises with respect to a financial instrument. The mismatch must be attributable "to the terms of the instrument." This test is not met if the mismatch is "solely attributable to the status of the taxpayer or the circumstances in which the instrument is held." The examples in the Final Report demonstrate that these limitations again result in some difficult and rather arbitrary line-drawing. For example, OECD example 1.13 suggests that the relationship between members of a corporate group should be counted as part of the terms of a loan instrument.[69] If the relationship between the issuer and holder of a financial instrument counts as terms of the instrument, then whether there is a mismatch or not may change when an instrument is transferred, for instance, from a related party to a third party or vice versa. This has the potential to add significantly to the complexity of administering this recommendation.

The OECD Final Report on BEPS Action 2 contains a number of examples where it suggests that the non-inclusion in ordinary income of a payment under a financial instrument is "solely attributable to the status" of a taxpayer or the circumstances in which the instrument is held. For example, this is the case where a sovereign wealth fund holds a financial instrument (example 1.5) or where an individual holds the instrument in a tax-privileged savings account (example 1.9). More problematic, example 1.6 suggests that there is no mismatch where the person receiving the payment is in a country that has no income tax or, in the case of a foreign payment, a country with a territorial system (no taxation of foreign source income). This is also the case where the payment is received through a foreign PE and the residence country of the holder of the instrument applies an exemption system to the profits of the PE (example 1.8).

These examples seem to suggest that the OECD considers that no mismatch arises when a residence country provides an exemption unless the exemption is specific to the financial instrument in question. This arbitrary limitation is a result of the highly stylized way in which the Final Report on BEPS Action 2 seeks to define mismatches and may promote distortive tax planning. At a fundamental level, it is not clear why the OECD suggests that source countries should treat a financial instrument differently depending on whether the residence State provides a general or specific exemption. This is particularly the case when the suggestion is that source countries should favour residence countries with general exemptions. This is likely to promote, rather than restrict, forum shopping. As Zaman notes with respect to the United Kingdom of Great Britain and Northern Ireland

[69] Ibid., paragraphs 92 – 94.

implementation of the Final Report, "[s]omewhat counter-intuitively, therefore, groups may find it easier to navigate their way out of [the anti-hybrid rules] where amounts are borrowed from a tax haven." [70] It would appear that the OECD has moved far from the initial BEPS position that "all income should be taxed somewhere." [71]

It appears that the "status of the taxpayer" may also affect whether a deduction gives rise to a mismatch. Example 1.29 of the OECD Final Report on BEPS Action 2 discusses the deduction that a trader may claim for the cost of acquiring a financial instrument. It suggests that the deduction is not "attributable to the terms of the instrument" but rather "the trader's particular status" and so a mismatch does not arise despite a sale where the recipient does not include the sale proceeds in ordinary income.[72]

3.1.2.2 Payments involving hybrid entities

Counteraction of mismatches that arise regarding payments made by hybrid entities are restricted in recommendations 3, 6 and 7 of the OECD Final Report on BEPS Action 2 by reference to "dual inclusion income." As noted in the introduction, mismatches resulting from

[70] Jeanette Zaman, "Hybrid Mismatch Arrangements: the UK's Take on Action 2," (2016) No. 1294 *Tax Journal*, at 12. Since the publication of this article, the United Kingdom has made a loose attempt to amend its implementation of OECD BEPS Action 2 to cater for some types of routing through tax havens. These amendments are so obscure that one commentator has suggested that the United Kingdom "government itself is not entirely clear about precisely what these new rules are supposed to catch." See James Ross, "Hybrids: making sense of the draft guidance," (2017) No. 1338 *Tax Journal*, at 14.

[71] Graeme S. Cooper, "Some Thoughts on the OECD's Recommendations on Hybrid Mismatches," supra note 14, at 345.

[72] OECD Final Report on BEPS Action 2, supra note 2, at 250, paragraph 6. Paragraph 7 seems to maintain the suggestion that the whole purchase price can be deducted as the cost of the instrument, even a part of the purchase price that is deductible immediately, because it is characterized as interest and is considered paid under the terms of the instrument. This confusing and arbitrary line-drawing seems to be a consequence of generally not treating the cost of assets as deductible (when as a matter of form in some countries traders do deduct the cost of their trading stock).

disagreement regarding income fundamentals may be either beneficial for taxpayers or detrimental for taxpayers. Dual inclusion income represents the Final Report's attempt to provide relief in a (very) limited range of mismatches that might be detrimental for taxpayers.[73] Broadly, the Final Report requires a matching of some types of deductible payments with inclusions in income (although it is limited in achieving this).

How close must the matching be? For every deduction (of which there may be multiples), does there need to be an equal inclusion (including an equal number of multiples)? If a taxpayer produces a mismatch with respect to a payment, should that mismatch be affected by reason of the taxpayer's suffering some other detrimental mismatch? If so, does the detrimental treatment have to relate to the same activity of the taxpayer? Is any activity of the taxpayer sufficient? Should detrimental treatment of related parties (such as corporate groups) be taken into account? The essential point is that once detrimental treatment is taken into account in the matching process, any attempt to draft rules descends into arbitrary line-drawing with great increases in complexity. Dual inclusion income is an attempt by the OECD to cater for some detrimental mismatches in limiting counteraction of taxpayer beneficial mismatches.

Dual inclusion income is defined in recommendation 12 of the OECD Final Report on BEPS Action 2 in terms of "any item of income that is included as ordinary income under the laws of the jurisdictions where the mismatch has arisen." Note that the inclusion need not be with respect to the payment that is deductible. Nor need it even be the same taxpayer that includes the item in income. However, the inclusion must be in the jurisdictions "where the mismatch has arisen." This phrase is not defined. In a simple two-country scenario, it seems that the item must be included in income in both the payer and the

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[73] Christian Kahlenberg and Agnieszka Kopec, "Hybrid Mismatch Arrangements—A Myth or a Problem That Still Exists?" (2016) Vol. 8, No.1 *World Tax Journal*, at 74, suggest that double taxation resulting from "double inclusion outcome … remains unresolved" by BEPS Action 2. Broadly, this is accurate but the rules for dual inclusion income may be viewed as a very limited exception.

payee jurisdictions (although this is not stated in the definition).[74] Presuming that to be the case, the potential taxpayer detriment is obvious. The situation is more confusing where there are multiple payer and payee jurisdictions (as will often be the case). Is there just one overall mismatch and, if so, must there be an inclusion in income in all of these jurisdictions?[75] Or is there a series of mismatches (involving various combinations of payer and payee jurisdictions) and so the inclusion must be matched with the jurisdictions involved in each mismatch? How many jurisdictions might be involved in a particular mismatch? If there are more than two, does an item have to be included in income of all jurisdictions to constitute dual inclusion income or is two enough, and, if so, which two? The position with respect to these important issues is unclear in the OECD Final Report on BEPS Action 2.

The definition of dual inclusion income proceeds to note that an item may be dual inclusion income despite benefiting from "double tax relief." Double tax relief is not defined as such, but foreign tax credits and a domestic dividend exemption are given as examples. To qualify, the relief must "ensure that income, which has been subject to tax at the full rate in one jurisdiction, is not subject to an additional layer of taxation under the laws of either jurisdiction." This provision is particularly obscure. Read literally, it seems it could not apply to economic double taxation (as there are different items of income involved), but the reference to dividend exemption suggests that this might not be the intention.

The qualification for double tax relief in the definition of dual inclusion income seems to cover similar ground to that in the qualification in the definition of ordinary income (reduced by a credit or other tax relief) discussed in section 3.1.1 above. Inclusion in ordinary income is a quality of dual inclusion income, but exactly what the relationship is between these qualifications in their respective definitions

[74] It would appear that inclusion in income twice in one of the countries (for instance, for different taxpayers) is not sufficient.

[75] OECD Final Report on BEPS Action 2, supra note 2, example 1.24, involves two primary jurisdictions and a third jurisdiction applying controlled foreign corporation (CFC) rules. The OECD analysis of that example sheds no light on the questions in the text.

is not clear. What is clear is that the other peculiarities of the definition of ordinary income (not covering capital gains and taxable at the full marginal rate) are imported into the definition of dual inclusion income.

The definition of dual inclusion income contains no nexus to the deductible payment giving rise to the potential mismatch. This is provided in recommendations 3.3 (disregarded hybrid payments), 6.3 (deductible hybrid payments) and 7.3 (dual resident payer) of the OECD Final Report on BEPS Action 2. These recommendations limit the mismatch covered to deductions that are "set-off against income that is not dual inclusion income." More specifically, each of these recommendations provides that there is no mismatch "to the extent that the deduction … is set-off against income that is" dual inclusion income.[76] The inclusion in income must be both in the payee and payer jurisdictions (disregarded hybrid payments), the parent and payer jurisdictions (deductible hybrid payments) and both residence countries (dual resident payer). The presumption seems to be that there are only two jurisdictions per mismatch.

In recommendations 3, 6 and 7 of the OECD Final Report on BEPS Action 2, there is a potential dislocation between the description of what is a mismatch (subsection 3) and what is not (subsection 1). This is because what is not a mismatch is described in terms of dual inclusion income, which is defined in terms of ordinary income. However, what is a mismatch is defined in terms of a deduction against income that is not dual inclusion income. Is income referred to in subsection 3 meant to be a reference to ordinary income (and, if so, why was ordinary income not referred to) or does it mean something different? For example, if the latter approach is taken and income includes capital gains, then a payment that is deductible against a capital gain produces a mismatch even if the capital gain is taxed in both jurisdictions.

These rules in recommendations 3, 6 and 7 of the OECD Final Report on BEPS Action 2 do not resolve the issue of the precise nexus between the deduction and the inclusion in income. When is a deduction for a payment set off against income? For example, if a deduction for a payment produces a loss that is carried forward and the loss is

[76] Ibid., recommendations 3.1 (c), 6.1 (c) and 7.1 (b).

used in a future year, is the deduction for the payment set off against income of the future year? Or did the deduction for the payment lose its individual character when it was used in the calculation of the loss? If the loss can be used by a taxpayer other than the taxpayer that made the payment (such as under various forms of group relief), is the deduction set off against the income of the other taxpayer? Examples in the OECD Final Report on BEPS Action 2 suggest that these may be treated as set-offs, although it is not clear that this is supported by the express wording of the recommendations.[77]

These rules on dual inclusion income also do not resolve the issue of the necessary nexus between the two inclusions in income. There is tension here between the definition of dual inclusion income in recommendation 12 and the specific rules in recommendations 3, 6 and 7 of the OECD Final Report on BEPS Action 2. The definition suggests that it is necessary that a particular "item of income … is included as ordinary income" in both jurisdictions. By contrast, subsection 1 of each of the recommendations seems to redefine dual inclusion income but only refers to income generally and not items of income or even ordinary income. More confusingly, subsection 3 of each of the recommendations refers to dual inclusion income, and it is not clear whether it is referring to subsection 1, the general definition in recommendation 12, or both.

Irrespective of the precise meaning of income as used in recommendations 3, 6 and 7 of the OECD Final Report on BEPS Action 2, there is also the question of who is the recipient of the income and when it is received. There is no requirement in the recommendations or the definition of dual inclusion income that the income be included in both jurisdictions for the same taxpayer or that they even be related.[78] There is also no requirement that the amount included twice be included twice in the same tax year or in any particular proximity to one another. However, if a payment is deducted against income in one country in year one, and the same income is not included in the second country until year two, the risk is that in year one the first country will recognize a mismatch and counteract it. Whether that counteraction

[77] Ibid. For instance, see example 6.4.

[78] Ibid., example 1.24 recognizes that potentially the second inclusion may be under CFC rules in the country of a parent corporation.

should be neutralized when the second inclusion occurs in year two is dealt with by specific deduction carry-forward rules.

Recommendations 3, 6 and 7 of the OECD Final Report on BEPS Action 2 provide that deductions that cannot be set against dual inclusion income of a particular period "may be eligible to be set-off against dual inclusion income in another period." [79] In addition, recommendations 6 and 7 (but not 3) incorporate an additional provision dealing with stranded losses. In the context of a DD outcome, where a taxpayer can show that the deduction in one jurisdiction can be set only against dual inclusion income (even though there is none currently), then the deduction in the other jurisdiction "may be allowed."

3.2 Nature of the recommendations: columns 3 and 4 of table 1

Columns 3 and 4 of table 1.1 of the OECD Final Report on BEPS Action 2 deal with how the OECD suggests countries should respond where they identify a mismatch. These columns are interesting, especially by comparison with tax treaties. They move beyond identifying the scope of application and move to the content of the recommendations. Many of the problems caused by hybrid mismatch arrangements are not regulated by tax treaties, that is, tax treaties contain gaps and do not deal with them.[80] Rather than seek to develop tax treaties more fully through changes to its Model Convention, the OECD proposes recommendations for dealing with the identified hybrid mismatch arrangements through changes to domestic tax law. These recommendations are of two types; specific recommendations and hybrid mismatch rules.

The difference between specific recommendations and hybrid mismatch rules is confusing. Apparently, specific recommendations are not targeted at hybrids, although table 1.1 suggests they are targeted at mismatches. This is because of the peculiar way in which these terms are defined in recommendation 12 of the OECD Final Report on BEPS Action 2. A mismatch is defined in terms of a DD or

[79] Ibid., recommendations 3.1 (d), 6.1 (d) and 7.1 (c).

[80] Generally, see Peter Harris and J. David Oliver, *International Commercial Tax,* supra note 63, at 345 – 368.

D/NI outcome. Hybrid mismatch is defined by reference to the OECD primary recommendations other than the specific recommendations for financial instruments (recommendation 2) and those for reverse hybrids (recommendation 5). Why the specific recommendations do not involve hybrids but the others (recommendations 1, 3, 4, 6, 7) do is not obvious. Imported mismatches are not hybrid mismatches, but nevertheless give rise to a hybrid mismatch rule rather than a specific recommendation. The issue merits a more thorough consideration.

The real difference between the specific recommendations and the hybrid mismatch rules lies in their implementation. The specific recommendations require no link with tax rules in another country, that is, they are stand-alone recommendations. By contrast, the hybrid mismatch rules are described as "linking rules" because they "depend on tax outcomes in the other jurisdiction."[81] In the past decade and a half there has been a steady increase in unilateral rules (outside granting foreign tax relief) that depend on tax treatment in another jurisdiction, especially with respect to hybrid mismatch arrangements. The difference in the OECD Final Report on BEPS Action 2 is that an international organization is recommending coordination of this specific set of rules. Historically, this sort of coordination in the tax field has been reserved for treaties.[82] This appears to be a fundamental shift in approach by the OECD and sits questionably with the OECD recommendations of what should appear in tax treaties, that is, the OECD Model Convention.[83]

The fourth column in table 1.1 of the OECD Final Report on BEPS Action 2 contains three subcolumns: (primary) response,

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[81] OECD Final Report on BEPS Action 2, supra note 2, paragraph 313.

[82] As Hugh J. Ault, "Some Reflections on the OECD and the Sources of International Tax Principles," supra note 4, at 1196, predicted, the OECD approach may be viewed as a development of "some of the ideas in the OECD partnership report." See OECD, The Application of the OECD Model Tax Convention to Partnerships (Paris: OECD, 1999).

[83] Peter Harris and J. David Oliver, *International Commercial Tax,* supra note 63, at 467, suggest that a major question and challenge for the international tax "system" in this century is whether the "old system of bilateral tax treaties … will be abandoned in favour of an intentionally structured system designed to best deal with modern situations or whether the new system will develop as a set of ad hoc rules with a loose attempt at coordination."

defensive rule and scope, with the latter seeming to place further limitations on (exceptions to) the application of the rule. The approach is that one State is the primary State for responding to a mismatch, with a secondary State responding only if the primary State fails to act. This coordination is to avoid double taxation.[84] The OECD proposals seem to be particularly concerned with the potential that anti-hybrid rules might produce double taxation, and avoiding this seems to be a source of much complexity in the proposals.[85] This is consistent with the OECD approach to transfer pricing,[86] but not with respect to economic double taxation of dividends and CFC rules.[87] It is not clear that countries are as concerned about such accuracy with respect to preventing double taxation. This is evident in domestic rules that cause double taxation, such as the denial of interest deductions for excessive debt (for instance, under earnings stripping rules) without recharacterization as a dividend qualifying for dividend relief.[88]

The OECD uses no express guiding principle in identifying the primary State.[89] The OECD is adamant that a State applying a rule not be required to "establish that it has 'lost' tax revenue."[90] Generally, D/NI

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[84] OECD Final Report on BEPS Action 2, supra note 2, at 11–12.

[85] For example, see OECD Public Discussion Draft on BEPS Action 2, supra note 2, paragraph 33.

[86] See the corresponding adjustments in Articles 7 (3) and 9 (2) of the OECD Model Convention.

[87] The OECD Model Convention has no provision for underlying foreign tax relief and does not resolve the potential for double taxation through the simultaneous application of CFC rules by more than one country. Generally, see Peter Harris and J. David Oliver, *International Commercial Tax,* supra note 63, at 291 and 303.

[88] For example, see Peter A. Harris, *Corporate Tax Law: Structure, Policy and Practice* (Cambridge: Cambridge University Press, 2013), at 198–204.

[89] Traditionally, the allocation of international taxing rights has been guided by "source country entitlement" (first entitlement to tax), although this principle more clearly underlines the United Nations Double Taxation Convention (United Nations Model Convention) than the OECD Model Convention. Generally, see Peter Harris and J. David Oliver, *International Commercial Tax,* supra note 63, at 103–105.

[90] For example, OECD Final Report on BEPS Action 2, supra note 2, paragraph 278; OECD Public Discussion Paper on BEPS Action 2, supra note 2,

outcomes result in a denial of deduction in the State of the payer. The DD outcome results in the denial of a deduction in the investor State.

The exceptions to the responses (scope) add a substantial layer of complexity to the design and implementation of the recommendations in the OECD Final Report on BEPS Action 2. This chapter does not specifically consider these exceptions. While they overlap substantially, they are not consistent and their scope therefore depends on the rule in question and which State is applying it.[91] The drivers for these exceptions seem to be the potential for capturing "arrangements outside the intended policy" and ability to administer the rules.[92] In many instances the intended policy in the Final Report is unclear; it is difficult to assess when a rule is worth administering more broadly or narrowly and when it is not.

3.2.1 Specific recommendations

Recommendation 2 of the OECD Final Report on BEPS Action 2 prescribes two non-linking rules for financial instruments. The first suggests denying a "dividend exemption … to the extent the dividend payment is deductible by the payer." There is no definition of "dividend," which is likely to give rise to disagreement between countries.[93] It seems clear that this rule can apply only if the dividend itself is deductible. It does not apply to an allowance for corporate equity that is granted irrespective of a payment, even if dividends are subsequently paid out of funds protected from corporate tax by the allowance. This seems to discriminate against a system such as that used in Brazil,

paragraph 27(a); and OECD, BEPS Action 2—2014 Deliverable, supra note 2, paragraph 36.

[91] For example, Graeme S. Cooper, "Some Thoughts on the OECD's Recommendations on Hybrid Mismatches," supra note 14, at 347, notes that some of the scoping rules for financial instruments mean that the tax treatment of payments under the instrument may change depending on "the behaviour of foreign taxpayers," such as when an instrument is sold or if the holder of an instrument becomes related to the issuer.

[92] OECD Public Discussion Draft on BEPS Action 2, supra note 2, at paragraph 117.

[93] OECD Final Report on BEPS Action 2, supra note 2, example 1.37, does not mention recommendation 2.1 and so seems to suggest that a manufactured dividend is not a dividend.

where the allowance (calculated in a similar manner to an allowance for corporate equity) depends on the payment of a dividend, compared with the system in Estonia, where there is no deduction for dividends, but undistributed profits of corporations are simply not taxed.

The first rule in recommendation 2 of the OECD Final Report on BEPS Action 2 also provides that "jurisdictions should consider adopting similar restrictions for other types of dividend relief." The precise meaning of this extension is unclear. There are six forms of dividend relief, three that reduce corporate tax and three that reduce shareholder tax.[94] It is clear that recommendation 2 is intended to extend to other forms of corporate-level dividend relief (split-rate and corporation tax credit systems),[95] but not to shareholder-level systems. For example, if a source country (where a corporation is resident) exempts dividends paid to a non-resident (while still collecting corporate profits tax), why should the shareholder's residence country deny an exemption for the dividends?

The second rule in recommendation 2 of the OECD Final Report on BEPS Action 2 is highly specialized, being targeted at duplication of foreign tax credits for withholding tax in the context of a hybrid transfer of a financial instrument. This is a narrow rule targeted at just one particular example of where tax benefits are simultaneously granted in more than one jurisdiction. It again illustrates the need for expanding the scope of the OECD recommendations.

This second rule in recommendation 2 of the OECD Final Report on BEPS Action 2 also highlights an imbalance in the recommendations. Duplication of foreign tax credits in this particular case is counteracted, but there is no recognition that withholding tax can reduce the benefit of hybrid mismatch arrangements generally. Take the first rule in recommendation 2. It is the mere deduction of the dividend in the source country that triggers the denial of the exemption in

[94] See Peter A. Harris, *Corporate Tax Law: Structure, Policy and Practice*, supra note 88, at 251–311.

[95] The precise mechanism for determining the denial of exemption will be complex in these cases. The primary rule denies an exemption to the extent of the deduction of the dividend. What does this mean if there is no deduction but the distributed corporate profits have been subjected to a reduced corporate rate or granted a tax credit?

the residence country. The dividend may have been subject to a high withholding tax in the source country. If the withholding tax rate is as high as the corporate tax rate, it completely neutralizes the benefit of the deduction. There is no merit in denying a residence country dividend exemption in this case in comparison with a case where there is no deduction but the source country imposes no withholding tax. Indeed the proposed counteractions in the recommendations generally fail to account for withholding tax on deductible payments. In this sense they are both arbitrary and inevitably lead to double taxation, a point returned to in section 4. As Cooper notes, "the rules overstate the size of the problem." [96]

Recommendation 5 of the OECD Final Report on BEPS Action 2 also contains two narrow rules involving reverse hybrids that make no attempt to interface with broader issues raised by hybrid mismatch arrangements. Those issues cannot be divorced from general planning to reduce effective tax rates, even if the Final Report attempts to keep them separate. The OECD Final Report on BEPS Action 3 deals with recommendations regarding the design of CFC rules, which are residence country rules designed to counteract this type of tax planning.[97] The first rule in recommendation 5 applies only to payments to reverse hybrids and suggests changes to CFC rules. There is no mention of the Action 3 recommendations.[98]

The second rule in recommendation 5 of the OECD Final Report on BEPS Action 2 suggests that in the case of reverse hybrids, the source country should change the character of the entity (to a tax subject) depending on the tax treatment in the residence country. There are many recommendations that presume inconsistent characterization of entities between source and residence countries. It is not

[96] Graeme S. Cooper, "Some Thoughts on the OECD's Recommendations on Hybrid Mismatches," supra note 14, at 340.

[97] OECD, *Designing Effective Controlled Foreign Company Rules, Action 3—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/designing-effective-controlled-foreign-company-rules-action-3-2015-final-report_9789264241152-en.

[98] This is despite a specific reference to considering interaction with Action 3 in the OECD Final Report on BEPS Action 2, supra note 2, recommendation 9.2 (g).

clear why the inconsistency should be reconciled only in this particular case. The rule applies only where the income is "not brought within the charge to taxation" in the residence country. Again, the OECD recommendations are not targeted at the level of tax, and so it appears that tax at a rate of 0.5 per cent would be enough to neutralize this rule.

3.2.2 Actions by payer/source/host State

3.2.2.1 D/NI mismatches

In the context of all D/NI mismatches, the OECD Final Report on BEPS Action 2 recommends that the State of the payer be the primary State. Accordingly, this State will deny the payer a deduction for the payment made that is not included in the income of the recipient.[99] To apply the primary rule, the State of the payer must determine whether the recipient is exempt in the investor State and, just as important, why the investor is exempt. For example, in the context of hybrid financial instruments, the State of the payer must be satisfied that the exemption is attributable to the terms of the instrument and not, for example, to some other status, such as an exemption for non-profit organizations.[100] The complexity of what is being asked of payer States should not be underestimated. The State of the payer will require information about the investor's tax affairs of a nature that many countries are not used to asking for.[101]

First, a payer State will need to determine whether the payment has been included in ordinary income in the payee State. Difficulties with the ordinary income concept were discussed in section 3.1.1 above. For example, what if the payee is not taxed on ordinary income as such but is subject to some alternate tax base, such as the presumptive

[99] Ibid., recommendations 1.1 (a), 3.1 (a) and 4.1.

[100] Ibid. There is a special rule in recommendation 1.5 suggesting the payer State not apply the primary rule to deductions claimed by certain investment vehicles, such as real estate investment trusts and similar entities. As the defensive rule in the investor State may still apply, it is not clear why the host State is not given a choice in whether to apply the primary rule.

[101] Ibid., paragraph 86, notes that "[i]n order to determine whether a payment has given rise to a mismatch, it is necessary to know the identity of the counterparty and the tax rules applying in the counterparty jurisdiction … it may be necessary to look to the laws of more than one jurisdiction …"

tax that is often applied in developing countries? What if the payee is subject to two or more alternate tax bases, such as a United States corporation that is subject to regular corporation tax, alternative minimum tax and accumulated earnings tax? Understanding foreign regimes of this nature will be challenging in itself, let alone applying hybrid mismatch rules as a response to them.

Further, any suggestion that the primary rule gives source States control of hybrid mismatch arrangements giving rise to D/NI outcomes is misleading. For example, in the context of hybrid financial instruments, denial of a deduction in the source State is subject to the general recommendation that the State of the recipient unilaterally deny a dividend exemption for any amount that is deductible in the State of the payer. In other words, application of recommendation 2 has priority over the rule for the State of the payer to deny a deduction.[102] Similarly, in principle, the source State will not deny a deduction if the payment is included in ordinary income under the CFC rules of a residence State.[103]

These two examples demonstrate the fundamental change the OECD Final Report on BEPS Action 2 makes to the current international tax order. Historically, source States have taxed with little regard for the tax treatment in residence States. Foreign tax relief and CFC rules in residence States have typically adapted to take into account source State taxation. The Final Report recommends that source States now respond depending upon the effectiveness of foreign tax relief and CFC rules of residence States. The ability of source States that are developing countries to make such an assessment must be questioned when they often do not have sophisticated systems of foreign tax relief or CFC rules in their own laws (but under the OECD recommendations, they would need to assess and respond to those of another country).

Assuming there is a D/NI outcome, the payer State should deny a deduction only to the extent that the payment gives rise to that outcome, that is, only to the extent that the payment is not included in ordinary income.[104] Apportionment issues are likely to raise substan-

[102] Ibid. This is clear from example 2.3.

[103] Ibid., paragraphs 36 – 40 and example 4.3.

[104] Ibid., recommendations 1.1 (a), 3.1 (a) and 4.1.

tial concerns for payer States and comprise at least two types. The first lies in determining the extent to which a payment is included in ordinary income in a foreign country. This is particularly difficult when the payment is subject to a partial exemption, subject to reduced rates or granted certain tax credits.[105] The payer State is supposed to determine how much of the payment was subject to tax at "the full marginal rate" and deny only a deduction for the excess.[106] For example, this might require tax officials in the payer State to understand and apply a very complex underlying foreign tax credit system applicable in the payee State (such as that in the United States of America).

The second type of apportionment giving rise to complexity is apportionment as to the character of a payment. The OECD Final Report on BEPS Action 2 contains many examples where a payment is considered to have a dual character, such as in the case of a payment for the purchase of a financial instrument, where part of the payment may be considered interest and the rest sales proceeds.[107] The countries may not agree regarding the fundamental character of the payment, but even if they do agree, they may not agree on how much of the payment is interest and how much is sales proceeds. That is, they may not agree as to the apportionment of the different characters. So, for example, to apply the recommendation for financial instruments a payer State must first understand how the payee State characterizes a payment and makes an apportionment before turning to how the payee State taxes the characterization and apportionment as determined under the law of the payee State.

In the context of the disregarded payments rule there is a different kind of apportionment for the payer State. Here a D/NI outcome does not arise to the extent that the deduction is set against dual inclusion

[105] Ibid., paragraphs 43, 46 – 48 and examples 1.2, 1.3 and 1.4.

[106] Ibid., example 1.4, paragraph 9.

[107] Ibid. For instance see examples 1.27 and 1.28. On apportionment of dual characterization, see also examples 1.13 and 1.16. It is possible that one country will see one payment and the other country will see two payments. It is also possible that the two countries will not agree on the quantity of the payment and will turn to bifurcating the payment into two or more characters. The report is less than enlightening on these matters and there is no coordination with other BEPS Action items, for instance, Actions 8, 9 and 10.

income. The complexities of these concepts were discussed in section 3.2.2 above. Here a payer State must not only apply an imprecise nexus test between a deduction in the payer State and income under the laws of the payee State, but must determine, based on another ill-defined test, whether there is a sufficient nexus with income in one or more other jurisdictions of one or more other persons. The host State must also carry forward payments for which a deduction is denied (set against dual inclusion income of future years).

The exceptions in the payer State for D/NI mismatches with respect to hybrid financial instruments, disregarded payments and payments made to reverse hybrids are not the same. The OECD intends that the rules should always apply in the context of structured arrangements. However, the rules on hybrid financial instruments and transfers apply only as between related persons, whereas the hybrid entity payment rules apply only as between members of the same control group.[108] Recommendation 10 of the OECD Final Report on BEPS Action 2 defines structured arrangements and recommendation 11 defines related persons and control group. While these concepts are broadly similar to concepts used in the tax laws of most countries, integrating them properly with those local concepts may not be straightforward.

3.2.2.2 DD mismatches

In the context of DD types of mismatch for hybrid entity payments, the OECD Final Report on BEPS Action 2 recommends that the host State be the secondary State. One reason for this may be because, for the host State, the expense is likely to have been incurred in deriving domestic source income. By comparison, for the investor State the expense is likely to have been incurred in deriving foreign source income. This reversal of roles of the host and investor States as the primary State raises critical questions regarding the allocation of expenses between domestic and foreign activities (although the Final Report and its predecessors make no reference to this). This issue is revisited in section 4 below.

In the context of hybrid entity payments, the host State, as the secondary State, must investigate whether a deduction was granted in

[108] Ibid., recommendations 1.4, 3.4 and 4.4.

the investor State and, if so, deny a deduction for the expense.[109] Again, this may be particularly difficult to administer, not only in terms of finding out what happened in the investor State, but also in characterizing it. First, the host State must enquire as to whether the investor State has denied a deduction under the primary hybrid mismatch rule.

If the investor State has not applied the primary mismatch rule, the host State must investigate whether the payment was directly deductible in the investor State. This must be distinguished from a situation in which the investor State provides another treatment, such as considering the payment as being for the acquisition of an asset and then granting depreciation for it. It seems irrelevant whether the investor State subjects the payment to withholding tax, which as noted above can lead to double taxation. If the investor State does not offer a deduction, the host State must still investigate whether the investor State granted the payment equivalent tax relief. For example, if the investor State offers some type of investment tax credit, how does the host State determine whether it is sufficiently related to the payment?[110]

The secondary rule for hybrid payments is also qualified by reference to the concept of dual inclusion income and so will give rise to difficulties for a host State as described with respect to D/NI outcomes. Here a host State must face not only the potential carry-forward of payments for which a deduction is denied (for setting against dual inclusion income of future years), but also the stranded loss rules mentioned above. For the host State only, the scope of the hybrid payments rule is limited to the controlled group and structured arrangement scenarios.[111] The complexity of applying these rules may verge on the impossible for many tax administrations.

In the context of payments made by dual residents, the primary rule applies to both countries of residence.[112] Thus, both countries are instructed to apply the rule (double taxation is intended).[113] Again,

[109] Ibid., recommendation 6.1 (b).

[110] Ibid. The nexus between the payment and the equivalent tax relief is particularly obscure in the definition of "deduction" in recommendation 12.

[111] Ibid., recommendation 6.4.

[112] Ibid., recommendation 7.1 (a).

[113] Ibid., paragraph 227.

even if the other State does not grant a deduction, the host State must enquire whether it has granted equivalent tax relief with respect to the payment. Again, the rule is qualified by reference to dual inclusion income, carry-forward of denied deductions and stranded losses. However, there is no limitation to scope on recommendation 7 of the OECD Final Report on BEPS Action 2 (for example, no limitation to related-party or structured arrangement scenarios).

3.2.2.3 Imported mismatches

In the context of imported mismatches, the OECD Final Report on BEPS Action 2 recommends that the State of the payer is the primary State. Accordingly, this State will deny the payer a deduction for the payment "to the extent the payee treats that payment as set-off against a hybrid deduction." [114] The complexities of attempting to determine whether the payment has been set off in this way were discussed in section 2.3.3 above. This is a case where the other hybrid mismatch rules are not applicable as between the payer and the payee States, but the payment is part of a chain of back-to-back payments that can be linked to a hybrid mismatch somewhere down the chain. The host State must trace the linkage between those payments. At each point in the chain, it must apply the tax laws of foreign countries to determine whether there is a mismatch.

While it appears that the payer State is the primary State in the context of this hybrid mismatch rule, that is not the case. If a State applies mismatch rules to neutralize the mismatch at the end of the chain, the payer State loses its right to make a counteraction. Indeed, there is likely to be tax planning to ensure that mismatch rules are triggered in low tax jurisdictions in order to ensure that the imported mismatch rule does not apply. This is a consequence of the recommendations in the OECD Final Report on BEPS Action 2 not taking effective tax rates into account.

The OECD Final Report on BEPS Action 2 notes that "tracing and priority rules" are the key to the imported mismatch rule. [115] A tax practitioner in one of the most sophisticated financial centres in a developed country suggests that "it is the imported mismatch rules which are likely

[114] Ibid., recommendation 8.1.

[115] Ibid., paragraph 235.

to present the greatest challenge." [116] The Final Report emphasizes that the "most reliable protection against imported mismatches will be for all jurisdictions to introduce rules recommended in this report." [117] "Once the hybrid mismatch rules are in place they will be applied automatically by taxpayers when determining their tax liability, and should not raise significant on-going administration costs for tax authorities." [118]

It would be reasonable to expect that the level of coordination in looking not only to the investor jurisdiction but through potential intermediaries in potentially uncooperative third countries could be substantial, or impossible, for many tax administrations. This is underlined by the examples with respect to recommendation 8 in the OECD Final Report on BEPS Action 2. On average, these are substantially longer than other examples. What these examples demonstrate is that the imported mismatch rule is potentially more complex than most underlying foreign tax credit or CFC regimes.

As with the rules for disregarded payments and payments to reverse hybrids, the imported mismatch rule applies only where the parties involved are in the same control group or where the payment is made under a structured arrangement. [119]

3.2.3 Actions by investor/residence/home State

In the context of D/NI mismatches for financial instruments and disregarded payments, the OECD Final Report on BEPS Action 2 recommends that the State of the investor be the secondary State. As such, it must determine whether the payer State has denied a deduction for the payment under the primary rule before deciding to include an amount in the ordinary income of the investor. [120] As noted above, in the context of financial instruments, this is subject to the rule that the investor State refuse a dividend exemption for any deductible payment under recommendation 2. All of the complexities arising for a payer State

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[116] Jeanette Zaman, "Hybrid Mismatch Arrangements — the UK's Take on Action 2," supra note 70, at 12.

[117] OECD Final Report on BEPS Action 2, supra note 2, paragraph 240.

[118] Ibid., paragraph 302.

[119] Ibid., recommendation 8.4.

[120] Ibid., recommendations 1.1 (b) and 3.1 (b).

noted in section 3.2.2 above apply similarly for the investor State in seeking to apply these hybrid mismatch rules.

There is no defensive rule for payments to a reverse hybrid. However, the special rule regarding CFC regimes in recommendation 5.1 of the OECD Final Report on BEPS Action 2 (noted in section 3.2.1) serves the same purpose. In fact, presuming the inclusion in income of a parent under a CFC regime constitutes an inclusion in ordinary income, this specific recommendation is in essence a primary rule as it will cause the primary rule for payments to a reverse hybrid not to apply.

In the context of DD mismatches for hybrid entity payments, the OECD Final Report on BEPS Action 2 recommends that the investor State be the primary State, in which case the investor State is to deny a deduction for the payment.[121] Here, too, all of the complexities arising for a payer State noted in section 3.2.2 above similarly apply for the investor State in seeking to apply this hybrid mismatch rule.

As regards exceptions to these hybrid mismatch rules, for D/NI mismatches these are the same as in the case of the payer/host State, discussed in section 3.2.2 above. By contrast, in DD mismatches for hybrid entity payments, there is no limit on the investor State applying the primary rule. This can be contrasted with the situation in the payer State where the secondary rule applies only in controlled group and structured arrangement situations.[122] As noted in section 3.2 above, the recommendation for dual residents applies equally to both residence States and there is no limitation as to scope.

As noted in section 3.2.3 above, both States apply the primary rule in the context of payments made by dual residents and there is therefore no secondary rule. There is also no secondary rule in the context of imported mismatches.

4. Other steps that may be taken

The OECD Final Report on BEPS Action 2 is a patchwork of highly specific rules that are long, disjointed, complex and difficult to

[121] Ibid., recommendation 6.1 (a).

[122] Ibid., recommendation 6.4.

follow,[123] and this discussion has sought to avoid some of their more complex parts. The number of issues raised in this brief consideration suggests that there will be amendments to the "final" report in the future. If this does not happen, then it is difficult to see how there could be any substantial level of uniformity in the application of the recommendations. The recommendations are intended to stop tax planning of particular varieties, but seem destined to promote different styles of tax planning.

The OECD Final Report on BEPS Action 2 contains a clear and appropriate set of design principles.[124] However, the recommendations appear to promote few of these. The recommendations are not comprehensive and will not "minimise the disruption to existing domestic law." They are not "clear and transparent in their operation," "workable for taxpayers [nor do they] keep compliance costs to a minimum" nor are they "easy for tax authorities to administer."[125] Further, as noted in section 3.1 above, in the face of other instances of "double taxation of the same economic income" not addressed by tax treaties,[126] it is not clear why the recommendations must necessarily "avoid double

[123] Regarding the patchwork nature of the OECD proposals and particularly regarding difficulties for developing countries, see S. Johnston, "Hybrid Mismatch: Proposed Rules May Expect Too Much From Developing Countries," (2014) Vol. 4, *Tax Notes International,* at 314; and Ryan Finley, "Africa Faces Its Own Base Erosion Issues, ATAF Executive Says," (2016) Vol. 109(5), *Worldwide Tax Daily*.

[124] Ibid., chapter 9.

[125] See Amanda Athanasiou, "Hybrid Mismatch Proposals: Practical Problems Remain," (2014) Vol. 74, *Tax Notes International*, at 1083, who notes that "foremost among stakeholder concerns during this process has been the fear that administration of the rules and coordination among jurisdictions, as well as with other base erosion and profit-shifting initiatives and domestic law, will be prohibitively difficult, leading to double taxation, competitive inequities, inefficiencies, and impossible compliance burdens." See also Michael L. Schler, "BEPS Action 2: Ending Mismatches on Hybrid Instruments, Part 2," (2014), *Worldwide Tax Daily*, at 581. Schler is a partner in a United States law firm who, at 580, describes the OECD recommendations as "enormously complicated."

[126] OECD Final Report on BEPS Action 2, supra note 2, paragraph 95.

taxation through rule co-ordination." [127] The critical thing is to ensure sufficient taxation. In any case, there are many circumstances in which the recommendations will not avoid double taxation. The primary of these is the failure to take into account withholding tax on deductible payments,[128] but there are many other examples.[129] Failure to meet the design principles may stem from the OECD attempt to be more targeted and precise than is necessary for this limited purpose.[130]

The level of coordination required between countries for implementation of the OECD recommendations is unprecedented. The recommendations are prescriptive as regards domestic tax law amendments in a manner not seen before.[131] Further, the recommendations require a country not only to investigate the terms of a financial instrument or entity and the tax treatment of it under the tax law of another country,[132]

[127] Ibid., recommendation 9.1 (d). Double taxation is a question of degree, not absolutes. Investors are likely to be deterred less by two light impositions of tax that are reasonably predictable and certain, than one high level of tax with substantial degrees of uncertainty.

[128] Graeme S. Cooper, "Some Thoughts on the OECD's Recommendations on Hybrid Mismatches," supra note 14, at 340.

[129] See, for example, OECD Final Report on BEPS Action 2, supra note 2, examples 1.27, 1.28, 1.29, and potentially, 1.31, 1.32, 1.33, 1.34 and 1.37. Example 1.29 is particularly harsh where the deductible interest is included in the sales proceeds of trading stock and so taxed as ordinary income. Despite this, it seems a deduction should be denied for the interest. Contrast this result with example 2.2, where there is no suggested counteraction for a clear mismatch.

[130] Hugh J. Ault, "Some Reflections on the OECD and the Sources of International Tax Principles," supra note 4, at 1199, accurately doubted that "the rules dealing with the BEPS issues can be structured so accurately that they hit only the desired targets and there will inevitably be situations when undesirable double taxation could arise."

[131] Graeme S. Cooper, "Some Thoughts on the OECD's Recommendations on Hybrid Mismatches," supra note 14, at 346, notes that under the OECD recommendations "a state's tax law would become much more contingent and structurally dependent on the policies and practices of other governments. Surrendering sovereignty over tax matters to other States is not something governments are used to or are likely to enjoy."

[132] OECD Final Report on BEPS Action 2, supra note 2, paragraph 86.

but the country might also need to investigate the relationship between each party to a payment and sometimes (as in structured arrangements) their motives.[133] Coordination between countries and responding to anti-avoidance is not new. What is new is the intensity of the focus and the lack of clarity in what is trying to be achieved. "Neutralizing" is no guiding principle without specifying a comparator or context, that is to say, neutralized by comparison to what. It is evident that the OECD dislikes certain behaviour, but its Final Report on BEPS Action 2 falls short of identifying in a clear and coherent fashion what that behaviour is.

The OECD rates the relevance of neutralizing hybrid mismatch arrangements for developing countries as "low."[134] While the relevance of the OECD recommendations in this regard may well be low, developing countries must be aware of the revenue risk raised by hybrid mismatch arrangements. There is a need to consider and respond to such arrangements, but not necessarily using the OECD recommendations.

Many countries will look for simpler ways of addressing hybrid mismatch arrangements, particularly if they can be coordinated more generally with measures to prevent base erosion and profit shifting.[135] In order to identify other options, it is necessary to return to the basics

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Even for a residence country, Jurgen Lüdicke, "'Tax Arbitrage' with Hybrid Entities: Challenges and Responses," (2014) Vol. 68, No. 6/7 *Bulletin for International Taxation*, at 313, suggests that knowledge about foreign taxes for purposes of foreign tax credit and CFC rules "seems easier" and requires "less technical understanding about the foreign tax rules" than knowledge required to implement the OECD proposals.

[133] Amanda Athanasiou, "OECD's Hybrid Mismatch Proposals Too Drastic, Commentators Say," (2012) Vol.94(1), *Worldwide Tax Daily*, quotes Ernst and Young as saying "[a]pplying different rules to several categories of hybrid arrangements is 'more complicated than any domestic law regime of any country in place today.'" Lee A. Sheppard, "News Analysis: Dual Consolidated Loss Rules and BEPS," (2014) Vol. 144(4), *Worldwide Tax Daily*, says that "[n]eeding to know with some precision the other country's treatment is a serious weakness" in the OECD Public Discussion Draft on BEPS Action 2.

[134] OECD, *Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* (Paris: OECD, 2014), Annex A.

[135] Amanda Athanasiou, "OECD's Hybrid Mismatch Proposals Too Drastic, Commentators Say," supra note 133, also notes that the issues covered by Action 2 "overlap with a number of other BEPS actions."

to identify the core of the problem. After all, financial instruments and different types of entities are not the problem; they are only vehicles that are used to exploit flaws in tax fundamentals. Those tax fundamentals need to be investigated to see what can be done.

Annex II considers what effect the other options identified under this heading might have on the 13 hybrid mismatch case studies used in the present chapter, the primary examples in the OECD Final Report on BEPS Action 2 and the figures in the OECD Public Discussion Draft on Branch Mismatches.

4.1 Stepping back: the bigger picture

The core structural problem that hybrid mismatch arrangements demonstrate is the mixing of source and residence tax bases. Historically, most income tax laws in Europe developed from separate taxes on the basis of source that were subsequently supplemented with a general tax on the basis of residence. The taxes on source and those on residence were quite distinct.[136] It was from this basis that the first tax treaties evolved, which not surprisingly incorporated a schedular approach.[137] This was not the case in the United Kingdom and the United States, which had general income taxes. Even though the categorization of income might have been schedularized, under a general income tax all income of a resident (foreign or domestic) is taxed at the same rate and domestic source income of non-residents is also taxed. This mixed or fused general income tax causes overlapping tax jurisdictions. As the twentieth century progressed, most countries moved to a mixed system.

[136] For example, see Peter A. Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems* (Amsterdam: IBFD, 1996), 73 – 88 and 286 – 300.

[137] Ibid., 286 – 306. The difference between schedular taxes on different sources of income and a complementary comprehensive income tax on the basis of residence is evident in some of the early model tax treaties of the League of Nations. For example, see Sunita Jogarajan, "The 'Great Powers' and the Development of the 1928 Model Tax Treaties," in Peter Harris and Dominic de Cogan, eds., *Studies in the History of Tax Law*, Vol. 8, chapter 12 (forthcoming).

Unlike earlier schedular source taxes with a supplementary residence tax, the mixed system provides no obvious allocation of taxing rights between countries. The allocation subsequently developed was based on tax treaties. As the OECD Model Convention demonstrates, tax treaties produce an uneven, somewhat random, schedularized source-based tax. This is then overlaid with a residual tax in the residence State that is subject to the provision of foreign tax relief. Wherever the source tax rate and the residence tax rate are different, this system facilitates gaming between different types of income. At one level, hybrid mismatch arrangements facilitate such gaming as one country thinks that income falls into one category and the other thinks that it falls into another.

Historically, residence-based taxes worked in an overarching fashion that attempted to ensure equity between particular residents and in doing so would often remove some of the benefits of gaming. The countries from which most investment was derived were often comparatively high-tax countries and this facilitated the protection role of residence-based taxes. When residence-based taxes began to be seriously challenged by deferral through third-country holding company structures, many investor countries implemented anti-deferral rules such as CFC rules. That was manageable where the ultimate investor was clearly within the jurisdiction. Often that is not the case anymore.

Globalization and the information age have made fragmentation of investment in artificial entities both easy and lightning fast, and this has made taxation purely on the basis of corporate residence inherently problematic. It is now common for persons resident in many countries to hold shares directly in multinational entities that derive income from many different countries. Any attempt by one country to impose any substantial tax on such a multinational entity purely on the basis of corporate residence (that is, to tax foreign source income) is likely to cause the entity to move its residence, which is not a difficult matter. And in many cases, not taxing on the basis of corporate residence is appropriate. Why should a country tax foreign source income of a resident corporation if the majority of its shareholders are foreign or tax exempt (for example, pension funds)?

Ensuring balanced taxation in the source State is a different matter and perhaps this is where the focus of attention with respect to hybrid mismatch arrangements and other base erosion and profit shifting efforts should be. Many source States care little about where investment comes from and, in any case, have little control over it. They care little whether the ultimate investor is some taxable entity or a non-taxable entity. Often source States even have little interest in whether an investment is from a high-tax country, a financial centre or a tax haven.[138] However, there are other things that a source State will care about. It will be concerned if the investment is insubstantial or from illegitimate funds. It will also wish to make sure that it does not obstruct the free flow of new technology and innovation into its jurisdiction.

Residually and critically, a source State will care (very much) whether its tax system favours foreigners over domestic enterprises in accessing the domestic market. At a minimum, a source State needs to protect the competitiveness of local business in the domestic market. There are things a source State can do to encourage foreigners seeking to access the domestic market to create a more substantial presence (for example, a PE) that is taxed on a non-discriminatory basis with domestically owned enterprises.[139] Taking action in this direction will also reduce tax benefits from hybrid mismatch arrangements and provide a useful context for assessing whether such arrangements are "neutralized."

4.2 Joint steps: separating source and residence tax bases

The OECD Final Report on BEPS Action 2 notes that its recommendations do not require a "jurisdiction applying the rule to establish that it has 'lost' tax revenue under the arrangement."[140] This is perceived to be a benefit of the recommendations, but at another level it seems a

[138] For example, Nathan Boidman and Michael Kandev, "BEPS Action Plan on Hybrid Mismatches: A Canadian Perspective," supra note 1, at 1237, note that "historically, tax law design has not conditioned deductibility of payments on their tax treatment for the recipient. If a source country wishes to reduce the level of tax incentives provided to inbound investors, it can simply tighten the deduction limitations already in place."

[139] Stephen Edge, "Base Erosion and Profit Shifting: A Roadmap for Reform—Tax Arbitrage with Hybrid Instruments," supra note 11, at 319, suggests that as a matter of fairness "businesses should be treated equally within the jurisdiction in which they are operating."

[140] OECD Final Report on BEPS Action 2, supra note 2, paragraph 278.

failure. If the international allocation of taxing rights was more specific, uniform and clear, perhaps it would be obvious whose rights were being eroded by hybrid mismatch arrangements. The tax benefits of many of the examples in the Final Report would be thwarted if source-country taxing rights were not eroded or denied by tax treaties. Other tax benefits in the examples would be thwarted if residence countries imposed CFC rules, something that until recently the OECD has refused to bring into the body of its Model Convention (relying rather on observations in the Commentary).[141] An intermediate jurisdiction is neither the ultimate source State nor the State of the ultimate investor and has little incentive to protect source and residence-State tax bases. Fragmentation of investment due to globalization means that more and more countries find that they are an intermediate jurisdiction in whole or in part.

To protect taxation from hybrid mismatch arrangements, countries should, perhaps, focus on what they are trying to protect—countries need to identify clearly and distinguish between their source (domestic) and residence (foreign) tax bases. This means more than just identifying the geographical source of income, whether domestic or foreign. A country needs to identify the source of the building blocks that make up income and, particularly, the source of payments. Some countries do have relatively clear rules on source of income and receipts, although not usually as separate matters. In other countries there are very few rules. What most countries do poorly is specifically identify which expenses can be deducted in calculating domestic source income and which can be deducted in calculating foreign source income. That is to say, most countries fail to identify the source of expenses and limit their use in a manner that is consistent with the taxation of receipts.

The source of expenses may be determined in a similar manner as the source of receipts. As a broad outline, domestic source income

[141] The OECD Final Report on BEPS Action 6 proposes to address this by inserting a new paragraph into Article 1 of the OECD Model Convention; see OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Paris: OECD, 2015), paragraph 63, available at http://www.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en.

could be calculated as the net of receipts with a domestic source less expenses with a domestic source. Foreign source income could be calculated in a similar fashion.[142] This is a point at which it makes little sense to follow financial reporting rules because those rules are designed for global reporting of income. They are inadequate for purposes of allocating tax bases between countries.[143] It seems inappropriate for taxpayers to be given discretion over whether foreign expenses offset domestic receipts or domestic expenses offset foreign receipts. It should be a conscious decision for a country, as a policy matter, to permit domestic losses (domestic expenses less domestic receipts) to offset foreign income (foreign receipts less foreign expenses) or foreign losses against domestic income.

4.3 Source-State steps: plugging the gaps

Granting a resident entity a deduction for an outbound payment that is not subject to withholding and that does not result in an equal inflow of resources into the country erodes the source country's tax base. These are the types of payments that are targeted by hybrid mismatch arrangements. They are particularly facilitated by the OECD Model Convention,[144] which presumes that such payments will be picked up by taxation in the residence country of the recipient. However, if residence-country taxation of artificial entities is failing in the face of globalization, this is something that needs to be revisited. There are only two ways to address source-State tax erosion: increase the scope and rate of withholding taxes or deny a deduction.

[142] For an example of rules of this nature, see Peter A. Harris, "The Symmetrica Income Tax Act 20** and Commentary," (2000), section 68, International Monetary Fund (a hypothetical tax law commissioned and peer reviewed by the Legal Department of the International Monetary Fund), available at http://www.imf.org/external/np/leg/tlaw/2000/eng/preface.htm. Some of these rules need refinement.

[143] See Peter A. Harris, "IFRS and the Structural Features of an Income Tax Law," in Victor Thuronyi and Geerten Michielse, eds., *Tax Design Issues Worldwide*, supra note 39.

[144] For example, lack of source-State taxation due to limits in Articles 7 (Business profits), 11 (Interest) and 12 (Royalties) and limitations on a source State's ability to deny deductions under Article 24 (Non-discrimination).

To prevent tax base erosion, source States might seek full and uniform withholding tax on all outbound payments that do not result in an equal inflow of resources into the country.[145] The rates should be sufficient not to discourage local provision of the service paid for. This can be a problem particularly with the provision of services, where many countries lack substantial withholding taxes. Services are commonly provided by foreigners into a source State through tax havens. The lack of taxation often means that foreigners can undercut the provision of equivalent services by a domestic provider. The same is true with respect to rent payments for the use of mobile assets. In a globalized world, a source State cannot presume that there will be appropriate taxation in the residence State. It is often fair to (and perhaps a source State should) presume that incoming resources will be provided through a tax haven or equivalent (such as a hybrid mismatch arrangement).

Tax treaties are particularly inflexible instruments that give away source-State taxing rights, sometimes unwittingly. A number of developing countries with substantial natural resources have concluded tax treaties that can be exploited to erode the country's tax base in ways that were not envisaged when the treaties were concluded. This can create tax administration resistance to applying such treaties, especially when local service providers are discriminated against. With appropriately selected withholding tax rates, a country can encourage

[145] Michael Lennard, Chief, International Tax Cooperation Unit, Financing for Development Office (FfDO), United Nations Department of Economic and Social Affairs, has been reported as saying that "[o]ne of the things that is important for developing countries, but that is not in the OECD Action Plan, as such, is the preservation of withholding taxes generally… I think that one of the outcomes of BEPS will be developing countries will be more and more recognizing the importance of preserving their withholding taxes, and not giving them away too readily in treaties." See David D. Stewart, "Lennard Distinguishes U.N. and OECD Approaches to BEPS, Previews Future Work," (2014) Vol. 95(3), *Worldwide Tax Daily*. The second part of the OECD report on the impact of BEPS in low-income countries does not make a recommendation to that effect (nor does the first part of its report) and only mentions withholding tax once. See OECD, *Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* (Paris: OECD, 2014).

foreign service providers to establish a taxable presence in their jurisdiction (for example, a PE) so that local expenses can be deducted, that is to say, taxation on a net basis.

The OECD Final Report on BEPS Action 2 makes little reference to withholding tax in its examples and none of any substance in the recommendations. It seems that the OECD is not able or willing to reconsider the provisions in its Model Convention that facilitate tax base erosion and profit shifting, at least not directly in the context of hybrid mismatch arrangements.[146] While the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention)[147] provides greater scope for protecting source-State taxing rights, care still needs to be taken in concluding tax treaties. If a country's representatives are not fully aware of the potential consequences of concluding a tax treaty, the safe option is not to do so.[148]

The second way to prevent source-State tax base erosion is to quarantine foreign expenses. This is the natural consequence of the rule option noted in section 4.2 above for calculating foreign source income separately from domestic source income. If a payment made by a resident of a State has no source in that State and the State can therefore not impose withholding tax, then the resident should be permitted to deduct that expense only in calculating foreign source income.[149] This option will protect the State of the investor in some

[146] See OECD, *Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries*, supra note 145, paragraph 12, which focuses on "denial of deductions in the payer state and/or forcing the inclusion in the payee state."

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

[148] Treaties that involve coordination of tax administration do not erode source-country taxing rights and do not fall into this category, for example, the 2011 multilateral Convention on Mutual Administrative Assistance in Tax Matters.

[149] For the reasons discussed in the OECD Final Report on BEPS Action 2, supra note 2, paragraph 448, the prevailing view is that such a rule does not breach Article 24 (4) of tax treaties.

hybrid mismatch arrangements as much as the State of the payer. As demonstrated in annex II, many of the examples in the OECD Final Report on BEPS Action 2 involve investors deducting foreign expenses against their domestic source income.[150]

Unlike the OECD recommendations, the effect of the above option is not to deny a deduction and the rule is a uniform rule irrespective of the country of the investor. This is a prime method by which source States can seek to ensure that foreign service providers are not indirectly granted a better tax treatment than local service providers. By contrast, the OECD recommendations seek to cherry pick certain payments for the denial of a deduction. This could be particularly distorting and difficult to administer. The OECD recommendations often require that the tax treatment in the payer jurisdiction depends on who holds an investment. Therefore, changes in circumstances of the investor and transfers of an investment (something over which the payer may have no control) may result in a changed tax treatment of the payer (denial of a deduction).[151] In turn, this could have a serious impact on the terms and interest rate on which instruments are issued.[152]

At a more extreme level, source States might consider introducing or broadening the scope of their earnings stripping rules. Many countries already have rules that deny a deduction for excessive interest. Some of these are based on transfer pricing (borrowing beyond an arm's length amount), debt to equity ratio (thin capitalization) or earnings stripping (interest beyond a set proportion of income before financing expenses) methodology.[153] However, interest payments

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[150] Wolfgang Schön, "International Taxation of Risk," (2014) Vol. 68, No. 6/7 *Bulletin for International Taxation*, 280–294, at 284, notes the "asymmetry" in setting foreign expenses against domestic source income.

[151] Graeme S. Cooper, "Some Thoughts on the OECD's Recommendations on Hybrid Mismatches," supra note 14, at 347, makes a similar point.

[152] OECD, *Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries*, supra note 145, section 3, does consider "base eroding payments" but only in the context of developing countries denying deductions for payments between related parties.

[153] For example, see Johanna Hey, "Base Erosion and Profit Shifting and Interest Expenditure," (2014) Vol. 68, No. 6/7 *Bulletin for International Taxa-*

are only one way in which a source-State tax base may be eroded. In particular, it is possible to modify an earnings stripping approach to cover all types of base-eroding payments. The total of deductions granted for payments made to entities with limited tax liability might be restricted to a certain percentage of the value of assets used in an earning activity.[154] Particularly, such a rule might be considered by source States that have already given up substantial taxing rights under tax treaties.[155]

4.4 Residence-State steps: do not discourage domestic investment

Deferred or non-taxation in the residence State of foreign income that has been lowly or not taxed overseas encourages foreign over domestic investment by residents. The only solution to this problem is a foreign tax credit system with anti-deferral rules, for example, CFC rules. The problem is that these rules need to be carefully crafted or they may discourage foreign investment into a country, at least where that foreign investment may bring with it a need or potential for deriving third-country income. In this context, it is natural for countries that are or wish to be financial centres to resist the adoption of (or erode existing) CFC rules. As noted in section 4.1 above, if the ultimate investor is a non-resident or tax exempt then CFC rules are distorting (in terms of location and form of investment). If the ultimate investor

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tion, 332–345, at 335–336. See also OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report_9789264241176-en.

[154] For an example of such a rule, see Peter A. Harris, "The Symmetrica Income Tax Act 20** and Commentary," supra note 142, section 27. This is a general rule which for administrative reasons is not restricted to related-party arrangements. See OECD, *Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries,* supra note 145, section 3.

[155] Here, too, for the reasons discussed in the OECD Final Report on BEPS Action 2, supra note 2, paragraph 448, the prevailing view is that such a rule does not breach Article 24 (4) of tax treaties.

is a local wealthy individual, then the lack of CFC rules is distorting. This suggests a need for investigating the better targeting of CFC rules at this latter category.[156]

A number of the recommendations in the OECD Final Report on BEPS Action 2 sit uncomfortably with OECD past practice with respect to CFC rules. As noted in section 3.3 above, a number of the recommendations prescribe taxation in the residence State (whether under a primary or secondary rule) in the case of reverse hybrids by lifting what the investor State perceives to be a corporate veil. To this extent, the recommendations are similar (or suggest an extension of) CFC rules, but more specific and prescriptive than the OECD has ever been on this front. The OECD Final Report on BEPS Action 3 makes recommendations regarding the design of CFC rules but falls short of prescribing their implementation.[157] It is not clear why a more aggressive position is taken with respect to hybrid mismatch arrangements than with respect to deferral or avoidance through more traditional tax havens.[158] A lack of coordination between BEPS Actions 2 and 3 is unfortunate.[159]

The same could be said of the recommendation that no dividend exemption be given for a payment that is deductible for the payer. Without questioning the appropriateness of such a rule, it is not clear that it is sensible without strong CFC rules. If countries grant a dividend exemption for payments from tax havens (or just low-tax countries), it is not clear why they should deny an exemption for payments

[156] Guglielmo Maisto, "Controlled Foreign Company Legislation, Corporate Residence and Anti-Hybrid Arrangement Rules," (2014) Vol. 68, No. 6/7 *Bulletin for International Taxation*, 327–331, at 328, suggests that a "key element to be addressed in the design of effective CFC legislation is how should states frame such legislation to take account of whether or not the ultimate individual investors are domestic or foreign."

[157] OECD, *Designing Effective Controlled Foreign Company Rules, Action 3—2015 Final Report*, supra note 97.

[158] See also Michael L. Schler, "BEPS Action 2: Ending Mismatches on Hybrid Instruments, Part 1," (2014), *Worldwide Tax Daily*, at 488.

[159] Guglielmo Maisto, "Controlled Foreign Company Legislation, Corporate Residence and Anti-Hybrid Arrangement Rules," supra note 156, at 329, considers coordination of OECD Action 2 and Action 3 to be "a critical matter."

that are deductible, which can produce the same result.[160] Trying to tax the deductible payment is likely to drive more business to be intermediated through tax havens. The point is that as a tax design matter, the denial of a dividend exemption for deductible payments should be integrated into and coordinated with CFC rules.

Problems of favouring foreign investment are dramatically aggravated where expenses pertaining to foreign source income can be set against domestic source income. This is a problem particularly with financing expenses. It makes little sense to permit residents to set expenses incurred in deriving potentially lowly taxed foreign source income against domestic source income. The result not only encourages source base tax erosion (taxation of income sourced in the residence State), but encourages residents to derive lowly taxed foreign source income (that is, income lowly taxed, expenses deducted against high tax amounts). The recommendations in the OECD *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report* are only a limited response in this regard.

As noted above, one way to prevent such distortions is to quarantine foreign expenses so that they can be deducted only in calculating foreign source income. Further, as noted below in annex II, this is an effective measure in addressing some forms of hybrid mismatch arrangements. There are a number of considerations in the form of any such quarantining, of a type faced when designing a limitation on credit under a foreign tax credit system, for example, whether the quarantining is worldwide, country by country, by type of income or item by item (slice by slice). These considerations are discussed elsewhere, but there should be consistency between quarantining foreign expenses and the limitation on foreign tax credit (or calculation of exempt foreign income).[161]

Granting a benefit with respect to foreign source income (whether deduction, loss, exemption or credit) should be denied where a similar

[160] See also Nathan Boidman and Michael Kandev, "BEPS Action Plan on Hybrid Mismatches: A Canadian Perspective," supra note 1, at 1237.

[161] See Peter A. Harris, "Taxation of residents on foreign source income," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries,* supra note 13, at 141–148.

benefit is granted in another State. Here, some of the recommendations in the OECD Final Report on BEPS Action 2 are unnecessarily prescriptive. The rules on hybrid payments (DD outcome) and disregarded hybrid payments (D/NI outcome) are unnecessarily prescriptive in that they create complexities that are difficult to administer for little benefit. Many of the worst of these complexities would be addressed by appropriate quarantining (foreign expenses and foreign tax credits) and careful targeting of the use of exemptions for foreign source income.

Irrespective of quarantining, no relief should be given for foreign expenses, losses and taxes if relief is given to any other person anywhere. Clearly, no foreign tax credit should be given for foreign taxes that are credited to someone else. No relief should be granted for a foreign loss (even if quarantined) if relief for the loss is granted to someone else. Concerns that such a rule might work harshly in some cases can be left for tax advisers to plan around, as they often have to do with matters such as limits on interest expense. For this purpose, whether another person has been granted relief, other than the resident person claiming the benefit, is logically determined according to the rules of the residence State.[162]

5. Conclusion

While the OECD Final Report on BEPS Action 2 contains much to analyse that is worthy of consideration,[163] none of the examples provide compelling reasons for the tax treatment in the represented States to be coordinated. The perceived tax benefits in all of the examples, while presented in some complex and sophisticated settings, all boil down to a disagreement on some basic fundamentals of income tax. In particular, many of the inconsistencies are a result of countries following different approaches to identifying income tax fundamentals and,

[162] In the case of a reverse hybrid, therefore, the residence State would not consider that a PE loss has been used by a person other than its resident, even where the host State happens to view the PE as a separate person.

[163] The United States has highly complex anti-hybrid rules that have been implemented on a unilateral basis and is considering whether these need amending in the light of the examples in the OECD Public Discussion Draft on BEPS Action 2, see Lee A. Sheppard, "News Analysis: Dual Consolidated Loss Rules and BEPS," supra note 133.

in particular, of whether legal form is accepted or more focus is given to substance, as when a country relies on classification for financial reporting purposes.

Even if coordination is considered necessary, a country should critically assess whether it will follow the OECD recommendations. The level of complexity and difficulty in administering these rules should not be underestimated, nor should the costs for taxpayers in complying with these rules. The examples in the OECD Final Report on BEPS Action 2 add substantial detail to already complex recommendations and, in many cases, a lack of comprehensive analysis in the examples creates further obscurity. For a few sophisticated economies with well-funded and highly trained tax administrations, the payoff in shutting down perceived abuses may be considered worthwhile. For a large number of countries (perhaps a great majority), the cost-benefit analysis may not look proportionate and for countries with struggling tax administrations, implementation may seem impossible. One commentator noted that the "length and complexity of the action 2 report … have discouraged both tax advisers and governments from attempting to make sense of or consider implementing it. Those who have tried have pointed out serious technical problems with the report's recommendations." [164]

In any case, as identified in section 4 above, there are other unilateral steps that countries may take to address hybrid mismatch arrangements that are consistent with addressing base erosion and profit shifting more generally. Consistent with the traditional approach to international tax matters, the identified measures that source States may take require no coordination with residence States. The identified measures that residence States may take do require them to consider tax treatment in source States, but not to any greater extent than has been usual for the purposes of providing foreign tax relief.

A basic task for countries in considering hybrid mismatch arrangements is to analyse them by reference to the income tax fundamentals of their own system. A country needs to perform this analysis both from the perspective of the country as a source State and separately

[164] Mindy Herzfeld, "New Analysis: Hybrids, PEs, and State Aid," (2016) Vol 176(1), *Worldwide Tax Daily*.

as a residence State. For this purpose, the country will need to consider very clearly "What is our source tax?" and "What is our residence tax?" In addition, it will need to ask whether the tax law currently makes a sufficient distinction between these two taxes. If it does not, the country should consider ways in which it can clarify that distinction.

After identifying whether hybrid mismatch arrangements expose any flaws in the fundamentals of its tax law, a country needs to consider how to respond. The logical and traditional response to flaws in a tax law is to make adjustments unilaterally. Another possibility, as recommended by the OECD, involves coordination with other countries. This coordination may be implemented through amendments to domestic law or by conclusion or amendment of tax treaties. A country must be up to the task before concluding tax treaties, for fear that it will introduce restrictions on its unilateral ability to respond to flaws and abuses.

In considering the response to hybrid mismatch arrangements, a country must consider what is and what is not capable of administration by its tax authority. It is possible to understand the basic types of benefits sought from hybrid mismatch arrangements in terms of the fundamentals of income taxation and to formulate a response accordingly. A more difficult issue is administratively looking through the myriad types and complexities of arrangements to identify what is happening and then administering the formulated response.

At a fundamental and cynical level, hybrid mismatch arrangements are just a means by which tax planners use two countries with normal (and decent) tax systems to produce mismatches comparable to those achieved by routing investment through a tax haven. Globalization and the electronic age mean that source States must be cautious in presuming that any foreign country will, as a residence State, tax appropriately a flow of funds that has been let out of the source State with minimal tax. Similarly, a residence State must be cautious in presuming that foreign source income of its residents has suffered sufficient foreign tax such that the income warrants foreign tax relief or any other relief. Neither presumption is warranted simply because the country has a tax treaty with the other country involved. A country's response should be similar and coordinated, irrespective of whether a mismatch is achieved directly as between two countries or indirectly involving a third country.

Annex I

Categorizing the 13 hybrid mismatch case studies and OECD examples and figures[a]

Legend

OECD examples

[NAR] No adjustment recommended

[PDT] Potential double taxation

[MHE] More than one hybrid element

[AD/NI] Apportionment D/NI

[ACP] Apportionment character of payment

[WT] Withholding tax

[Q] Quarantine

Payments

- Identification
  - Hybrid mismatch case study 1
    - OECD example 1.14 [NAR]: Deemed interest on interest-free loan [WT]
    - OECD example 1.20 [NAR]: Release from a debt obligation not a payment [Q]
- Allocation of recipient
  - Hybrid mismatch case study 2

[a] All hybrid mismatch case studies are from the present chapter. The examples cited throughout the annex are those contained in OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report_9789264241138-en; the figures are contained in OECD, *Public Discussion Draft, BEPS Action 2: Branch Mismatch Structures* (Paris: OECD, 2016), available at https://www.oecd.org/tax/beps/Discussion-draft-Action-2-Branch-mismatch-structures.pdf).

Allocation of payer

Hybrid mismatch case study 3

Quantification

Hybrid mismatch case study 4

OECD example 1.15 [NAR]: Differences in value attributable to share premium paid under mandatory convertible note [WT]

OECD example 1.17 [NAR]: No mismatch with respect to measurement of foreign exchange differences [WT]

OECD example 6.3 [MHE]: Double deduction outcome from the grant of share options [WT, Q]

Timing

Hybrid mismatch case study 5

OECD example 1.22 [NAR]: No mismatch resulting from accrual of contingent interest liability [WT]

Character

Hybrid mismatch case study 6

OECD example 1.16: [ACP] Differences in valuation of discount on issue of optional convertible note [WT]

OECD example 1.18: Payment in consideration for an agreement to modify the terms of a debt instrument [WT]

OECD example 1.19: Payment in consideration for the cancellation of a financial instrument [WT]

OECD example 1.27 [PDT]: [ACP] Interest component of purchase price [WT]

OECD example 1.28 [PDT]: [ACP] Interest paid by a trading entity [WT]

OECD example 1.29 [PDT]: [ACP] Interest paid to a trading entity [WT]

OECD example 1.30: Purchase price adjustment for retained earnings [WT]

OECD example 1.36: [ACP] Deduction for premium paid to acquire a bond with accrued interest [WT]

OECD branch mismatch figure 5 [AD/NI]: DD Branch Structure [WT, Q]

OECD branch mismatch figure 6 [MHE]: Imported Branch Mismatches [WT]

Character of asset

Hybrid mismatch case study 10

OECD example 1.1: Interest payment under a debt/equity hybrid [WT]

OECD examples 1.2, 1.3, 1.4 [AD/NI]: Interest payment under a debt/equity hybrid [WT]

OECD example 1.12: Debt issued in proportion to shares re-characterised as equity [WT]

OECD example 2.1: Application of recommendation 2.1 to franked dividends [WT]

OECD example 2.3: Co-ordination of hybrid financial instrument rule and recommendation 2.1 [WT]

OECD example 3.1 [MHE]: Disregarded hybrid payment structure using disregarded entity and a hybrid loan [WT]

Presumed debt/equity hybrid

OECD example 1.23 [MHE]: Payment by a hybrid entity under a hybrid financial instrument [WT, Q]

OECD example 1.24 [NAR]: Payment included in ordinary income under a CFC regime [WT]

OECD examples 8.1, 8.2, 8.3, 8.4, 8.5, 8.6, 8.7, 8.8, 8.9, 8.10: Imported mismatch rule [WT]

OECD example 8.16: Carry-forward of hybrid deductions under imported mismatch rules [WT]

Persons and personal characteristics

Identification of payer

Hybrid mismatch case study 11

OECD example 1.23 [MHE]: Payment by a hybrid entity under a hybrid financial instrument [WT, Q]

OECD example 3.1 [MHE]: Disregarded hybrid payment structure using disregarded entity and a hybrid loan [WT]

OECD example 3.2: Disregarded hybrid payment using consolidation regime and tax grouping [WT]

OECD example 4.4 [MHE]: Interaction between recommendation 4 and recommendation 6 [WT, Q]

OECD example 6.1 [MHE]: Accounting for valuation and timing differences [Q]

OECD example 6.3 [MHE]: Double deduction outcome from the grant of share options [WT, Q]

OECD example 6.4: Calculating dual inclusion income under a CFC regime [Q]

OECD example 6.5: DD outcome under a loan to a partnership [WT]

OECD examples 8.11, 8.12: Imported mismatch rule [WT]

OECD example 8.13 [MHE]: Deductible hybrid payments, reverse hybrids and the imported hybrid mismatch rule [WT, Q]

OECD example 8.14: Deductible hybrid payments, tax grouping and imported hybrid mismatch rules [WT, Q]

OECD example 8.15: Interaction between double deduction and imported mismatch rule [WT, Q]

OECD branch mismatch figure 3 [MHE]: Deemed Branch Payment [WT]

OECD branch mismatch figure 4 [MHE, AD/NI]: Allocation of Interest Expense [WT, Q]

OECD branch mismatch figure 6 [MHE]: Imported Branch Mismatches [WT]

Identification of recipient

OECD example 4.1: Use of reverse hybrid by a tax exempt entity [WT]

OECD example 4.2 [AD/NI]: Application of recommendation 4 to payments that are partially excluded from income [WT]

OECD example 4.3: Recommendation 4 and payments included under a CFC regime [WT]

OECD example 4.4 [MHE]: Interaction between recommendation 4 and recommendation 6 [WT, Q]

OECD example 6.1 [MHE]: Accounting for valuation and timing differences [Q]

OECD example 8.13 [MHE]: Deductible hybrid payments, reverse hybrids and the imported hybrid mismatch rule [WT, Q]

Residence of recipient

Hybrid mismatch case study 12

Residence of payer

Hybrid mismatch case study 13

OECD example 7.1: DD outcome using a dual resident entity [WT or Q]

Unclassified OECD examples

No tax in residence State

OECD example 1.5 [NAR]: Interest payment to an exempt person [WT]

OECD example 1.6 [NAR]: Interest payment to a person established in a no-tax jurisdiction [WT]

OECD example 1.7 [NAR]: Interest payment to a taxpayer resident in a territorial tax regime [WT]

OECD example 1.8 [NAR]: Interest payment to a tax exempt PE [WT]

OECD example 1.9 [NAR]: Interest payment to a person holding instrument through tax-exempt account [WT]

No hybrid element—mismatch in tax treatment only

OECD example 1.10 [NAR]: Deductible dividends paid by a special purpose entity [WT]

OECD example 1.11: Tax relief equivalent to a deduction [WT]

OECD example 1.35: Share lending arrangement where neither party treats the arrangement as a financial instrument [Part exempt versus share loss deduct]

No hybrid element and no mismatch

OECD example 1.26 [NAR]: Consideration for the purchase of a trading asset

No cross-border element

OECD example 1.13: [ACP] Accrual of deemed discount on interest free loan

OECD example 1.21: Mismatch resulting from accrual of contingent interest liability

Annex II

Effects of other steps on the 13 hybrid mismatch case studies and OECD examples and figures[a]

A.1 Payments: hybrid mismatches 1, 2, 3, 4, 5 and 6

Identification

A.1.1 The mismatch in hybrid mismatch 1 would largely be addressed by quarantining foreign expenses. Country B might deny this loss on the debt instrument to be deducted against domestic source income if the return on the instrument has a foreign source. Country A might consider amending its law to include debt forgiveness.

Examples 1.14 and 1.20 of the OECD Final Report on BEPS Action 2 are examples of mismatches in the identification of a payment. In both examples, the Final Report recommends no adjustment (despite a D/NI outcome). In example 1.14 the payer is granted a deduction for a deemed payment of interest that the payee jurisdiction does not include in income. This mismatch would largely be addressed by comprehensive withholding tax in Country B on what it sees as a payment of interest. Example 1.20 is effectively the same as hybrid mismatch 1 of the present chapter.

Allocation

A.1.2 The mismatch in hybrid mismatch 2 would largely be addressed by comprehensive withholding in Country A. Further, presuming that

[a] All hybrid mismatch case studies are from the present chapter. The examples cited throughout the annex are those contained in OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report_9789264241138-en; the figures are contained in OECD, *Public Discussion Draft, BEPS Action 2: Branch Mismatch Structures* (Paris: OECD, 2016), available at https://www.oecd.org/tax/beps/Discussion-draft-Action-2-Branch-mismatch-structures.pdf).

X is a subsidiary of Y, CFC rules would prevent any avoidance of tax in Country B, whether imposed on Y or directly on the shareholders of Y. Alternately, if Y is a subsidiary of Z or X, Country B has little concern in this matter. CFC rules in Country A would then address deferral of residence-State tax.

A.1.3 The mismatch in hybrid mismatch 3 would largely be addressed by quarantining foreign expenses. There are three possibilities here. First, the payment is made through a PE situated in Country B. In this case, quarantining of foreign expenses in Country A would protect its tax base and the deduction in Country B seems appropriate. If Country B permits a loss of the PE to offset profits of, for instance, Y, then the deduction in Country A would be denied (irrespective of quarantining). Second, the payment is made through a PE situated in Country A. In this case, comprehensive withholding in Country A will largely address its tax base erosion, and B will get a foreign tax credit for this tax. Country B will be protected by quarantining the foreign interest expense of X and denying it if Z transfers a loss to a related party in Country A.

A.1.4 The third possibility in hybrid mismatch 3 is that there is no PE in Country A or Country B through which the payment is made. If the payment is made through a PE in a third country, then both Country A and Country B will quarantine and potentially deny a deduction for what both believe to be a foreign expense, which will resolve any mismatch. It is conceivable that the interest expense is not incurred through a PE anywhere, or Country A and Country B each consider the expense to be incurred through a PE situated in their jurisdiction. Comprehensive withholding in Country A will largely address its tax base erosion. The risk is in Country B if X is granted a deduction and the tax liability of Y is offset with a foreign tax credit granted in respect of Country A withholding tax.[b] Country B could deny a deduction to X in such a case, but perhaps this approach is overly prescriptive and dependent upon the treatment in Country A.

[b] Some countries may take the view that where they are Country B, they will not grant a foreign tax credit for foreign tax on a payment that they consider is made by a resident of Country B. This is a well-grounded position. However, there is at least some risk that as a matter of law the relief from the double taxation article in a tax treaty (Article 23) requires that a foreign tax credit be granted.

A.1.5 A more straightforward rule would be to presume, for the purposes of quarantining expenses but not withholding tax, that a payment made by a resident that is not attributable to a local PE is considered to be a foreign expense and so quarantined. The risk in this version of hybrid mismatch 3 is that both Country A and Country B quarantine the expense. Tax planners should be able to ensure that such a scenario does not arise. The chance that both Country A and Country B simultaneously presume that the expense is attributable to a PE in their own jurisdiction is quite remote and can be left for general anti-abuse rules. Either country may also take the position that relief for the expense has been granted to another person and deny the deduction on that basis. Again, the risk of the expense not being deducted anywhere is remote and can be discounted.

Quantification

A.1.6 The mismatch in hybrid mismatch 4 would have to be addressed by Country A changing its domestic law. Country A has let a gain escape its jurisdiction without taxation, perhaps by presuming that Country B will tax, which it will not. Perhaps Country A should treat Z as receiving full market value for the sale even if domestically it has a no gain/no loss rule for related-party transfers. Sales to non-residents would always be treated as made at market value, unless the purchased asset is included in the assets of a domestic PE.

Examples 1.15, 1.17 and 6.3 of the OECD Final Report on BEPS Action 2 are examples of mismatches in the quantification of a payment. In the case of examples 1.15 and 1.17, the Final Report recommends no adjustment (despite a D/NI outcome). Example 1.15 involves a deduction for an interest substitute where a lesser amount is included in the income of the payee. The resulting mismatch would largely be addressed by comprehensive withholding tax in Country B on the amount for which it granted a deduction in Country B.

Example 1.17 of the OECD Final Report on BEPS Action 2 involves a loss on a foreign currency loan. This is a common occurrence where taxpayers in developing countries borrow in a strong currency. It is a complex area that requires careful consideration and the present discussion makes only the briefest of comments. It is easy to suggest that there is a real loss and so there is no reason to address this mismatch. However, care must be taken because the question is a loss by comparison to what? If the money had been borrowed in local currency, then it is likely that a higher interest rate would have been charged. In this way the foreign currency loss is (from the perspective of many developing countries) an interest substitute. If all of the interest on a loan in domestic currency is taxed, then it would be appropriate to treat the foreign currency loss as interest and subject it to withholding tax in Country B. Otherwise, there will be a disincentive to borrow in local currency. If the loss is not subjected to withholding tax, then the foreign currency loss should be quarantined so that it can only be set against foreign currency gains. It might also be included in calculating interest limitation rules such as those for earnings stripping.

By contrast, OECD example 6.3 involves both a mismatch as to quantification of the grant of share options as well as the use of a hybrid entity. Presuming the employee is resident and working in Country B, the excessive deduction in Country A would be addressed by quarantining the deduction for the options so that it could not be set against the domestic source operating income.

Timing

A.1.7 The mismatch in hybrid mismatch 5 would largely (though not entirely) be resolved by aligning comprehensive withholding of tax from the payment with the granting of a deduction for it. Tax treaties may be interpreted as limiting the ability of a source State (Country A) to withhold tax at the time of accrual (when the deduction is claimed).[c] However, it might be possible to require the payer to make a prepayment of tax equal to the withholding at the time of accrual or deny a deduction for payments to non-residents until the payment is made, although the latter option might also be limited by tax treaties.[d] Country B should be aware that in a case like this, it might be encouraging its residents to invest offshore. Accordingly, it might consider accelerating the time of recognition of income under this style of deferral instrument. In any case, both Country A and Country

[c] For example, by suggesting that Article 11 (2) of the OECD Model Convention limits not only the amount of source-State tax but also the time of taxing.

[d] In particular, by Article 24 (4) of the OECD Model Convention.

B should consider domestic rules to regulate the taxation of deferral instruments and these rules should cater for the foreign elements.

Example 1.22 of the OECD Final Report on BEPS Action 2 is an example of a mismatch in timing of a deduction. Here, too, the Final Report recommends no adjustment, despite a D/NI outcome accruing over a 15-year period. This is excessive and should be addressed. The mismatch would largely be addressed by comprehensive withholding tax in Country B on the interest and denying a deduction for the interest until the withholding tax is imposed.

Character

A.1.8 The mismatch in hybrid mismatch 6 would largely be addressed by comprehensive withholding in Country A and denial of an exemption in Country B. If Country A does impose withholding tax on the outbound payment and is satisfied that granting a deduction is unlikely to produce a benefit for foreign investors over domestic investors, there seems little reason for Country A to care whether Country B taxes or not. Even if it looks through to the investor, it may find an entity that is exempt in Country B for whatever reason. Country A could make a value judgement on the appropriateness of the exemption or on whether Country B really intended it, but the administrative burden of doing so will often be disproportionate for a country in the position of Country A. Further, to deny a deduction depending on the tax status of the holder is likely to cause substantial distortions and complications in the administration of the tax law of Country A.

A.1.9 As a general rule, in the context of hybrid mismatch 6, Country B would deny dividend relief for deductible payments. This applies to all types of dividend relief, whether traditional underlying foreign tax relief given to a parent company or any domestic form of dividend relief extended to foreign dividends. The OECD focuses on an exemption for foreign dividends and, in the face of substantial source-State withholding tax, the benefits of an exemption will not be significant. Further, it is possible for some abuse to occur if an indirect foreign tax credit is granted for a deductible payment.[e] The same is true of other

[e] This is because the credit is likely to be calculated by reference to the corporation tax on the whole of the profits of the payer and not just on the

forms of dividend relief, for example, notional dividend tax credit or lower tax rate for dividends.

A.1.10 Country B may consider the payment in whole or in part as having some other character (other than a dividend) for which it grants relief. The most likely example is a return of capital on the investment and the consequence that Y may have to recognize income or gain at some future point, for example, when the asset is disposed of. Accordingly, this could be viewed as largely a timing issue similar to (though not the same as in) hybrid mismatch 5. The comments for Country B with respect to hybrid mismatch 5 equally apply with respect to this version of hybrid mismatch 6.

The OECD Final Report on BEPS Action 2 contains numerous examples of mismatch arising from disagreement as to the character of a payment that is not caused by some other mismatch (for instance, as to character or ownership of an asset). In example 1.18, it appears that one country considers the payment as deductible interest (although no character is given) and the other as a return of capital on the loan. In example 1.19, one country treats the payment as deductible (no character is given) and the other as for the sale of a loan. In example 1.30 the seller country treats the adjustment to the purchase price (presumed a separate payment) as additional sales proceeds and the buyer country treats it as a deductible expenditure (no character given). In example 1.37 the manufactured dividend is treated as interest by one country and a dividend by the other. The Final Report suggests no counteraction in this case, despite a clear D/NI outcome.

Five of the OECD examples involve apportionment on bifurcation. In example 1.16 the payment for the convertible note is bifurcated so that it has two characters (part for the debt and part for the option) but the two countries divide the payment in different proportions. In examples 1.27, 1.28 and 1.29, the seller country treats the deferred payment of the purchase price as just a purchase price and the buyer country treats it as part purchase price and part deductible interest. In example 1.36 the seller country treats the whole payment as purchase price and

funds used to pay the dividend (which the deduction causes to suffer no corporation tax). See also OECD Final Report on BEPS Action 2, supra note a, example 1.4.

the buyer country treats part of it as a deductible premium. In all of these examples, the mismatch would largely be addressed by comprehensive withholding tax on the interest (or interest substitute) in the payer country.

A.2 Earning activities and resources: hybrid mismatches 7, 8, 9 and 10

Earning activities

A.2.1 The importance of hybrid mismatches 7 and 8 is that they demonstrate disagreement between countries in determining whether there is a taxable presence (PE). This makes the case studies similar to those involving hybrid entities, for example, as in hybrid mismatch 11, which also turns on whether there is a taxable presence or not.

A.2.2 The mismatch in hybrid mismatch 7 would have to be addressed by Country B changing its domestic law. For example, Country B may limit its foreign PE exemption to situations in which the foreign State (Country A) recognizes a taxable presence. Country B might also limit the exemption to the amount of the income of the PE subject to full tax in Country A. Similar observations are made in the OECD Public Discussion Draft on Branch Mismatches.[f] Such requirements are unlikely to breach tax treaties. Subject to tax treaties, Country B might also use the foreign tax credit method or a subject-to-tax clause.

A.2.3 The mismatch in hybrid mismatch 8 would have to be addressed in domestic law, but tax treaties may override this. Country A might ensure that, as a matter of domestic tax law, the profits of Y from the sale of goods through a local commissionaire are treated as sourced and taxable in Country A. Tax treaty issues involving commissionaire structures are complicated and are covered in the OECD Action Plan on BEPS Action 7: Prevent the Artificial Avoidance of Permanent Establishment Status. Source countries might seek to ensure that their tax treaties are sufficiently broad so as not to deny a taxing right in this kind of case. The position of Country B is similar to that discussed with respect to hybrid mismatch 7.

[f] Supra note a, paragraph 14.

Figure 1 in the OECD Public Discussion Draft on Branch Mismatches is similar to hybrid mismatch 8 and should be resolved in a similar fashion. An additional complication in figure 1 is that it involves a third country (Country C). The mismatch in this figure would largely be addressed by comprehensive withholding tax on the interest in Country C.

Ownership of an asset

A.2.4 The mismatch caused by double-dip depreciation through a finance lease in hybrid mismatch 9 would largely be addressed by quarantining foreign expenses. As discussed above with respect to hybrid mismatch 3, a quarantining rule may be constructed in such a fashion that it would be difficult for both Country A and Country B to consider that the depreciation expense has a domestic source. Here the focus of the mismatch is on deduction of depreciation in both jurisdictions and not on the character of the payments under the finance lease. However, sale and repurchase agreements can be structured in such a way that the primary benefit from disagreement as to ownership of an asset results in a mismatch of the character of payments made with respect to the asset.

A.2.5 The OECD Final Report on BEPS Action 2 contains six examples of disagreement regarding the character of payments caused by disagreement as to who owns an asset. Example 1.25 relates to a finance lease, although no counteraction is recommended. In this example the ownership mismatch is the opposite to that in hybrid mismatch 9 of the present chapter in that neither country considers a resident the owner of the asset. The rent is fully deductible in the payer country but the payee country treats it as interest and a partial return of capital. The resulting D/NI outcome would largely be addressed by comprehensive withholding tax on the rent in the payer country. Tax treaties cause substantial limitations on a country's ability to impose such withholding tax, as discussed in chapter XI on rents and royalties.

A.2.6 The other five examples in the OECD Final Report on BEPS Action 2 involve sale and repurchase or financial instrument lending agreements. Here again, one country views a transaction with respect to the asset as a sale and the other views it as a financing transaction (loan). In example 1.31 the country of the acquirer (Country B) views the transaction as a sale whereas the country of the seller (Country A) sees no transfer of ownership (views it as a financing transaction). The mismatch in this example would largely be addressed by Country A imposing comprehensive withholding tax on the deductible financing expenses (and denying a deduction until the withholding tax is imposed). Further, Country A might deny underlying foreign tax relief to A Co for foreign tax that is granted relief in Country B. In this sense, the example is similar to that in hybrid mismatch 10 of the present chapter, discussed below (a discussion that is relevant here).

In OECD examples 1.32, 1.33 and 2.2 also, the country of the acquirer (Country B) views the transaction as a sale whereas the country of the seller (Country A) sees no transfer of ownership (viewing it as a financing transaction). In these cases, however, the deductible payment (manufactured dividend or interest) is paid from Country B. The mismatch would largely be addressed by Country B imposing comprehensive withholding tax on the deductible payment (and denying a deduction until the withholding tax is imposed). Further, as in example 1.31, in example 1.32, Country A might deny underlying foreign tax relief to A Co for foreign tax that is granted relief in Country B. This is not the case in example 1.33 because in that example Country B grants no such relief. Example 2.2 is similar, although in this example Country B should investigate the manner in which it calculates the limitation on credit under its foreign tax credit system.[g] Country A should not give a foreign tax credit for tax credited in another country (Country B).

The disagreement regarding ownership in OECD example 1.34 is the same as in examples 1.32 and 1.33. Here, however, the host State (Country B) treats the manufactured dividend as a cost in calculating the "gain or loss on the share trade" (paragraph 3 of example 1.34). The result is a deductible loss for a share trader. If the manufactured dividend is not part of the cost of acquisition of the shares by the share

[g] Regarding the factors Country B might take into account, see Peter A. Harris, "Taxation of Residents on Foreign Source Income," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries,* (New York: United Nations, 2013), available at http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf, chapter III, 126-148.

trader, then it is likely to be an interest substitute which might be subjected to withholding tax in the manner described for examples 1.32 and 1.33. If it is treated by Country B as part of the cost of the shares, then the loss on trade raises a different issue for Country B that is essentially beyond the scope of this chapter. Developing countries should be very careful about recognizing losses on financial instruments as deductible on an unlimited basis precisely because of the potential tax base erosion demonstrated in this example.[h] The same erosion is demonstrated in example 1.26 although here there is no hybrid mismatch, only an issue with Country B granting a deduction for any loss. A sensible rule that developing countries might consider is to quarantine losses on the disposal of financial instruments so that they can only be set against gains from financial instruments.

As noted in section 1.1 of the chapter, countries may also disagree about the allocations of assets and liabilities to particular activities of a person. The OECD Public Discussion Draft on Branch Mismatches contains a number of examples of this type. Figure 2 is presumed to involve an inconsistent allocation of an asset (debt on which interest is paid) between the head office and the branch. An additional complication in figure 2 is that it involves a third country (Country C). The mismatch in this figure would largely be addressed by comprehensive withholding tax on the interest in Country C. As with hybrid mismatch 2, applying CFC style rules to the branch in Country B would prevent any avoidance of tax in Country A. This example raises issues regarding the scope and structure of exemptions for foreign PE profits, which were discussed in A.2 above under earning activities.

Example 6.2 of the OECD Final Report and figures 4 and 5 of the Public Discussion Draft contain similar examples of mismatch of allocation of, in this case, a liability between the head office and the branch. In example 6.2, the debt owed to the third party on which interest is paid seems to be allocated twice in full (to both the Country A head office and the Country B PE). In figures 4 and 5, Country B allocates more of the third party interest expense to activities located in Country B

[h] In the context of losses on the disposal of shares, these risks are described in Peter Harris, *Corporate Tax Law: Structure, Policy and Practice* (Cambridge: Cambridge University Press, 2013), at 423-424

than does Country A, which suggests a mismatch in allocation of the underlying debt. The mismatch in these examples would largely be addressed by comprehensive withholding tax on the interest in both Country A and Country B. Further, as regards foreign tax relief in Country A, the same comments apply as with respect to figure 2 (see preceding paragraph). Quarantining of foreign expenses may also be relevant, if this is the cause of a deduction against domestic source income in either country.

Figures 3 and 6 of the OECD Public Discussion Draft (which incorporate the same example) also involve a mismatch of allocation of an asset (intangibles) to earning activities. The country of the head office views the intangibles as being attributable to the branch and the country of the branch views them as being attributable to the head office. Here the tax advantage results from a notional payment of royalties from the branch to the head office. This is viewed as a mismatch in the identification of a payer, and is further discussed in A.3 below. This, too, is the case with figure 4 (discussed in the previous paragraph), which also involves a notional payment by a branch.

Character of asset

A.2.10 The mismatch in hybrid mismatch 10 would largely be addressed by denying a foreign tax credit for foreign tax that has been relieved. There are no considerations for Country A in this case. As noted in section 4.4 above, the broad issue here is that a residence country like Country B arguably should not grant relief for, in this case, foreign tax that has already been relieved to another person. A detailed consideration of this case study is beyond the scope of the present chapter, but the case demonstrates that care must be taken in designing an indirect foreign tax credit system.[i] Similar issues could arise for Country B if Country A exempts the amount received by X instead of granting dividend tax credits.

A.2.11 The OECD Final Report on BEPS Action 2 contains eight examples of disagreement regarding the character of payments caused by disagreement as to the character of assets, and another 13 that are

[i] Broadly, the issue is one of allocating foreign tax to the profits considered distributed; see ibid., at 378-379.

presumed to involve this kind of mismatch. The most common of these is (as in hybrid mismatch 10 of the present chapter) where one country considers an asset as debt and the other country considers it as equity. However, in the OECD examples, this is simply the case of the source country considering a financial instrument as debt and the residence State considering it as equity (see examples 1.1-1.4, 1.12, 2.1, 2.3 and 3.1). Examples 1.23, 1.24, 8.1 to 8.10 and 8.16 are presumed to involve debt/equity mismatches. The consequences in these OECD examples are similar to those in hybrid mismatch 6 of the present chapter, and the mismatch would largely be addressed as discussed above with respect to that case study, for instance, though withholding tax and by denying dividend relief for deductible payments.

OECD examples 1.23 and 3.1 are of additional note because they involve the simultaneous use of a hybrid financial instrument and a hybrid entity. In example 3.1, from the perspective of Country B, this is a D/NI outcome due to receipt of interest by a hybrid entity. From the perspective of Country A, this is a D/NI outcome resulting from a payment under a hybrid financial instrument. The manner of addressing these mismatches is as described for the other debt/equity mismatches. In example 1.23, however, Country B is not affected by the mismatches but the base erosion in Country A is attributable to both. Country A could address the erosion by imposing comprehensive withholding tax on the deductible payment or, if it considers that the payment has a foreign source, quarantining the deduction so that it may only be set against foreign source income (such as that from the PE in Country B).

A.3 Persons and personal characteristics: hybrid mismatches 11, 12 and 13

Identification of payer

A.3.1 The mismatch in hybrid mismatch 11 (identifying person) would largely be addressed by comprehensive withholding in Country A. As it sees Z as an entity, it is not clear that Country A has any greater interest in this arrangement. There are likely to be many other scenarios in which a Country A resident is allowed a deduction for a payment to a non-resident that is not subject to substantial taxation, for example, where the recipient is exempt, in a loss position or resident in a tax haven. It is not clear that this scenario warrants any special treatment. As for Country B, this situation is similar to hybrid mismatches 7 and 8 in that it may be granting an unnecessary PE exemption and should perhaps limit its exemption to the amount of income of Z subject to tax in Country A. Further, hybrid mismatch 11 is unlikely to give rise to tax benefits if Country B adopts a foreign tax credit system. The other comments discussed with respect to Country B for hybrid mismatches 7 and 8 apply equally to hybrid mismatch 11.

A.3.2 The OECD Final Report on BEPS Action 2 contains 14 examples of disagreement regarding whether a payment has been made and, if so, who made the payment. Example 3.1 is essentially the same as that in hybrid mismatch 11 of the present chapter except (as noted above), it simultaneously involves a hybrid financial instrument. The mismatch in OECD example 3.1 would largely be addressed in the same manner as described for hybrid mismatch 11 of the present chapter. OECD example 3.2 is similar, except that the hybridity of the entities is a function of the group relief systems in the two countries. Nevertheless, the mismatch would largely be addressed in the same manner as described for hybrid mismatch 11. OECD examples 6.5, 8.11 and 8.12 are complex, but essentially involve a mix of examples 3.1 and 3.2 and would be addressed in the same fashion.

In OECD example 1.23, a payment is clearly made, but the hybrid entity leads to a mismatch as to who made the payment. As noted above, this example also involves a hybrid financial instrument and the mismatch would largely be addressed in the manner described above at A.2.

OECD examples 6.3, 6.4, 8.14 and 8.15 all involve hybrid entity payers. There are no issues for the host State (Country B). Country A could address the erosion (in any of these cases) by imposing comprehensive withholding tax on the deductible payment or, if it considers that the payment has a foreign source, quarantining the deduction so that it may only be set against foreign source income. Example 6.3 also involves a mismatch in the quantification of a payment (the share option), which was discussed in A.1 above.

As discussed in section 2.3 above, a mismatch with a PE may arise under the OECD Model Convention, which under the Authorised OECD Approach under Article 7 (2) requires treating the PE in the host State as a separate entity for purposes of calculating its income.[j] This can give rise to a deduction for notional payments in the State of the PE. While a similar approach is suggested for the residence State in calculating foreign tax relief, the domestic law of many countries will not authorize this, that is to say, domestic tax law will ignore dealings between a PE and its owner and so ignore notional payments. This may give rise to a mismatch of the same style as in OECD examples 6.3, 6.4, 8.14 and 8.15, and the comments made in the preceding paragraph are relevant here. One difference is that tax treaties may see the payment for purposes of calculating the income of the PE but not for purposes of imposing withholding tax on such a payment. Tax treaties may therefore prohibit withholding tax on the deemed payment.[k]

These issues are well illustrated in figures 3 and 6 of the OECD Public Discussion Draft on Branch Mismatches (which incorporate the same example), involving a deemed payment by a branch under the Authorised OECD Approach. The OECD identifies a mismatch in allocation of intangibles as the cause of the outcome; this example was therefore also discussed in A.2 above under ownership of an asset. The mismatch would largely be addressed by comprehensive withholding tax on the deemed payment of interest in Country B. In addition, Country A could apply CFC style rules to the branch in Country B. This example raises issues regarding the scope and structure of exemptions for foreign PE profits, which were discussed in A.2 above under earning activities. An additional complication in figures 3 and 6 is that they involve a third country (Country C). Country C may also protect itself by applying comprehensive withholding tax to the service fee.

Figure 4 of the OECD Public Discussion Draft on Branch Mismatches contains a similar example involving a notional payment from a PE. The OECD identifies a mismatch in allocation of interest (presumed a mismatch in allocation of the underlying debt) as the cause of the outcome; this example was therefore also discussed in A.2 above under earning activities. It is viewed as being similar to figure 5, also discussed above under earning activities. The mismatch in both cases

[j] Paragraph 15 of the Commentary on Article 7 of the OECD Model Convention.

[k] Paragraphs 28 and 29 of the Commentary on Article 7 of the OECD Model Convention.

would largely be addressed as outlined in A.2 above (and as discussed in the preceding paragraph with respect to figures 3 and 6).

OECD examples 4.4, 6.1 and 8.13 involve the use of two hybrid entities. To the extent example 4.4 involves a payment by a hybrid entity (D Co 1), the mismatch would largely be addressed in the manner described for hybrid mismatch 11 of the present chapter and for OECD example 1.23. To the extent examples 6.1 and 8.13 involve a payment by a hybrid entity (B Co 1 in both cases), there is no issue for Country B, and Country A could address the erosion in the manner described in the preceding paragraph for OECD examples 6.2 to 6.4. To the extent these examples involve receipt of a payment by a hybrid entity (C Co in example 4.4 and B Co 2 in examples 6.1 and 8.13), the mismatch would be addressed as described below.

Identification of recipient

A.3.6 The OECD Final Report on BEPS Action 2 also contains six examples of the use of hybrid entities resulting in disagreement as to who receives a payment (what the OECD refers to as a reverse hybrid). Example 4.1 involves the source country considering that a payment is received by a corporation in the home country, and the home country considering that it is received by a corporation (the hybrid) in the source country. As the consequences are similar to those in hybrid mismatch 2 of the present chapter, the mismatch would largely be addressed as discussed above in A.1 with respect to that example, for instance, by comprehensive withholding in the country of the payer and CFC rules in the country of the ultimate investor. OECD example 4.2 is essentially the same, except the home country is split as between two individual investors (and the source country has changed from Country B to Country A). Example 4.3 is also the same, although four countries are involved (Country C is the source country and Countries A and B the home countries).

As noted above, OECD examples 4.4, 6.1 and 8.13 involve the use of two hybrid entities. To the extent example 4.4 involves receipt of a payment by a hybrid entity (C Co), the mismatch would be addressed in the same manner as described with respect to hybrid mismatch 2 of the present chapter. In OECD examples 6.1 and 8.13, no action is required on the part of Country B as the D/NI outcome is purely internal.

Country A should address the issue as described above with respect to the hybrid payer part of the examples, but might also consider applying CFC rules to the hybrid entity recipient (B Co 2).

Residence

A.3.12 The mismatch in hybrid mismatch 12 is not clearly a direct issue for either Country A or Country B. The benefit of the goods has passed into the jurisdiction of Country A and presuming a market value price is paid, there are no immediate tax consequences in Country A for Z. Z may deduct the cost of the goods either as trading stock (inventory), a depreciable asset or other capital asset and is unlikely to have any right to withhold tax from the purchase price. If the goods are sold by Y through a PE situated in either Country A or Country B, then the country where the PE is located will tax accordingly. If Y does not sell through such a PE, then Country A and Country B have no taxing rights with respect to the sale. The unease with this type of example is that Y may avoid paying tax anywhere in the world and as a result have a market advantage in terms of price over other market competitors.

A.3.13 Country A and/or Country B could expand their test of corporate residence (to include both management and formation) or expand their test of PE, but neither would be a complete answer to the problems of so-called toll manufacturing or toll processing. Any such attempt will simply cause Y to be formed and managed in a more tax-friendly environment. If Y is a company controlled by a resident of Country A or Country B, then the country of the controller may apply CFC rules to ensure that there is no bias against making a sale through a PE in the jurisdiction of the controller. That is also not a satisfactory answer because corporate groups that suffer CFC rules are at a competitive disadvantage to groups that do not, whatever the market, including the market in the jurisdiction of the controller. There have been a number of headline examples involving base erosion and profit shifting which demonstrate that CFC rules should be careful when incorporating an exemption for foreign active business.[1]

[1] For example, see Anthony Ting, "iTax—Apple's International Tax Structure and the Double Non-Taxation Issue," (2014), No. 2 *British Tax Review*, 40-71.

A.3.14 The mismatch in hybrid mismatch 13 would largely be addressed by quarantining foreign expenses and denying duplication of losses. This case study is similar to the double-dip deduction in hybrid mismatch 3, and the discussion with respect to that case study is relevant here. The losses of Z are likely to have a foreign source for either Country A or Country B (or both) and thus would not be available to offset domestic source income. If, for example, the losses have a source in Country A and are surrendered to a related company there, then Country B would deny a deduction for the losses. Similarly, Country A would deny the losses if they are surrendered under group relief in Country B. The possibility that the loss would be denied in both countries is something that tax planners can usually address and does not seem to warrant specific consideration.

Example 7.1 in the OECD Final Report on BEPS Action 2 is effectively the same as hybrid mismatch 13 of the present chapter but with the addition of income received by a hybrid entity. The hybrid entity adds little to the analysis (other than a source of income to set against one of the losses). So in addition to addressing the dual residence in the manner described in the last paragraph, Country A (the home country) might consider applying CFC rules.

A.4 Unclassified OECD examples

As noted in annex I, there are a number of examples in the OECD Final Report on BEPS Action 2 that cannot be classified according to the above conceptual framework. The first group of these are examples 1.5 to 1.9, where the residence country would not tax in any case, whether a hybrid was involved or not. The OECD believes that this fact alone is sufficient to justify the source country's not counteracting the obvious D/NI outcomes. That is a policy matter for source countries. The other steps that may be taken, which were discussed in section 4 and in this annex, are in no way dependent upon taxation in the residence State.

There are a number of examples in the OECD Final Report on BEPS Action 2 that contain a mismatch in tax treatment but no hybrid element. In other words, in examples 1.10, 1.11 and 1.35, the countries agree with regard to all of the income tax fundamentals discussed in section 1. The countries have merely decided, as a matter of policy, to provide inconsistent tax treatments to the payments in question. This seems of little consequence for a source country, but a residence country may wish to consider whether its foreign tax relief regime is sufficiently robust.

Example 1.26 of the OECD Final Report on BEPS Action 2 also contains no hybrid element, but it also contains no inconsistent tax treatment between the two countries. If there is an inconsistency at all, it is between the tax treatment of persons holding shares as capital assets and those holding shares as trading assets. Inconsistencies of this type have been exploited in domestic laws for many years. As noted in the discussion in A.2 above with respect to this example, care should be taken in allowing a deduction for losses incurred on the disposal of shares and other financial instruments.

Examples 1.13 and 1.21 of the OECD Final Report on BEPS Action 2 contain no cross-border element; therefore while they do involve hybrids, they do not involve an inconsistent tax treatment as between two countries. Again, the inconsistent treatment is internal to Country A. These examples demonstrate that the OECD recommendations are so far reaching that they could apply to a purely domestic scenario. These examples also demonstrate the risk of overreliance on financial reporting standards in determining income tax fundamentals.

Chapter VI

Preventing tax treaty abuse

Graeme S. Cooper*

1. Introduction

Many developing countries have already negotiated a number of tax treaties with their neighbours and with capital exporting countries. Others are keen to expand their existing tax treaty network. An extensive treaty network is typically considered to be an important signal by a developing country that it is keen to attract foreign direct investment (FDI) and will tax foreign investors according to internationally accepted taxation norms. Bilateral income tax treaties are a manifestation of a country's desire for economic development and greater integration in the global economy.

While income tax treaties are thus important indicators to the international community, the experience of many developing countries is that treaties can be misused as part of sophisticated tax planning to frustrate tax laws. Tax treaty abuse is a matter which has caught the attention of the revenue authorities of some developing countries already. For example, in response to the questionnaire circulated in 2014 by the United Nations Committee of Experts on International Cooperation in Tax Matters — Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries, Mexico noted that "our priorities are Action 6 and the Actions related to Transfer Pricing (Actions 8, 9 and 13)." [1] Similarly, part 1 of the report of the Organisation for Economic Co-operation and Development (OECD) on the impact of the project to deal with base erosion and

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[1] Government of Mexico, "Mexico's experiences regarding base erosion and profit shifting issues," available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsMexico.pdf. The responses from Chile, India, Thailand and Zambia also emphasized the importance of treaty abuse: see http://www.un.org/esa/ffd/tax-committee/tc-beps.html.

profit shifting (BEPS) in low income countries[2] lists treaty abuse as one of the high priority action items for developing countries, noting particularly the concerns of Zambia and Mongolia. The present chapter is about how developing countries can protect their domestic tax base against erosion arising from the abuse of the tax treaties they have negotiated or are pursuing.

1.1 OECD Action Plan on BEPS

The OECD work on BEPS which began in 2013 included Action 6 on the ways in which taxpayers can abuse a country's network of tax treaties. Action 6 of the Action Plan on BEPS required the OECD to:

> Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be coordinated with the work on hybrids.[3]

By the time the OECD/G20 Final Report on this Action was released, in October 2015,[4] the project covered issues surrounding five distinct themes:

- Recommendations for changes to the text of the Organisation for Economic Co-operation and Development Model Tax

[2] Organisation for Economic Co-operation and Development (OECD), *Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* (Paris: OECD, 2014), available at http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf.

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

[4] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en.

Convention on Income and on Capital[5] (OECD Model Convention) and changes to domestic tax rules to make treaties more resilient against abuse;

- New text expressly providing that tax treaties are not intended to generate double non-taxation. This theme was also connected to the work on hybrids under Action 2;[6]
- New text for the Commentary to the OECD Model on the considerations which should influence a country in deciding whether to enter into a tax treaty with another country;
- Examination of instances where a treaty is used as the pretext for an argument that renders a domestic anti-abuse rule ineffective; and
- A number of specific instances where the drafting of the OECD Model Convention should be tightened or clarified to control identified abusive practices.

The OECD/G20 agenda for countering tax treaty abuse is thus rather more expansive than typical discussions of "treaty shopping." The first theme focuses on "abuse" consisting of non-residents inappropriately gaining access to a treaty in order to enjoy treaty benefits. It is abuse "of" a treaty. But in the fourth theme, the abuse consists of structures or transactions, especially those undertaken by residents, which are designed to employ a treaty to defeat a domestic anti-abuse outcome. It is abuse "by" a treaty. The potential for treaties to thwart anti-abuse rules, the exploitation of treaties to generate double non-taxation and the policy drivers for selecting appropriate treaty partners, which have all been incorporated into this Action, are examined far less often.

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

[6] A separate discussion paper was issued by the OECD in March 2014 dealing with amendments to the OECD Model Convention and Commentary to address the problem of hybrid entities and instruments. See OECD, *Public Discussion Draft, BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)* (Paris: OECD, 2014), available at http://www.oecd.org/ctp/treaties/hybrid-mismatch-arrangements-discussion-draft-treaty-issues-march-2014.pdf.

The OECD project also included Action 2 on the problem of hybrid entities — that is, entities which are treated differently in different countries. The work on that item included an examination of how to handle:

- Entities that are transparent for tax purposes; and
- Entities that are resident in two countries.

As will be seen below, this work on Action 2 is relevant here because transparent and dual resident entities can be used in sophisticated tax planning to abuse a country's treaty network.

The OECD/G20 work will lead to changes to the text of the OECD Model Convention and Commentary and includes recommendations for changes to domestic tax laws.

1.2 United Nations work on BEPS

The United Nations Committee of Experts on International Cooperation in Tax Matters has undertaken its own work on BEPS because of the importance of the matter to developing countries, forming a Subcommittee on Base Erosion and Profit Shifting in October 2013.

One of the principal effects of a tax treaty is to limit the ability of source countries to retain tax claimed under domestic law. This can come about explicitly through the allocation rules in a treaty (for example, the requirement of a permanent establishment (PE) before the source country can tax business profits), through the rate limitation provisions (for dividends, interest and royalties), and less obviously, through income classification rules.[7] As developing countries

[7] Limits on the taxing rights claimed by source countries can come about through the income classification rules that treaties employ. For example, income which a source country might classify and tax under domestic law as a royalty (and thus amenable to tax at source under Article 12 of the United Nations Model Convention) might, where the treaty supplants domestic law definitions, be classified for the purposes of a treaty as business profits (and thus taxable at source only if a permanent establishment (PE) exists). One obvious example of this kind of outcome arose from the reclassification in the OECD Model Convention of income from the leasing of cargo containers in the mid-1990s.

are predominantly source countries, and less prominent as capital exporting countries, limits on the ability of source countries to insist on domestic law tax claims are particularly important for them. When developing countries negotiate a treaty, therefore, they are making a decision to surrender tax claimed under domestic law in exchange for the benefits that the treaty promises. Because this work on BEPS is directed at curtailing the circumstances where treaties can be invoked—and source-country tax claims reduced—it should be especially valuable for developing countries.

The Subcommittee on BEPS is currently working on the text of changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention).[8]

The work of the United Nations and the OECD is likely to lead to changes to their two Model Conventions and this will influence the text of future tax treaties. The last section of the present chapter will discuss briefly the work of the OECD aimed at changing existing treaties, including through the proposed Multilateral Instrument.

2. The problem of inappropriate access to treaty benefits

Where a State has concluded that a tax treaty with another State is valuable to it, arrangements by which taxpayers from a third country can gain access to a State's treaty network may pose a serious threat to the tax system of that State. Tax treaties are individually negotiated bargains between sovereign States, and one significant effect for a source country from concluding a treaty is that its ability to retain tax claimed by domestic law will be constrained. Presumably source countries have entered into a treaty in the expectation that this reduction in tax will be enjoyed only by the residents of the other contracting State. Where residents of third States are able to enjoy those benefits,

[8] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011). An account of related work by the Subcommittee can be found in the reports prepared for meetings of the Committee of Experts on International Cooperation in Tax Matters, available at http://www.un.org/esa/ffd/ffd-follow-up/tax-committee.html.

governments cannot be sure that they have appropriately quantified the amount of revenue loss that the treaty will produce. Similarly, source countries may find that other benefits they hoped to secure from the treaty — access to information held offshore, a formal system for resolving tax disputes, the promise of non-discrimination, assistance in collecting taxes, and so on — cannot be fully provided by the tax administration of the treaty partner because the taxpayer lacks any real presence in the other contracting State.

A State might, nevertheless, be tempted by the argument that any new investment is to be welcomed, even if it comes as a result of third State investors shopping into the country's treaty network. After all, the point of the treaty was to encourage greater inward investment and this has been achieved, albeit from an investor resident in a third State. This position may be tempting, but it is short-sighted.[9]

Just how serious the threat of improper access to a country's tax treaties is depends to some extent on who is gaining access to the treaty. It can be helpful to draw a distinction between two different forms of inappropriate access to a treaty:

- Shopping into a tax treaty—a taxpayer resident in State C (a State which does not have a treaty with the source country, State A) puts in place a mechanism to get access to the treaty between State A and State B; and
- Shopping between tax treaties—a taxpayer resident in State C (a State which has a treaty with the source country, State A) puts in place a mechanism to get access to the treaty between State A and State B, instead of being subject to the terms of the treaty between State A and State C.

The second situation may be less problematic for State A.

[9] The considerations for capital exporting countries are slightly different. Their concern will likely be that third countries will see less need to negotiate a treaty if their residents can freeride on the treaty of another country. The residents of the capital exporting country will not enjoy reduced source-country taxation in those third countries. This will mean that the capital exporting country will reduce its revenue claims without the offsetting increase in revenue expected to arise from a corresponding reduction in the source country.

The principal factors which encourage shopping into tax treaties and shopping between tax treaties are:

- The extent of the divergence of the tax treaty from the claims made under domestic tax law; and
- The extent of the divergences between treaties negotiated with different States.

Where the tax claims made by domestic law are not significantly reduced by the terms of a treaty and the terms of the individual treaties in a State's treaty network are not significantly different, the attractiveness of treaty shopping is much reduced. Thus there is a place for States to consider the design of their domestic law as a means of controlling treaty abuse.

This point is worth emphasizing as developing countries have traditionally expressed the view that the architecture of the international tax framework should provide greater scope for the taxation of income at source. While greater source taxation may seem appealing, given international competition for investment, it is likely to be sustainable only in cases where the source country has some specific advantage which is peculiar to the country, such as a particular resource. In the absence of some particular advantage, source countries may discover that insisting on high source-country taxation produces reduced levels of foreign investment. Consequently, it may well be that in many cases — for example, withholding taxes on interest paid to unrelated lenders — low source-country taxation is necessary in order to attract capital and has the added advantage of reducing the scope for treaty abuse.

The most difficult part of any discussion of "inappropriate" access to treaties lies in defining what is, and is not, appropriate. The Commentary to Article 1 of the United Nations Model Convention states that:

> . . . two elements must therefore be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of a tax treaty:
>
> — a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position, and

— obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions.[10]

The Commentary to Article 1 of the United Nations Model Convention contains a long description of various forms of abuse of treaties and some mechanisms that countries may employ to counter these practices.[11] However, it is not always easy to identify when non-residents claiming to be entitled to the benefits of a treaty should be denied those benefits:

- Most of the definitions of treaty shopping or treaty abuse (like the one quoted above from the Commentary to Article 1) involve some notion of purpose or intention—that is to say, the result of deliberate planning and conscious decision-making, rather than a more objective set of facts and circumstances. Tests which rely upon notions of "purpose" or "intention" are notoriously difficult for tax administrations to administer and for taxpayers to comply with.
- It is not surprising, therefore, that other more mechanical tests are sometimes proposed to identify misuse of treaties. These tests, however, can create their own problems if they are triggered in inappropriate circumstances.
- It can, therefore, be important to have a further fallback, allowing the competent authorities to deliver access to treaties or deny access that might otherwise be given.

As will be seen below, the approach being advocated by the OECD and the United Nations combine all three elements: a test based on the taxpayer's purpose, a test that is more mechanical and describes a state of affairs, and a safety valve in the form of negotiations between the competent authorities.

[10] Paragraph 25 of the Commentary on Article l of the United Nations Model Convention.

[11] See paragraphs 8–103 of the Commentary on Article l of the United Nations Model Convention. See also Philip Baker, "Improper use of tax treaties, tax avoidance and tax evasion," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties* (New York: United Nations, 2013), available at http://www.un.org/esa/ffd/wp-content/uploads/2014/08/UN_Handbook_DTT_Admin.pdf.

2.1 Examples of some structures for accessing treaties

There are many mechanisms by which treaty benefits might be inappropriately enjoyed. The simplest arrangements involve the creation in the treaty partner (State B in the example below) of a contractual or legal arrangement that is transparent for tax purposes under the law of State B. For example, income may be paid to an entity in the treaty partner which receives the income:

- As an agent for a principal resident in a third State (State C);
- As a nominee or custodian for a taxpayer resident in a third State;
- As trustee of a bare trust for a beneficiary resident in a third State;
- As trustee of an active trust for beneficiaries primarily resident in a third State;
- As a partnership of entities most of whom are resident in a third State.

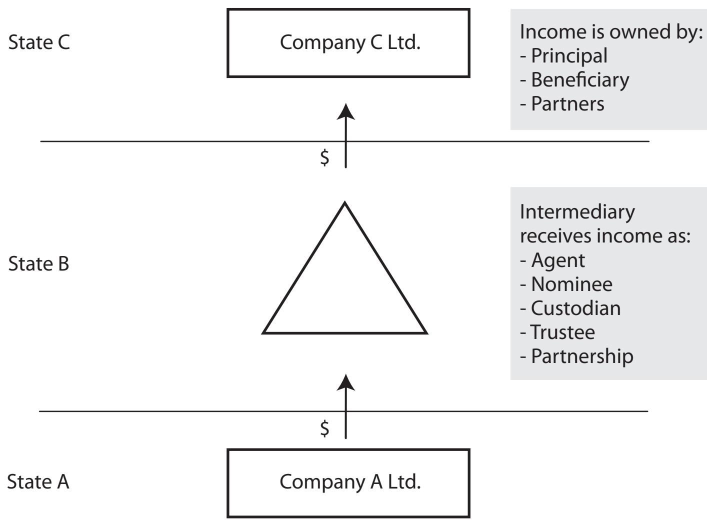
If, under the law of State B, these arrangements are fiscally transparent—that is to say, no tax is levied in State B on the income in the hands of the agent, nominee, custodian, trustee or partnership—the treaty between State A and State B should not be invoked to limit tax claims by State A.

Accepted interpretations of several provisions already found in tax treaties could deny treaty benefits to the intermediary in State B. For instance, in example 1 where the relevant arrangement is simply contractual (the resident of State C has arranged for its income to be collected by an agent or custodian), the relevant "person" for treaty purposes is the person with whom the resident is dealing, and that is the resident of State C not its agent.[12] Second, the intermediary may not satisfy the requirements of being a "resident" of State B for the purposes of the treaty—if the tax liability falls on the principal, beneficiary or partners and not on the intermediary, the intermediary is not a "person who, under the laws of that State, is liable to tax therein." Similarly, if the income involved is a dividend, interest or royalty, the intermediary should not be regarded as the "beneficial owner" of the income.

[12] See Joanna Wheeler, "Persons qualifying for treaty benefits," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*, supra note 11.

However, there will often be less obvious arrangements by which taxpayers can gain access to a treaty network. For instance, in example 2, an entity is established in the treaty partner which is a taxpayer in that State in its own right and a resident, but in effect it is an empty shell because it pays its entire income as a deductible outgoing to a taxpayer resident in a third country (that is, base erosion). While these payments might sometimes trigger withholding tax on the way out of State B, they may not bear tax at the full corporate rate levied in State B. Indeed, the withholding taxes levied by State B may themselves be reduced if a treaty exists between State B and State C.

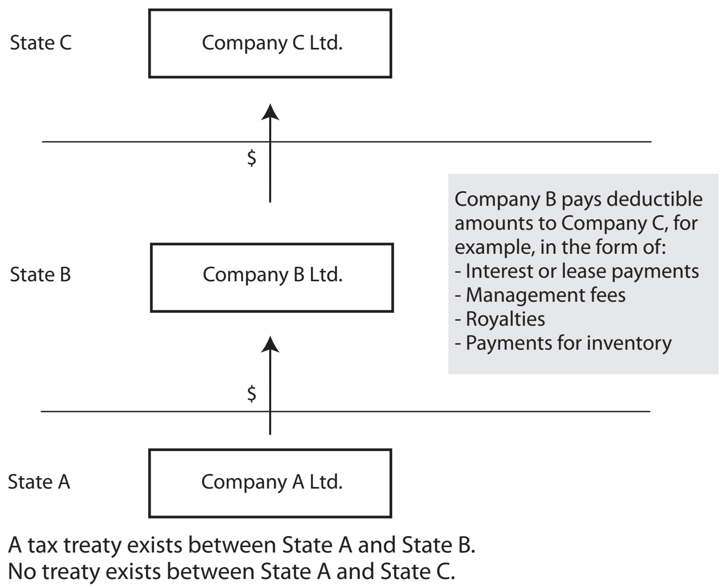
Example 1



A tax treaty exists between State A and State B.
No treaty exists between State A and State C.

In this situation it is less obvious that the transaction will be easily amenable to challenge without provisions in the treaty or perhaps domestic law—provisions which the laws and treaties of a developing country might currently lack. Company B is clearly a "person" for the purposes of the treaty; it is likely to meet the tests for being a "resident" of State B; and it is harder to argue that Company B is not the "beneficial owner" of the amounts it has received merely because it has undertaken a second obligation to spend that income or distribute it as a dividend.[13]

Example 2



3. Challenging inappropriate access to treaty benefits using domestic law

Most countries will have domestic rules which aim to prevent or minimize the scope for tax avoidance, and these measures may be suitable for use as a defence against treaty abuse as well.

The first issue that arises is to ensure that a country has a complete set of domestic anti-avoidance rules. Developed countries will often have a very large suite of domestic anti-avoidance rules, such as thin capitalization rules, controlled foreign company and

[13] The meaning of "beneficial owner" is examined at length in Joanna Wheeler, "Persons qualifying for treaty benefits," supra note 12. See also OECD, *OECD Model Tax Convention: Revised Proposals Concerning the Meaning of "Beneficial Owner" in Articles 10, 11 and 12* (Paris: OECD, 2012), available at http://www.oecd.org/ctp/treaties/Beneficialownership.pdf.

foreign investment fund rules, indirect asset transfer rules, transfer pricing rules, specific anti-avoidance rules and a statutory general anti-avoidance rule.[14] Developing countries which lack comprehensive anti-abuse rules will find the task of countering the most common forms of abuse more difficult.

Similarly, existing judicial doctrines (with labels such as "business purpose," "economic substance," "abus de droit," "fraus legis" or "substance over form"), which were developed initially to control domestic tax abuse, may also be available to counter treaty abuse.

The obvious issue is whether domestic legislative and judicial rules can be raised against practices where a treaty seems applicable and apparently offers tax relief. It is sometimes argued that domestic anti-avoidance rules and judicial anti-avoidance doctrines cannot be applied if they would have the effect of denying the benefits which a treaty apparently confers. The Commentaries to both the United Nations and the OECD Model Conventions recognize that specific legislative anti-abuse rules, general anti-abuse rules and general judicial doctrines that are part of domestic law do have the potential to generate conflicts between the treaty and domestic law.[15]

The issue is not simple, however. The United Nations Commentary and the OECD Commentary both suggest there may not be a conflict in some cases because domestic anti-abuse laws are not meant to be affected by treaties.[16] Some countries such as Australia, Canada and the United Kingdom of Great Britain and Northern Ireland have attempted to put the matter beyond doubt by inserting a provision in their domestic law which asserts that their general anti-abuse rule will prevail over their treaties, and once that provision is in place, it is assumed that all treaties entered into thereafter are negotiated on the basis that this provision is acceptable to the other treaty partner.

[14] The design and operation of a domestic general anti-abuse rule is discussed in detail in chapter XII, The role of a general anti-avoidance rule in protecting the tax base of developing countries, by Brian J. Arnold.

[15] See paragraph 15 of the Commentary on Article 1 of the United Nations Model Convention.

[16] See paragraph 21 of the Commentary on Article 1 of the United Nations Model Convention and paragraph 22 of the Commentary on Article 1 of the OECD Model Convention.

The Commentary to the United Nations Model Convention proposes another way of dealing with any argument about inconsistency.[17] It suggests mechanisms inside a treaty which are likely to mirror the intended scope and operation of domestic rules. Being in the text of the treaty, the possibility of a conflict is removed — the domestic law provisions need to be called upon to counter the abuse. The OECD Action Plan on BEPS suggests some similar approaches to be included in the text of the OECD Model Convention and the Commentary. These recommendations are discussed further below.

The administrative requirements necessary to enjoy treaty benefits may also play a part in detecting and countering treaty abuse.[18] Clearly, some evidence must exist to establish the entitlement of a non-resident to treaty benefits and States should consider carefully the kind and the extent of the evidence that needs to be provided, the entity to whom this evidence should be provided and who is responsible for retaining this evidence. For income such as dividends, interest, royalties or gains, there may be a question whether treaty benefits are delivered at source or whether non-resident taxpayers must apply to have the relevant tax refunded to them. It may be appropriate for the revenue authority's audit programmes to undertake subsequent confirmation and verification to ensure that the facts which justified the granting of treaty benefits still exist. Part of this process may involve using the exchange of information provisions of a bilateral treaty or the multilateral Convention on Mutual Administrative Assistance in Tax Matters[19] to verify and detect instances of inappropriate access.

This role that administrative systems can play in controlling inappropriate access to tax treaties is not discussed in the work on

[17] See paragraphs 34 ff. of the Commentary on Article 1 of the United Nations Model Convention.

[18] See generally, paragraphs 100 ff. of the Commentary on Article 1 of the United Nations Model Convention. See also, Peter A. Harris, "Taxation of Residents on Foreign Source Income," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*, supra note 11.

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

BEPS, but States should carefully consider how their administrative regimes are established so that they both clearly deliver the benefits that the treaty requires and have inbuilt safeguards that can impede inappropriate access to treaties. Clearly, excessive administrative obligations have the potential to undermine the benefits that the treaty was intended to secure, and so the issue becomes one of balancing the need for a quick and streamlined process against the possibility of ongoing undetected abuse.[20]

4. Challenging inappropriate access to treaty benefits by refining treaties

The section above argued that domestic substantive and administrative rules found outside the terms of a tax treaty can play a part as a defence against treaty abuse. The work on BEPS has sought to supplement those measures by proposing further refinements to the text of treaties, directed at controlling tax avoidance practices which involve treaties.

The problem of treaty abuse is not something that has taken the international community by surprise. The United Nations and the OECD already have very detailed Commentaries on the operation of their Model Conventions and each Commentary already outlines a number of strategies and approaches which might be invoked to counter treaty abuse.

The Commentary in the United Nations Model Convention (quoting Commentary in the OECD Model Convention) examines the notion of the abuse of a treaty as a doctrine of international law which might allow the benefits of a treaty to be denied; that is to say, a notion which already underlies the operation and interpretation of tax treaties as international instruments:

> [A] proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions

[20] See generally, paragraphs 100 ff. of the Commentary on Article 1 of the United Nations Model Convention; see also paragraph 26.2 of the Commentary on Article 1 of the OECD Model Convention.

of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties).[21]

The Commentaries to individual articles in each Model Convention also contain many passages which draw attention to possible interpretations of the text which can buttress the arguments of tax officials seeking to deny treaty benefits.

The recommendations coming from the work on BEPS encourage some new approaches to the problem which will be incorporated in the Model Conventions and Commentary. Some of these measures are in common use; others are not. Developing countries may wish to include provisions such as these in their treaties in order to enhance the integrity of future treaties.

The remainder of the present chapter discusses the recent developments arising from this work on BEPS, directed towards controlling various kinds of tax avoidance practices that involve treaties, namely:

- Considerations to keep in mind in deciding whether to conclude a tax treaty (section 5);
- Changes to the title of treaties and the preamble (section 6);
- A proposed general anti-abuse rule to be included in tax treaties (section 7);
- Limiting access to tax treaties by a limitation on benefits article (section 8);
- New targeted anti-abuse measures, including for dealing with tax-transparent entities and dual resident entities (section 9);
- Inserting a "saving clause" into treaties which preserves a country's right to tax its residents without impediment (section 10); and
- New measures for handling special tax regimes enacted by a treaty partner (sections 11 and 12).

[21] See paragraph 9.3 of the Commentary on Article 1 of the OECD Model Convention.

5. Tax considerations in choosing treaty partners

One important message emphasized in the OECD/G20 work on BEPS was to assist countries by setting out "the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country." [22] The Final Report on Action 6 will add further text to the Introduction to the OECD Commentary, articulating some of the relevant considerations explaining why countries should be very reluctant to negotiate tax treaties with low- or no-tax jurisdictions.[23] This is an important discussion because it serves as a counter to the apparent assumption in many countries that a bigger tax treaty network is always to be preferred, even if those treaties are with low- or no-tax jurisdictions. Clearly, there are significant non-tax considerations that have a bearing on the decision whether to have a tax treaty with another country, but insofar as tax considerations are important, developing countries should have a clear understanding of the tax costs and tax benefits for them from negotiating a treaty.

One of the main tax considerations that should have a bearing on the issue is the recognition that source countries surrender tax claimed under domestic law in exchange for the economic and administrative benefits that the treaty promises. Thus, the initial question for a country should be "Is there a real likelihood of significant and increased inward investment from negotiating a treaty with the treaty partner?" Another way of thinking about this question would be to ask: "Are there significant tax-driven impediments to greater cross-border trade and investment for which the best solution is a tax treaty?"

It is important to appreciate why this question is posed with an inbound investment focus. A State might wish to pursue a treaty as a means of encouraging greater outbound investment and trade, but many instances of double taxation for outbound investment can be solved unilaterally without the need to negotiate a treaty. It may be that tax impediments to outbound trade and investment can be adequately addressed by domestic law.

[22] OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 3, at 19.

[23] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report*, supra note 4, at 94 (inserting paragraphs 15.1 ff into the Introduction).

In deciding whether and with whom to negotiate a treaty, source countries should thus consciously take into account whether amounts of income, which they will no longer be taxing, will be taxed in the residence country. The proposed Commentary will restate that this is part of the bargain which underlies a treaty:

> [W]here a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State.[24]

This is not simply a self-serving position of "if the treaty partner is not going to tax the income we might as well tax it." Rather, if the income is not taxed in the residence country, the possibility of double taxation and tax-driven impediments to greater trade and investment don't exist. The source-country tax is being reduced or eliminated but, in the absence of significant residence country tax, there is little scope for double taxation and any argument that unrelieved double taxation is frustrating trade and investment is unconvincing.

While the benefit usually sought from a treaty is eliminating tax as an impediment to greater levels of cross-border trade and investment, a State may wish to conclude a tax treaty with a low- or no-tax country in order to secure some of the other benefits that tax treaties promise, particularly assistance from abroad in the administration and collection of domestic taxes: access to information held offshore that is currently not available, a formal system for resolving tax disputes between States, promises of non-discrimination, assistance in collecting domestic taxes, and so on. The OECD makes the judgement that these benefits:

> would not, by themselves, provide a sufficient tax policy basis for the existence of a tax treaty because such administrative assistance could be secured through more targeted alternative agreements, such as the conclusion of a tax information exchange agreement or the participation in the multilateral Convention on Mutual Administrative Assistance in Tax Matters.[25]

Moreover, there will undoubtedly be instances where the treaty partner will be unable to perform fully the administrative

[24] Ibid., at 95.

[25] Ibid., at 96.

commitments it undertakes in signing a treaty, whether through legal impediments, administrative capacity limitations or for other reasons. A treaty signed in the hope of gaining merely administrative benefits may ultimately produce little of lasting value, while at the same time reducing the source country's tax.

Finally, the discussion above has suggested an overarching principle that tax treaties should not result in double non-taxation. Where the source country gives up its own tax claims knowing that the residence country imposes no significant taxation, the country is in effect assisting in producing a double non-taxation outcome.

6. Changes to the Title and Preamble to treaties

The OECD and the United Nations propose similar changes to the Title and Preamble to their Model Conventions to reinforce the notion that treaties are not meant to be exploited through inappropriate access to the treaty by residents of third countries.

The changes to the Title will reinstate a proposition that once was common — that the treaty is being negotiated both to relieve double taxation and, equally importantly, to prevent tax avoidance and evasion:

> Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance[26]

The Preamble will provide that two contracting States are entering the treaty:

> intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)[27]

[26] Ibid., at 91.

[27] Ibid., at 92.

There are consequential changes to the Commentary explaining what the changes to the Title and Preamble mean and what, it is hoped, they will accomplish.

The assumption behind these changes is that the new Title and Preamble will be influential in interpreting treaty provisions in the case of disputes because the Title and Preamble should play an important role in the interpretation of the provisions of the Convention "according to the general rule of treaty interpretation contained in Article 31(1) of the *Vienna Convention on the Law of Treaties*." [28] Even though these changes do not directly amend the text of the substantive articles in the treaty (Articles 6–22), the Title and Preamble can and should be referred to when there is some question about the scope and meaning of a particular provision.

It is important to note that this change is quite narrow in its focus. The new text does not seek to overturn all instances of double non-taxation. It does not even seek to overturn double non-taxation due to some lack of clarity or uncertainty about how the rules are meant to operate. Rather, it is directed towards a much narrower class: "non-taxation or reduced taxation through tax evasion or avoidance." That is a very important qualification—the changes are directed at situations where double non-taxation arises and it involves abuse.

Indeed in many cases, there will be no doubt that double non-taxation will result from the operation of the treaty, and that result will be both clear and unambiguous, and a result that a State "acting in good faith" must reach. But because it does not involve "tax evasion or avoidance" the result will be allowed to stand.

For example, assume Company A sells all the shares of Subsidiary, a company resident in State B, for a gain. It is quite conceivable that no tax will arise in either State—with a few exceptions, State B will be precluded from taxing Company A under the treaty, and State A may have a participation exemption so that it does not tax gains made on the sale of shares in offshore operating subsidiaries. The result is double non-taxation of Company A, and it seems clear that, in the absence of some indication of tax evasion or avoidance, the changes to the Title or Preamble are not meant to overturn that result.

[28] Ibid., at 93.

Thus, the recommended changes may be helpful in cases where there is evidence of tax evasion or avoidance, and cases where there is some doubt about the way a particular provision should be understood and applied. However, the proposed changes will not create a universal rule to negate the operation of a treaty simply because double non-taxation will result.

It is worth noting that it would be possible for a developing country to go beyond this proposal, and to insist that treaty provisions may be invoked against a State only where the same amount of income will be (or perhaps, has been) taxed in the hands of the same taxpayer in the other State. This would require specific language in the treaty and goes beyond the current recommendation. However, since one major objective of a treaty is to remove double tax as a barrier to closer economic integration, it is entirely consistent with that objective to insist that treaty benefits be conditional upon proving the imposition of tax by the other State.

7. A general anti-abuse clause in treaties

A further recommendation which has emerged from the work on BEPS is to include a purpose-based general anti-abuse clause. The clause is intended to operate as an overarching general ground for denying treaty benefits, which can be invoked where a taxpayer might otherwise appear able to satisfy the requirements for enjoying treaty benefits.

The clause, which is proposed for insertion into both the United Nations and the OECD Model Conventions, reads as follows:

> Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the main purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.[29]

[29] Ibid., at 55. The kind of provision being envisaged is akin to a general anti-abuse rule of the kind seen in domestic law but directed just to the abuse

The clause is meant to be an overarching rule — it applies "notwithstanding [any of] the other provisions of this Convention . . . ." The clause contains two distinct elements — a rule which would deny access to treaty benefits based on the "purposes of any arrangement or transaction," and an exception which would retain access to treaty benefits where doing so "would be in accordance with the object and purpose" of the treaty provision.

According to the OECD/G20 Final Report, this article would simply express in the text of the Model Conventions notions that are currently contained in the Commentary. Consequently, the new provision is not seen as a major departure from existing principles:

> [It] mirrors the guidance in . . . the Commentary to Article 1. According to that guidance, the benefits of a tax convention should not be available where one of the principal purposes of certain transactions or arrangements is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax convention. [It] incorporates the principles underlying these paragraphs into the Convention itself . . . [30]

The United Nations maintains the clause will assist in ensuring that treaties accomplish the purpose for which they were entered into — namely, providing tax benefits in respect of bona fide exchanges of goods and services, and movements of capital; and denying benefits to arrangements, the principal objective of which is to secure more favourable tax treatment.

The wording of the general anti-abuse rule suggests it is meant to require an objective enquiry based on evidence about the transactions which occurred. The subjective state of mind of the participants is not the focus of attention in this formulation. Instead, the investigation is meant to be about the purpose of "the arrangement." This formulation is intended to make the enquiry more objective and more

of treaties. The design and operation of a domestic rule is discussed in more detail in chapter XII, The role of a general anti-avoidance rule in protecting the tax base of developing countries, by Brian J. Arnold.

[30] Ibid., at 55.

focused on observable facts and circumstances than would be the case were the enquiry directed towards ascertaining the mindset of a particular taxpayer or their advisers.

The tax considerations must be important, but they need not be the sole or the motivating goal. In other words, a taxpayer is not immune from this rule simply by pointing to certain commercial effects which the transaction also achieved.

The second aspect of the clause is clearly very important: many taxpayers will undoubtedly undertake investments and transactions in the knowledge of the effects of the treaty and intending to enjoy its benefits. Indeed, treaties are negotiated in order to induce taxpayers to change their behaviour; therefore, denying treaty benefits simply on the basis that taxpayers have responded to that inducement is inappropriate. Rather, the clause is meant to focus on whether the way in which taxpayers have responded to that inducement — the way they structured their investment or transaction — has produced an outcome that is not in accordance with the object and purpose of the treaty provision being relied upon.

8. A limitation on benefits article

Another measure discussed in the work on BEPS is the inclusion in the text of the United Nations and the OECD Model Conventions of a general "limitation on benefits" (LOB) article. The design of a possible LOB article is already discussed in the Commentary to the United Nations Model Convention[31] and the Commentary to the OECD Model Convention,[32] but the clause will be given much greater prominence if it is moved into the body of the Models. The recommended clause differs in some important respects from the suggestions in the Commentaries, no doubt reflecting current thinking about how to design LOB clauses, and the OECD/G20 Final Report actually proposes two versions of an LOB article — a "simplified version" and a "detailed version." Some countries routinely employ LOB provisions,

[31] See paragraph 56 of the Commentary on Article 1 of the United Nations Model Convention.

[32] A limitation on benefits article is already set out in paragraph 20 of the Commentary on Article 1 of the OECD Model Convention.

and including an LOB article as part of both Model Conventions will likely lead to more widespread adoption of such clauses.

An LOB clause adds a further requirement that must be fulfilled before treaty benefits will be conferred: it is not sufficient that the relevant taxpayer is a "resident" of the other contracting State; in addition, the taxpayer will have to meet the further tests set out in the clause. Because these clauses are difficult to draft and administer, there is no single preferred design at this stage.

Nevertheless an LOB is typically built around five key propositions, which are then assembled in various ways to create the LOB clause:

- A taxpayer will be entitled to full treaty benefits if it is a qualified person;
- A taxpayer who is not a qualified person may nevertheless be entitled to treaty benefits only for its business income in certain situations;
- Treaty benefits can be lost, however, if there is base erosion—that is, if too much of the income received by the taxpayer is paid out to a person resident in a third State;
- But benefits can be reinstated if the third person would have enjoyed equivalent benefits if the income had been paid to it directly;
- And a residual discretionary power to remedy any anomalies which might arise is conferred on the competent authorities.

8.1 Qualified person

If the taxpayer can demonstrate that it meets the definition of a "qualified person," it will enjoy all of the benefits of the treaty. Whether or not an entity is a "qualified person" is reassessed for each year.

The definition of "qualified person" is drafted using a number of observable criteria. There are alternative means of satisfying the "qualified person" test. The discussion below breaks down the proposed OECD clause into a series of discrete clauses, and explains the kinds of entities and situations to which it applies. The qualifications and limitations surrounding the rules are also examined.

One set of tests focuses on the status of the foreign entity.

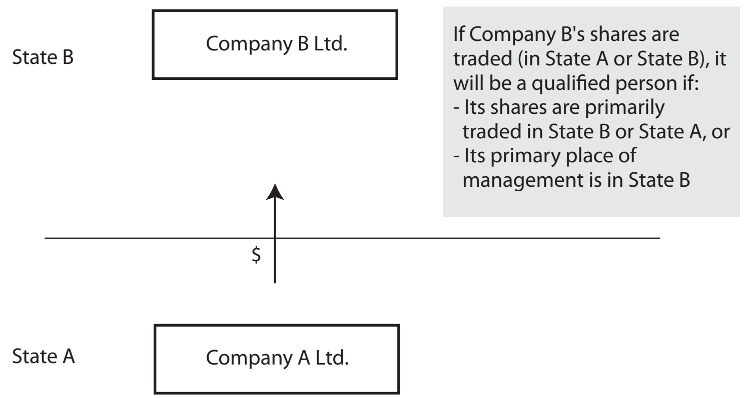
- An individual who is a resident of one of the contracting States will always be a “qualified person”;
- The government of the other contracting State and some government-owned agencies will also be a “qualified person”;
- Various types of charities, benevolent and cultural institutions will often also be a “qualified person” if they are established for specified purposes;
- Private pension funds established to provide pension and similar benefits principally to persons who are residents of either of the contracting States may also be included; and
- Some investment funds that do not provide retirement income benefits may also be included.

A second part of the “qualified person” test focuses on the ownership structure of the entity. This part of the test is intended for artificial legal entities such as companies, trusts and partnerships. For these kinds of entities, the tests focus on a number of different criteria — sometimes the residence of the owners of the entity, sometimes the place where it is managed, sometimes the place where its shares are traded, and so on:

- A publicly traded company—that is to say, a company in which the principal class of shares is regularly traded on a recognized stock exchange in either State—can be a “qualified person” in one of two ways: either its shares are principally traded on the local stock exchange, or the company’s principal place of management and control is located in its State of residence (that is, the test focuses on the place where operating decisions are made, not, for example, where the company’s directors meet or where shareholder meetings occur).

Where either the “locally traded’ or “locally managed’ test is satisfied, the listed company will enjoy access to all treaty benefits, but the most important ones are likely to be treaty benefits for dividends, interest and royalties received from its subsidiary in the source country, and treaty benefits for income from business activities conducted in the source State without a permanent establishment (PE).

Example 3

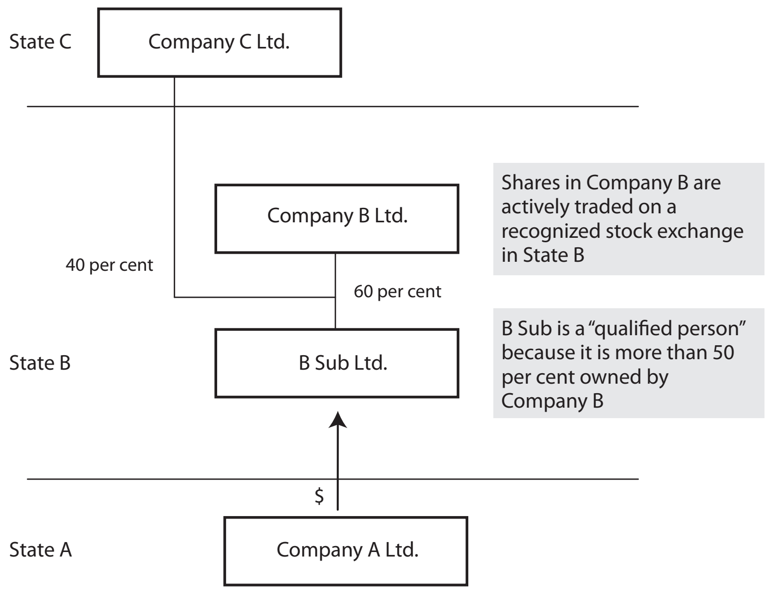


- A separate rule may exist for subsidiaries of publicly traded companies—that is to say, a company can be a "qualified person" if it is at least 50 per cent owned by a listed and publicly traded company that is resident in one of the States and itself a "qualified person." The test can extend to partly owned subsidiaries and joint-venture companies: the test will be satisfied by tracing at least 50 per cent of the shareholding in the relevant company to one or more publicly traded companies resident in either State. And the test does allow for a significant portion of the company being examined to be owned by shareholders resident in a third State.

- A residual test may apply to any "person other than an individual." For example, an entity that is not a company (such as a trust or partnership), an entity that is privately held (its shares are not listed on a stock exchange) or a widely held company which is actively traded on a stock exchange but does not satisfy either the "locally traded" or "locally managed" elements of those tests. In order for this type of entity to be a "qualified person," two tests must be satisfied:
  - An ownership test: during at least half of the year, more than 50 per cent of the interests in the entity must be held by taxpayers which are (a) resident in the same contracting State and (b) are themselves "qualified persons"; and

➤ A base erosion test: less than 50 per cent of its gross income is paid in any year in the form of tax deductible payments either to non-residents or to persons who are not themselves "qualified persons" (although this requirement is not applied to payments made to purchase goods, real estate or services at arm's length prices in the ordinary course of business).

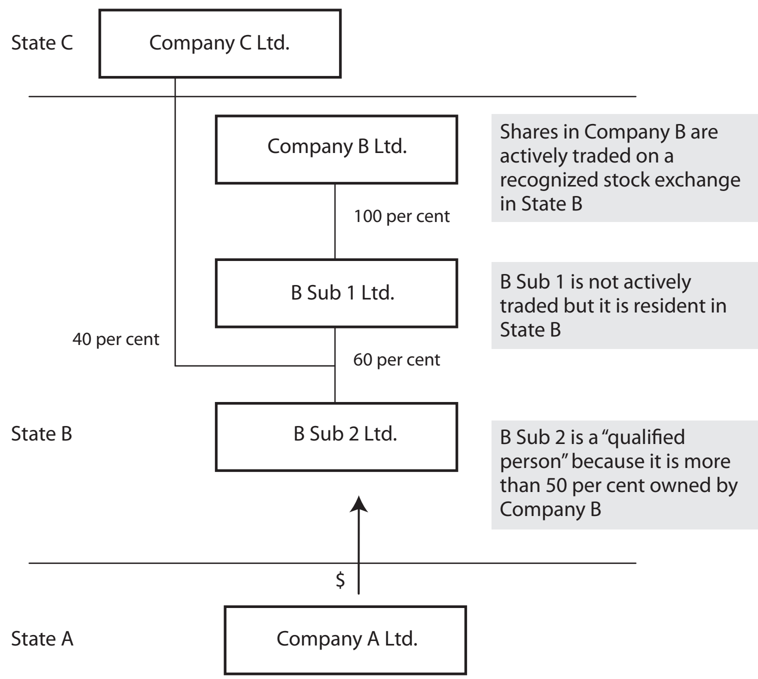
Example 4



There are several important aspects of the ownership test. First, given that the ownership of interests in the entity may change during the year, the test needs to be satisfied only for at least half the year. Second, the owners must be resident in the same State as the entity being tested. Third, the owners must account for at least 50 per cent of ownership, which still permits a substantial portion of the ownership of the entity to be held offshore. Fourth, ownership is measured by looking to the "aggregate voting power" and to the "value" of the interests being tested, and apparently both aspects must be satisfied. Finally, while a subsidiary of a listed entity is eligible to become a "qualified person" by applying this test, a subsidiary of that company must trace through to its ultimate listed parent.

The base erosion test focuses on the proportion of gross income that is paid to residents of third countries or to persons who are residents but are not "qualified persons." Again, up to 50 per cent of the gross income of the tested entity can be paid to residents of third countries without offending this rule. The reference to amounts flowing "directly or indirectly" to such persons may prove very problematic in practice, where income flows are supplemented or dissipated as they move through successive taxpayers.

Example 5



8.2 Active business income

A second way in which a taxpayer will be able to enjoy (some) treaty benefits is if the taxpayer satisfies an active business income test. While a "qualified person" will enjoy all of the benefits of the treaty, satisfying the active business income test will entitle the taxpayer to enjoy treaty benefits for only "an item of income."

In order for the entity to be a "qualified person" for a particular item of income, the taxpayer must meet two and sometimes three tests. It must be:

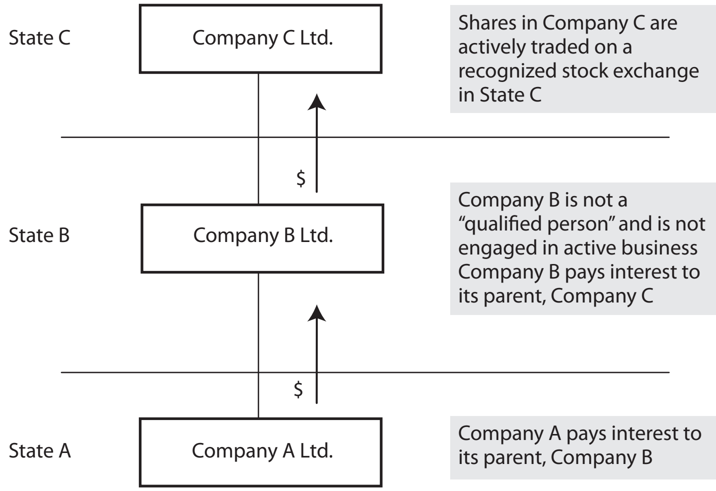
- Engaged in the active conduct of a trade or business in its State of residence. Special rules will usually disqualify investment activities unless the entity is a bank, insurance company or registered securities dealer, respectively;
- The income derived from the other contracting State must be derived in connection with that trade or business. In other words, a company which satisfies the active income test based on its status as a manufacturer cannot rely on that status to enjoy treaty benefits for all items of income it earns from the source country—merely for income which is earned in connection with its manufacturing operations.

8.3 Equivalent benefits

The OECD/G20 Final Report discusses a third method for qualifying for treaty benefits. This option would deal with structures that appear to involve shopping between treaties (rather than into treaties). For example, a structure might exist which would not satisfy the objective LOB tests for a particular treaty, but the participants in that structure would all be entitled to similar benefits under other treaties. The obvious question is: should the source country simply apply the original treaty anyway, given that it would afford similar benefits if it applied the other relevant treaties instead?

In the example below, Company B may not be entitled to treaty benefits under the A-B treaty where its shares are not traded on a local stock exchange, its only shareholder is resident in State C, and its only activity is to collect and remit interest from Company A. While the structure may seem abusive, it is not obvious that State A has suffered any loss of revenue from applying the A-B treaty when the ultimate owner of the income is an entity that would be entitled instead to the benefits of the identical A-C treaty.

Example 6

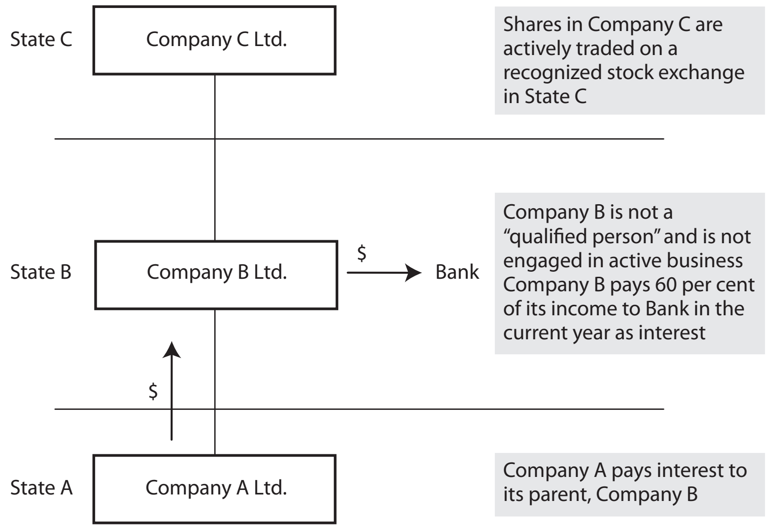


A tax treaty exists between State A and State B. The rate in article 11 (2) therein is 10 per cent.
A tax treaty exists between State A and State C. The rate in article 11 (2) therein is 10 per cent.

An LOB clause could reinstate the original treaty (in the example, the A-B treaty) in its entirety where a company is owned by an "equivalent beneficiary." The original treaty will be reinstated if both an ownership test is met [that is, Company B is owned by a company, Company C, that would itself be a qualified person] and a base erosion test is met [almost all of the income of Company B flows to Company C]. In addition, for dividends, interest and royalties, the rates stipulated in the treaty with State C must be the same or lower than the rates in the treaty with State B.

A second version for becoming an "equivalent beneficiary" might be offered for entities where there is some income leakage but the income remains within the contracting States. In the example below, Company B is 100 per cent owned by Company C. Company C will be an "equivalent beneficiary" if there is an A-B treaty and Company C is entitled to full benefits under that treaty. However, since 60 per cent of the gross income of Company B is paid to Bank, it will also be necessary for Bank to be an "equivalent beneficiary" if Company B is to qualify for treaty benefits. If Bank is both a resident of State B and a "qualified person" under the terms of the A-B treaty in its own right, this will have an effect on Company B: Company B can now enjoy the benefits of the A-B treaty.

Example 7



Just how this kind of situation should be handled is still under consideration, and it may be that a better solution to this problem lies in the discretionary power proposed in the general LOB clause which would permit the competent authorities to treat a resident as a "qualified person" in circumstances such as this.

8.4 Residual power to cure problems

Because the LOB rule would be drafted using objective, observable criteria, there is often a residual power in the competent authorities to overcome any unintended exclusion from treaty benefits.

9. Targeted anti-abuse provisions in the treaty

It was noted above that the work on BEPS grew into a long list of Action items. In the area of tax treaties, the United Nations and the OECD took the opportunity to work on some housekeeping, using the

BEPS project as the opportunity to address a list of potential changes (sometimes to the text of the Model Conventions and sometimes to the text of the Commentaries) to deal with transactions that have been identified as causing problems:

- Splitting of contracts for construction, exploration and similar projects into several short periods so that no permanent establishment (PE) arises;
- Arrangements for hiring out of labour;
- Recharacterization of dividends to avoid source-country taxation;
- Share transfers occurring just prior to dividend payments to access lower withholding tax rates in the hands of the recipient;
- Transactions attempting to eliminate source-country taxation from the sale of shares in land-rich companies;
- Prevention of abuse through the creation of a permanent establishment in a third State.

Some of these transactions are already examined in the Commentary to Article 1 of the United Nations Model Convention.

Two particular changes are worth noting. Both stem from the work on Action 2 on hybrid entities but they are relevant to the discussion of controlling treaty abuse:

- First, there is a recommendation to replace the automatic tie-breaker rule for entities other than individuals with a case-by-case judgment by the competent authorities. Under the current Models, the residence of dual-resident companies is usually automatically assigned to the State in which the company's place of effective management is located. This will be replaced by a rule which requires the competent authorities to consult and decide; and
- The second recommendation deals with income flowing to entities that are transparent for tax purposes (in many countries, partnerships and trusts are transparent for tax purposes). It is proposed that treaty benefits will be granted for income flowing to these entities, but only to the extent that the income derived by the entity is treated as the income of a resident of that State.

10. Saving clause

One issue which emerged during the BEPS work was the desire to make it clear that treaties do not prevent the application of domestic anti-abuse provisions that could prevent abusive transactions.

The OECD/G20 project and the United Nations work both refer to arguments which have been made to the effect that tax treaties can prevent the application of a wide variety of domestic anti-abuse rules: domestic thin capitalization rules, CFC rules, exit taxes, rules restricting tax consolidation to resident entities, anti-dividend stripping rules, anti-assignment of income rules and specific and general anti-avoidance rules. The organizations do not accept that these arguments have technical merit, pointing to various parts of the Commentary where the arguments are considered and rejected; but the organizations have acknowledged the value of trying to express more clearly which domestic provisions are meant to be subordinated because of the operation of a treaty.

While the Commentaries to the United Nations and OECD Model Conventions currently try to protect domestic anti-abuse rules, there are obvious practical difficulties in trying to distinguish rules which are anti-abuse rules from those which are not. They also note the difficulty in trying to distinguish general anti-abuse rules (which are meant to be immune from challenge under a treaty) from specific or targeted anti-abuse rules which might be drafted around objectively observable facts and circumstances.

The approach to this problem that has been chosen is not to entrench in the treaty a long list of domestic regimes which will be immune from challenge, but rather to approach the problem in a much more ambitious way. The approach focuses on the fact that many of these regimes are directed at the tax position of residents and proposes inserting a new "saving" clause which would preserve any regime (whether viewed as an anti-abuse measure or not) directed at the taxation of residents, with a few exceptions. Tax treaties are, for the most part, directed towards the tax situation of the residents of the other Contracting State. The text notes that this approach is already evident in the "saving clause" included in United States tax treaties.[33]

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[33] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Cir-*

The new clause would allow a State to tax its residents without any concern that treaty measures, which exist primarily for the benefit of non-residents, will also constrain the ability of a State to tax its own residents. The new clause would provide that:

> This Convention shall not affect the taxation, by a Contracting State, of its residents . . . [34]

The blanket immunity for any rule being applied to residents is then made subject to specific exceptions. The residence State must still give effect to those parts of a treaty which:

- Adjust the tax position of a resident consequent upon a transfer pricing analysis reallocating profits between the resident and an offshore branch or associated company;
- Protect from tax income from services rendered by a resident to the government of the other State or as a member of a diplomatic or consular mission of the other State;
- Protect from tax income earned by a resident student or apprentice in the form of a scholarship provided from another State;
- Give tax relief in the residence country for income taxed in the other State; and
- Ensure residents have unfettered rights to protection against discrimination and the ability to seek assistance from the competent authority.

The proposed Commentary to this new provision specifically alludes to the problem of dual resident taxpayers. The Commentary says the domestic tax laws of the residence State can be applied to a dual resident without interference from the treaty if the entity is still a resident after the application of the "tie-breaker" rule.

11. Protecting treaties from subsequent developments

One issue which has emerged recently is how to accommodate post-signature developments in the tax laws of a treaty partner. Treaties

cumstances, Action 6—2015 Final Report, supra note 4, at 86. See Article 1 (4) and (5) of the United States Model Convention.

[34] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report*, supra note 4, at 86.

are negotiated based on the current state of each State's tax laws, and will typically last for many years, but it is unfortunately the case in most countries that governments will constantly tinker with their tax laws. Some tinkering may be modest but some may be substantial, and the other contracting State may find the changes unattractive. If significant changes are made, the contracting State may face a difficult choice: either trying to renegotiate the treaty, or else terminating it.

The OECD and the United Nations are considering a provision which would allow the treaty to remain in effect after a significant change, but with parts of the treaty ceasing to have effect. The issue was raised late in the OECD project but the United Nations BEPS subcommittee has proposed amendments to Article 11 (Interest), Article 12 (Royalties) and Article 21 (Other Income) which would, in effect, allow the source State to tax interest, royalties and guarantee fees without the limit imposed by the treaty on the source State where:

- The person who owns the interest, royalty or guarantee fee is connected with the payor; and
- The person will benefit from a "special tax regime" that applies to that kind of income in their State of residence.

A "special tax regime" will be defined in detail and will include both reductions to the ordinary tax rate (the rate applied to sales of goods and services) and measures which exclude particular amounts from the usual taxable base.

This measure should help ensure that these kinds of income are taxed in full in at least one of the contracting States; if the residence State decides that it will no longer tax the amounts in full in the hands of the recipient, then the source State will be free to do so.

12. The OECD Multilateral Instrument

The recommendations arising from the work of the OECD/G20 and the United Nations will likely lead to changes to the text of the United Nations and OECD Model Conventions and Commentaries. These changes will clearly be influential in the negotiation of future treaties between States, but there is an obvious question about what can be done to the more than 3,000 existing treaties in the light of these recommendations.

It is clearly impractical for a country with a large treaty network to attempt to renegotiate quickly all of its existing treaties to include these developments. Thus, in order to handle existing treaties, Action 15 of the OECD Action Plan on BEPS proposes the creation of a single multilateral instrument (the "MLI") which would update existing bilateral treaties to accommodate these developments in treaty practice.

In November 2016 the OECD released the text of the MLI.[35] It contains articles to address many of the measures just discussed: changes to the title and preamble of treaties (MLI article 6), a principal purpose test (MLI article 7), a simplified LOB article (MLI article 7), provisions about transparent and dual resident entities (MLI articles 3 and 4) and a saving clause (MLI article 11), as well as many other measures.

The objective of the MLI is to have a single instrument which a country can sign to update its suite of treaties relating to these items at a single stroke — that is, without having to renegotiate each treaty individually. So, if a country decides to sign the instrument, potentially all its existing treaties could be amended in one place. Countries which chose to participate in the OECD/G20 BEPS project agreed to meet certain minimum standards and signing the MLI would be one way to implement these minimum standards.

This one instrument has to be flexible enough to effect amendments to over 3,000 treaties — treaties based on different treaty models; reflecting different compromises; some already containing versions of the amending provisions (for example, an LOB clause); of varying scope and age; some with protocols; in a variety of languages; and between countries that have different views on just how much and which parts of the BEPS work they want to implement (from merely the minimum standards to all of the recommendations). That presents a serious drafting challenge; the MLI therefore offers countries recourse to elections, options and reservations to specify exactly which treaties will be affected, and by which of the clauses in the MLI.

[35] OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (November 2016), available at http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm.

Even where a country signs the MLI, the MLI does not necessarily apply to all of the country's tax treaties. Countries can choose which treaties will be modified by the MLI by notifying the OECD when it signs the MLI. Thus, a country can choose to modify some of its treaties through the MLI but other treaties only through bilateral negotiations. Importantly, a country's tax treaties will be modified by the MLI only if the country and its treaty partner agree to the same modifications. Thus, if a country agrees to a certain provision of the MLI but its treaty partner does not agree to that provision, their treaty will not be modified. Similarly, if a country chooses one option provided in the MLI but its treaty partner chooses a different option, the treaty will not be modified. In these circumstances, the countries are expected to resolve their differences through bilateral negotiations.

A developing country will need to consider carefully the implications of signing the MLI, and in particular which treaties will be covered by it and how to handle the various elections, options and reservations available to signatories.

Chapter VII

Preventing avoidance of permanent establishment status

Adolfo Martín Jiménez*

1. Introduction

Action 7: Prevent the Artificial Avoidance of PE Status (Action 7) in the Organisation for Economic Co-operation and Development Action Plan on Base Erosion and Profit Shifting[1] (OECD Action Plan on BEPS) deals with very complex issues, from both a theoretical and practical perspective. First, it affects one of the most relevant and complicated concepts in international taxation, the definition of permanent establishment (PE), as well as Article 5 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention)[2] and the OECD Model Tax Convention on Income and on Capital[3] (OECD Model Convention). Second, it impacts the attribution of profits to PEs under Article 7 (Business profits) of the United Nations and OECD Model Conventions, which is another intricate and controversial issue. Third, this topic has a direct connection to transfer pricing issues and international taxation of groups of companies. Fourth, Action 7 has a very close connection to the division of the tax base between residence and source countries and the role of the PE as a threshold for source taxation. From a practical perspective, having a PE in a jurisdiction is crucial for tax administrations and taxpayers since the threshold effect

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

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

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

of the PE concept denotes whether a taxpayer obtaining business profits is subject to tax (or not) in the source country. The conceptual difficulties connected with PEs and their evolution, and the attribution of profits thereto, have an important impact upon practical situations: lack of clarity and different interpretations of the same concepts mean that there is a wide margin for conflict between tax administrations and taxpayers, on the one hand, and the tax administrations themselves, on the other. Still, tax administrations in general, and those in developing countries in particular, should be able to identify when a taxpayer is conducting a relevant business activity within their territory while attempting to avoid the presence of a PE, and should know how to react in order to tax economic activity carried on within the source State. For taxpayers, it is also critical to know when they may have a PE in a given jurisdiction so as to avoid disputes, manage tax risk and, ultimately, pay the correct taxes that are due to every jurisdiction where economic activity is conducted.

It is, therefore, crucial for tax administrations in developing countries to understand that BEPS Action 7 had and will continue to have an impact upon a domain that is extremely complex, and subject to scrutiny and discussion in the international tax arena, where there are controversial issues that have not been fully settled, and where, as a consequence, disputes may often arise. In this context, it is difficult to speak about "artificial avoidance of PE status": if the concept of PE, a central element of international taxation, is not completely clear, it is hard to establish the contours of artificial avoidance of PE status. Moreover, as this concept works mainly in favour of residence countries and, to a large extent, permits taxpayers to avoid source taxation even if relevant economic activity is carried out in the source State, developing countries should consider whether to focus on artificial avoidance or on plain avoidance of PE status in order to recover (or keep) the right to tax activities taking place within their borders.

These ideas form the basis of the present chapter. Before trying to define what is abusive in terms of avoiding a PE, it is essential to discern, first, the context of Action 7 in the OECD Action Plan on BEPS and the importance of PEs for tax administrations and taxpayers (see section 2 below). Second, as it is difficult to grasp when there may be artificial avoidance of PE status if the main features, configuration and evolution of PEs over time are not known, a study of the historical evolution of this concept in the OECD context is required (see section 3 below). Only after that can an attempt be made to describe an anti-avoidance standard for Article 5 of the OECD Model Convention in the pre-BEPS context (see section 3.5 below) since this will give definition to the limited scope and effects, especially for developing countries, of the final deliverable of BEPS Action 7.[4] This complex, albeit necessary, exercise seeks to explain why it is difficult to speak of artificial avoidance of PEs in the OECD context. This is because such a concept is designed to work in favour of residence countries and to avoid source taxation, and only a very limited number of cases will fall under the label of "artificial." Therefore, one of the main conclusions of the historical overview in section 3 and the study of BEPS Action 7 in section 4 below is that if developing countries would like to address tax base erosion issues, it would probably be more productive to focus on avoidance of PE status and methods of dealing with it rather than to concentrate on "artificial" avoidance of PEs as Action 7 does. From the perspective of developing countries, BEPS Action 7 is not only difficult to implement, it also has inherent limits that those countries should consider and take into account. In section 5 below, the contribution of Article 5 of the United Nations Model Convention to this subject is examined, together with the relevant differences between the United Nations and the OECD Model Conventions. The conclusion is reached that even if Article 5 of the United Nations Model Convention works more in favour of source countries, it is basically anchored in the same principles and foundations of the OECD Model Convention, and has certain similarities with the final output in BEPS Action 7. As will be explained below, in some aspects, the final Article 5 as a result of BEPS Action 7 is even better for developing countries than current Article 5 of the United Nations Model Convention (2011), although the latter will be modified in the 2017 update to align with the BEPS changes. Finally, other potential solutions and tools for use by developing countries in combating artificial or simple avoidance of PE status are explored in section 6 below.

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[4] OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report* (Paris: OECD, 2015) (hereinafter "OECD Final Report on BEPS Action 7"), available at http://www.oecd-ilibrary.org/taxation/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report_9789264241220-en.

It should be noted that the effects of BEPS Action 7 go beyond the strict boundaries defined therein and that there is important overlap with and direct connections to other parts of the OECD Action Plan on BEPS[5] (for example, Action 1 on addressing the tax challenges of the digital economy; Action 6 on preventing treaty abuse; and Actions 8, 9, 10 and 13 on transfer pricing) and other chapters of the present publication.[6] The present chapter will, however, try to focus on the main problems of avoidance of PEs from the perspective of Action 7 in the OECD Action Plan on BEPS and developing countries, and will touch on other Actions only indirectly. Due to the special connection of the PE concept with transfer pricing, the link between them is also briefly studied in sections 4 and 6 so as to fully understand the effects of BEPS Action 7.

2. OECD BEPS Action 7: context and scope

2.1 Introduction

The present section describes the context and scope of OECD BEPS Action 7 on preventing the artificial avoidance of PE status and explains the policy and practical problems behind it. This section is designed to help identify its origins and the problems faced with this Action. The contents of BEPS Action 7 are, however, dealt with extensively in section 4. First, reference is made to the OECD documents in which Action 7 was considered before the final document was released. Second, some observations are added on the policy difficulties inherent in this Action. Last, it is shown that there is a connection between BEPS Action 7 and the current problems faced by taxpayers and tax administrations (including those in developing countries) regarding PEs. These are very intensively linked with the policy issues and problems dealt within the Action. The aim of the present section is to explain that the scope of BEPS Action 7 is more complex than may initially be thought because it touches on core issues in international taxation; it also makes developing countries aware of the difficulties of trying to rely on BEPS Action 7

[5] OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 1.

[6] See chapter II, "Taxation of income from services," by Brian J. Arnold; and chapter VIII, "Protecting the tax base in the digital economy," by Jinyan Li.

to fight avoidance of taxation in source countries or to achieve a closer alignment of economic activity and taxation.

2.2 The scope of OECD BEPS Action 7, the limited content of the final document on BEPS Action 7 and its controversial nature

Action 7 should be read in the context of the main policy goal of the OECD Action Plan on BEPS:

> No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.[7]

Therefore, BEPS Action 7 was expected to deal with the disconnect between business activity and taxation in a country produced by the concept of PE or, rather, by the artificial avoidance of PE status. Artificial avoidance of a PE may deprive a country of taxing rights over income derived from substantial activities which are carried out in its jurisdiction.

However, in the first OECD Report on Addressing Base Erosion and Profit Shifting[8] the issue of artificial avoidance of PE status was not directly mentioned, there being only some general references to the problems of PEs.[9] Artificial avoidance of PEs arose, therefore, to some extent as a new issue — although not surprisingly — in Action 7 in the OECD Action Plan on BEPS, which explained and proposed the following:

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[7] OECD, *Action Plan on Base Erosion and Profit Shifting,* supra note 1, at 10.

[8] OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd-ilibrary.org/docserver/download/2313151e.pdf?expires=1491404261&id=id&accname=ocid57015271&checksum=A30D5C5DEAA1BD362EE2CA72DA6B19D6.

[9] Ibid., at 35 – 36 (on the need for adequate international tax rules in a world of changing business models and increasing advances in technology and communications) and at 84 (on the connection between BEPS-related work and the previous work of the OECD on PEs). The Final Report, however, makes an attempt to connect this to the BEPS Action Plan in a direct way, but it is in fact less direct than actually intended. See OECD, Final Report on BEPS Action 7, supra note 4, at 13.

> **The definition of permanent establishment (PE) must be updated to prevent abuses**. In many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by "commissionaire arrangements" with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. Similarly, multinational enterprises (MNEs) may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.
>
> *ACTION 7—Prevent the artificial avoidance of PE status*
>
> *Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.*[10]

Basically, as described in the OECD Action Plan on BEPS, Action 7 seemed to be concerned with two specific cases: commissionaire agreements, which refers to Article 5 (5) of the OECD Model Convention, and artificial fragmentation of activities to take advantage of the exemptions in Article 5 (4) of the OECD Model Convention. As such, the scope of Action 7 was very limited. There was speculation on whether this Action could have a wider effect[11] but, in fact, it has not entailed a broad revision of the concept of PE in Article 5 of the OECD Model Convention. Rather, it has proposed some limited

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[10] OECD, *Action Plan on Base Erosion and Profit Shifting,* supra note 1, at 19.

[11] See the first edition of the present work, *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (New York: United Nations, 2015), at 329 ff.

changes, albeit ones that seem to be very relevant for MNEs, which may affect their business models. The contents of this Action will be explained in detail in section 4, but they can be summarized as follows:

- Commissionaires and similar agreements: Changes with regard to the concepts of dependent agent PE and independent agent that affect Article 5 (5) and 5 (6) of the OECD Model Convention and their Commentaries;
- Specific PE exemptions and fragmentation of activities: Changes in Article 5 (4) of the OECD Model Convention to clarify the concept of preliminary and auxiliary activities that affect all of the letters of the Article or add an anti-fragmentation clause in Article 5 (4) (1) of the OECD Model Convention (new provision) that affects closely related parties. Relevant changes to the Commentary on Article 5 (4) of the OECD Model Convention are also proposed;
- Splitting up of contracts: On the splitting up of contracts to avoid the time threshold in Article 5 (3) of the OECD Model Convention, two alternatives are proposed: (a) to add an example in the Commentaries on the principal purpose rule proposed by BEPS Action 6;[12] or (b) to change the Commentaries on Article 5 (3) in order to include a model of an anti-fragmentation clause that could be added to tax treaties.

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting was adopted on 24 November 2016 by more than 100 countries and jurisdictions.[13] It reflects the changes to Articles 12–15 and their Commentaries proposed by the Final Report on BEPS Action 7. The Multilateral Convention will enter into force once five countries have signed it (the

[12] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Paris: OECD, 2015) (hereinafter "OECD Final Report on BEPS Action 6"), available at http://www.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en.

[13] OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (24 November 2016), available at http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm.

signing ceremony will take place in Paris in June 2017); the Convention will be effective for two parties after each of them has ratified it and a certain period has passed (to ensure legal certainty).

It should also be taken into account that BEPS Action 7 has a direct link with BEPS Actions 8–10[14] on transfer pricing. That relationship will also be explained below in section 4.7.

Not all countries accept the proposals derived from BEPS Action 7. Apart from specific examples cited in section 6.4 below, the United States Model Income Tax Convention (United States Model Convention), released in February 2016,[15] did not accept the most significant changes to Article 5 (4), (5) and (6) of the OECD Model Convention derived from the Final Report on BEPS Action 7. The United States Model Convention, however, explicitly accepts the anti-fragmentation clause that BEPS Action 7 proposed in paragraph 18.1 of the Commentary on Article 5 (3) of the OECD Model Convention, to deal with abuse in the context of the 12-month period referred to in that provision.

2.3 Policy issues behind Action 7: Are developing countries interested in artificial avoidance of PEs as defined by Action 7?

As mentioned above, BEPS Action 7 had several inherent weaknesses:

- The OECD outcome on Action 7 ultimately concentrated on very limited issues; this being the case, it will not fully solve the problems with tax planning structures and avoidance of PE status or help to fully align economic activity and taxation. In fact, by keeping in substance the threshold contained in Article 5 of the 2014 OECD Model Convention, the Final Report on BEPS Action 7 did not satisfy the requirements of countries that wanted more source taxation. It can even be said that this action reinforces

[14] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en.

[15] Available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf.

the tax planning elements that BEPS Actions 8–10 leave open to MNEs.[16] This weakness has had an effect on the reaction of some countries (which will be commented on in section 6.4 below).

- The limited time allowed for completing this Action (by September 2015; finally released in October 2015) made it very difficult to expect a transformative approach that could solve all the problems regarding the concept and attribution of profits to PEs that have not been dealt with satisfactorily in almost a century of experience with PEs. The final outcome is a very limited revamp of the PE concept that is not yet fully finished, since the OECD is still working on the problems of attribution of profits to the PEs in connection with the modifications of the concept of PE that derive from BEPS Action 7[17] (the work on attribution of profits will continue in 2017 or possibly even beyond). BEPS Action 1,[18] however, heralds that the debate is not fully closed and will resurface sooner rather than later;
- The importance of the problems with the PE definition in Article 5 of the OECD Model Convention made it difficult not to contemplate lowering the PE threshold. In themselves, the changes proposed by BEPS Action 7 are a move towards more source taxation, even though they are very limited in scope. Countries that do not perceive this move as bringing enough source taxation will not accept the new standard easily (see section 6.4 below);

[16] See, on this issue, section 5 below and Adolfo Martín Jiménez, "Tax Avoidance and Aggressive Tax Planning as an International Standard? BEPS and the 'New' Standards of (Legal and Illegal) Tax Avoidance," in Ana Paola Dourado, *Tax Avoidance Revisited: Exploring the Boundaries of Avoidance and Anti-Avoidance Rules in the BEPS Context* (Amsterdam: International Bureau of Fiscal Documentation (IBFD), 2016) (in print), section 4.

[17] See OECD, Final Report on BEPS Action 7, supra note 4, paragraphs 19 and 20. See also OECD, *Public Discussion Draft on BEPS Action 7—Additional Guidance on the Attribution of Profits to Permanent Establishments* (Paris: OECD, 2016).

[18] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en.

- The ambiguity of the Commentary on Article 5 of the OECD Model Convention and its evolution from the 1920s to the beginning of the work of the OECD project on BEPS, without a guiding policy principle that is clearly explained (and with the inbuilt tension between source/residence countries), has produced different interpretations, in different countries, of the concept of PE and has resulted in a real need for taxpayers and administrations to have more certainty in this area. Rather than remove existing uncertainty, BEPS Action 7 may contribute to it because of the use of terms that are not easy to interpret or that admit different interpretations by the tax administrations of different countries (see section 4 below). MNEs that used previously admitted models (commissionaires) will probably adapt to the changes in BEPS Action 7, and it is likely that new conflicts with tax administrations on whether or not there is a PE will proliferate in the coming years.

Therefore, Action 7 comprises different elements that do not easily lend themselves to obtaining a satisfactory and holistic solution that is globally accepted. It touches the definition of PE, as well as attribution of profits to it (although this part is not yet finalized), but does not have a well-defined and principled approach to aligning economic activity and the tax base (other than limited changes to the status quo). It also moves in a context where it is easy to connect its scope with the debate on source/residence-country taxation and, at the same time, has an effect on a domain that is subject to different interpretations and approaches in different jurisdictions. All of these aspects make it difficult to take any kind of coordinated action at the international level and they may cloud the outcome of Action 7, given that countries will independently assess which models better fit their specific situation. As previously mentioned, several countries have already taken actions that go in the direction of more source country taxation (see section 6.4 below). On the opposite side of the spectrum, the United States Model Convention has not accepted most of the contents of Action 7 and still adheres to a concept of PE that is closer to Article 5 of the OECD Model Convention (2014).

Additionally, it may be perceived that combating artificial avoidance of PEs would be easier with increased source-country taxation. It is important to keep in mind that two issues are intertwined in Action 7 (that is, adjusting Article 5 to new realities and business models to prevent artificial avoidance of PEs and giving source countries more taxing rights), but it should be clear from the outset that they should not be confused. Whereas opposing artificial avoidance might amount to restoring source-country rights that are already (or should be) recognized in the OECD system of distributing tax jurisdiction (Article 5 of the OECD Model Convention), giving countries more source taxing rights implies changing the threshold of Article 5 in a substantial manner, which was not the goal of Action 7: it did the former and not the latter. It has concentrated on the most extreme cases of artificial avoidance of PEs. This theoretically clear-cut difference (Action 7 aimed to attack artificial avoidance of PEs, not avoidance of PEs derived from the weaknesses of this concept from a source-country perspective) may not be so evident in the practice of PEs: the contours of this notion are not clearly defined in the current international tax framework and, therefore, the two conceptually different issues of restoring tax jurisdiction and attributing more source-country jurisdiction may become conflated. This is especially the case for countries with less sophisticated tax administrations for which the easiest way to tax activities taking place within their borders would be to have more taxing rights, rather than to address issues of PE and attribution of profits to PEs from the position of more developed tax administrations.

One of the main problems for the tax administrations of developing countries is that when they find a PE, they may not really know how to attribute profits to it, because either they do not have the appropriate legislation in this regard or they lack the know-how to do it, or both (that is also a problem in some of the more developed tax administrations). Inevitably, therefore, the debate on BEPS Action 7 for developing countries raises the issue of source-country taxation and it is difficult to limit it to the contours of preventing artificial avoidance of PEs. Therefore, even if BEPS Action 7 gives source countries more rights, the questions are (a) Can developing countries easily apply that new PE threshold? (the answer is probably not for many of them); and (b) Would it be more convenient (and easier) for developing countries to adopt other models of source taxation that are not as complex to administer as the PE concept?

These observations are an attempt to underscore that countries — and especially developing countries — should consider and reflect upon whether the PE, as it is now defined after BEPS Action 7, is the right threshold for taxation of business profits or whether they should opt for other models that recognize more source-taxation rights. This theoretical debate requires a full understanding of the limits and conditions of the PE threshold and of BEPS Action 7 in order to know whether countering artificial avoidance (the goal of Action 7) is really what a (developing) country needs to do to align economic activity and taxation within its borders or whether it should opt for other alternatives.

The foregoing reveals that the PE concept and the debate surrounding it currently present many difficulties and uncertainties,[19] and that Action 7 in the OECD Action Plan on BEPS has developed in a fragile and difficult context from a technical and policy perspective. From a practical perspective, PEs and artificial avoidance of PE status pose no fewer problems. All this, as explained, affects the outcome of Action 7 and its final acceptance or rejection in the international community or in individual countries.

2.4 The importance of managing PE risks for companies and tax administrations, especially in developing countries

The very limited response to the invitation by the OECD for comments on Action 7 of the OECD Action Plan on BEPS (only one reply) does not mean that artificial avoidance of PE status is not of relevance to taxpayers and tax administrations, as the responses to the first and second drafts of BEPS Action 7 revealed.[20] A number of factors have

[19] Richard Collier, "BEPS Action Plan, Action 7: Preventing the Artificial Avoidance of PE Status," (2013) No. 5 *British Tax Review,* at 641.

[20] More than 800 pages of comments were sent to the OECD on the first Public Discussion Draft on Action 7 of 30 October 2014, available at http://www.oecd.org/tax/public-comments-action-7-prevent-artificial-avoidance-pe-status.htm; and approximately 326 pages of comments were received on the revised Draft of 15 May 2015, available at http://www.oecd.org/ctp/treaties/public-comments-revised-beps-action-7-prevent-artificial-avoidance-pe-status.pdf.

contributed to raise the practical importance of PEs in recent years.[21] Doubtless, the evolution of the business models of multinational companies (the generalization of so-called principal company models[22]), their virtualization and internationalization, the "presence" of these companies in more and more jurisdictions, together with the increased mobility of employees and assets around the world, have increased the risks of having PEs in different jurisdictions. For taxpayers, therefore, the need to plan for contingencies and manage PE risks is critical, as the aspiration to reduce their overall tax exposure in different jurisdictions, among other things, by avoiding having a PE (as long as this cannot be labelled artificial) is legitimate. For multinational groups, the current state of uncertainty (enhanced by BEPS Action 7) with regard to PEs is not satisfactory: taxpayers often prefer to pay something rather than be subject to the uncertainty of arbitrary tax claims, double or multiple taxation, and lengthy disputes. Uncertainty has not ended with BEPS Action 7; rather, this Action presents elements that will not only maintain the previous problems, but may also increase the potential for conflicts between taxpayers and tax administrations (see section 4 below).

In recent years, the PE concept has provided tax administrations with a powerful tool to increase the tax base within their jurisdiction, especially when transfer pricing policies of multinationals cannot be challenged under national law or the OECD standard. A PE audit, if successful, may bring more revenue to the source country than transfer pricing audits of domestic subsidiaries of a group. The PE concept has even been used in the context of transfer pricing audits as a threat to increase attribution of profits to domestic subsidiaries. In this respect, some high-profile cases (for example, in Spain[23]) have proba-

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[21] See PwC, "Permanent Establishments 2.0: At the Heart of the Matter," (2013), available at http://www.pwc.com/gx/en/tax/publications/permanent-establishments.jhtml.

[22] See Joseph Andrus and Michael Durst, "Standing on 'Principal': Transfer Pricing Structures Using Limited Risk Manufacturers and Distributors," in *PwC Transfer Pricing Perspectives* (2006), available at https://www.pwc.com/us/en/transfer-pricing-strategies/assets/transfer-pricing-perspectives.pdf, at 56 – 64.

[23] See the following cases: *Borax* (Judgment of the Audiencia Nacional of 9 February 2011, rec. n. 80/2008, confirmed by the Judgment of the Supreme

bly increased the appetite of tax administrations to enter into PE audits, especially in a context where it is widely known that multinational companies have diverted profits from source countries through well-known structures like commissionaires and other risk-stripping strategies, as well as fragmentation of activities in source jurisdictions. An example of this was also provided by the International Manual of HM Revenue & Customs in the United Kingdom, and its consideration of commissionaire arrangements before the United Kingdom applied the Diverted Profits Tax. It proposed that where significant people functions and risks were connected with United Kingdom activities, it was feasible to argue that there was a PE in the United Kingdom and that profits could be attributed to the foreign head office by using a cost-plus method so that the rest of the profits would be taxable in the United Kingdom.[24] Uncertainty and ambiguity on the interpretation

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Court of 18 June 2014, rec. 1933/2011); *Roche* (Judgment of the Audiencia National of 24 January 2008, rec. 894/2004, confirmed but with a different reasoning by the Judgment of the Supreme Court of 12 January 2012, rec. 1626/2008); *Dell* (Judgment of the Audiencia Nacional, 8 June 2015, rec. 182/2012 confirmed by the Judgment of the Supreme Court 20 June 2016, rec. 2555/2015). For a commentary on these cases, see N. Carmona Férnandez, "The Concept of Permanent Establishment in the Courts: Operating Structures Utilizing Commission Subsidiaries," (2013) *Bulletin for International Taxation* (online version) or Adolfo Martín Jiménez, "The Spanish Position on the Concept of a Permanent Establishment: Anticipating BEPS, Beyond BEPS or Simply a Wrong Interpretation of Article 5 of the OECD Model?" (2016) Vol. 70, No. 8 *Bulletin for International Taxation.* All of these court decisions seem to deviate from the conventional OECD approach in interpreting Article 5 of the OECD Model Convention (1963 – 2014) before or even after BEPS Action 7.

[24] See HM Revenue & Customs (United Kingdom), "Transfer pricing: Transactions and Structures: business structures: marketing and distribution — commissionaires: practicalities," in *International Manual*, INTM441050, available at http://www.hmrc.gov.uk/manuals/intmanual/intm441050.htm. The following excerpt is illustrative of the approach of the United Kingdom tax administration: "Attribution of profit between a principal and a PE in another country involving the transfer of function and risk cannot be dictated by a legal agreement alone — there must be a detailed consideration of whether in fact the risks and functions lie with a PE or the principal overseas. Once the functions and risks have been allocated between the PE and the home territory of the principal, appropriate profits can be allocated to those functions and risks. It will be simpler to establish a reward

of key concepts of Article 5 of the OECD Model Convention have created a breeding ground for more aggressive application of the PE concept by tax administrations.[25]

In the final analysis, an evolutionary interpretation of the PE concept by tax administrations of some developed countries revealed in the pre-BEPS context not only that there was scope for different interpretation and application of the same concept, but also that tax planning was occurring in this domain, that there was discontent with the current situation and that something should be done. There is also some evidence that avoidance of PE status is not only a problem for developed countries but that it is also affecting developing countries. In this respect, the International Monetary Fund (IMF) explained the following:

> [A] large proportion of non-natural resource based multinational businesses located in developing countries are organized as low risk, routine, light manufacturing or commercial ventures, rewarded with accordingly low profit rates. It is common, under the application of transfer pricing methods, to assign these operations a fixed rate of return for tax purposes, under which productivity gains rarely translate themselves into higher local profit margins. A risk in introducing such simplified schemes, despite their attractions for administration, is that they thus may not respond to changing commercial circumstance, and can perpetuate inappropriately low fixed profit rates in developing countries …

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for the activities, which relate to ownership of the assets, such as managing and insuring stock. A cost-plus method could be used, leaving the balance of the profits from the overall selling activity to be allocated to the PE. The questions of whether there is a PE of the principal trading in the UK, and if so the profits that should be attributed to the PE are very complex issues. The OECD guidelines on the attribution of profits to a PE say that there should be no automatic force of attraction of profits to the PE. In the same way, there should be no automatic force of attraction to the head office of the enterprise. Only a careful examination of the facts will show whether functions are carried out by the PE in the United Kingdom or by the rest of the entity overseas."

[25] See PwC, "Permanent Establishments 2.0: At the Heart of the Matter," supra note 21, with warnings in this regard to companies to manage the risk of PEs by establishing adequate procedures and safeguards as a consequence of the reaction of some tax administrations.

> Countering this aggressiveness would be greatly facilitated by developing concrete guidance where it is lacking and repudiating perverse interpretations of the ALP [arm's length principle] (commonplace and often tacitly accepted), such as condoning risk stripping and other arrangements that provide no documented productivity gain for the MNE. Carefully designed harbours that apply a fixed mark up to certain costs can play a greater role than generally recognized [Brazil rules for transfer pricing could be an example: minimum gross profit margins, very specific rules upon indices of commodities transactions, limitations on intracompany export transactions as a total of net export transactions].[26]

While the latter part of the quote considers the problems of tax base shifting from developing countries and solutions thereto from a "transfer pricing perspective," ultimately it refers to "commissionaire" and "fragmented" structures (principal company models) that keep a substantial presence in a (developing) economy but manage to substantially reduce source-country taxation by avoiding PE status. In this regard, tax administrations of developing countries should be aware of the fact that transfer pricing may help bring a part of the tax base to the source country, but identifying the existence of PEs or lowering PE thresholds may be an alternative to that route (sometimes an even more productive or easier one).[27]

From the perspective of developing countries, the answers to the questionnaire circulated in 2014 by the United Nations Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries also reveal that BEPS Action 7 is regarded as very important, which shows the need to act in this area.[28]

The question is whether developing countries should focus on the PE concept and BEPS Action 7 or whether they should consider

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[26] IMF, "Spillovers in International Corporate Taxation," (2014) *Policy Paper, International Monetary Fund*, at 33.

[27] See, on this issue, section 6 below.

[28] Responses to the questionnaire circulated by the Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries are available at http://www.un.org/esa/ffd/tax-committee/tc-beps.html.

other routes to align activities carried out within their territory and tax bases that can be taxed by them. The answer depends on the limits of PE as a concept and on what can be regarded as artificial avoidance of PE status in the State of source. This issue is explored in sections 3 and 4 below. It can already be advanced that BEPS Action 7 (together or in connection with Actions 8–10) is not likely to represent a solution for the problems of developing countries, although it is a slight improvement with respect to the pre-BEPS world. Section 6 below therefore also explores other strategies (that either complement BEPS Action 7 or are different from it).

3. What is the PE function and when is it (artificially) avoided? The concept of PE and its evolution in the context of the OECD Model Convention

3.1 The basic function of PE

Artificial avoidance of PE status — and, therefore, Action 7 in the OECD Action Plan on BEPS — can be fully understood only if the function and role of PE is clear.

The concept of PE is defined in Article 5 of the United Nations and OECD Model Conventions[29] and has been used in the international tax arena from the outset, starting with the work of the League of Nations[30] and the first bilateral tax treaties negotiated between

[29] The concept of PE will be modified to adapt to BEPS Action 7, but this will only take place once the Multilateral Convention connected with BEPS Action 15 is signed and in effect or if bilateral tax treaties that use the concept of PE derived from Action 7 are negotiated by countries. A certain attempt to apply changes retroactively by changing domestic legislation in line with Action 7 or by interpretation cannot, however, be discarded. See Lee Sheppard, "BEPS and EU Progress Report," (2016) Vol. 82, No. 13 *Tax Notes International,* at 1219, quoting Quyen Huynh.

[30] For a thorough study of the concept, see, for instance, Brian J. Arnold, "Commentary on Article 5 of the OECD Model Convention," in IBFD, *Global Tax Treaty Commentaries* (Amsterdam: IBFD, 2014–2016); and Arvid A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Deventer: Kluwer, 1991).

countries. The PE concept is one of the thresholds — perhaps the most important one — in the United Nations and OECD Model Conventions, as well as in actual tax treaties. It identifies a level of presence in the source country which allows that country to tax non-residents on business profits that are attributable to a PE located within its territory, under Article 7 of the United Nations and OECD Model Convention.

A fixed place of business (Article 5 (1) of the OECD Model Convention), construction projects that last more than a fixed time (12 months under Article 5 (3) of the OECD Model Convention), or a dependent agent with the authority to habitually enter into contracts in the name of the taxpayer (Article 5 (5) of the OECD Model Convention) may constitute a PE.[31] However, Article 5 (4) of the OECD Model Convention excludes the right of the source country to tax business profits that can be attributed to specific activities listed therein or other activities of a preparatory or auxiliary character, even if these activities are carried out through a fixed place or through a dependent agent in that country.

At first glance, the function of the PE concept is clear, although its interpretation and application are not. The Commentary on Article 5 of the OECD Model Convention can be read in different — sometimes even contradictory — ways, with the consequence that there are no uniform interpretations by tax authorities or courts in different countries. The underlying economic/policy principles behind the PE clauses in Article 5 of the United Nations and OECD Model Conventions are not always obvious either: the PE was designed to tax significant activity carried on in the State of source, but it permits some relevant presence and activity taking place there to go untaxed (even in the post-BEPS world). Furthermore, the system of updating the Commentaries on the OECD Model Convention from time to time

[31] There are relevant differences between Article 5 of the OECD Model Convention and Article 5 of the United Nations Model Convention. Similarly, attribution of profits does not follow the same principles in Article 7 of the OECD Model Convention and Article 7 of the United Nations Model Convention. These differences will be discussed in section 4 below. As commented, there are also relevant differences with the definition of PE derived from BEPS Action 7. See section 4 on the changes to the PE concept after this Action.

without having a fully established policy direction may add confusion and lead to divergent interpretations. From time to time, the perception of what is admissible may vary, the boundaries of the PE threshold may move over the years and what is admissible in a country today may not be accepted tomorrow, thus creating an issue for discussion between countries with fiscal systems in different stages of development.

In this context, it is complex to talk about "artificial avoidance" of a PE, because what may be "artificial" for one country may not be the same for another that interprets the PE concept in a different way. This is obvious, for instance, in the *Dell* cases decided in Norway and Spain: a typical commissionaire structure withstood the examination of the Norwegian Supreme Court,[32] which ruled that there was no PE in such a situation, although the same agreement was regarded as a PE in Spain.[33] Perceptions of what is admissible in a country also change over the years as its own situation changes.

In these circumstances, understanding the current problems of the PE concept—and, therefore, defining what artificial avoidance of PE is — calls for a reference to its historical evolution; without it, it is not easy to fully comprehend the present problems relating to that concept. Moreover, history may help to create an understanding of the policy, economics or legal reasoning behind the PE concept. It will also aid in establishing whether there has been any behaviour over the years that could be regarded as artificial, a kind of "common," internationally accepted standard of when avoidance of PE is artificial. In addition, it would make it easier to assess the scope of Action 7 and determine whether the concept of PE may help to align economic activity within a country and tax bases or whether other options should be considered. Due to the nature of this work, only a summary of the historical evolution of the PE concept through the years is provided to help developing countries understand the concept and opt for other alternatives to set up thresholds of source taxation if they so wish.

[32] Norwegian Supreme Court, *Dell Products v. Tax East*, 2 December 2001, H-R-2011-02245-A, sak 2011/755.

[33] Judgment of the Audiencia Nacional of 8 June 2015, rec. 182/2012, confirmed by Judgment of the Supreme Court of 20 June 2016, rec. 2555/2015.

3.2 League of Nations and the PE concept: priority of residence taxation, legal form and arm's length as basic principles

The 1923 Report on Double Taxation of the League of Nations[34] marked a significant change in international taxation: from a more or less active defence of the situs or origin principle, this report initiated a change in the status quo when it proposed a move to resident-State taxation. In the ensuing years, the pillars of the current international tax system were established: the primary right of taxation should correspond to the State of residence and the source State should have a right to tax only as an exception.

The reasons behind the acceptance of the residence taxation principle as a general rule and the PE concept as an exception were not clearly explained — neither in the League of Nations materials nor later on in the documents of the Organisation for European Economic Co-operation (OEEC, later OECD). The main arguments for changing the status quo were that tax treaties embraced only the residence principle and that it was difficult to tax foreign enterprises efficiently and equitably if they did not have a PE in the source country. The concern of industrialized countries about giving up revenue in favour of source countries probably was a very important driving force behind the position adopted, first by the League of Nations and later on by the OECD.[35] A mixture of economic theory, administrative convenience and political interest after the First World War explains the bias in the current international system towards residence taxation.[36]

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[34] See "Report on Double Taxation: Document E.F.S.73.F.19; April 5, 1923," (1962) Vol. 4, *Legislative History of United States Tax Conventions,* available at http://setis.library.usyd.edu.au); see also Arvid A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle*, supra note 30, 80 ff.

[35] Ibid., 82 ff. Initially the United States, and Thomas Adams in particular, defended more source taxation, but, since the United States adopted the foreign tax credit as a form of relief of double taxation, less source taxation has meant more taxation for the United States. On the position of the United States during this period, and the contributions of Adams to international taxation, see Michael Graetz and Michael O'Hear, "The 'Original Intent' of U.S. International Taxation," (1997) Vol. 46, *Duke Law Journal*, 1021 ff.

[36] For a thorough review of the foundational premises of the current

It was in this context, in the 1920s and 1930s, that the PE concept began to exist in its current form, and its main features were defined to reduce the level of taxation in the source country along the following lines:[37]

- Only profits attributable to a fixed presence in the source country should be taxed by it. This was a natural option as most business models at the time required fixed presence to do business, even if the concept of fixed place was limited;
- The concept of PEs and companies within the same group was conceived of in terms of a legal definition—which facilitated the independent consideration of foreign subsidiaries—rather than as a substantive/economically oriented notion of group activities. Subsidiaries were first regarded as PEs of their foreign head offices, but soon they were removed from that definition;
- Dependent (in a legal, not in an economic sense) agents were included within the PE definition, but independent (even if not economically) agents were not included within it.

The genesis of the current system of attribution of profits also originated at that time, with the work of Carroll,[38] as a tool to serve the interest of resident countries. By establishing the principle that subsidiaries or PEs have to deal with their head offices at arm's length, the residual value of transactions — the reason why corporate groups exist — was diverted from the source countries. In this model, remuneration of PEs or subsidiaries for the "service provided" is natural, as the PE/subsidiary is assumed to be remunerated as an independent

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international tax system, see Michael Graetz and Michael O'Hear, "The 'Original Intent' of U.S. International Taxation," supra note 35 (also explaining the United States position); or Bret Wells and Cym Lowell, "Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin," (2011) Vol. 65, *Tax Law Review*, 535 – 617.

[37] See Richard Vann, "Tax Treaties: The Secret Agent's Secrets," (2006), No. 3 *British Tax Review*, 345 ff.; and Richard Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," (2013) Vol. 2, No. 3 *World Tax Journal*, 291 ff.

[38] See Mitchell B. Carroll, *Prevention of international double taxation and fiscal evasion: two decades of progress under the League of Nations* (Geneva: League of Nations, 1939).

party, but profits are allocated mainly to where managing activities are carried out, that is to say, the head office/parent company.[39] The advantages of this system were immediately noticed by multinational corporations and the first cases of commissionaire-like arrangements and fragmentation started to be heard by courts during this period.[40]

Another feature of Carroll's theory was that profits were attributable to each PE. This is probably the genesis of most of the historical and modern problems of PEs as the tax base of a single taxpayer could be fragmented among different presences in a country. The result was that if some of them did not meet the PE threshold, the taxable income was attributed to the residence country and, if the PE threshold was met, the independent enterprise theory accepted by Carroll also favoured attribution of residual value to the same residence country.[41]

3.3 OEEC work and the preparation of the (Draft) OECD Model Convention (1963–1977): establishing the contours of the modern PE concept

From 1957 to 1958, the contours of the modern PE concept were further refined in two mutually reinforcing movements: the definition of

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[39] In cases of contract manufacturing, the manipulation of the outcome of the transaction is relatively easy: a manufacturing subsidiary is set up in the country of source as a contract manufacturer that sells to the parent company, which, in turn, sells back to another subsidiary situated in the country of source, but in such a way that the subsidiary is only providing services to the parent and not acting as its legal agent by assisting in the sales to the third parties. See Richard Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37.

[40] Richard Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37, at 345 ff.

[41] See Richard Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 37, at 319. According to this author, the separation of activities in determining PE status is the "more important problem," as "[i]t encourages tax planning by artful segregation of activities and reliance on the implied or express limitations in the fixed place/agency/minor activities rules .... More significantly, separation of activities pervades the whole transfer pricing mindset by shifting the focus from the overall to individual activities of the firm in a country."

PE and the attribution of profits to it. In 1957, the concept of PE was further reduced by: (a) linking PEs with fixed places and, therefore, explicitly removing itinerant business from the concept; (b) including the exceptions of the, by then, Article 5 (3) (present Article 5 (4) of the OECD Model Convention), which encompassed the maintenance of a stock of goods in the source country (previously included within the PE concept); and (c) detaching the concept of dependent agent from a fixed place and linking it to the authority to conclude contracts on behalf of the principal.[42] These developments reduced further the rights of source countries and introduced the dependent agent PE concept without any policy explanation of whether or not it was a measure of economic activity. The policy reasons behind this option were explained only in 2002.

In 1958, a report on allocation of profits to PEs and subsidiary companies,[43] in addition to accepting Carroll's system of attribution of profits to separate enterprises, proposed a "per PE" taxation and formally rejected the force of attraction principle, with the consequence that the various presences of a foreign taxpayer in a jurisdiction could give rise to more than one PE to which profits should be attributed.[44] This understanding is at the core of fragmentation of activities in the source State because several business presences in a country, regardless of whether or not they give rise to a PE, cannot be "horizontally" accumulated.

The drafters of the 1958 report were well aware of the fact that rejection of the force of attraction principle and attribution of profits per PE facilitated avoidance of the PE status through fragmentation of activities in the source State, but they preferred to protect free trade without "undue restrictions," as fragmentation could in any case result

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[42] OEEC, FC/WP1 (57) 3, 8 November 1957.

[43] OEEC, FC/WP7 (58) 1, 4 September 1958.

[44] Ibid., Appendix II, where it is stated that "the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. In taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate items of profit that the enterprise derives from their country and should apply to each item of profit the permanent establishment test."

for genuine reasons and the most problematic cases could be dealt with by adequate domestic provisions (that is to say, anti-avoidance norms). The respect accorded to business dealings and structures, as well as the goal of simplification and administrative convenience, were fundamental features of a system geared towards promoting free trade. This left little margin for attention to tax avoidance doctrines: any business reason for not meeting the PE threshold and for fragmentation of activities discounted the effects of anti-avoidance theories, regardless of the fact that tax reasons could also be a powerful motive for the business structure. The arm's length and the independent and separate entity principles, as well as the legal consideration of subsidiaries as "independent entities," also facilitated the reduction of the tax base in source countries and the proliferation of structures designed to avoid source-country taxation.

After 1963, further refinement of the PE concept was needed and the work on it in connection with the 1977 OECD Model Convention and Commentary on Article 5 began to reveal some of the inherent problems of PEs and the tension between a formalistic and a more substantive interpretation of it. The most relevant document in this regard is the OECD 1970 Preliminary Report on the questions in connection with the definition in Article 5 of the term "permanent establishment." [45] In this report, fragmentation of activities of the same enterprise, even though limited to the same place of business, received some consideration in support of a more economic and less legalistic interpretation of Article 5 (3) (current Article 5 (4)) of the OECD Model Convention. At the same time, however, the report introduced explicit references to the "per project" computation of the time period in Article 5 (3) (current Article 5 (4)) of the OECD Model Convention and to the geographical and commercial coherence test for that Article. This report was in fact the precursor of the "commercial and geographical coherence test" which, according to its evolution, is applied nowadays in the context of Article 5 (1) (since 2003) and Article 5 (3) of the OECD Model Convention (since 1977).

Even if the Commentaries on Article 5 of the 1977 OECD Model Convention represented a tepid change in approach, as they

[45] OECD, FC/WP1 (70) 1, 17 August 1970.

gave a less literal interpretation of the concept of PE,[46] they basically followed the principles established in the preceding periods and did not involve any substantial change in this respect. In other words, the more substantive view regarding "preliminary" and "auxiliary" activities, which was contained in the 1970 report, was not totally accepted in the Commentary in 1977, which continued to support the basic pillars of the PE concept as established in the 1950s. Therefore, the rights of source countries were not increased — neither directly (the same principles applied to PEs as before) nor indirectly — by recognizing their right to apply anti-avoidance norms or doctrines.

In the period from 1958 to 1977, there is no discussion of anti-avoidance/economic doctrines in the Commentary on Article 5 of the OECD Model Convention, although the problem of avoidance had emerged in some of the reports (1958, 1970) used in developing it. It is not known whether avoidance is not referred to in the Commentary because it was an ancillary worry for the delegates — which is confirmed by the reports of the 1950s — or because they (and, as a result, the OECD) adopted a rather formalistic position in which anti-avoidance doctrines could not be accommodated easily in the context of tax treaties. Certainly, promotion of free trade and administrative simplification ranked high in the preferences of the drafters of the Commentaries on Article 5 of the OECD Model Convention (1963 and 1977) and avoidance was not a fundamental concern. In defence of the drafters of the Commentaries, it should be remembered that the foundations of the modern concept of PE were established in eras of (sometimes desperate) promotion of free trade as a goal (first, after the First World War and the Great Depression; and, second, after the

[46] For example, the fixed place of business test in Article 5 (1) was more flexible, with the result that several fixed places could be accumulated within the same PE; a fixed place could exist even if no premises were available or simply because there was space at the enterprise's disposal; the construction works to be taken into account for the 12-month period were those not totally unconnected (if they were a single project, they would form a coherent whole commercially and geographically); some mobile activities could qualify for the test in Article 5 (1) if they moved from one place to another as a result of the project undertaken; Article 5 (3), as well as Article 5 (4), admitted a more substantial interpretation when several preliminary or auxiliary activities were combined within the same place.

Second World War and in the context of the GATS[47] and the, by then, nascent European Economic Community (EEC)). It is understandable that in such an environment, promotion of economic growth, free trade and elimination of obstacles to commerce was the main priority of the delegates.

In view of this evolution, only in very limited cases could it be said that there was artificial avoidance of PEs in the source State where it could claim its right to tax non-resident taxpayers. The PE was designed to foster residence-country taxation and avoid source-country tax (except where the fixed place and dependent agent thresholds were met) and, therefore, only modifications in the PE threshold could increase taxing rights of the source country.

3.4 (R)evolution of the PE concept: 1990s to present

3.4.1 PEs reveal their limits

In the 1990s the debate over the PE concept continued for several reasons: removal of barriers to banks and financial institutions, integration of financial markets, technological advances, developments and substantial increase in the trade in services, new business models, the incremental importance of services; and not least, increased tax planning opportunities, which were facilitated by all these factors and the specific configuration of the PE in Article 5 of the OECD Model Convention and the system of attribution of profits in Article 7 of the OECD Model Convention.[48] All these developments marked another phase in the evolution of PEs; in particular, the PE concept and attribution of profits to PEs were the object of new studies, especially after the arm's length principle was developed and explained in the 1995 OECD Transfer Pricing Guidelines.

These changes revealed not only the limits of the PE concept, but also those of "artificial avoidance" of PEs. First, the fixed place of

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

[48] Richard Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37, at 373.

business under Article 5 (1) and the threshold for construction projects in Article 5 (3) were relatively easy to avoid — in some cases not necessarily in an artificial manner — as described below:[49]

- Some business models do not need physical presence in a country, and this does not involve any type of avoidance or aggressive planning. This is especially the case with mobile businesses, services, technological enterprises and the digital economy.[50] Simply put, in these cases the fixed place of business may not be relevant to capturing profits in the source State;[51]
- The separate consideration of various fixed places of business/projects of the same taxpayer could allow for the PE threshold to be easily avoided. It may even be said that this principle, which affects Article 5 (1) and (3) of the OECD Model Convention equally, encourages tax avoidance in the State of source. The separate consideration of the activities of different companies, even if within the same group or for the same project or line of business, also increases the possibilities of avoiding the PE threshold;[52]

[49] See, on this issue, Arvid A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle*, supra note 30, 109 ff.; Brian J. Arnold, "Threshold Requirements for Taxing Business Profits Under Tax Treaties," in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties* (Toronto: Canadian Tax Foundation, 2004), 81 – 84; and Jean Schaffner, *How fixed is a Permanent Establishment?* (Alphen aan den Rijn: Kluwer Law International, 2013).

[50] The subject of the digital economy is not covered under the present chapter and is dealt with in chapter VIII, "Protecting the tax base in the digital economy," by Jinyan Li. See also Tatiana Falcão and Bob Michel, "Assessing the Tax Challenges of the Digital Economy: An Eye-Opening Case Study," (2014) Vol. 42, No. 5 *Intertax*, 317 ff.

[51] See Walter Hellerstein, "Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments," (2014) Vol. 68, No. 6 *Bulletin for International Taxation*, 346 ff., where it is argued that the virtual PE may not be a solution either.

[52] See Brian J. Arnold, "Threshold Requirements for Taxing Business Profits Under Tax Treaties," supra note 49, at 81; and Richard Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 37, at 319.

- The connection between the fixed place of business and the carrying on of business could be severed by conducting business at places that, in theory, may not be considered to be available to or at the disposal of the non-resident taxpayer: for example, hotels, homes of employees, premises of clients. Certain elements of artificiality—attempts to avoid PEs—might be present in some models, however. This also affects the permanence test of the PE concept, as it is very easy for some businesses to have short-term or intermittent presences in a country without being continuously in the same location (for example, rental of meeting rooms, presence on the premises of a client, in hotels, on ships entering and exiting the jurisdiction);
- The exceptions in Article 5 (4) of the OECD Model Convention, especially if interpreted literally, offer a wide margin for carrying out activities within a jurisdiction without exposure to tax.[53] If combined with the more and more frequent possibility of avoiding having a business presence or dependent agent in a territory, the per PE approach and the legal independence of companies within a group may create a considerable margin for minimizing taxation in the source country.

Second, while the problem of dependent and independent agents in Article 5 (5) and (6) of the OECD Model Convention has existed from the very outset of the work of the League of Nations and the OEEC, it has been exacerbated by the economic and technological changes of the past three decades, as described below:

- In a world with better telecommunications, connecting the PE dependent agent to the conclusion of contracts "in the name/on behalf of" the enterprise does not make much sense. At the time of the League of Nations or the OEEC, it was probably assumed that the agent was, more or less, immobile. However, since the 1990s, it has become easy to avoid this requirement, either by

[53] Ibid., note 73, where it is pointed out that while "the exception does not cover firms whose very business is the activity in question, it is not clear if there is an overall preparatory or auxiliary limit on the exceptions, and nowadays the listed activities include significant value-adding elements—purchasing, warehousing, delivery, advertising, collection of information, and market research."

concluding the contract outside the country of source or by making the principal ultimately sign the contract.[54] Moreover, a person who has only dependent agents in a country who are not empowered to conclude contracts or who are independent (or are a combination of both) can avoid having a PE as long as the fixed place of business test is not met;[55]

- Reliance on legal (as opposed to economic) dependence often led subsidiaries to be considered "independent" creatures of other companies in the same group. As long as their activity was remunerated at arm's length and they were not dependent agent PEs according to Article 5 (5) of the OECD Model Convention, substantial business profits could be stripped from the country of source provided that they were attributable to a non-resident company, which could be located in a low-tax country,[56] took advantage of hybrid structures[57] or benefited from ring-fenced regimes[58] to reduce taxation;
- Article 5 (4) is also relevant in this context: a subsidiary or another person could carry on auxiliary and preliminary activities without such activities being accumulated and attributed to those of other persons who are related somehow to the same group of companies within the same jurisdiction, especially if they take place in different locations.

In this context, as early as the 1990s and even before, fragmentation of activities or commissionaire-like agreements that permitted foreign companies to have a substantive economic business presence in a country without having a PE there could easily exist. The problem was perceived to be so acute that, already in 1991, Skaar wrote the following:

> The effects of the PE concept in international fiscal law have changed, in particular during the last few decades. Rather than protecting the tax base in the source State, the PE

[54] Brian J. Arnold, "Threshold Requirements for Taxing Business Profits Under Tax Treaties," supra note 49, at 91.

[55] Ibid., 91–93.

[56] For example, Ireland.

[57] For example, hybrid structures in the Netherlands.

[58] For example, special regime for principals in Switzerland.

principle today has become instrumental in ensuring avoidance of source-state taxation for some economically important business operations.[59]

As explained below, the reaction of the OECD was to preserve the status quo with some very limited changes and, therefore, the PE principle continued to act in favour of residence countries to limit the taxing rights of source countries.

3.4.2 OECD reaction: 1992–2005

While the evolution of the OECD work on the subject of PEs during the period 1992–2005 is complex, it did not result in significant changes compared with the preceding period. It can be summarized as follows:

- In 1992, a new paragraph 18—still valid at the present time—was added to the Commentary on Article 5 (3) of the OECD Model Convention, to point out that contracts could be artificially split up to avoid the 12-month test and that anti-avoidance rules could be applied for these purposes or specific clauses could be included in tax treaties. The new paragraph marked a relevant change of perspective—it was an explicit recognition that some of the paragraphs in Article 5 of the OECD Model Convention could be abused. However, the change affected only the computation of the time threshold in Article 5 (3), and abuse had to be considered within the context of: (a) respect for business structures and groups; and (b) the per PE principle and geographical and commercial coherence test, which severely limit the possibilities of regarding two or more separate presences in a country as a PE;
- The 1994 change to paragraph 32[60] of the Commentary on Article 5 of the OECD Model Convention constituted a step

[59] Arvid A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle*, supra note 30, at 559.

[60] In the 1994 update to the OECD Model Convention, it was provided that "the phrase 'authority to conclude contracts in the name of the enterprise' does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise."

towards a less formalistic interpretation of Article 5 (5) of the OECD Model Convention (dependent agent PE), but only with regard to intervention in the negotiation of contracts, and not with regard to the elimination of the problem of commissionaires, even if the paragraph was ambiguous enough to be interpreted by some countries in a non-formalistic way. Therefore, the change did not represent any relevant move to abandon or substantially modify the dependent agent PE threshold;

- The controversial 2002–2003 revision[61] to the Commentary on Article 5 of the OECD Model Convention did not add much with regard to the problem of (artificial) avoidance of PEs even if it did represent a (limited) move in favour of more source-country taxation. Rather, it could be said the changes limited even further the scope of anti-avoidance rules in the context of Article 5 of the OECD Model Convention with regard to the problems of commissionaires and fragmentation and, thereby, the possibility for source countries to react against these structures:[62]

(a) Changes to Article 5 (1), (3) and (4)

Even if a less formal interpretation and some changes in anti-avoidance intent are evident (for example, the factual disposal test, or supervision of activities in Article 5 (3)), the basic principles of the PE concept remained untouched or were even reinforced. For instance, the geographical and commercial coherence test was imported from Article 5 (3) to Article 5 (1) of the OECD Model Convention, and the controversial examples of the painter and the consultant

[61] See OECD, *Issues arising under Article 5 (Permanent Establishment) of the Model Tax Convention* (Paris: OECD, 2002).

[62] The Commentaries on Article 1 of the OECD Model Convention represented a dramatic shift, since it was recognized that domestic anti-abuse or anti-avoidance doctrines could be applied. As a result, the Commentaries on Article 1 and Article 5 of the OECD Model Convention are not fully aligned in this regard. There are two different anti-avoidance standards in connection with Article 5 and Article 1, respectively: the first only admits an "exclusively-tax-motived standard" whereas the second picks up a "main purpose test." The same issue still arises with regard to BEPS Actions 6 and 7 in that they have different anti-avoidance standards.

or the coordination office aim to illustrate how it should be applied. Moreover, the new paragraph 27.1[63] of the Commentary on Article 5 (4) and the introduction of the term "combination of activities" did not contribute much to eliminating the formalistic reading of Article 5 (4) and, certainly, did not help the effort to deal effectively with the fragmentation of activities in the source country. Rather, it could be interpreted as a limit to the application of anti-avoidance rules against fragmentation: if read correctly, it means that activities of several taxpayers cannot be combined and activities of the same taxpayer can be considered together only if they are carried out in the same place of business and are not separated organizationally. As a matter of fact, even some examples on business restructuring contained in the 2002 OECD Report on Issues in International Taxation[64] are supportive of limiting tax avoidance doctrines or legislation to affect exclusively tax-motivated transactions.[65]

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[63] See paragraph 27.1 of the Commentary on Article 5 of the OECD Model Convention, where it is provided that "Places of business are not 'separated organisationally' where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity."

[64] OECD, *Issues in International Taxation: 2002 Reports Related to the OECD Model Tax Convention* (OECD: Paris, 2002).

[65] Ibid., at 100, where the following example was provided: "A non-resident parent company owns a resident subsidiary that hitherto has been engaged in selling both automobiles and spare parts. The spare parts storage facility is now to be hived off and treated as a separate branch of the parent company. The activities of the storage facility will be limited to the storage, relocation, and distribution of the spare parts, which will be ordered 'directly' from the parent by the customers. Specifically, this means that: (a) the settlement of the transactions, with regard to both contracting and accounting, is to be effected exclusively by the parent in its name and for its account; (b) ancillary activities such as settling warranty claims, installing, performing customer service, and advertising are not performed by the storage facility; and (c) the necessary staff is provided under a lease contract,

(b) Changes with regard to dependent agent PEs

Even though the underlying philosophy of the dependent agent PE was explained for the first time in the above-mentioned 2002 Report, the main limitation of Article 5 (5) was already clear: signing of contracts is not an adequate substitute for fixed place of business as it is not a measure of economic presence in the source country. This led to the acknowledgement that "signing," as such, was not a crucial element of the test under Article 5 (5). In this regard, the threshold was lower for cases where final signature—rubber stamp—was reserved for the non-resident (all the elements of the contract having been negotiated by someone in the source country). Also, it was recognized that splits to avoid "habitually contracting" needed to be addressed with anti-avoidance rules. This was evidence of the inappropriateness of the dependent agent PE test as a measure of presence in a country. On the other hand, the independence of the same companies of a group was reinforced by the changes in the Commentary on Article 5 (6) of the OECD Model Convention and by the new paragraph 38.1 therein, although the issue of commissionaires or business models that did not need agent PEs (or fixed places) was not addressed.

- The reaction of the OECD to the *Philip Morris* case was another example of a formalistic interpretation and limitation of the scope of anti-avoidance norms as opposed to a substantive interpretation in the context of Article 5 of the OECD Model Convention. In that case,[66] the Italian Supreme Court (Corte di Cassazione) linked the dependence/independence test to

and the facility's own staff is engaged merely in instructing and supervising." It was concluded that in this example the source country had lost taxing rights because the new activities carried out by the branch fell squarely under Article 5 (4). Also, it was recognized that Article 5 (4), letters (a) through (d), "are always exempt and are not subject to examination for whether or not they are truly preparatory or auxiliary." Even if this could give rise to tax planning, it was argued that, as long as the transaction was not "exclusively" tax-motivated, the taxing rights should be allocated to the residence country.

[66] Decisions of the Italian Supreme Court (Corte di Cassazione) of 7 March 2002, No. 3667 and No. 3368.

> the circumstances of the group as a whole, and not to the subsidiaries considered in isolation. The OECD dismantled that approach, which could have represented a fundamental change regarding the evolution of the PE concept.[67] The changes of 2005 in the OECD Commentary on Article 5 (paragraphs 33, 41, 41.1 and 42) basically made clear that: (a) companies of a group were to be considered separately and, therefore, the PE test must be applied to each of them; and (b) where a company provides services to another company of the same group on the former's premises and with its own personnel, that company cannot be considered to be a PE of the company receiving the services unless its premises are at that company's disposal or it acts as a dependent agent of that company.[68]

The OECD position in these years (1992–2005) was basically in line with the main principles of Articles 5 and 7 of the OECD Model Convention as designed at the outset. Even if some elements of change can be found in the Commentaries (that is to say, they are more anti-abuse oriented and offer a less literal interpretation of Article 5), it cannot be said that artificial avoidance or even avoidance of PEs in the source country was the most important issue for the OECD during this period. Further, these elements have given rise to conflicting interpretations in some countries. Rather, with limited exceptions, the changes in the Commentary on Article 5 of the OECD Model Convention moved in the direction of making the underlying philosophy of Article 5 and its principles more robust to counteract substantive interpretations, anti-avoidance theories or corrections that could favour source countries. This occurred despite the fact that it was already evident in these years that PE was probably not the right test for aligning economic presence and taxation in the source country.

[67] See United States Council for International Business, "OECD Work on the PE Definition," available at www.uscib.org/docs/OECD_Note_PE_Definition.pdf; see also Luís E. Schoueri and Oliver-Christoph Günter, "The Subsidiary as a PE," (2011) Vol. 65, No. 2 *Bulletin for International Taxation*, 69 ff.

[68] See Richard Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37, at 374, where it is pointed out that "the changes reinforce the separate legal entity status of associated enterprises and indicate that it is not generally possible to pierce the corporate veil and attribute the acts of one associated enterprise to another on the basis of a deemed agency or place of business."

3.4.3 *OECD work on attribution of profits to PEs and OECD Transfer Pricing Guidelines (1995–2010)*

Although transfer pricing and attribution of profits to PEs are not the subject of the present chapter, a brief reference to these topics is useful because evolution in these areas in the period 1995–2010 was a very relevant issue. On the one hand, the discussions reinforced the PE principle and limitation of source-country rights but, on the other, they contributed to a change in the landscape of PEs for taxpayers and tax administrations alike. The latter have realized the potential for challenging some tax-oriented structures through the PE concept and the former have also noticed that conflict in this area can be significant.

As explained in section 3.2 above, the current transfer pricing system — derived from the original work of Carroll and developed in the OECD Transfer Pricing Guidelines — has fostered the attribution of (residual) value to residence countries. The freedom of contract between associated companies and the independence of companies within a group also helps to obtain this result. In fact, conversion of full-fledged manufacturers into toll or contract manufacturers, and full and even low-risk distributors into commissionaires, very much relied on the possibility of associated companies being able to shift risk through legal contracts between companies of the same group. Preference in the 1995 OECD Transfer Pricing Guidelines for traditional methods of valuation (for example, cost-plus) has promoted this result: the local subsidiary is remunerated as a routine entity (on the basis of the cost-plus method or even, subsequently, the transactional net margin method (TNMM)) that permits the allocation of the most relevant part of the profit to a foreign parent or associated company, usually located in a favourable tax environment (without that company having a PE in the source State), that has contractually assumed the relevant risk from which profits will follow. With the revision of Chapters I–III, and especially Chapter II, of the OECD Transfer Pricing Guidelines in 2010, the hierarchy of methods was eliminated — now there is a "most appropriate method" rule — although a certain preference for traditional methods over profit-based ones (for example, profit-split) was retained especially for routine subsidiaries; generalization of the TNMM has also reinforced this outcome.[69]

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[69] See, for instance, Caroline Silberztein, "The 2010 Up-Date to the OECD Transfer Pricing Guidelines" and Guglielmo Maisto, "OECD Revision of

In the end, this creates the same outcome of attribution of residual profits of MNEs to countries where the principal is located if the subsidiaries in source countries only perform routine activities.

In this context, Chapter IX of the OECD Transfer Pricing Guidelines (2010) on business restructuring supported separating business profits from presence in a jurisdiction because business restructurings that were well executed from a transfer pricing perspective could not be challenged even if local entities were transformed into limited risk distributors, toll/contract manufacturers or commissionaires. The only limits to this (the disregard principle or domestic GAARs) were not very effective as they clashed with the PE thresholds in Article 5 of the OECD Model Convention, which operate in favour of residence countries/separate companies within a group.[70]

The fact is that the PE principle and the transfer pricing rules, together, have operated in parallel and as mutually reinforcing tools in favour of the interest of residence countries. The situation changed slightly after BEPS with Action 7 and Actions 8–10 on transfer pricing, but the new model still favours residual attribution of profits to residence countries at the expense of source ones (see section 4 below).

The OECD work on attribution of profits to PEs (mainly addressed in the 2008[71] and 2010[72] Reports), which has evolved since

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Chapters I–III and IX of the Transfer Pricing Guidelines: Some Comments on the Hierarchy of Methods and Re-characterization of Actual Transactions Undertaken," in Dennis Weber and Stef van Weeghel, *The 2010 OECD Up-Dates: Model Tax Convention and Transfer Pricing Guidelines* (Alphen aan den Rijn: Kluwer Law International, 2011).

[70] Paragraph 9.182 in Chapter IX of the OECD Transfer Pricing Guidelines (2010) manifestly recognizes this: "Provided functions, assets and/or risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNE group to restructure in order to obtain tax savings. However, this is not relevant to whether the arm's length principle is satisfied at the entity level for a taxpayer affected by the restructuring." See also, for instance, Example (A) in paragraph 9.188 in Chapter IX of the OECD Transfer Pricing Guidelines.

[71] OECD, *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, 2008) (2008 Report).

[72] OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, 2010) (2010 Report).

2001, has also had an impact on current developments and on the attitudes of taxpayers and tax administrations.[73] Two main features of the reports on attribution of profits stand out. First, because a PE is part of an entity, there is no possibility of contractual allocation of risks within the same corporation, unlike between associated companies. Risks follow functions and these are located where significant people in a corporation carry out their job; capital and assets are to be allocated to where the significant people functions are performed.[74] Second, the reports gave support to the dual taxpayer approach, especially for dependent agent PEs. Under this approach, if the dependent agent PE assumes functions, assets or risks beyond those attributed to the dependent agent company (associated company of the same group), those additional profits are also taxable in the source State in the hands of the enterprise having the PE. The dual taxpayer approach is not inherent to the Authorised OECD Approach (AOA); in addition, it could be applied in the context of the traditional attribution of profits to PEs,[75] but probably the OECD work in this regard was eye-opening

[73] The 2008 and 2010 Reports have an important impact on the interpretation of Article 7 of the OECD Model Convention (1963–2008 versions and 2010–2014 versions, respectively). As a result, these Reports project their effects upon both existing and new tax treaties.

[74] See paragraph 15 in Part I (General Considerations) of the 2010 Report: "Accordingly, the authorised OECD approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risks are performed by people in the PE and also attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE."

[75] As a matter of fact, the 2008 Report—which also recognizes the dual taxpayer approach—is attributed an important function with regard to Article 7 of the 2008 OECD Model Convention (and previous versions of that Article), which follows the traditional approach to attribution of profits to PEs. For examples of the use of the dual taxpayer approach in cases involving subsidiaries and PEs of the same group or commissionaire agreements, see Australian Taxation Office, *Attribution of Profits to a Dependent Agent PE* (Canberra: Australian Taxation Office, 2005) available at http://www.transferpricing.com/pdf/Australia_PE.pdf; or the HM Revenue & Customs (United Kingdom), "Transfer Pricing: Transactions and Structures: Business Structures: Marketing and Distribution—Commissionaires: Overview," in *International Tax Manual*, INTM441040.

for some tax administrations, which tried to use it to correct the bias in favour of residence countries in the international context.

As a consequence, the OECD reports on attribution of profits to PEs have worked in two divergent ways that may help to explain why conflicts around PE structures have proliferated recently:

- For tax advisers, the new approach provided an important tax planning tool: if significant people functions are located in favourable tax jurisdictions, this would mean that a relevant portion of a company's profits would go with them (risks follow functions, and functions are identified with significant people within the company).[76] Constant travelling by these individuals into and out of the source country, as long as that does not create a PE, has only the effect of removing more profit from that jurisdiction if "services" are provided to resident companies. This approach tends to ignore that a company is much more than "significant people" and that all parts of the firm, especially employees but also other associated companies and subcontractors, contribute to profits.[77] Combined with the PE thresholds and the freedom of contract to allocate risks between associated companies (recognized until the reform of the OECD Transfer Pricing Guidelines in 2016), the final result is that it is relatively easy to remove profits from the country of sale or manufacture of a product (through contract-manufacture agreements combined with fragmentation and/or commissionaire agreements if the country is also a relevant market) provided significant people are in the right place.[78]

For tax administrations, in the pre-BEPS world, the OECD reports (together with the functional analysis in the OECD Transfer Pricing Guidelines), by emphasizing risks and significant people

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[76] See Richard Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 37, 326.

[77] Ibid., 330–332. Contrary to the usual assumption, according to this scholar the profits from services provided by significant people should be located where they are used (given that in modern corporations it is increasingly difficult to know the place of provision of services). The OECD Model Convention, however, does not allow this.

[78] Ibid., at 337.

functions, offer an important tool to challenge traditional fragmentation and commissionaire-like agreements.[79] Some tax administrations established that where functions and risks are de facto, not de jure, in a source country, a PE may exist.[80] Relaxation of some of the criteria for interpreting PE thresholds after 2003 has contributed to this outcome. Intuitively, one may think that the solution to the problem of under-taxation of groups in the country of source should be provided at the level of the subsidiary by increasing its profits. If this is not possible, the only way of correcting the undesirable result is by attributing to a PE of the parent in the source country all or part of the residual value obtained by the parent company from activities in the source country.[81] In fact, it seems that both strategies have been considered by tax administrations as mutually reinforcing: sometimes the PE argument is used as an instrument (that is reinforced by the ambiguous

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[79] Richard Collier, "BEPS Action Plan, Action 7: Preventing the Artificial Avoidance of PE Status," supra note 19, 640.

[80] See HM Revenue & Customs (United Kingdom), "Transfer Pricing: Transactions and Structures: Business Structures: Marketing and Distribution — Commissionaires: Practicalities," supra note 24. The following excerpt illustrates the point: "The principal, through the UK commissionaire, is participating in the selling activity in the UK; the selling activity is the source of the profits of the PE. In the example, the profits included in the accounts for the principal are derived from the inventory and debtor functions and risks and the residual profit. Attribution of profit between a principal and a PE in another country involving the transfer of function and risk cannot be dictated by a legal agreement alone — there must be a detailed consideration of whether in fact the risks and functions lie with a PE or the principal overseas. Once the functions and risks have been allocated between the PE and the home territory of the principal, appropriate profits can be allocated to those functions and risks. It will be simpler to establish a reward for the activities, which relate to ownership of the assets, such as managing and insuring stock. A cost-plus method could be used, leaving the balance of the profits from the overall selling activity to be allocated to the PE." See also, on the deemed PE theory, Joseph Andrus and Michael Durst, "Standing on 'Principal': Transfer Pricing Structures Using Limited Risk Manufacturers and Distributors," supra note 22.

[81] See Richard Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 36, 345 ff.; and Richard Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 37, 291 ff.

Commentary on Article 5 of the OECD Model Convention) to reach a more balanced result in the transfer pricing area.[82] Even if, in theory, other solutions could be more desirable, the current interpretation of PE by the OECD limits its more active use, although this has not stopped some tax administrations from using it aggressively.[83]

[82] See Johan Müller, "Attribution of Profits to a PE: A Business Perspective" in Dennis Weber and Stef van Weeghel, *The 2010 OECD Up-Dates: Model Tax Convention and Transfer Pricing Guidelines*, supra note 69, where it is pointed out that "You always know when you have a subsidiary. PEs, especially dependent agent PEs, can appear out of nowhere. In various countries inside and outside of the OECD, the opening move of an aggressive tax authority will be to claim the existence of a PE. For example, some tax authorities argue that entities carrying no risk must be dependent agents for those entities carrying the risk instead. To date many of these disputes end up in transfer pricing settlements, where it is acknowledged by the taxpayer that the local entity does in fact carry some risk, and therefore should receive an increased compensation."

[83] See Richard Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37, 376–380, for a criticism of the Authorised OECD Approach to dependent agent PEs. In this article, the author concluded by proposing the following solution: "If a PE is avoided on legal form grounds even though not independent, it is necessary to have recourse to the associated enterprises article to capture the profits in the country of the alleged PE. The second problem relates to … use of legal form based on separate legal entities and the respect for transactions to shift the residual more or less at will (taking care to relocate a bit of brainpower at the same time) … . If PEs could be created on an economic substance approach (based on independence for the boundary of the firm) with real profits attributed to them for significant activities in a country regardless of playing with risks between associated enterprises, the residual might end up where it seems to belong. Alternatively if transactions between associated enterprises were less sacrosanct than they are now and a realistic value approach were taken to allocation of residual profits, again it would be more likely that profits align with reality" (at 380). Moreover, the author proposes to solve the current problems in the following manner: "(1) the independence criterion should be used to conceptualize the firm and its boundaries, the recognition of separate legal entities in international taxation and the concept of the firm based on common ownership has been the source of much confusion since independence has been relegated to a secondary role to legal form (treaty provisions could be re-interpreted to reverse the current situation); (2) the use of legal form to oust economic substance

As currently devised, transfer pricing instruments (in their pre-BEPS form) and attribution of profits to PEs have been part of the problem of avoidance of source-country taxation. They have exacerbated the effects of Article 5 of the OECD Model Convention, even if the work on attribution of profits to PEs (or even transfer pricing) has opened the eyes of some tax administrations, with both instruments now being used as tools to challenge some of the commissionaire and fragmentation structures. As shown below in section 4, BEPS Actions 7 and 8 – 10 have provided solutions to some of the most problematic cases but still admit a good deal of tax planning and BEPS behaviours. Conflicts will be frequent in the post-BEPS world, which is neither in the interest of business nor of the tax administrations involved.

3.4.4 More recent works (2011–2012) by the OECD on Article 5 and PEs

It will be recalled that prior to the adoption of the OECD Action Plan on BEPS (2013), the OECD published two drafts (2011[84] and 2012[85]) on the concept of PE. They provided clarification on a vast array of issues, some of them closely related to Action 7. The reaction to these documents was not positive from the business perspective,[86] but from

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needs to be recognized and addressed … independence can be made concrete by treating associated enterprises in the sense of common ownership as PEs of each other unless it is established that they are legally and economically independent. In this way legal form would not stand in the way of substance, but rather assist it. It would again be possible, though more daring, to reach this result by treaty reinterpretation. The PE definition could be regarded as incorporating a concept of independence. Both the fixed place of business and the agency PE provisions could be interpreted in this light. The provision on associated enterprises not constituting a PE would only apply if the enterprises are in fact independent." The influence of this opinion is prevalent in the work of the OECD project on BEPS.

[84] OECD, *Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention* (Paris: OECD, 2011).

[85] OECD, *Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention* (Paris: OECD, 2012).

[86] See Richard Collier, "BEPS Action Plan, Action 7: Preventing the Artificial Avoidance of PE Status," supra note 19, 640 – 641, where it is reported

a BEPS viewpoint it was not satisfactory either as the legal independence of group companies was reinforced. This facilitated tax strategies with respect to business restructuring and supported the continued defence of the traditional understanding of anti-abuse and transfer pricing rules to combat the fragmentation of activities, without really changing the threshold for taxation at source or the formal interpretation of it in the Commentary on Article 5 of the OECD Model Convention. It can even be said that an attempt had been made with those documents to halt aggressive interpretations by some tax administrations of some forms of business restructuring or fragmentation. For the moment, with the 2015 BEPS outputs, this work has stopped, although BEPS Action 1 on addressing the tax challenges of the digital economy announced that there are still issues to be considered and it is also likely that some changes will be made in the Commentary on Article 5 of the OECD Model Convention in 2017 to take into account some parts of the previous work on the PE concept.

3.5 Conclusion: standard for (artificial) avoidance of PEs in the OECD Model Convention before BEPS Actions 7 and 8–10

The historical evolution of the PE concept shows that since its inception, it has comprised two opposing elements. It is a threshold permitting source-State taxation, but it also encompasses limitations in favour of residence-State taxation. As a consequence, the PE has created a dissociation between the idea that a source State should tax "substantial participation" within its economic life and the taxation rights that can be claimed upon that participation: if there is no fixed place of business or dependent agent with authority to habitually conclude contracts, there will be no source taxation for business profits, regardless of the level of economic penetration in the source State. In an economy based on immobile factors, there seemed to have been more alignment between the PE tests and economic presence in the State of source; at the present time, however, changes in the economy, communication or business models (especially in the digital economy) have contributed to making the lack of alignment between economic presence and PEs more acute.

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that there were concerns about lowering the PE threshold and a feeling that the bright-line test for PEs was being diluted.

Several conceptual assumptions have traditionally contributed to a separation of "business presence" and taxation in the source country. First, there is the so-called per PE principle and the configuration of PEs and business presences of a taxpayer or a group of companies, horizontally (within the same country) and vertically (from the source to the residence country) independent of each other. The PE tests and application of the PE concept to a stream of income and not to a taxpayer make it possible to have a considerable economic penetration in the source State without being taxed at source. This result can be obtained as long as none of the streams meets the thresholds of Article 5 of the OECD Model Convention. The per PE principle and the geographical (as well as the commercial coherence) test, as applied especially with regard to Article 5 (1), (3) and (4) (for the combination of activities), maximize this effect. The legalistic interpretation of Article 5, on the possibility of combining different activities of the same taxpayer or a group, as well as Article 5 (7), which enables a strict separation of companies of the same group even if they are not in fact independent, has increased the residence bias.

Second, the system of attribution of profits admitted in the OECD Model Convention, the OECD Transfer Pricing Guidelines (in their pre-BEPS form, until their modification in 2016) and the OECD reports on attribution of profits have also helped create further distance between economic activity in the source State and taxable income therein:

- Profits can be attributed to a PE only for the activities (risks and personal functions) specific to it without attracting other presences in the State of the same taxpayer or others of the group, even if they can be closely connected;
- The special importance of risks and significant people functions in the attribution of profits to PEs make it easy to move people elsewhere in order to reduce source taxation;
- The traditional view of companies within a group as independent parties and the remuneration of subsidiaries as service providers (routine subsidiaries) have had the effect of transferring the "residuum" of the profits of the group to the State of residence, thereby reducing the tax base in the State of source.

Third, when conceptually adhering to the PE, the drafters of the OECD Model Convention made a deliberate choice between two competing goals: facilitating trade and reducing administrative burdens to international trade, on the one hand, and preventing tax avoidance on the other. The history of PE reveals the clear "bias" towards free trade and the respect of business models associated with it, as well as the limited role that was assigned to the prevention of artificial tax avoidance as a mechanism to restore source-country rights (a tool of last resort). By making that choice, the anti-avoidance threshold was placed very high, at a level where only the most aggressive, exclusively tax-driven structures, could be challenged. As the evolution of the OECD Model Convention shows, this threshold has not been corrected over time.

Under these premises, BEPS could not lead to radical changes. This is because the nature of the historical configuration of the PE concept as currently supported by the OECD could not be changed in two years (the lifespan of the design of BEPS Actions): if this concept, for the reasons mentioned above, produced a disconnect between the economic presence and taxation rights of the source country, it would not be possible for the notion of artificial avoidance of PEs to make a consistent contribution to an alignment of those concepts in a manner not suggested by the PE notion itself. Full alignment of the source-country economic presence and taxation rights can be achieved only through relevant and substantial changes in the concept of PE or by using other tools, not by reinterpreting it or by forcing the acceptance of anti-avoidance rules in a context where they do not fit very easily (because the PE concept is not designed to work for the benefit of the source country).

Not all countries have readily accepted this status quo. Ambiguity and lack of clarity in the Commentary on Article 5 of the OECD Model Convention have fostered attempts to rebalance the alignment of economic presence and taxable rights with regard to PEs by, more or less, aggressive interpretation of the Commentary on Article 5 of the OECD Model Convention. In this respect, the Commentary—unclear or contradictory as it may be after evolving over half a century—allows room for manoeuvre, but States should know that "interpretations" of Article 5 and its Commentary that assume too aggressive an approach may place them in an awkward situation from an international perspective.

These conclusions basically mean that focusing on artificial avoidance of PEs in tax treaties may not be of much help to those developing countries that seek more source taxation.

4. Final Report on BEPS Action 7 (in connection with BEPS Actions 8–10 on transfer pricing)

4.1 Introduction

To the extent that the outcome of BEPS Action 7, as well as the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (Articles 12 – 15), assumes the historical pillars of the PE concept and corrects only some extreme cases so as to give source countries more – albeit very limited – taxing rights, neither will contribute significantly to the achievement of a more balanced result. As a consequence, developing countries should focus on avoidance of PEs rather than on artificial avoidance of PEs if they would like to increase their power to tax the economic activity taking place within their borders. This is why sections 5 and 6 explore the options available to them. However, it is first relevant to review carefully the outcome of the proposals in BEPS Action 7 first, on their own, and second, in connection with the transfer pricing Actions of the BEPS Plan (Actions 8 – 10). For better readability, references will be made only to the Final Report on BEPS Action 7 and not to the corresponding articles of the Multilateral Convention (Articles 12 – 15); the observations, however, apply both to the proposals of the Final Report and the Articles of the Convention.

4.2 Commissionaire arrangements and similar strategies

Commissionaire agreements are well known and have been a matter of concern for some time to tax authorities all over the world and the OECD.[87] Commissionaire agreements exploit the differences between

[87] For a discussion on commissionaire agreements and the problems of Article 5, paragraphs (5) – (7), see Brian J. Arnold, "Commentary on Article 5 of the OECD Model Convention," supra note 30, at 47 ff.; N. Carmona Férnandez, "The Concept of Permanent Establishment in the Courts: Operating Structures Utilizing Commission Subsidiaries," (2013) Vol. 67, No. 6 *Bulletin*

civil and common law regarding agency. In civil law countries, there is no dependent agent PE where the subsidiary located in that country sells the products/services of a group, acting ostensibly in its own name but actually on behalf of a foreign company, usually located in a low-tax jurisdiction; or where it is regarded as a hybrid, to obtain low-tax treatment. These structures are based on a literal and legal interpretation of Article 5 (5) of the United Nations and OECD Model Conventions (1963–2014). In addition, remuneration attributed to the subsidiary acting as commissionaire in high-tax countries is normally low—determined by applying a cost-plus method with a low margin—because, ultimately, most of the relevant risks (for example, inventory, obsolescence, bad debts) connected with the sales belong to companies of the same group located abroad. These structures can usually be combined with contract/toll manufacturing subsidiaries or with subsidiaries that provide low-value services within a source jurisdiction that are also attributed routine profits (the same entity may act, for instance, as a commissionaire and a contract manufacturer). Oftentimes, the commissionaire or the contract manufacturing company pay service fees, interest or royalties to associated parties located in low-tax jurisdictions. The effects of commissionaires (alone or combined with those other structures) is that residual profits of the group are accumulated outside of the countries where a substantial level of activity is conducted, resulting in BEPS.

BEPS Action 7 has only addressed the cases of commissionaires and similar strategies[88] identified as cases of structures that are put in

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for International Taxation (online version); Lee Sheppard, "The Brave New World of the Dependent Agent PE," (2013) Vol. 71, *Tax Notes International*, at 10 ff.; Belema Obuoforibo, "In the Name of Clarity: Defining a Dependent Agent Permanent Establishment," in Carlos Gutiérrez and Andreas Perdelwitz, eds., *Taxation of Business Profits in the 21st Century* (Amsterdam: IBFD, 2013), 57 ff.; and Joseph Andrus and Michael Durst "Standing on 'Principal': Transfer Pricing Structures Using Limited Risk Manufacturers and Distributors," supra note 22.

[88] Similar strategies are described in the Final Report on BEPS Action 7, supra note 4, paragraph 7, as situations that seek to avoid the application of Article 5 (5) "where contracts which are substantially negotiated in a State are not concluded in that State because they are finalised or authorised abroad, or where the person that habitually exercises an authority to conclude con-

place "primarily in order to erode the taxable base of the State where sales took place".[89] Cases of low-risk distribution agreements with related parties are excluded from this action and should be addressed with the changes to the OECD Transfer Pricing Guidelines (2016) derived from BEPS Actions 8 – 10.

What BEPS Action 7 proposes is, first, to change the wording of Article 5 (5) of the OECD Model Convention to regard a dependent agent PE not only as the person that habitually concludes contracts in the name of, or on behalf of, a non-resident (for the transfer of goods or services of another non-resident company), but also as the person that "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without the material modification by the non-resident company."

Second, Article 5 (6) of the OECD Model Convention is also given a new wording that makes clear that: (a) Article 5 (5) will not apply where the person acting in the source State is an independent agent and acts for the non-resident in the ordinary course of its business; and (b) if a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be an independent agent with respect to that non-resident enterprise.

A definition of closely related parties is also provided in new Article 5 (6) that has two different tests: (a) a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under common control; and (b) a person shall be closely related to a company if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other, or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest in the person and enterprise. In cases of companies, the percentage is referred to aggregate vote and value of the company's shares or of the beneficial equity interest in the company.

New Commentaries on Article 5 (5) and 5 (6) of the OECD Model Convention are also proposed to explain the new wording of

tracts constitutes an 'independent agent' to which the exception of Article 5 (6) applies even though it is closely related to the foreign enterprise on behalf of which it is acting."

[89] Final Report on BEPS Action 7, supra note 4, paragraph 8.

those paragraphs. This is not the place for a detailed study of the new Commentary on Article 5 of the OECD Model Convention derived from BEPS Action 7 (and included in the Multilateral Convention), but there are some issues that should be considered:

(a) Unlike in a literal reading of former Article 5 (5), commissionaires or similar arrangements can now be regarded as dependent agent PEs, since, for the purposes of Article 5 (5), it is no longer relevant whether the commissionaire is bound to the client or whether the legal bond is created between the client and the non-resident entity. What is relevant is the degree of intervention of the dependent agent in the contract (concludes contracts or habitually plays the principal role leading to the conclusion of contracts).[90]

(b) Low-risk distributors (even so-called flash title distributors that take a very short title to goods sold) are not dependent agent PEs provided they obtain a profit in the selling, and not a commission.[91] Toll or contract manufacturers or other subsidiaries providing services (or even where the same subsidiary is a toll manufacturer plus commissionaire) do not fall within Article 5 (5) unless the threshold of intervention in contracts is met. In these cases, the remuneration of the subsidiary has to be determined according to transfer pricing rules in connection with the intervention in the contract (other functions will be remunerated depending on their nature). This still provides an ample margin to have a presence in a jurisdiction while avoiding a PE or taxation within the jurisdiction. If the subsidiary provides routine functions, remuneration will be based on a low margin, which still permits the concentration of profits

[90] See paragraph 32.8 of the new Commentary on Article 5 of the OECD Model Convention.

[91] Lee Sheppard, "Permanent Establishment Americano," (2016) Vol. 81, *Tax Notes International*, at 1073, points out that the exclusion of low risk distributors is inspired by the influence of the United States on the drafting and that it gives a broad margin for tax planning: apart from flash title distributors, a distributor can be served by employees outside the jurisdiction of the source State, which will further reduce the tax base of such low risk distributors.

in the group outside the jurisdiction where sales are made, services are provided, goods are processed and, maybe, eventually sold (other techniques may be employed to reduce even that low margin: interest deductions, provision of services, payments for use of intangibles, and so forth).

(c) Even if the dependent agent PE threshold is reduced under new Article 5 (5), the profits attributable to the dependent agent PE may be low or nil, so this provision may not have a substantial effect (depending on the case) for the jurisdiction where the new PE arises.[92] In addition, attribution of profits to these new PEs may not be straightforward, especially for less developed tax administrations. In cases where no profits are attributable to the newly created PE, the compliance costs for business and administrations will increase unreasonably. In fact, a new strategy could be for MNEs to openly disclose their PEs and attribute very little income or no income to them, so that the burden of proof that more income must be attributed to the PE is shifted to the tax authorities, thereby avoiding aggressive positions by tax administrations that find a PE and then try to attribute as much profit as possible to it. The final outcome of the work of the OECD on profit attribution to the newly created PEs has yet to be released but the 2016 Public Discussion Draft, apart from having shortcomings and being quite controversial, seems to move in the direction of reversing the trend in favour of source countries that BEPS Action 7 may represent.

(d) The new dependent agent PE threshold leaves open many doubts and uncertainties that will probably give rise to conflicts.[93] The new threshold is unclear in several aspects:

[92] See paragraph 35.1 of the proposed Commentary on Article 5 (5) of the OECD Model Convention derived from BEPS Action 7 or OECD, *Public Discussion Draft on BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments*, supra note 17.

[93] See Lee Sheppard, "Permanent Establishment Americano," supra note 91, at 1073, or Richard Collier "Revised BEPS PE Proposals: Indeterminate Agents, Principals, and Principles," (2015) Vol. 79, *Tax Notes International*, at 61 ff.; or Richard Collier, "More Guidance Needed on PE Threshold Issues," (2015) Vol. 80, *Tax Notes International*, at 249 ff.

(i) Conclusion of contracts still refers to formally signing the contract or doing all or most of the acts necessary with the exception of signing.[94] The final document on Action 7 has therefore not lowered the threshold to the level proposed in the first draft of the Action. The first draft referred to negotiation of "material elements of a contract," however, the final drafting of Article 5 (5) has moved the focus from negotiation of contracts to the process of concluding them.[95]

(ii) The reference to "or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" is too vague and abstract: the reference to "the principal role"[96] seems to exclude the presence of the dependent agent PE where the role is important, relevant or even a principal one but cannot be considered to be "*the* principal."[97] For instance, what if all the terms of the contract are fixed by the non-resident party and the dependent agent simply presents them to the taxpayer that, in turn, will order through a web page presented by the agent? What is principal and what is not principal in the conclusion of a contract? The Commentaries identify the principal role with the "actions of the person who convinced the third party to enter into a contract with the enterprise." Paragraph 32.5 attributes a substance element to this test and excludes promotion and marketing activities from that role in a way that does not directly result in the conclusion of contracts. But these tests are unclear apart from the obvious examples in paragraphs 32.5

[94] Paragraph 32.4 of the Commentary on Article 5 (5) of the OECD Model Convention, emanating from BEPS Action 7.

[95] Richard Collier, "More Guidance Needed on PE Threshold Issues," supra note 93, at 250.

[96] OECD, Final Report on BEPS Action 7, supra note 4. See new Article 5 (5) of the OECD Model Convention, at 18.

[97] Richard Collier, "More Guidance Needed on PE Threshold Issues," supra note 93, at 250.

and 32.6 of the Commentary on Article 5 of the OECD Model Convention since there are no indications as to what is principal (conclusion activity) and what is not (promotion and marketing).[98] In automatic processes of conclusion of contracts where there are personal contacts in the source State, the test may also not work well because it is not clear whether the role of the agent is the principal one in this case. The same applies where the agent only negotiates according to a set of fixed instructions or general terms decided by the principal, with limited room for negotiation.[99] This vagueness will cause conflicts between taxpayers and tax administrations.

(iii) Even when the threshold of Article 5 (5) is reached, the remuneration of the dependent agent PE is to be calculated by using the principles of attribution of profits to PEs and, in some cases, that remuneration will be very low or even nil. For instance, how much remuneration would be attributed in the example of the person soliciting and receiving orders that paragraph 32.5 regards as playing the principal role in the conclusion of contracts? How much would be attributed in processes where the contract is finally concluded online and the terms have been set and the risks are assumed by the foreign principal? This is also a question in cases where the terms of the contract are all fixed ex ante by the principal that assumes the risks and controls them. The 2016 Public Discussion Draft shows that there might be more cases of zero profit attribution to the newly created PEs than originally anticipated.

5. Article 5 (6) and the concept of independent agent also present some uncertainties. It is clear that Article 5 (6) is an exception to Article 5 (5) (dependent agent PE) and, therefore, it implies that, where the features or requirements of Article 5 (5) are present, the independent agent exception

[98] Ibid., at 250.

[99] Ibid., at 250.

will not be applicable where the agent "exclusively or almost exclusively" acts on behalf of enterprises to which it is closely related. That is to say, the fact that an agent is not independent within the terms of Article 5 (6) does not mean anything in terms of finding a dependent agent PE, since for that PE to arise, the threshold of Article 5 (5) must be met. It is not clear, however, if concluding that a subsidiary is not independent in the context of Article 5 (6) leads to the conclusion that the premises of a subsidiary are at the disposal of the foreign connected party. Since Article 5 (7) of the OECD Model Convention has not been modified, this will not be the case. But this is indeed an unusual outcome. If the presumption of dependency applies for related parties that work exclusively, or almost exclusively, for related companies to exclude the possibility of independence, it is unclear why that presumption applies only in that context and is not explored further. In fact, it is indeed unusual that the OECD presumes *iuris et de iure* that where the agent (almost) exclusively acts for related parties there is no independence for the purposes of Article 5 (6) without recognizing that, in some cases, even subsidiaries acting for related companies could act independently and provide proof thereof [100] (although it will be unlikely). Why are the effects of Article 5 (6) not extended to other contexts? Related parties are either independent or they are not (most of the time, they are not), and all of the consequences of one position or the other should be drawn. What creates confusion is the fiction of no independence within the limited field of Article 5 (6) that has no effect or is even contradicted in other contexts (Article 5 (7) in connection with Article 5 (1)). This is even more so because, as defended by other authors, the concept of independence remains unclear in

[100] Richard Collier, "Revised BEPS PE Proposals: Indeterminate Agents, Principals, and Principles," supra note 93, at 63. The author legitimately questions why a subsidiary with the same functions and risk profiles of an independent competitor that is not related to a group should be regarded as a PE in all cases without having the possibility to prove that it acts independently from other related parties.

the new Commentary on Article 5 (6) of the OECD Model Convention.[101]

In conclusion, it does appear that the most egregious cases of artificial avoidance of PEs with commissionaires are addressed by BEPS Action 7, but it leaves open ample avenues for tax planning to avoid source taxation and also for conflicts due to lack of clarity in the formulation of the new threshold in Article 5 (5) and (6) of the OECD Model Convention in its post-BEPS form. New Article 5 (5) and (6) will create a lot of uncertainty.

4.3 Fragmentation of activities

As explained above, fragmentation of activities is closely related to commissionaire-like agreements. Fundamentally, fragmentation pursues the same outcome, that is to say, to avoid taxation in the source country by splitting functions among different persons or places of business in the same jurisdiction, and this tax planning technique is usually combined with commissionaire-like structures. From 1992 onwards (but also prior to that), relevant work on this issue of fragmentation was contemplated with some concern in the Commentary on Article 5 of the OECD Model Convention, but a comprehensive study of the effects of Article 5 (4) was left aside. This is particularly the case where the exceptions in Article 5 (4) are combined with fixed places and dependent agents that do not meet the PE test or even independent agents for the same company or other companies in the group, which may be in the same jurisdiction. This type of fragmentation was already explored in the context of the preparatory work for the OECD Model Convention that was published in 1977 and, therefore, like commissionaires, it is not a new phenomenon. Ultimately, fragmentation permits a company or group to have a substantial economic presence in a country without incurring tax liabilities there commensurate with it.

However, BEPS Action 7 has opted for a very limited approach that will hardly eliminate all of the problems of fragmentation. First, it is proposed that Article 5 (4) of the OECD Model Convention be limited to preparatory or auxiliary activities, that is to say, that

[101] Ibid.

subparagraphs (a) to (f) in Article 5 (4) be subject to the requirement that the activities be of a preparatory or auxiliary character (an interpretation that was inherent in the origins of the Article but is not shared by all countries). That concept is explained in paragraph 21.2 of the new Commentary on Article 5 of the OECD Model Convention (preparatory activities are those carried on in contemplation of essential and significant activities of the enterprise, they usually precede other activities and often last for a short period, although there may be relevant exceptions; auxiliary activities are those in support of essential activities of the enterprise and they do not require a significant proportion of assets or employees). The new Commentaries also refer to examples of activities that are not preparatory or auxiliary to clarify doubts that arose in the digital economy. For example, paragraph 22 excludes the application of Article 5 (4) (a) to a warehouse in which a significant number of employees work for the purpose of storing and delivering goods sold online in that market.

It is doubtful to what extent this option will really stop fragmentation of activities. First, there are examples that do not easily fit with the clarification. For instance, why does paragraph 22.1 characterize a warehouse maintained for the delivery of spare parts to customers for machinery sold to those customers as an auxiliary activity "where after sale" assistance can be even more profitable than the sale itself or may be a fundamental circumstance to buy one good or another? Second, the new Commentaries seem to admit that a relevant level of economic activity can take place within a country without triggering the PE threshold. Apart from the after-sale example in paragraph 22.1, paragraph 22.4 makes it clear when a toll manufacturer is not a fixed place of business of the foreign principal (if the principal does not have unlimited access to the premises of the manufacturer, and even, in some cases, where it has access to the place where stock is maintained, Article 5 (4) (c) may apply depending on the circumstances).

The Commentary on the new Article 5 (4) of the OECD Model Convention would even appear to indicate how having a PE in the source State could be avoided and how activity could be fragmented without triggering the PE threshold (for instance, by outsourcing to third parties, by using toll manufactures, possibly combined with other activities, and by avoiding having a fixed place, the application of Article 5 (4) is avoided altogether through use of examples that are not clearly auxiliary activities and portraying them as being covered by the Article 5 (4) exceptions). Further, paragraph 30.1 gives the option to the contracting States simply to keep Article 5 (4) as it was before BEPS.[102]

It could be argued that the concerns expressed in the previous paragraphs are overcome with the new anti-fragmentation rule that is proposed as new Article 4 (1), which replaces the ambiguous formulation of paragraph 27.1 of the Commentary on Article 5 of the OECD Model Convention (2014). The new rule excludes the application of Article 5 (4) to a fixed place or business if: (a) the same enterprise or a closely related entity carry on business activities at the same place or at another place in the same contracting State; (b) the place or places of business are a PE for the enterprise or closely related entity, or the overall activity resulting from the combination of the activities in the same place or two places is not of a preparatory and auxiliary character; and (c) the business activities carried on by the two enterprises at the same place (or closely related enterprises at the two places) constitute complementary functions that are part of a cohesive business operation.

However, the application of the new anti-fragmentation rule also presents several problems, mainly that its scope is limited and not entirely clear:

- For the rule to apply, there must be closely related companies performing complementary activities in the same or different places of business. If, however, there is only one place of business and the other activities are outsourced to third parties by the non-resident company, there will not be accumulation even if the activities are complementary and are part of a cohesive business operation (for instance, a subsidiary and a warehouse of a third, non-related party where goods of the parent are kept but no access is granted to the parent).

[102] Richard Collier, "More Guidance needed on the PE threshold issues," supra note 93, at 252, explains with regard to this option that it "sits oddly with the large amount of focus it has been given by some States and the OECD to apparent widespread BEPS practices based on abuse of Article 5 (4) provisions."

- The rule seems to be limited to two enterprises, when fragmentation can take place among three or more, so it seems to cover the easiest cases. There is no reason why it should not apply to cases of three or more entities and, therefore, should not be literally interpreted. In fact, if paragraph 15 of the Final Report on BEPS Action 7 is interpreted jointly with the anti-fragmentation rule, it can be concluded that the rule is not limited in its application to only two enterprises.
- The meaning of cohesive business operation and how it interacts with the geographical and business coherence tests of the concept of PE under Article 5 (1) and 5 (3) of the OECD Model Convention is not fully clear. This is also the case with reference to complementary functions and cohesive business operation. This is related to the fact that how the clause applies and to whom is unclear. From the examples in paragraph 30.4 of the new Commentary (example A: a bank with branches plus an office to verify information; and example B: a subsidiary plus a warehouse of a related party where goods sold by the subsidiary are stored, and the subsidiary acquires the goods only when they leave the warehouse), it seems that the fixed place claiming the benefits of the application of Article 5 (4) of the OECD Model Convention is regarded as a new PE under Article 5 (1), independent from other PEs the same non-resident party may have or from subsidiaries whose functions it complements. Some authors have interpreted that a subsidiary in the source country can be attributed the activity of the PE of a non-resident related company,[103] which would not seem to be a correct interpretation. In that context the commercial and geographical coherence tests of Article 5 (1) and (3) remain untouched and permit a good degree of fragmentation and, therefore, profit shifting.
- In connection with the above, it should be taken into account, in terms of attribution of profits, that the cohesive business operation in the State where the PE is located will only attract the profits strictly attributable to what is performed in that State, since significant people functions and risks not located within that State (as in the bank example A above) will have the

[103] Lee Sheppard "Permanent Establishment Americano," supra note 91, at 1074 – 1075.

effect of attributing profits to the State where those functions are effectively carried on. This may have the effect of limiting the attribution of profits even when the anti-fragmentation clause applies. That is to say, the anti-fragmentation clause does not permit the horizontal accumulation of all the profits linked with the source State (even if a full business cycle is performed there). It serves only to avoid the application of Article 5 (4) to some activities, which does not have the effect of attracting profits to the source State that are not strictly linked with the functions performed and risk controlled in the fixed place. The Public Discussion Draft released by the OECD in 2016 clearly shows this outcome, that profits attributed to the source State will be very limited.

As in the case of commissionaires, the proposal seeks to address the most aggressive forms of fragmentation, but it does not pursue a holistic view of all the presences a company or associated companies may have in a jurisdiction; therefore, accumulation of different presences or benefits obtained in the source State will not be the rule.

4.4 Splitting-up of contracts

Splitting-up of contracts for the purposes of Article 5 (3) of the OECD Model Convention (or the alternative service PE provision in paragraph 42.23 of the Commentary on Article 5 of the OECD Model Convention) was also another concern in the BEPS process. Two alternatives have been proposed:

(a) Add an example in the Commentary on the principal purpose rule derived from BEPS Action 6, so that it captures only tax-driven splitting-up of contracts (the example given is two related companies that divide a 22-month contract into two parts, each lasting for 11 months, in order to avoid the application of Article 5 (3) of the OECD Model Convention); or

(b) For States that prefer the following option over (a) above, include a new model clause in paragraph 18.1 of the Commentary that refers to Article 5 (3) of the OECD Model Convention and accumulates the activities in the same place of closely related companies for the purposes

> of computation of the 12-month period in that Article. Paragraph 18.2 adds a clarification to note the factors that may be taken into account to determine whether the activities of both companies are connected, depending on the facts and circumstances of the case: for instance, contracts on the same construction work that are concluded with the same or related persons or if one contract is the logical consequence of the other and concluded with a related party, or whether, absent tax planning considerations, the activities would have been covered by a single contract, whether the nature of the work under the different contracts is the same or similar, or whether the same employees are performing the activities under the different contracts. This rule, which is to be used by States that have more problems with the application of anti-abuse rules, differs from the example in (a) above in that it is of automatic application, that is to say, even if there are good commercial reasons for splitting the contract (for example, one of the companies specializes in the part it undertakes). The definition of "connected activities" introduces tax considerations in this expression that approximate it to an anti-avoidance rule, so its nature is not completely clear.

The scope of the rules against the splitting-up of contracts is very limited as it affects only the computation of the time period in Article 5 (3) of the OECD Model Convention and does not affect fragmentation involving different places of business (different building sites, construction or installation projects), that is to say, it refers to a contract regarding one site, but not to a splitting-up that involves different sites or projects. This issue is dealt with only by the limited changes to Article 5 (4), but the anti-fragmentation rule in that paragraph does not affect Article 5 (3). In this context it is still possible to have a presence in two or more different construction sites in the source country and if the presence in those sites does not exceed the time threshold in Article 5 (3), the activities will not be accumulated. For instance, a construction company may have different construction projects in a State with each one of them lasting for six months. If that company performs its tasks successively one after another, there will not be a PE.

4.5 Insurance

Insurance companies have also been the object of some consideration in the OECD Public Discussion Drafts on BEPS Action 7. Finally, it was agreed in the context of Action 7 not to include a specific insurance clause and to deal with insurance companies through the more general changes to Article 5 (5) and (6) of the OECD Model Convention mentioned above for commissionaires.

4.6 Attribution of profits to newly created PEs as a consequence of BEPS changes

The importance of joint consideration of the BEPS/Multilateral Convention changes in Article 5 of the OECD Model Convention with the work on attribution of profits to PEs is also underlined by BEPS Action 7 (paragraphs 19 – 20), but it is likewise stressed that no substantial modifications to the current rules are needed even if additions and clarifications may be useful. Notwithstanding the latter, no more clarifications were included in BEPS Action 7, as the work on attribution of profits was closely linked with other Actions in the OECD Action Plan on BEPS, namely, Actions 8 – 10. Until the works of Actions 8 – 10 were finalized, it was acknowledged that no other conclusions on attribution of profits to PEs could be reached and therefore that clarification on PE attribution of profit issues could be finished only in 2016.

On 4 July 2016, a (quite controversial) Public Discussion Draft on Additional Guidance on the Attribution of Profits to PEs was released by the OECD for comments.[104] It should be stressed that the analysis of this document is connected with Article 7 of the OECD Model Convention (2010) which fully picks up the Authorised OECD Approach, an approach not accepted in the United Nations context.

Since this chapter refers to the PE threshold, rather than to attribution of profit issues, suffice it to say that the OECD Public Discussion Draft reveals two main ideas: (a) lowering the PE threshold may not entail, in the OECD context, a significant increase in the PE country's tax base; rather, there are examples where it does not increase the tax base at all since the profit attributed to the newly

[104] Supra note 17.

created PE is zero (in these cases, a valid question may be whether it makes sense to recognize the newly created PE, thereby increasing the burdens for business and tax administrations); and (b) the noteworthy complexity (and base erosion opportunities) of the exercise of attribution of benefits to PEs, especially for less developed tax administrations in developing countries. As explained above, reliance on significant people functions (PEs) and risk-effective control (associated companies) in the OECD works on attribution of profits; and transfer pricing increases the possibilities of tax planning to avoid taxation in the source State and, therefore, also reduces the effectiveness of lowering the PE threshold in Article 5 of the OECD Model Convention, unless significant people and risks are located within the PE State.

In fact, the 2016 Public Discussion Draft shows that as long as most functions and risks are located in the head office State, the lion's share of the profits in the source country goes to the head office (in most of the examples, intangibles are not considered, which would further contribute to reducing the tax base attributable to the PE). This, together with the ample margin for avoiding the new PE threshold described in previous sections, is a relevant weakness in the concept of PE as derived from BEPS Action 7.

The 2016 Public Discussion Draft has been very controversial for the following reasons:

- More than 400 pages of comments were received by the OECD, revealing little agreement on very basic issues. This proves that the document is clearly insufficient as a guide.
- The cases used in the document as examples to provide guidance are confusing: in some cases it is doubtful whether there is a PE; in others the underlying assumptions are not based on reality, the examples failing to correspond to real or most common business situations. More real examples, such as a combination of commissionaire with toll manufacturing, may be needed.
- The hypotheses in the examples or the description of facts is not sufficiently reasoned or even connected with real situations. Additionally, it is difficult to have clear policy principles based only on examples; it would be better to have clear principles first and then develop examples to illustrate those principles.

- The draft reveals that more coordination between Articles 5, 7 and 9 of the OECD Model Convention (BEPS Actions 7 and 8–10) is probably needed: for instance, since the interaction of the significant people criterion used in the Authorised OECD Approach to attribution of profits to PEs with the criterion of control of risk and capacity to bear it or the criterion of intangibles (development, enhancement, maintenance, protection, and exploitation of intangibles, "DEMPE functions") is not fully clear and may need further refinement. That is to say, the conclusions of the 2008 and 2010 OECD Reports on Attribution of Profits to Permanent Establishments and the Final Reports on BEPS Actions 8–10 may not be fully aligned.
- It is unclear also how the new Article 5 will interact with double tax treaties in which the Authorised OECD Approach to attribution of profits is not recognized (for example, those that follow Article 7 of the United Nations Model Convention, which does not accept the Authorised OECD Approach and those tax treaties negotiated before or after 2010 that do not accept that approach).
- Most importantly, the document has a bias in favour of attribution of profits to residence countries (head offices) and non-recognition of real functions/intangibles in the country where the PE is located. In terms of tax compliance, the document also creates unnecessary complexities (for instance, the need to recognize a PE in the arguable zero profit attribution cases it uses as examples).

Because of the weaknesses of the 2016 OECD Public Discussion Draft, the OECD plans to release another one in the summer of 2017. However, the OECD approach to attribution of profits in the 2016 Public Discussion Draft reveals why developing countries should probably adhere to the United Nations approach to attribution of profits to PEs in Article 7 of the United Nations Model Convention, rather than try to apply the Authorised OECD Approach (this observation is likely to hold true in connection with future work by the OECD in this field, that is to say, future drafts on attribution of profits to PEs).

4.7 Connection of BEPS Action 7 with Actions 8–10 on transfer pricing[105]

In the post-BEPS context, it is very important to understand the connection between BEPS Action 7 and Actions 8 – 10. The final output of Actions 8 – 10 has led to a very relevant amendment to the OECD Transfer Pricing Guidelines.[106] The most relevant feature of the amendment is that there is an approximation (which still needs some fine-tuning, as explained in the previous section) between the OECD Transfer Pricing Guidelines and the 2008 and 2010 OECD Reports on Attribution of Profits to Permanent Establishments[107] in that the amendments to Chapter 1 of the OECD Transfer Pricing Guidelines place more relevance on factual control of functions and risk and capacity to bear risk. The OECD, in the context of the functional analysis, recommends delineating the real transactions so that shifting risks from one country to another simply by signing a contract is no longer possible. Risk-related returns should go to where significant people factually control the risk and have the capacity to bear it. This approach, which resembles the one on attribution of profits to PEs derived from the Authorised OECD Approach (AOA),[108] has a clear anti-avoidance flavour since it limits the possibilities of shifting risks from one part of a multinational group to another simply with

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[105] The conclusions of this section are derived mainly from Adolfo Martín Jiménez, "Tax Avoidance and Aggressive Tax Planning as an International Standard? BEPS and the 'New' Standards of (Legal and Illegal) Tax Avoidance," supra note 16.

[106] The reform of the OECD Transfer Pricing Guidelines to incorporate the amendments derived from BEPS Actions 8 – 10 and 13 was finally approved by the OECD Council on 23 May 2016. See the press note of 15 June 2016, available at http://www.oecd.org/tax/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm.

[107] See supra notes 71 and 72.

[108] There are still some differences between the AOA on attribution of profits to PEs and the new Chapter 1 of the OECD Transfer Pricing Directives. Since the AOA refers to a single entity, in the end some risks may be shared by a head office and PEs, whereas with Article 9 of the OECD Model Convention, risks may not be shared by two associated companies provided that one of them has the functions to control risks and the capacity to assume them.

contracts, a common tax planning technique in the pre-BEPS world (as explained in previous sections). BEPS Actions 8–10 also have another very relevant feature. This refers to the reform of Chapter VI of the OECD Transfer Pricing Guidelines on intangibles. In the new context, the function of intangibles (very broadly defined) as value/profit drivers within multinational groups is emphasized, so that intangibles (most specifically people with significant, real functions with regard to intangibles) would attract most of the residual profits of groups.

In this new "post BEPS" scenario, subsidiaries of a group that simply perform routine functions (for instance, contract and toll manufacturers, low risk distributors and support service companies) and do not have functions regarding intangibles will not be entitled to the residual profits of the group that will flow to the jurisdictions where intangibles are controlled. At the same time, since in the new context factual control of risk and capacity to bear it (with regard to intangibles or to any other function) act as a source rule for the attribution of profit, this means that the new tax planning techniques will revolve around placing significant people who control risks in low tax jurisdictions, even if they outsource most of the functions (especially the routine ones) to other parts of the multinational group.

In this post-BEPS world, the relationship of the PE concept with the transfer pricing rules has the following features:

- Transfer pricing rules have preference in connection with the PE principle. That is to say, with regard to multinational groups the analysis should start with the actual delineation of the transactions to understand whether legal contracts are aligned with factual control of functions, assets and risks. If a subsidiary in a country factually controls risks that are legally assumed by another (offshore) part of the group, an adequate remuneration for those functions will permit the source country to attribute more benefits to the subsidiary;[109]
- BEPS Action 7, even if reducing the threshold for PEs, reinforces the outcomes of the transfer pricing rules in two forms:

[109] The analysis in the OECD, *Public Discussion Draft, BEPS Action 7—Additional Guidance on the Attribution of Profits to Permanent Establishments*, supra note 17, illustrates this point.

> (a) the PE threshold derived from Action 7 permits significant activities to be carried on within a jurisdiction without having a PE there (for example, where the most significant functions and intangibles are offshore and, for instance, a routine subsidiary is within the jurisdiction), with the effect that profits go to the States where the main value drivers of the group are located (significant people who control risks and intangibles); and (b) even if there is a PE, as long as significant risks/intangibles are not factually located within the PE jurisdiction, the profits attributable to the PE may not be very significant.[110]

Therefore, the model derived from BEPS, with its weak source rules (represented by control of risk and capacity to bear it, or control of functions referred to intangibles) still permits significant BEPS outcomes and double non-taxation (especially with regard to intangibles).[111] This effect is reinforced by the PE thresholds in BEPS Action 7 (and the 2016 OECD Public Discussion Draft on attribution of profits referred to in the previous section).

4.8 Conclusions on BEPS Action 7 and developing countries

Even if BEPS Action 7 has reduced the PE threshold and the reform of the 2016 OECD Transfer Pricing Guidelines derived from Actions 8 – 10 permits a challenge to the legal shifting of risk as a tool to shift profits outside of a jurisdiction, source countries may want to explore other avenues that will limit the BEPS/tax planning opportunities that the new context provides and overcome its weaknesses. Tax administrations should not overlook the complexity of the tools derived from BEPS (the factual delineation of the value chain of multinational groups and the problems of attribution of profits to subsidiaries and PEs). Even the most developed countries may find it very difficult to apply the new

[110] Ibid. See the examples in the *Public Discussion Draft* to illustrate this point.

[111] On permitted and non-permitted BEPS and double non-taxation see Adolpho Martín Jiménez, "Tax Avoidance and Aggressive Tax Planning as an International Standard? BEPS and the 'New' Standards of (Legal and Illegal) Tax Avoidance," supra note 16.

standards[112] and conflicts, due to different interpretations of the standard, may arise even more frequently than before. Because of that, the following sections will explore other alternatives for developing countries, starting with the United Nations Model Convention.

5. United Nations Model Convention and (artificial) avoidance of PE status

5.1 Differences between the United Nations and OECD Model Conventions

This section compares the PE threshold in the OECD and United Nations Model Conventions in a pre-BEPS context, that is, with reference to Article 5 of the OECD Model Convention (2014). The comparison between Article 5 as derived from BEPS Action 7 and the United Nations Model Convention will be drawn in section 5.2 below. The differences between the United Nations (2011) and OECD (2014) Model Conventions regarding the PE concept are well known, and the present chapter will mention them only very briefly:

- Article 5 (3) of the United Nations Model Convention has two paragraphs:[113]

[112] OECD, *Public Discussion Draft on BEPS Action 7—Additional Guidance on the Attribution of Profits to Permanent Establishments,* supra note 17, again illustrates that, in view of the outcomes of the new approach (for example, not attributing profits to newly created PEs even though the PE may have filing obligations, and connecting the profits of the new PE with those of subsidiaries of the same group in the country and the problems of double taxation that may arise), countries may want to adopt simplified approaches that facilitate the filing obligations of taxpayers. Apart from referring to paragraph 246 of Part I of the 2010 Profit Attribution Report, supra note 72, (the possibility that the subsidiary files its own return and that of the PE), the draft asks for suggestions for simplification.

[113] See Brian J. Arnold, "Commentary on Article 5 of the OECD Model Convention," supra note 30, at 36, where it is pointed out that there is a much stronger argument in favour of Article 5 (3) (a) of the United Nations Model Convention being a deeming provision (that is to say, it does not have to meet Article 5 (1) requirements) than Article 5 (3) of the OECD Model Convention.

- Article 5 (3) (a) of the United Nations Model Convention is broader than Article 5 (3) of the OECD Model Convention as it covers assembly projects and supervisory activities—even if a similar interpretation of Article 5 (3) of the OECD Model Convention is suggested by the Commentary on Article 5 of the OECD Model Convention (2014)—and the time limit for a PE to exist is shorter, 6 months instead of 12.
- Article 5 (3) (b) of the United Nations Model Convention permits the source State to tax the provision of services in its territory, provided they refer to a project or connected projects lasting for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the year concerned (a similar provision is included as an alternative in paragraphs 42.11–42.48 of the Commentary on Article 5 of the OECD Model Convention).

A controversial issue, however, is whether the geographical and commercial coherence requirements apply to projects under both subparagraphs (a) and (b) of Article 5 (3) of the United Nations Model Convention. Paragraph 11 of the Commentary on Article 5 of the United Nations Model Convention explicitly accepts paragraph 18 of the Commentary on Article 5 of the OECD Model Convention, which means that the geographical and commercial coherence test will also apply with regard to Article 5 of the United Nations Model Convention. However, the effects of such a paragraph should probably be limited to Article 5 (3) (a), as the main reason for the existence of Article 5 (3) (b) is precisely to avoid the geographical coherence test.[114] The key limit for this subparagraph is "the same or a connected project," that is to say, commercial coherence;[115]

[114] Ibid., at 67, where it is suggested that the main goal of Article 5 (3) (b) of the United Nations Model Convention is to overcome the problems of the geographical coherence test.

[115] On the interpretation of "the same or a connected project," see paragraph 12 of the Commentary on Article 5 of the United Nations Model Convention; see also "Article 5: the meaning of 'the same or a connected project'" presented at the ninth session of the United Nations Committee of Experts on International Cooperation in Tax Matters, Geneva, 21–25 October 2013

- Article 14 of the United Nations Model Convention refers to independent personal services, which may be taxed at source if they are connected with a fixed base or physical presence in the source country. This Article may have some interaction (and pose interpretative problems) with both deeming provisions in Article 5 (3) of the United Nations Model Convention. However, it extends the source-country rights to cover not only the remuneration of the enterprise, as in Article 5 (3) (b) of the United Nations Model Convention, but also the remuneration of the individual providing services to that enterprise. The differences between the PE and the fixed base concepts for some countries are also arguments for the retention of Article 14 of the United Nations Model Convention in tax treaties;
- Article 5 (4) of the United Nations Model Convention, unlike Article 5 (4) of the OECD Model Convention, excludes delivery of goods from the preliminary and auxiliary activities of subparagraphs (a) and (b). In this regard, paragraph 17 of the Commentary on Article 5 (4) of the United Nations Model Convention, explains that "[t]he deletion of the word 'delivery' reflects the majority view of the Committee that a 'warehouse' used for that purpose should, if the requirements of paragraph 1 are met, be a permanent establishment." It would seem, however, that the United Nations Committee of Experts on International Cooperation in Tax Matters (United Nations Committee of

(E/C.18/2013/CRP.2), available at http://www.un.org/esa/ffd/wp-content/uploads/2014/09/9STM_CRP2B_Article5.pdf; and paragraph 42.41 of the Commentary on Article 5 of the OECD Model Convention. At the eleventh session of the United Nations Committee of Experts in 2015, it was agreed that, under the traditional interpretation of Article 5 (3) (b) of the United Nations Model Convention, the application of this paragraph requires the physical presence of individuals, employees or personnel of the enterprise furnishing the services in the source State. However, a minority view holds the position that physical presence is not a requirement under Article 5 (3) (b) of the United Nations Model Convention because a business cycle can be closed without that physical presence. See, United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, Report on the eleventh session, Geneva, 19–23 October 2015 (E/2015/45-E/C.18/2015/6), paragraph 29. On the meaning of the "same or a connected project," see paragraphs 30–32 of the same Report.

Experts) acknowledges that little income can be attributed to this activity;[116]

- Article 5 (5) of the United Nations Model Convention covers, in addition to the normal dependent agency PE, a person not having authority to conclude contracts but habitually maintaining (in a contracting State) a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of an enterprise of the other contracting State. There seems to be some intent to challenge commissionaire agreements with this provision where the Commentary observes that: "Some countries believe that a narrow formula [on Article 5 (5)] might encourage an agent who was in fact dependent to represent himself as acting on his own behalf." It is interesting to note that the Commentary on Article 5 (5) of the United Nations Model Convention still reflects that the former United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters, with regard to the 1999 version of the United Nations Model Convention, noted that: (a) "if all the sales-related activities take place outside the host State and only delivery, by an agent, takes place there, such a situation would not lead to a permanent establishment"; and (b) "if sales-related activities (for example, advertising or promotion) are also conducted in that State on behalf of the resident (whether or not by the enterprise itself or by its dependent agents) and have contributed to the sale of goods or merchandise, a permanent establishment may exist." [117] The independent agent of Article 5 (7) of the United Nations Model Convention may be interpreted as an exception to this paragraph, which makes its effect very limited, especially if it is considered that associated companies are, in principle, regarded as independent when the conditions of that Article are met (see below). This may explain why the United Nations Committee of Experts pointed out, with regard to Article 5 (4), that having a warehouse for delivery would lead to little income being attributed to it;

[116] See paragraph 21 of the Commentary on Article 5 of the United Nations Model Convention.

[117] See paragraph 26 of the Commentary on Article 5 of the United Nations Model Convention.

- An insurance provision (excluding reinsurance) is provided in Article 5 (6) of the United Nations Model Convention whereby a PE is deemed to exist if the foreign enterprise collects premiums in the territory of the other State or insures risk there through a dependent agent;
- Article 5 (7) of the United Nations Model Convention (the independent agent provision equivalent to Article 5 (6) of the OECD Model Convention) adds a sentence considering that the agent loses independence "when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their financial relations which differ from those which would have been made between independent enterprises;
- Article 7 (1) of the United Nations Model Convention follows a limited force of attraction principle whereby the profits of a PE also encompass, apart from those connected with its activities, those attributable to: (a) sales of goods or merchandise of the same or similar kind as those sold through the PE; and (b) other business activities carried out in the PE State of the same or similar kind as those effected through the PE. This is viewed as an objective rule, as it is shown by the observation of some States that the limited force of attraction rule should not apply where an enterprise "is able to demonstrate that the sales or business activities were carried out for reasons other than obtaining treaty benefits," which "recognizes that an enterprise may have legitimate business reasons for choosing not to carry out sales or business activities through its permanent establishment." [118]

Finally, the work of the United Nations Committee of Experts on adding a technical service article in tax treaties is very relevant because, ultimately, it will considerably lower the threshold for taxation of activities in the host State.[119] The update of the United Nations

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[118] See paragraph 7 of the Commentary on Article 7 of the United Nations Model Convention.

[119] See "Note from the Coordinator of the Subcommittee on Tax Treatment of Services: Draft Article and Commentary on Technical Services," presented to the tenth session of the Committee of Experts on International Cooperation in Tax Matters, Geneva 27 – 31 October 2014 (E/C.18/2014/CRP.8),

Model Convention in 2017 will also be relevant in terms of alignment with the BEPS Final Reports. The expected changes are mentioned in the following section.

5.2 Standard for avoidance of PEs in the United Nations Model Convention (a comparison with BEPS Action 7)

In comparison with the OECD Model Convention (2014), the United Nations Model Convention (2011) has a lower PE threshold, the source country has more taxing rights and, as a result, fewer profits escape taxation there. The United Nations Model Convention, however, does not presently take into account the BEPS developments that were released in 2015, since the most recent edition was published in 2011. Especially relevant in the United Nations Model Convention are the service PE rule, the independent agent rule, the force of attraction principle, the warehouse fixed place/agent PE provisions, and the insurance provision. Some attention is given to these provisions in this section, and they are also compared with the new PE threshold derived from BEPS Action 7.

Article 5 (3) (b) of the United Nations Model Convention deserves a special mention, since it contains the most relevant difference in (reduction of) threshold for a PE in comparison with the OECD Model Convention: it introduces a physical presence test into the PE concept to add to the fixed place of business and dependent agent PEs. The physical presence PE in cases of provision of services continues to be an alternative provision in the OECD Model Convention after BEPS. If adopted, this Article reduces the problems of fragmentation of fixed places of business because the geographical coherence test is not relevant as this PE-deeming rule is tied to the concept of physical presence (in the majority view) and the "same or a connected project" test (commercial coherence). Like Article 5 (3) (a) of the United Nations Model Convention, the rule, however, is vulnerable to avoidance through artificial splitting of the project/connected projects

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available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/10STM_CRP8_TechnicalServices1.pdf; or United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, Report on the eleventh session, supra note 115, paragraphs 63–73.

so as not to meet the time threshold among associated companies. Consequently, one relevant issue in this context is whether the requirement that the services be connected to the same or a connected project really makes sense within a test that assumes physical presence as a proxy of economic penetration in a country,[120] although this requirement may be eliminated in the 2017 update to the United Nations Model Convention. In addition, the Commentary on Article 5 of the United Nations Model Convention mentions that "measures to counteract abuse would apply equally under Article 5, paragraph 3, subparagraph (b)" [121] and accepts rules analogous in this respect to those in paragraph 18 of the Commentary on Article 5 of the OECD Model Convention. In this context, the recommendations derived from BEPS Action 7 (to consider artificial cases of splitting of contracts as abusive along the lines of the example given with regard to Action 6, or to add an anti-fragmentation clause, as explained in section 4.4 above) can also have relevant effects in connection with Article 5 (3) (b) as well as Article 5 (3) (a) of the United Nations Model Convention, although, as indicated, the application of anti-abuse rules in this regard were already explicitly admitted in the United Nations context.

In terms of preventing abuse, two differences with the OECD Model Convention also stand out: Article 5 (7) of the United Nations Model Convention (the independent agent clause) and the force of attraction principle. Contrary to how it may appear at first glance, Article 5 (7) of the United Nations Model Convention does not add much, if properly interpreted, to Article 5 (6) of the OECD Model Convention. The provision has a number of interpretative problems and its conditions can be easily avoided by having more than one principal (either related or unrelated) or, better still, by avoiding agency arrangements in the jurisdiction altogether (which is not difficult to achieve).[122] In fact, it may be argued that countries are worse off

[120] See, on this issue, paragraph 12 of the Commentary on Article 5 of the United Nations Model Convention; and "Note from the Coordinator of the Subcommittee on Tax Treatment of Services: Draft Article and Commentary on Technical Services," supra note 119.

[121] See paragraph 11 of the Commentary on Article 5 of the United Nations Model Convention.

[122] See Richard Vann, "The UN Model and Agents: "Wholly or Almost Wholly," (2011) *Sydney Law School Legal Studies Research Paper*.

if this provision is included because it may make the application of anti-abuse provisions more difficult: it would be enough to establish remuneration at arm's length of the agent in order to argue its independence and hence reduce the possibilities of bringing profits accruing to non-resident entities to the tax base of the source country. Unless "arm's length" is interpreted in a non-conventional form, this provision does not guarantee that the source country will increase its taxing rights over groups of companies and related parties. For instance, if cost-plus/TNMM is accepted as the method for remunerating activities of a subsidiary in the source country (routine activities), this will allow the residual value of activities in the jurisdiction to go to the country of residence of the principal. This would mean that as long as the subsidiary does not assume substantial risks and functions regarding, for instance, sales in the same country by the parent, the attribution of profit to it may be very limited.

Moreover, the consequences of a non-arm's length remuneration could be brought into question. For instance, the subsidiary may be a dependent agent within the meaning of Article 5 (5) of the United Nations Model Convention. However, this finding would not guarantee that the parent/associated company would be taxed within the source country—that is to say, as long as the PE tests were not met (fixed place, physical presence or habitually concluding contracts or having stock to deliver merchandise). In this context, the wording of Article 5 (7) of the United Nations Model Convention, in connection with Article 9 thereof, suggests that simply adjusting transfer pricing paid to the subsidiary in the source country would be enough to avoid any problem and, certainly, to avoid the dependent agent PE. Again, this may not be very satisfactory from the source country's perspective, unless a non-conventional approach to transfer pricing is applied. This stance seems to be incompatible with the Authorised OECD Approach to attribution of profits, which basically supports a dual taxpayer approach as opposed to the single taxpayer approach that seems to be at the heart of Article 5 (7) of the United Nations Model Convention (2011).[123] In some cases, however, as explained in section 4.6 above, it

[123] In this vein, see Mukesh. Butani and Parul Jain, "Permanent Establishment Concept—An Indian Perspective," (2014) *Asia-Pacific Tax Bulletin*, 247 ff. These authors have criticized the trend in Indian case law of adopting a single taxpayer approach which, after the Supreme Court decision in the

Morgan Stanley case (*DIT v. Morgan Stanley and Co. Inc.* (2007) 292 ITR 416 (SC)), may lead to the acceptance of arm's length remuneration for Indian subsidiaries of foreign companies with the residual value accruing to non-resident entities, as it is deemed that there is no PE in such cases. The Morgan Stanley case referred to the tax treaty between the United States of America and India (1989) which had a provision on independent agents in line with Article 5 (7) of the United Nations Model Convention. Other authors, however, have taken the view that, on a closer reading, the decision in the Morgan Stanley case is in line with the dual taxpayer approach: see, for example, H. Pijl, "Morgan Stanley: Issues Regarding PEs and Profit Attribution in Light of the OECD View," (2008) Vol. 48, No. 5 *Bulletin for International Taxation*, 174 ff. It must be noted that the decision is somehow ambiguous, even if the majority position, later confirmed by other decisions in India, seems to be in favour of the single taxpayer approach: "The object behind enactment of transfer pricing regulations is to prevent shifting of profits outside India. Under Article 7(2) not all profits of MSCo would be taxable in India but only those which have economic nexus with PE in India. A foreign enterprise is liable to be taxed in India on so much of its business profit as is attributable to the PE in India. The quantum of taxable income is to be determined in accordance with the provisions of I.T. Act. All provisions of I.T. Act are applicable, including provisions relating to depreciation, investment losses, deductible expenses, carry-forward and set-off losses etc. However, deviations are made by DTAA in cases of royalty, interest etc. Such deviations are also made under the I.T. Act (for example: Sections 44BB, 44BBA etc.). Under the impugned ruling delivered by the AAR, remuneration to MSAS [the Indian Subsidiary] was justified by a transfer pricing analysis and, therefore, no further income could be attributed to the PE (MSAS). In other words, the said ruling equates an arm's length analysis (ALA) with attribution of profits. It holds that once a transfer pricing analysis is undertaken; there is no further need to attribute profits to a PE. The impugned ruling is correct in principle insofar as an associated enterprise, that also constitutes a PE, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise. In such cases nothing further would be left to be attributed to the PE. The situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered. Therefore, in each case the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits and that would depend on the functional and factual analysis to be undertaken in each case. Lastly, it may be added should be recognized that the dual taxpayer approach will not result in further, or even relevant, attribution of profits to the PE.

Article 5 (7) of the United Nations Model Convention has some similarities with Article 5 (6) of the OECD Model Convention in the drafting proposed by BEPS Action 7. The independent agent exception will not apply to either Article in certain cases of related parties, but the version derived from BEPS excludes independency of the agent in any case where the latter is acting for closely related parties. That is to say, contrary to the United Nations Model Convention, even if the agent is remunerated at arm's length, independence will not be recognized, which may favour source countries (as explained above, a provision such as Article 5 (6) in the BEPS version may produce unfair outcomes where subsidiaries in a source State are remunerated in the manner of independent agents operating for non-closely related parties). In treaties that contain Article 5 (7) of the United Nations Model Convention, it could also be interpreted that the new configuration of the arm's length principle, as derived from BEPS Actions 8 – 10 (delineation of transactions, works on risks) is also applicable to attribute profits to the independent agent, which may contribute to increased profits of the subsidiary but, contrary to the OECD Model Convention, may not have the effect of recognizing a PE of the foreign principal in the source country. In this respect, it can be said that the BEPS definition of independent agent (new Article 5 (6) of the OECD Model Convention) is probably more favourable for developing countries than the United Nations definition.

The limited force of attraction under Article 7 of the United Nations Model Convention has an evident anti-avoidance connotation but, apart from the interpretative and administrative problems it presents, its effects are very limited.[124] First, it is conceivable that a company could organize its business to carry out only auxiliary activities in a jurisdiction with the core activities being performed outside that jurisdiction or through independent agents, the PE thus

that taxing corporates on the basis of the concept of Economic Nexus is an important feature of Attributable Profits (profits attributable to the PE)."

[124] See Jacques Sasseville and Richard Vann, "Commentary on Article 7 of the OECD Model Convention," in IBFD, *Global Tax Treaty Commentaries* (Amsterdam: IBFD, 2014 – 2016).

being avoided. If there is no PE, the effects of force of attraction will be eliminated. Second, it would be sufficient to turn the PE into a company and the principle of limited force of attraction could then be short-circuited.[125] This would make it possible to operate by fragmenting activities between subsidiaries in the jurisdiction, independent agents and other (non-resident) companies of the group that do not meet the PE threshold. The legal independence of companies of a group is therefore a serious limit to the force of attraction principle. In this context, the new anti-fragmentation rule proposed by the OECD, Article 5 (4) (1) in BEPS Action 7, could act as a complement.

The reduced thresholds for PEs in the United Nations Model Convention make it more difficult to avoid the PE status because of the effects of Article 5 (3) (b) of that Model Convention, although there are doubts as to whether force of attraction could be applied with regard to services in view of the fact that said Article applies on a project-by-project basis. The same can be said of Article 5 (3) (a) of the United Nations Model Convention. In any event, the force of attraction in both cases could easily be avoided by using separate entities for different projects.[126]

The "warehouse PE" in Article 5 (4), without mention of delivery in subparagraphs (a) and (b), and Article 5 (5) (b) (stock agent) of the United Nations Model Convention also reduces the possibilities of avoidance of PE status. However, it is not difficult to avoid the effects of Article 5 (4) and (5) of the United Nations Model Convention (for instance, the warehouse is kept by an independent agent, which, in the United Nations Model Convention, can be a subsidiary remunerated at arm's length, or any other independent party). On this issue, Article 5 (4), (5) and (6) of the OECD Model Convention, as drafted by BEPS Action 7, may achieve similar effects to the United Nations Model Convention or even be more beneficial (even if they are more difficult to apply):

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[125] See A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle*, supra note 30, 339 – 340.

[126] See Jacques Sasseville and Richard Vann, "Commentary on Article 7 of the OECD Model Convention," in IBFD, *Global Tax Treaty Commentaries*, supra note 124.

- Paragraph 22 of the new Commentary on Article 5 (4) of the OECD Model Convention, derived from BEPS Action 7, makes it clear that "a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in State S" will not be covered by such Article. That is to say, if the activities in the warehouse are an essential part of the business, there will be a PE (the problem is that, as explained above, in the new Commentary it is not clear when a warehouse plays that essential role apart from that example). The essential nature of the activity in the warehouse, at least in theory, will avoid the problem pointed out in paragraphs 20 and 21 of the Commentary on Article 5 of the United Nations Model Convention. Almost no attribution of profits to the warehouse would be the rule if warehouses maintained for delivery of goods are regarded as PEs if they are an essential part of the business. However, it still remains to be seen whether essential or relevant warehouses will attract significant profits or not after BEPS Action 7 in the context of the OECD Model Convention (this will only occur if significant functions and risks are identified in the State where the warehouse is located). In Article 5 (4) of the United Nations Model Convention, however, essential or non-essential warehouses for delivery of goods may fall within the fixed place PE, in some cases with no or almost no attribution of profits to the PE, but without presenting the problem of having to decide on the nature of the PE and the warehouse (although the issue of profit attribution may also be problematic and more burdensome for the tax administrations and taxpayers).
- The new drafting of Article 5 (5) of the OECD Model Convention recognizes the dependent agent as a PE, even if that person does not have the authority to conclude contracts in the name of the principal, but still "plays the principal role leading to the conclusion of contracts" for the transfer of ownership of goods of the principal or the provision of services by that principal. This new provision, as with the "stock of goods" dependent agent PE of Article 5 (5) (b) of the United Nations Model Convention, contributes to the fight against commissionaires, although they both focus on different aspects and, therefore, have different

> effects. The new drafting in Article 5 (5) of the OECD Model Convention focuses on the role played by the dependent agent in the negotiation of the contract, whereas Article 5 (5) of the United Nations Model Convention refers to the stock of goods from where goods are distributed on behalf of the principal. Both provisions can be easily avoided (for instance, with a low-risk distributor, removing the principal role in the negotiations for the agent in the new drafting of Article 5 (5) of the OECD Model Convention, or placing the warehouse with an independent agent that does not act wholly or almost wholly on behalf of the principal in Article 5 (5) (b) of the United Nations Model Convention) and this should be taken into account by developing countries. In the case of the provisions of the United Nations Model Convention, the interaction of the stock/warehouse agent (if a related party) with the new transfer pricing rules is also relevant. For instance, if the related party is factually controlling the inventory risks, this will justify a higher attribution of profits to the subsidiary.

It should also be noted that in the end, BEPS Action 7 did not propose an insurance clause similar to that in Article 5 (6) of the United Nations Model Convention, since there could be no justification for a rule that affects only the insurance sector. The new drafting of Article 5 (5) and (6) will address BEPS concerns in this case.

Finally, paragraph 35 of the Commentary on Article 5 (8) of the United Nations Model Convention states the following:

> Determining whether or not a permanent establishment exists on a separate entity basis may entail vulnerability to abusive arrangements. Depending on the domestic law of States, safeguards against purely artificial structures may be found through application of a rule according to which substance overrides form.

That statement does not add much to the interpretation of Article 5 (7) of the OECD Model Convention because, in the final analysis, the principle of separate entities can also be questioned by applying anti-abuse legislation, and the United Nations Model Convention has accepted the principles added after 2005 by the OECD as a reaction to the *Phillip Morris* case in Italy. Respect for legal business forms and free trade also seems to be part of the foundation of the PE concept in the United Nations Model Convention, which limits the margin for application of anti-avoidance doctrines or regulations. The observation in paragraph 35 cited above, therefore, seems to serve as a reminder or clarification. A certain deviation may be identified if the paragraph is interpreted to introduce domestic anti-avoidance standards that could overrule the OECD standard in Article 5 that only those "exclusively tax motivated" structures designed to avoid having a PE may be challenged. It did not seem to be the case, however, because the main pillars of the PE concept and its evolution are also accepted in the context of the United Nations Model Convention, and, as such, this includes the principle of legal independence and separate consideration of PEs of companies within a group.

However, that paragraph may be interesting in a BEPS context since it could be used as a legal basis to achieve similar effects to those of the anti-fragmentation clause that is proposed in BEPS Action 7 with regard to Article 5 (4) of the OECD Model Convention. In fact, as suggested, the clause in paragraph 35 in the Commentary on Article 5 of the United Nations Model Convention may permit source countries to interpret that they can go beyond the limited effects of the anti-fragmentation clause proposed in the BEPS context.

In comparing Article 5 of the OECD and United Nations Model Conventions, even with the changes in BEPS Action 7, it can still be concluded that the United Nations version goes beyond that of the OECD, although BEPS has approximated both articles to some extent. It is true that the new version of Article 5 of the OECD Model Convention and its Commentaries, in a limited manner, give more rights to source countries and that Article 5 of the United Nations Model Convention may need an update to reflect the new realities. But, as explained in section 4, the changes proposed as a consequence of BEPS Action 7 (even in connection with BEPS Actions 8 – 10) are very limited and, in very relevant aspects, Article 5 of the United Nations Model Convention (the service PE or insurance provisions) still continues to favour source countries much more than Article 5 of the OECD Model Convention in its post-BEPS version. Developing countries should, however, consider that Article 5 of the United Nations Model Convention needs some adjustments to take into account the BEPS developments along the lines mentioned above.

It appears that the 2017 update to Article 5 of the United Nations Model Convention will align that Article with the BEPS work and will change the drafting of paragraphs 5 and 7 to bring the definitions of dependent and independent agents closer to the ones proposed in the Final Report on BEPS Action 7. As explained above, it seems that the "same or connected project" requirement in Article 5 (3) (b) of the United Nations Model Convention will also be eliminated.

However, despite the fact that the United Nations Model Convention clearly leans towards more recognition of source-country rights, and in this regard may reduce vulnerability of source countries to (artificial) avoidance of PE status, it has inherent limitations, in line with the OECD Model Convention (in the versions of Article 5 both before and after BEPS). These limitations also make Article 5 of both Model Conventions susceptible to the effects of the most common strategies of company groups aimed at avoiding the presence of a PE in the source State. As a consequence, an effective strategy to counteract these types of behaviours should be considered also by those countries which use the United Nations Model Convention. Additionally, it is easy to avoid having a PE in the context of business models that do not use contrived or abusive structures and simply do not need much presence within the source State, but can still conduct relevant business activity within its borders. If States want to tax these activities, they may need to reconsider their strategies and tax treaty policies, because the PE concept will not help them much in this regard.

6. Strategies against (artificial) avoidance of PE status

6.1 Introduction

In any critical review of the possible routes that can be proposed for developing countries to combat (artificial) avoidance of PE, special importance is attached to administrative concerns: theoretical solutions that are difficult to implement or enforce should be discarded. The term "difficult" is clearly relative and the correct strategy will ultimately depend on the specific situation of individual countries. As explained above, the preferred OECD solution for putting an end to PE tax planning appears to be the application of anti-avoidance rules or doctrines and/or transfer pricing legislation, combined with a slight move in favour of source countries, especially after BEPS Action 7 (in connection with BEPS Actions 8–10, as explained above). It should not be forgotten that the PE threshold operates mainly in favour of residence countries, and this is still the situation after BEPS. The United Nations Model Convention combines reduction of thresholds for taxation in the source country (mainly with the service PE) with anti-avoidance doctrines. The OECD standard after BEPS (Article 5 as derived from BEPS Action 7) and Article 5 of the United Nations Model Convention (especially if revised in 2017 to take into account BEPS Action 7) may help developing countries more than Article 5 of the OECD Model Convention (2014), but they could be complemented with still other options.

For countries with less developed administrations, the best solution probably would be not to focus too much on artificial avoidance of PEs but to concentrate on avoidance of PEs within their jurisdiction and taxation of economic activity within their borders with tools other than the PE concept. This concept is not easy to use by less developed administrations and even if they have a clear idea and policy of what a PE is (which is not easy to determine in view of the different international interpretations of this concept and the vagueness of the Commentary on Article 5 of the OECD Model Convention), the issue of attribution of profits to PEs may represent an insurmountable task for them or may be a source of conflict that they cannot manage in an efficient manner. For these reasons, solutions that shy away from the PE concept may be far easier to apply for some administrations; or, at the very least, they could act as a complement. In this context, BEPS Action 7 is directed more towards limited modification of the PE concept (in connection with transfer pricing rules), and this may not be a solution for countries that want to align taxation and economic activity.

Moreover, in the current international context of competition among jurisdictions, legal certainty is a very important asset. This should be taken into account seriously by developing countries. Being too aggressive with regard to foreign investors may be profitable for tax administrations in some cases, but it may incur collateral damage in terms of reputation, particularly with regard to attracting and keeping other investors. Therefore, any initiative developing countries may adopt should have legal certainty as a precondition and as a goal. This requires that any solution be accompanied by clear administrative measures and legislation, and drafted as part of a process that ensures a certain level of quality and transparency.

Lastly, there is no "best" solution to help developing countries tax economic activity that is carried on within their territory, but there is indeed a set of options that may assist them in trying to find their own framework and policy, depending on the situation regarding their tax systems and administrations. This means that a combination of all or some of the solutions proposed below might be considered.

6.2 Tax treaty policy

6.2.1 Introduction

As explained above, much of the separation between economic activity and taxation in the State of source can be attributed to the specific configuration and interpretation of PE as a concept, with a strong bias in favour of residence taxation. Evolution of business models has also made it easy for some enterprises which do not need a continuous or substantial presence in the State of source to avoid the PE threshold without any trace of artificiality. These problems can be tackled only by changing the tax treaty policy of (developing) countries with a view to realigning economic presence and taxation in the source country. Along these lines, it should be stressed once again that BEPS Action 7 (in connection with Actions 8 – 10) represents only a very timid move in favour of more taxation at source and, therefore, countries that want to capture more profits from activities that have relevant economic consequences upon their territories have to consider the possibilities offered by options that are beyond the BEPS standards.

This solution — reconsidering tax treaty policy — has an advantage over others, especially with regard to anti-avoidance norms or doctrines: if tax treaties are drafted clearly and can be easily administered, they may be much easier to apply than anti-avoidance rules or doctrines, or transfer pricing legislation, when they are used to try to increase attribution of income to local subsidiaries or PEs. Developing countries may not be able to negotiate departures from OECD or United Nations standards with developed countries that have more bargaining power, but they should at least be aware of the options that are present in the international context and try to use them to defend their interests, regardless of their bargaining power and whether they are capable of having those options finally recognized in the tax treaties they may sign.

Taking the above into consideration, there are several options that could be assessed by developing countries. No preference is expressed in this regard, as every country should consider its tax treaty policy in the light of its particular situation. However, these alternatives should be taken into account and assessed before adhering to the multilateral treaty in the context of BEPS Action 15,[127] which will implement the OECD standard derived from BEPS Action 7 (the Multilateral Convention was adopted on 24 November 2016 and will be open for signature in June 2017; it will enter into force after five countries sign it and will be applicable only after a certain period of time, in order to promote legal certainty).

6.2.2 *Adopting the standard of Article 5 of the United Nations Model Convention*

The option of adopting the standard of Article 5 of the United Nations Model Convention has the advantage that it represents a move away from the fixed place of business/dependent agent PE threshold in the direction of taxing at source significant economic (physical) presence, as provided for in subparagraph (3) (b). The specific features of Articles 5 and 7 of the United Nations Model Convention, as explained above, also help prevent some typical avoidance structures, and taxation of services or royalties at source may also help to generate additional income for developing countries.[128] It should be taken into account that, in some aspects, after BEPS Action 7, Article 5 of the OECD and the United Nations Model Conventions have become more aligned, and will become even more so once Article 5 of the United Nations Model Convention has been adapted to BEPS Action 7 in the 2017 update (see section 5.2 above).

[127] OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties*, *Action 15—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/developing-a-multilateral-instrument-to-modify-bilateral-tax-treaties-action-15-2015-final-report_9789264241688-en.

[128] Royalties/services taxation at source is considered in the following section.

However, there are some disadvantages of Article 5 of the United Nations Model Convention that need to be taken into account by developing countries:

- The similarity of Article 5 of the United Nations Model Convention to Article 5 of the OECD Model Convention may not ensure that the source country could tax all the relevant activities that take place within its borders;
- Article 5 (3) (b) of the United Nations Model Convention is neither easy to interpret nor to administer. Some of the most relevant problems are the following:[129]
  - The terms it uses (for example, furnishing of services, enterprise) have no clear-cut meaning and this may create differences in interpretation (for example, there is some dispute about whether "furnishing of services" may be taken to mean in-State provided services or services consumed within the source State;[130] also, it is not clear whether secondment of employees falls under this Article or not);
  - The limitation of the Article to the "same or a connected project," while eliminating the geographical coherence test of Article 5 (1) and (3) of the OECD Model Convention, retains the commercial coherence logic, which reduces the possibilities for source States to tax economic activity taking place

[129] See Brian J. Arnold, "The Taxation of Income from Services under Tax Treaties: Cleaning Up the Mess—Expanded Version," (2011) Vol. 65, No. 2 *Bulletin for International Taxation* (online version); Brian J. Arnold, "The New Services Permanent Establishment Rule in the Canada-United States Tax Treaty," in A. Cockfield, ed., *Globalization and its Tax Discontents* (Toronto: University of Toronto Press, 2010), 280 ff.; Claudine Devillet, "Note on Article 5: The Meaning of 'the Same or a Connected Project'," presented at the ninth session of the United Nations Committee of Experts on International Cooperation in Tax Matters, Geneva, 21–25 October 2013 (E/C.18/2013/CRP.2).

[130] As explained above, this issue has been considered in United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, Report on the eleventh session, supra note 115, paragraphs 9–10, with a view to clarifying the position in the Commentaries on Article 5 of the United Nations Model Convention.

within their borders. Coherence with the physical presence test would call for eliminating the reference to same or connected projects (or at least applying some anti-fragmentation clause in this context);

- The meaning of "same or a connected project" is not clear even if the factors in paragraph 42.11 of the Commentary on Article 5 of the OECD Model Convention can be considered as a point of reference, and further clarification is being pursued by the United Nations on this difficult issue,[131] with the likely goal of eliminating or limiting the effects of this expression in the 2017 update of the United Nations Model Convention;
- It is relatively easy to avoid conditions that fall within Article 5 (3) (b) of the United Nations Model Convention. First, presence of the service provider for more than 183 days needs to be detected, which may not be that simple. Associated companies may divide the "project" so as to avoid meeting that threshold and, even if they do meet it, in line with the Commentary to the United Nations Model Convention which provides for the accumulation of any relevant period of time by applying a rule similar to that given in paragraph 18 of the Commentary on Article 5 of the OECD Model Convention, the association of companies needs to be detected and artificiality of the split needs to be proved (unless objective clauses are added to prevent

[131] In this respect, see ibid., paragraph 31, which explains the following: "In addition, at the tenth session, the Committee had requested that revisions be made to the proposed commentary on article 5 (3), and include some examples to clarify that reference should be made to the perspectives of both the service provider and the customer when determining what constitutes 'the same or a connected project'. The Committee agreed to include such a clarification. With this explicit recognition of the significance of the perspective of the customer, the commentary would include some relevant factors for consideration, such as whether the projects are provided at the same location, whether they would usually be provided under a single contract, whether the services are provided consecutively, whether the projects resulted from the same bidding or negotiation process, whether each project is capable of separate delivery or acceptance and whether a reasonable person would not have entered into the contract as a separate project."

this). Difficulties in application and ease to avoid this type of PE is, however, a feature that service PEs share with other PE clauses;[132]

- Attribution of profit issues are not easy with regard to Article 5 (3) (b) of the United Nations Model Convention. Some countries have abandoned this provision because of the difficulty in deciding what profits can be attributed to this form of PE and because of disputes with their tax treaty partners. The interaction of subparagraph (b) with the limited force of attraction principle in Article 7,[133] or even Article 14 of the United Nations Model Convention, is also unclear when all of these clauses are incorporated in a tax treaty;

- Article 5 of the United Nations Model Convention, by adopting a very similar anti-avoidance threshold to Article 5 of the OECD Model Convention (the threshold of both Articles is closer after BEPS Action 7 (see section 5.2 above)), is also vulnerable to the most important strategies of tax planning adopted nowadays. As explained above, Article 5 (7) of the United Nations Model Convention does not add much to and may even hinder the application of other anti-avoidance devices, or may permit the erosion of tax bases in the source country if the single taxpayer approach is adopted (for instance, as decided by the Indian Supreme Court in the *Morgan Stanley* case).

If Article 5 of the United Nations Model Convention is the preferred option, developing countries may want to consider reducing the time period triggering the application of Article 5 (1) or (3) (for example, to 90 or 60 days), eliminating the reference to project or connected projects in Article 5 (3) (b) or eliminating the second sentence in Article 5 (7) of the United Nations Model Convention and adjusting the wording to some of the BEPS proposals in Action 7. As noted above, the 2017 update will probably bring the drafting of Article 5 (5) and (7) of the United Nations Model Convention in line with the proposals on

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[132] The main issues which are mentioned in paragraphs 42.12 and 42.13 of the Commentary on Article 5 of the OECD Model Convention are not exclusive of service PEs.

[133] See Claudine Devillet, "Note on Article 5: The Meaning of 'the Same or a Connected Project'," supra note 129.

dependent and independent agents of BEPS Action 7, thereby eliminating one of the most serious problems that those paragraphs present in their current form. In view of the above-mentioned disadvantages, and the fact that the PE definition in the United Nations Model Convention is still very similar to that of the OECD, developing countries may also want to consider adopting other measures.

6.2.3 Withholding taxes on services/royalties and other similar measures

Although services or royalties taxation is not the subject of the present chapter,[134] it undoubtedly affects the topic studied here. The option of applying withholding taxes to technical services has been supported by the United Nations Committee of Experts[135] and a new article on technical services that will permit the source country to withhold at source for those services will be included in the United Nations Model Convention (2017). Whatever source rule is chosen, and this is an issue that should be carefully considered, a withholding tax upon services is easy to apply and has the advantage that it changes the function of Article 5 of the United Nations and OECD Model Conventions: having a PE in the source country would be the way to avoid the withholding tax (that is to say, businesses that want net taxation can easily move away from withholding taxes and have a PE). The same is true for withholding taxes on royalties, which are already permitted by Article 12 of the United Nations Model Convention. In addition, withholding taxes allow tax administrations to monitor deductions of expenses paid to non-residents and, therefore, base erosion (although in presumptive systems used by some countries, this information may not be relevant).

Such a withholding tax at source for (technical) services/royalties, which requires clear source rules, also has disadvantages that

[134] See chapter II, "Taxation of income from services," by Brian Arnold; see, on royalties, Adolfo Martín Jiménez, “Commentary on Article 12 of the OECD and United Nations Model Conventions (Including Technical Services),” in IBFD, *Global Tax Treaty Commentaries* (Amsterdam: IBFD, 2014 – 2016).

[135] See United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, Report on the eleventh session, supra note 115, paragraphs 63 – 73.

should be carefully considered. First, if fixed at high rates, it may be an entry barrier to the market as it can discourage foreign enterprises from conducting business within a country; or the tax may be shifted to local companies with the effect of increasing the costs of access to technology or high-value services. Low withholding tax rates may help to overcome this disadvantage. Moreover, having the possibility of levying withholding taxes in a tax treaty does not mean that they have to be levied: if tax treaties permit the source country to tax royalties or services at source, the source country can always decide whether to levy the tax or to give tailored incentives in specific sectors (for example, imports of technology) without being limited permanently (until termination) by a tax treaty.

Second, a well-known problem of withholding taxes is that they are usually levied on a gross basis. Although an elective system of net taxation (non-final withholding tax) can be offered as an alternative to provide a fairer result for the taxpayer, it imposes compliance burdens on taxpayers and withholding agents, as well as on tax administrations, to process the refunds and assess the deductibility of expenses. There are, however, several ways of making the system easier to apply for taxpayers and administrations:

- Withholding taxes may be fixed at a rate that takes into account a (presumptive) profit margin. Foreign investors and tax administrations often prefer this simpler system (some taxation at low rates) rather than having to overcome the hurdle of submitting and processing further applications for refunds. The margin and rates need not be the same for all productive sectors, which makes the system fairer;
- Withholding taxes may be fixed at higher rates and presumptive deductions granted and expressly provided for under domestic law or tax treaties. For instance, the Protocol to the tax treaty between China and Spain (1990)[136] provides, with regard to certain types of royalties, that the withholding tax rate of 10 per cent will be applied only on 60 per cent of the gross amount

[136] Agreement between the Government of the People's Republic of China and the Government of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital, of 22 November 1990.

paid. Once again, presumptions may apply for all services or only for certain types;

- A withhold and refund system may be designed and deduction permitted only for certain expenses (for example, those incurred in the source country, or some of the most relevant expenses), with regard to all types of services or only some of them.

As most of these systems require legislation that cannot be accommodated easily within a tax treaty, a treaty could set a limit (for example, 10 per cent of the gross income) and the system could be implemented within the limit of the treaty through national legislation.

Countries should also consider that levying withholding taxes on royalties may create problems of differentiating royalties and technical services. If withholding taxes are levied for both royalties and technical services, that problem is eliminated (provided the withholding tax rates are the same for both categories); but a new one may arise, that is, how to distinguish technical services and royalties, on the one hand, from different services, on the other (and how the new provision interacts with others in tax treaties that also relate to services in general).

Obviously, withholding taxes on deductible payments (for example, service fees or royalties) cannot be applied where there are treaties in force that follow the OECD Model Convention. In this case, denial of base-eroding deductions or special surtaxes on payments causing base erosion may be an alternative. The configuration of these alternatives should be considered carefully so that they do not affect legitimate transactions, infringe upon domestic constitutional principles or cause double taxation. At the same time, it should be ensured that these measures are compatible with international obligations in tax treaties (for example, Article 24 (4) and (5) of the United Nations and OECD Model Conventions on non-discrimination).

Along this line of possibilities, BEPS Action 6 [137] has proposed adding specific provisions to tax treaties that deal with changes in the tax treatment (special regimes that provide preferential treatment) or allowing exemption of certain types of income in the State of residence. The effects of those new provisions would permit the State of source to apply its domestic withholding taxes without being

[137] OECD Final Report on BEPS Action 6, supra note 12, at 96 – 98.

restricted by the tax treaty. To a certain extent, if there are withholding taxes at source for services and royalties from the outset, there will be no need to apply these complex provisions on special regimes that are not easy to administer. It should be borne in mind that the work on special provisions in BEPS Action 6 is not yet finished and will probably be completed only once the United States of America releases its technical explanation of the definition of special regimes in the United States Model Convention. The definition of special regimes in the United States Model Convention has important differences with the one in BEPS Action 6.

It should be stressed that some structures may not be affected by these measures: for instance, typical agreements for the sale of goods (or some services not regarded as technical) in market countries avoiding the PE threshold, or toll/contract manufacturers that act as service providers. In such cases, other options (for example, lowering PE thresholds or rethinking transfer pricing policies) would need to be considered. In addition, where there are withholding taxes on services or royalties, it may not be unusual to find that there has been an increase in the selling price of goods to domestic subsidiaries that masks the payment of a royalty or even the provision of a service. In these cases, recharacterization of transactions and splitting of the price between that of the good and the royalty would be a useful tool.

6.2.4 Lowering the PE threshold through adoption of specific clauses designed to recognize a significant presence as a PE or to counteract avoidance of it

6.2.4.1 Introduction

Whereas withholding tax or other similar measures on service fees/royalties may be more general in scope and effect, there might be better-targeted solutions for certain sectors or activities. These are based on the reduction of the PE threshold and are considered below. In fact, the solutions presented in BEPS Action 7 mostly pursue a limited reduction of the PE threshold that is designed to counteract the most obvious cases of (artificial) avoidance of PE in the source country. As explained in section 4, they fall short of aligning economic activity and tax base in the source State. To achieve this, developing countries may want to consider other clauses that will reduce the PE threshold.

The different types of clauses examined below do not exclude the use of other categories and all or some of them can be used in combination. An example of their cumulative use is provided in section 6.2.4.6 below.

6.2.4.2 Clauses for exploration and exploitation of natural resources

Some countries use specific clauses to capture income from extractive industries, where vast amounts of money are at stake,[138] thus reducing the PE threshold with respect to Article 5 (1) of the United Nations and OECD Model Conventions. An example can be found in Article 5 (6) of the tax treaty between Ireland and Spain (1994):[139]

> 6. A person engaged in a Contracting State in exploration of the seabed and its subsoil or in exploitation of natural resources situated there, as well as in activities which are complementary or auxiliary to such activities, shall be deemed to exercise such activities through a permanent establishment in that State. However, this provision shall not apply where these activities are carried on in the other Contracting State for a period not exceeding 30 days.

This type of clause — which may have several variations in drafting — overcomes two problems: (a) the fact that these activities are often carried out by using mobile devices that may not be regarded as PEs under Article 5 (1) because they are not fixed; and (b) fragmentation of activities among companies engaged in the same project in order to avoid meeting the time threshold of the PE in the country concerned (this is why the clause refers to "a person engaged" and establishes a very short period of time which triggers the effects of the clause, that is to say 30 days).

[138] The following countries are reported to use these clauses: Australia, Ireland, Japan, Norway, the Russian Federation, the United Kingdom and the United States. See Brian J. Arnold, "Commentary on Article 5 of the OECD Model Convention," supra note 30.

[139] Convention between Ireland and the Kingdom of Spain for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, of 10 February 1994.

Such clauses often pose interpretative problems. In the above-mentioned example, questions arise as to: (a) how "engaged" is defined and what types of activities are covered; and (b) what complementary or auxiliary activities are within their scope, how they are defined and what types of activities are not complementary or auxiliary so that the clause will not apply. Interpretative issues may, however, be mitigated by a more precise drafting, protocols or mutual agreement procedures, but, as there are several types of these clauses in the international tax arena, preference should be given to those that are less difficult to interpret and administer. The interaction with articles on technical services in tax treaties should also be considered because quite often activities that are captured by these clauses will also fall within the technical services provisions. If this occurs, the clause would be a way out of the withholding tax often levied on a gross basis. It should be noted that the source rules may need to be coordinated to cover payments made by non-residents to non-resident companies if these payments are not captured by the technical services provision where the payer criterion is used.

A United Nations handbook on selected issues in taxation of the extractive industries is expected to be published by the United Nations in 2017 and will provide more detailed information on these clauses.

6.2.4.3 Clauses against the splitting-up of contracts/projects

Even before BEPS Action 7, which has proposed a clause against the splitting-up of contracts/projects (see section 4.4. above), provisions against fragmentation continue to be common in the international tax arena and often apply with regard to Article 5 (3) of the United Nations Model Convention. That is to say, where they are included, they also cover provisions equivalent to Article 5 (3) (b) of that Model Convention, and sometimes even other deeming provisions included within Article 5 (3), for example, clauses on the provision of services by individuals. A common example of these clauses is the following, which is included at the end of Article 5 (3) of the tax treaty between Chile and Spain (2003):[140]

[140] Convention between the Kingdom of Spain and the Republic of Chile for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital, of 7 July 2002.

> For the purposes of computing the time limits referred to in this paragraph, activities carried on by an enterprise associated with another enterprise within the meaning of Article 9 shall be aggregated with the period during which activities are carried on by the enterprise to which it is associated if the activities of both enterprises are identical or substantially similar.

It should be noted that the potential effects of this clause in favour of source-country rights are more important if, as is the case with regard to Article 5 (3) of the tax treaty between Chile and Spain, the service clauses are not linked to a particular project and simply provide for a physical presence test regarding the provision of services. Unlike that example, the anti-splitting up of contracts clause derived from paragraph 18.1 of the Commentary to Article 5 of the OECD Model Convention, as proposed by BEPS Action 7, is linked with specific building sites or construction or installation projects, which reduces its effects from the perspective of source countries.

This clause has automatic application and it is not necessary to resort to anti-avoidance provisions for accumulating periods in order to determine whether there is a PE. Therefore, periods may be accumulated regardless of whether there is avoidance or not or whether the splitting of the contract is done in the context of the business model of the group of companies. This means that it captures not only cases of abuse, but also other cases where the division of work between associated companies may be explained by legitimate business reasons.

The clause has, however, several disadvantages:

- Tax administrations should have the resources to detect the presence of associated companies/related parties within their territory for more than the time threshold established in the treaty in order to accumulate the periods of presence of all associated enterprises. For implementation purposes, establishing obligations in this regard on the persons that act as clients can be considered (for example, notification of projects lasting for more than the time threshold, withholding tax obligations, obligation to request the attendance records of employees from the contractor or other companies of the same group, potential liabilities of the clients);

- The application of the clause to "substantial or identical activities" of the different companies providing the service leaves room for debate over when this condition is met;
- The reference to Article 9 includes only associated enterprises—one in a contracting State and another in the other contracting State. It may not be fully effective in cases where the splitting is likely to take place between two or more non-resident companies, a situation that is not covered by Article 9 of the OECD Model Convention. In order to avoid this problem, some treaties provide a definition of associated companies, for example, Article 5 (4) (c) of the tax treaty between the United Kingdom and Australia (2003),[141] Article 5 (5) of the tax treaty between Japan and Australia (2008),[142] or the clause proposed in paragraph 18.1 of the new Commentary on Article 5 of the OECD Model Convention derived from BEPS Action 7, which refers to "closely related companies," within the meaning of that expression in the new Article 5 (6) (b) of the OECD Model Convention (see section 4.4 above);
- Subcontracting by associated companies to non-associated companies should also be covered, although it may be interpreted that the period for subcontractors should be imputed to the principal contractor;
- The clause obviously does not address the fragmentation of the activities which are covered by Article 5 (1), (3) or (4) of the United Nations and OECD Model Conventions. Cases where the geographical and commercial coherence tests may be allowed to apply, for instance, because the effects of the clause are limited per project or do not apply in cases of fixed place PEs in Article 5 (1) of the OECD Model Convention, or even Article 5 (4) of the OECD and United Nations Model Conventions, may have the effect of not triggering the existence of a PE.

[141] Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains, of 21 August 2003.

[142] Convention between Japan and Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, of 31 January 2008.

These types of clauses have been proposed in the OECD Model Convention with regard to the alternative service PE provision in paragraph 42.45 of the Commentary on Article 5 of the OECD Model Convention, or are being considered by the United Nations with regard to Article 5 (3) (b) of the United Nations Model Convention.[143] The main difference between these clauses and the one used as an example above is that they refer to the "same or a connected project" and, therefore, their ability to expand source-country taxation is much more limited. This is because they do not use a mere "physical presence test" and the scope of the service PE provision is limited by commercial coherence.

As mentioned, a similar clause is one of the alternatives (the other deals with the splitting-up of contracts through anti-avoidance provisions) proposed in BEPS Action 7 to combat the splitting-up of contracts with regard to Article 5 (3) of the OECD Model Convention (see paragraph 18.1 of the new Commentary on Article 5 (3)). The effects of the OECD proposal would be much more limited from the perspective of the source country if a service PE paragraph was not included, and also because it applies per project (per PE) and does not have a real physical presence test.

6.2.4.4 Clauses on substantial equipment

Australia often includes a clause in tax treaties deeming a PE to exist if a foreign enterprise has substantial equipment in the source country. For instance, Article 5 (3) (b) of the tax treaty between the United Kingdom and Australia (2003) provides that a resident of the other contracting State will have a PE if that resident

> maintains substantial equipment for rental or other purposes within that other State (excluding equipment let under a hire-purchase agreement) for a period of more than 12 months.

Once again this is a clause that relies on physical presence—in this case, the equipment—within a country to extend the scope of Article 5 (1) of the United Nations and OECD Model Conventions.

[143] See Claudine Devillet, "Note on Article 5: The Meaning of 'the Same or a Connected Project'," supra note 129 (in particular, draft paragraph 12.5 of the Commentary on Article 5 of the United Nations Model Convention).

Developing countries should assess whether it is worth including this type of clause in their tax treaties, for a number of reasons:

- If tax treaties include a withholding tax at source for royalties (including fees for the use of equipment within the definition of royalties) and/or services, or clauses on the exploitation or exploration of natural resources, or other services equivalent to those falling under Article 5 (3) (b) of the United Nations Model Convention, income from "substantial equipment" may already be covered and taxed in the source country. It should be taken into account, however, that these clauses may also apply to leasing of equipment that has a service rather than a letting nature (that is to say, fully manned equipment) that may not be covered by royalty clauses, for instance;
- Under the current approach to attribution of profits to PEs (the 2008 and 2010 OECD Reports on the Attribution of Profits),[144] where significant people functions play a very important part, the presence of equipment only in a State (unless fully manned) may not attract a very relevant tax base to the source country. This would be a disadvantage of the clause, unless the profits attributable to these PEs were linked with the contract that justifies presence of the equipment in the country without taking into account significant people functions. In cases of fully manned equipment (service, not letting contracts), it may be of some help to capture activities taking place within the territory of the source country;
- These clauses are not free from either interpretative problems, such as the meaning of "substantial equipment," or the interaction with Article 8 of the United Nations and OECD Model Conventions.

6.2.4.5 Anti-fragmentation and commissionaire clauses that differ from those in BEPS Action 7

Clauses against the most common avoidance structures of PE status have been used in tax treaties by some countries long before BEPS Action 7. In this respect, the Australian experience — one of the first countries which

[144] Supra notes 71 and 72.

had judicial decisions on these types of tax planning transactions — is a useful example.[145] Australia adds three different types of clauses:

- A deemed PE for non-residents having contract-manufactures/ maquila services in the other country, which may have two forms. It is either included in the equivalent of Article 5 (3)[146] or Article 5 (6) of the OECD Model Convention (in the latter case to facilitate the application of the independent agent exception);[147]
- Article 5 (4) is drafted so that it is clear that the preliminary and auxiliary conditions apply to the whole paragraph and not only to subparagraph (f) (which is one of the options proposed in BEPS Action 7 to reform Article 5 (4) of the OECD Model Convention);
- The equivalent of Article 5 (5) of the United Nations and OECD Model Conventions does not refer to the controversial "in the name of" and mentions only "on behalf of" in connection with the conclusion of contracts. Whereas this change may have to do with specific features of agency law in Australia, it also certainly covers the case of commissionaire structures, which was an early worry in that country as proved by the inclusion of a

[145] See Richard Vann, "Tax Treaties: The Secret Agent's Secrets," supra note 37.

[146] See, for example, Article 5 (3) of the tax treaty between the United Kingdom and Australia (2003): "An enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if: … c) a person acting in a Contracting State on behalf of an enterprise of the other Contracting State manufactures or processes in the first-mentioned State for the enterprise goods or merchandise belonging to the enterprise."

[147] See, for example, Article 5 (7) of the tax treaty between Finland and Australia (2006): "Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 8 applies—is acting on behalf of an enterprise and: a) has, and habitually exercises, in a Contracting State an authority to substantially negotiate or conclude contracts on behalf of the enterprise; or b) manufactures or processes in a Contracting State for the enterprise goods or merchandise belonging to the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for that enterprise, unless the activities of such person are limited to those mentioned in paragraph 6 and are, in relation to the enterprise, of a preparatory or auxiliary character."

commissionaire clause in Article 4 (8) of the tax treaty between Australia and the United Kingdom (1967).[148]

The above clauses may be a good option because they are rather comprehensive and define a PE threshold that substantially reduces the risks of abuse. In fact, the OECD BEPS Action 7 has adopted a similar, albeit more limited approach (for instance, there is no reference to contract manufacturing or the dependent agent PE clause, and Article 5 (5) derived from BEPS Action 7 is less beneficial for source countries).

Because the above-mentioned clauses are to be included within a tax treaty, it will be made clear that the OECD PE threshold (even with regard to Article 5 of the OECD Model Convention as modified by BEPS Action 7) is substantially lowered in that treaty and any potential dissension will be prevented. However, separate consideration of PEs (per PE principle) or groups of companies is still the rule. This leaves some room for avoidance that should be dealt with by domestic anti-avoidance doctrines or rules, or with other relevant clauses or modifications of treaty policy. For instance, Australian reaction in this respect has been to reform its legislation to create a specific anti-avoidance rule that applies to certain types of companies and structures (see section 6.3 below). The issue of attribution of profits to PEs/associated companies also needs attention in these cases and may cause some conflict because both sets of rules (also those in the post-BEPS environment) permit the movement of profits away from

[148] See the Agreement between the Government of the Commonwealth of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland, of 7 December 1967, which stated the following: "Where an enterprise of one of the territories sells to a person in the other territory goods manufactured, assembled, processed, packed or distributed in the other territory by an industrial or commercial enterprise for, or at, or to the order of, that first-mentioned enterprise and: (a) either enterprise participates directly or indirectly in the management, control or capital of the other enterprise, or (b) the same persons participate directly or indirectly in the management, control of capital of both enterprises, then, for the purposes of this Agreement, that first-mentioned enterprise shall be deemed to have a permanent establishment in the other territory and to carry on trade or business in the other territory through that permanent establishment." See also supra note 147 for another clause of this type in the tax treaty between Australia and Finland (2006).

the source country in favour of residence countries, even if clauses such as the Australian ones may permit the attribution of more profits to source country PEs and subsidiaries.

6.2.4.6 Combination of clauses in the PE article

All of the clauses, or a majority of those described, whether or not included in the United Nations Model Convention, that lower the PE threshold can be combined in the PE Article, thus substantially reducing the PE threshold. This reduction can also be mixed with withholding taxes at source for royalties and technical services fees, which would increase divergence from the OECD Model Convention and contribute to lowering the thresholds for taxation at source (this seems to be the route taken by the forthcoming United Nations Model Convention (2017), since it includes a new article on technical services (12 A) which permits the source country to apply withholding taxes at source for related payments; Article 12 of the United Nations Model Convention already permits the source country to apply withholding taxes for royalties).

For example, Article 5 of the tax treaty between the United States of America and India (1989)[149] combines some variations of the clauses studied and a withholding tax at source for royalties and "included services" (services, ancillary and subsidiary, to any property included within the royalty definition or consisting of making available some knowledge or technical plans or design). This treaty, however, replicates the limitation of Article 5 (7) of the United Nations Model Convention and, therefore, independence may be presumed if the subsidiary of a non-resident company is remunerated at arm's length.

An interesting variation is also found in the tax treaty between the United Kingdom and India (1993),[150] which has two distinguish-

[149] Convention between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, of 2 September 1989.

[150] Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, of 25 January 1993.

ing features when compared with the tax treaty between the United States and India:

- Whereas Article 5 has a broad definition of PE very similar to that in Article 5 of the tax treaty between the United States and India, there is a very relevant difference in the independent agent provision which, as drafted in the tax treaty between the United Kingdom and India, excludes independence if the agent acts wholly, or almost wholly, for the non-resident enterprise or associated companies without adding the reference to arm's length remuneration found in Article 5 (7) of the United Nations Model Convention. This provision, which is also in line with BEPS Action 7 and the new independent agent clause in Article 5 (6), contributes to the elimination of some of the problems of Article 5 (7) of the United Nations Model Convention (2011) as arm's length remuneration is not a condition for establishing independence, and even arm's length remuneration of the agent would not preclude attribution of other profits to the PE of the foreign enterprise;
- Article 7 (3) of the tax treaty between the United Kingdom and India attributes to the source State a relevant portion of the profits obtained by the enterprise through contracts which the PE has negotiated, concluded or fulfilled.

These provisions have been used by the tax administration and courts in India to "pierce the veil" of some subsidiaries and attribute to India more than a cost-plus remuneration of the services provided by the Indian subsidiary to its United Kingdom parent.[151]

Countries must be sure, however, that they are able to apply and administer these complex PE (or attribution of profits) provisions also in connection with withholding taxes at source for royalties and technical services in general, or some services in particular (for example, "included services," as in Indian tax treaties).

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[151] See, for instance, Income Tax Appellate Tribunal-Delhi Bench "F" New Delhi, *Rolls Royce Plc. vs. Dy. Director of Income Tax*, 26 October 2007 (2008) 113 TTJ 446.

6.3 Anti-avoidance rules and artificial avoidance of PE status

As described above, applying general anti-avoidance rules (GAARs) or doctrines has been the preferred option for the OECD to counteract PE avoidance, together with respect for business models and the arm's length principle. In this regard, therefore, domestic anti-abuse rules and doctrines should take into account the standard of avoidance internationally accepted or followed by the tax treaty being applied, which may reduce their effectiveness.[152] In particular, with regard to PEs, their history (see section 3 above) shows that only exclusively artificial structures to avoid PEs can be challenged, which may not be in line with the general anti-avoidance standard of the Commentary on Article 1 of the OECD Model Convention or with the standards commonly accepted in domestic legal orders. That is to say, the anti-avoidance standard of Article 5 of the OECD Model Convention is not the same as that developed in the Commentary on Article 1 of the OECD Model Convention or Action 6 of the OECD Action Plan on BEPS. This is because the PE concept is designed to preserve residence-country taxation, which is seen as undesirable only when the PE is avoided based on exclusively tax-driven behaviours. Any business reason or model that avoids a PE is, therefore, protected even if tax reasons play a very relevant role in choosing it. Countries should be aware of this, as the configuration and inherent principles of Article 5 of the OECD Model Convention very much reduce the possibility of applying GAARs to strategies aimed at avoiding having a PE in the source State.

However, because less formal interpretations of Article 5 of the United Nations and OECD Model Conventions than the one proposed by the OECD are possible (even desirable), there is some

[152] See Richard Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 37, 342, where it is suggested that substance over form rules "could be applied to transfer pricing avoidance strategies where nothing of economic substance happens, such as risk shifting by contract within the corporate group. In many cases, however, there is economic substance … corporate restructures often have commercial purposes as well as tax purposes. In that event the application of general anti-avoidance rules becomes more problematic."

scope for using domestic anti-avoidance rules or doctrines.[153] This could be achieved, for instance, by adopting a more economic view of independence and groups of companies. In this context, GAARs (or targeted anti-avoidance rules (TAARs) or specific anti-avoidance rules (SAARs) for specific structures) should be preferable to administrative or judicial doctrines.[154] Although this is not the place to study the advantages and disadvantages of GAARs, which are often (somewhat unfairly) charged with creating uncertainty, it is sufficient to state that they have proved their effectiveness in developing countries, which already have experience in their application or are on their way to testing their usefulness.[155] Moreover, there are ways of reducing the charges of uncertainty against GAARs by regulating an appropriate administrative framework for their application.[156] Tax legislation, administrative instructions or circulars could address the main principles relating to the correct interpretation of GAARs, and could make any necessary corrective adjustments, at least, in the most severe cases. This strategy has several advantages: (a) it provides legal certainty to foreign investors; (b) it unifies the criteria used by different tax offices in a country; (c) it may, depending on its form, also have an important effect upon courts when interpreting tax treaties; and (d) subject to consultations with treaty partners (competent authorities), it also provides certainty in the application of tax treaties and reduces conflicts between jurisdictions. Uncertainty regarding PEs may also be reduced by making the administrative opinions on when

[153] BEPS Action 6 and the principal purpose test/clause it proposes are also not effective for fighting cases of PE avoidance in a source country, since they allow some of the structures used by MNE groups to achieve that outcome in the context of this clause. See Adolfo Martín Jiménez, "Tax Avoidance and Aggressive Tax Planning as an International Standard? BEPS and the 'New' Standards of (Legal and Illegal) Tax Avoidance," supra note 16, section 5.

[154] See Judith Freedman, "Designing a General Anti-Abuse Rule: Striking a Balance," (2014) *Asia-Pacific Tax Bulletin*.

[155] See Cesare Silvani, "GAARs in Developing Countries," *International Fiscal Association Research Paper* (Amsterdam: International Fiscal Association, 2013).

[156] See, Judith Freedman, "Designing a General Anti-Abuse Rule: Striking a Balance," supra note 154.

there is artificial avoidance of PEs public, or, alternatively, by publicizing the decisions taken by administrative boards in charge of deciding whether there is avoidance of domestic rules on this issue. In addition, an advance ruling procedure could be established to determine whether or not some structures are PEs.[157]

It should be recalled, however, that GAARs are there to ensure that laws and treaties are not interpreted too literally, not to create completely new rules. They cannot be used, therefore, to turn Article 5 of the United Nations and OECD Model Conventions into a completely new and different rule. If GAARs, or too aggressive interpretations thereof, are used to overrule the main principles and more conventional interpretation of the PE concept, the position of a country may suffer from the perspective of legal certainty and attraction of investment.

In this context, the new Australian Multinational Anti-Avoidance Law[158] is a reaction to BEPS along the lines described above: Australia has created a specific anti-avoidance clause designed to counter the schemes adopted by MNEs (with a turnover of 1 billion Australian dollars or more) to avoid having a PE in Australia while at the same time conducting business within Australian territory. The advantages of this measure are that it clearly delineates the avoidance standard that Australia will be accepting in cases where a PE is avoided for tax reasons. The disadvantages are that this measure may not be in line with the original standard that the OECD or a treaty partner accepted as avoidance in the case of PEs (although it is designed to be applied in a context where Australia has already lowered the PE threshold significantly, as explained above), or even with BEPS Action 7. This clause may also be difficult to administer for developing countries. On the other hand, by focusing only on specific taxpayers that have a high

[157] This kind of advance agreement on whether there may be a PE or not is also a risk-management tool that permits countries to concentrate on taxpayers that have not approached the tax authorities.

[158] For an official explanation of the new Australian provision, see the web page of the Australian Tax Office (ATO) where the main features of this clause are described, available at https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Doing-business-in-Australia/Combating-multinational-tax-avoidance---a-targeted-anti-avoidance-law/.

turnover, and by embedding in a law the case where the measure will apply, legal certainty is promoted and administration is eased.

6.4 Some unilateral reactions

Dissatisfaction with the PE threshold has led some countries to enact measures, both before and after BEPS Action 7 was finalized, that go beyond BEPS.

First, the United Kingdom introduced a 25 per cent tax on structures or arrangements that avoid having a PE within its borders (the diverted profits tax (DPT)), which went into effect on 1 April 2015.[159] In its PE variant, the DPT applies where goods are sold or services are provided in the United Kingdom by a non-United Kingdom company and it is reasonable to assume that the structure is organized in order to avoid having a PE in the United Kingdom. Small or medium-size companies are not subject to the tax, and an exemption is provided for supplies of goods and services not exceeding £10 million for a 12-month accounting period.

This tax is, in fact, a substitute for GAARs in the United Kingdom or the reduction of PE thresholds in tax treaties. In view of how complex the tax and its application may be, and the fact that it may not be compatible with tax treaties, other countries, especially developing ones, should probably not follow this path for the time being, but could monitor its development. Even though the tax seems to be designed not to formally breach the treaty obligations of the United Kingdom, it is doubtful whether that is achieved (it may breach the equivalent of Articles 2, 5 and 7 of the OECD Model Convention included in United Kingdom tax treaties). In addition, it is a non-conventional move that departs from the consensus on BEPS Action 7 (in fact it is uncertain, at the time of writing, whether the United Kingdom will adhere to the articles in the OECD Multilateral Convention that implement BEPS

[159] See the official guidance on the Diverted Profits Tax by the United Kingdom Tax Administration available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf. A somewhat similar base-protecting surtax was also proposed in Bret Wells and Cym Lowell, "Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin," (2011) Vol. 65, *Tax Law Review*, 604 ff.

Action 7). It is also likely that the DPT will ultimately be challenged, because it breaches tax treaties or European Union law (at least in the period before "Brexit" is finalized). On the other hand, it seems that the measure is having a practical effect and securing additional taxes from companies with structures that avoided having a PE within the United Kingdom and have reached agreements with the United Kingdom tax authorities to avoid being affected by the DPT.[160]

The Indian equalization levy on internet advertising[161] is another unilateral post-BEPs reaction. It is a 6 per cent tax on business-to-business payments for "specified services"[162] provided by non-residents in India to residents carrying on a business in India or non-residents having a PE in India.[163] The payer of the service has the obligation to deduct the levy from payment and the payment is not deductible for income tax purposes unless the levy has been paid to tax authorities. The levy will not apply if the service provider has a PE in India and the services are connected with the PE or payments do not exceed 1 lakh (100.000) rupees.

This new levy seems to have originated as a consequence of several judgements by Indian courts that concluded, against the opinion of the tax administration, that there was no PE of a foreign company doing business in India or with Indian taxpayers. The tax

[160] On the agreement between Google and the United Kingdom, see, for instance, "Google Tells Parliament It Won't Pay 'Google Tax' in U.K.," Bloomberg News (online), 11 February 2016, available at http://www.bloomberg.com/news/articles/2016-02-11/google-tells-parliament-it-won-t-pay-google-tax-in-u-k

[161] On this levy, see D. P. Sengupta, "The Indian Equalisation Levy," 23 March 2016, available at http://www.taxindiainternational.com/columnDesc.php?qwer43fcxzt=MjQ1; and Amar Mehta, "Equalization Levy' Proposal in Indian Finance Bill 2016: Is It Legitimate Tax Policy or an Attempt of Treaty Dodging?" (2016) Vol. 22, No. 2 *Asia-Pacific Tax Bulletin*; or Mukesh Butani and Sumeet Hemkar, "Indian Equalisation Levy—Progressive or Regressive?" 27 June 2016, available at http://kluwertaxblog.com/2016/06/27/indian-equalisation-levy-progressive-regressive/.

[162] "Specified service" means online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement, and includes any other service as may be notified by the Central Government.

[163] Finance Act 2016, No. 28 of 2016, effective 1 June 2016.

administration and Parliament in India would seem to have interpreted BEPS Action 1 (Addressing the Tax Challenges of the Digital Economy) as legitimizing this levy, whereas this Action only mentions that equalization levies are a possibility for some countries, although these levies may breach tax treaty obligations. The disadvantage of the levy, therefore, is that it may not be compatible with tax treaties in force in India and will probably cause litigation with an uncertain outcome for the tax administration and the taxpayers. If, however, it is explicitly acknowledged in tax treaties that the treaties do not apply to the levy, it may be an option for taxing taxpayers without PEs.

Some countries are also trying to levy similar taxes as indirect taxes to prevent treaty-based challenges.[164] And still others are designing and enforcing expansive interpretations of tax treaties that may go beyond the concept of PE in Article 5 of the OECD or United Nations Model Convention. For instance, that is the case for Turkey with the electronic place of business PE,[165] or Israel with its expansive interpretation of the PE concept for companies doing online activities in Israel.[166] Spain has also traditionally interpreted the concept of

[164] See Mukesh Butani and Sumeet Hemkar (2016), "Indian Equalisation Levy—Progressive or Regressive?" available at http://kluwertaxblog.com/2016/06/27/indian-equalisation-levy-progressive-regressive/. These authors explain that "Japan has introduced a consumption tax at 8 percent on provision of cross border digital services to Japanese residents. Argentina has introduced a turnover tax withholding system for revenues derived by non-residents from rendition of online services, wherein 3 percent of the net price is to be withheld at the time of remitting funds abroad. Australia has issued guidance on a new law that will apply GST to international sales of services and digital products from July 1, 2017."

[165] See Ayse Devranoglu, "Turkey Introduces 'Electronic Place of Business' Concept," (online) (25 April 2016), available at www.internationaltaxreview.com/Article/3548543/Turkey-introduces-electronic-place-of-business-concept.html?utm_source=Compliance%20Management&utm_medium=email%20editorial&utm_content=Editorial&utm_campaign=635968432652711823&utm_term=Turkey%20introduces%20%u2018electronic%20place%20of%20business%u2019%20concept.

[166] Henriette Fuchs, "'PE or Not to BE'—Taxing the Online Activities of Foreign Companies in Israel" (2016) Vol. 82, *Tax Notes International*, at 877–879.

PE in an expansive form that is not in line with Article 5 of the OECD Model Convention and even goes beyond BEPS Action 7.[167]

All of the different initiatives mentioned in the previous paragraphs hold in common the desire of source countries to increase their tax bases while being prevented from doing so by the PE threshold in tax treaties. These initiatives, however, have the disadvantage that their compatibility with tax treaties is doubtful. Mainly at issue are conflicts with Articles 2, 5 and 7 of the OECD and United Nations Model Conventions, which may be more or less clear depending upon the configuration of the specific tax or interpretation. To the extent that these initiatives are not in line with tax treaties, they may fuel conflicts between taxpayers and tax authorities, create legal uncertainty and, in some cases, double taxation. They will also reduce the practical effects and consensus around BEPS Action 7 and the November 2016 Multilateral Convention, to be signed in early June 2017, to implement BEPS Action 15.

6.5 Transfer pricing rules

As explained above, the current framework of transfer pricing and attribution of profits to PEs and subsidiaries (pre- or post-BEPS) promotes, rather than prevents, the separation of economic activities from tax bases for source countries. As is the case with PEs, developing countries need a clear agenda with regard to the implementation and application of the arm's length principle.[168] Consequently, transfer pricing rules, as they are today, are of limited use in the context of artificial fragmentation of operations or transactions undertaken to avoid having a PE in a jurisdiction. As noted earlier, the current conventional transfer pricing analysis can frequently be used as a shield to defend artificially fragmented structures, even if this result is questioned more and more by tax administrations.

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[167] See Adolfo Martín Jiménez, "The Spanish Position on the Concept of a Permanent Establishment: Anticipating BEPS, Beyond BEPS or, Simply, a Wrong Interpretation of Article 5 of the OECD Model?" (2016) Vol. 70, No. 8 *Bulletin for International Taxation*.

[168] See, for instance, IMF, "Spillovers in International Corporate Taxation," supra note 26.

As a consequence of BEPS Actions 8 – 10, there have been significant changes in the OECD Transfer Pricing Guidelines (the effect of the Guidelines will depend upon each domestic legal order). The new context is characterized by some features that are worth stressing even though they have already been referred to in section 4.7:[169]

- Delineation of transactions and risks: Value chains of multinational groups have to be delineated not only to take into account contracts, but also the factual reality (value chain) of the group. In this context risks can no longer be shifted simply by contracts. Risks are linked with factual control of risk and capacity to bear it. In itself, emphasis on factual control of risks and capacity to bear them is a weak source rule that will facilitate tax planning of multinationals in the post-BEPS era.
- Intangibles are regarded as the main value drivers in multinational groups (at the expense of capital and labour): Over-attribution of residual profits of groups to intangibles in the new context is a rule in favour of more technologically advanced countries. Subsidiaries that do not add value to intangibles (as defined in Chapter VI of the OECD Transfer Pricing Guidelines) and simply play routine functions (for instance, low risk distribution, contract-manufacturing and support services) will be attributed little profit (with a cost-plus/TNMM method) and, therefore, the residual benefits of the group will flow to countries where intangibles are controlled and value is added.
- The current configuration of the PE principle, as derived from BEPS Action 7, supports the effects of the current transfer pricing rules: The PE threshold, as derived from Action 7, reinforces the outcome that transfer pricing rules produce and permit groups to avoid taxable presence/reduce profit attribution in source countries.

It is true that in the current BEPS context the situation of developing countries is slightly better: if relevant risks are factually controlled within the jurisdiction where a subsidiary claims that it

[169] For a more detailed explanation of the new context, see Adolfo Martín Jiménez, "Tax Avoidance and Aggressive Tax Planning as an International Standard? BEPS and the 'New' Standards of (Legal and Illegal) Tax Avoidance," supra note 16.

simply carries on a routine activity, the profits linked with control of those risks can be attributed to that company (for instance, if a low-risk distributor controls inventory or has marketing intangibles). Transfer pricing rules will permit the country of the subsidiary to correct the benefits of the subsidiary to take into account the real functions and risks it performs. However, transfer pricing rules, together with the PE threshold in Article 5 of the OECD Model Convention (derived from Action 7) and the system of attribution of profits to PEs, still give multinational groups a broad margin for conducting activities within a jurisdiction and even erode tax bases there without much tax exposure in that country.

However, in addition to the new understanding derived from BEPS Actions 8 – 10, transfer pricing rules could help a source country retain a relevant part of the tax base that might otherwise be allocated to the residence country. Several options are being considered and developed either by international institutions or by some developing countries. As it is not the objective of the present chapter to deal with transfer pricing issues, suffice it to say that some examples are mentioned in the United Nations Practical Manual on Transfer Pricing for Developing Countries.[170] For instance, fixed profit margins are used in Brazil for distribution of products.[171] China adopts an approach aimed at correcting what is seen as overvaluation of purchases by local subsidiaries and undervaluation of functions — sales, marketing and distribution — and considering value location savings and other specific advantages and, in general, the contribution of local subsidiaries to global supply chains.[172] A similar approach is adopted by

[170] United Nations, Department of Economic and Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2013), available at http://www.un.org/esa/ffd/wp-content/uploads/2014/08/UN_Manual_TransferPricing.pdf. A second edition of this Manual is forthcoming.

[171] Ibid., 358 – 374.

[172] Ibid., 374 – 388. See also Richard Ainsworth and Andrew Shact, "UN Transfer Pricing Guidelines: China's Contribution to Chapter 10," (2014) Vol. 74, No. 12 *Tax Notes International*, 1147 ff. It seems that developed countries are also using similar approaches: see, for instance, Pinakin Desai and Shefali Goradia, "Cross Border Outsourcing: Issues, Strategies and Solutions," in *Cahiers de droit fiscal international* (The Hague, The Netherlands: SdU Uit-

India to correct the profits of local subsidiaries by adequately valuing marketing intangibles or the contribution of local subsidiaries to the group's profits.[173] In the case of both China and India, the cost-plus method is deemed not to give a correct outcome in terms of valuation. Other examples are related to fixed margins for some sectors (for example, hotels and resorts). This was the case in the Dominican Republic[174] where fixed margins were applicable until enough experience and information on the relevant sectors was obtained. Other proposals from different perspectives to make more intensive use of profit splits[175] could also be taken into account.

The main advantage of these new trends in transfer pricing rules and methodologies is that a broader tax base is allocated to subsidiaries located in developing countries. But this requires adequate legislation to be in place, as well as capability in transfer pricing analysis that not all countries have. For these reasons, the IMF has suggested that developing countries should develop a specific agenda for building transfer pricing capability while applying other transitional measures.[176] Within these measures, account should be taken of the fact that reduction in the thresholds for taxation either in the PE Article or through withholding taxes upon royalties and services may help these countries to capture some revenue linked with activities carried on within their territories. Moreover, developing countries should remember that transfer pricing rules should be effectively linked with the PE concept, as adopting a single taxpayer approach when local

gevers, 2014) Vol. 99a, where it is reported that the Canadian authorities are also using an aggressive approach to define "location savings" and attribute higher margins to local subsidiaries.

[173] United Nations, Department of Economic and Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries*, supra note 170, 388 – 409.

[174] See Fernando Velayos and Alberto Barreix, "Towards a New Form of International Taxation: the View from Latin America and the Caribbean," (2013) Vol. 41, No. 3 *Intertax*, 128 ff.

[175] See IMF, "Spillovers in International Corporate Taxation," supra note 26, and Richard Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," supra note 37.

[176] IMF, "Spillovers in International Corporate Taxation," supra note 26, 33 – 34.

subsidiaries are regarded as PEs (as in India after the *Morgan Stanley* case or in Article 5 (7) of the United Nations Model Convention) may contribute to erosion of the tax bases of source countries.

It should not be forgotten that transfer pricing rules may also apply in the case of the restructuring of a business group which is aimed at compensating distributors or manufacturers for their loss of benefits, activity in the creation of intangibles, transfer of know-how, and so forth. In the post-BEPS context (BEPS Actions 8 – 10), the transfer of functions (and, therefore, of risks and intangibles) from one country to another will be a very relevant tax planning tool,[177] which will require targeted legislation to curb it. However, rules in this respect are probably too complex to be applied by countries with limited resources and knowledge of transfer pricing, or which have less sophisticated tax systems.

6.6 Administrative measures tailored to identify PEs

Finally, identification of PEs may be a challenge for those administrations with fewer resources. This means that, for less developed tax administrations, the priority is probably to have rules that would permit the early detection of PEs (and to sanction effectively and proportionately non-reporting of PEs[178]). In this connection, they may wish to consider implementing some of the following measures that would enable them to do so. For instance, India introduced, effective April 2012,[179] annual reporting obligations for liaison offices (conducting auxiliary activities in India), which seek to obtain information about: (a) the activity in India of the foreign entity to which the liaison office belongs and other entities of the same group operating

[177] See Adolfo Martín Jiménez, “Tax Avoidance and Aggressive Tax Planning as an International Standard? BEPS and the ‘New’ Standards of (Legal and Illegal) Tax Avoidance,” supra note 16.

[178] On the issue of sanctions on unreported PEs in the current context of uncertainty regarding whether or not there is a PE, see Jonathan Schwarz, “Hidden or Accidental PEs and Penalties” (24 January 2016), Kluwer International Tax Blog, available at http://kluwertaxblog.com/2016/01/24/hidden-or-accidental-permanent-establishments-and-penalties/.

[179] Notification No. 5/2012 of 6 February 2012. The author wishes to express his gratitude to D.P. Sengupta, Principal Consultant, National Institute of Public Finance and Policy, New Delhi, for his assistance on this subject.

in India (for example, sales and purchases and services to and from India; details of the products sold and agents used by the group in India; identification and activity in India of other companies of the same group or their liaison offices; other group entities operating from the same premises); (b) the human resources used by the liaison office and those visiting it (for example, number of employees and salaries); and (c) clients and projects located in India. The reporting form must be signed by the chartered accountant of the company in India or by the person so authorized on its behalf by the non-resident person. Similar information is to be provided to the Reserve Bank of India before setting up a liaison office. Developing countries may wish to consider establishing this obligation with regard to foreign entities with a fixed place of business within their territory that claim the benefits of Article 5 (4).

Reporting obligations, penalties and liabilities may also be established for clients and subcontractors of non-resident companies claiming not to have a PE in the source country in specific sectors that are more vulnerable to tax avoidance (for example, large construction works and engineering projects, exploitation and exploration of natural resources, and distribution of specific foreign products). These could also be applied to specific service providers to non-resident entities (maquilas, distributors, and so forth) and/or subsidiaries of foreign companies. The scope of these reporting obligations should be limited to the information that can be provided by those subjects and should be aimed at discovering any relevant business activity performed by the foreign head office/group within the source country. Thus, for example, clients and subcontractors could provide information on specific contracts; distributors could do so regarding their activity, products distributed and links with other entities of the same group in the same jurisdiction; and subsidiaries could provide information about other activities of the group in the same jurisdiction that are similar to those requested in India for liaison offices—or they could simply be required to provide some basic information about activities of the group in the jurisdiction within their tax return (apart from the transfer pricing documentation obligations mentioned below). Withholding taxes in targeted sectors (construction, services, and so forth) may be even more effective than the present reporting obligations to detect PEs through the refund procedure.

Additionally, country-by-country reporting and transfer pricing documentation, as recommended in BEPS Action 13,[180] may be very relevant risk-management tools for developing countries with regard to PE issues and may even obviate the need to establish some specific reporting obligations. This is one of the reasons why not only the country of residence of the parent company of a group should have access to country-by-country reporting. If local authorities do not have access to such reporting, they may feel inclined to impose more reporting obligations locally on group subsidiaries, possibly adding to the administrative burden of groups of companies (master file and taxpayer documentation obligations must be in line with the OECD standard to avoid creating undue burdens for multinationals). Any local documentation should be tailored to identifying the real activity of a group of companies and PEs within the jurisdiction of the source State and could be accompanied by fair penalties to be effective, but it should not create undue burdens for taxpayers. In this context, reporting obligations should be designed to take into account the new transparency requirements derived from BEPS Action 13 in order to avoid unnecessary burdens for taxpayers. This requires that countries have legislation on transfer pricing documentation (master file and taxpayer documentation), staff who can assess the country-by-country reports received, and reporting obligations in tax returns that are coordinated with transfer pricing documentation and the information obtained in country-by-country reports.

Specific audit programmes may also be established for subsidiaries of foreign companies (for example, the accounts of the subsidiaries of foreign companies would easily reveal whether there was a shift of risks/functions outside the jurisdiction) in general, or for specific sectors or transactions (for example, business restructurings, strategic sectors). In this regard, although anecdotal, a judgement in India stated that LinkedIn profiles of employees of a foreign entity were relevant evidence that led to the conclusion, in the context of a tax audit, that there was a PE in India.[181] Internet searches of this kind, in addi-

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[180] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 — 2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report_9789264241480-en.

[181] Income Tax Appellate Tribunal, *GE Energy Parts Inc. v. ADIT*, 4 July 2014 (ITA No. 671/Del/2011).

tion to material made available on the web pages of companies and groups, will provide very useful information.

Effective exchange of information with other administrations within the same country (for example, exchange controls, social security, visa authorities) is also crucial in this respect for identifying business activities taking place within a jurisdiction.

Specific administrative measures will depend on the situation of each country and should be proportionate and adequate to the goals they are intended to achieve and their administrative capacity; they also should not create undue burdens for good-faith taxpayers.

Chapter VIII

Protecting the tax base in the digital economy

Jinyan Li*

1. Introduction

Protecting the tax base in the digital economy is Action 1 of the Organisation for Economic Co-operation and Development (OECD) project on Base Erosion and Profit Shifting (BEPS).[1] The reason is simple: "International tax rules, which date back to the 1920s, have not kept pace with the changing business environment, including the growing importance of intangibles and the digital economy."[2] They can no longer distribute taxing rights fairly among countries and adequately define a country's tax base.

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[1] At the request of the G20 Finance Ministers, in February 2013, the Organisation for Economic Co-operation and Development (OECD) prepared a report outlining the BEPS issues, and in July 2013, followed up with an Action Plan, which was to address those issues in a coordinated and comprehensive manner. Specifically, it was to provide countries with domestic and international instruments that would better align rights to tax with economic activity. Draft reports for public consultation on each of the 15 actions were released in 2014 and the Final Reports were released in 2015. At their 2015 summit, the G20 leaders committed themselves to implementing the BEPS recommendations. OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (Paris: OECD, 2015) (hereinafter "OECD Final Report on BEPS Action 1"), available at http://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en, is largely consistent with the draft report. These reports were prepared by the Task Force on the Digital Economy, a subsidiary body of the OECD Committee on Fiscal Affairs (CFA).

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

Existing international tax rules are based on fundamental assumptions that include the following: tax laws are creatures of sovereign States and national tax laws interact via bilateral tax agreements; transactions are physical, involving goods and services; physical locations are necessary for carrying on business activities; and international income is allocated for tax purposes between the residence country and source country. These assumptions are disrupted by the digital economy, which is inherently borderless, intangible, characterized by an unparalleled reliance on intangible assets, massive usage of data (notably personal data) and widespread adoption of multisided business models capturing value from externalities generated by free products. The digital economy threatens the tax base of the corporate income tax (CIT) and the value added tax (VAT) by facilitating BEPS and potentially causing the tax base to disappear (base cyberization). The problem of BEPS is not unique to the digital economy, but is, and will be, exacerbated by it. BEPS is the result of tax planning designed to take advantage of gaps in the interaction of different tax systems. This includes artificially reducing taxable income or shifting profits to low-tax jurisdictions in which little or no economic activity is performed. The targeted BEPS structures are "artificial" in that they are undertaken primarily for tax purposes. Digital enterprises, such as Amazon, Apple, Facebook and Google are among the top BEPS practitioners.

The problem of base cyberization is of a different nature—the income is not in a country's tax base because the current rules are inapt to capture it. This is a more fundamental issue with much broader policy implications than BEPS. In a digital economy, multinational enterprises (MNEs) can "legitimately" separate profit and profit-generating activities through new business models made possible by technological advances. For example, base cyberization occurs when MNEs can sell goods and services to developing countries without the need for a local business presence or without falling within the jurisdictional threshold. It is the result of the collision of new business models coupled with an increasing proportion of unconventional value added activities and the existing tax rules designed to carve out the sovereign territory for taxation on some form of physical presence. The collision creates substantial challenges in taxing business transactions undertaken not only by major global technology conglomerates, but also other businesses that are less wholly "digital" in nature.[3] Addressing BEPS is unlikely to solve the problem of base cyberization.

Developing countries are part of the growing digital economy. The BRICS[4] countries and other emerging markets are significant, if not equal, players in this economy, particularly in the sense of providing essential markets for goods and services delivered through e-commerce platforms. The reason is not only the existing size of the Internet population in these countries, but also the immense growth potential. For example, by 30 June 2016, the Internet population in Africa, Asia, Latin America and the Caribbean, and the Middle East accounted for 73 per cent of the world's Internet users.[5] Whereas 65 per cent of Chinese shoppers make purchases online via their mobile devices, the same is true of only 22 per cent of American shoppers, in spite of the fact that more Americans are Internet users.[6] The disruptive nature of the Internet and digital economy enables people in less developed countries to participate in the world economy without being constrained by geographic, physical barriers. The potential for growth is tremendous. For example, Africa's middle class has reportedly tripled over the past 30 years, and the current trajectory suggests that it will grow to 1.1 billion in 2060, making it the world's fastest growing continent.[7] This growth, coupled with the forecasted gross domestic product (GDP) growth of over 6 per cent, is expected to drive the growth of e-commerce as businesses seize upon opportunities arising

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[3] International Monetary Fund, "Spillovers in International Corporate Taxation," (2014), *IMF Policy Paper*, available at http://www.imf.org/external/np/pp/eng/2014/050914.pdf, at 48, (hereinafter "IMF Spillovers Report").

[4] Brazil, Russian Federation, India, China and South Africa.

[5] Internet World Stats, "Internet Usage Statistics - The Internet Big Picture: World Internet Users and 2016 Population Stats," available at www.internetworldstats.com/stats.htm.

[6] PwC, "Total Retail Survey 2016: Online Shoppers Around the World are Fundamentally Disrupting Retail – Again," (2016), available at http://www.pwc.com/gx/en/industries/retail-consumer/global-total-retail.html.

[7] Deloitte, "The Rise and Rise of the African Middle Class," (2013), available at http://www2.deloitte.com/content/dam/Deloitte/au/Documents/international-specialist/deloitte-au-aas-rise-african-middle-class-12.pdf.

from the growing number of digitally empowered consumers, who are opting to purchase goods and services online.[8]

The tax base of developing countries is presumably more at risk than that of OECD countries. The CIT usually figures more prominently in developing countries than in developed countries in terms of its share of the total tax revenues.[9] The VAT generates the largest share of tax revenue in many developing countries.[10] As a result, any erosion of the tax base of the CIT and/or the VAT could have profound consequences on the revenue capacity of developing countries. Furthermore, the loss of tax revenue is presumably more urgent and real in developing countries as they are net importers of digital goods and services.

To protect their tax base while embracing the digital economy, developing countries need to participate in the "globalization of tax policy" and work with and through international organizations to develop international tax rules that can take into account their interests as source or market jurisdictions. Interestingly, the technological advances that enable the growth of the digital economy may further help developing countries improve overall efficiency in their tax administration and transform them into more modern tax systems.

The present chapter aims at exploring the options available for developing countries to protect their tax base in the face of the growing digital economy.[11] It draws on the work of the OECD[12] and

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[8] E-commerce news, "Potential for Retail Growth in Africa," (2014), available at http://www.bizcommunity.com/Article/196/394/112923.html.

[9] IMF Spillovers Report, supra note 3, at 7.

[10] Richard M. Bird and Pierre-Pascal Gendron, *VAT in Developing and Transitional Countries* (Cambridge University Press, 2007).

[11] Because the digital economy issue cuts across all sectors of the economy and all forms of BEPS, the scope of the present chapter can potentially be very broad and overlap with that of other chapters in this publication, particularly Chapter II, "Taxation of income from services," by Brian Arnold, and Chapter VII, "Preventing avoidance of permanent establishment status," by Adolfo Martín Jiménez. To the extent possible, the present chapter will defer to these other chapters on general issues and principles and focus on digital services and unique PE issues arising from the digital economy.

[12] For instance, see OECD Final Report on BEPS Action 1, supra note 1; OECD, "Electronic Commerce: Taxation Framework Conditions," as pre-

reports by the European Commission Expert Group on Taxation of the Digital Economy,[13] the French Task Force on Taxation of the Digital Economy,[14] and the Davis Tax Committee,[15] along with recent legislative measures introduced by selected countries and literature on the taxation of e-commerce and the sharing economy.[16] After a brief overview of the current international tax rules in section 2, sections 3 and 4 examine the key features of the digital economy and the main challenges for the tax base of developing countries. Section 5 suggests some policy options for developing countries and section 6 concludes the chapter.

The present chapter offers several conclusions. First, BEPS and base cyberization affect predominantly market jurisdictions. The CIT base of these jurisdictions is eroded or lost primarily because the rules that define a country's source-based taxing rights are outdated and ineffective for the digital economy. The VAT base is eroded due to difficulties in enforcing and collecting tax. Because developing countries

sented to Ministers at the OECD Ministerial Conference on 8 October 1998; and paragraphs 42.1–42.10 of the Commentary on Article 5 of the OECD Model Tax Convention.

[13] European Commission (EC), *Commission Expert Group on Taxation of the Digital Economy Report* (2014), available at http://ec.europa.eu/taxation_customs/taxation/gen_info/good_governance_matters/digital_economy/index_en.htm.

[14] Pierre Collin and Nicolas Colin, "Task Force on Taxation of the Digital Economy," (2013), available at http://www.hldataprotection.com/files/2013/06/Taxation_Digital_Economy.pdf.

[15] Davis Tax Committee, "Addressing Base Erosion and Profit Shifting in South Africa," Davis Tax Committee Interim Report, available at http://www.taxcom.org.za/docs/New_Folder/1%20DTC%20BEPS%20Interim%20Report%20-%20The%20Introductory%20Report.pdf (see Action 1: Address the Tax Challenges of the Digital Economy).

[16] For instance, see Richard Doernberg, Luc Hinnekens, Walter Hellerstein and Jinyan Li, *Electronic Commerce and Multi-Jurisdictional Taxation* (The Hague: Kluwer Law International, 2001); Arthur J. Cockfield and others, "Taxing Global Digital Commerce," (2013); Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2002); and Shu-yi Oei and Diane M. Ring, "Can Sharing Be Taxed?" (2016) Vol. 93, No. 4 *Washington University Law Review*.

are predominantly market jurisdictions, the impact of BEPS and base cyberization is presumably more severe on them.

Second, to protect their tax bases, developing countries need to develop some new tax tools for the new economy, ideally through multilateral efforts. An evolutionary approach is preferable as a radically different tax regime for the digital economy would be unlikely to receive international support and would violate one or more key policy objectives, such as neutrality and efficiency. The United Nations Model Double Taxation Convention between Developed and Developing Countries[17] (United Nations Model Convention) provides more tools for source taxation than the OECD Model Tax Convention on Income and on Capital[18] (OECD Model Convention). Examples are the lower threshold for physical presence or permanent establishment (PE) and withholding taxes on royalties. Extending the policy rationale of these broader source taxation rules to the context of the digital economy seems to be both consistent with the wider policy rationale of preventing BEPS and the right direction for formulating tax measures for the digital age. As regards VAT, there are some best practices for developing countries to consider, such as requiring foreign online vendors to register for VAT if the sales in a country exceed a specified threshold.

Third, while recognizing the merits of an evolutionary approach, the global and intangible nature of the digital economy also calls for some original thinking about where value is created for tax purposes and how States can share the new tax base fairly. New nexus rules or new ways of implementing existing principles are necessary to ensure a fair sharing of the tax base among countries, especially between developed and developing countries.

Fourth, it is in the best interest of developing countries to participate in multilateral efforts to tackle the tax challenges of the digital economy. Economies of developing countries are increasingly tied to the global economy, as is their tax base. The global nature of

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

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

the new economy defies any unilateral nation-centric tax policies or enforcement measures.

2. Tax base of developing countries

2.1 Corporate income tax

The tax base of the CIT is the net profit earned by corporations from various activities, such as trading, manufacturing and processing, retail, extractive and services. The tax rate is generally flat. Corporations are required to file tax returns and self-assess their tax liability.

A country's right to tax international income (or its tax base) is determined by the residence of a corporation and the source of income. The rules defining corporate residence and source of income are found in domestic law and modified in some cases by tax treaties.

Resident corporations are typically required to pay tax on income derived from domestic sources as well as foreign sources. Corporate residence is generally based on the place of incorporation, the place of central management and control, or the place of effective management. Resident corporations generally receive tax relief in respect of foreign income taxes paid on its foreign income.

Non-resident corporations are generally taxable only on income derived from domestic sources. Different jurisdictional nexus (or sourcing) rules apply to business profits and investment income (and capital gains). These are the rules that are most vulnerable in the digital economy.

The foundation of the nexus rule for business income is the same under domestic law and tax treaties — a certain level of physical presence in the source jurisdiction is required, either directly or through the actions of a dependent agent. The physical presence can be manifested by the existence of a physical place or physical presence of human service providers. Many developing countries have concluded tax treaties on the basis of the United Nations Model Convention. The effect of tax treaties is to modify domestic tax laws by limiting the tax jurisdiction of the source country. For example, the nexus rule for business profits is elevated to the level of a PE, requiring a business presence that is "permanent" or "fixed," which is a higher threshold than the rule under domestic laws. Article 5 of the United Nations Model Convention also deems certain services activities to be equivalent to a PE if the activity satisfies a time requirement. A person acting on behalf of the non-resident corporation and habitually exercising an authority to conclude contracts in the name of the corporation is deemed to be a PE. Article 5 (4) further raises the threshold by not considering warehousing, marketing and other "preparatory or ancillary" activities to constitute a PE.[19] Article 5 (8) of the United Nations Model Convention provides that a subsidiary of a foreign corporation shall not of itself constitute a PE of the parent company.

The nexus rule for investment income is generally the same under domestic laws and tax treaties—the residence of the payer or the "base-erosion rule." The base erosion rule traces the source of tax-deductible charges, such as interest or royalties, to the place of PE where the interest or royalty charge is deducted in computing profit attributable to the PE.

In the case of services, the nexus rule depends on the characterization of the service fees as giving rise to business profits, employment income, professional or independent services, or technical services. Typically, the nexus rule requires services be performed in the country.

When a resident corporation and a non-resident corporation are related to each other, such as being members of the same corporate group, their transactions are subject to the transfer pricing rules. These rules require related-party transactions to be priced in accordance with the arm's length principle for purposes of determining the profit of each corporation.

[19] Article 5 (4) of the United Nations Model Convention refers to: "(a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise; (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display; (c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise."

2.2 VAT

VAT is a broad-based tax on the consumption of goods and services. Although taxes are collected by businesses at different stages of production, distribution and sale of goods and services, the ultimate burden of VAT is intended to fall on the eventual consumers. Domestic businesses and certain foreign businesses conducting commercial activities in a given country are required to register for VAT purposes, collect VAT on their sales and claim a credit or refund for VAT paid on their business inputs. For various policy reasons, the supply of certain goods or services is exempt from VAT. Examples are necessities, financial services, basic health and education services, and importation of small-value items.

A country's right to collect VAT on cross-border supplies is based on the destination principle.[20] Under this principle, VAT is levied in the jurisdiction of the final consumer. This means that exports are not subject to VAT (and the associated input tax is refunded to the exporter) and imports are taxed on the same basis as domestic supplies. In the case of imported tangible goods, VAT is generally collected from the importer at the same time as customs duties. To ease compliance, many countries allow an exemption for relatively low-value goods.

In the case of imported services and intangibles, however, applying the destination principle is more difficult. The nature of services and intangibles is such that there are no customs controls that can effectively confirm their exportation and impose the VAT at importation. Currently, there are two approaches in dealing with the imposition of VAT to imported services: (a) self-assessment by the importer

[20] OECD, *International VAT/GST Guidelines* (Paris: OECD, 2014). Some developing countries have not adopted the destination principle. China is one such country. The Chinese VAT system does not differentiate the place of taxation for business-to-business (B2B) and business-to-consumer (B2C) cross-border supplies of services and intangibles. VAT is payable on supplies of intellectual property rights and certain services if either the supplier or the recipient is inside China. China does not have specific tax rules dealing with cross-border supplies of digital content. For importation of intangible supplies, the Chinese VAT requires the importers to withhold VAT and settle tax payments with local tax authorities. In practice, the withholding rules are not strictly enforced against individual importers who do not maintain VAT registration in China.

under a so-called reverse-charge mechanism; or (b) a requirement for non-resident suppliers to register for VAT purposes and to collect and remit the VAT.

Under the reverse-charge mechanism, registered VAT businesses which import services from non-resident suppliers (that is to say, business-to-business or B2B) would have the onus of self-assessing the VAT (or charging themselves the VAT) and claiming an input credit for a tax refund. There is no net tax cost to the importer in such cases. However, if the importer is the final consumer and cannot claim any input credit, there is a risk that the importer would be motivated to abstain from its duty, and not self-assess and remit the tax to the government. It would be very difficult for the authorities to enforce the reverse-charge mechanism in such cases.

Alternatively, under the registration mechanism, non-resident suppliers of selected services must register for VAT purposes once the amount of supply exceeds a defined threshold (see section 5.8 below).

2.3 Fundamental concepts and assumptions

International tax rules are designed to allocate the taxing rights among countries over an international tax base. In the case of CIT, the allocation of taxing rights over income from cross-border transactions is guided by the economic allegiance theory and the benefit theory of taxation. In the case of VAT, the allocation of the tax base on cross-border supplies is guided by the destination principle. Avoidance of double taxation has been a main objective of international income tax.

The residence of taxpayers and source of income are concepts or instruments designed to achieve a fair allocation of taxing rights under the CIT. Both concepts emphasize the territorial connection between a corporation and the taxing jurisdiction. As a fictional entity, a corporation's residence is based on the place of incorporation (a choice of constituting law) or the place of management and control (a choice of situs of management). The source of income is generally based on the place of transaction (such as a sale), the use of property (such as rent) or the residence of the payer (such as a dividend).

When the rules were initially devised, it was safe to assume the following: (a) each country had the sovereign power to set its own tax policy and international tax relations were regulated by tax agreements; (b) a corporation was liable to tax in a country only if it had a taxable presence in that country; (c) corporate residence and source of income were reasonable proxies for the locations where economic activities and value creation took place;[21] (d) businesses were conducted through a physical place or human agents; (e) corporate income could be characterized as income from business, dividends, interest, rent and royalties, or capital gains; and (f) "each country in which an MNE group did business had its own subsidiary with full functionality, carrying out a broad range of activities reflecting the group's business as a whole." [22]

Similarly, the international VAT rules assume that cross-border supplies of goods and services generally require a physical presence (such as a PE) in the market jurisdiction and there are intermediaries between the original producer and the final consumer. Furthermore, even though VAT is eventually paid by consumers, it is collected by the supplier of goods and services.

The way business transactions are done defies some of the fundamental assumptions and challenges the effectiveness or even relevance of existing tax rules. As a result, the tax base of some countries, especially market jurisdictions, is at risk.

3. Business transactions in the digital economy

3.1 Digital economy

The "digital economy" can be described as "the global network of economic and social activities that are enabled by platforms such as the

[21] For example, in *De Beers Consolidated Mines, Ltd. v. Howe*, [1906] A.C. 455 (H.L.), Lord Loreburn stated, at 458:

> In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business .... [A] company resides for purposes of income tax where its real business is carried on .... I regard that as the true rule, and the real business is carried on where the central management and control actually abides.

[22] OECD Final Report on BEPS Action 1, supra note 1, paragraph 231.

Internet, mobile and sensor networks." [23] The spread of information and communication technologies (ICT) across business sectors leads to the growth of the digital economy in both developed and developing countries. The current spread of ICT or broadband connectivity is high in OECD countries (for example, universal for large enterprises and 90 per cent or more for smaller enterprises) [24] and is expanding rapidly in developing countries. [25]

The digital economy is inherently global. The Internet virtually connects everybody who has access to it using a computer or mobile device.

3.2 E-commerce

E-commerce is the better known element of the digital economy. It refers to "the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders." [26] E-commerce includes offline transactions that involve online ordering of goods and services and delivery through traditional channels, as well as purely online transactions involving digital goods and services. Depending on the parties, the activities can be classified as business-to-business (B2B), business-to-consumer (B2C), consumer-to-consumer (C2C), [27] or business-to-government (B2G).

[23] Australian Government, Department of Broadband, Communications and the Digital Economy, "What is the digital economy?" The term "digital economy" was coined by Don Tapscott in *The Digital Economy: Promise and Peril in the Age of Networked Intelligence* (New York: McGraw-Hill, 1995).

[24] OECD Final Report on BEPS Action 1, supra note 1, paragraph 109.

[25] World Economic Forum, Silja Baller, Soumitra Dutta and Bruno Lanvin, eds. "The Global Information Technology Report 2016: Innovating in the Digital Economy," available at https://www.weforum.org/reports/the-global-information-technology-report-2016/.

[26] OECD, *Guide to Measuring the Information Society 2011* (Paris: OECD, 2011). See also World Trade Organization, *E-Commerce in Developing Countries: Opportunities and challenges for small and medium-sized enterprises* (Geneva: WTO, 2013), available at https://www.wto.org/english/res_e/publications_e/ecom_devel_countries_e.htm.

[27] C2C transactions are becoming more and more common. Businesses involved in this model play the role of intermediaries, helping individual

B2B commerce accounts for the vast majority of global e-commerce,[28] although it accounts for less in developing countries.

In terms of e-commerce involving digital goods, services and intangibles, developing countries are net importers, especially as regards B2C transactions.[29] Cross-border B2C e-commerce has been growing in BRICS countries with the growth of the middle class and connectivity to the global networks in these countries.[30] China led all other countries in B2C and C2C purchases by the end of 2013.[31] Specific reasons for cross-border online shopping include: greater selection of products online — popular categories of goods bought online include computer hardware, personal electronics, apparel and accessories as well as automobile parts (particularly in the Russian Federation); higher level of consumer trust in quality, and time-saving; and perhaps most importantly, cost-saving.[32] One of the reasons for

consumers to sell or rent their assets by publishing their information on the website and facilitating transactions. An example of this would be eBay.

[28] OECD Final Report on BEPS Action 1, supra note 1, paragraph 118.

[29] The major exporters are developed countries such as France, Germany, the Netherlands, the United Kingdom of Great Britain and Northern Ireland and the United States of America. Brazil, China and the Russian Federation are among the top online retail importers. China was ranked number 1 in the Global Retail e-Commerce Index in 2013, Brazil was ranked number 8, and the Russian Federation number 13. See yStats.com, *Global Cross-Border B2C E-Commerce* (2014), available at http://www.ystats.com/product/global-cross-border-b2c-e-commerce-2014/; *ATKearney 2013 Global Retail Development Index*, available at http://www.atkearney.com/consumer-products-retail/global-retail-development-index.

[30] In 2014, the Internet penetration rate (number of Internet users per 100 population) was 57.6 per cent in Brazil, 49.3 per cent in China, 18.0 per cent in India and 70.5 per cent in the Russian Federation. World Bank (2016), "Internet users (per 100 people)," available at http://data.worldbank.org/indicator/IT.NET.USER.P2.

[31] See KPMG, "E-commerce in China: Driving a New Consumer Culture," (2014) No. 15 *China 360*, available at http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/China-360/Documents/China-360-Issue15-201401-E-commerce-in-China.pdf.

[32] For further information, see Research on International Markets, "Russia B2C E-Commerce Report," (2012), *Market Report*; Market Watch, "East-

the price advantage is tax.[33] The popular international websites for B2C transactions are those hosted by companies in the United States of America, such as Amazon, and other developed countries.[34]

Similar growth trends exist in other developing countries. In 2014, for example, the Asia-Pacific region was expected to claim more than 46 per cent of global digital buyers and to spend more on e-commerce purchases than North America, and the potential to grow remains huge as Internet users currently account for only 16.9 per cent of the Asia-Pacific region's population.[35] Similarly, Africa's e-commerce has been defined and accelerated by mobile networks. To promote e-commerce, entrepreneurs are reportedly contemplating circumventing the barriers of road transportation by opting for air transportation, even drones.[36] In Latin America, social networks are propelling the boom in e-commerce in the region. Moreover, 74 per cent of Internet users in Latin America regularly use social media sites such as Facebook or LinkedIn.

Companies in developing countries take advantage of e-commerce in cross-border trade, especially B2B trade in goods. For

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ern Europe B2C E-Commerce Report 2013" ; Deloitte, "Doing Business in Russia 2014," available at http://www2.deloitte.com/content/dam/Deloitte/ru/Documents/tax/doing_business_in_russia_2014.pdf.

[33] For example, in the Russian Federation, parcels are not subject to customs duties and import VAT if they do not exceed 31 kg in weight and 1,000 euros in value each month per recipient. In the case of intangibles (such as computer programs, e-books, music or video content), there is no concept of electronic import in the Russian Federation, allowing the content to be delivered to Russian users tax-free.

[34] Some of the websites are also hosted by Chinese companies, such as Alibaba.

[35] See "India, China to help APAC become largest e-commerce market in 2014," *The Economic Times* (online), 18 February 2014, available at http://articles.economictimes.indiatimes.com/2014-02-18/news/47451222_1_e-commerce-emarketer-emerging-markets.

[36] See Monty Munford, "The African Version of Amazon Will Emerge from Nigeria," (2014) *Mashable*, available at http://mashable.com/2014/03/18/nigeria-ecommerce-drones/. For further information, see "Africa B2C E-Commerce Report 2013," *Market Reports*, available at http://www.ystats.com/product/africa-b2c-e-commerce-report-2013/.

example, Chinese companies sell into other countries.[37] Alibaba's top foreign markets are Australia, the United Kingdom of Great Britain and Northern Ireland, the United States and, more recently, Brazil, the Russian Federation and the Middle East.[38] Exports by small and medium-size enterprises (SMEs) in developing countries are aided by B2B e-commerce. For example, 15,000 SMEs in India export a variety of Indian handcrafted products to 190 countries. That is "just the tip of the iceberg,"[39] as many small businesses still do not have their own website and are looking to the third-party B2B exchanges/marketplace platforms to gain access to new markets.[40]

The potential benefits of e-commerce can be illustrated by the Dell business model.[41] Dell relied on e-commerce to support a virtual company. Orders for computers are placed with Dell by telephone or through the Internet. Through the process of just-in-time (or lean) manufacturing, items ordered by customers are produced by contract manufacturers and shipped as soon as they are manufactured. This approach enables Dell to forgo having brick-and-mortar store fronts with inventory that must be kept on the books or that might become obsolete, thereby significantly reducing the costs of production and sales. This process allows Dell to custom design systems for its

[37] In 2015, it was reported that five of the top fifteen websites on the worldwide web were Chinese: Baidu, Hao123.com, Sina Corp., Taobao and Tencent QQ. See http://www.alexa.com/topsites. Other top 15 websites were: Amazon, Facebook, Google, Google India, LinkedIn, Twitter, Wikipedia, Windows Live, YouTube and Yahoo.

[38] Alibaba launched the world's largest initial public offering (IPO), raising over US$ 21 billion in September 2014. See *The Wall Street Journal*, "What is Alibaba?" available at http://projects.wsj.com/alibaba/. Transactions on Alibaba's online sites totalled US$ 248 billion in 2013, more than those of Amazon and e-Bay combined, and the majority of Alibaba's transactions take place inside China.

[39] Ibid.

[40] On India's Internet industry, see "India: Already Booming E-commerce Market Continues to Grow," (2014).

[41] See Kenneth Kraemer and Jason Dedrick, "Dell Computer: Using E-commerce to Support the Virtual Company" (2001), Center for Research on Information Technology and Organizations, University of California, Irvine, available at http://escholarship.org/uc/item/7r55529z.

customer within certain parameters as well as to offer a range of items rather than a single system.

3.3 New business models

In addition to e-commerce, the digital economy has given rise to a number of innovative business models, products and services, such as online app stores, online advertising, cloud computing, payment services, high frequency trading and participative networked platforms. Participants of the digital economy include Internet giants such as Facebook and Google as well as, more importantly, traditional businesses whose activities are linked and enhanced through the use of ICT.

There is a variety of revenue models in the digital economy, including: (a) the advertising-based model, under which the company offers content, services and/or products and provides a forum for advertisements and receives fees from advertisers (for example, Facebook and Google); (b) the subscription model, under which the website that offers users content or services charges a subscription fee for access to some or all of its offerings (for example, Consumer Reports Online, *The New York Times*, and so on); (c) the sales model, under which a company derives revenue by selling goods, information or services to customers (for example, Amazon.com and Gap.com); (d) the licensing content and technology model, under which a company provides access to specialist online content (for example, publications and journals), algorithms, software, cloud-based operating systems, and so on, or a specialist technology such as artificial intelligence systems; and (e) sale of user data and customized market research models, used by Internet service providers (ISPs), data brokers, data analytics firms, and enterprises requiring telemetrics and data gained from non-personal sources. In addition, some companies may charge a fee for enabling or executing a transaction: examples are eBay, E*Trade and Airbnb.[42]

[42] For example, Airbnb provides a platform for people who have space to rent (hosts) to travellers. Hosts and travellers create a free Airbnb account so they can list their space and book accommodations anywhere in the world. Airbnb charges a fee for their services.

3.4 Key features

3.4.1 Remote connectivity

Connectivity of the Internet and other platforms enhances the ability of companies to carry out activities remotely and to expand the number of potential customers that can be targeted and reached. It enables companies to generate revenue from customers located in foreign jurisdictions without having any old-fashioned business presence in those jurisdictions. Such connectivity also increases "the flexibility of businesses to choose where substantial business activities take place," and as a result, "it is increasingly possible for a business's personnel, IT infrastructure (for example, servers), and customers each to be spread among multiple jurisdictions, away from the market jurisdiction." [43] Digital businesses are, thus, intrinsically global; the "where" issue is neither here nor there. [44]

3.4.2 Dematerialization

Dematerialization [45] in the context of the digital economy refers to the transformation of any material object into something of virtual or digital quality. Anything that can be digitized can be delivered online or dematerialized. A common example is the online sale and delivery of information or entertainment products which used to be delivered in physical forms, such as books, newspapers, movies or television shows. Furthermore, advances in 3D printing technologies have the potential to transform manufactured goods (for instance, machines and spare parts) into intangibles (such as licence plans and specifications) that allow customers to manufacture the physical items whenever customers actually need them. [46]

[43] OECD Final Report on BEPS Action 1, supra note 1, paragraph 254.

[44] Borrowing from Bill Bryson, *Neither Here nor There: Travels in Europe* (New York: William Morrow — Harper Collins Publishers Inc., 1993).

[45] The dematerialization of a product literally means less or no physical material is used to deliver the same level of functionality to the user. See Iddo K. Wernick and others, "Materialization and Dematerialization: Measures and Trends," (1996) Vol. 125, No. 3 *Dædalus, Journal of the American Academy of Arts and Sciences*, 171 – 198.

[46] 3D printing is defined as "additive manufacturing techniques to create

Dematerialization is also manifested by the increasing value attributable to "intangibles." Even when a product remains tangible in form, such as a car or telephone, much of its functionality and value is driven by artificial intelligence. More pervasively, dematerialization occurs in the expansion of the scope of services. Services can be delivered digitally as opposed to face to face. Goods can be transformed into services, deliverable online. For example, in the early days, computer software had to be installed onto a computer locally by means of a physical disc. Today, many software applications assume the virtual form of a website (for example, Dropbox) that provide a service accessible over the Internet without the need for any local medium of delivery. The service can be about providing access to content (as a portal) or about providing access to executable code performing certain features. Conventional services can now be identified by the prefix "e" and can be delivered online. Examples are advertising, auction services, banking and finance, broadcasting and publication, education, entertainment, health care, insurance, logistics services (such as transportation, warehousing and distribution) and travel.

New services arising from the digital economy are largely virtual or digital. Examples are the services of information technology (IT), ISPs, application service providers (ASPs), network operators and telecommunications, web-hosting and cloud computing. For example, through cloud computing, software, data and other resources are transformed into services, known as "X-as-a-Service" (XaaS). Customers are granted access to resources that are not stored on a single computer, but instead on many networked computers that are available to everyone who has access to that "cloud" of computing resources. Cloud computing often provides customers with a cost-effective alternative to purchasing and maintaining their own IT infrastructure because the cost of the consumer resources is generally shared among a wider user base.[47]

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objects by printing layers of material based on digital models," James Manyika and others, *Disruptive Technologies: Advances that Will Transform Life, Business, and the Global Economy* (McKinsey Global Institute: 2013). See also OECD Final Report on BEPS Action 1, supra note 1, at paragraph 93.

[47] OECD Final Report on BEPS Action 1, supra note 1, paragraphs 140 – 146.

Dematerialization in the digital economy does not, however, mean that everything is virtual. Human beings remain important as producers and consumers. Physical delivery of tangible goods remains a significant part of e-commerce. Also, some people may still want to test products before ordering online. However, the proportion of e-commerce involving "intangibles" or "digitized goods and services" is rising.

3.4.3 Multiple roles of the consumer in value creation

In a digital economy, consumers are empowered and turned into "free workers" for digital companies. "Consumers are more empowered than ever before"[48] as they have more choices, more convenience, more bargains and more say in how they want to be "served."[49] Unbeknown to them, they are also contributors to the value-creation process. They seem to create value in at least two ways: as part of an "ecosystem enabling a continuous, symbiotic and reciprocal relationship of value exchange" and as a source of big data.[50]

[48] The Insider White Paper, "Rise of the Empowered Consumer: How to Reach Audiences in 2012," (2012) MediaCom, available at http://www.mediacomusa.com/media/2088012/mediacom%20the%20insider_the%20empowered%20consumer_whitepaper.pdf.

[49] Internet users who shop online tend to be middle class, more educated, younger and more autonomous. The rise of social media has also offered an instant global platform for sharing ideas. There has been a recent shift in the balance of power "from developed markets to the developing world and from institutions such as governments to individuals, who exercise their new power as consumers to gain information to their advantage." See Gregory Carpenter, "Power Shift: The Rise of the Consumer-focused Enterprise in the Digital Age," (2013), available athttp://www.reviewtrackers.com/wp-content/uploads/Rise-of-the-Consumer-Focused-Enterprise-1.pdf. A 2012 survey found that 70 per cent of customers use their smartphones to read reviews, 61 per cent to compare prices and products and 42 per cent to contact the retailer. More and more, these individuals are doing these activities while they are shopping. See also Stephanie Clifford and Claire Cain Miller, "The shrewd shopper carries a smartphone," *The New York Times*, 22 November 2012.

[50] Comments of the BEPS Monitoring Group on the OECD Public Discussion Draft on BEPS Action 1, "Address the Tax Challenges of the Digital Economy," published on the OECD Website and available at https://bepsmonitoringgroup.files.wordpress.com/2014/04/bmg-digital-economy-submission-2014.pdf.

Unlike the relationship between suppliers and consumers in the traditional economy, the relationship is no longer one of a passive, discrete nature, but rather symbiotic and continuous, and creates real economic value. Such a relationship may be cultivated through the supply of a bundle of hardware, a stream of services, and new products or enhancements. An example of this is Apple, who has bundled the sale of hardware (for example, the iPhone) and software or services (for example, the App Store). These symbiotic relationships can also be the product of participative networked platforms, such as Wikipedia and YouTube. These platforms allow users to generate user-created content, such as product reviews, creative or how-to videos, and social media sharing, which add value by attracting an audience and provoking interactions between users and businesses. Frequent updating of content increases a website's visibility in search results, which drives the value of advertisement.

Consumers play a more important role in multisided business models or platforms, which are the modern versions of the ancient village market and matchmakers.[51] Prominent platforms include Alibaba, Amazon, eBay, Facebook and Google, each of which carries a global reputation and is virtually a mini-kingdom on its own. This business model is based on a market in which "multiple distinct groups of persons interact through an intermediary or platform, and the decisions of each group of persons affects the outcome for the other groups of persons through a positive or negative externality."[52] "In a multisided business model, the prices charged to the members of each group reflect the effects of these externalities. If the activities of one side create a positive externality for another side (for example more clicks by users on links sponsored by advertisers), then the prices to that other side can be increased."[53]

[51] Andrei Hagiu, "Multi-Sided Platforms: From Microfoundations to Design and Expansion Strategies," (2006), available at www.hbs.edu/faculty/Publication%20Files/07-094.pdf; and Andrei Hagiu and Julian Wright, "Multisided Platforms," (2011), Harvard Business School Working Paper 12-024, available at http://faculty.chicagobooth.edu/workshops/marketing/past/pdf/MultiSidedPlatformsHagiu.pdf.

[52] OECD Final Report on BEPS Action 1, supra note 1, paragraph 173.

[53] Ibid., paragraph 174.

Customers are an irreplaceable source of data generation. Data is intrinsically valuable. Big data means big value.[54] It is an important factor of production, alongside labour and capital.[55] Companies use the data collected to gather insights for product development, marketing and customer service. "Big data—large pools of data that can be captured, communicated, aggregated, stored, and analyzed—is now part of every sector and function of the global economy."[56] Big data creates value by, among other things, creating transparency, improving performance management, developing more precisely tailored products or services, improving decision-making, and improving the development process of new business models, products and services.[57] More potential value lies in the use of social media to enhance communications, knowledge sharing, and collaboration within and across enterprises.[58]

[54] See David Dean, Carl Kalapesi and John Rose, "Unleashing the Value of Consumer Data," (2013), The Boston Consulting Group, which states: "Every second of the day, a wealth of data stream from a global maze of social networks, smartphones, point-of-sale devices, medical records, financial transactions, automobiles, energy meters, and other digital sources. Such big data, fuelled largely by personal data about all of us, represent an asset class every bit as valuable as gold or oil." available at www.bcgtelaviv.com/documents/file124851.pdf.

[55] James Manyika and others, "Big Data: The Next Frontier for Innovation, Competition, and Productivity," (2011), McKinsey Global Institute, available at http://www.mckinsey.com/business-functions/business-technology/our-insights/big-data-the-next-frontier-for-innovation; and World Economic Forum, "Unlocking the Value of Personal Data: From Collection to Usage," (2013), available at http://www3.weforum.org/docs/WEF_IT_UnlockingValuePersonalData_CollectionUsage_Report_2013.pdf.

[56] James Manyika and others, "Big Data: The Next Frontier for Innovation, Competition, and Productivity," supra note 55.

[57] Ibid.

[58] It was estimated by the McKinsey Global Institute that by fully implementing social technologies, companies have an opportunity to raise the productivity of interaction workers—high-skill knowledge workers, including managers and professionals—by 20 to 25 per cent. See Michael Chui and others, "The Social Economy: Unlocking Value and Productivity through Social Technologies," (2012), *McKinsey Global Institute Report*, available at http://www.mckinsey.com/industries/high-tech/our-insights/the-social-

4. Tax challenges for developing countries

The above business models and features of the digital economy raise important questions about where and how much profit is earned for tax purposes. The dematerialization and mobility features of the digital economy are, fundamentally, at odds with the existing tax policymaking process and tax principles which were developed for the traditional economy.

The digital economy challenges the tax base of market jurisdictions because it has features that render the existing tax rules inapplicable. In a digital economy, knowledge and information (data) is considered a main production factor, in addition to the three major production factors of an industrial, capitalist society—labour, capital and land. Digitization of core economic activities, such as production, distribution and consumption of goods and services, turns tangibles into intangibles, physical things into digital bits and bytes.

4.1 National tax sovereignty in a borderless world

Existing CIT and VAT laws applicable to cross-border transactions are creatures of national tax sovereignty. Cross-border coordination is achieved through formal bilateral tax treaties in the case of CIT or the adoption of international norms or best practices in the case of VAT. There are no formal global tax institutions, legal instruments or processes for addressing cross-border tax issues. The OECD has been a de facto world tax organization in terms of developing the OECD Model Convention and its Commentaries, as well as guidelines on transfer pricing and other international tax issues. At best, these amount to "soft law" for OECD countries and would have, expectedly, no legal effect on non-OECD countries. The United Nations plays an increasingly important role in the area of international taxation but, similar to the OECD, it also has no tax law-making power.

The digital economy is borderless in nature. It offers opportunities for businesses (especially MNEs) to exploit differences between and among national tax laws in order to minimize their tax obligations

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economy; and James Manyika and others, Big Data: The Next Frontier for Innovation, Competition, and Productivity," supra note 55.

in host or home jurisdictions. At the same time, different national tax laws may also cause double or multiple taxation of income arising from cross-border transactions.

4.2 Physical presence in the digital economy

Jurisdictional nexus under existing tax laws of developing countries is based on physical and tangible connections between a taxpayer and a taxing country. These connections include residential ties or territorial source of income. Under bilateral tax treaties, the jurisdictional threshold for business income is that of a PE, which requires an element of "permanency" in the activity. In the digital economy, a PE is either not needed or can be more easily circumvented.

4.2.1 Physical presence not needed in market jurisdictions

Since e-commerce requires little, if any, physical presence in the market jurisdiction, an offshore company can carry on business through a website in the market country without any physical presence. In the following examples, the company located in Country S does not need to have any physical presence in Country C where its customers are:

1. Mr. A, a resident of Country C, purchases a book from BookCo, a publishing company located in Country S. BookCo maintains its server outside Country C and delivers the book to Mr. A via an independent courier service.
2. Ms. B, a resident of Country C, places an order to purchase milk powders from MilkCo, a company located in Country S via MilkCo's website. MilkCo's server is outside Country C and its business personnel and production facilities are located in Country S. Ms. B pays for the purchase with her credit card. MilkCo leases warehouse space in Country C to store its products. MilkCo's agent in Country C handles the orders and delivers the goods to Ms. B.
3. Cco is a company located in Country C and operates a fashion retail store, featuring products designed and made by FashionCo, a company in Country S. Cco's orders are placed online and payments are made via credit card. The merchandise is delivered through air shipping.

4. Mr. D, a resident of Country C, is enrolled in a language training class offered by LanguageCo located in Country S. Mr. D watches on his computer or mobile phone videos produced by LanguageCo in Country S and has one-on-one tutorial lessons with an instructor once a week via Skype.
5. CCo, a resident of Country C uses CloudCo to store and manage its data and its Intranet. CloudCo is located in Country S and maintains its servers outside Country C.

In the above scenarios, the company located in Country S is not considered to have the necessary taxable presence (to carry on business through a PE) in Country C. A website is not regarded as a sufficient taxable presence. A digital business can locate its website on servers outside the market country and deliver digital goods and services online, barring any legal or logistical issues as well as any Internet controls imposed by the host Government. Social network providers may not need any physical presence in the market country to reach their users. Conventional sales outlets in the market country can be replaced with online licensing of software or specifications if the products can be produced through 3D printing.

It is therefore possible for an offshore company to interact with customers (B2B or B2C) in a country through a website or other digital means without maintaining a physical presence in that country. Remote servers are often not needed in the market country as they can be located anywhere where ICT infrastructure is available. This point is illustrated by the *ITO v. Right Florists Pvt Ltd*[59] case in India. In this case, the taxpayer, Right Florists, was a company based in India which advertised on search engines supplied by Google (Ireland) and Yahoo (United States) to generate business. Both Google and Yahoo had web servers located outside of India. The issues were whether the payments to Google and Yahoo were subject to Indian withholding tax as "technical service fees" and whether Google and Yahoo earned the fees through a PE in India. The Tribunal held that the advertising fees were not technical services and a search engine, which has only its presence in India through its website, cannot be a PE.

[59] Income Tax Appellate Tribunal Kolkata "B" Bench, Kolkata, *Income Tax Officer v. Right Florists Pvt Ltd*, I.T.A.No. 1336/Kol./2011.

4.2.2 *Avoiding a PE*

E-commerce and new business models in the digital economy enable MNEs to sell goods and services in market countries with a significant business presence, but to avoid having a PE. This can be achieved through: (a) avoiding an agency PE; (b) taking advantage of the exceptions under Article 5 (4) of the OECD Model Convention; or (c) fragmenting business activities to avoid the temporal threshold of a PE.

A commissionaire arrangement is an example of avoiding an agency PE. An example of this is where the sales force of a local subsidiary of an online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modification by the parent company. These arrangements may not result in a PE for the parent company because the contract was not formally concluded by the subsidiary.

Article 5 (4) of the OECD Model Convention excludes a list of activities in the market country from giving rise to a PE. When the list was originally devised, these activities were of a "preparatory or auxiliary" character. For example, where an online seller or supplier of services and intangibles sets up a website and an office in the market country to support the technical aspects of the website and complete e-commerce transactions, it is unlikely to have a PE because of the list of exceptions. Another example is the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers.

Rapid advances in ICT have meant that services such as data entry, information processing, research, consulting, design and training can increasingly be carried out remotely or carried out by different parties of the MNE group. The amount of time spent in the market country can therefore remain below the time requirement (less than 183 days) for having a PE in that country. For example, the services of architects, such as schematic design, consultation and development of construction documents can be rendered remotely.

4.3 Attribution of profit and value creation

In the digital economy, machines (computers, mobile phones and other devices) are connected by the Internet and perform functions that were traditionally performed by humans. With advances in artificial intelligence, this trend will continue. The transformation to software-driven business challenges the existing tax rules not just in respect of the jurisdictional nexus, but also in the determination of value creation and profit attribution. Under the existing rules, attribution of profit is based on assets, ownership of intangibles and risks. Little or no profit is attributed to the role of the market, connectivity infrastructure provided by the market country, or the role of customers in generating data which is critical to the success of the digital business.

4.3.1 Limitations of supply-side factors

The limitations of attributing profit to supply-side factors are illustrated by three Indian cases: *Galileo International Inc. v. DCIT*,[60] *Amadeus Global Travel v. DCIT*[61] and *Travelport L.P. USA, New Delhi v. Assessee.*[62] In these cases, the facts are similar and the decisions were consistent. The taxpayers were found to have a PE in India, but no profit was attributed to the PE.

In the *Travelport* case, for example, the taxpayer developed and maintained a fully automatic reservation and distribution system with the ability to perform comprehensive information, communication, reservation, ticketing, distribution and related functions on a worldwide basis. The computers installed on the premises of the subscribers in India were connected to the global central reservation system (CRS) owned and operated by the non-resident company. The taxpayer provided the subscribers with a computer modem and software so that they could access the CRS. A host computer (server) was situated in the United States. Using part of the CRS, the subscribers in India were

[60] Income Tax Appellate Tribunal, *Galileo International Inc. v. DCIT* (2008) 19 SOT 257 (Del).

[61] Income Tax Appellate Tribunal, *Amadeus Global Travel v. DCIT* (2008) 113TTJ (Delhi) 767.

[62] Income Tax Appellate Tribunal, *Travelport L.P. USA, New Delhi v. Assessee* (2015) available at https://indiankanoon.org/doc/176227912/.

capable of reserving and booking a ticket. The taxpayer also authorized its local agent to conclude contracts with subscribers. It paid one third of its gross revenue to the local agents as commission. The Tribunal found that the taxpayer had a fixed place of business PE in India as well as an agency PE. Notwithstanding the presence of a PE, the Tribunal found that the taxpayer had no profit attributable to the PE since 15 per cent of its gross revenue was sourced to India and the fees paid to its agent in India were one third of its gross revenue. In other words, the Indian source gross revenue was less than the fees paid to the agent in India, hence no profit.

The Tribunal attributed 15 per cent of gross revenue to the PE based on an analysis of functions performed, assets used and risk shared inside and outside of India. It stated that "but for the presence of the assessee in India and the configuration and connectivity being provided in India, the income would not have been generated." [63] However, it also found that "the extent of work in India is only to the extent of generating request and receiving end-result of the process in India … the majority of the assets, i.e., host computer which is having very large capacity which processes information of all the participants, is situated outside India." [64] The major functions, such as collecting the database of various airlines and hotels which had entered into a participating carrier agreement with the taxpayer, took place outside India; the risk in this regard rested entirely with the taxpayer, and that was outside India.

The Tribunal's approach to profit attribution in the *Travelport* case is not inconsistent with the OECD Commentary on Article 7 (Business Profits) of the Model Convention.[65] It focuses on location of physical assets (a host computer) and the development of the automated process (CRS). Under this approach, it would be very difficult to attribute a profit to the PE of an online business. It would be even more difficult where access to the automated process is online, requiring no use of computers connected to the process, and the PE exists due to the activities of a local agent. In the *Travelport*, *Galileo International* and *Amadeus Global Travel* cases, the Tribunal made no specific reference

[63] Ibid., paragraph 12.

[64] Ibid.

[65] Paragraphs 10 and 42.4 of the Commentary on Article 5 of the OECD Model Convention.

to the value created by the activities of the local agent and seemed to assume that the commissions earned by the agent exceeded the revenue earned in India.

4.3.2 "Free" data created by customers

Current international tax norms do not attribute profit to the demand side or the role of customers in creating data valuable to e-commerce or digital companies. In the digital economy, data gathered from various sources is often a primary input into the process of value creation. The "expanding role of data raises questions about whether current nexus rules continue to be appropriate or whether any profits attributable to the remote gathering of data by an enterprise should be taxable in the State from which the data is gathered, as well as questions about whether data is being appropriately characterised and valued for tax purposes." [66] The reliance of MNEs on intangibles accompanied by the increasing importance of data in the global value chains put additional pressure on transfer pricing rules and profit attribution to PEs.[67]

Take the *Right Florists* case as an example. Google and Yahoo earned fees from an Indian florist for online advertisements targeted primarily at Indian residents and other local businesses. Presumably, the advertising fees were priced on the basis of the number of clicks or impressions by Internet users who searched for florist shops in India (or a specific location in India). The more clicks by Indian users, the more advertising fees Google and Yahoo earned. For tax purposes, however, there was no profit allocated to India for lack of a PE. Even if a website were deemed to constitute a PE, there would be no profit attributable to the website under the approach adopted in *Travelport*. It is the algorithm and the host server that would be assumed to have earned the profit, and they were outside India.

4.4 Traditional characterization disrupted

Dematerialization blurs the traditional distinction between goods and services. A traditional sale of tangible goods can be transformed into

[66] OECD Final Report on BEPS Action 1, supra note 1, paragraph 262.

[67] It is beyond the scope of the present chapter to discuss transfer pricing issues.

a licence for downloading a digital file. The increasing use of 3D printing technology may further convert goods (sales profit) into intangibles (royalties or fees for technical services) if direct manufacturing for delivery evolves into a licence of designs for remote printing directly by purchasers. Are payments for cloud computing in the nature of technical services, fees for the use of intangible property rights or general services? More specifically, questions arise regarding whether Infrastructure-as-a-Service transactions should be treated as services, rentals of space on the cloud service provider's servers, or fees for the provision of technical services. The same questions arise regarding payments for Software-as-a-Service or Platform-as-a-Service transactions.

Controversial characterization of payments is not unique to payments in the digital economy. For example, payments for the use of satellite, transponder, cable or optic fibre are characterized as "rental fees" in some countries,[68] but "business profits" in others.[69] Withholding tax on royalties is avoided when payments are characterized as services that give rise to business profits. The growth of the digital economy means the disappearance of the traditional withholding tax on royalties as the existing characterization rules are ill-suited to capturing payments for new digital products or services.

4.5 Risk to the tax base of developing countries

Conceptually, the tax base of developing countries is potentially at risk in the digital economy for the following reasons: the income or transaction is not captured by the existing tax rules because the business models require no physical presence or defy the characterization rules; the new business models of the digital economy make it easier for companies to circumvent the existing tax rules and avoid source-country taxation (resulting in BEPS); furthermore, the taxes due under existing laws cannot be effectively administered due to the

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[68] China, State Administration of Taxation, Circular [1998] No. 201, which was upheld by Chinese courts in *PanAmSat International Systems, Inc.* (2001).

[69] This is the more common characterization. For example, the tribunals in India held that such payments do not give rise to "royalty" for treaty purposes. See Asia *Satellite Communication Co. Ltd.* (332 ITR 340) (Del) and *Skycell Communications Ltd.* (251 ITR 53) (Mad).

lack of enforcement mechanisms. However, it is difficult to ascertain the extent of this risk or the amount of loss in tax revenue.

4.5.1 Base cyberization

Base cyberization is the broader and more fundamental issue because profit is not even in the tax base as defined by the existing rules. This issue goes to the fundamental assumptions underlying the design of the current system: physical presence of activities and the factors of production including land, labour and capital. As mentioned above, these assumptions do not apply to digital transactions or value derived from data sourced from customers.

More specifically, business profits earned by non-resident companies from online sales or supply of services or intangibles are not taxable in the market country for lack of a PE or lack of profit attributable to the PE. Fees for online services, such as cloud computing and online travel booking, do not generally give rise to royalties or technical service fees for withholding tax purposes, even though the proprietary technology in the form of an algorithm, software or code enables the online business to generate such fees.[70] "Other income" is taxable exclusively in the resident country.

4.5.2 Base erosion

The BEPS issues are relevant to the extent that suppliers of goods and services in the digital economy still require physical presence in the market country, where a substantial portion of their profit is earned. For example, Google has offices in more than 40 countries, supports more than 130 languages or dialects and offers a personalized version of the search engine for more than 115 countries. Amazon has subsidiaries and/or fulfilment centres in over 22 countries in Africa, Asia, Australia, Europe, Latin America and North America.[71] Corporations

[70] Indian case law suggests that technical services should be supplied by a "human touch"; see Income Tax Appellate Tribunal Kolkata "B" Bench, Kolkata, *Income Tax Officer v. Right Florists*, *Pvt Ltd,* supra note 59; and Income Tax Appellate Tribunal, *Siemens Ltd. v. Commissioner of Income Tax,* 2013, TII-34-ITAT-MUM-INTL.

[71] See http://www.amazon.com/Locations-Careers/b?ie=UTF8&node=239366011.

conducting e-commerce may minimize assets and risks in market jurisdictions by using a subsidiary or PE to perform marketing or technical support, or to maintain a mirrored server to enable faster customer access to the products sold by the corporate group, with a principal company, often in the form of a holding company located in a low-tax jurisdiction or a tax haven, bearing the contractual risks and claiming ownership of intangibles generated by these activities.

BEPS occurs when a corporate group can avoid having a PE in the market country by using legal structures, such as commissionaires, or fragmentation of activities to avoid the time requirement, such as 183 days or six months.[72] In the case of a business selling tangible products online, a local subsidiary or PE may maintain a warehouse and assist in the fulfilment of orders and qualify for the exemptions under Article 5 (4) of the OECD Model Convention.

If a PE must be maintained, BEPS can also occur when business profit attributable to the PE is deliberately minimized by limiting the services provided through the PE. Alternatively, functions purported to be undertaken by local staff under contractual arrangements may not correspond with the substantive functions performed by the staff. For example, staff may not have formal authority to conclude contracts on behalf of a non-resident enterprise, but may perform functions that indicate effective authority to conclude those contracts. If purported allocations of assets, functions and risks do not correspond to actual allocations, or if less-than-arm's length compensation is provided for intangible property of a principal company, these structures may present BEPS concerns, particularly if emphasis is overly placed on the form or structure of transactions, and not their substance or actual reality on the ground.

BEPS issues are not unique to digital companies or e-commerce companies. All MNEs have adopted business models that incorporate ICT or e-commerce.[73] For example, Yihaodian is a Chinese

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[72] In the absence of such structures, both the "legal profit" as defined under existing rules and "economic profit" as determined by the business activities would be taxed in the source country.

[73] *The Economist,* "The emporium strikes back: Retailers in the rich world are suffering as people buy more things online. But they are finding ways to adapt," 13 July 2013, available at http://www.economist.com/news/

company owned by Walmart. The subsidiary uses an app to allow smartphone users to shop online in 1,000 "virtual stores" accessible only on specific websites. To operate the "virtual" aspect of its business, Walmart has 1,500 employees in Silicon Valley (United States) "trying to out-Amazon Amazon in areas such as logistics and making the most of social media." [74] Therefore, the global platforms used by digital companies or e-commerce companies and the reliance on data and intangibles presumably create more opportunities for BEPS.

4.5.3 Collection of taxes

Collection of taxes (CIT and VAT) is more complicated when the subject matter of cross-border transactions is digital or intangible, especially when no local intermediaries (either ISPs or financial institutions) are involved. The enforcement challenges are more immediate in respect of the VAT.

Enforcing the destination principle is difficult in the digital economy because non-resident vendors are generally not required to register for the collection of VAT purposes unless they carry on business in the destination jurisdiction. The collection of VAT on imported goods and services depends on self-assessment by the consumer. Self-assessment in B2B transactions is less problematic as the customer is often registered for VAT purposes and entitled to claim an input credit for the VAT. In contrast, self-assessment of VAT by individual customers is problematic as the amount of VAT owed might be small and the process for reporting and remitting the amount of tax lacking or inefficient. Cross-border movement of goods is subject to customs clearance, and thus creates no major issues. However, there is no equivalent fiscal frontier for the movement of digital goods and services. This is a particular concern in respect of B2C transactions, because it is unrealistic to rely on individual customers to self-report and remit the tax on online purchases from unregistered non-residents.

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briefing/21581755-retailers-rich-world-are-suffering-people-buy-more-things-online-they-are-finding.

[74] Ibid.

5. Some options for developing countries

5.1 Opportunity for change

The tax challenges raised by the digital economy are global. Global solutions are therefore needed. Back in the 1920s when the current international tax system was developed, developing countries were not at the table. In spite of the subsequent efforts to modify the system to meet the needs of capital-importing countries, the system remains one that is largely made by developed countries for developed countries. Recent international efforts in combating BEPS provide an historic opportunity for developing countries, some of which are part of the G20, to actually have some real say in how international tax problems are resolved.

Because the digital economy brings about a fundamental shift in how business is conducted and value is created, it is necessary to investigate whether there should be a fundamental shift in thinking about the basis for allocating taxing rights. Developing countries should play an active role in the process of reshaping the international tax system. The United Nations is the ideal institution to lead this important initiative and to coordinate with the OECD.

In developing appropriate international tax rules to allocate taxing rights between countries in a fair manner, it may be helpful to revisit the fundamental theories and principles underlying the existing system. A digital economy may involve a shift in how business is done and how value is created, but it does not necessarily remove the need for an economic nexus between income and the taxing jurisdiction. Therefore, a digital economy may require new "tools" to allocate the global tax base among nation States. It remains important to keep in mind the fundamental theories and policy justifications in designing the new tools.

Developing country concerns with BEPS and base cyberization differ from those of OECD countries. To begin with, they are predominantly source countries. The tax base of the source country is defined differently under the United Nations and OECD Model Conventions, especially in respect of royalties and services. The BEPS debates have been focused primarily on the use of legally sophisticated structures to avoid the tax base defined under the OECD Model Convention, such as the use of commissionaires to avoid the classification of a dependent agency PE. The more common issue in developing countries is likely base cyberization, where the income is not captured by the existing rules, due to the design of the rules (not due to the use of artificial legal structures). Developing countries are thus advised to go beyond BEPS and to take advantage of the historic opportunity of a burgeoning multilateral process and address the fundamental base definition and tax enforcement issues that arise in a digital economy. Specifically, the focus should be on how to change the tax rules that govern the digital economy, rather than on attempting to fit the digital economy into traditional tax rules.

5.2 Designing rules fit for the digital economy

The principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility continue to be a good starting point for a framework for evaluating options for addressing the tax challenges raised by the digital economy.[75] It makes little sense to develop new rules to apply only to digital transactions. Ring-fencing the digital economy is very difficult to implement as the entire economy is increasingly digitized. It violates the tax neutrality principle without any apparent policy or principled justifications.[76]

However, because the digital economy exposes the weaknesses in the fundamental design of the existing rules, it is imperative to address these fundamental design issues in order to allocate the international tax base fairly among countries. For example, when significant amounts of profits are derived by a non-resident enterprise from sales to customers in the market country without the need for any physical presence or human agent, it makes little sense from a policy perspective to leave the market country without any right to tax the profits. The non-resident taxpayer benefits from the ICT connectivity and the legal infrastructure for digital businesses provided by the

[75] These principles were endorsed by 29 OECD Member countries and 11 non-member countries at the Ottawa Ministerial Conference on Electronic Commerce (1998) (Ottawa Framework).

[76] This is the position stated in the OECD Final Report on BEPS Action 1, supra note 1, paragraphs 20–21.

market country. Consequently, the non-taxation of the non-resident enterprise in the market economy violates the economic allegiance theory and benefit theory, causing inequitable treatment of traditional business and digital business.

Therefore, existing principles of international taxation call for the use of new rules in order to fairly allocate the tax base in the digital economy. The new rules should recognize the features of the digital economy and the increasing role of consumers and the market in creating value for the non-resident enterprise.

5.3 Reimagining the PE test

The current definition of PE is anchored in the notion of a physical presence or human agents. Such a physical footprint is redundant or avoidable in the digital economy. A redesign is warranted and some leading ideas are summarized below.[77]

5.3.1 Amending Article 5

Amending Article 5 (Permanent Establishment) is a modest step in ensuring that the threshold for source-country taxation is low enough to capture some profit from e-commerce transactions. This can be achieved through revising the list of exemptions under Article 5 (4) of the OECD Model Convention and the time requirement in Article 5 (3) of the United Nations Model Convention, and introducing anti-fragmentation rules into both Model Conventions.

Article 5 (4) of the OECD Model Convention can be revised to ensure that each of the exceptions listed in this paragraph is restricted to activities that are otherwise of a preparatory or auxiliary character. This will reflect the fact that the use of a fixed place of business to purchase, warehouse and deliver merchandise can be a core activity for e-commerce businesses.

[77] See OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report_9789264241220-en, which is relevant to transactions in the digital economy; and chapter VII of the present *Handbook,* supra note 11.

An anti-fragmentation rule is suggested to prevent the avoidance of PE status via the breaking up of a cohesive operating business into a number of discrete and distinct operations in order to claim that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions in Article 5 (4) of the OECD Model Convention, or that the required time period has not been met.

Article 5 (3) (a) of the United Nations Model Convention may be modified by reducing the period of time required to give rise to a PE in respect of construction, assembly or installation projects, or supervisory and consultancy services. Even with further dematerialization, these types of services still need to be provided with some physical presence in the client's country. However, dematerialization can significantly reduce the amount of time required for the physical presence. Thus, the current six months or 183 days should be adjusted downwards significantly, especially in cases where a portion of the project is implemented in the service provider's home country or a third country.

Article 5 (3) (b) of the United Nations Model Convention can be modified to prevent fragmentation by removing the requirement that services be rendered in respect of "the same or a connected project." For example, a PE is deemed to exist where "an enterprise that performs services in the other Contracting State, for a period or periods exceeding in the aggregate 183 days in any twelve-month period, and these services are performed through one or more individuals who are present and performing such services in that other State." [78]

Finally, the dependent agency PE definition can be changed to ensure that where the activities exercised by an intermediary in a contracting State are intended to result in the regular conclusion of contracts to be performed by a non-resident enterprise, that enterprise should be considered to have a PE in that State, unless the intermediary is performing these activities in the course of an independent business.

[78] See the Agreement Between the Government of the Republic of Chile and the Government of the People's Republic of China for the Elimination of Double Taxation and the Prevention of Tax Evasion and Avoidance with respect to Taxes on Income of 25 May 2015.

5.3.2 *A virtual PE based on significant economic presence*

Moving away from a physical footprint, a website or other forms of digital presence in the market jurisdiction can be considered to exhibit a sufficient nexus — a virtual PE — for sourcing the profit to that jurisdiction for tax purposes.[79] A new paragraph can be added to Article 5 of the OECD Model Convention to deem a non-resident enterprise to have a PE if it "has a significant economic presence in a country on the basis of factors that evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools."[80]

The virtual PE would apply to the remote supply of digital goods and services. This option is a radical departure from the traditional physical presence test. In the absence of a meaningful threshold, it would be difficult to enforce, causing uncertainties for businesses and customers. The OECD project on BEPS recommends a significant economic presence test based on the revenue derived from remote transactions into the market country.[81] A range of digital factors (such as a local domain name, a local digital platform and local payment options) and/or user-based factors (such as monthly active users, online contract conclusion, and data collected) can also be used as part of a test for significant economic presence.

Some countries have indicated that they will adopt the virtual PE test.[82] For example, Israeli tax authorities published a draft circular stating that where a foreign corporation's core activity is conducted through the Internet and some or all of certain terms (such as the Internet site's connection with the Israeli market) are found to exist, the corporation's activity should constitute a PE in Israel. It is considered to have the digital presence necessary to maintain close client relations.

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[79] See OECD Final Report on BEPS Action 1, supra note 1, paragraphs 277–283.

[80] Ibid., paragraph 277.

[81] Ibid.

[82] See Ernst and Young, "Global Digital Tax Developments Review," (2015), available at http://www.ey.com/GL/en/Services/Tax/ey-global-digital-tax-developments.

5.3.3 General revenue-based PE

Instead of applying the significant economic presence test to e-commerce and digital transactions, developing countries may wish to explore the option of using a revenue-based significant economic presence as a general PE. A revenue-based threshold would replace the existing thresholds based on a fixed place of business, duration-of-service activities, or the conclusion of contracts by dependent agents. It would remove the need for having a list of exceptions or distinguishing between dependent and independent agents. The revenue realized from transactions (online or offline) with customers in a market country would be the only, or main, basis.

The goal of the revamped PE is to ascertain the level of a non-resident enterprise's engagement in the economy of the market country and the enterprise's benefit from the infrastructure and business environment created by that country. It would treat traditional businesses and digital businesses in the same manner. A non-resident enterprise's significant economic presence in a market country entitles that country to tax the profit derived from such presence. It would be consistent with the policy rationale of the current test. However, as a radical change from the existing test, it could be difficult to develop an international consensus on the issue.

5.4 Attributing profit to a PE

5.4.1 Factors of attribution

Merely revising the PE test will not suffice to protect the tax base of the market jurisdictions. The current profit attribution rules must also be revisited so that meaningful profit could be attributable to the market jurisdiction. Under the existing rules, profit is attributable to people functions, assets or risks, which are factors on the supply side of an enterprise. A virtual PE would involve little or no physical presence in terms of tangible assets and/or personnel in the market country. More fundamentally, the current rules do not attribute profit to the market itself or the value created by customers or users.

One option to consider is to extend the force of attraction principle under Article 7 of the United Nations Model Convention so that income earned by a non-resident enterprise from transactions with customers in the market country would be attributable to a PE.[83] Such a change would require some clarification of Article 7 of the United Nations Model Convention, which currently limits the principle to profit attributable to a PE, profit from sales of the same or similar kind as those sold through that PE, or other business activities carried on in the market jurisdiction of the same or similar kind as those effected through the PE. In essence, the expanded force of attraction principle would deem all online or digital activities as "same or similar" for purposes of Article 7.

Other options include: deeming the customer/user to perform certain functions on behalf of the non-resident enterprise;[84] deeming a portion of automated services as being performed in the market country; or including sales as a factor in attributing profit.

5.4.2 Methods for determining profit

Instead of attributing profits to a PE based on functions, assets and risks and treating the PE as a separate entity dealing at arm's length with the non-resident enterprise, the profit of the PE could be based on other methods, such as fractional apportionment or deemed profit methods.[85]

A fractional apportionment method would "apportion the profits of the whole enterprise to the digital presence either on the basis of a predetermined formula, or on the basis of variable allocation factors determined on a case-by-case basis."[86] It is possible to include sales as an allocation key.

According to the OECD Final Report on BEPS Action 1, deemed methods have already been used in the insurance industry and the domestic law of some countries. For the insurance industry,

[83] See Walter Hellerstein, "Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments," (2014), Vol.68, No. 6/7 *Bulletin for International Taxation* at 349.

[84] This is suggested in the OECD Final Report on BEPS Action 1, supra note 1, paragraph 286.

[85] Ibid., paragraphs 287–291.

[86] Ibid., paragraph 287.

the deemed profit method is used by applying a coefficient based on the ratio of profit to gross premiums of resident insurance companies to gross premiums received from policy holders in the market country.[87] Chinese domestic law allows the use of deemed profit methods based on the profit rate of identical or similar enterprises, the enterprise's cost plus reasonable profit, or a reasonable proportion of the related party's group profit. [88]

5.5 Deeming online services as technical services for withholding tax purposes

A withholding tax on digital transactions is a possible option for protecting the tax base of market countries.[89] It could apply to payments by residents of a country for online purchases of goods and services from non-resident enterprises. This withholding tax could be a stand-alone gross-basis final tax or a collection mechanism to backstop a net-basis tax on profit of the PE in the market country.

The current United Nations Model Convention allows a broader scope of withholding taxes than the OECD Model Convention, especially in respect of royalties and technical fees. Developing countries may find this option of great interest because dematerialization has meant a conversion of traditional services, including technical services into automated services online. Certain online services can be deemed to be technical services for withholding tax purposes. In such cases, the withholding tax would be a gross-basis final tax. Alternatively, if non-resident enterprises are taxable in the market country for having a virtual PE, the withholding tax can be used as a collection tool. The requirement for the withholding of taxes on digital transactions can begin with B2B transactions as a business making online purchases is likely to deduct the payment in computing its income, thereby reducing its CIT liability.

Deeming all B2B payments for online services (such as cloud computing) to be technical fees would have several advantages. First, it is evolutionary and, thus, would be more easily accepted. The United

[87] Ibid., paragraph 289.

[88] Ibid., paragraphs 289 – 291.

[89] Ibid., paragraph 292.

Nations Committee of Experts on International Cooperation in Tax Matters has added a new provision on technical services in the United Nations Model Convention. Second, it is consistent with the principle of neutrality, as services delivered online would be subject to the same rules (as an alternative, all digital services could be deemed to be "technical services" or royalty-generating services) as services delivered through various physical media. Third, it would be administratively feasible. The existing mechanism of withholding can be used. As discussed above, it is difficult to characterize transactions in the digital economy in general and related-party B2B transactions in particular. Thus a general deeming rule has a catch-all effect that allows the effective collection of the widest base possible, although B2C transactions would not be subject to this deeming rule.

However, this option is not without disadvantages. It would be a shift in the "source rule" for services. Instead of the place of performance, the source rules would be similar to that in Article 12 (5) (residence of payer) or Article 12 (6) of the United Nations Model Convention. It would be a departure from the current OECD position that e-commerce payments should be characterized as business profits, not subject to withholding tax. A withholding tax might be a poor proxy for a tax on net income and the tax burden would be shifted to resident companies, increasing their cost of doing business. If the source-country tax is not recognized by the residence country, there is potential for double taxation. Like other options, there are administrative challenges.

Countries that adopt a virtual PE test can impose a gross-basis withholding tax on all payments for digital transactions to back up the net-basis taxation of profit earned through the PE.

5.6 Domestic anti-avoidance measures

Some countries have introduced measures to prevent profit diversion through contrived or artificial means. For example, the United Kingdom imposed a Diverted Profits Tax of 25 per cent on profits that are considered to be artificially diverted from the State. One situation in which the tax may be triggered is where a non-resident company sells goods or services to customers in the United Kingdom and a related company that is domestically located performs activities related to those sales without triggering the existing PE threshold.[90]

Australia announced a change to the General Anti-avoidance Rule (Part IVA) to tackle perceived tax avoidance by MNEs, especially United States-based technology companies.[91] The new rules will affect global groups with annual revenue exceeding A$ 1 billion based on accounting principles, and the tax rate is 40 per cent of the diverted profits. This diverted profits tax is aimed at arrangements involving transactions with overseas related parties which are subject to a tax rate of less than 80 per cent of the tax rate applied in Australia, where the arrangement lacks economic substance.

Another possible anti-avoidance measure is to deny the deduction to domestic taxpayers in respect of payments to non-resident enterprises when the payments are free from domestic withholding tax. For example, a rule in Greece provided that in order for a taxpayer to deduct expenses from certain transactions, the taxpayer would be required to withhold an amount equal to the income tax corresponding to the tax benefit of the deduction.[92]

5.7 Registration and enforcement measures

Registration for VAT purposes is particularly important and urgent. Some countries have already introduced measures to mandate non-resident vendors that do not have a PE in the market country to register, collect and remit VAT to that country. For example, South Africa introduced this requirement in respect of "electronic services"

[90] For further information, see HM Revenue & Customs (United Kingdom), "Diverted Profits Tax: Guidance," available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf.

[91] Australian Government, "Implementing a Diverted Profits Tax," Treasury Consultation Paper, 3 May 2016, available at http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2016/Implementing-a-diverted-profits-tax.

[92] This rule was repealed, in part, on the grounds that it was found by the European Commission to have violated several principles of the Treaty on the Functioning of the European Union. See Ernst and Young, "Global Digital Tax Developments Review," supra note 82, at page 32.

in B2B and B2C transactions. The threshold for registration is the value of such sales exceeding R50,000.

Multilateral cooperation among countries could help make the requirement easier to enforce. Corporations, such as Amazon, eBay and Google would certainly have the technology and administrative means to comply with the requirement. In the United States, Amazon and other online vendors are required to collect and remit state-level sales taxes under the laws of a number of states in which they have a warehouse or distribution centre — the "Amazon tax." [93]

5.8 Collection of VAT

Under the existing rules, many countries require that VAT be assessed at the border for each import of goods, subject to a low-value exemption threshold. No such requirement applies to importation of digital goods or services.

Maintaining separate systems for material goods and digital goods or services is one option. Several models of collection can be considered to improve efficiency in collecting VAT on tangible goods. These include: using electronic processes by customs to assess VAT; requiring the purchaser to self-assess and pay the VAT on the imports; requiring the non-resident vendors to charge, collect and remit the VAT in the country of importation; or requiring intermediaries (such as postal operators, express carriers, transparent e-commerce platforms and financial intermediaries) to collect and remit VAT in the country of importation.[94]

Some countries, such as Israel, Japan and New Zealand have indicated that cross-border supplies of services would be subject to VAT.[95] For example, the New Zealand Government released a discussion document on 18 August 2015 containing proposals to require

[93] Amazon collects sales taxes on sales sold into over 20 states in the United States, see http://www.amazon.com/gp/help/customer/display.html?nodeId=468512.

[94] OECD Final Report on BEPS Action 1, supra note 1, paragraphs 326 – 331.

[95] Ernst and Young, "Global Digital Tax Developments Review," supra note 82.

overseas suppliers to register and return a Goods and Services Tax (GST) when they sell "remote-services" to consumers in New Zealand. Remote-services include digital services that are typically electronically delivered (such as e-books and music videos), as well as more traditional cross-border services supplied remotely by a business offshore (such as professional advice). The registration requirement may also apply to intermediaries, who market and sell services on behalf of a non-resident supplier, considered to be "electronic marketplaces."

Australia has proposed to abolish the low-value exemption for imported goods online so that a single system of VAT collection can apply to all digital transactions. A non-resident vendor must register and remit GST if the amount of its supplies to Australian customers exceeds the threshold for registration (A$ 75,000). New Zealand is likely to follow suit.

6. Conclusion

The digital economy raises the same kind of tax challenges for developing countries and OECD countries. However, the adverse impact of these challenges is likely greater in developing countries as they rely more heavily on CIT and VAT and are net-importing countries. To protect the tax base, developing countries have options. Some options are more immediate, such as amending domestic law to require VAT registration of offshore suppliers of digital goods and services or extending withholding tax to technical services. Other options require more multilateral coordination, such as reforming the test for jurisdictional nexus or new profit determination methods. Ultimately, the tax base of developing countries is tied to the growing global digital economy.

Chapter IX

Tax incentives in developing countries: maximizing the benefits and minimizing the costs

Eric M. Zolt*

1. Overview

All countries face challenges from base erosion and profit shifting by multinational entities transferring income from domestic economic activity to low-tax jurisdictions. For many developing countries, however, the major revenue loss results not from profit shifting strategies but from tax incentives granted by governments. This chapter examines the costs and benefits of tax incentives and seeks to provide assistance to policymakers in designing tax incentives to maximize the benefits and minimize the costs. It focuses on three key questions:

(a) How can developing countries best design and administer tax incentives to increase their effectiveness?

(b) How do tax systems in developed countries influence the desirability or effectiveness of tax incentives in developing countries?

(c) How does the Organisation for Economic Co-operation and Development (OECD) project to address base erosion and profit shifting (OECD project on BEPS)[1] change the tax environment related to developing countries' tax incentives?

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[1] See Organisation for Economic Co-operation and Development (OECD), *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/tax/beps-reports.htm; OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf; and OECD, 2015 Final Reports on BEPS (Paris: OECD, 2015), available at http://www.oecd.org/ctp/beps-2015-final-reports.htm.

Before turning to these questions, the following are some initial observations.[2] Some contend that tax incentives, particularly for foreign direct investment, are both bad in theory and in practice. Tax incentives are bad in theory because they distort investment decisions. Tax incentives are bad in practice because they are often ineffective, inefficient and prone to abuse and corruption.

Yet almost all countries use tax incentives. In developed countries, tax incentives often take the form of investment tax credits, accelerated depreciation and favourable tax treatment for expenditures on research and development. To the extent possible in the post-World Trade Organization (WTO) world, developed countries also adopt tax regimes that favour export activities and seek to provide their resident corporations a competitive advantage in the global marketplace. Many transition and developing countries have an additional focus. Tax incentives are used to encourage domestic industries and to attract foreign investment. Here, the tools of choice are often tax holidays, regional investment incentives, special enterprise zones and reinvestment incentives.

Much has been written about the desirability of using tax incentives to attract new investment. The United Nations,[3] the International Monetary Fund (IMF),[4] the OECD[5] and the World

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[2] Parts of the discussion in the present chapter rely on Alex Easson and Eric M. Zolt, "Tax Incentives," World Bank Institute (Washington, D.C.: World Bank Group, 2002), available at http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf.

[3] See, for example, United Nations Conference on Trade and Development, *Tax Incentives and Foreign Direct Investment* (United Nations publication, Sales No. E.96.II.A.6); and *Tax Incentives and Foreign Direct Investment: A Global Survey* (United Nations publication, Sales No. E.01.II.D.5).

[4] See, for example, George E. Lent, "Tax Incentives for Investment in Developing Countries," (1967) Vol. 14, No. 2 *Staff Papers, International Monetary Fund,* 249; Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries," International Monetary Fund (Washington, D.C.: IMF, 2001); Alexander Klemm, "Causes, Benefits and Risks of Business Tax Incentives," International Monetary Fund (Washington, D.C.: IMF, 2009); David Holland and Richard J. Vann, "Income Tax Incentives for Investment," in Victor Thuronyi, ed., *Tax Law Design and Drafting* (Washington, D.C.: IMF, 1998), Vol. 2, 986–1020.

[5] See, for example, Organisation for Economic Co-operation and Devel-

Bank[6] have produced useful reports (separately, and jointly[7]) that provide guidance to policymakers on whether to adopt tax incentives and how best to design them. The empirical evidence on the cost-effectiveness of using tax incentives to increase investment is inconclusive. While economists have made significant advances in determining the correlation between increased tax incentives and increased investment, it is challenging to determine whether tax incentives caused the additional investments. This is partly because it is difficult to determine the amount of marginal investment associated with the tax benefit—that is to say, the investments that would not otherwise have occurred "but for" the tax benefits. While foreign investors often claim that tax incentives were necessary for the investment decision, it is not easy to determine the validity of the claim. Governments often adopt tax incentives in a package with other reforms designed to improve the climate for investment, making it difficult to determine the portion of new investment that is attributable to tax benefits and the portion that relates to other pro-investor reforms. With these qualifications, it is sometimes easy to conclude that a particular tax incentive scheme has resulted in little new investment, with a substantial cost

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opment, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis*, Tax Policy Study No. 17, (2007); OECD, "Tax Incentives for Investment: A Global Perspective: Experiences in MENA and Non-MENA Countries," in *Making Reforms Succeed: Moving Forward with the MENA Investment Policy Agenda* (Paris: OECD, 2008).

[6] See, for example, Robin W. Broadway and Anwar Shah, "Perspectives on the Role of Investment Incentives in Developing Countries," World Bank (1992); Sebastian James, "Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications," World Bank Group (2013); Sebastian James, "Incentives and Investments: Evidence and Policy Implications," World Bank Group (2009); Alex Easson and Eric M. Zolt, "Tax Incentives," supra note 2.

[7] At the request of the G20 Development Working Group, the staff of the IMF, OECD, United Nations and World Bank Group prepared a report titled "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment," (October 2015), available at https://www.imf.org/external/np/g20/pdf/101515.pdf; and "Background Document: Tools for the Assessment of Tax Incentives," available at http://www.oecd.org/tax/tax-global/options-for-low-income-countries-effective-and-efficient-use-of-tax-incentives-for-investment-background-document.pdf.

to the government. In other cases, however, tax incentives have clearly played an important role in attracting new investment that contributed to substantial increases in growth and development.

One place to start thinking about tax incentives is to consider what role governments should play in encouraging growth and development. Governments have many social and economic objectives and a variety of tools to achieve those objectives.[8] Tax policy is just one option, and taxes are just one part of a complex decision as to where to make new domestic investment or commit foreign investment. Governments have a greater role than to focus on relative effective tax burdens. Governments need to consider their role in improving the entire investment climate to encourage new domestic and foreign investment, rather than simply doling out tax benefits. Thus, while much of the focus on tax incentives is on the taxes imposed by government, it is also important to examine the government spending side of the equation. Investors, both domestic and foreign, benefit from government expenditures. A comparison of relative tax burdens requires consideration of relative benefits from government services.

1.1 Definition of tax incentives

At one level, tax incentives are easy to identify. They are those special provisions that allow for exclusions, credits, preferential tax rates or deferral of tax liability. Tax incentives can take many forms: tax holidays for a limited duration, current deductibility for certain types of expenditures, or reduced import tariffs or customs duties. At another level, it can be difficult to distinguish between provisions considered part of the general tax structure and those that provide special treatment. This distinction will become more important when countries become limited in their ability to adopt targeted tax incentives. For example, a country can provide a 10 per cent corporate tax rate for income from manufacturing.

[8] See, generally, Richard M. Bird and Eric M. Zolt, "Tax Policy in Emerging Countries," (2008) Vol. 26, *Environment and Planning C: Government and Policy*, 73–86; Richard M. Bird, "Tax Incentives for Investment in Developing Countries," in Guillermo Perry, John Whalley and Gary McMahon, eds., *Fiscal Reform and Structural Change in Developing Countries* (London: Canada: Macmillan in association with the International Development Research Centre, 2000), Vol. 1, 201–221.

This low tax rate can be considered simply an attractive feature of the general tax structure as it applies to all taxpayers (domestic and foreign) or it can be seen as a special tax incentive (restricted to manufacturing) in the context of the entire tax system.

Tax incentives can also be defined in terms of their effect on reducing the effective tax burden for a specific project.[9] This approach compares the relative tax burden on a project that qualifies for a tax incentive to the tax burden that would be borne in the absence of a special tax provision. This approach is useful in comparing the relative effectiveness of different types of tax incentives in reducing the tax burden associated with a project.

Commentators contend tax incentives may now play a larger role in influencing investment decisions than in past years. Several factors explain why tax considerations may have become more important in investment decisions.[10] First, tax incentives may be more generous now than in past years. The effective reduction in tax burden for investment projects may be greater than in the past, as tax holiday periods increase from two years to ten years or the tax relief provided in certain enterprise zones comes to include trade taxes as well as income taxes. Second, over the past several decades there has been substantial trade liberalization and greater capital mobility. As non-tax barriers decline, the significance of taxes as an important factor in investment decisions increases. Third, business has changed in many ways. Firms have made major changes in organizational structure, production and distribution methods, and the types of products being manufactured and sold. Highly mobile services and intangibles are a much higher portion of cross-border transactions than in past years.

Fewer firms now produce their products entirely in one country. Many of them contract out to third parties (either unrelated third parties or related "contract manufacturers") some or all of their production. With improvements in transportation and communication,

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[9] Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries," supra note 4.

[10] Alex Easson, "Tax Incentives for Foreign Investment, Part I: Recent Trends and Countertrends," (2001) Vol. 55, *Bulletin for International Fiscal Documentation,* 266.

component parts are often produced in multiple countries, which results in increased competition for production among several countries. In addition, distribution arrangements have evolved, where the functions and risks within a related group of corporations are allocated to reduce tax liability through so-called commissionaire arrangements. Finally, there has been substantial growth in common markets, customs unions and free trade areas. Firms can now supply several national markets from a single location. This will likely encourage competition among countries within a common area to serve as the host country for firms servicing the entire area.

While tax incentives can make investing in a particular country more attractive, they cannot compensate for deficiencies in the design of the tax system or inadequate physical, financial, legal or institutional infrastructure. In some countries, tax incentives have been justified because the general tax system places investments in those countries at a competitive disadvantage compared with other countries. It makes little sense, however, to use tax incentives to compensate for high corporate tax rates, inadequate depreciation allowances or the failure to allow companies that incur losses in early years to use those losses to reduce taxes in later years. The better approach is to bring the corporate tax regime closer to international practice rather than grant favourable tax treatment to specific investors. Similarly, tax incentives are a poor response to the economic or political problems that may exist in a country. If a country has inadequate protection of property rights, rigid employment laws or a poorly functioning legal system, it is necessary to engage in the difficult and lengthy process of correcting these deficiencies rather than provide investors with additional tax benefits.

The effectiveness of tax incentives is directly related to the investment climate (including investor confidence that a revenue authority will actually honour tax incentives without controversy) in a particular country.[11] While two countries could provide identical tax incentives (for example, a 10-year holiday for corporate income taxes), the relative effectiveness of the incentive in attracting foreign direct

[11] Stefan Van Parys and Sebastian James, "Why Tax Incentives May Be an Ineffective Tool to Encouraging Investment?—The Role of Investment Climate," International Monetary Fund, World Bank Group (2009), available at http://ssrn.com/abstract=1568296.

investment is substantially greater for the country with the better investment climate.[12]

1.2 Different types of tax competition

Tax incentives are all about tax competition — how can a country attract investment that otherwise would have gone to a different region or country? Countries may seek to compete for different types of investments, such as headquarters and service businesses, mobile light assembly plants or automobile manufacturing facilities. The starting point in thinking about tax competition is to consider the reasons why foreign investors invest in a particular country. At a highly-stylized general level, there are three primary reasons to engage in cross-border investments: (a) to exploit natural resources; (b) to facilitate the selling or production of goods or services in a particular market; and (c) to take advantage of favourable conditions in a particular country (such as relatively low wages for qualified workers) to produce goods for export (either as finished products or as components). The competition for foreign investment will differ depending on the reason for the investment. For example, tax competition will exist among countries of a common customs union for the manufacturing or distribution facility that will service the entire region. In contrast, for export platforms, the competition will be among countries that have similar comparative advantages. As such, the competition for investment may be global, among countries in a particular region, or even among states within a particular country. The key point is that the design and the effectiveness of tax incentives will differ depending on the type of investment.

1.3 Additional investment incentives

Countries will compete for foreign investment using any means available to them. Non-tax incentives, such as training grants, low-cost

[12] Sebastian James, "Providing Incentives for Investment: Advice for Policymakers in Developing Countries," Investment Climate in Practice, No. 7, (Washington, D.C.: World Bank Group, 2010). He estimates that tax incentives in a country with a good investment climate may be eight times more effective in attracting foreign investment than in countries with less favourable investment environments.

loans or infrastructure improvements can be substitutes or complements to tax incentives. If challenges exist to using tax incentives (for example, due to agreements not to use particular types of tax incentives or because of the structure of the tax regime in the foreign investor's home country), then countries will likely make greater use of non-tax incentives.

A different form of investment incentives is tax-related, but not generally included in the list of types of tax incentives. These disguised tax incentives can include liberal safe harbours in transfer pricing rules, provisions that facilitate aggressive tax planning, and even tacit forms of lax tax enforcement. For example, the United States "check-the-box" regulations can be viewed as a tax incentive to allow United States multinational entities to compete more effectively with non-United States multinational entities by using hybrid entities to minimize foreign tax liability in high-tax countries.

1.4 Role of non-tax factors

Deciding whether and where to invest is a complex decision. It is not surprising that tax considerations are just one factor in these decisions. Commentators have listed several factors that influence investment decisions, particularly those of foreign investors.[13] A partial list of these factors is set forth in box 1.

Box 1
Non-tax factors influencing investment decisions

1. Consistent and stable macroeconomic and fiscal policy.
2. Political stability.
3. Adequate physical, financial, legal and institutional infrastructure.
4. Effective, transparent and accountable public administration.
5. Skilled labour force and flexible labour code governing employer and employee relations.
6. Availability of adequate dispute resolution mechanisms.

[13] Sebastian James, "Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications," supra note 6.

7. Foreign exchange rules and the ability to repatriate profits.
8. Language and cultural conditions.
9. Factor and product markets—size and efficiency.

Most surveys of business executives conclude that taxes were often not a major consideration in deciding whether and where to invest. For most types of investments, there is a two-part decision. First, from a business perspective, which country would be the best choice for achieving a particular investment objective? And second, from a tax perspective, how would activities be structured to minimize tax liabilities (both on a country basis and an aggregate worldwide basis)?

1.5 Review of empirical evidence

Several economic studies have examined the effect of taxes on investment, particularly foreign direct investment. While it is not easy to compare the results of different empirical studies, scholars have attempted to survey the various studies and to reach some conclusions as regards the effect of taxes on levels of foreign investment. Useful surveys are included in the "Ruding Report,"[14] Hines,[15] Mooij and Ederveen,[16] and Klemm and Van Parys.[17] These surveys note the difficulty of comparing the results of different studies because the studies contain different data sources, methodologies and limitations.

[14] Commission of the European Communities (CEC), *Report of the Committee of Independent Experts on Company Taxation* (1992) (Official Publications of the EC, ISBN 92-826-4277-1).

[15] James R. Hines, Jr., "Tax Policy and the Activities of Multinational Corporations," in Alan Auerbach, ed., *Fiscal Policy: Lessons from Economic Research* (Cambridge, MA: MIT Press, 1997) and James R. Hines, Jr., "Lessons from Behavioral Responses to International Taxation," (1999) Vol. 52, No. 2 *National Tax Journal,* 305.

[16] Ruud A. de Mooij and Sjef Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research," (2003) Vol. 10, No. 6 *International Tax and Public Finance,* 673–693.

[17] Alexander Klemm and Stefan Van Parys, "Empirical Evidence on the Effects of Tax Incentives," International Monetary Fund (Washington, D.C.: IMF, 2009).

The studies also report different types of elasticities in measuring the responsiveness of investment to taxes.

Part of the difficulty in determining the effect of taxes on foreign investment is getting a good understanding of the different types of foreign investment and the different sources of funding for foreign investment. Foreign investment consists of both portfolio and direct investment. While different ways to distinguish portfolio and direct investment exist, a common approach is to focus on the foreign investor's percentage ownership of the domestic enterprise. For example, if the foreign investor owns a greater than 10 per cent stake in an enterprise, the investment is likely more than a mere passive holding for investment purposes. Foreign direct investment can be further divided into direct transfers from a parent company to a foreign affiliate through debt or equity contributions and reinvested earnings by the foreign affiliate.

The different forms of foreign investment are also important, as each form may respond differently to taxes. Types of foreign investment include: (a) real investments in plant and equipment; (b) financial flows associated with mergers and acquisitions; (c) increased investment in foreign affiliates; and (d) joint ventures. Finally, commentators have noted that taxes may affect a decision as to the source of financing more than decisions as to the level of investment.[18] Investors have several alternatives on how to fund new ventures or expand existing operations. Taxes likely play a role in the choice of whether to make a new equity investment, use internal or external borrowing or use retained earnings to finance investments.

When the results of tax incentive regimes are examined seriously, there are successes and failures.[19] A good review of the results of incentives is set forth in a 1996 United Nations study.[20] The United

[18] Alan Auerbach, "The Cost of Capital and Investment in Developing Countries," in Anwar Shah, ed., *Fiscal Incentives for Investment and Innovation* (Washington, D.C.: World Bank Group, 1995), Vol. 1.

[19] See Ngee Choon Chia and John Whalley, "Patterns in Investment Tax Incentives Among Developing Countries," in Anwar Shah, ed., *Fiscal Incentives for Investment in Developing Countries* (Washington, D.C.: World Bank, 1992).

[20] United Nations Conference on Trade and Development, *Tax Incentives and Foreign Direct Investment*, supra note 3.

Nations study concludes that "as other policy and non-policy conditions converge, the role of incentives becomes more important at the margin, especially for projects that are cost-oriented and mobile." [21] The OECD reaches a similar conclusion in finding that host country taxation affects investment flows and that it is an increasingly important factor in locational decisions. [22]

1.6 Potential gains from preferential tax regimes

Countries compete for capital investment, often by trading tax revenue for additional investment. One common position is that this "race to the bottom" makes all countries worse off. But, perhaps, the story is more complicated than it seems.

Preferential tax incentive regimes may allow countries to confine their most aggressive tax competition to specific parts of the tax system. [23] Just as a dual income tax regime allows countries to set differential rates on income from labour and income from capital, [24] tax incentive regimes allow countries to provide tax advantages to certain targeted activities while maintaining current tax rates for other investments. This split-rate approach may allow countries to withstand pressure to reduce the regular tax rate by providing selective tax relief. Tax incentive regimes thus may allow countries greater flexibility in setting tax rules for different types of investments. [25]

The recent debate in the tax haven literature provides some context to this analysis and two views have emerged. The negative view

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[21] Ibid., 44 – 45.

[22] W. Steven Clark, "Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options," (2000) Vol. 48, *Canadian Tax Journal,* 1139.

[23] Michael Keen, "Preferential Regimes Can Make Tax Competition Less Harmful," (2001) Vol. 54, No. 4 *National Tax Journal*, 757.

[24] Richard M. Bird and Eric M. Zolt, "Dual Income Taxation: A Promising Path to Tax Reform for Developing Countries," (2011) Vol. 39, No. 10 *World Development*, 1691.

[25] Whether this differential approach is preferable to the conventional recommendation that countries adopt broad-based, low-rate tax systems is open to question. Eric M. Zolt, "The Uneasy Case for Uniform Taxation," (1996 –1997) Vol. 16, *Virginia Tax Law Review*, 39.

considers tax havens as parasites on the revenue due to other countries.[26] Tax havens impose real economic costs: first, by diverting resources from more productive uses to investments in income-shifting and tax enforcement activities; and, second, by forcing non-tax haven countries to reduce tax revenues and reduce the supply of public goods and services at levels below what they would otherwise choose.[27] Under this view, eliminating or reducing tax havens would have positive economic effects.

In contrast, the positive view of tax havens contends, under certain conditions, that tax havens can serve to enhance efficiency and even mitigate tax competition.[28] The availability of tax havens allows high-tax countries to impose lower effective tax rates on highly mobile firms while taxing immobile firms more heavily. There is also some support that high-tax countries located close to tax havens have increased levels of foreign direct investment because of the presence of tax havens. This results because tax havens enable multinational entities to structure their operations to lower the tax costs of investing in high-tax countries, thereby increasing the level of investment.[29]

2. Tax incentives: benefits and costs, design and administrative considerations

This section examines the benefits and costs of using tax incentives as well as important considerations in designing, granting and monitoring the use of tax incentives to increase investment and growth. Tax incentives are often criticized on grounds that they erode the tax base without any substantial effects on the level of investment. It is not easy, however, to separate criticism of the tax incentive regimes that are actually adopted from criticism of all tax incentives. Advisers have

[26] Joel Slemrod and John D. Wilson, "Tax Competition with Parasitic Tax Havens," (2009) Vol. 93, *Journal of Public Economics*, 1261.

[27] Ibid., at 1262.

[28] Dhammika Dharmapala, "What Problems and Opportunities are Created by Tax Havens?" (2008) Vol. 24, No.4 *Oxford Review of Economic Policy*, 661.

[29] Mihir A. Desai, C. Fritz Foley and James R. Hines, "Do Tax Havens Divert Economic Activity?" (2006) Vol. 90, No.2 *Economics Letters*, at 223 –24.

recognized that certain well-designed tax incentives have been successful in increasing investment. Simply stated, countries should not adopt tax incentives where the social costs exceed the social benefits.

2.1 Benefits and costs of tax incentives

2.1.1 Benefits of tax incentives

If properly designed and implemented, tax incentives are a useful tool in attracting investments that would not have been made without the provision of tax benefits. Tax incentives are justified if they correct market inefficiencies or generate positive externalities. Some commentators view such tax incentives as desirable, in that without government intervention the level of foreign direct investment would be suboptimal.[30]

It is not surprising that governments often choose tax incentives over other types of government action. It is much easier to provide tax benefits than to correct deficiencies in the legal system or to dramatically improve the communications system in a country. Also, tax incentives do not require an actual expenditure of funds by the government. Some alternatives do, such as the provision of grants or cash subsidies to investors. Although tax incentives and cash grants may be similar economically, for political and other reasons, it is easier to provide tax benefits than to actually provide funds to investors.

New foreign direct investment may bring substantial benefits, some of which are not easily quantifiable. A well-targeted tax incentive programme may be successful in attracting specific projects or specific types of investors at reasonable costs compared with the benefits received. The types of benefits from tax incentives for foreign investment follow the traditional list of benefits resulting from foreign direct investment. These include increased capital transfers, transfers of know-how and technology, increased employment and assistance in improving conditions in less-developed areas.

[30] Yoram Y. Margalioth, "Tax Competition, Foreign Direct Investment and Growth: Using Tax Incentives to Promote Developing Countries," (2003) Vol. 23, *Virginia Tax Review,* 161.

Foreign direct investment may generate substantial spillover effects. For example, the choice of location for a large manufacturing facility will not only result in increased investment and employment in that facility, but also at firms that supply and distribute the products from it. Economic growth will increase the spending power of the country's residents that, in turn, will increase demand for new goods and services. Increased investment may also increase government tax revenue either directly from taxes paid by the investor (for example, after the expiration of the tax holiday period) or indirectly through increased tax revenues received from employees, suppliers and consumers.

This positive view of the benefits of foreign direct investment has recently been challenged by Yariv Brauner.[31] Like other scholars, Brauner questions whether tax incentives actually increase the level of foreign direct investment. However, Brauner goes further and challenges whether foreign direct investment actually generates economic growth that is beneficial for development. Under this view, even if tax incentives succeed in attracting new investment, it is not clear, with many types of foreign investments, that the developing country benefits.

One can provide a general description of the types of benefits of additional investment resulting from tax incentives. It is difficult, however, to estimate the benefits resulting from tax incentives with any degree of certainty. Sometimes the benefits are hard to quantify. Other times the benefit accrues to persons other than the firm receiving the tax benefits.

2.1.2 Costs of tax incentives

In considering the costs of a tax incentive regime, it may be useful to examine four different types of costs: (a) revenue costs; (b) resource allocation costs; (c) enforcement and compliance costs; and (d) the costs associated with corruption and lack of transparency.[32]

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[31] Yariv Brauner, "The Future of Tax Incentives for Developing Countries," in Yariv Brauner and Miranda Stewart, eds., *Tax Law and Development* (Cheltenham: Edward Elger Publishing, 2014).

[32] Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries," supra note 4.

2.1.2.1 Revenue costs

The tax revenue losses from tax incentives come from two primary sources: first, forgone revenue from projects that would have been undertaken even if the investor did not receive any tax incentives; and, second, lost revenue from investors and activities that improperly claim incentives or shift income from related taxable firms to those firms qualifying for favourable tax treatment.

Policymakers seek to target tax incentives to achieve the greatest possible benefits for the lowest costs. Ideally, the objective would be to offer tax incentives only to those investors who at the margin would invest elsewhere but for the tax incentives. Offering tax incentives to those investors whose decisions to invest are not affected by the proposed tax benefit merely results in a transfer to the investor from the host government without any gain. However, it is very difficult to determine on a project-by-project basis which of them were undertaken solely due to tax incentives. Similarly, it is hard to estimate for an economy as a whole what the levels of investment would be with or without a tax incentive regime.

For those projects that would not have been undertaken without tax incentives, there is no real loss of tax revenue from those firms. To the extent that the firms become regular taxpayers or that these operations generate other tax revenue (such as increased profits from suppliers or increased wage taxes from employees), there are revenue gains from those projects.

An additional revenue cost of tax incentives results from erosion of the revenue base due to taxpayers abusing the tax incentive regimes to avoid paying taxes on non-qualifying activities or income. This can take many forms. Revenue losses can result where taxpayers disguise their operations to qualify for tax benefits. For example, if tax incentives are available only to foreign investors, local firms or individuals can use foreign corporations through which to route their local investments. Similarly, if tax benefits are available only to new firms, then taxpayers can reincorporate or set up many new related corporations to be treated as a new taxpayer under the tax incentive regime.

Other leakages occur where taxpayers use tax incentives to reduce the tax liability from non-qualified activities. For example, assume that a firm qualifies for a tax holiday because it is engaged in a type of activity that the government believes merits tax incentives. It is likely quite difficult to monitor the firm's operation to ensure it does not engage in additional non-qualifying activities. Even where the activities are separated, it is very difficult to monitor related-party transactions to make sure that income is not shifted from a taxable firm to a related one that qualifies for a tax holiday.

Additional costs of tax incentives are the opportunity costs from public investment that is not undertaken because of forgone tax revenues. If a country has 50 million less in tax revenues because of tax incentives granted, then it has 50 million less to spend on public goods and services. Assuming that these funds are used effectively and generate a substantial economic benefit (a challenging assumption in some developed and developing countries) then these are social benefits that are not realized.

2.1.2.2 Resource allocation costs

If tax incentives are successful, they will cause additional investment in sectors, regions or countries that would not otherwise have occurred. Sometimes this additional investment will correct for market failures. Other times, however, the tax incentives will cause allocation of resources that may result in too much investment in certain activities or too little investment in other non-tax favoured areas.

It is difficult to determine the effects of tax provisions in countries where markets are relatively developed. It is even more difficult to determine the consequences of tax provisions in developing countries where markets are not well approximated by existing competitive models. As such, where markets are imperfect, it is not clear whether providing tax incentives to correct market imperfections will make markets more competitive.[33]

2.1.2.3 Enforcement and compliance costs

As with any tax provision, there are resource costs incurred by the government in enforcing the tax rules and by taxpayers in complying. The cost of enforcement relates to the initial grant of the incentive as well

[33] Richard George Lipsey and Kelvin Lancaster, "The General Theory of Second Best," (1956) Vol. 24, No. 11 *Review of Economic Studies*.

as the costs incurred in monitoring compliance with the qualification requirements and enforcing any recapture provisions upon termination or failure to continue to qualify. The greater the complexity of the tax incentive regime, the higher the enforcement costs (as well as compliance costs) may be. Similarly, tax incentive schemes that have many beneficiaries are harder to enforce than narrowly targeted regimes.

It is also difficult to get revenue authorities enthusiastic about spending resources to monitor tax incentive schemes. Revenue authorities seek to use their limited administrative resources to improve tax collection, so it is not surprising that they prefer auditing fully taxable firms rather than those firms operating under a tax holiday arrangement.

2.1.2.4 Opportunities for corruption

The existence of corruption can constitute a major barrier to foreign investment in a country. This does not, however, prevent foreign investors from benefiting from a corrupt system. Recent scholars have focused on the corruption and other rent-seeking behaviour associated with the granting of tax incentives. Several different policy approaches exist to designing the qualification requirements for tax incentives. Policymakers can choose between automatic and objective approaches versus discretionary and subjective approaches. The opportunity for corruption is much greater for tax incentive regimes, where officials have much discretion in determining which investors or projects receive favourable treatment. The potential for abuse is also greater where no clear guidelines exist for qualification.

The IMF, the OECD and the World Bank have projects that try to reduce corruption and provide assistance to countries to establish anti-corruption programmes.[34] One element of such programmes

[34] OECD, United Nations Office on Drugs and Crime (UNODC) and World Bank, *Anti-Corruption Ethics and Compliance Handbook for Business,* available at http://www.unodc.org/documents/corruption/Publications/2013/Anti-CorruptionEthicsComplianceHandbook.pdf; OECD, Asian Development Bank Organization for Economic Co-operation and Development, Anti-Corruption Initiative for Asia and the Pacific (see http://www.oecd.org/site/adboecdanti-corruptioninitiative/publications.htm); Vito Tanzi, "Corruption Around the World: Causes, Consequences, Scope and Cures," (1980) Vol. 45, No. 4 *Staff Papers, International Monetary Fund.*

should be the monitoring of foreign investment projects and, especially, the granting of investment incentives. If a tax incentive is subsequently found to have been improperly obtained, then, in addition to any other legal sanctions, the privileges should be withdrawn and any tax that has been avoided should be repaid.

2.1.2.5 Estimates of costs of tax incentives

Even where tax incentives succeed in attracting investment, the costs of the incentives may exceed the benefit derived from the new investment. This is difficult to substantiate, as problems exist in estimating the costs and benefits of tax incentives. One method of cost-benefit analysis is to estimate the cost (in terms of revenue forgone and/or direct financial subsidies) for each job created. Studies using this approach may not provide a true measure of efficiency, because they measure only the cost, and not the value, of the jobs created. The cost of jobs, however, varies widely according to the country and the industrial sector, and the more "expensive" jobs may bring with them greater spillover benefits, such as technology transfer.

All revenue estimates are based on a set of assumptions about responses of taxpayers to particular tax law changes. In assessing the performance of tax incentive schemes, the objective is to determine the amount of incremental investment resulting from tax incentives and to be able to determine the costs and benefits associated with attracting that investment.

This requires making assumptions about such items as: (a) the amount of investment that would have been made without the tax incentive programme; (b) the amount of "leakage" from the tax base due to taxpayers improperly claiming the tax incentives or from shifting income from taxable to related tax-exempt (or lower-taxed) entities; and (c) the tax revenue gained from either activities from taxpayers granted a tax incentive after the incentive expired or from the activities generating other sources of tax revenue.[35]

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[35] A comprehensive discussion of methodologies to evaluate the costs and benefits of tax incentives is set forth in Duanjie Chen, "The Framework for Assessing Tax Incentives: A Cost-Benefit Analysis Approach," paper submitted to the United Nations Workshop on Tax Incentives and Base Protection, New York 23 and 24 April 2015, available at http://www.un.org/esa/ffd/

Two methods to increase accountability and transparency of tax incentives are tax incentive budgets and general tax expenditure analysis. As discussed below, in many countries the tax authorities do not have sole responsibility or discretion in designing and administering tax incentive programmes. In many countries, different government agencies, such as foreign investment agencies or ministries of economy, have a role in designing investment regimes, approving projects, and monitoring investments. These agencies' major objective is attracting investments; they are often less concerned with protecting the tax base.

One approach that merits consideration is to set a target monetary amount of tax benefits to be granted under a tax incentive regime. This would require both the tax authorities and other government agencies to agree on both a target amount and a methodology for determining the revenue costs associated with a particular tax incentive regime.

A second method that merits serious consideration is to include tax incentives in a formal "tax expenditure budget." All OECD countries and several other countries require estimates to be prepared on the revenue impact of certain existing and proposed tax provisions. The goal of these budgets is to highlight the revenue consequences of providing tax benefits. This approach seeks to treat tax expenditures in a manner similar to direct spending programmes, and thus effectively equates direct spending by the government with indirect spending by the government through the tax system. While the scope of tax expenditure analysis goes beyond tax incentives, countries can choose to follow this approach for only certain types of tax incentives or for a broader class of tax provisions. For those countries that do not have a formal tax expenditure requirement, it makes good sense to go through the exercise in deciding whether to adopt or retain a tax incentive regime.[36]

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wp-content/uploads/2015/04/2015TIBP_PaperChen.pdf; and OECD, "Background Document: Tools for the Assessment of Tax Incentives," supra note 7.

[36] Sebastian James, "Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications," supra note 6.

2.2 Design considerations for tax incentives

2.2.1 Eligibility issues

Tax incentives are departures from the benchmark system that are granted only to those investors or investments that satisfy prescribed conditions. These special tax privileges may be justified only if they attract investments that are both particularly desirable and that would not be made without such tax benefits. Thus, the first question in designing a tax incentive system is "What types of investment are the incentives intended to attract?"

2.2.1.1 Targeting of incentives

Incentives may be broadly targeted — for example, they may target all new investment, foreign or domestic — or they may be very narrowly targeted, and designed with one particular proposed investment in mind. The targeting of incentives serves two important purposes: (a) it identifies the types of investment that host governments seek to attract; and (b) it reduces the cost of incentives because it reduces the number of investors that benefit.

This raises the question of whether a government should treat some types of investment as more desirable or beneficial than others. Should a government seek to attract tax incentives and target them at particular types of investments and not others, or should investment decisions be left solely to market forces? Justifiable doubt exists about the ability of politicians to "pick winners," particularly in countries where markets are less than perfect. Also, there are some types of investment that, while not prohibited altogether, may not deserve encouragement in the form of tax benefits. Ideally, incentives should be given only for incremental investment; that is, for investments that would not otherwise have occurred but for the tax benefits.

An initial question is whether the granting of tax incentives should be discretionary or automatic once the prescribed conditions are met. In many cases it may be advisable to limit discretion. But if qualification for incentives is made largely automatic, it becomes necessary for the qualifying conditions to be spelled out clearly and in detail.

Many countries grant preferential tax treatment to certain sectors of the economy, or to certain types of activities. Sectoral targeting has many advantages: (a) it restricts the benefits of the incentives to those types of investment that policymakers consider to be most desirable; and (b) it also makes it possible to target those sectors that are most likely to be influenced by tax considerations. Among the activities commonly preferred are manufacturing activities, pioneer industries, export promotion, locational incentives and investments that result in significant transfers of technology.

Countries may elect to restrict investment incentives to manufacturing activities or provide for those activities to receive preferential treatment (for example, China, Ireland). This may reflect a perception that manufacturing is somehow more valuable than the provision of services, perhaps because of its potential to create employment, or a view that services (with some exceptions) tend to be more market-driven and therefore less likely to be influenced by tax considerations.

Some countries adopt a more sophisticated approach and restrict special investment incentives to certain broadly listed activities or sectors of the economy. These countries can restrict tax incentives to "pioneer" enterprises. Generally, to be accorded pioneer status, an enterprise must manufacture products that are not already produced domestically, or engage in certain other listed activities that are not being performed by domestic firms and that are considered especially beneficial to the host country.

Many countries also provide tax incentives to locate investments in particular areas or regions within the country. Sometimes the incentives are provided by regional or local governments, in competition with other parts of the same country. In other cases, the incentives are offered by the central government, often as part of its regional development policy, to promote investment in less developed regions of the country or in areas of high unemployment.

One benefit of foreign direct investment is the creation of new employment opportunities and, not surprisingly, incentives are frequently provided specifically to encourage job creation. Policymakers could provide for tax incentives for investment in regions of high unemployment, or they could tie the tax incentive directly to employment, with the creation of a stipulated number of new jobs as a qualifying condition for the tax holiday or other incentive.

Foreign direct investment often results in the transfer of technology. Even critics of tax incentives concede that they may be useful to promote activities such as research and development, if only as a way of correcting market imperfections. Countries attempt to attract technologically advanced investment in several ways: (a) by targeting incentives at technologically advanced sectors; (b) by providing incentives for the acquisition of technologically advanced equipment; and (c) by providing incentives for carrying out research and development (R & D activities).

Finally, the experience of many developing countries is that export promotion, and the attraction of export-oriented investment, is the quickest and most successful route to economic growth. It is therefore hardly surprising that competition to attract such investment is especially fierce, and investment incentives are frequently targeted at export-oriented production. Incentives targeted specifically at export-oriented investment may be more effective than other tax incentives, due to the higher degree of mobility of such investment.

2.2.1.2 Forms of tax incentives

Designing tax incentives requires two basic decisions: (a) determining the types of investment that qualify; and (b) determining the form of tax incentive to adopt. Tax incentives for investment take a variety of forms. Table 1 sets forth the most commonly employed tax incentives.

This section examines three different types of tax incentives: tax holidays, investment credits and allowances, and tax credit accounts. While the first two types of incentives are used frequently, the tax credit account approach has received too little attention from policymakers.

2.2.1.3 Tax holidays

In developing countries, tax holidays are by far the most common form of tax incentive for investment. A tax holiday may take the form of a complete exemption from profits tax (and sometimes from other taxes as well), a reduced rate of tax, or a combination of the two (for

Table 1:
Prevalence of tax incentives around the world

	Number of countries surveyed	Tax holiday/ tax exemption	Reduced tax rate	Investment allowance/ tax credit	VAT exemption/ reduction	R & D tax incentive	Super-deductions	SEZ[a]\Free ZonesEPZ[b]/ Free port	Discretionary process
		Percentage							
East Asia and the Pacific	12	92	92	75	75	83	8	83	25
Eastern Europe and Central Asia	16	75	31	19	94	31	0	94	38
Latin America and the Caribbean	24	75	29	46	58	13	4	75	29
Middle-East and North Africa	15	73	40	13	60	0	0	80	27
OECD	33	21	30	61	79	76	18	67	27
South Asia	7	100	43	71	100	29	57	71	14
Sub-Saharan Africa	30	60	63	73	73	10	23	57	47

Source: Sebastian James, "Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications," World Bank Group (2013).
[a]Special economic zone (SEZ).
[b]Export processing zone (EPZ).

example, two years exemption, plus a further three years at half-rate). The exemption or reduction is granted for a limited duration.

Tax holidays can vary in duration from as little as one year to as long as twenty years. In determining the length of the tax holiday, a clear trade-off exists between the attractiveness to investors and the revenue cost to the host country's treasury. Most studies have concluded that short tax holidays are of limited value or interest to most potential investors and are rarely effective in attracting investment, other than short-term, "footloose" projects. Substantial investments often take several years before they begin to show a profit, by which time the tax holiday may have expired. Short tax holidays are of the greatest value to investments that can be expected to show a quick profit and are consequently quite effective in attracting investment in export-oriented activities such as textile production. Since that sector is highly mobile, however, it is not uncommon for a firm to enjoy a tax holiday in one country and, when it expires, to move its entire operation to another country that is willing to give a new holiday. Consequently, the benefit of the investment to the host country may be quite limited.

Tax holidays have the apparent advantage of simplicity for both the enterprise and the tax authorities. The simplest tax holiday regime, and most investor-friendly, provides not only that no tax is payable during the holiday period, but also that taxpayers are not required to file information or tax returns. While this results in an absence of compliance or administrative costs, the better approach is to require the filing of a tax return during the holiday period. For example, if the enterprise is allowed to carry forward losses incurred in the holiday period or to claim depreciation allowances after the end of the holiday for expenditure incurred during the holiday, the enterprise will obviously need to file a return or at least keep appropriate records.

Additionally, tax holidays are especially prone to manipulation and provide opportunities for tax avoidance and abuse. Another disadvantage is that the revenue cost of tax holidays cannot be estimated in advance with any degree of accuracy, nor is the cost related to the amount of the investment or to the benefits that may accrue to the host country. Finally, tax holidays exempt profits without regard to the level or amount of profits that are earned. For potential investments that investors believe will earn above market returns, tax holidays will result in a loss of tax revenue without any benefits. Because of the high return, investors would have undertaken these projects even without the availability of tax incentives.[37]

2.2.1.4 Investment allowances and credits

As an alternative, or sometimes in addition, to tax holidays, some governments provide investment allowances or credits. These are given in addition to the normal depreciation allowances, with the result that the investor may be able to write off an amount that is greater than the cost of the investment. An investment allowance reduces taxable income, whereas an investment tax credit is set against the tax payable; thus, with a corporate income tax rate of 40 per cent, an investment allowance of 50 per cent of the amount invested equates to an investment credit of 20 per cent of that amount.

Investment allowances or credits may apply to all forms of capital investment, or they may be restricted to specific categories, such as machinery or technologically advanced equipment, or to capital investment in certain activities, such as research and development. Sometimes, countries limit eligibility to contributions to the charter capital of the firm. This approach may encourage investors to increase the relative amount of equity capital rather than related-party debt capital in the firm's initial capital structure.

One objection to the use of investment allowances and credits is that they favour capital-intensive investment and may be less favourable towards employment creation than tax holidays. They may also distort the choice of capital assets, possibly creating a preference for short-lived assets so that a further allowance or credit may be claimed on replacement.

Investment allowances and credits seem preferable to tax holidays in almost every respect: (a) they are not open-ended; (b) the revenue cost is directly related to the amount of the investment, so there should be no need for a minimum threshold for eligibility; and (c)

[37] Vito Tanzi and Howell H. Zee, "Tax Policy for Emerging Markets: Developing Countries," International Monetary Fund (Washington, D.C.: IMF, 2000).

their maximum cost is more easily estimated. A recent study, however, finds that investment credit and allowances are significantly less effective in attracting foreign investment than tax holidays.[38]

2.2.1.5 Tax credit accounts

Vito Tanzi and Howell Zee propose an interesting approach to offering tax benefits to potential investors that allows taxing authorities to determine with great certainty the revenue costs of the tax incentive programme.[39] This approach provides each qualifying investor a specific amount of tax relief in the form of a tax credit account (say, for example, potential exemption for 500,000 of corporate income tax liability). The investor would be required to file tax returns and keep books and records just like any other taxpayer. If the investor determines it has 60,000 of tax liability in year one, it would pay no tax, but the amount in its tax account would be reduced to 440,000 for future tax years. The tax credit account has the advantage of providing transparency and certainty to both the potential investor and the government.

The tax credit account may be regarded as a sort of hybrid: a cross between a tax holiday and an investment tax credit. It resembles a tax holiday, except that the tax exemption period, instead of being a fixed number of years, is related to the amount of taxes due on the income earned (for example, the exemption applies to the first 500,000 of taxable income). This has two important advantages: the cost of the incentive to the host government is known, and there is no strong built-in advantage for those investments that make quick profits. The tax credit account also resembles an investment tax credit in that the amount of the credit is a fixed sum; where it differs is that the amount is not determined by the amount of the investment. It consequently does not provide a preference to capital-intensive investments.

[38] Alexander Klemm and Stefan Van Parys, "Empirical Evidence on the Effects of Tax Incentives," supra note 17.

[39] Vito Tanzi and Howell H. Zee, "Tax Policy for Emerging Markets: Developing Countries," supra note 37.

2.2.2 Implementation issues

2.2.2.1 Initial compliance with qualifying conditions

The first administrative issue is determining whether an investor meets the qualifying conditions. Some incentive provisions require initial approval or some other positive decision. For example, officials may need to determine that the investment is in a priority sector or that prescribed employment or export targets will be met, or that environmental requirements will be complied with. Generally, tax authorities will require some form of written certification of qualification. A second type of qualifying condition requires what is essentially a factual determination: for example, that the foreign participation in a joint venture exceeds a stipulated percentage, that a certain number of new jobs have been created, that a particular capital investment falls within a category qualifying for accelerated depreciation, or that imported equipment can be classified as "advanced technology." Tax authorities sometimes carry out this verification: otherwise, they can be expected to require written confirmation from the appropriate authority or department. A third type of condition requires a valuation of assets. For example, investors may be required to establish that the amount invested exceeds the minimum stipulated amount needed to qualify for a tax holiday, or that an investment qualifies for a tax credit of a given amount.

2.2.2.2 Reporting and monitoring continuing compliance

Conditions are sometimes attached to incentives that are related to ongoing performance — for example, requirements that a given number of jobs are maintained, or that a certain percentage of production is exported, throughout the tax holiday period. Incentives of this type require continual monitoring. Although this imposes an additional administrative burden on authorities, it does have the merit of providing the host government with a reasonably accurate idea of how an investment is performing. Without a formal monitoring mechanism, investors have little reason to make realistic projections as to the number of jobs that will be created, or the volume of exports that will be produced, and some studies have shown large discrepancies between investor prediction and performance. However, it is important that administrative capabilities to conduct necessary monitoring are taken into account when incentive legislation is drafted so that unnecessary supervision is avoided.

2.2.2.3 Common abuses

Ongoing monitoring of investments is necessary not only to ensure continuing compliance with qualifying conditions but also to detect tax avoidance or evasion. Tax avoidance presents greater difficulties, because countries have different attitudes as to what constitutes avoidance, and what to do about it. For example, a tax holiday may be conditional upon employing a given number of persons. In some countries an investor could legitimately make up the qualifying number by hiring "employees" with minimal duties and at low wages. In other countries, this course of action might be considered an abuse of the legislation and result in the denial or withdrawal of the tax privilege.

Box 2 sets forth some of the more common abuses associated with tax incentives. The related discussion provides additional details of some of these abuses.

Box 2
Top ten abuses of tax incentive regimes

1. Existing firms transforming to new entities to qualify for incentives.
2. Domestic firms restructuring as foreign investors.
3. Transfer pricing schemes with related entities (sales, services, loans, royalties, management contracts).
4. Churning or fictitious investments (lack of recapture rules).
5. Schemes to accelerate income (or defer deductions) at the end of a tax holiday period.
6. Overvaluation of assets for depreciation, tax credit, or other purposes.
7. Employment and training credits—fictitious employees and phony training programmes.
8. Export zones—leakages into the domestic economy.
9. Regional investment incentives and enterprise zones—diverting activities outside of the region or zone.
10. Disguising or burying of non-qualifying activities into qualifying activities.

2.2.2.4 *Round-tripping*

Round-tripping typically occurs where tax incentives are restricted to foreign investors or to investments with a prescribed minimum percentage of foreign ownership. Domestic investors may seek to disguise their investments to qualify for incentives for foreign investment by routing their investment through a wholly controlled foreign corporation. Similar practices have occurred in a number of transition economies, especially in connection with the privatization of State-owned firms, where the existing management has acquired ownership of the firm through the vehicle of an offshore company.[40]

2.2.2.5 *Double dipping*

Many tax incentives, especially tax holidays, are restricted to new investors. In practice, such a restriction may be ineffective or counter-productive. An existing investor that plans to expand its activities will simply incorporate a subsidiary to carry on the activity, and the subsidiary will qualify for a new tax holiday. A different type of abuse occurs where a business is sold towards the end of the tax holiday period to a new investor who then claims a new tax holiday. Sometimes the "new" investor is related to the seller, although the relationship is concealed. A more satisfactory approach for policymakers may be to use investment allowances or credits, rather than tax holidays, so that new investments, rather than investors, qualify.

2.2.2.6 *Transfer pricing*

Transfer pricing has been described as "the Achilles heel of tax holidays,"[41] although it can be a problem with other forms of investment incentives as well. The tendency is to think of transfer pricing as a phenomenon that occurs internationally in transactions between related enterprises in different countries. Transfer pricing can also

[40] Round-tripping is not always undertaken in order to meet foreign ownership requirements; it may also be used to take advantage of favourable tax treaty provisions.

[41] Charles E. McLure, Jr., "Tax Holidays and Investment Incentives: A Comparative Analysis," (1999) Vol. 53, *Bulletin for International Fiscal Documentation,* 326–327.

take place in a single country where an investor has two or more operations within a country or where the investor derives income from more than one activity. If one of those operations, or one type of income, enjoys a tax preference, profits will tend to be allocated to the preferred activity.

Transfer pricing is likely to take place where: (a) an investor undertakes two or more activities, one of which qualifies for an incentive (for example, manufacturing, exporting) and another does not; (b) an investor has operations in two or more locations, one of which is in a tax-privileged region and another is not; or (c) an investor owns two or more subsidiaries, one of which enjoys a tax holiday and another does not. In each of these cases the investor will wish to allocate as much profit as possible to the tax-exempt (or tax-privileged) entity or activity. In cases (a) and (b) there may be only a single entity, in which case there is no transfer pricing as such, but an equivalent result is achieved through the allocation of revenues and expenditures.

Substantial challenges exist for monitoring transfer pricing, especially for small or less-developed countries. One approach may be to use those tax incentives that are less prone to transfer pricing abuses. For example, in contrast to tax holidays, investment allowances or credits provide an exemption from tax of a given amount, rather than for a given period. Consequently, artificial transfers of profits to a firm that has been granted an investment allowance or credit may result in tax liability being postponed but not eliminated.

2.2.2.7 Overvaluation

Overvaluation (or sometimes undervaluation) is a constant problem in any tax system. Tax incentives, however, may provide additional temptations to inflate the values of assets. For example, where a tax holiday is conditional upon a certain minimum amount being invested, the value of assets contributed to the new firm can be manipulated to achieve the target figure. Sometimes this is done legitimately. For example, firms may purchase machinery rather than lease property from independent lessors. Other times, however, an inflated value is attributed to the property contributed, especially in the case of intellectual property. In cases where investors also receive an exemption from customs duty for newly contributed capital, no compensating motivation exists to correctly state the value, and no reason exists for customs authorities to pay much attention to the declared value.[42]

2.2.2.8 Abuse of duty-free privileges

A common investment incentive takes the form of an exemption from customs duty on imported equipment. A danger is that, once imported, items may be resold on the domestic market. A partial solution is to restrict the exemption to those assets that are contributed to the charter capital of the enterprise. Even so, it may be necessary to verify periodically that the assets remain in the enterprise. Another approach is to restrict the exemption to assets such as machinery (which are less likely to be resold) and to exclude items such as passenger vehicles and computer equipment.

2.2.2.9 Asset stripping and "fly-by-night" operations

Many countries have experienced problems with "fly-by-night" operators that take advantage of tax incentives to make a quick, tax-free profit and then disappear to begin operations in some other country that offers tax privileges. This problem most often arises with the use of tax holidays and export processing zones. A further problem sometimes occurs where a foreign investor acquires control of an existing local enterprise and instead of contributing new capital to modernize the enterprise, the investor strips it of its useful assets and simply disappears.[43]

Some countries have attempted to counter the "fly-by-night" problem by introducing "clawback" provisions. For example, a country can grant a tax holiday for a 5-year period, but only if the venture continues for a period of 10 years. If the venture is terminated before the end of the ten-year period, any tax "spared" must be repaid. The

[42] Sometimes there is a further problem. Foreign investment agencies have an incentive to boost their investment figures, so that there is some degree of common interest between the agency and the investor to inflate the amount of the investment. It is thus important for the tax administration to be involved in the valuation process.

[43] This latter problem is not necessarily linked to the availability of tax incentives, although the ability to make a tax-free capital gain is an added attraction to the asset stripper.

difficulty with such a provision is that the investor may have vanished before it is possible to claw back any of the forgiven tax liability.

2.2.3 Review and sunset provisions

The costs and benefits of tax incentives are not easy to evaluate and are hard to quantify and estimate. Incentives that may work well in one country or region may be ineffective in another context. Tax incentive regimes in many countries have evolved from general tax holidays to incentive regimes that are more narrowly targeted.

It therefore may make sense (a) to limit the duration of tax incentive regimes to reduce the potential costs of unsuccessful or poorly designed programmes by including a specific "sunset" provision as part of the original legislation; (b) to design incentive regimes to require information reporting by beneficiaries to investment agencies and to specify what government agency has responsibility for monitoring and enforcing qualification and any recapture provisions; and (c) to require an evaluation as to the costs and benefits of specific tax incentive regimes and to specify the timing of the evaluation and the parties responsible for conducting the review.

2.2.4 Guidance for policymakers

No shortage exists on advice to policymakers on how to design and implement tax incentives. Richard M. Bird has put forth a relatively concise prescription.[44] He first recommends that policymakers keep tax incentives simple. Bird contends that attempts to fine-tune incentives to achieve detailed policy goals are likely to be costly to administer and unlikely to produce the desired result. Second, Bird recommends that the government keep good records on who gets what tax incentives, for what time period and at what costs in revenue forgone. This information is necessary to ensure transparency and accountability. Finally, governments must evaluate the effectiveness of tax incentives in achieving the desired results and be willing to terminate or modify those incentive programmes that fail to achieve their objectives.

[44] Richard M. Bird, "Tax Incentives for Investment in Developing Countries," supra note 8.

The OECD has prepared a "best practice" guide to aid in the transparency and governance of tax incentives in developing countries.[45] Box 3 provides a summary of the OECD recommendations.

Box 3. OECD draft principles to enhance the transparency and governance of tax incentives for investment in developing countries

1. Make public a statement of all tax incentives for investments and their objectives within the governing framework.
2. Provide tax incentives for investment through tax laws only.
3. Consolidate all tax incentives for investment under the authority of one government body, where possible.
4. Ensure tax incentives for investments are ratified through the lawmaking body or parliament.
5. Administer tax incentives for investment in a transparent manner.
6. Calculate the amount of revenue forgone attributable to tax incentives for investment and publicly release a statement of tax expenditures.
7. Carry out periodic review of the continuance of existing tax incentives by assessing the extent to which they meet the stated objectives.
8. Highlight the largest beneficiaries of tax incentives for investment by specific provision in a regular statement of tax expenditures, where possible.
9. Collect data systematically to underpin the statement of tax expenditures for investment and to monitor the overall effects and effectiveness of individual tax incentives.
10. Enhance regional cooperation to avoid harmful tax competition.

The World Bank Group has developed a template that allows government officials to evaluate the efficacy of tax incentives for investment. It provides a useful tool for evaluating tax incentive regimes by providing a series of questions, a methodology for scoring the effectiveness of a regime, and the data sources required to complete the

[45] OECD, Draft Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries, available at http://www.oecd.org/ctp/tax-global/transparency-and-governance-principles.pdf.

assessment. It focuses on four key dimensions: rule of law, transparency, efficient administration, and incentive reviews.[46]

2.2.5 Singapore's experience with tax incentives

Why have some countries been more successful than others in using tax incentives to attract foreign investment? Some insights may be gained by looking at Singapore's experience with tax incentives over the last 50 years.[47] First, Singapore recognized that tax incentives were only a part of a broader economic strategy and that they were just one tool for increasing investment. This approach requires countries to adopt a clearly defined economic strategy with tax incentives playing a supporting role. Second, Singapore was willing to change tax incentive regimes over time to reflect changing objectives. For example, the use and design of tax incentives changed as the goals moved from job creation in the 1960s, to upgrading technology in the 1970s, to encouraging knowledge-intensive industries in the 1990s,[48] to recent attempts to encourage growth and transformation across complementary sectors and to increase the attractiveness of Singapore as an international and regional headquarters and as an international financial centre. Third, Singapore was successful in developing a transparent process of evaluation and review of tax incentive proposals. Fourth, Singapore had an effective process for administering tax incentives, monitoring compliance with the terms and conditions associated with the granting of tax incentives, and reviewing effectiveness of tax incentive regimes. Finally, Singapore recognized that non-tax factors were key to attracting foreign investment, and the country has been successful in improving the political and economic environment to encourage economic development.

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[46] IMF, OECD, United Nations and World Bank, "Options for Low Income Countries' Effective and Efficient Use of Tax of Incentives for Investment," supra note 7, 30.

[47] Charles Oman, "Policy Competition for Direct Foreign Investment: A Study of Competition among Governments to Attract FDI," OECD Development Centre Studies (Paris: OECD, 2000), at 45; and Augustine H.H. Tan, "Singapore's Economy: Growth and Structural Change," (1986) *Southeast Asian Affairs*, 273.

[48] United Nations Conference on Trade and Development, *Tax Incentives and Foreign Direct Investment*, supra note 3, 16.

In examining Singapore's recent experience, several key factors emerge. A strong focus exists on attracting and retaining real economic activity that will continue for years after the expiration of the tax incentives. Unlike many other countries, Singapore's Economic Development Board is proactive in identifying and contacting potential investors that meet economic objectives rather than just waiting for investors to apply for tax incentives. The Economic Development Board is also charged with creating new and more efficient global and regional business models by bringing together companies in the same or related activities through the use of tax incentives and other government subsidies. Finally, Singapore has been flexible in tailoring tax incentives (and non-tax incentives) to meet the specific needs of an investor while balancing them against economic objectives; and in administering and negotiating tax incentives to reflect changing circumstances and economic conditions. While it is very difficult to replicate Singapore's political and economic environment, Singapore's experience does provide guidance to other countries in designing and administering tax incentive regimes.

3. Impact of developed countries' tax systems on the desirability or effectiveness of tax incentives

The effectiveness of tax incentives is tied not only to taxes imposed in the country of the investment but also to the taxes imposed by other countries, most notably the home country of the foreign investor. Foreign investors focus on their aggregate worldwide tax liability, which requires consideration of the tax systems of those countries where they are required to pay taxes as well as the tax regimes of their country of residence. It is therefore important to consider the investor's home country's tax system in estimating the influence of tax incentives offered by the host country in attracting investment. Countries generally tax their corporate taxpayers on their foreign source income under one of two alternatives: (a) the "credit" method, whereby corporate taxpayers are taxed on their worldwide income and receive a foreign tax credit against their domestic tax liability for foreign income taxes paid on the foreign source income; or (b) the "exemption" or "territorial" method, whereby corporate taxpayers are generally taxed only on their domestic source income and can exempt certain foreign source income in computing their tax liability.

In theory, foreign investors from countries that adopt the credit method are less likely to benefit from tax incentives, as the tax revenue from the favoured activities may be effectively transferred to the investor's revenue service from the tax authorities in the host country. In practice, however, because foreign investors have different alternatives to structuring their foreign investments, the effect of the different tax approach is likely to be relatively small.

3.1 Simple model

One approach to understanding how a foreign investor's home country's tax system affects the attractiveness of developing countries' tax incentives is to begin with a simple model of foreign direct investment. This simple model of direct investment assumes the foreign investor invests directly in a developing country either through a branch or through a subsidiary that immediately repatriates any profits to the parent corporation.

Under a "territorial" system, for many types of income, the tax imposed by the host country would constitute a final tax on profits earned in that country. Because foreign source income is generally not subject to tax in the investor's country of residence, any tax advantages from tax incentives will flow directly to the foreign investor.

In contrast, under a "worldwide" tax system, the foreign investor is subject to tax in both the country of the source of the income and the country of residence. This potential double taxation is generally reduced through the resident country providing a credit for foreign income taxes paid on foreign source income. But what happens if the foreign investor receives a tax incentive that substantially reduces or eliminates the tax in the country of investment?

The 2000 UNCTAD Survey on Tax Incentives and Foreign Direct Investment provides an answer to the question above:

> In order to assess the full tax treatment of FDI [foreign direct investment], it is necessary to look into the way home countries tax the income generated in host countries. Where an investor is subject to tax under a residence-based principle, the introduction of a tax incentive such as a tax holiday reduces or eliminates tax credit in the host country. It has the effect of increasing

the tax revenues in the home country dollar for dollar. For an investor, the total tax burden remains unchanged, negating the benefits of tax incentives. Tax incentives simply result in the transfer of tax revenues from the host country treasury to the home country treasury.[49]

The following is a simple example based on the assumption that the corporate tax rate in South Africa is 30 per cent and the corporate tax rate in the United States of America is 35 per cent and that a United States corporation invests directly in a business in South Africa. If the South African business generates 1 million in profits and repatriates the profits to the United States, the South African Revenue Service would collect 300,000 in taxes and the United States Internal Revenue Service would collect 50,000 (the United States would impose a 35 per cent tax on the foreign income but then allow a foreign tax credit for the 300,000 tax paid to the South African Government). On the further assumption that the South African Government provided a tax holiday for this investment in South Africa while the South African tax liability on the 1 million profits would be reduced to zero, the United States tax liability would be increased from 50,000 to 350,000 (the 35 per cent United States tax without any reduction for foreign income taxes paid). While the aggregate tax liability of the United States investor remained the same, the South African tax incentive results in an effective transfer of 300,000 from the South African Government to the United States Government.

To address this concern, tax sparing provisions are often included in treaties between developed and developing countries. These provisions generally treat any source country tax that, but for the tax incentive, would have been paid as foreign taxes paid for purposes of computing the tax liability in the country of residence. These tax sparing provisions ensure that the investor gets the tax benefit from tax incentives (rather than the investor's home government).

Several developed countries (with the notable exception of the United States) have included tax sparing provisions in their treaties with developing countries. Some scholars contend that the failure of

[49] United Nations Conference on Trade and Development, "*Tax Incentives and Foreign Direct Investment: A Global Survey*," supra note 3.

the United States to provide tax sparing has severely limited the attractiveness for United States companies to invest in developing countries. In order to increase investment in less developed regions, they call for the United States to provide tax sparing in treaties with developing countries or adopt an exemption system for investment in certain countries.[50]

One view of tax sparing provisions is that they constitute a form of foreign assistance from developed countries to developing countries.[51] In essence, the developed country is transferring an amount equal to the taxes they would have collected but for the tax sparing arrangement to the treasury of the developing country. The desirability of this form of foreign assistance rests on the effectiveness of tax incentives in providing benefits to developing countries compared with the benefits from other forms of foreign assistance. Thus, if one believes that tax incentives in developing countries are largely ineffective in promoting foreign investment or economic growth, then developed countries should provide foreign assistance in a form other than tax sparing provisions.[52]

A different view of tax sparing considers the sovereign rights of countries to determine the tax liability of operations conducted in

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[50] Other scholars have proposed alternatives to the simple tax sparing approach outlined above by either allowing tax sparing but only after grossing the amount of income to include the value of the tax subsidy, or by allowing tax sparing only for the excess profits amounts and only if the source country exempts the taxation of normal returns. See Paul McDaniel, "The U.S. Tax Treatment of Foreign Source Income Earned in Developing Countries," (2003) Vol. 35, No. 2. *George Washington International Law Review*, 265; William B. Barker, "An International Tax System for Emerging Economies, Tax Sparing, and Development: It Is All about Source," (2007) Vol. 29, *University of Pennsylvania Journal of International Law*, 349. While both approaches merit further consideration, the likelihood of them being adopted is small.

[51] While tax sparing provisions remain in many tax treaties between developed and developing countries, the necessity of tax sparing has been reduced because many countries have moved to territorial tax systems (at least with respect to active business income).

[52] OECD, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998).

their country.[53] Here, the focus is not on paternalistic transfers from the rich to the poor, but rather the right of any country to have its tax policy respected by other countries. Thus, treaty policy should respect the right of source countries to have exclusive jurisdiction to decide tax policy for activities conducted in their country.

3.2 A more complex view

The question arises as to how much revenue is really being transferred from developing countries to the treasuries of developed countries, and how much foreign investment is being deterred by the absence of tax sparing provisions. The answer is probably very little. This is partly because many countries that previously had worldwide tax regimes have moved to territorial regimes. But even if a country (most notably, the United States) still retained a nominal worldwide regime, several features of the tax regime make it highly unlikely that the income earned outside the country of residence would be subject to current (or, in many cases, future) taxation.

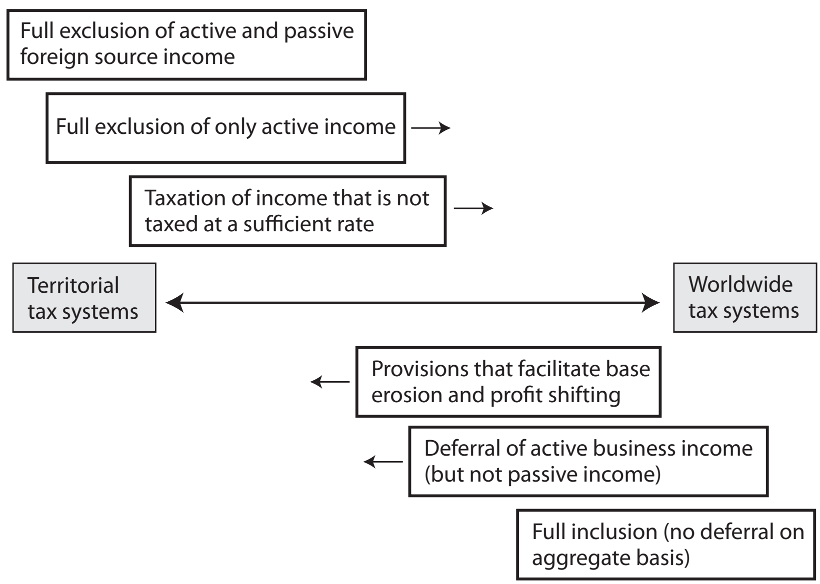
For the reasons set forth below, the simple model of foreign direct investment likely substantially overstates the degree to which the economic benefits from tax incentives are actually diverted from the foreign investor to the tax coffers of the residence country. To see why this is the case, it is helpful to appreciate that territorial tax systems and worldwide tax regimes may be much less different from one another in practice than they appear in theory. Figure 1 shows the continuum between tax systems that are purely territorial and those that are purely worldwide tax regimes. The distinction between worldwide and territorial regimes is blurred as some worldwide regimes have territorial features and some territorial regimes (primarily through Controlled Foreign Corporation (CFC) provisions) have worldwide features.

Although the general rule is that a taxpayer subject to worldwide taxation (such as in the United States) is taxed currently on income earned abroad, the key exception is that taxation in the home

[53] Luis Eduardo Schoueri, "Tax Sparing: A Reconsideration of the Reconsideration," in Yariv Brauner and Miranda Stewart, eds., *Tax Law and Development* (Cheltenham: Edward Elger Publishing, 2013).

country of foreign income earned through a subsidiary is deferred until the income is repatriated. While sometimes the deferral is temporary, in many cases corporations choose to "permanently reinvest" their funds outside the United States. Because of the opportunity to defer tax on foreign source active income simply by non-repatriation, United States corporations have accumulated an extraordinarily large amount of cash and other liquid securities outside the United States. Some commentators have estimated the amount to be more than US$ 2 trillion.[54] With such a large amount of money looking for productive investments, very little investment in other developed or developing countries will be made directly from the United States.

Figure 1
Continuum of types of international tax regimes



But even without the availability of deferral of unrepatriated income, foreign investors could structure their investments in developing countries through other countries (including tax havens) so as to minimize the potential tax liability associated with foreign

[54] Martin A. Sullivan, "Economic Analysis: Designing Anti-Base-Erosion Rules," (2013) Vol. 70, *Tax Notes International,* 375.

investments. So, for example, a large percentage of foreign investments in Africa from developed countries is routed through Mauritius, the Netherlands Antilles or Switzerland. To make matters worse, these countries have been successful in negotiating treaties with several African countries that have zero withholding rates on dividends and other types of distributions. As a result, many developing countries with extensive tax incentive regimes are not collecting revenue on the income either when earned in their country or when it is transferred out of the country in the form of dividends or interest.

Additionally, as discussed earlier, the tax consequences for foreign investors depend on their worldwide tax attributes, not just their tax position in the country of investment. For those taxpayers whose countries of residence have worldwide tax systems with credits for foreign taxes paid, tax consequences will vary greatly depending on the availability of tax credits from taxes paid not only in the country which provided the tax incentives, but also from taxes paid in other foreign countries. For those taxpayers with substantial excess tax credits, the lack of tax sparing provisions does not prevent the foreign investor from obtaining the benefits of tax incentives for investments in developed or developing countries.

In sum, a strong argument can be made that the tax regimes of developed countries (even those with nominal worldwide tax systems) have little impact on the desirability or effectiveness of tax incentives in developing countries. Indeed, under certain circumstances, the potential availability of zero or low-taxed active income from foreign sources will often be very attractive to those tax directors in multinational corporations who seek to minimize the overall worldwide tax liability of the corporation. This results because tax directors can effectively "blend" other types of foreign income that are subject to tax rates above the tax rate of the country of residence with low-taxed income from developing or other countries to reduce the tax liability in the investor's home country.[55] While foreign investors will likely not choose to invest in a particular company simply for the purpose of gaining low-taxed active income, for many investors the availability of

[55] Edward D. Kleinbard, "Stateless Income," (2011) Vol. 11, *Florida Tax Review*, 699; Edward D. Kleinbard, "Stateless Income's Challenge to Tax Policy," (2012) Vol. 68, *Tax Notes International,* 499.

zero or low-taxed income from countries using tax incentives will be a positive factor rather than a negative one.

Interestingly, proposed changes to the tax regimes governing cross-border transactions of some developed countries may change the conclusion that developed countries' tax regimes have little impact on the effectiveness of tax incentives. Mostly motivated by the success of multinational corporations in shifting income to low-tax jurisdictions while still maintaining substantial operations and sales in high-tax jurisdictions, some countries are considering imposing some type of minimum tax on foreign source income.[56] While the types of minimum taxes being considered vary greatly both within and across countries, the basic notion is that the most desirable tax rate (for political and economic reasons) on active foreign source income is somewhere between zero and the full corporate tax rate imposed on domestic source income. For example, if the corporate tax rate imposed on domestic profits is 30 per cent, then income from foreign sources could be taxed at 15 per cent. Under tax systems that allow foreign tax credits, some or all of the foreign taxes paid could be used to offset the minimum tax imposed by the residence country. Depending on the form of minimum tax adopted, it may be that the desirability of tax incentives to foreign investors will be reduced.

4. How does the OECD project on BEPS change the tax environment for tax incentives in developing countries?

4.1 Overview

The OECD project on BEPS has the potential to significantly change the tax regimes for cross-border transactions in both developed and developing countries. It is ambitious in both its scope and time tables. In September 2013, the G20 leaders endorsed the OECD Action Plan to propose measures to limit the opportunities for base erosion and profit shifting.[57] In October 2015, the OECD completed their initial

[56] Mindy Herzfeld, "The Case For and Against a Minimum Tax," (2016) Vol 81, *Tax Notes International*, 807.

[57] OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 1.

project and issued a package of 13 reports.[58] The OECD deserves great credit in setting forth a series of recommendations and proposals to limit actions by multinational corporations to shift income to low-tax or no-tax jurisdictions.

For some measures, the OECD was able to achieve commitments from participating countries to adopt minimum standards to combat specific abuses. In other areas, the OECD put forth recommendations or best practices that countries could choose to adopt to protect their revenue base. The OECD proposals are not self-enforcing, and for the project on BEPS to be successful, countries will need to implement the minimum standards or adopt recommendations and proposals in their domestic legislation.

But it is also important to focus on what the OECD project on BEPS did not do. The project's objective was to repair a broken system of taxing cross-border transactions. The project did not consider alternatives which would have fundamentally changed the current framework for taxing cross-border transactions.[59] Most notably, the OECD project on BEPS did not consider proposals that would: (a) adopt a unitary approach, whereby the separate legal status of related corporations would be ignored; (b) reconsider the arm's-length standard as the primary means of determining transfer prices for intragroup transactions; (c) revise the existing collection of source rules for determining rights to taxation, some of which likely work to the disadvantage of developing countries; or (d) consider different innovative approaches for taxing corporate income, such as a destination-based corporate income tax.

While it is still too early to determine the success of the OECD project on BEPS, here are a few observations. First, the project has changed the economic and political environment for tolerating and addressing tax avoidance strategies by multinational entities. While corporations will continue to engage in tax minimization strategies,

[58] OECD, 2015 Final Reports on BEPS, supra note 1, available at http://www.oecd.org/ctp/beps-2015-final-reports.htm.

[59] For a valuable discussion of the scope of the OECD project on BEPS, see Jeffrey M. Kadet, "BEPS: A Primer on Where It Came From and Where It's Going," (2016) Vol. 150, *Tax Notes,* at 793 and 804.

taxpayers will likely be less aggressive in adopting artificial arrangements to avoid tax liability in jurisdictions where they have significant economic operations. Second, the project provides both developed and developing countries the political cover for a limited period of time to address base erosion and profit shifting strategies in their domestic legislation. In many countries, the likely success of adopting legislation to combat tax avoidance is significantly greater because of the apparent international consensus on these changes being required to protect the domestic revenue base. Finally, while the OECD would prefer multilateral coordination on limiting abuses, several countries have and will continue to act unilaterally in designing their own approaches to combating base erosion and profit shifting. Countries, such as the United Kingdom of Great Britain and Northern Ireland and Australia, have been active in adopting legislation to curb aggressive taxpayer behaviour, and the European Commission and European Parliament have focused their efforts on adopting measures to protect the tax revenue base of member countries.

4.2 Relative change in tax burdens

The effectiveness and desirability of tax incentives have the potential to change substantially if the OECD project on BEPS succeeds in better matching reported taxable income with level of economic activity. This section examines two areas where tax changes resulting from the OECD project on BEPS could alter the relative attractiveness of tax incentives: first, the relative tax burdens between activities in a developing country that are not eligible and those that are eligible for tax incentives; and second, the relative tax burdens between activities conducted in developed and developing countries.

4.2.1 Relative tax burdens of activities that qualify or do not qualify for tax incentives

A key factor in considering the effectiveness and desirability of tax incentives is how much the tax liability is reduced because of tax incentives compared to the tax liability incurred by the foreign investor in the developing country under the regular tax regime. While the primary focus of the OECD project on BEPS is on how multinational entities reduce their tax liability in developed countries, it is important to appreciate that these corporations have used similar techniques in developing countries to shift taxable profits outside of the developing countries while still conducting substantial sales and manufacturing activities within the country.

As discussed below, the OECD project on BEPS has the potential to provide developing countries with additional tools that would aid in improving the ability of these countries to tax foreign investors. Proposals that improve the quality of information available to tax authorities in developing countries have substantial potential to improve tax compliance. Here, improved rules regarding transfer pricing documentation and other OECD efforts with respect to country-by-country reporting will likely aid increasing both the level of tax compliance and the effective tax burden of doing business in a developing country.

The insight here is that increasing the relative tax burden of those activities not qualifying for tax benefits will increase the relative attractiveness of conducting activities that qualify for tax incentives. Phrased differently, foreign investors have two options for decreasing tax liability related to activities in a country—they can use base erosion and profit shifting techniques to avoid paying taxes, or they can seek tax incentives. By reducing the availability of techniques to shift profits outside the country, the relative attractiveness of tax incentives will increase.

4.2.2 Relative tax burdens in doing business in developing and developed countries

If the OECD project on BEPS succeeds in better matching economic activity with reported taxable income, then the cost of doing business in developed countries will increase.[60] This increase in tax burdens in doing business in developed countries will likely make the tax regimes of developing countries relatively more attractive. The key determination is whether tax reform changes resulting from the OECD project on BEPS increase the tax burdens of doing business in developed countries more than they increase the tax burdens of doing business in developing countries.

[60] International Monetary Fund, "Spillovers in International Corporate Taxation," (2014) *IMF Policy Paper.*

There are two primary reasons why the effective increase in tax burdens will be greater in developed than in developing countries. First, some of the proposed recommendations may be more easily adopted and implemented in countries that have the capacity to administer and enforce very complex rules to counter very complex structures to avoid tax liability. Second, if multinational enterprises can no longer conduct operations in developed countries and shift profits to low-tax jurisdictions, then the relative attractiveness of locating economic activity in developing countries will increase, especially with the availability of tax incentives.

4.3 Additional tools

The OECD project on BEPS has the potential to provide tax authorities with additional tools to improve tax collection in developing countries. In several important areas, such as addressing hybrid mismatch arrangements, interest-stripping strategies, treaty abuse, and transfer pricing abuses, the OECD project on BEPS provides either minimum standards, recommendations or a framework for countries to consider in reforming their tax rules to more effectively tax the income of foreign investors.

Similarly, developing countries could be major beneficiaries if the OECD project on BEPS succeeds in increasing the quality of information available to tax authorities. Again, this assumes the information is in a form that can be useful to tax authorities. For example, transfer pricing documentation, including country-by-country reporting requirements, and rules that require taxpayers to disclose aggressive tax planning arrangements could prove extremely useful to tax authorities in developing countries in identifying and combating tax avoidance strategies.

In summary, the OECD project on BEPS provides developing countries with both recommendations for making changes to domestic tax legislation related to cross-border transactions and the political cover (at least for a limited amount of time) to adopt provisions targeting tax avoidance transactions. Developing countries should not miss this opportunity to adopt provisions that could minimize the loss of tax revenue from aggressive taxpayer strategies.

5. Conclusion

Tax incentives can play a useful role in encouraging both domestic and foreign investment. How useful they may be, and at what cost, depends on how well the tax incentive programmes are designed, implemented and monitored. The present chapter has examined the costs and benefits of tax incentives, the relative advantages and disadvantages of different types of incentives, and important considerations in designing, granting and monitoring the use of tax incentives to increase investment and growth.

No easy answers exist to the questions of whether to use tax incentives and what form they should take. There are, however, some clear guidelines that may improve the chances of success of tax incentive programmes. First, the objectives of the tax incentive programme should be clearly set forth. Second, the type of tax incentive programme should be crafted to best fit the objective. Third, the government should estimate the anticipated costs and benefits of the incentive programme in a manner similar to other types of tax expenditure analysis. Fourth, the incentive programme should be designed to minimize the opportunities for corruption in the granting of incentives and for taxpayer abuse in exploiting the tax benefits. Fifth, the tax incentive regime should have a definite "sunset" provision to allow for a determination of the merits of the programme. Finally, the government should be required at a specific time to assess the success and failure of each incentive programme.

Chapter X

Transparency and disclosure

Diane Ring*

1. Introduction

1.1 Base erosion and profit shifting and tax information

Across the globe, countries increasingly express the concern that they are facing serious financial challenges from base erosion and profit shifting (BEPS). Without a stable and adequate tax base, countries lose the financial capacity to provide the infrastructure, social services and development opportunities important to their citizens. In response, the G20 and the Organisation for Economic Co-operation and Development (OECD) organized the project on BEPS. Much of the project has been focused on substantive law—the rules and practices that can allow the tax base of a country to be eroded and profits to be shifted out of the country. But the project recognizes that improved substantive tax rules alone are not sufficient to guarantee the tax base of a country. Without adequate transparency and disclosure of tax information to the taxing authorities, even the most carefully designed substantive tax rules will fail to protect the base. Thus, an important part of BEPS work targets the more administrative issues of transparency and disclosure. Ultimately, the goal is to ensure that tax authorities have adequate and appropriate access to the information necessary for the effective administration of the tax law. As part of this mission, the OECD project on BEPS has included the development of standards for information reporting by multinational enterprises—referred to as "country-by-country reporting" (see section 3.3.2 below).

1.2 Broader context for tax information issues

BEPS work on transparency and disclosure is not occurring in a vacuum. Existing tools offer tax administrators different avenues for

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accessing information. Such tools include: bilateral tax treaties — based on the United Nations Model Double Taxation Convention between Developed and Developing Countries[1] (United Nations Model Convention) and/or the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital[2] (OECD Model Convention)—tax information exchange agreements (TIEAs), regional agreements, and the work of the Global Forum on Transparency and Exchange of Information for Tax Purposes (see sections 5.2 – 5.6 below). Additionally, there are new developments taking place outside the formal OECD project on BEPS, some initiated by individual countries, others by regional networks or other international bodies, including: intergovernmental agreements (IGAs) (see section 4.5 below), automatic exchange of information agreements, the Common Reporting Standard (CRS) for automatic exchange (see section 4.3 below), increased attention to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (section 5.4 below) and automatic exchange of tax rulings among jurisdictions (section 4.7 below). More recently, transparency regarding the beneficial ownership of entities has gained traction as the next frontier on transparency (see section 4.6 below). Although the primary focus of global work on transparency and disclosure has targeted exchange with and disclosure to governments, there is a related and active, but distinct, debate over whether and to what degree such information should be made public.

1.3 Scope of the chapter

The purpose of this chapter is to provide developing countries with an overview of both the new developments in transparency and disclosure as well as existing options for obtaining information. Some of the new developments remain in progress. But the examination provided below of the key goals, concerns, advantages and disadvantages of various options (including existing methods and newly proposed ones)

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

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

may help countries evaluate their own circumstances and determine which options make the most sense for them in their efforts to curb BEPS. Given the newness of certain proposals (for example, actions taken under the OECD project on BEPS, including country-by-country (CbC) reporting), this chapter will devote more attention to reviewing the content and implementation of those options with which countries may be less familiar.

1.4 Pervasive questions in transparency and disclosure

Regardless of the specific mechanism for providing information to tax administrators, a number of universal questions arise: (a) What type of information must be provided? (b) How difficult will it be for the taxpayer to provide that information? (c) How will the information be provided? (d) What kind of technology and infrastructure will be needed by the taxpayers and the country to implement this system? (e) To whom will the information be distributed? (f) What are the permissible uses of the information? (g) Does the country have the capacity to meaningfully use the information? and (h) How will data protection and taxpayer privacy be ensured? The success, failure and impact of a given regime for providing tax information will depend significantly upon the responses to these concerns. That said, there is no single appropriate response to these questions. By examining each of the new emerging information regimes, as well as the existing ones, against the backdrop of these questions, a country can determine its own most effective path towards appropriately protecting its tax base.

2. Transparency and disclosure in the current tax world

2.1 Overview

Recent efforts to ensure that countries have access to the information needed to meaningfully and effectively implement their tax laws have focused on the goals of "transparency" and "disclosure." These terms appear in the OECD Action Plan on BEPS[3] and a variety of related

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

documents and commentaries. These two terms are distinct from the related phrase "exchange of information"; thus, it may be useful to specify their meaning. All three play a critical role in guaranteeing that countries have the needed information.

2.1.1 Transparency

The term "transparency" reflects the idea that a country needs to understand how a taxpayer is conducting its business, structuring its operations and making investments in the country. To achieve this level of understanding, it may be necessary for the country to have a solid grasp of the activities, transactions and business structure of the taxpayer beyond the borders of its jurisdiction.

2.1.2 Disclosure

The term "disclosure" captures the idea that a country will need access to the information necessary to provide transparency regarding the activities of a taxpayer.

2.1.3 Exchange of information

The phrase "exchange of information" refers to the process (and mechanism) by which a country can obtain information regarding a taxpayer or the transactions of the taxpayer, typically from another country. The most well-known mechanisms for exchange of information are bilateral tax treaty provisions based on Article 26 of both the United Nations and the OECD Model Conventions, discussed in section 5.2 below.

2.2 Current need for information

As noted above, and discussed more extensively in section 5.1 below, the demand for taxpayer information by taxing authorities is not new. However, the current lack of transparency that many countries face (owing in part to insufficient disclosure) has become a significant problem. The growth in cross-border commerce by multinational enterprises (MNEs), both foreign and domestic, has created a crisis in information for several reasons, as outlined below.

2.2.1 *Cross-border tax planning*

Taxpayers with cross-border activities can engage in a wider array of tax planning techniques which can lead to base erosion and profit shifting. Substantive tax law changes that are designed to eliminate various arbitrage opportunities are one tool for attacking this problem. But substantive tax reform is insufficient given that arbitrage may be difficult to identify and fully eradicate. Adequate disclosure remains vital for the needed transparency regarding taxpayer activities.

2.2.2 *Volume of cross-border business*

Both the number of taxpayers engaging in cross-border business and the volume of business they conduct have been increasing. Thus, the scale of the base erosion and profit shifting at stake is significant. Correspondingly, the amount of information that countries must access, process and evaluate to stem the loss of tax base is also quite large. Mechanisms for providing information to countries must be tailored to promote the goal of transparency and understanding.

2.2.3 *Role of developing countries in the global economy*

Developing countries have experienced significant growth in inbound investment by foreign multinationals as well as in outbound activities of their own multinationals. Income generated by these MNEs forms a critical portion of the tax base and, as noted in section 2.2.1 above, is especially susceptible to base erosion and profit shifting tax planning.[4]

For all countries facing such base erosion and profit shifting from multinationals, the ability to access and use tax information is vital. However, developing countries may find that they encounter serious barriers to securing needed information, compared with other jurisdictions. Not only do developing countries often experience

[4] OECD, *Measuring and Monitoring BEPS, Action 11—2015 Final Report* (Paris: OECD, 2015) (noting that the "fiscal effects [of BEPS] on developing countries, as a percentage of their GDP . . . are higher than in developed countries given the greater reliance on CIT revenues and often weaker tax enforcement capabilities of developing countries"), at 79, available at http://www.oecd-ilibrary.org/taxation/measuring-and-monitoring-beps-action-11-2015-final-report_9789264241343-en.

a number of domestic constraints on their ability to access and use taxpayer information (see section 2.2.4.2 below), they also may find it more difficult to obtain information from other jurisdictions (see section 2.2.4.3 below). Additionally, to the extent that foreign multinationals pose a greater information transparency and disclosure risk than domestic ones, developing countries face a distinct challenge. These countries typically have a substantial amount of inbound investment relative to outbound and therefore have more foreign multinational taxpayers than domestic ones.

2.2.4 Informational challenges for developing countries

As noted in section 2.2.3 above, developing countries are especially dependent upon corporate taxation of MNEs for their tax base. To the extent that MNEs are able to engage in successful BEPS transactions, developing countries typically have fewer alternative tax bases upon which to draw (for example, individual taxes and consumption taxes).[5] Thus, BEPS problems can be particularly significant for these jurisdictions. The costs of BEPS to developing countries may be more severe and the impediments to overcoming BEPS may also be greater for these jurisdictions. Developing countries may experience a number of hurdles in securing information, transparency and disclosure from multinational businesses. A review of these barriers directs attention to the changes that may be needed and allows reform proposals to be measured against the list of challenges so as to see where and to what extent such proposals can help. The impediments can be grouped into roughly three categories: (a) domestic law; (b) domestic enforcement; and (c) international support.

2.2.4.1 Domestic law impediments

Some countries already have in place domestic law reporting requirements that provide relevant taxpayer information. Such reporting requirements can include the obligation of the taxpayer to provide information regarding: (a) foreign related entities and related-party

[5] See, for example, OECD, *Part I of the Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* (Paris: OECD, July 2014), at 11, available at http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf.

transactions; (b) foreign financial assets and accounts; (c) discrepancies between tax reporting and accounting treatment; and (d) certain kinds of tax shelters or otherwise suspect transactions and structures. This information can be useful in helping a country determine whether to initiate an audit, and where and how to direct its attention in an audit. If a developing country does not have such reporting regimes in place, changes to domestic law reporting requirements may be one step in the process of enhancing transparency and disclosure. The final recommendations from the OECD project on BEPS regarding Actions 12 and 13 in the OECD Action Plan can serve as a guide for countries that are just starting to institute such reporting requirements (see sections 3.4 and 3.3 below, respectively).

The work of the Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum) identifies other fundamental domestic law features that can inhibit (or conversely, facilitate) transparency. The peer review process of the Global Forum serves as a mechanism for assessing the compliance of a country with "the international standard of transparency and exchange of information" [6] (see section 5.6 below). In evaluating a jurisdiction against this standard, the Global Forum reviews a number of key dimensions of the domestic law critical to transparency. One set of factors looks to the availability of information on the following topics: (a) ownership and identity information for entities and structures; (b) accounting records; and (c) banking information for account holders. Another set of factors looks at the rules and procedures governing access to that information. The expectation is that the designated tax authority in the country (the competent authority) has the power under domestic law to obtain such information and provide it under an exchange of information mechanism, while respecting taxpayer rights.[7] Although

[6] OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2014: Report on Progress* (Paris: OECD, 2014), at 16, available at http://www.oecd.org/tax/transparency/GFannual-report2014.pdf; see also ibid., *Progress Report to the G20 Finance Ministers and Central Bank Governors: Update on Effectiveness and On-going Monitoring* (September 2014).

[7] OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, Information Brief (November 2013), at 6–7, available at http://www.oecd.org/tax/transparency/global_forum_background%20brief.pdf.

the focus of the peer review process and recommendations may be directed towards enhancing exchange of information with other countries, many of the same rules, practices and procedures that enable a country to participate actively in the exchange of information would improve the ability of a country to implement its own tax system and limit base erosion and profit shifting. The same availability of and access to information that enables a jurisdiction to be a global partner in sharing information with other countries would facilitate its own tax enforcement and revenue collection. Thus, engagement in the work of the Global Forum may be useful for developing countries, regardless of the amount of taxpayer information sought from their jurisdiction (see section 5.6 below).

A more targeted form of peer review, assessing for compliance with BEPS Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting, is being implemented under the auspices of the OECD (see section 3.3 below).[8]

2.2.4.2 Domestic enforcement impediments

All countries face the question of whether their administrative system is effective in using the information available. However, developing countries may face barriers to deriving maximum benefit from the information that they currently possess (or that they may be able to acquire in the immediate future).[9] These barriers can include: (a) limited audit staff; (b) audit staff without the required training and experience (for example, an ability to review foreign language documents, a detailed understanding of transfer pricing and tax law); (c) regular attrition of highly trained staff; (d) technological limitations to the ability to receive, manage, store and work with different types of data; (e) inadequate systems for identifying and matching taxpayers; and (f) existing culture of limited tax compliance.

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[8] OECD, *BEPS Action 13 on Country-by-Country Reporting: Peer Review Documents* (Paris: OECD, 2017), available at http://www.oecd.org/tax/beps/beps-action-13-on-country-by-country-reporting-peer-review-documents.pdf; see also OECD, "Country-by-country reporting," available at http://www.oecd.org/tax/beps/country-by-country-reporting.htm.

[9] See generally, OECD, *Part I of the Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries*, supra note 5.

Any recommendations on how to increase access to information and improve transparency and disclosure (for example, recommendations pursuant to Actions 11, 12 and 13 of the OECD Action Plan on BEPS) should be evaluated against the backdrop of such domestic enforcement impediments. For example, transparency and disclosure recommendations that could ease any of the current impediments might be particularly attractive to developing countries, even if other options were more effective for developed economies. To the extent that a particular recommendation would yield more limited benefits for a developing country owing to domestic enforcement constraints, adoption of that recommendation might be paired with a concrete support plan designed to build the capacity of the tax administration to use the information effectively so as to curb BEPS in its jurisdiction.[10] In recognition of the capacity-building needs of many developing countries, the International Monetary Fund (IMF), the OECD, the United Nations and the World Bank announced their joint engagement on a "Platform for Collaboration on Tax" in April 2016. The accompanying "Concept Note" emphasized that this collaboration among these major international organizations aims to offer support and assistance to developing countries.[11] As an example of such support, in January 2017, the Platform announced that it had designed a "draft toolkit" to provide developing countries with assistance in transfer pricing analysis and implementation, and in particular with the identification of "comparables."[12] Additionally, in July 2015, the United Nations Development Programme (UNDP) and the OECD initiated a joint

[10] See, for example, C20, "Position Paper Background: Governance" (7 August 2014), at 6, which encourages research regarding the cost/benefit trade-off for automatic exchange of information and the impact on developing countries.

[11] International Monetary Fund-OECD-United Nations-World Bank, "The Platform for Collaboration on Tax: Concept Note", at 5 (19 April 2016), available at https://www.imf.org/external/np/sec/pr/2016/pdf/pr16176.pdf.

[12] World Bank, "The Platform for Collaboration on Tax Invites Comments on a Draft Toolkit Designed to Help Developing Countries Address the Lack of Comparables for Transfer Pricing Analyses," (24 January 2017), available at http://www.worldbank.org/en/news/press-release/2017/01/24/the-platform-for-collaboration-on-tax-invites-comments-on-a-draft-toolkit-designed-to-help-developing-countries-address-the-lack-of-comparables-for-transfer-pricing-analyses.

project for building tax capacity, "Tax Inspectors without Borders" (TIWB). As part of the TIWB mission, "tax experts from both developed and developing countries are deployed to work side-by-side with local tax officials on tax audits." [13] Among the criteria that the TIWB has developed for assessing success in building tax capacity within a jurisdiction are: (a) increases in requests made by the jurisdiction to other countries for exchange of information; and (b) increased willingness among taxpayers to "provide data and information to tax administration", characterized as "voluntary disclosure of data and information." [14]

2.2.4.3 International impediments

The success of a country in tackling BEPS will depend in part upon its ability to actively engage with the international community and obtain information from other jurisdictions. The most obvious examples of such engagement arise under exchange of information provisions in bilateral tax treaties (based on Article 26 of the United Nations and OECD Model Conventions) and under TIEAs (such as those based on the OECD Model Agreement on Exchange of Information on Tax Matters) (see sections 5.2 and 5.3 below). Therefore, the more limited the network of bilateral treaties and TIEAs of a country, the more constrained it may be in gathering needed information. In the same vein, bilateral tax treaties and TIEAs whose terms impose significant barriers to exchange (such as the level of information that the requester must provide, or the nature of the tax violation in the requesting State) effectively reduce the value of these agreements as meaningful tools for developing countries.

International mechanisms for sharing information across borders are important in their own right as independent and currently existing tools for responding to BEPS problems. But the availability of these mechanisms may also be important as the OECD BEPS project final recommendations are being implemented across the globe. The

[13] OECD-UNDP, Tax Inspectors Without Borders, "Progress Report and 2016 Work Plan for Discussion and Approval," at 1 (16 April 2016), available at http://www.tiwb.org/About/governing-board/governing-board-progress-report-and-2016-work-plan.pdf.

[14] Ibid., at 16.

ability of a country to benefit fully from BEPS recommendations will depend upon its treaty network. For example, as discussed more extensively in section 3.3., access to CbC reports under BEPS Action 13 requires a country to obtain that information from the home jurisdiction of the MNE parent. The expected mechanism is an exchange of information provision in an existing treaty (including the Multilateral Convention on Mutual Administrative Assistance in Tax Matters).[15] Thus, developing jurisdictions, particularly those with more limited treaty networks (tax treaties and TIEAs) will find it harder to obtain the information and proceed with their efforts to stop base erosion and profit shifting. This issue is widely acknowledged, and is discussed more extensively in section 3.3.5.2 below.

2.3 Response to increased need for information

The focus of the global tax community on BEPS has included recognition of the centrality of information to tax administrations. As discussed below, the G20 also supports the OECD Action Plan on BEPS, including its attention to transparency, disclosure and information. The Action Plan operates against the backdrop of existing mechanisms for the provision of information. Its value added derives from its focus on the information-driven crisis points in BEPS. It targets the gaps created by the current system of providing information to tax authorities that leave countries susceptible to BEPS through related-party transactions, transfer pricing and cross-border arbitrage.

However, the BEPS setting is not the only context in which global tax actors continue to examine how tax administrations can be strengthened through transparency and disclosure. In some cases, individual countries have taken action that has triggered a more global response. For example, the United States implementation of the Foreign Account Tax Compliance Act (FATCA) regime, which requires foreign financial entities to disclose information regarding United States taxpayers to the United States tax authorities or face penalties, has led

[15] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 — 2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report_9789264241480-en.

to the signing of IGAs (see section 4.5 below). Additionally, other countries increasingly seek to secure similar commitments for taxpayer information from foreign financial entities. In yet other cases, international bodies are promoting enhanced access to information through automatic information exchange (see section 4.2 and 4.7 below) and/or through the expansion of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (section 5.4 below).

Thus, while the need to acquire information is as old as the international tax system itself, the current climate for tax administrations differs from that of the past. The scale of information needed, its complexity and its importance have all grown dramatically. Although traditional information-based tools for facilitating tax compliance remain relevant and valuable, close examination of the ways in which transparency and disclosure can be enhanced is now a critical topic for countries. To that end, section 3 of this chapter reviews and analyses the work on transparency and disclosure carried out by the OECD project on BEPS. Section 4 then undertakes a similar examination of new developments in information-gathering occurring outside of the OECD project on BEPS. Finally, section 5 provides context for the new reforms and recommendations by revisiting more familiar tools and techniques currently available for enhancing transparency and disclosure.

As the review of each new and old information-related provision and practice reveals, there are no simple solutions to the complexity of today's information-rich (and information-dependent) environment. There may be substantial agreement on the importance of transparency and disclosure as broad concepts, but the effort to translate those principles into specific practices and regimes unmasks the challenges and concerns outlined in section 1.4 above. A country's assessment of the right balance and mix among these risks, trade-offs and benefits may vary depending upon its domestic infrastructure, economic position, existing network of tax agreements and tools, and substantive tax system.

2.4 Summary of the current tax environment and its connection to transparency and disclosure

Multinationals with significant cross-border business activities form an important part of today's economy for all countries. The growth in cross-border commerce has increased the opportunity for tax planning and, correspondingly, the needs of countries for taxpayer information. Developing countries may confront a number of challenges as their tax administrators seek the information necessary for effective enforcement of the tax laws. The challenges include: (a) domestic law impediments (inadequate required reporting by multinationals regarding assets, accounts and transactions); (b) constrained domestic enforcement (owing to limited audit staff; inexperienced staff; attrition of trained staff; and insufficient technological capacity to receive, manage and store data, and to link taxpayers to data); and (c) international impediments (a limited treaty network and high treaty thresholds for requesting information). The OECD project on BEPS recognizes the centrality of tax information to meaningful tax administration and the action items discussed below explicitly seek to increase both the quality and the availability of relevant information. But in addition to the OECD project on BEPS, transparency and disclosure is the subject of other international efforts to curtail base erosion and profit shifting, including the rising number of IGAs, the support for automatic exchange of information, and the expansion of treaty networks. Finally, the varied efforts to enhance countries' access to information through both transparency and disclosure have been accompanied by a growing call for more public disclosure of tax information. The public disclosure of tax and tax-related information is greatly debated, and the resulting tension is playing out on a national, regional and global level.

3. BEPS and transparency and disclosure

3.1 Overview of BEPS action items related to tax information, transparency and disclosure

The OECD Action Plan on BEPS released in July 2013 included two significant action items related to the increased provision of information to countries by taxpayers:[16] Action 12: Require taxpayers to disclose

[16] Other action items may, in a more limited manner, enhance transparency and disclosure through mechanisms not based on taxpayer provision of information. For example, Action 5: Counter harmful tax practices more

their aggressive tax planning arrangements; and Action 13: Re-examine transfer pricing documentation (including the "country-by-country reporting" template). The final reports were issued on 5 October 2015.

The most serious attention has been directed to Action 13 (transfer pricing and related issues), which includes the recommendation for CbC reporting. This action item, which has been ranked as being of "high" relevance to developing countries,[17] is discussed extensively in section 3.3 below. The companion information-reporting provision, Action 12 (aggressive tax planning), which has been reported as being of "medium" relevance to developing countries,[18] is more briefly considered in section 3.4 below.

One additional action item, Action 11, seeks to improve the understanding of countries (and of the global tax community) of the "scale and economic impact" of BEPS by establishing "methodologies to collect and analyse data on BEPS and the actions to address it." This action item, which has been listed as being of "high" relevance for developing countries,[19] is considered in section 3.2 below.

3.2 Action 11: collect and analyse data on BEPS

Although Actions 12 and 13 share with Action 11 the common mission of helping countries more effectively address BEPS problems through improved knowledge and understanding, their focus and "solutions" are different. Actions 12 and 13 target specific taxpayer conduct through enhanced reporting requirements for actual taxpayers. Both Actions 12 and 13 change the kinds of information that taxpayers

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effectively, taking into account transparency and substance, focuses in part on "including compulsory spontaneous exchange on rulings related to preferential regimes." OECD, *Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 — 2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en.

[17] OECD, *Part I of the Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries*, supra note 5, at 31.

[18] Ibid., at 30.

[19] Ibid.

must provide to countries. The new information presumably will enable a country to evaluate a multinational taxpayer more effectively and accurately and identify conduct that is creating BEPS (either by aggressive planning or by cross-border related-party transactions and structures). In that way, Actions 12 and 13 function more as a support to and enhancement of the audit function.

3.2.1 Goals of Action 11

In contrast to Actions 12 and 13, Action 11 targets a more systemic goal — obtaining a comprehensive, overall picture of the BEPS problem. Action 11 identifies "[s]ix indicators of BEPS activity" that "highlight BEPS behaviours using different sources of data, employing different metrics, and examining different BEPS channels." [20] Under Action 11, ongoing analysis and monitoring of BEPS impacts across jurisdictions and across time seek to determine the effects of BEPS and of BEPS countermeasures on overall tax receipts, total employment, geographic location of employment, investment in physical capital, investments in knowledge-based capital, tax competition, and so forth.[21] However, the Final Report observes that the use of the six BEPS indicators and the resulting BEPS analyses are "severely" hindered by "the limitations of the currently available data." [22] The data to be collected pursuant to Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance and Action 13 (transfer pricing-related documentation, see section 3.3 below) are expected to be an important new source of BEPS-related data. Once the data and methodologies are in place to "measure" the problem, the indicators and tools to monitor the success of BEPS actions taken by countries can provide guidance on continuing challenges as well as areas of success.[23]

[20] OECD, *Measuring and Monitoring BEPS, Action 11—2015 Final Report*, supra note 4, at 15.

[21] Ibid., at 80; see also OECD, "*Request for Input, BEPS Action 11: Establish methodologies to collect and analyse data on BEPS and the actions to address it*" (4 August 2014), at 3, available at http://www.oecd.org/ctp/public-request-for-input-beps-action-11.pdf.

[22] OECD, *Measuring and Monitoring BEPS, Action 11—2015 Final Report*, supra note 4, at 16.

[23] Ibid., at 15–16.

The focus is on not only what is happening within a given country owing to BEPS, but also the "spillover" effects on other jurisdictions.[24] This newly collected information, along with the diagnostic tools in Action 11, is expected to help policymakers and countries evaluate all of the changes implemented pursuant to the OECD Action Plan on BEPS and determine whether the implementation of steps under other BEPS action items are meeting their goals.

3.2.2 Data collection under Action 11 and its impact

Some of the data will be collected on an aggregate basis (such as foreign direct investment (FDI) and balance-of-payments data), but as noted in section 3.2.1 above, Action 11 also envisages that taxpayer-level data (financial statements, tax returns) will play an important role. We can expect that the taxpayer-level data portion of Action 11 will raise many of the same questions and concerns as Actions 12 and 13. Thus, the examination of these questions in section 3.3 below in the context of CbC reporting should be relevant and helpful to the discussions surrounding implementation of Action 11 undertaken by governments and researchers. Data collection, reporting and analysis under Action 11, though potentially influential in the longer term, will have less immediate relevance for those developing countries seeking to protect their tax base.

3.3 Action 13: transfer pricing–related documentation

3.3.1 Overview

Action 13 responds to the determination that transfer pricing is a crucial facet of BEPS and that tax administrators face a serious problem in responding to these BEPS issues because of information asymmetry between tax authorities and taxpayers. Tax authorities need the ability

[24] See, for example, International Monetary Fund, "Spillovers in International Corporate Taxation," (2014) *IMF Policy Paper*, at 1, available at http://www.imf.org/external/np/pp/eng/2014/050914.pdf. It observes that "spillovers [from the international aspects of corporate taxation] are especially marked and important for developing countries." See also OECD, *Measuring and Monitoring BEPS, Action 11—2015 Final Report*, supra note 4, at 80, 99, (noting the importance of assessing and addressing spillover effects).

to evaluate the global value chain of an MNE and to obtain detailed data on the structure of its activities, operations and intragroup transactions. Taxpayers, too, may find current transfer pricing regimes unsatisfactory to the extent that varying transfer pricing documentation standards and practices across countries place an unnecessary and unproductive burden on reporting taxpayers.[25]

Action 13 calls for a re-examination of transfer pricing documentation, with attention devoted to two potentially competing goals: enhancement of transparency for tax administration, and sensitivity to taxpayer compliance costs. But perhaps more importantly, Action 13 seeks the establishment of rules that would require an MNE to "provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template."[26] This reporting template concept is known as "country-by-country reporting."

The introduction in Action 13 of the new reporting format with new information has raised a number of questions that have dominated the discussion of CbC reporting. Briefly, the issues can be broadly identified as: (a) the kind of information required; (b) the burden on taxpayers; (c) the permitted recipients of the information; (d) the permitted uses of the information; (e) the ability of a country to use the information; (f) the protection of taxpayer data; and (g) the delivery mechanism.[27]

3.3.2 OECD introduction of Action 13

In October 2015, the OECD released the Final Report on Action 13 regarding Transfer Pricing Documentation and CbC Reporting.[28] It

[25] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report*, supra note 15, at 10; see also OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 3, at 23.

[26] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report*, supra note 15, at 9; see also OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 3, at 23.

[27] See, for example, OECD, *Memorandum on Transfer Pricing Documentation and Country by Country Reporting* (3 October 2013), available at http://www.oecd.org/ctp/transfer-pricing/memorandum-transfer-pricing-documentation-and-country-by-country-reporting.pdf.

[28] OECD, *Transfer Pricing Documentation and Country-by-Country*

identified the three core goals for transfer pricing documentation: (a) risk assessment: "to provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment"; (b) appropriate taxpayer pricing practices: "to ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns"; and (c) audit support: "to provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction." [29]

3.3.3 Transfer pricing documentation and country-by-country reporting under Action 13

Action 13 recommends a standardized reporting system for taxpayers, with three components: (a) the master file; (b) the CbC template; and (c) the local file.

3.3.3.1 Master file

The master file should contain "standardized information for all MNE group members." The goal of this information is to provide an "overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity in order to assist tax administrations in evaluating the presence of significant transfer pricing risk." [30] The information required in the master file covers five categories: (a) the group organizational structure; (b) a description of business or businesses; (c)

Reporting, Action 13—2015 Final Report, supra note 15. The Final Report includes modifications reflecting input and comments received on the OECD Discussion Draft on Action 13, which had been released more than a year earlier, in January 2014: OECD, *Public Consultation: Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (30 January 2014), available at http://www.oecd.org/ctp/transfer-pricing/discussion-draft-transfer-pricing-documentation.pdf.

[29] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report*, supra note 15, at 12.

[30] Ibid., at 14.

the intangibles held by the group; (d) the intercompany financial activities; and (e) the financial and tax positions of the MNE.

The relative brevity of the description of the master file belies the number of complicated choices and options embedded in its design. One issue was whether to have MNEs prepare the file for the group as a whole or by line of business. The Final Report specifies that the taxpayer "should present the information in the master file for the MNE as a whole." [31] But the report allows for the organization of information by line of business, where appropriate—although emphasizing that "[e]ven where line of business presentation is selected, the entire master file consisting of all business lines should be available to each country in order to assure that an appropriate overview of the MNE group's global business is provided." [32] The Final Report reiterated that the master file information is intended to provide a high-level risk overview and should be used consistent with that function (and, for example, should not replace actual audits and more detailed taxpayer-specific analysis and inquiry).

3.3.3.2 Country-by-country template

The CbC template requires taxpayer reporting on the following items: (a) revenue (related and unrelated party); (b) profit (loss) before income tax; (c) cash tax; (d) current year tax accruals; (e) stated capital; (f) accumulated earnings; (g) number of employees; and (h) tangible assets. [33] This information should be provided on a country-by-country basis (as opposed to entity-by-entity). The template should be accompanied by a list of all group entities and permanent establishments (PEs), by country, along with a specification of their major activities.

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[31] Ibid., at 15.

[32] Ibid., at 15.

[33] Ibid., at 29. The January 2014 Discussion Draft for Action 13 had originally suggested 17 reporting items, but this was reduced following extensive taxpayer comments. See, for example, Kevin A. Bell, "Country-by-Country Template Won't Require Entity-by-Entity Financial Details, Andrus Says," BNA Transfer Pricing Report (10 April 2014), available at http://www.bna.com/countrybycountry-template-wont-n17179889500/; see also OECD Update on BEPS Project—Webcast PowerPoint (2 April 2014), available at http://www.oecd.org/ctp/OECD-BEPS-Webcast-2April.pdf.

The Final Report responded to several questions regarding the CbC template:

(a) *Accounting approach*: In addressing a number of questions that arose regarding the proper source of data used in the CbC report and whether the template should reflect a bottom-up approach using local statutory accounts, or whether the template should reflect top-down allocation of the group's consolidated income, the Final Report noted:

   (i) The Reporting MNE should use the same data sources consistently from year to year in the CbC report;

   (ii) The Reporting MNE may "use data from its consolidation reporting packages, from separate entity statutory financial statements, regulatory financial statements, or internal management accounts";[34]

   (iii) The revenue, profit and tax reporting in the CbC template need not be reconciled to the consolidated financial statements;

   (iv) If the Reporting MNE chooses to use statutory financials as the foundation for the CbC report, then "all amounts should be translated to the stated functional currency of the Reporting MNE at the average exchange rate for the year";[35]

   (v) Differences in accounting principles across jurisdictions do not have to be reflected through adjustments.

(b) *Taxes*: Taxes paid "include[s] withholding taxes paid by other entities" (whether associated or independent) on behalf of the MNE group.[36]

(c) *Cross-border related-party payments*: The revenue reported on the CbC template should be divided into related party and unrelated party revenues. These revenue numbers "include revenues from sales of inventory and properties, services, royalties, interest, premiums and any other

[34] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report*, supra note 15, at 32.

[35] Ibid.

[36] Ibid., at 33.

> amounts," but does not include payments that are treated by the payor jurisdiction as dividends.[37]

Thus, in summary, taxpayers have the flexibility to use either statutory account data or financial statement reporting packages to complete the template—if data usage is applied consistently across the group and across years. Information contained in the CbC template should provide tax authorities with a clearer picture of the relationship between reported profits, taxes paid and the underlying details of economic activity (for example, tangible assets, employees, employee expense). The information provided through the CbC template offers countries the ability to assess the transfer pricing and base erosion risk they face with the multinational and thus determine where and how to audit. But acknowledging a serious concern of taxpayers, the Final Report cautions against countries effectively bypassing detailed audit work and using the CbC data to assert transfer pricing adjustments.

3.3.3.3 Local file

The third element in the Action 13 package of transfer pricing information is the local file. The local file includes jurisdiction-specific information that complements the master file in helping the country ensure that the taxpayer complies with the arm's length principle and transfer pricing rules in its major transactions connected to that jurisdiction. Broadly, the local file includes more detailed information regarding relevant transactions between the MNE entity in the local jurisdiction and its related entities in other countries, such as financial details of the transactions, a comparability analysis for pricing, and "selection and application of the most appropriate transfer pricing method."[38]

The Final Report contains an annex delineating the local file information.[39] The information is grouped into three categories:

(a) *Local entity*: The first concerns information regarding the local entity itself: its management structure, organization chart, identification of individuals to whom the local

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[37] Ibid., at 33.

[38] Ibid., at 15.

[39] Ibid., at 27–28.

management must report (and the jurisdiction of their principal offices), local entity business strategy, any recent participation by the local entity in a business restructuring, and key competitors.

(b) *Controlled transactions*: The second category pertains to information regarding controlled transactions involving the local entity. A more specific list of information is enumerated here, which goes to the core of how the taxpayer applies the transfer pricing rules:

- Description of the transactions (for example, services, purchase of goods, loans) and the context in which that transaction took place (for example, business activity, financial activity, cost contribution arrangement);
- Aggregate charges for each category of transaction;
- Identity of the related parties involved and the nature of their relationships;
- Functional analysis of the taxpayer and the related entities regarding each category of controlled transactions (functions performed, assets used, assets contributed, intangibles involved, risks borne and changes compared to prior years);
- Identification and description of controlled-party transactions that might impact the transaction in question;
- Specification of the most appropriate transfer pricing method by category, the reasoning for the selection, which entity is the tested party (where relevant) and why, assumptions made in using the method, and financial information used;
- If using a multi-year analysis, include an explanation why;
- Information regarding comparables—how selected, search strategy, application of method, and relevant financial indicators used in the analysis;
- Any adjustments to comparables, to the tested party;
- Copies of material intercompany agreements executed by the local entity;
- Copies of unilateral, bilateral, and/or multilateral APAs, or other tax rulings, to which the local jurisdiction is not a

party but which are related to the controlled transactions included above;

- Conclusions regarding the arm's length status of related-party transactions based on application of the selected method.

(c) *Financial information*: The third category seeks financial information important to the application of transfer pricing analysis: the annual financial accounts of a local entity (audited, if available), schedules showing how financial data that was used in the transfer pricing method is linked to the annual financial statements, and summary schedules of the financial data of the comparables and the source of that data.

3.3.4 Implementation issues under Action 13

Documentation and burden: Taxpayers are expected to price at arm's length based on contemporaneous information, and prior to engaging in the transaction, with confirmation completed before filing the tax return. But Action 13 urges countries to consider the burden on the taxpayers when making documentation requests. For example, taxpayers that can reasonably demonstrate the absence of comparables (or their absence at an appropriate cost) should not be required to bear such a burden.[40] Furthermore, the Final Report specifically does not recommend that transfer pricing documentation be certified by an outside auditor.[41]

Timing: Given the diversity in country expectations regarding when documentation should be available (at the time of filing the return or by the time of audit) and how long taxpayers should have to respond to requests, the suggested best practice is to require that taxpayers have the local file ready by the time the tax return for the relevant year is filed (unless the jurisdiction practises contemporaneous auditing, which would require the information prior to the filing of the return). The master file should be updated, if necessary, by the filing date for the ultimate MNE parent's tax return. In countries for which final statutory financial statements and related CbC reporting data are not available until after the tax return is due, the best practice

[40] Ibid., at 16.

[41] Ibid., at 20.

would allow for extension of completion of the CbC template to one year after the last day of the fiscal year of the MNE parent.

Materiality: Conscious of the need to balance the competing interests of countries (seeking access to transfer pricing information) and taxpayers (seeking a "reasonable" documentation burden), Action 13 recommends documentation requirements with materiality thresholds based on the "size and nature of the local economy, the importance of the MNE group in that economy, and the size and nature of local operating entities, in addition to the overall size and nature of the MNE group."[42] For example, many jurisdictions offer simplified transfer pricing documentation rules for small and medium-sized enterprises. Nonetheless, such smaller businesses would be expected to provide data and documentation regarding material cross-border related-party transactions upon request and also to complete the CbC template.

Document retention: Again, balancing taxpayer burdens and the need of a country to access information, the Final Report recommends that tax administrators take into account the difficulty in locating documents from prior years, and that they should make such requests only when there is a "good reason" relating to a transaction under review. To assist in the balance of burden and need, taxpayers should be permitted to store the documentation in a manner they deem appropriate (electronic, paper, and so forth) as long as it can be produced in a useable form to the tax authorities.

Documentation updates: The master file, the local file and the CbC report should be updated annually, although in many cases information (for example, functional analysis or description of business) may not change. To the extent that operating conditions are unchanged, tax administrations may permit taxpayers to update their database searches for comparables in the local file every three years. However, financial data for the comparables would be updated annually.

Language: Recognizing the potential cost and burden of providing documentation in the local language, the Final Report states that local law should specify the required language. But Action 13 encourages countries to permit filing of documentation in "commonly used languages where it will not compromise the usefulness of the

[42] Ibid., at 77.

documents."[43] To the extent the tax authorities need a translation of documents, they can make that request to taxpayers and provide adequate time to secure the translation.

Penalties: The Final Report cautions against the imposition of documentation-related penalties (civil or criminal) where taxpayers do not have access to the information. But it is not a good defence to contend that some other related party bears the group responsibility for documentation. The decision not to impose these penalties would not prevent a jurisdiction from making the underlying transfer pricing adjustment in order to bring taxpayers into compliance with the arm's length principle. Two strategic observations regarding documentation-related penalties may guide the thinking of a country about designing a penalty regime:

(a) Differences in penalty regimes among countries may influence whether a taxpayer "favours" one jurisdiction over another in pricing. For example, if one jurisdiction imposes stronger penalties (compliance and/or underlying substantive pricing penalties) than another, the taxpayer may be more inclined to shift resources (and even transfer pricing profits) to the jurisdiction with the stronger penalty regime so as to avoid the imposition of large penalties;

(b) A documentation regime that includes benefits for compliant taxpayers may increase the actual compliance of a taxpayer with the documentation rules, resulting in a favourable outcome for the country. For example, if taxpayers who meet documentation requirements receive some measure of penalty protection or a shift in burden on some or all issues, there will be added taxpayer incentive for upfront conformity with the documentation requirements.

Confidentiality: As the prospect of increased disclosure of information becomes more likely, taxpayers are expressing greater concern regarding confidentiality. Action 13 urges tax administrations to protect taxpayers from public disclosure of trade secrets, scientific secrets and other confidential information. The need for protection should lead countries to carefully consider their requests for such information and

[43] Ibid., at 18.

to provide assurances to the taxpayer regarding confidentiality. To the extent that public court proceedings or judicial decisions will entail some measure of disclosure, confidentiality should be preserved to the extent possible and disclosure should be as limited as possible.

Implementation:

(a) *Changes to domestic law*: Tax law, including transfer pricing rules, are a function of domestic law. Thus, in order to achieve the benefits of increased uniformity under Action 13 (as well as the widespread adoption of best practices advocated by the Final Report), countries need to make changes to their own domestic law. Thus, for example, countries need to enact transfer pricing and documentation rules that require their locally based MNE affiliates to produce information required for the master file, CbC template and local file (as detailed in the three annexes attached to the Final Report). Given the general importance of consistency, and the need for master file information to be consistent across jurisdictions, countries should review their own domestic rules. The goal would be domestic rules that require production of information for the master file that conforms to the annexes contained in the Final Report (detailing the information in both the master file and the CbC reporting template). In terms of timing, Action 13 recommends that MNEs (with annual consolidated group revenue equal to or exceeding €750 million) be required to file their first CbC report for fiscal years beginning on or after 1 January 2016, although the Final Report acknowledges that some jurisdictions may need additional time to follow their domestic law procedures for implementing new rules. To facilitate timely introduction of these new reporting requirements, the annex contained in the Final Report includes model legislation for requiring the MNE parent to file the CbC report in its residence jurisdiction. This model could be modified by individual jurisdictions to meet their specific needs.

(b) *Delivery mechanism*: The Final Report recommends that the MNE parent make the master file and the local file available to the local affiliates, who will then share it with their local taxing authorities ("the master file and local file [will] be filed directly with the tax administrations in each relevant jurisdiction as required by those administrations").[44] The CbC reports, however, would be filed with the residence jurisdiction of the MNE parent. Then, the MNE parent jurisdiction would share the CbC report with the jurisdictions of the local affiliates through a treaty information exchange mechanism. The Final Report includes three model competent authority agreements (CAAs) to be used to facilitate exchange of CbC reports. The models are based on exchange under: (a) the Convention on Mutual Administrative Assistance in Tax Matters; (b) bilateral tax conventions; and (c) tax information exchange agreements (TIEAs). Although three models are provided, ideally the mechanism would be a CAA under the Multilateral Convention. That is, parties to the Convention could sign the CAA under the Convention and achieve widespread automatic exchange in a more streamlined manner. In accordance with this CAA, each signatory would exchange any CbC reports it received from MNEs headquartered in its jurisdiction with other signatories satisfying the terms of the CAA (including confidentiality). As at 26 January 2017, 57 jurisdictions have signed the CAA for automatic exchange of CbC reports under the Multilateral Convention.

Under what are expected to be limited circumstances, a secondary mechanism for obtaining the CbC report, including local filing, may be possible as a backup.

Given that access to this new reporting format and information is at the heart of Action 13, many countries have strongly advocated that the delivery mechanism should be uncomplicated and widely available (see section 3.3.6.2.2

[44] Ibid., at 20. This direct filing has raised some concerns regarding taxpayer protection. See Ryan Finley, "Lawmakers Urge Limiting Exchange of CbC Reports," (2016) Vol. 81, *Tax Notes International*, 751. (The Vice President of Tax and Domestic Economic Policy at the National Association of Manufacturers noted she was particularly troubled by the direct filing of the master report with local tax authorities because it would not be protected by the Treasury's safeguards that are in place for the exchange of the CbC reports.)

below). Taxpayers, however, have repeated their concerns that the delivery mechanism should include appropriate safeguards ensuring the protection of their information.

3.3.5 General questions regarding Action 13 recommendations

3.3.5.1 Taxpayer burden

The Action 13 recommendations (see section 3.3.3 above) have sought to reflect the concerns raised by multinational taxpayers and their advisers. Primarily, these concerns centre on an overarching theme that compliance with documentation is much more difficult than the OECD and governments understand. Taxpayers had enumerated a variety of challenges and barriers to their immediate, low-burden compliance with the master file, CbC template and local file requirements. These difficulties included: existing reporting systems not aligned to the requested information; different reporting and measurement approaches within different parts of a multinational and across multinationals; difficulty in securing the information in a timely fashion; the need to rework data from affiliates into a consistent reporting format; the cost of gathering requested data; the burden arising from uncertainty in definitions and applications (for example, what counts as an employee). Not surprisingly, given the objections articulated, taxpayers raised the most questions about the CbC template.

Despite this general critique, taxpayer responses to the release of the recommendations under Action 13 seem to vary considerably. MNEs have pursued one or more of the following steps: (a) reported that their operations are significantly out of step with the data sought; (b) used the OECD comment period (after release of the Discussion Draft) to press for modifications; (c) tested their ability to comply with the master file, CbC template and local file structure; and (d) explored new information management systems to facilitate their compliance with anticipated reporting requirements. As jurisdictions have begun enacting domestic legislation regarding the master file, local file and CbC report, taxpayers have commenced their own corresponding data collection process. In some cases, MNEs may have already been gathering such information in order to comply with pre-existing, country-specific reporting requirements imposed by jurisdictions which already had required reporting on the worldwide activities of their MNEs and certain foreign subsidiaries.

3.3.5.2 Delivery mechanism

Among the most controversial issues raised by Action 13 is how the required information (master file, CbC template, local file) is delivered. As noted in 3.3.4 above, the CbC report will be filed with the MNE parent's residence jurisdiction and shared with other countries via a treaty exchange mechanism. The master file and local file will be filed directly with the local jurisdiction.

Taxpayers had generally urged that required filings be made to the country of the MNE parent corporation. The primary argument advanced for the single central filing (at least of the master file and the CbC template) was the concern that some jurisdictions might not adequately protect information. The expectation is that if the data is provided only to the parent jurisdiction and then shared via treaty request, there will be additional protection because countries requesting information pursuant to a treaty must ensure and commit to specified confidentiality requirements.

The significance of the taxpayer concern about confidentiality turns on two points: the legitimacy of the concern over protection of taxpayer information, and the sensitive nature of the data. First, appropriate protection of taxpayer data is an accepted norm, although there are differences in exactly what is protected, when it is protected and how. Model exchange of information provisions (for example, Article 26 of both the United Nations and OECD Model Conventions) make reference to the expectations regarding taxpayer privacy, and expound further upon the application of the standard in the accompanying commentaries. Thus, the decision in the Final Report to share the CbC template via treaty mechanisms directly addresses taxpayer concerns over data protection. But that same delivery mechanism decision poses challenges for requesting jurisdictions, particularly developing countries (see section 3.3.6 below).

Second, regardless of the broader subject of taxpayer privacy, to the extent that information in the master file and the CbC template is generally publicly available in the case of many multinationals, the argument in favour of filing those documents only with the jurisdiction of the parent—as ultimately concluded in the Final Report—may be weakened. For example, in the case of publicly traded entities, how much of the information is publicly reported in compliance with securities (or other) regulations? Are there other public sources for that information? If so, how much weight should have been given to arguments about uncertain protection of the data? Alternatively, should the public availability of data be less relevant in the debate if the "public" information is cumbersome to gather? This argument would be grounded on the assumption that difficult-to-assemble data is in reality "less public" and thus there would be a real impact on these taxpayers if their well-organized reporting to the tax authorities were inadvertently made public. Should privately held multinationals be treated differently if their publicly available entity information is more limited?

The conclusion in the Final Report to specify treaty-based delivery of the CbC report reflects OECD determination that arguments favouring enhanced confidentiality were ultimately more persuasive.

3.3.5.3 Use of information

Related to the delivery mechanism concern (see section 3.3.5.2 above) is the separate question of which information a country may access and what it may appropriately do with the information. Taxpayers typically have expressed several concerns about what jurisdictions might do with information compiled by taxpayers.

Replace audit: One concern articulated by taxpayers is that countries, particularly those that may be resource-constrained, will use the master file and the template data as the basis for an actual transfer pricing allocation. For example, if such a jurisdiction draws the conclusion that inadequate income (and thus tax) is being reported in its jurisdiction relative to the value chain, functions and reporting of income worldwide, the tax authorities might simply stop at that stage and make a transfer pricing adjustment. The OECD has stated that the purpose of the master file and the CbC template is to facilitate risk assessment and decisions about where to allocate audit resources — not to replace the audit. The Final Report explicitly states that the master file and CbC template are understood to be a high-level view and are not expected to displace an audit of the taxpayer.[45]

[45] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 — 2015 Final Report*, supra note 15, at 22.

Shift to formulary: In a similar vein, taxpayers are also concerned that countries may use this information (master file and CbC template) to shift informally to a formulary approach to transfer pricing, despite formally being committed to an arm's length approach. In part, countries might be inclined to use the information in this way if they find it difficult to locate comparables for the traditional application of the arm's length method. Again, developing countries, in particular, may face this challenge (see section 3.3.6 below). Although substantive reforms to transfer pricing rules are not part of Action 13, this taxpayer concern reveals the connections among administration, documentation and substantive law. However, the work of the Platform for Collaboration on Tax (see section 2.2.4.2 above) in developing a transfer pricing draft toolkit could serve as a brake on any inclination to informally shift to formulary, by assisting developing countries in identifying useful comparables.

Assist beyond transfer pricing: Should countries use some of this high-level information, in particular the CbC template, to assist more broadly in efforts to combat base erosion and profit shifting? Certainly, Action 11 envisions that the data generated through compliance with Action 13 (including the CbC report) will assist in assessing the medium- and longer-term effects of BEPS and BEPS countermeasures.[46] The decisions made in the Final Report regarding the content of the CbC template and the specific columns of information will impact how countries can effectively use the filings to reach beyond transfer pricing concerns to other causes of base erosion.

Format and function: Taxpayers raised a variety of questions regarding exactly how to report data properly, especially under the CbC template, including how to handle various accounting differences within the multinational group, how to define "employees" and how to treat PEs. The annex to the Final Report provides "specific instructions" on completing each column of the template.[47] The basic content of the columns, along with these instructions, likely reflects the intended and appropriate uses of the data, and the potential burdens on taxpayers.

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[46] OECD, *Measuring and Monitoring BEPS, Action 11—2015 Final Report*, supra note 4, at 202–203, 260.

[47] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report*, supra note 15, at 33–35.

For example, the decision to require reporting of only the number of employees and not their compensation likely reflects a conclusion that the effort of trying to ascertain what counts as compensation for all employees across entities and jurisdictions is not necessary for a high-level risk assessment given the burden it might impose. "Number of employees" in each jurisdiction might be an adequate and less burdensome measure of the MNE presence in a country. Emphasizing consistency in reporting across tax years, the instructions provide guidance on full-time equivalent reporting of employees, reliance on average employment levels and treatment of independent contractors.

The flexibility permitted in sourcing financial data similarly reflects the view that a steady comparative picture of the MNE activities across countries and years is the core of the high-level risk assessment intended by the master file and CbC template. However, the Final Report's flexibility on whether taxpayers report information from the bottom up or the top down (see section 3.3.3.2 above) has been viewed by some as directly impacting the template's ability to aid in providing even a high-level risk assessment. From this viewpoint, bottom-up reporting effectively replicates (and obscures) any BEPS already in place and thus fails to signal the real risk to the tax authorities; only top-down reporting reveals even the high-level risk of BEPS problems for the jurisdiction.

3.3.5.4 Data protection and authorized public disclosure

In addition to the concern expressed by countries regarding how the master file and template will be reported and shared (see section 3.3.5.2 above) is a general focus on data protection and a special focus on the potential for authorized public disclosure. On a broad level, taxpayers fear that some jurisdictions will not follow agreed and accepted standards for data protection, either because of inadequate internal rules and oversight mechanisms or because of a more intentional decision to share information with other agencies or domestic competitors. As discussed in section 3.3.5.2 above, the decision in the Final Report that MNEs file the CbC report only with the parent jurisdiction, who shares it only with countries committed to data protection consistent with the model treaties, provides a measure of certainty regarding data protection. Suggestions for further enhancing confidentiality have included a mechanism for reviewing country compliance with confidentiality protocols, a reporting system for taxpayers experiencing confidentiality problems and possible penalties for jurisdictions that fail to appropriately protect taxpayer data.

A country's compliance with the confidentiality standards of Action 13 will be assessed as part of a peer review process under the auspices of a new OECD-based group. In February 2016, following the October 2015 release of the BEPS Final Reports, the OECD announced a "new framework" for country participation in the continuing BEPS work and in the updating of international tax rules: the Inclusive Framework.[48] The goal of the Inclusive Framework is to enable all interested jurisdictions to "participate as BEPS Associates in an extension of the OECD's Committee on Fiscal Affairs (CFA)."[49] Participation in the Inclusive Framework, however, requires that the BEPS Associates commit to implementing the four minimum standards from the final BEPS Project recommendations: (a) tackling harmful tax practices; (b) confronting treaty shopping; (c) implementing CbC reporting; and (d) improving dispute resolution.[50] This commitment will be tested through a peer review process. In February 2017, the OECD released a document containing "key documents" to be used in the peer review of Inclusive Framework members regarding their commitment to CbC reporting: (a) terms of reference; (b) methodology for the conduct of peer reviews; and (c) detailed outline of the phases of the review.[51] Compliance with confidentiality standards plays a prominent role in this review.[52]

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[48] OECD, "All Interested Countries and Jurisdictions to Be Invited to Join Global Efforts Led by the OECD and G20 to Close International Tax Loopholes," (23 February 2016), available at http://www.oecd.org/ctp/all-interested-countries-and-jurisdictions-to-be-invited-to-join-global-efforts-led-by-the-oecd-and-g20-to-close-international-tax-loopholes.htm.

[49] Ibid. See also OECD, "Background Brief: Inclusive Framework for BEPS Implementation" (January 2017), at 5, (specifying how jurisdictions would participate on an equal footing), available at https://www.oecd.org/tax/background-brief-inclusive-framework-for-beps-implementation.pdf.

[50] Ibid., at 13.

[51] OECD, *BEPS Action 13 on Country-by-Country Reporting: Peer Review Documents*, supra note 8.

[52] The three major elements of compliance with Action 13 to be explored in the review process are: (a) the domestic legal and administrative frame-

In the context of BEPS, data protection has an additional dimension beyond the above-discussed concern that countries might either: (a) carelessly allow unauthorized access to private commercial or tax information; or (b) intentionally share information with State-owned competitors or with favoured domestic competitors. Specifically, taxpayers also worry that reporting to governments under Action 13 will serve as a prelude to authorized public disclosure of certain tax information. Not only have there been explicit demands for public disclosure of some Action 13 material (particularly the CbC template), but a disclosure trend can be observed in recent public disclosure projects, including new United States Securities and Exchange Commission reporting rules and other similar projects in extractive and financial industry sectors (see section 4.4 below). The increased public awareness of the role and conduct of multinationals in the economy and the import of BEPS issues has led to calls for public disclosure of some, or all, of the information that would be provided by businesses to tax authorities under the BEPS initiatives.[53] From a perspective that citizens should be able to assess and evaluate the conduct of their own government with MNEs, and should be able to ensure that the country and the treasury are properly protected, public release of some or all of the master file and template data would likely be sought. Public release of basic tax information could serve as a check on corruption, inadequate enforcement and/or inadequate substantive tax rules.

Following the release of the 2014 BEPS Deliverables, including on Action 13, the BEPS Monitoring Group issued a review of the progress on the BEPS action items to date. With regard to the question of disclosure of Action 13 to the public, the group concluded:

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work; (b) the exchange of information network; and (c) confidentiality and use of CbC reports. Ibid., at 12.

[53] See, for example, C20, "Position Paper Background: Governance," supra note 10, at 5 (advocating a "commitment to make public country-by-country reporting the global standard" assuming that "[e]nsuring this information is made public would enable tax administrators in the poorest countries to easily access this information and address base erosion and profit shifting"). See also, Andrew Goodall, "U.K. Ministers Reject MPs' Call to Action on Transparency," *Worldwide Tax Daily* (23 January 2017) (discussing new United Kingdom power to require public disclosure).

> In view of the very general nature of the information required by the CbC report template, there seems no valid reason why these reports should not be published. The [BEPS] report rightly stresses the need for tax authorities to preserve strict confidentiality of information which may be commercially confidential. However, the CbC report as now designed would not normally include such information. Publication should therefore be the norm, subject perhaps to allowance for exceptional cases. There is widespread public interest in such greater corporate transparency, which has led to mandatory publication requirements especially in the EU and the US of such reports in specific sectors (extractive industries and financial services). Finally, this data would constitute an invaluable information resource, which should be treated as public domain. At present, corporate data, even if they originate from state legal requirements e.g. for publication of company accounts, are in practice extremely difficult to access. Hence, both researchers and even government bodies such as tax authorities, are dependent on private providers of data-bases. This is particularly damaging to developing countries, both because of the high cost of subscriptions, and because the coverage of developing countries in such databases is poor. The G20 should take a lead in making this important standard a worldwide expectation, and ensure that the data is publicly available to support corporate transparency and facilitate tax enforcement everywhere in the world.[54]

Other organizations have similarly urged increased public reporting.[55] For example, Christian Aid, in commenting on the January 2014 OECD Discussion Draft for Action 13, stated that it is "firmly of the belief that the Country by Country (CbC) report be made public," citing the opportunity to hold both governments and multinationals more accountable on the basis of such tax information.[56] The

[54] BEPS Monitoring Group, *OECD BEPS Scorecard* (7 October 2014), available at https://bepsmonitoringgroup.files.wordpress.com/2014/10/oecd-beps-scorecard.pdf.

[55] Ryan Finley, "NGOs Urge Treasury, IRS, to Make CbC Reports Public," (2016) Vol. 82, *Tax Notes International*, 765.

[56] Christian Aid Submission, *OECD BEPS project: Discussion draft on*

Trade Union Advisory Committee to the OECD (TUAC) similarly supported public disclosure of certain MNE taxpayer information in order to facilitate informed public discussion.[57]

The government of the United Kingdom of Great Britain and Northern Ireland was granted domestic statutory power in 2016 to require multinationals to publicly report their CbC profits and taxes. Now the debate in the United Kingdom concerns whether, when and how it should exercise this new power. The United Kingdom Department for International Development maintains that the OECD is the best and most appropriate place to pursue such discussions and action.[58] On a more regional level, the European Union (EU) Council

Transfer Pricing Documentation and CbC Reporting (February 2014), available at http://www.oecd.org/ctp/transfer-pricing/volume1.pdf.

[57] See Trade Union Advisory Committee (TUAC), *OECD Public Consultation on Draft Revised Guidance on Transfer Pricing Documentation and Country-by-Country Reporting: Comments by the TUAC* (21 February 2014), available at http://www.oecd.org/ctp/transfer-pricing/volume4.pdf. It states that "[p]ublic disclosure would resolve a number of outstanding issues, including the above mentioned problem of access to information for developing countries. It would also help inform other stakeholders, who are affected by the activities and operations of MNEs, including workers, local communities, civil society groups and of course citizens at large. The content of the public filing could cover a selected number of reporting items which in our view would not threaten or violate business confidentiality rights. Items could include: (i) organisational structure, (ii) important drivers of business profit, (iii) supply chain for material products and services, (iv) service arrangements between members of the MNE group, (v) business restructuring transactions during the fiscal year, (vi) geographic distribution of the top 5/10% highest compensated employees, (vii) geographic distribution of employees and other supervised workers expressed in number of full-time employments, and (viii) MNE's important financing arrangements with unrelated lenders. . . . Regarding reporting on tax and incomes, reporting should include (i) consolidated group accounts and (ii) tax due and tax paid in each country. The public filing should at least include reporting on a single ratio between tax charge and declared profits to give some indication on the potential presence of risk for transfer pricing manipulation and other aggressive tax planning schemes."

[58] Andrew Goodall, "UK Ministers Reject MPs' Call to Action on Transparency," supra note 53 (noting the debate within the United Kingdom

has been reviewing a proposal to require MNEs to publicly disclose their income taxes paid and certain other information.[59] But in December 2016, the French Constitutional Council ruled that public CbC reporting is not constitutional.[60]

Business organizations continue to strongly urge careful protection of taxpayer data and reject the idea that public disclosure of some of the Action 13 information (such as the CbC report) could be an appropriate response. The Business and Industry Advisory Committee to the OECD (BIAC) contended that the master file and the CbC report "should only be provided by taxpayers to their home (headquarter) tax administrations, to then be shared through existing exchange of information channels with the necessary confidentiality requirements."[61] Rather than contemplate some form of limited public disclosure, BIAC sought enhanced measures to safeguard taxpayer information (including "anti-infringement procedures" to protect taxpayers from unauthorized disclosure, the viewing of certain information only at the taxpayer site, and legally binding confidentiality agreements between taxpayers and tax administrations).[62] The International Alliance for Principled Taxation similarly recommended that "the CbC report be filed with the parent company's home country tax authority as the Discussion Draft contemplates, but that it then be shared with other tax authorities only through a formal EOI channel (whether spontaneously or upon request), so that confidentiality obligations will apply to the recipient governments."[63]

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regarding whether and how the government should exercise its new (2016) statutory power to require multinationals to publish CbC reports of their profits and taxes).

[59] EU Council, "EU Council Reviews Status of Income Tax Information Disclosure Proposal," *Worldwide Tax Daily* (19 December 2016).

[60] Alexander Lewis, "French Constitutional Council Finds Public CbC Reporting Unconstitutional," *Worldwide Tax Daily* (12 December 2016).

[61] OECD Business and Industry Advisory Committee (BIAC), *"OECD Discussion Draft on Transfer Pricing Documentation and Country by Country Reporting"* (21 February 2014), available at http://www.oecd.org/ctp/transfer-pricing/volume1.pdf.

[62] Ibid.

[63] International Alliance for Principled Taxation, *Comments on Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (23 February 2014), available at http://www.oecd.org/ctp/transfer-pricing/volume2.pdf.

In addition to the concerns about the public disclosure of trade secrets and related information, multinationals and their representatives have expressed concern that public disclosure of tax information could easily be misinterpreted and used (inappropriately) for political purposes.

The OECD has repeatedly asserted that the Action 13 information is intended only for governments and only for the purposes of making risk assessments for BEPS. The Final Report reiterates that "[t]ax administrations should take all reasonable steps to ensure that there is no public disclosure of confidential information." [64] Given the importance of this issue (access and use of information) and the widely differing views on what information should be made available to whom, and on what terms, implementation of Action 13 will continue to generate significant debate.

3.3.5.5 Independent country action

One important thread paralleling the entire BEPS process is the distinct possibility that countries may pursue unilateral responses to their BEPS problems. Such action could be in advance of broad agreement on BEPS steps or contemporaneous with it. Additionally, as noted in section 3.3.5.1 above, some countries already impose fairly extensive reporting obligations on their own multinationals, as well as on other entities doing business in their jurisdiction. The risk or possibility of independent unilateral action by countries on BEPS problems is relevant throughout the debates on specific BEPS recommendations. For example, in measuring and evaluating the burden imposed on taxpayers by the requirements under the master file, CbC template and local file, it is fair to consider the reduction in burden that corporations may experience through such a unified and streamlined reporting system. Similarly, taxpayers themselves may reassess their resistance to the OECD project on BEPS given the risk of multiple, country-specific reporting requirements that might arise should the project not continue to move forward with some success. Such individual country requirements seem all the more possible given that countries could use the Action 13 master file and CbC template as a baseline in crafting

[64] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report*, supra note 15, at 19.

their own reporting legislation.[65] This "risk" of independent action by countries may be greatest with respect to those jurisdictions that have some leverage in the market. In contrast, a developing country that perceives itself as having more limited negotiating power vis-à-vis multinationals may be less inclined to impose independent reporting requirements perceived as "unfriendly" to business. Effectively, countries could be competing based on their relative lack of disclosure. Those developing countries might find it advantageous if a uniform standard of public reporting is broadly adopted (along the lines of BEPS Action 13), if it is adopted at all.

3.3.6 Developing country issues regarding Action 13

Although all countries share many of the same concerns, questions and goals regarding reporting under Action 13, developing countries may have a distinct perspective. In terms of both the overall mission of Action 13 and the implementation-specific decisions, developing countries should evaluate the BEPS project against their own circumstances.

3.3.6.1 Overall perspective

The broad mission of Action 13, to improve a country's risk assessments for BEPS (through the master file and CbC template) and to facilitate transfer pricing audits (through the local file), is likely important to developing countries with limited audit and other resources. First, to the extent that developing countries must decide where to direct their most sophisticated audit resources, they would want to identify their most serious BEPS problems. A high-level assessment tool (master file and CbC template) for each MNE operating in the jurisdiction would provide the country with a solid basis for making that preliminary risk assessment and assigning audit resources.

Second, assuming the form and content of the information package (the master file, CbC template and local file) becomes standard for MNEs, developing countries can rely on a unified format as they make both high-level risk assessment decisions and as they evaluate taxpayer-specific transactions among related entities. Both their

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[65] See section 3.3.5.4 above for examples regarding the efforts in the United Kingdom, France and the EU to require public CbC reporting.

own MNEs, as well as foreign multinationals conducting business in their jurisdiction, will be utilizing the same format and standards, thereby producing more uniform information that may be more readily subject to comparison. Again, for a jurisdiction with limited resources, this enhanced uniformity in reporting (assuming it carries the requisite content) should allow the tax administration to process and evaluate the information more effectively — and train new tax professionals.

Third, a global commitment to Action 13 recommendations should benefit developing countries. If many countries, including countries with more enforcement resources, are seeking the information, presumably taxpayers will more readily comply. Moreover, this compliance would likely be not only in name (for example, providing documents labelled "master file" and "template") but also in spirit (providing materials meeting the expectations articulated for each of these documents). Thus, use of the BEPS process to enhance information reporting and document production by MNEs offers certain advantages for resource-constrained jurisdictions.

3.3.6.2 Implementation-specific perspective

Although the driving purpose behind Action 13 would be compatible with and would help facilitate most developing country audit and enforcement goals, the details regarding the actual implementation of Action 13 are critical to their real-world impact. Both the content of the reporting (the master file, the CbC template and the local file) and the manner in which this information is provided to countries will ultimately determine whether the potential value of Action 13 is realized.

3.3.6.2.1 Content

Several of the design questions that have arisen in the context of crafting the master file, CbC template and local file may be particularly relevant for developing countries.

Reporting entities: First, given that developing countries may find they have many permanent establishments (PEs) operating in their jurisdiction, the clarifications in the Final Report regarding the operations for which reporting is required should prove valuable. The annex contained in the Final Report confirms that a "Constituent Entity" of the MNE group which must be included in the reporting is: (a) any separate business unit of the MNE group included in the Consolidated Financial Statements (or that would be included if publicly traded); (b) any business unit excluded from the MNE group's Consolidated Financial Statements solely on size or materiality; (c) any PE of any separate business unit of the MNE group included in (a) or (b) if the unit prepares separate financial statements for financial reporting, regulatory, tax reporting or internal management control purposes.[66]

Accounting: Second, as initially noted in sections 3.3.3.2 and 3.3.5.3 above, countries in general, but developing countries especially, might prefer the top-down allocation of group income to the extent that they are concerned that use of the local statutory accounts to construct a bottom-up reporting may disguise underlying BEPS problems. If the local statutory accounts reflect inappropriate pricing and profit shifting, that reality might be built into the template responses and effectively obscure the base erosion and profit shifting. This concern is not unique to developing countries. As noted in 3.3.5.3 above, the Final Report allows either approach so long as it is applied consistently by the MNE. However, the choice of the MNE, and the resulting template, may play a more pivotal role in the tax enforcement process of a developing country if it lacks other reporting mechanisms or information that could signal a risk for BEPS with regard to a particular taxpayer.

Verification: Third, although attention has been given to the source of data used in constructing the files, less attention has been focused on verification of the information. Of course, verification of data is always an issue for tax authorities. If there are expectations regarding the ability of a country to verify information, it would be useful to outline them more specifically; the Final Report has not addressed this issue. This concern may be most prominent in the local file context because that information would likely be circulated to a more limited pool of tax authorities. In contrast, the master file and CbC template would likely receive wider circulation. It is not clear, however, whether a jurisdiction that finds the master file or template inaccurate would be expected to unilaterally share that information with other countries in possession of the file or template.

[66] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 — Final Report*, supra note 15, at 31.

Language: Fourth, the Final Report does not specify a reporting language and leaves that decision to local law. However, countries are "encouraged" to allow taxpayers to file their documentation in "commonly used languages." [67] Certainly, in many cases it is likely to be more efficient for the developing country that the master file be in English rather than the language of the MNE parent jurisdiction (assuming that language is not English). However, the personnel constraints that developing country tax administrations face include the limited pool of English-speaking tax professionals with sufficient international tax training to effectively review the files, make risk assessments and then pursue taxpayer audits where appropriate. If more information is made available in the language of the developing country, the number of tax professionals in government available to work on audits, reviews and examinations may increase.

Burden: Fifth, the dominant taxpayer critique of Action 13 reporting (master file, CbC template and local file) has been that of the burden it imposes on taxpayers (see section 3.3.5.1 above). Although the question of burden is important, and requested information should be useful and reasonable in context, the balance of benefit and burden may look different from a developing country perspective. Taxpayers have urged that they not be asked to provide difficult-to-gather data that a country would be unable to use. This objection is not levelled solely at developing countries, but it is one that is heightened where a country has limited resources and is ultimately constrained in its ability to process information meaningfully. However, despite this claim, which might suggest that the benefits to developing countries would be less than the burden to the taxpayer, a broader look at the benefits and burden question might produce a different conclusion. Developing countries are often understood to be highly dependent upon income taxes, specifically corporate income taxes, for their revenue base. There are a number of factors contributing to this fiscal picture and although it may shift in the long term, at present there is a serious cost to the fiscal welfare and stability of these countries when they are unable to collect corporate income tax otherwise due. Additionally, developing countries have fewer internal resources to engage in extensive monitoring and reviewing of multinational taxpayers and their tax planning. Thus,

[67] Ibid., at 18.

the benefit to these jurisdictions in having MNEs provide relatively uniform, comprehensive information of both a qualitative and quantitative nature that assists in risk assessment and in audit is distinctly valuable. That said, the BEPS project is a group effort by countries to respond to BEPS. However, in making a group-wide assessment of the burden imposed on taxpayers by Action 13 compared to the benefit for tax administrations, it will be important to bear in mind that the benefit should not be measured solely from a developed country perspective.[68]

3.3.6.2.2 Delivery

Just as the question of to whom (and how) information will be provided is very significant for taxpayers, it is equally critical for developing countries. As suggested in section 3.3.6.1 above, Action 13 will play little meaningful role if countries cannot predictably and effectively access the information in the master file, CbC template and local file. Given that many of the key advantages of this information package for developing countries derive from the resource-savings opportunities it provides (see section 3.3.6.1 above), it is important that countries have easy access to the information in a timely fashion. To the extent that

[68] Various international groups have urged that the OECD project on BEPS appropriately incorporate the views and needs of developing countries. See, for example, C20, "Position Paper Background: Governance," supra note 10, at 2 (recommending "an inclusive and transparent process that ensures developing countries benefit from these tax reforms"); G20 Leaders' Declaration (St. Petersburg, 6 September 2013), at 13 ("Developing countries should be able to reap the benefits of a more transparent international tax system, and to enhance their revenue capacity, as mobilizing domestic resources is critical to financing development"), available at https://g20.org/wp-content/uploads/2014/12/Saint_Petersburg_Declaration_ENG_0.pdf; G20 Leaders' Communiqué (Brisbane, 16 November 2014), at 2 ("We welcome deeper engagement of developing countries in the BEPS project to address their concerns. We will work with them to build their tax administration capacity and implement AEOI."), available at https://www.g20.org/Content/DE/_Anlagen/G7_G20/2014-g20-abschlusserklaerung-eng.pdf?__blob=publicationFile&v=3. It was in part in response to these critiques that the OECD introduced its Inclusive Framework in February 2016, discussed above in 3.3.5.4. The Inclusive Framework commits to providing all members with the opportunity to participate on an equal footing.

the delivery mechanism imposes costs, the value of the entire process for developing countries is diminished.

For example, given that the CbC report is provided only to the jurisdiction of the MNE parent, with the expectation that other countries will secure that information through an automatic exchange of information, several barriers are created. First, the developing country must be a signatory to a relevant treaty (Multilateral Convention, bilateral treaty or TIEA). Given that developing countries typically have more limited treaty networks and more limited capacity to expand their networks, straightforward access to the CbC report may be problematic for some countries. Second, even if the developing country is a signatory to one of the three categories of treaties, there must also be a competent authority agreement (CAA) in place providing for automatic exchange. Particularly in cases where a developing country has only a TIEA, or perhaps a bilateral treaty, it may take time to get the treaty partner to execute the necessary CAA (this practical limitation was the motivation in the Final Report for advocating for a multilateral CAA under the Multilateral Convention). In the absence of the CAA for automatic exchange, the developing country could pursue the process of requesting the information. This step requires the efforts of a tax professional sufficiently familiar with the process, the rules and possibly a foreign language. Moreover, it is not clear what information the requesting jurisdiction would have to provide to make this request. One of the long-standing problems with treaty-based exchange of information provisions has been the requirement imposed on requesting jurisdictions to provide upfront details regarding the underlying taxpayer and the matter being investigated. This requirement would contradict one of the core tenets of Action 13—allowing countries to make more meaningful BEPS risk assessment early in the process. Yet depending upon the precise treaty mechanism under which the country is making the request for information, it might need to know much more information in order to request the master file and template. Not only would this be difficult to accomplish in some cases, it will inevitably require more audit resources simply to secure the information intended to provide the risk assessment tools. Developing countries will be able to take these steps for fewer taxpayers, thus decreasing the beneficial impact of Action 13.

Third, tax administrations generally are seeking to make the audit process more contemporaneous. Working through an on-request treaty mechanism to obtain the master CbC report, particularly if the requesting country must provide detailed supporting information, would only extend the audit process.

Fourth, developing countries are less likely to have MNEs with the parent located in their jurisdiction. As a result, a much larger portion of their enforcement work to combat BEPS would require the preliminary step of obtaining CbC reports from other countries. In contrast, developed countries typically have more multinationals headquartered in their jurisdictions and would (under a system of filing only in the parent country) have the information immediately available. Moreover, these developed countries would likely be particularly, though not exclusively, interested in BEPS on the part of their own major multinationals. Thus, although all countries would (under this approach) be required to seek information via treaty (including automatic exchange), the burden would be most significant for developing countries which are resource-constrained, dependent upon corporate income taxes and have few domestic multinationals.

3.3.6.2.3 Domestic

Commitment to implementation of Action 13 raises several questions for countries from a domestic perspective. As with some of the observations above, these points may not apply uniquely to developing countries, but they may resonate strongly with them. First, domestic legislation would be required to fully implement the recommendations. To the extent that countries have not yet implemented significant reporting requirements for MNEs, they would likely need to do so now. Given the importance of obtaining the information, developing countries would want to ensure their ability to enact the required legislation.

Second, taxpayers have expressed the concern that countries, especially developing countries, may be inclined to bypass a real audit, and use the master file and CbC template to impose a transfer pricing adjustment based on a more formulary approach (see 3.3.5.3). Some taxpayers have urged that the OECD secure commitments from countries affirming that they will not forgo the arm's length method, even informally. It is unclear what such a commitment would look like. However, the peer review for the Inclusive Framework will include examination of whether a jurisdiction is using the CbC reports appropriately to ensure that it is not employing them as conclusive evidence for an adjustment or as the basis of a formulary adjustment. Given this attention to the issue, it makes sense for jurisdictions, including developing countries, to review their own positions and commitments on the subject.

Third, taxpayers have also repeatedly raised confidentiality as an objection to widespread filing of the master file and CbC template. Regardless of the delivery mechanism(s), countries receiving access to information are expected to comply with standards of confidentiality and privacy regarding taxpayer information. If the current domestic law of a country is not consistent with the typical expectations reflected in, for example, the Multilateral Convention and Article 26 of either the United Nations or OECD Model Convention, the country may wish to pre-emptively evaluate the changes that would be necessary to domestic law for compliance.

Fourth, Action 13 itself does not impose documentation or transfer pricing penalties. That remains the province of the individual countries. The Final Report recommends against documentation penalties in cases where the taxpayer does not have access to the data. But the Final Report anticipates the need for both documentation and mispricing penalties in some cases. As countries examine their own documentation and substantive pricing penalties, it is important to bear in mind the risk that taxpayers will "favour" jurisdictions with more severe penalties: taxpayers might devote more resources to documentation compliance in such jurisdictions and, where in doubt on pricing, shift profits to the jurisdiction with higher penalties (to avoid the imposition of such penalties). Given that developed countries frequently have well-established transfer pricing documentation and substantive penalties regimes, developing countries should carefully evaluate their own penalty regimes with these observations in mind.

3.3.6.3 Options

Assuming that developing countries secure workable access to the CbC template, there remains the question of how they can best use this information. Given the resource constraints faced by many developing countries, targeted capacity-building might enhance the ability of these countries to use the information received from all three formats (master file, CbC template and local file) in a strategic manner. For example, training for developing country tax auditors could focus on the information included in these files and how to use that information to make overall risk assessments and, where appropriate, to pursue taxpayer-level audits. Using "case studies" of hypothetical taxpayers with corresponding master files, CbC templates and local files would help developing countries not only receive the information but begin to use it effectively and more immediately to tackle base erosion and profit shifting.[69] Real-time technical assistance and capacity-building could also be pursued through the "Tax Inspectors Without Borders" programme,[70] which provides expertise to developing-country tax administrations during the course of real-time audit and enforcement.[71] The G20 has noted its support for this programme.[72]

3.3.7 Summary of Action 13

Action 13 in the OECD Action Plan on BEPS addresses the challenge of transfer pricing documentation and the need to understand the activities of an MNE across the globe. The action item introduces three new reporting mechanisms: (a) the master file (standardized information for the entire MNE group regarding business activities, finance, debt structure, taxation and allocation of income); (b) the CbC reporting

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[69] See, for example, African Tax Administration Forum, *A Practical Guide on Information Exchange for Developing Countries* (2013), at 46 – 47 (outlining an abbreviated version of the case study concept in the context of requesting information).

[70] See generally, OECD website at http://www.oecd.org/tax/taxinspectors.htm.

[71] OECD Task Force on Tax and Development, *Final Report on the Feasibility Study into the Tax Inspectors Without Borders Initiative* (5 June 2013), at 1 ("Experts would be deployed to work directly with local tax officials on current audits and audit-related issues concerning international tax matters, and to share general audit practices. In addition to improvements in the quality and consistency of audits and the transfer of knowledge to recipient administrations (tax administrations seeking assistance), broader benefits are also anticipated including the potential for more revenues, greater certainty for taxpayers and encouraging a culture of compliance through more effective enforcement"), available at http://www.oecd.org/ctp/tax-global/TIWB_feasibility_study.pdf.

[72] G20 Leaders' Declaration, supra note 68, at 13 ("we welcome the OECD Tax Inspectors without Borders initiative, which aims to share knowledge and increase domestic capacities in developing countries in the tax area").

template (a template completed by each multinational providing data on a country-by-country basis on seven key questions); and (c) the local file (jurisdiction-specific information on the local entities, their financial accounts, financial data of comparables for transfer pricing analysis and detailed information on related-party transactions).

The goal of this reporting is to assist countries in: (a) risk assessment; (b) enforcement of transfer pricing requirements; and (c) audit. The reporting under Action 13 has raised a number of implementation issues: (a) burden on the taxpayer; (b) timing of the provision of information; (c) scaling of documentation requirements to reflect the materiality of the taxpayer and the transactions (based on the size and nature of the local economy, and the size and nature of the MNE and its activities both globally and locally); (d) expectations regarding document retention and updates; (e) language requirements for reporting; (f) nature and impact of documentation penalties; (g) confidentiality; and (h) actual implementation (domestic law changes, oversight of taxpayer reporting, mechanism(s) for delivering information — centralized to MNE parent, locally or other options). Among some of the most important concerns that have emerged regarding the design and implementation challenges are: (a) burden: the gap between how MNEs manage their group reporting and the expectations under Action 13; (b) delivery mechanism: the need to ensure taxpayer confidentiality while also ensuring meaningful access to reported information, especially by developing countries; (c) use of information: the expectation that the CbC template will not lead countries to bypass audit and directly impose a transfer pricing adjustment, and the expectation that countries will not abandon an arm's length approach.

Developing countries may want to devote particular attention to the following key issues in Action 13: (a) the broad goal of Action 13 (to improve information necessary for tax authorities to make valid risk assessments) may be especially valuable to resource-constrained developing countries which must decide where and how to allocate scarce audit resources; (b) similarly, as the Action 13 reporting package (master file, CbC template and local file) becomes the MNE standard, the increased reporting uniformity should also help developing countries conserve and best direct their tax and audit resources; (c) the choice of reporting language can also directly impact the ability of developing countries to access information; thus, reporting at least the local file in the local language may be very important; (d) the actual availability of CbC data will be diminished for developing countries that have a smaller treaty network, or have few CAAs for automatic exchange under a treaty and must rely on limited tax enforcement staff to make the treaty-based inquiries for all information sought; (e) the ability to ensure confidentiality under domestic law will be vital and will be the subject of peer review; and (f) the capacity-building support that would benefit developing countries in making the most of information available under the Action 13 reporting package.

3.4 Disclosure of aggressive tax planning: BEPS Action 12

Action 13 is not the only part of the OECD project on BEPS seeking increased information from taxpayers. Action 12 targets aggressive tax planning arrangements and seeks taxpayer disclosure regarding these structures. The Final Report for Action 12 was also issued on 5 October 2015.[73]

3.4.1 Goals of Action 12

Based on the view that countries can more effectively tackle base erosion and profit shifting if they receive timely and relevant information, Action 12 provides a framework for jurisdictions seeking to design a disclosure regime for aggressive or abusive tax planning. Paralleling the work on Action 13, the work on Action 12 includes the design of a reporting standard that specifies who reports, what is reported and when information is reported, and what the consequences for non-compliance are. Many of the same concerns raised under Action 13 for both taxpayers and governments will also arise, including: taxpayer burden, consistency, country-specific needs, and value of qualitative and group-wide information. Action 12 provides three key outputs in service of its general mission: (a) recommendations for the modular design of mandatory disclosure rules; (b) a focus on international tax schemes and consideration of a wide definition of tax benefit to capture relevant transactions; and (c) enhanced

[73] OECD, *Mandatory Disclosure Rules, Action 12—2015 Final Report* (Paris: OECD, 2015), at 14, available at http://www.oecd-ilibrary.org/taxation/mandatory-disclosure-rules-action-12-2015-final-report_9789264241442-en.

models of information sharing for international tax schemes. In order to achieve the necessary integration of individual country needs and broader international cohesiveness, the Action 12 recommendations for mandatory disclosure aim to allow maximum consistency between countries "while being sensitive to country specific needs and risks and the costs for tax administrations and business." [74]

Not surprisingly, the analysis in the Final Report on Action 12, like that of Action 13, includes extensive consideration of burden on the taxpayer and the benefits to tax enforcement and tax compliance from mandatory disclosure of certain information. However, unlike Action 13, the recommendations under Action 12 are viewed explicitly as modular and optional for jurisdictions seeking to construct a mandatory reporting regime that makes the most sense within their legal system. Action 12 advocates for exchange of information with other jurisdictions regarding abusive transactions and explores how data gathered under mandatory disclosure could be part of the information sharing within the Joint International Tax Shelter Information and Collaboration Network (JITSIC Network).[75] Although all countries should be concerned about the impact of aggressive tax planning structures and transactions on their tax base, many developing countries may find that their more immediate BEPS threat comes from "straightforward" profit shifting. In that case, the recommendations under Action 13 may have more significant, immediate relevance to such countries. That said, if developing countries currently experiencing BEPS through more traditional transfer pricing mechanisms successfully curb this loss of tax revenue, they may find that taxpayers shift to more sophisticated techniques for reducing their tax bill. At that point, Action 12 would take on a greater role in the response of developing countries to BEPS.

3.5 Summary of the OECD project on BEPS and transparency and disclosure

The OECD Action Plan on BEPS includes two action items directly bearing on transparency and disclosure. Action 12 outlines options for

[74] Ibid., at 14.

[75] Ibid., at 81.

jurisdictions looking to design a mandatory regime in their country for disclosure of aggressive tax planning. Perhaps of greater importance for developing countries at present, however, are the recommendations under Action 13 pertaining to documentation of transfer pricing and the multinational group. This action item has been the subject of extensive debate and comment and its three-part reporting package (master file, CbC template and local file) could play a very significant role in developing country tax enforcement. Additionally, Action 11 might play a role in the future to the extent that its anticipated collection of broad-level data regarding the success of strategies targeting BEPS provides guidance on future reform.

4. Other new developments in transparency and disclosure

4.1 Overview

The OECD project on BEPS is the most expansive effort to address base erosion and profit shifting, including through transparency and disclosure. But it is not the only venue for such action. Other work on transparency, disclosure and exchange of information is taking place at the national, regional and global levels — including at the OECD. A review of these efforts helps provide a more complete picture of the tools being developed to enhance the ability of countries to enforce their tax laws in a global economy.

4.2 Automatic exchange of information

4.2.1 Overview

Before the OECD project on BEPS began, countries were struggling with the question of how to improve access to taxpayer information and thus improve tax enforcement. Although global taxpayers are not new and exchange of information provisions have existed in bilateral tax treaties for decades, the explosion of cross-border commercial activity and investment by businesses and individuals has increased the need of tax authorities for information from locations outside their jurisdiction. Existing exchange of information provisions in bilateral tax treaties have been insufficient, in part because they generally call for exchange of information upon request. But that process can be slow, burdensome and difficult for requesting countries (see section 5.2 below). Many in the international tax community have advocated for automatic exchange of information—a process and commitment between or among jurisdictions to regularly send country specific types of tax-related information regarding the taxpayers of that country. Others, however, have resisted on various grounds, including: domestic traditions of bank secrecy, administrative burden, the inability of the recipient to meaningfully process large quantities of information, and privacy concerns. Perhaps a less often acknowledged reason that some resist automatic exchange of information is related to tax competition. Countries which impose low taxes on outsiders investing in or through their jurisdiction would see little upside to helping the home country gather information and impose tax and thereby negate the "value" of "investing" in that low tax jurisdiction.

4.2.2 Current practices

At present, neither Article 26 (Exchange of information) of the United Nations Model Convention nor Article 26 of the OECD Model Convention requires automatic exchange (see section 5.2 below). However, the United Nations Commentary on Article 26 offers alternative language that would include automatic exchange of information as part of the commitment of the State.[76] The OECD Commentary on Article 26 similarly considers automatic exchange of information as one of the mechanisms available for countries to adopt.[77] The OECD Model Tax Information Exchange Agreement, which formally uses the upon-request mode of exchanging information, envisages in its Commentary that countries could use the document for automatic exchange of information subject to agreement by the two States.[78] In this

[76] Paragraph 29.2 of the Commentary on Article 26 of the United Nations Model Convention.

[77] Paragraphs 9 and 9.1 of the Commentary on Article 26 of the OECD Model Convention.

[78] OECD, *Model Tax Information Exchange Agreement* (Paris: OECD, 2002), available at http://www.oecd.org/tax/exchange-of-tax-information/2082215.pdf. See paragraph 39 of the Commentary on Article 5.

way, for example, a CAA for automatic exchange of CbC reports could be executed by two jurisdictions pursuant to their existing TIEA, based on the model CAA provided by the BEPS Action 13 Final Report (see section 3.3.4 above). The Multilateral Convention on Mutual Administrative Assistance in Tax Matters provides for automatic exchange of information between members pursuant to terms mutually agreed to by those States (see section 5.4 below). The multilateral model CAA included in the BEPS Action 13 Final Report serves as the foundation for agreement to automatically exchange CbC reports among signatory jurisdictions. As noted above in section 3.3.4, 57 jurisdictions have signed the CAA under the Multilateral Convention as at 26 January 2017.

The EU Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation (repealing Directive 77/799/EEC)[79] requires mandatory automatic exchange of information, effective 1 January 2015. The Directive mandates automatic exchange of information in specified categories: employment income, directors' fees, life insurance products, pension, ownership and income from immovable property. The EU Council Directive 2014/48/EU of 24 March 2014 (amending Directive 2003/48/EC) on taxation of savings income in the form of interest payments[80] generally requires member countries to report interest income paid to an individual beneficial owner resident in another member State. More recently, in January 2016, the European Commission introduced an "Anti-Tax Avoidance Package."[81] Among the measures included is a proposal for amending the Directive for CbC reporting between member States on important tax-related information of MNEs operating within the EU.[82]

[79] Available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:064:0001:0012:En:PDF.

[80] Available at http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0048&from=EN.

[81] European Commission, "Anti-Tax Avoidance Package," (January 2016), available at http://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en.

[82] EU Council, "European Commission Proposal for a Council Directive Amending Directive 2011/16/EU as Regards Mandatory Automatic Exchange of Information in the Field of Taxation," at 2–3, (28 January 2016), available at http://euro-01aa75ed71a1.0014.02/DOC_1&format=PDF.

4.2.3 *Challenges*

Successful automatic exchange of information requires several elements: (a) a common standard regarding information reporting; (b) due diligence by financial institutions; (c) an exchange process; (d) a legal framework through which to execute the exchange; and (e) compatible technical systems.[83] Primary challenges in moving from the idea of automatic information exchange to the reality of widespread committed implementation have included: historic bank secrecy provisions, disagreement on the types of information, reciprocity, confidentiality, taxpayer identification, data security, format and feasibility. The first challenge, bank secrecy, has been under attack since approximately 2009. Over the past seven years, most countries have substantially limited or eliminated domestic rules on bank secrecy that barred their own financial institutions from providing client information (to the local government or foreign governments) and/or barred the country from providing that information to another country pursuant to an exchange of information request.

4.2.4 *OECD, the G20 and automatic exchange*

The remaining challenges have been the focus of global work over the past two years. As of April 2013, the G20 has formally supported the "progress made towards automatic exchange of information which is expected to be the standard, and urge[d] all jurisdictions to move towards exchanging information automatically with their treaty partners, as appropriate." [84] The G20 had given the OECD a mandate to prepare standards and guidance on automatic exchange of information. In February 2014, the OECD released the first part of this project, the "Standard for Automatic Exchange of Financial Account Information:

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[83] OECD, *Automatic Exchange of Information: What it is, How it works, Benefits, What remains to be done* (Paris: OECD, 2012), available at http://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-of-information-report.pdf.

[84] Communiqué, G20 Meeting of Finance Ministers and Central Bank Governors (Washington, 18-19 April 2013), available at https://www.banque-france.fr/fileadmin/user_upload/banque_de_france/Eurosysteme_et_international/The-Final-Communique-of-G20_FM_CBG_Meeting-in-Aprill_2013.pdf.

Common Reporting Standard,"[85] which the G20 approved: "We endorse the Common Reporting Standard for automatic exchange of tax information on a reciprocal basis and will work with all relevant parties, including our financial institutions, to detail our implementation plan at our September meeting."[86]

As a follow-up to its February 2014 document, the OECD released its more comprehensive "Standard for Automatic Exchange of Financial Account Information in Tax Matters" in July 2014.[87] The July report included: (a) the text of a Model Competent Authority Agreement (CAA) for automatic exchange of certain tax information; (b) the Common Reporting Standard (CRS); and (c) Commentary intended to facilitate uniform implementation of the agreement and standard. Exchange of information under this system requires that each country take two basic steps.

First, countries must implement any domestic law changes necessary for: (a) requiring financial entities to gather and report the designated information; and (b) ensuring appropriate protection of taxpayer data. Second, countries (through their competent authorities) must agree to the exchange on an automatic basis and must set the terms of that exchange (for example, the CAA). The report urges that this agreement be executed under the legal framework of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (see section 5.4 below) because it allows for more than one country to enter into such a competent authority agreement, potentially reducing the amount of negotiating a country must do. Alternatively, the competent authority agreement could be executed under a bilateral tax treaty between two countries. These options

[85] OECD, *Standard for Automatic Exchange of Financial Account Information: Common Reporting Standard* (Paris: OECD, 2014), available at http://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-financial-account-information-common-reporting-standard.pdf.

[86] Communiqué, G20 Meeting of Finance Ministers and Central Bank Governors, supra note 84.

[87] OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (Paris: OECD, 2014), available at http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-information-in-tax-matters.htm.

foreshadowed the options supported by BEPS Action 13, which also encouraged and facilitated automatic exchange via a multilateral CAA under the Multilateral Convention, or a bilateral CAA under a bilateral tax treaty or TIEA.

Much of the discussion and debate surrounding implementation of automatic exchange of information concerns the same questions that arose in considering the work under BEPS Action 13: the information to be provided, the level of burden imposed, the usefulness of the information and the protection of taxpayer data. One notable difference is that automatic exchange of information places the reporting burden on third-party financial entities, not the taxpayer.

In October 2014, 51 countries signed a Multilateral Competent Authority Agreement committing to automatic exchange of information based on the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. Some States signed as "early adopters" committing to exchanges by September 2017. Others will seek to implement automatic exchange by 2018. In total, as at January 2017, over 100 jurisdictions have committed to exchange under the CRS.[88] As a support to the automatic exchange process, the Global Forum on Transparency and Exchange of Information for Tax Purposes plans to establish a peer review process to ensure effective implementation of the new agreement, although a panel of experts from committed jurisdictions already has been conducting "confidentiality and data safeguard pre-assessments of committed jurisdictions."[89]

To the extent that the recommendations regarding automatic exchange of information in the July 2014 OECD report form the baseline for automatic exchange of information relationships, developing countries must carefully evaluate whether its contents and structure would adequately meet their informational needs for the foreseeable future. In section 4.3 below, the Common Reporting Standard and the

[88] OECD, Automatic Exchange Portal, "CRS by Jurisdiction," available at http://www.oecd.org/tax/automatic-exchange/crs-implementation-and-assistance/crs-by-jurisdiction/#d.en.345489.

[89] OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2016: Report on Progress* (Paris: OECD, 2016), at 24, available at https://www.oecd.org/tax/transparency/GF-annual-report-2016.pdf.

Model Competent Authority Agreement are outlined briefly and then analysed from a developing country perspective.

4.3 Common Reporting Standard and Model Competent Authority Agreement

4.3.1 Overview

The underlying goal of the OECD automatic exchange of information project is to put in place a system that: (a) enables the sharing of taxpayer information that is necessary for effective tax enforcement; and (b) does so in a manner that is sufficiently uniform and standardized that information can be efficiently provided, shared and processed. The OECD commented that it drew "extensively" on the intergovernmental response to the United States financial reporting requirements (the Foreign Account Tax Compliance Act (FATCA)) in designing the CRS (see section 4.5 below for further discussion of the intergovernmental agreements). Under this system, certain financial entities have an obligation to report specified information on account holders to the tax authorities in their own jurisdiction. That jurisdiction would then share the account information with the country in which the account holder is a resident. The expectation is that the emerging standard and system would be a minimum standard of sharing information between jurisdictions. Countries could, of course, decide to exchange additional information.

4.3.2 Common Reporting Standard

The CRS details the entities that must report, the type of information to be reported, the types of accounts for which information must be reported and the due diligence required of the reporting financial entities.

Reporting entities: Under the CRS, the following types of financial institutions are required to participate in reporting financial information of taxpayers: custodial institutions, depository institutions, investment entities and specified insurance companies (unless there is low risk of evasion). In November 2016, the OECD reported that financial institutions in over 50 participating jurisdictions were already collecting information to be exchanged in 2017, and have in place the necessary implementing international agreements. Financial institutions in an additional 50 countries are expected to join the reporting process for 2018.[90]

Information provided: The types of financial information to be provided by the reporting financial entities include: interest, dividends, account balance or value, income from certain insurance produces, sales proceeds from financial assets, and other income generated by assets held in the account or payments made with respect to the account.[91]

Covered accounts: The accounts ("reportable accounts") for which reporting must be made by the reporting financial entities include accounts held by individuals and entities (including trusts and foundations). To limit evasive tax planning, the reporting financial entities must look through passive entities and report on the controlling persons. In terms of providing identifying information regarding the account, the financial entity must report the "name, address, jurisdiction(s) of residence, TIN(s) and date and place of birth (in the case of an individual) of each Reportable Person that is an Account Holder."[92]

Due diligence: To ensure meaningful and effective provision of information, reporting financial entities must perform a specified level of due diligence aimed at securing accurate information regarding the identity of the account holder. Different standards of diligence are applied depending upon when the account was created, its contents, its value and other information known to the financial entity.

4.3.3 Model Competent Authority Agreement

The CAA is drafted as a bilateral agreement between two jurisdictions to commit to the automatic exchange of financial account information. Pursuant to the agreement, the countries agree to have domestic rules requiring financial institutions to report accounts and follow due

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[90] OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2016: Report on Progress*, supra note 89, at 22.

[91] OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, supra note 87, at 15.

[92] Ibid., at 29.

diligence procedures consistent with the CRS and the terms of the specific CAA. Additionally, the signatories confirm that they have: (a) the appropriate safeguards to protect the confidentiality of taxpayer data; and (b) the infrastructure necessary for effective exchange (including mechanisms for "timely, accurate, and confidential information exchanges, effective and reliable communications, and capabilities to promptly resolve questions and concerns about exchanges or requests for exchanges").[93]

4.3.4 Developing country analysis

4.3.4.1 Overview

A range of developing countries have expressed interest in automatic exchange of information and a number of them have already committed to exchange for either 2017 or 2018.[94] Income tax evasion poses a serious fiscal challenge for many developing countries which rely substantially on the income tax base. Current methods for obtaining information located outside the jurisdiction can be costly or unavailable. Treaties generally permit exchange of information only upon request (a process that can be burdensome in terms of time, money and expertise). Moreover, many developing countries have a more limited treaty network (even including TIEAs), and may not have treaties with key tax haven jurisdictions (used by their residents to avoid the developing country income tax). As a result, some developing countries are among those who have committed to early adoption of the CRS (see section 4.2.4 above)

4.3.4.2 Advantages of the Common Reporting Standard and the Competent Authority Agreement

The overall automatic exchange of information project advances the potential for meaningful income tax enforcement. Widespread dissemination of relevant taxpayer information to the appropriate taxing authorities enhances real enforcement and, more broadly, alerts taxpayers to the risks of tax evasion. As noted in section 4.3.4.1 above, current

[93] Ibid., at 21–22.

[94] OECD, Automatic Exchange Portal, "CRS by Jurisdiction," supra note 88.

information exchange mechanisms can be too burdensome to serve as a regular component of tax enforcement. Automatic, bulk provision of the information enumerated in the CRS would significantly reduce the costs of acquiring that information through existing mechanisms. Additionally, the automatic nature of the delivery reduces the opportunity for pressure, leverage and corruption in tax administration.

The scope of taxpayers whose accounts are covered by the CRS further increases the value of the information exchange. The decision to include entities and not just individuals, and to reach trusts and other often opaque holding structures, expands the coverage of this automatic exchange of information system beyond that of some other programmes.

4.3.4.3 Limitations of the Common Reporting Standard and the Competent Authority Agreement

The advantages of the CRS and CAA described above essentially reflect the reduced costs and difficulties of acquiring information compared with obtaining it via an existing bilateral treaty. But the ability to participate in the CRS and CAA is currently contingent upon; (a) meeting the standards necessary to commit to providing—not just receiving—information (required reciprocity); and (b) getting the key jurisdiction to sign a CAA (participation).

4.3.4.3.1 Reciprocity

The CAA is premised on reciprocity between or among signatories. Although countries may sign a CAA in advance of being ready to participate, the agreement takes effect only when they are in fact prepared to share information reciprocally.[95] The only option for non-reciprocal participation in the CRS and CAA is provided for countries which do "not need to be reciprocal" (for example, because one of the jurisdictions does not have an income tax).[96] This has been characterized by some commentators as intended to facilitate automatic exchange of information from tax havens. There is no current model or provision

[95] See, for example, OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, supra note 87, at 27.

[96] Ibid., at 223.

allowing for non-reciprocal automatic exchange of information with (or more precisely, to) a developing country (that is to say, providing information to that developing country without receiving information in return). The absence of such an alternative may render the current CRS and CAA out of reach of developing countries that cannot currently commit to or meet the standards for domestic collection of the required tax information (that is, the domestic law provisions and enforcement of data collection from reporting financial entities) and the processing and transmission of the information (inside the tax administration). These developing countries could benefit from the receipt of information under automatic information exchange, however. The only requirement they would need to meet would be the protection of taxpayer data. Even if the developing country were not yet able to make maximum use of the bulk data it receives, the country could nonetheless begin to improve tax enforcement with the information.

If non-reciprocity with developing countries were permitted, it could be managed in a gradual manner. The country could commit to meeting established benchmarks for domestic information collection and processing. While the country was meeting the benchmarks, it could receive information under the CRS and CAA, with the goal being full and reciprocal participation. The loss for the other country during this period of time would likely be minimal. Developing countries are typically not the financial destinations of major tax evaders, and developed countries would likely receive little significant information from this automatic exchange of information. Thus, the cost of helping developing countries improve tax collection while building their internal capacity to fully participate in automatic exchange should not be unduly high.

Although a reciprocity phase-in is not currently part of the CRS automatic exchange structure, the Global Forum on Transparency and Exchange of Information for Tax Purposes has identified technical assistance as an important key in enabling developing countries to participate in and benefit from the automatic exchange.[97] The Global Forum has five pilot projects under way that partner a developing country with

[97] OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2016: Report on Progress*, supra note 89, at 26.

a developed country.[98] The goal is to help the developing country implement the new CRS standard in an "appropriate" time frame. Any developing country member "which is not a financial centre" can request to participate in this technical assistance pilot programme.[99]

More broadly, the Global Forum has introduced a new programme, an "Induction Programme," designed to help new members (most of which are developing countries) become familiar with the work of the Global Forum on Transparency and Exchange of Information for Tax Purposes, and to assist them on implementing standards, preparing for reviews, and putting in place the infrastructure necessary to participate in and benefit from the information exchange mechanisms. The Induction Programme engages not only with the tax administration but also with the finance ministries in the developing countries. Current assistance under way includes drafting of automatic exchange of information legislation (assisting 20 jurisdictions), data confidentiality safeguards and information security management (assisting 5 jurisdictions), and automatic exchange implementation seminars (113 participants representing 41 jurisdictions).[100] Additionally, the Global Forum has engaged with regional partnerships in Africa, Asia and Latin America and the Caribbean.[101]

4.3.4.3.2 Participation

Even with adequate infrastructure to participate in automatic exchange of information under the CRS and CAA, developing countries must

[98] The paired jurisdictions are: (a) Albania and Italy, (b) Colombia and Spain, (c) Ghana and the United Kingdom, (d) Morocco and France, and (e) Philippines and Australia. OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2016: Report on Progress*, supra note 89, at 26.

[99] OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2016: Report on Progress*, supra note 89, at 26.

[100] OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2016: Report on Progress*, supra note 89, at 30.

[101] OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2016: Report on Progress*, supra note 89, at 31.

actually be able to persuade partner countries to sign these agreements. The bilateral version offered as the main example of a CAA would be less effective for many developing countries. It would have to be negotiated on a bilateral basis with each country and could be completed only with current treaty partners (bilateral tax treaties or TIEAs). The alternative, multilateral version of a CAA provided in Annex 1 of the July 2104 OECD document (signed by 51 countries in October 2014, and a total of 87 as at 2 November 2016)[102] has its legal basis in the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (see section 4.2.4 above).[103] This multilateral version offers two key advantages to developing countries — only a single agreement to negotiate and a wide pool of potential signatory partners. There are, however, three problems.

First, with the availability and prominence of the bilateral version, there may be inadequate motivation for some countries to pursue the multilateral one, although the number of signatories suggests this may not prove to be a significant problem. Second, even if countries do participate in a multilateral CAA, it is not clear that they would be required to invite a developing country to sign (signatories to the multilateral CAA for automatic exchange retain the power to determine which other signatories they will accept as exchange partners). Specifically, some developing countries that have been unable to sign treaties with tax havens may be concerned that tax havens would also refuse to participate in a CAA with them. Yet these havens are key jurisdictions from which a developing country may need to acquire tax information, and unlike developed countries the developing country may have little leverage to persuade or entice the participation of the tax haven. Finally, unlike the United States FATCA regime, which inspired the CRS and CAA, it is not clear what sanctions would apply to non-participants. The absence of sanctions may be a concern for developing countries that are trying to get tax havens to join them in a CAA.

[102] OECD, "Signatories of the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information and Intended First Information Exchange Date, Status as of 2 November 2016," available at https://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/MCAA-Signatories.pdf.

[103] OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, supra note 87, at 215.

4.4 Industry-specific reporting requirements (natural resources, financial services)

Industry-specific CbC reporting has also been a focus of increased transparency for countries. For example, United States securities law regulations now require extractive industries to report various payments made to foreign governments by businesses engaged in extractive industries (exploration, extraction, processing and export of oil, natural gas or minerals, or the acquisition of a licence to engage in such activity). These payments, which must be reported on a country-by-country basis, include "taxes, royalties, fees (including licence fees), production entitlements, bonuses, and other material benefits." [104]

On a more global scale, the Extractive Industries Transparency Initiative (EITI) seeks to promote a two-pronged reporting approach for transparency in extractive industries[105] under which businesses report what they pay to each jurisdiction, and the governments report what they receive.[106] However, work on industry-targeted disclosure has not been limited to extractive industries. Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC)[107] seeks disclosure by covered financial institutions of information on a country-by-country basis, including: profit or loss before tax, tax paid, subsidies received, average number of employees. Member States of the EU must enact rules domestically to require the reporting.[108]

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[104] United States Securities Exchange Act of 1934, 15 U.S.C. section 78m(q)(1)(A)(2012). Implementing regulations were issued in July 2016. Disclosure of Payments by Resource Extraction Issuers, 81 Fed. Reg. 49,359 (27 July 2016).

[105] Extractive Industries Transparency Initiative Fact Sheet 2014, available at http://eiti.org/files/2014-03-26%20Factsheet%20English_0.pdf.

[106] EITI countries and country reports are available at http://eiti.org/countries.

[107] Available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:EN:PDF.

[108] See, for example, the United Kingdom reporting rules which came into effect in January 2014, with the first reporting required by 1 July 2014. See

In some cases, efforts to combat corruption prompted the push for transparency and disclosure initiatives. Where transparency and disclosure serve an anti-corruption role, the public release of disclosed information can be important. Not surprisingly, the nature and scope of any public disclosure of taxpayer data has generated debate and objection in the business community (see sections 2.4 and 3.3.5.4 above).

Although the issue of public disclosure of taxpayer information has been raised by some advocates in the context of BEPS (see section 3.3.5.4 above), the OECD does not expect that Action 13 files would be made available to the public. But corruption concerns have surfaced as a possible factor in the limited collection of income tax in some countries, and public disclosure of at least some information in the master file, CbC template and/or local file could play a role in improving tax enforcement.

4.5 Intergovernmental agreements and related developments

In 2010, the United States enacted the Foreign Account Tax Compliance Act (FATCA).[109] Prompted by the number of United States taxpayers using offshore financial accounts to avoid United States income tax, the new legislation effectively requires a wide range of financial institutions (foreign and domestic) to provide data to the United States regarding its taxpayers who hold accounts at those institutions. The FATCA legislation imposes due diligence and reporting burdens on these third-party entities, and failure to comply can result in negative United States tax consequences for the financial institutions' own United States source income.

In an effort to streamline compliance for foreign financial entities required to report under FATCA, and to address various disclosure

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also final United Kingdom regulations, available at http://www.legislation.gov.uk/uksi/2013/3118/made, and final United Kingdom guidance, available at https://www.gov.uk/government/publications/capital-requirements-country-by-country-reporting-regulations-2013-guidance/capital-requirements-country-by-country-reporting-regulations-2013-guidance.

[109] United States Internal Revenue Code, sections 1471–1474.

and confidentiality concerns, a number of countries entered into intergovernmental agreements (IGAs) with the United States that provided specific guidance on the type of information that their own domestic financial institutions would gather on United States taxpayers and detailed how that information would be provided to the United States.[110] These IGAs were negotiated under the legal framework of the existing bilateral tax treaty of each country with the United States. Given the increasing number of IGAs being signed with the United States, other countries have expressed interest in receiving the same type of tax-related information on the foreign financial accounts of their own residents, and have pursued a broader IGA format.[111]

4.6 Beneficial ownership information

Concern over the level of transparency in some jurisdictions regarding beneficial ownership of entities is not new, but the topic received renewed attention in 2016 following a high-profile global leak of significant beneficial ownership data. A number of jurisdictions have now turned their attention to the importance of transparency regarding beneficial ownership of offshore entities. Some have announced steps to register the beneficial ownership of offshore trusts and other entities.[112] The G5 countries have agreed to develop a global multilateral

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[110] Ultimately, the United States provided two model intergovernmental agreements that formed the basis of its negotiations with other countries, IGA Model 1 and Model 2.

[111] See, for example, letter dated 9 April 2013, signed by the finance ministers of France, Germany, Italy, Spain and the United Kingdom announcing their pilot programme to automatically exchange information (a "multilateral exchange facility"), available at http://taxnews.lexisnexis.co.uk/TaxNewsLive/Members/BreakingNewsFullText.aspx?id=4335&css=1&xml=0. The signatories encouraged other European Union member States to join them in their pilot programme based on IGAs signed with the United States pursuant to FATCA. See also Itai Grinberg, "Taxing Capital in Emerging Countries: Will FATCA Open the Door?" (2013) Vol. 5, *World Tax Journal*, 325.

[112] These jurisdictions include Australia, Germany, Ireland, New Zealand and the United Kingdom. William Hoke, "Government to Review Trust Disclosures," (2016) Vol. 82, *Tax Notes International*, 242; Teri Sprackland, "German Transparency Registry Proposal Derided as 'Joke'," (2016) Vol. 82, *Tax Notes International*, 249; Stephanie Soong Johnston, "More Countries

system for automatic exchange of beneficial ownership information, and the European Commission adopted a proposal in July 2016 for full public access to beneficial ownership registries for certain entities.[113] These developments in the context of beneficial ownership reveal the increasingly intertwined, though not uncontroversial, expectations regarding both transparency and disclosure to tax administrations and transparency and disclosure to the public.

4.7 Exchange of government information

A new EU Council Directive of 8 December 2015 called on member States to agree to automatic exchange of advance cross-border tax rulings and advance pricing agreements.[114] The impetus for this 2015 Directive came from the public awareness that tax rulings were issued in some member States resulting in low taxes on "artificially high amounts of income in the country issuing . . . the advance ruling" and yet leave "artificially low amounts of income to be taxed in any other country involved" in the transactions or financial flows.[115] Relatedly, in June 2015, the European Commission launched a consultation on corporate transparency, exploring whether requiring MNEs to disclose more information about taxes paid (via public CbC reporting), and/or public disclosure of tax rulings, would reduce tax avoidance

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Commit to Public Beneficial Ownership Registries," (2016) Vol. 82, *Tax Notes International*, 649.

[113] Ryan Finley, "EU Countries Announce Beneficial Ownership Exchange Plan," (2016) Vol. 82, *Tax Notes International*, 238; Alexander Lewis, "*EU Adopts Public Registries of Beneficial Ownership Information,*" (2016) Vol. 83, *Tax Notes International*, 100.

[114] EU Council Directive 2015/2376. 2015 O.J. (L332) 1, 203 (EU), available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015L2376&qid=1487009643392&from=en.

[115] Ibid., at 1. In parallel developments, the European Parliament created the Special Committee on Tax Rulings and Other Measures Similar in Nature or Effect (TAXE 1), which was tasked with investigating ruling practices. The European Parliament adopted the final report of the Special Committee on 25 November 2015; the report contains legislative recommendations for tax transparency and for EU-wide tax policy convergence through a common corporate tax base, available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P8-TA-2015-0408+0+DOC+XML+V0//EN.

and aggressive tax structuring by MNEs.[116] In July 2015, the members of the European Parliament voted in favour of a revised Directive requiring CbC reporting of taxes paid by MNEs.[117]

4.8 Summary of other developments in transparency and disclosure

In addition to the OECD project on BEPS, there are several other global efforts to limit base erosion and profit shifting. The OECD and G20 have been advocating introduction of automatic exchange of information including a "Common Reporting Standard" for the information that should be exchanged. The OECD released its comprehensive standard in July 2014 (including the CRS itself), a Model Competent Authority Agreement and a Commentary (to facilitate uniform implementation). The CRS specifies which financial entities must report taxpayer information, which information must be reported and which accounts are subject to reporting. Exchange of information as a tool for transparency and disclosure avoids the burdens of pursuing exchange upon request. But it still requires an agreement to the exchange. The implementation of a multilateral CAA through the Multilateral Convention on Mutual Administrative Assistance in Tax Matters obviates the need to enter into many bilateral arrangements. This would be an advantage for countries with few current treaties and limited resources for tax administration. In October 2014, over 50 countries signed a multilateral CAA to implement automatic exchange of information (see section 4.2.4 above). However, even this path (use of the Multilateral Convention) would not guarantee that crucial jurisdictions would join

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[116] European Commission Press Release, "Commission Launches Public Consultation on Corporate Tax Transparency," (17 June 2015), available at http://europa.eu/rapid/press-release_IP-15-5156_en.htm; European Commission, "Factual Summary of the Responses to the Public Consultation on Assessing the Potential for Further Transparency on Corporate Income Taxes, European Commission" (20 January 2016), available at http://ec.europa.eu/finance/consultations/2015/further-corporate-tax-transparency/docs/summary-of-responses_en.pdf.

[117] European Parliament, "Texts Adopted" (8 July 2015), available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2015-0257+0+DOC+PDF+V0//EN.

a developing country in exchange of information. Another barrier for developing countries is the "reciprocal" nature of the CAA. Exchanges would start only after both countries complied fully under the agreement. Phasing in reciprocity would allow developing countries to receive valuable tax information and tackle base erosion straight away, while building their internal capacity to comply with all aspects of the CAA. Other potentially interesting initiatives for transparency and disclosure include: (a) efforts such as the Extractive Industries Transparency Initiative, which encourages industry-based reporting of tax payments (with both business and government reporting payments and receipts); (b) bilateral and regional efforts to replicate the kind of information exchange being promised under IGAs that have been signed in the wake of the new United States reporting requirements for financial entities; (c) transparency and disclosure of beneficial ownership of entities; and (d) disclosure of tax rulings to other governments, and potentially the public.

5. Existing mechanisms supporting transparency and disclosure

5.1 Overview

Significant attention has been directed to transparency and disclosure in recent years, but these concepts are not new to the tax system. For example, tax treaties have included exchange of information provisions for decades, which although more limited in scope and effect than some of the transparency and disclosure projects currently under way, have nonetheless sought to enhance access of a tax administration to vital taxpayer data. A brief review of these existing mechanisms which support and facilitate tax transparency and disclosure provides: (a) a better understanding of what may be needed in new mechanisms; and (b) the role that these current agreements or structures can play in supporting any new developments in transparency and disclosure.

5.2 Article 26 of the Model Conventions

Both the United Nations Model Convention and the OECD Model Convention include an Article 26 (Exchange of information) that outlines the primary terms governing exchange of information between the two signatories: the duty to exchange, the duty to protect taxpayer information, the grounds upon which a request for information can be declined and the grounds which do not form an appropriate basis for refusal to exchange information. The United Nations[118] and OECD versions of Article 26 (and their respective Commentaries) differ in some regards and on balance share several common deficits, but their common features are reflected in the bilateral tax treaties of many countries. Moreover, as referenced below, changes have been made to Article 26 of both Conventions in an effort to increase the likelihood of meaningful exchange of information.

5.2.1 Standard governing requests

As noted earlier, Article 26 of neither the United Nations nor the OECD Model Convention requires automatic exchange of information. Thus, countries requesting information must meet certain thresholds for documenting their request (in other words, "no fishing expeditions"). This step limits jurisdictions to requesting information only about taxpayers and activities for which they already have some knowledge. Moreover, the specific threshold requirements imposed by existing bilateral tax treaties decrease the likelihood that information will be requested. Recent changes to Article 26 of the United Nations Model Convention decreased the impact of these "thresholds." For example, changes to Article 26 (1) in 2011 sought to extend the scope of exchange of information by providing that information should be exchanged if it is "foreseeably relevant for carrying out the provisions of [the] Convention or to the administration or enforcement of the domestic laws of the Contracting States." The phrase "foreseeably relevant" replaced the earlier term "necessary." [119] The Commentary

[118] At its twelfth session in Geneva, 11–14 October 2016, the United Nations Committee of Experts on International Cooperation in Tax Matters introduced "Proposed BEPS-related Changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries," (E/C.18/2016/CRP.10), available at http://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP10_-beps.pdf. Although the provisions are BEPS related, they do not bear directly on the application of Article 26.

[119] Paragraph 4 of the Commentary on Article 26 of the United Nations Model Convention characterized the change to "foreseeably relevant" as one

on Article 26 of the United Nations Model Convention offers some alternative language for the new phrase "foreseeably relevant," but these options are intended to allow treaty partners to choose language that they find clear in specifying the goal of "effective" exchange of information.[120]

Despite the expanded scope of exchange of information under the "foreseeably relevant" language of Article 26, it is important to note that automatic exchange of information entirely eliminates even a broad test for demonstrating the connection between the requested information and the investigation of the taxing authorities. The automatic receipt of specified bulk data effectively would place no such constraints on jurisdictions seeking information in the designated categories. Additionally, the current "upon request" process requires an allocation of the potentially limited resources of the requesting country, which would be alleviated under automatic exchange of information.

5.2.2 Bank secrecy

Historically, States have declined to comply with a request for information under Article 26 on the grounds that compliance would violate domestic law, specifically, bank secrecy rules. Where countries had such domestic law provisions severely limiting (often under significant penalty) the ability of a financial institution to share information with the government regarding a client, and/or limiting the ability of the government to share such information with another country, domestic law regularly trumped the operation of Article 26. In 2011, Article 26 of the United Nations Model Convention was revised to provide that certain domestic laws may not be used as a defence in complying with an exchange of information request. Thus, the new language in Article 26 (5) states: "In no case shall the provision of paragraph 3 [outlining appropriate grounds to refuse a request] be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or

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that was not substantive. Rather, it was intended to "remove doubts" and "clarify" the prior language.

[120] Article 26 of the OECD Model Convention also uses the phrase "foreseeably relevant."

person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person." [121]

5.2.3 *Information sought not needed by requested State for own purposes*

A further 2011 change to Article 26 of the United Nations Model Convention sought to eliminate an additional argument that a State might use to decline to provide requested information: that the State asked to produce the information has itself no need or use for the information in administering its tax law. Article 26 (4) now provides that: "If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information-gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes." Anticipating that some States might try to argue that they are not legally capable of providing information that they do not need for a tax purpose (despite the language in Article 26 (4)), the United Nations Commentary on Article 26 offers alternative language. This alternative phrasing requires that each Contracting State must undertake to ensure that its competent authority will have the requisite power under domestic law to secure the information needed for tax treaty information exchange purposes. In some cases, domestic legislation, rulemaking or administrative changes may be necessary to ensure that power.[122]

5.2.4 *Format*

Article 26 exchange of information provisions do not require that information be provided in a certain format. But more uniformity in the content and format of information provided by taxpayers to the government might, increasingly, lead to the government of a requesting State receiving information in a desired format. For example, recommendations under BEPS Action 13 would notably enhance transparency and disclosure by requiring that taxpayers collect, generate and

[121] Article 26 of the OECD Model Convention also bars refusal on the grounds of bank secrecy.

[122] See paragraph 26.3 of the Commentary on Article 26 of the United Nations Model Convention.

provide information in a specified format to the tax authorities. This rule, implemented in each jurisdiction through domestic legislation (master file, CbC template and local file reporting requirements), would shift the burden to the taxpayers, who have a distinct ability to access their own information. To the extent that reporting for the master file, CbC template and local file is fairly uniform and consistent over time, across countries and across taxpayers, the information may be easier for tax authorities to use. For resource-constrained developing countries, this uniformity could facilitate training and decrease audit burdens.

5.2.5 Article 26 of the Model Conventions: summary

Existing bilateral tax treaties still constitute a relevant tool in encouraging transparency and disclosure. First, they can provide the legal basis or framework for an agreement between competent authorities to exchange information on an automatic basis (as can TIEAs or the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (see sections 5.3 and 5.4 below)). Second, they may explicitly permit requests regarding persons neither resident nor engaged in economic activity in the State from which information is sought. An automatic exchange of information arrangement would be unlikely to include data regarding such persons. Third, the "residual" ability under Article 26 provisions to seek information upon request remains useful if a country finds that it requires information beyond the scope of that provided automatically.

Although bilateral treaty provisions based on Article 26 of either the United Nations or the OECD Model Convention are inadequate in meeting the full range of transparency and disclosure needs of tax administrations today, they continue to provide possible access to information not likely available through automatic exchange of information or through the taxpayer reporting envisaged by BEPS Action 13 recommendations.

5.3 Tax Information Exchange Agreements

TIEAs are stand-alone agreements, typically negotiated between countries that have not negotiated a bilateral tax treaty, that focus exclusively on exchange of information. The expectation is that even countries that do not have a bilateral treaty may still seek to exchange tax information. The TIEA provides the legal basis and structure for doing so. The OECD Model TIEA, not surprisingly, is very similar to Article 26 of the OECD Model Convention (and the United Nations Model Convention). The primary differences between the OECD Model TIEA and Article 26 include the following: (a) TIEAs can be bilateral or multilateral; (b) TIEAs focus on exchange "upon request"; (c) TIEAs cover specific taxes; and (d) TIEAs provide more detail regarding the information that the requesting State must provide to initiate its request.

For countries pursuing increased transparency and disclosure in tax, TIEAs provide a legal framework and context to agree to exchange information automatically. That is, although TIEAs call for exchange "upon request," they permit contracting States to expand their cooperation through agreement by the competent authorities. Thus, as with comprehensive bilateral treaties in the case of Article 26, TIEAs can serve as the legal foundation for countries to agree to automatic exchange under CRS and under the BEPS Action 13 CbC framework. To the extent that some developing countries have a more limited network of comprehensive tax treaties but do have a network of TIEAs, such a role for TIEAs could become important.

5.4 Multilateral Convention on Mutual Administrative Assistance in Tax Matters

The multilateral Convention on Mutual Administrative Assistance in Tax Matters, which originally was developed by the OECD and the Council of Europe in 1988, was amended in 2011 to welcome all countries as participants.[123] At present, over 60 countries have signed the Convention, including developing countries. The Convention must be signed and ratified by a country in order for it to apply—and countries can make individual reservations to the basic terms of the Convention. As a result, reliance on the Convention depends upon whether the countries in question have ratified it and whether they have made any

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

relevant reservations to significant terms. But, as a multilateral framework, the Convention offers a potentially valuable legal foundation for countries looking to pursue enhanced transparency and disclosure among a group of nations in a relatively simultaneous and efficient way.

With respect to exchange of information, the Convention includes a comprehensive consideration of: (a) prerequisites to exchange; (b) what can be exchanged; and (c) the mechanism for exchange. As drafted, the Convention envisages exchange of information upon request, spontaneously and automatically (according to procedures and terms mutually agreed to by two or more parties).[124] The Commentary on the Convention emphasizes the value of standardization in automatic exchange, noting savings in time and workload, but observes that these advantages accrue primarily when large numbers of countries participate in the standardization process. The Multilateral CAA that was signed by 51 countries in October 2014 (and by over 100 as at January 2017), committing to automatic exchange of information, is grounded in the legal framework of the Convention, with the advantages and concerns for developing countries noted in sections 4.3.4.2 and 4.3.4.3 above.

5.5 Regional agreements

In addition to bilateral tax treaties, TIEAs and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, regional agreements exist which could serve as the legal basis and framework for exchange of information among the signatory States. Examples of such regional agreements include: (a) the 2008 West African Economic Monetary Union (WAEMU) Income and Inheritance Tax Convention (Article 33); (b) the South Asian Association for Regional Cooperation (SAARC) Limited Multilateral Agreement on Avoidance of Double Taxation and Mutual Administrative Assistance (Article 5); and (c) the Agreement Among the Member States of the Caribbean Community (CARICOM) for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Profits or Gains and Capital Gains and for the Encouragement of Regional Trade and Investment (Article 24). However, a major limitation of

[124] Ibid., Articles 6 and 7.

regional agreements is their membership. Both the requesting State and the country from which it is seeking information must be members of the applicable regional agreement. To the extent that the taxpayers of a country conduct business or hold their assets and accounts in other jurisdictions, the regional agreements offer little assistance. Moreover, their relatively abbreviated exchange of information provisions do not detail the expectations regarding the delivery mechanism for information and do not call for automatic exchange.

5.6 Global Forum on Transparency and Exchange of Information for Tax Purposes

5.6.1 Overview

In the late 1990s, many countries became concerned with the effects of tax havens and preferential tax regimes which impeded effective tax enforcement by virtue of their lack of transparency and their lack of information exchange. As a response, the predecessor of the current Global Forum on Transparency and Exchange of Information for Tax Purposes was formed in 2000 under the auspices of the OECD. The Global Forum has 139 members (as at February 2017),[125] including developed and developing countries, and OECD and non-OECD members.

The Global Forum has pursued two projects relevant to transparency and disclosure: (a) the development of the Model Tax Information Exchange Agreement (TIEA) (see section 5.3 above); and (b) the development and implementation of the peer review process (the legal and regulatory framework for assessing countries' compliance with the standards for transparency and exchange of information). The peer review process, which began in 2009, is undertaken in two phases (Phase 1 and Phase 2), although they can be combined.[126] The review evaluates a country by reference to its capacity for and actual performance in providing information upon request. Thus, the peer review process explores the degree to which a country is compliant with

[125] See http://www.oecd.org/tax/transparency/.

[126] OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2016: Report on Progress*, supra note 89.

commitments under treaty provisions comparable to Article 26 of the United Nations and OECD Model Conventions, or to the Model TIEA. Additionally, following the signing of the Multilateral CAA for automatic exchange, the Global Forum announced its intent to establish a peer review process to ensure compliance with the exchange commitment (see section 4.2.4 above).

The current peer review process examines the domestic laws and practices of a country along a number of dimensions to assess whether: (a) the ownership and identity of entities and arrangements are available to the competent authority; (b) reliable accounting records are maintained for such entities; (c) account holder banking information is available; (d) the competent authority has the power to obtain and provide information pursuant to an exchange of information request; (e) appropriate safeguards apply to persons in the requested country; (f) all relevant partners are covered by the network of information exchange mechanisms of the jurisdiction; (g) adequate confidentiality mechanisms exist to protect information received; (h) the rights and safeguards of taxpayers and third parties are respected; and (i) information is provided in a timely manner for requests made under its exchange of information mechanisms.

Input is sought from all members of the Global Forum during the process of reviewing a specific country.[127] Members complete an extensive questionnaire about their own practical experience in working with the country under review. The review is performed by an assessment team (two expert assessors from peer jurisdictions, along with a coordinator from the Global Forum secretariat). The report of the team is presented to the 30-member Peer Review Group (PRG), and upon approval becomes a formal report of the PRG. At that stage, the entire membership of the Global Forum is asked to approve the report. To date, 113 countries have participated in the peer review process and have been the subject of a completed and published report.

[127] OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Information Brief, supra note 7*, at 6–7; OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Exchange of Information on Request: Handbook for Peer Reviews 2016–2020* (Paris: OECD, 2016), at 42, available at http://www.oecd.org/tax/transparency/global-forum-handbook-2016.pdf.

As part of the review process, recommendations are made to countries for ways in which to improve their ability to participate and cooperate in exchange of information. Over 80 countries have introduced or proposed domestic law changes in order to implement the more than 400 recommendations that have emerged from the peer review process.[128]

5.6.2 Developing countries and the Global Forum

From the perspective of a developing country, a number of observations can be offered regarding the work of the Global Forum. First, the promotion of TIEAs can be beneficial to jurisdictions not currently in a position to negotiate many bilateral treaties. Second, to the extent that the peer review process improves the general transparency of domestic banking, tax and regulatory rules of other jurisdictions, developing countries may gain. Assuming that developing countries would have had little leverage to instigate these transparency changes on their own, they may now find that their information requests made to other jurisdictions are more efficiently managed.

Third, a peer review of a developing country itself may provide support for the internal efforts of the tax administration to encourage and effectuate domestic law (and practice) changes consistent with active participation in exchange of information. This will be most true where the developing country receives any needed and requested technical assistance on the more detailed facets of managing information and requests.[129] As discussed above in section 4.3.4.3.1, the Global Forum on Transparency and Exchange of Information for Tax Purposes has introduced new programmes to provide more effective and targeted technical assistance to developing countries. Fourth, the current benchmark for the peer reviews is exchange upon request (which still imposes burdens on developing countries (see section

[128] OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Information Brief,* supra note 7, at 4.

[129] See, for example, OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2013: Report on Progress (Paris: OECD, 2013)*, at 23 (outlining technical assistance opportunities), available at http://www.eoi-tax.org/keydocs/f6eb5861601672f34b5e25e8a4f57380#default.

4.3.4.1 above)). But the domestic law and infrastructure standards that the peer review process promotes would also be essential if and when countries ultimately adopt some version of automatic exchange of information. Finally, to gain the maximum benefit from enhanced compliance by other countries, developing countries need to be in a position to request information (until automatic exchange takes hold) and to make effective use of such information. Additional work by the Global Forum in providing relevant assistance to developing countries, consistent with the G20 emphasis on ensuring that all States benefit from improved exchange of information, would help guarantee that developing countries are not just providers of information but also knowledgeable "consumers" of exchanged information.[130]

5.7 Summary of existing support for transparency and disclosure

Transparency and disclosure are not new to the international tax system. The versions of Article 26 of both the United Nations and the OECD Model Conventions call for exchanging information "upon request" and in recent years, changes made to the provision have enhanced the likelihood of effective and useful information exchange taking place. Among the most important reforms are: (a) elimination of domestic bank secrecy rules as a justification for denying a request for information; (b) reduction of the threshold that the requesting State must meet to demonstrate that the information requested is "foreseeably relevant for carrying out the provisions of [the] Convention or to the administration or enforcement of the domestic tax laws of the Contracting States"; and (c) elimination of the argument that requested information

[130] See, for example, Communiqué, G20 Meeting of Finance Ministers and Central Bank Governors (Moscow, 20 July 2013), available at http://en.g20russia.ru/events_financial_track/20130719/780961553.html ("All countries must benefit from the new transparent environment and we call on the Global Forum on Exchange of Information for Tax Purposes to work with the OECD task force on tax and development, the World Bank Group and others to help developing countries identify their need for technical assistance and capacity building"); OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2013: Report on Progress*, supra note 129, at 25.

need not be provided because the requested State itself does not need the information. Additionally, the work of the Global Forum, particularly in the peer review process, has the potential to help countries seeking to improve their own transparency and disclosure laws (which will improve both their own enforcement capacity and their ability to participate globally in transparency and disclosure projects). Moreover, to the extent that the peer review process improves the transparency and disclosure capacity of countries from which a developing country is seeking information, the developing countries need not expend resources to encourage such reform in its partners.

6. Summary observations regarding the role of tax transparency and disclosure in preventing base erosion and profit shifting

Base erosion and profit shifting are critical problems for all countries, but especially for developing countries that rely significantly on the corporate income tax. Although many reforms will be important for a successful global response to this challenge, increased transparency and disclosure regarding multinational businesses are essential. Countries face a number of barriers to achieving this level of transparency and disclosure. First, domestic law may not currently require adequate reporting regarding financial accounts, cross-border related-party transactions, foreign financial assets or foreign business activities. The final recommendations from the OECD project on BEPS, in particular those grounded in Actions 12 and 13, can serve as useful guides for countries exploring domestic reform. Additionally, the Global Forum peer review process provides a mechanism for both assessing and facilitating domestic improvements in transparency and disclosure.

Second, countries may face domestic enforcement impediments to their effective acquisition and use of information. Developing countries that are resource-constrained (for example, limited audit staff, limited international tax expertise, limited technological resources) might find it difficult to seek and acquire the information necessary to effectively audit all of the major multinational businesses operating in their jurisdiction. To the extent that proposed reforms can ease any of these constraints or burdens, they may be particularly useful to developing countries. Conversely, if reforms require resources or treaty relationships not currently available to many countries, their formal adoption will likely have less impact on resource-constrained States.

Third, effective responses to BEPS will require engagement with the broader tax community. Information can be sought directly from taxpayers, but often important information will be needed from other countries. Thus, the crucial question is whether a State has treaty relationships (bilateral, TIEA or other) with the countries from which it is most likely to need information. If the transparency and disclosure reforms rely less on bilateral relationships and more on multilateral approaches, jurisdictions with more limited treaty networks can more readily enjoy the benefits of the new reforms.

Among the most prominent transparency and disclosure reforms currently under way are the documentation reforms in Action 13 of the OECD Action Plan on BEPS (focused on improved reporting for transfer pricing documentation and the global activities of a multinational group). The reporting package under Action 13 includes: (a) the master file (standardized global information regarding the multinational group); (b) the CbC template (which reports selected information on a country-by-country basis for the group, along with identifying information on entities operating in each jurisdiction); and (c) the local file (more country-specific details regarding activities, assets, income and related-party transactions). The reporting package should help tax administrators assess risk and focus audit efforts. This assistance is especially valuable for resource-constrained countries seeking to allocate scarce audit resources to their more serious and relevant BEPS problems. A number of important issues continue to be debated regarding Action 13. The decision to have MNEs provide the CbC report only to the residence jurisdiction of the MNE parent (then to be shared via treaty), means that developing countries with limited treaty networks, or limited resources to pursue treaty requests, or both, will face a burden in retrieving the information. At the same time, taxpayers have voiced concerns over their own potential documentation burden, the risks of inadequate data protection and the possibility that countries could use the information in unintended ways (for example, as a replacement for audit).

The OECD project on BEPS is not the sole avenue for potential reforms in transparency and disclosure. The OECD and the G20 have advocated for increased use of automatic exchange of information. To further this goal, in 2014 the OECD released a proposed Common Reporting Standard (CRS) along with a Commentary for automatic exchange of information. In October 2014, 51 countries signed a Multilateral Competent Authority Agreement under the Multilateral Convention on Mutual Administrative Assistance in Tax Matters committing themselves to automatic exchange; by January 2017, the number was over 100. As with the work under Action 13, reforms that increase uniform provision of information more directly to States can be distinctly advantageous for developing countries trying to maximize the impact of their available tax administration resources. A critical question is the ease with which countries can join an automatic exchange of information. The multilateral mechanism for sharing information best serves States with limited treaty partners. But other barriers, including reciprocity, may constrain the ability of developing countries to participate. Allowing developing countries temporary access to automatic exchange on a non-reciprocal basis would enable these countries to start tackling base erosion immediately, with relatively little risk to other countries.

Finally, countries can continue to explore the use of existing bilateral treaties and TIEAs to seek taxpayer information. The United Nations and OECD Model Conventions both incorporate new standards that reject bank secrecy as a ground for refusing to share information and reduce the burden of the requesting State to show the precise use of the information sought.

Ultimately, transparency and disclosure of information remain vital to the effective enforcement of tax laws in a global economy. All countries should be attentive to the existing techniques for obtaining needed information, and should evaluate active reform proposals for their relevance, effectiveness and required capacity-building. Transparency and disclosure have centre stage in international tax policy reform, and the goal is to ensure that the outcomes of this focus meaningfully reduce the base erosion and profit shifting faced by jurisdictions around the world.

Chapter XI

Taxation of rents and royalties

Peter A. Harris*

The topic of payment of rents and royalties as a means of engaging in base erosion and profit shifting (BEPS) is an important one for a number of reasons. Perhaps the primary reason is that none of the actions in the BEPS Action Plan of the Organisation for Economic Co-operation and Development (OECD) specifically deals with rents and royalties.[1] A search reveals that there are only fleeting references to "rents" and not much more with respect to "royalties" in the Final Reports on the OECD action plans.[2] This is despite the fact that many developing countries face substantial BEPS through the manipulation of payments of rents and royalties.

The topic is also important because it links a number of other topics considered in the present *Handbook*. For reasons that will be discussed, the characterization of payments as rents and royalties stands

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[1] The scope of the OECD *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) is outlined in chapter I of the present publication, "Protecting the tax base of developing countries: an overview," by Hugh J. Ault and Brian J. Arnold.

[2] There are 17 references to "rent(s)" in the OECD BEPS 2015 Final Reports and 231 references to "royalty(ies)." The Final Report on Action 1 (digital economy) has 48 references to royalty(ies), many of which have relevance for the purposes of this chapter. The Final Report on Action 6 (treaty abuse) has 29 references to royalty(ies)"—most in the context of withholding tax—which have some relevance for the purposes of this chapter. The Final Report on Actions 8–10 (transfer pricing) has 41 references to royalty(ies), which are of limited relevance as transfer pricing is not considered in this chapter. The most references to royalty(ies) are in the Final Report on Action 11 (measuring BEPS), which has 83; these references are of limited relevance for this chapter as they are largely used in the context of identifying BEPS by reference to ratios comparing royalties to research and development expenditure. These overall numbers should be considered in the context of the total volume of Final Reports, which weigh in at 1873 pages. The 2015 Final Reports are available at http://www.oecd.org/tax/beps-2015-final-reports.htm.

at the interface between payments for the provision of services,[3] capital payments giving rise to capital gains[4] and payments in the nature of interest.[5] Rents and royalties can also give rise to hybrid mismatch arrangements,[6] although they often are not covered by OECD Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements. They can also be used as a means to avoid creating a permanent establishment (PE),[7] or at least attribution of profits to a PE.

Rents and royalties are each a species of payment, and that means the passing of value between one person recognized for tax purposes and another such person.[8] Understanding the nature of rents and royalties is critical for purposes of understanding the manner in which they give rise to BEPS risks. As payments, rents and royalties always give rise to two potential tax outcomes, one for the payer and one for the recipient, and it is the overall effect of these two outcomes that must be considered from a BEPS perspective. In its simplest form, BEPS through the payment of rents and royalties results from a deduction being claimed by the payer (base erosion) without an equivalent pick-up in the taxation of the recipient (no base addition). The situation becomes more complex once questions are raised regarding how to identify rents and royalties and when the extent of taxation of the payer and the recipient are considered.

In a multinational group, there is a tax incentive to have rents and royalties received where there is the smallest tax increase and, similarly, to have rents and royalties paid where they are likely to have the biggest tax reduction. This may involve four primary types of manipulation. The first is whether the payment in question is a rent or royalty, or a particular type of rent or royalty (if relevant), and it is possible that the characterization of the payment may be different in the hands of the payer than in the hands of the recipient. The second

[3] See chapter II, "Taxation of income from services," by Brian J. Arnold.

[4] See chapter III, "Taxation of non-residents' capital gains," by Wei Cui.

[5] See chapter IV, "Limiting interest deductions," by Peter A. Barnes.

[6] See chapter V, "Neutralizing effects of hybrid mismatch arrangements," by Peter A. Harris.

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

[8] See the discussion in chapter V, supra note 6, section 1.1.

is manipulation of who makes the payment and who receives it for tax purposes. Artificial entities are particularly problematic in this regard (as in other areas of BEPS) and provide tax planners with plenty of scope to change the form of relationships (where that is relevant). Third, even where the character and allocation of payer and payee are clear, tax planners may seek to manipulate the activity to which the rent or royalty is allocated, for example, allocation to investment or business activities. Finally, timing is important. Tax planners may be able to arrange an accelerated deduction for the payer of rents or royalties or a delayed recognition for the recipient.

Each one of these potential manipulations is available in an international setting. Two countries may characterize rent and royalty payments differently, or the characterization may be different for domestic law and tax treaty purposes. Allocation to particular payers and recipients makes a difference because it often affects jurisdiction to tax on the basis of residence. Allocation to particular activities also makes a difference because if often affects jurisdiction to tax on the basis of source. Two countries may recognize a payment of rents or royalties at different times and this may also give rise to cross-border manipulation. While BEPS risks from cross-border payments of rents and royalties are the primary focus of the present chapter, the issues discussed in this chapter are not inherently international in nature. BEPS from the payment of rents and royalties can arise in a purely domestic scenario depending on the tax profile of the payer and the tax profile of the recipient. In this context, the manipulation is commonly referred to as "tax arbitrage." [9]

With the generic nature of this topic in mind, the present chapter contains three main sections. The first focuses on domestic tax law issues and the structural features of an income tax that give rise to BEPS risks. This discussion includes a consideration of international factors and is particularly relevant for developing countries considering non-treaty scenarios. It should be noted here, however, tax treaties, as an overlay to domestic tax laws, often give rise to BEPS risks in and of themselves. The second section considers BEPS risks arising

[9] See, for example, *IBFD International Tax Glossary*, Julie Rogers-Glabush, ed. (Amsterdam: IBFD, 2017), definitions of "arbitrage" and "asymmetric taxes."

from treatment under tax treaties with particular focus on the provisions of the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention).[10] The third section considers particularly problematic areas involving BEPS through the payment of rents and royalties. These are rents and royalties giving rise to hybrid mismatches and BEPS arising from the use of intermediaries in third countries. The chapter concludes by reflecting on the differences and commonalities between rents and royalties and other types of payments giving rise to BEPS.

1. Domestic law treatment leading to BEPS

The purpose of this section is to investigate BEPS risks that arise under domestic tax law from the payment of rents and royalties. As explained in the introduction, this requires a consideration of the comparative tax treatment of the payer and the recipient and the ways in which those treatments may be manipulated. The tax treatment of both payer and recipient depends on the way in which the domestic tax law identifies and allocates rents and royalties, and these are definitional issues. Accordingly, this section begins by discussing definitional issues pertaining to rents and royalties and how these are relevant for BEPS purposes. It then considers the domestic tax treatment of rents and royalties, and in that context identifies BEPS risks. Finally, consistent with the focus of this chapter, the discussion moves to consider international connecting factors under domestic tax law and how these also give rise to BEPS risks.

1.1 Definitional issues

As discussed in the introduction, rents and royalties stand at the interface between payments for the provision of services, capital payments (giving rise to capital gains) and payments with respect to financial instruments such as interest and dividends. The tax treatment of a particular payment under domestic tax law (and so the risks of BEPS) is

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

often critically affected by the character of the payment. This means that developing countries need to pay particular attention to the manner in which payments are characterized under domestic law and how that might affect BEPS risks. This is the first matter considered in the following discussion.

Rent and royalties are payments and character is only one of the fundamental features affecting tax treatment. That treatment is also affected by the manner in which rents and royalties are allocated: whether to particular persons, activities or time periods. This is the second matter considered in the following discussion. A final, critical fundamental feature concerns the quantification of rents and royalties and the valuation of property giving rise to them. These issues can be particularly problematic for developing countries, for example, in the quantification of rent or price paid for intangibles or second-hand property such as vehicles and mining equipment. These matters are closely linked to transfer pricing rules and are beyond the scope of this chapter.[11]

1.1.1 What are "rents" and "royalties"?

Countries do not adopt uniform definitions of "rent" and "royalty" in their domestic laws and many do not define these terms at all.[12] As explained in chapter V,[13] income tax fundamentals suggest that there are only two ways of earning income, the provision of services and the provision (use or transfer) of assets. Both rent and royalty suggest a payment (bestowal of value) by one person for a provision of resources by another person.[14] To identify rent and royalty then requires investigation into the relationship between these terms and (a) payments for

[11] In particular, many of these are discussed in OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en.

[12] For example, see *IBFD International Tax Glossary*, supra note 9, definitions of "rent" and "royalties."

[13] Supra note 6.

[14] For the sake of simplicity, the discussion presumes a cash payment, but in-kind payments and benefits may also constitute rents and royalties.

the provision of services, (b) payments for the transfer of assets and (c) payments for the use of assets.

It is generally accepted that rents and royalties do not involve payment for the provision of services, although tax treaties can confuse this observation. This is important because the tax treatment of payments received for the provision of services may differ from the tax treatment of the receipt of rents and royalties. In particular, tax rates may vary depending on this distinction, such as where income from services is subject to progressive rates whereas rents and royalties are subject to flat rates or where there is a difference between gross and net basis taxation. In addition, many countries levy social security contributions on income from services (at least on income from employment), but not on rents and royalties.

It is also generally accepted that rents and royalties involve payment for the use of assets but do not involve payment for the transfer of ownership of assets, for example, as in a purchase price. This is necessarily a problematic distinction. Ownership is often viewed as the right to exclusive possession or use of property. Therefore, it is conceptually difficult to distinguish between an absolute or residual right of use (ownership) at one end of the spectrum and a temporary or non-exclusive right of use at the other, most commonly referred to as a "lease" or "licence." In the middle of this spectrum is a grey area where it is not clear whether a payment is for the use of an asset or for its partial transfer.[15]

Depending on whether it falls on one side of the line (payment for temporary use) or the other (transfer of an asset), the difference in tax treatment of a payment can be dramatic. Rents and royalties typically give rise to the potential of an immediate right of deductibility for the payer and inclusion in calculating income of the recipient. The purchase price of an asset commonly falls under the transactional part of the income tax. As such, the payer does not get full recognition of the payment in the year of payment and potentially not until the year the asset is disposed of (although there may be depreciation or amortization

[15] See, for example, paragraph 12 of the Commentary on Article 12 of the United Nations Model Convention, quoting paragraph 12.2 of the Commentary on Article 12 of the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital (OECD Model Convention).

in the meantime). Similarly, there may be a differing treatment of the recipient, such as where the taxability of the receipt of sales proceeds may be offset by otherwise quarantined amounts, such as capital losses.

Rents and royalties both involve the use of assets, but it is also generally accepted that they do not involve a return for the use of money such as is the case with interest, dividends and other returns on financial instruments.[16] This raises particularly problematic issues in seeking to define "financial instruments," which is critical for purposes of characterizing payments for the use of property (including money). It may be appropriate to rely on financial reporting standards for purposes of identifying financial instruments,[17] but as discussed in chapter V,[18] that can also cause problems from a domestic tax law perspective.[19] As a result, the tax laws of many countries do not define "interest" and "dividends" by reference to financial instruments. Classification as rents or royalties, on the one hand, or interest or dividends, on the other, can also be important in terms of tax treatment. For example, rules imposing limitations on the deductibility of interest, such as those discussed in chapter IV,[20] typically do not extend to payments of rents and royalties.[21] Similarly, the tax treatment of the recipient may also differ, such as where dividends are subject to some limited tax treatment (relief from economic double taxation). Examples 1 and 2 below illustrate these points.

[16] For example, OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports*, supra note 11, 67, paragraph 6.6, identifies an "intangible" as "something which is not a physical asset or a financial asset."

[17] Such as under International Accounting Standard 32 *Financial Instruments: Presentation*. The International Accounting Standards and International Financial Reporting Standards are available at http://www.ifrs.org/IFRSs/Pages/IAS.aspx.

[18] Supra note 6.

[19] Regarding these problems, see P. Harris, "IFRS and the Structural Features of an Income Tax Law," in G. Michielse and V. Thuronyi, eds., *Tax Design Issues Worldwide* (Netherlands: Kluwer Law International, 2015), 37–97, at 57–60.

[20] Supra note 5.

[21] As discussed under section 3, rent payable under a finance lease may be an exception.

Example 1
Substituting rent for interest

Y Co is the parent company of Z Co and both are residents of Country A. Z Co needs to buy a new piece of equipment worth 1000 for a business run by Z Co. It is presumed that the cost of finance in Country A is 10 per cent and the equipment depreciates at a rate of 5 per cent (straight line). Y Co is in a position to finance the purchase by Z Co. Z Co has been struggling with debt levels in recent years and is close to triggering the interest limitation rule in the tax law of Country A. These rules deny a deduction for interest incurred in excess of 30 per cent of EBITDA (earnings before interest, taxes, depreciation and amortization) and apply to both purely domestic and cross-border loans.

If Y Co lends Z Co 1000 to buy the equipment, in the first year of the loan (Year 1) Z Co will pay Y Co 100 as interest. Z Co will also suffer depreciation of the equipment of 50. Under the EBITDA rules, it is likely that all or at least part of the interest of 100 paid on the loan is non-deductible for Z Co. Nevertheless, receipt of the interest by Y Co continues to be taxable. This produces a form of economic double taxation. For example, if the profits of Z Co are 80 before the EBITDA limitation and after application of that limitation they are 180 (presuming Z Co has some other interest expense and the deduction of 100 interest on the loan is disallowed), the rules result in Z Co being taxed on an extra 100 profit (not reflected in its accounts). The taxation of this extra profit to Z Co and the taxation of Y Co with respect to the 100 interest received is a form of economic double taxation.

The tax treatment is likely to be different if Y Co buys the equipment and leases it to Z Co. In this case, as the asset is owned by Y Co, Y Co suffers depreciation of the equipment. This means that the rent payments made by Z Co to Y Co are likely to approximate the financing cost plus the depreciation, that is, 150 (100 plus 50) rent for Year 1 of the arrangement. Payment of rent (that is not recharacterized as interest) is typically outside the scope of the limits on deduction under EBITDA rules. If the financing is structured in this way, the rent of 150 is deductible by Z Co without limit. The 150 is income for Y Co, but can be reduced by the 50 depreciation, leaving the net financing return of 100 as taxable. In this case there is no economic double taxation as the 100 financing return is taxed only once (to Y Co). The same strategy involving payment of rent can be used to avoid interest limitation rules that are based on a debt to equity ratio or an arm's length borrowing threshold.

Example 2
Substituting dividends for rent or interest

The facts are the same as in example 1, except that Z Co has been incurring losses in recent years. Z Co has 600 of losses that are available for carry forward, which represent an excess of legitimate business expenses in prior years. Z Co has little expectation of being sufficiently profitable to use those losses in the near future. As a result, even if Country A has no EBITDA rules to limit the deductibility of interest paid by Z Co to Y Co, the deduction of the interest is of little tax value for Z Co. A deduction for interest paid by Z Co simply increases the amount that Z Co can carry forward as losses. With a deduction for interest, Z Co will have 520 in losses that continue to be available for carry forward at the end of Year 1 (600 less the 80 profits). Without a deduction for interest, Z Co will have 420 in losses left (600 less 180). Similarly, even if the arrangement is structured as a lease, the deduction of the rent payments made by Z Co is of little value for Z Co and simply increases the amount of losses available for a carry-forward.

Carried-forward losses are often subject to some form of time limitation. Presume that Country A limits the carry-forward of losses to 5 years and that 200 of Z Co losses will expire if not used by the end of Year 1. This means that with respect to Year 1, the deductibility of the 100 interest paid to Y Co is irrelevant for tax purposes of Z Co. If the interest is deductible, then 120 in losses will expire at the end of Year 1 (200 in losses due to expire less 80 in Year 1 profits). If the interest is not deductible then only 20 in losses will expire (200 less 180). The result can again be viewed as a form of economic double taxation, that is, Z Co is denied a deduction for legitimate business expenses and Y Co is taxable with respect to a similar amount in the form of interest.

The tax treatment is likely to be different if Y Co finances Z Co with 100 of share capital and Z Co uses the funds to buy the equipment. In this case, it is presumed that the financing return of 100 for Year 1 takes the form of dividends and that there is no corporate law restriction on Z Co in respect of distributing dividends (for example, due to its losses). The dividends are not deductible for Z Co and its tax position for Year 1 is similar to that where it pays non-deductible interest. However, the tax position of Y Co is likely to change. Dividends paid between two resident companies are often not taxable to the recipient. Presuming this is the case in Country A, Y Co is not taxable on the financing return when it takes the form of dividends. In this case there is no economic double taxation.

Accordingly, rents and royalties may be viewed as the residual characterization of payments for the use of assets, that is to say, payments other than payments made under financial instruments. Identifying what is a payment for "use" is one problem; identifying what are "assets" can also be a problem in characterizing a payment as rents or royalties. Some countries may phrase this question in terms of whether a payment is for the use of "property," and from a legal perspective property is not necessarily the same as assets. The present chapter does not investigate this matter separately, but simply notes its relevance in identifying rents and royalties. For example, issues arise in terms of whether payments made with respect to the provision of know-how, client lists or assembled workforces are rents or royalties for domestic tax purposes. Such payments are also at the interface of characterizing payments as payments for services. With these important issues as background, this chapter generally uses the term "assets" except when referring to movable and immovable property.

Rents and royalties are payments for the use of assets (excluding financial instruments) and a suitable definition of assets is needed for this purpose.[22] However, what is the difference between a rent and a royalty? Again, there is no consistent response to this question in the context of the domestic tax laws of developing countries. The distinction can be important because it may affect domestic tax treatment, such as where rents and royalties are subject to different withholding tax rates.

One way (though not the only way) of distinguishing between rents and royalties is to consider the nature of the underlying asset. All countries recognize a distinction between tangible and intangible assets, whether for legal or accounting purposes. A simple distinction may then be drawn between rents being payments for the use of

[22] For an accounting definition of "asset," see International Financial Reporting Standards: Conceptual Framework, paragraph 4.4, available at http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Pages/Conceptual-Framework-Summary.aspx. By contrast, OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports*, supra note 11, 67, paragraph 6.6, identifies an "intangible" by reference to something "capable of being owned or controlled" but without reference to an asset. Paragraph 6.7 continues; "[i]ntangibles that are important to consider for transfer pricing purposes are not always recognized as intangible assets for accounting purposes."

tangible assets and royalties being payments for the use of intangible assets.[23] In some countries this may not be a sufficiently accurate distinction, but in perhaps most cases it is broadly appropriate and a useful, simple rule for tax purposes. This approach requires rules for identifying precisely what is a "tangible" asset as compared with an "intangible" asset. This chapter does not deal with this distinction as a separate issue, but simply notes that legal categorizations or accounting categorizations may be usefully followed in this regard.[24]

It may be that even after rents and royalties are identified, they are subcategorized in a manner that is relevant for tax purposes. Perhaps the most significant distinction is the subcategorization of rents from "immovable property." Such a distinction also requires definition and tax laws commonly use general legal categorizations for this purpose.[25] Terminology used and its meaning vary from

[23] The *IBFD International Tax Glossary*, supra note 9, is clear in defining rent as "remuneration paid for the transfer of the right to use tangible assets." It is less prescriptive in the definition of royalties. However, OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports*, supra note 11, 68, paragraph 6.13, and 88, paragraph 6.86, uses royalty only in the context of use of intangibles and notably distances itself from the definition of royalties as used in tax treaties. Similarly, see OECD, *Designing Effective Controlled Foreign Company Rules, Action 3—2015 Final Report* (Paris: OECD, 2015), 44–45, paragraph 78, referring to "royalties and other income from IP," available at http://www.oecd-ilibrary.org/taxation/designing-effective-controlled-foreign-company-rules-action-3-2015-final-report_9789264241152-en. See also OECD, *Measuring and Monitoring BEPS, Action 11—2015 Final Report* (Paris: OECD, 2015), 70, note 5, available at http://www.oecd-ilibrary.org/taxation/measuring-and-monitoring-beps-action-11-2015-final-report_9789264241343-en.

[24] For example, International Accounting Standard 38 *Intangible Assets*, paragraph 8, defining "intangible asset." The International Financial Reporting Standards contains no apparent definition of "tangible asset." The International Accounting Standards and International Financial Reporting Standards are available at http://www.ifrs.org/IFRSs/Pages/IAS.aspx.

[25] Accounting standards often do not identify immovable property as a separate category of assets, for example, see the categorizations of assets in International Accounting Standard 1 *Presentation of Financial Statements*, paragraph 54. The International Accounting Standards and International Financial Reporting Standards are available at http://www.ifrs.org/IFRSs/Pages/IAS.aspx.

country to country. For example, common law jurisdictions often use phrases such as “real estate,” “real property” or “land” in contrast with “personalty,” whereas civil law jurisdictions are more likely to use the “movable”/“immovable” property distinction. All approaches have problems with the degree of attachment of an asset to land, for example, houseboats, caravans and even oil rigs.[26]

1.1.2 Special problem areas: finance leases, restrictive covenants and embedded rents and royalties

The distinctions discussed above are not so relevant if there is consistency in the manner in which payments of different characters are treated for tax purposes. However, tax treatment often varies depending on characterization.[27] Where this occurs, tax planners may seek to manipulate the distinctions underlying rents and royalties to produce a certain tax outcome. The following discussion seeks to illustrate this point by reference to some problematic areas that are often the subject of tax planning and, potentially, BEPS.

Payments made under finance leases stand at the interface of the distinction between rents and interest. In legal form, finance leases are leases giving rise to payments of rent. However, from the perspective of financial reporting, finance leases are often recharacterized as a financing transaction. In this case, the rent payments are recharacterized as in part interest and in part a repayment of capital under a loan.[28] For tax

[26] An additional problem is that there are intangible forms of immovable property (or real property). Practice is to nevertheless refer to payments for the use of such property as rents, so this category of asset is not separately identified in the following discussion.

[27] In some cases it is impossible to provide consistent treatment because tax laws draw black and white distinctions in spectrum areas. This can be the case with whether a payment is deductible or not, such as when it is characterized as being of a revenue or of a capital nature, but not partially both. The same is true at an asset level, such as where a tax law characterizes a financial instrument as debt or equity, but not partially both.

[28] For example, see International Accounting Standard 17 *Leases*, particularly at paragraph 25. The International Accounting Standards and International Financial Reporting Standards are available at http://www.ifrs.org/IFRSs/Pages/IAS.aspx.

purposes, some countries follow the legal form and others follow the financial reporting treatment (or a tax law version of that). Countries that follow legal form often experience tax planning around the distinction between a finance lease and a loan.[29] Example 3 below illustrates these points.

Example 3
Form versus substance approach to finance leasing

The facts are the same as in example 1 where Y Co buys the equipment and leases it to Z Co. Presume that the terms of the lease are such that it qualifies as a finance lease under International Accounting Standard 17. If Country A accepts the form of the lease for tax purposes, then the treatment for Year 1 is the same as in example 1. That is, Z Co has a deductible expense in the nature of rent of 150. Y Co receives income in the form of rent of 150 and claims depreciation of 50.

However, if the tax law of Country A follows the approach in International Accounting Standard 17, then the legal form of the transaction is recharacterized for tax purposes. Z Co is treated as the owner of the asset and claims the depreciation of 50. Y Co is viewed as having provided debt financing equal to the value of the asset (1000). The rent payment of 150 made in Year 1 is apportioned between a part that is treated as a payment of interest and a part that is treated as a repayment of part of the loan. This is usually done on the basis that the loan forms a "blended loan," that is, where the interest part is calculated on capital outstanding at the time of each payment and using compound interest. The treatment is likely to be the same or very similar to that in example 1 where Y Co finances Z Co with a loan.

There are three tax issues that give rise to the use of finance leases for manipulation that can lead to BEPS. The first is the taxability of interest (and returns of capital) compared to rents in the hands of the recipient. If interest is taxed less than rents (for example, is subject to a lower withholding tax) then a straightforward loan may be favoured. However, a finance lease may be favoured if rents are taxed less than interest. Second, if there are limits on interest

[29] See P. Harris, "IFRS and the Structural Features of an Income Tax Law," supra note 19, 64.

deductibility for the payer (such as of the type discussed in chapter IV),[30] then a finance lease may be favoured if rents fall outside those limits. Third, the owner of the subject asset is different under a finance lease (the financer is the owner) than under a loan (the borrower is the owner). This means that the party granted depreciation of the subject asset under a finance lease is different from that in the case of a loan. If depreciation rates are higher than economic depreciation, the tax profile of the contracting parties may make a difference to the form in which the transaction is structured.

In countries that respect the legal form of finance leases, tax planners will carefully weigh up the tax profiles of the parties by reference to these three issues in seeking to minimize tax. While this constitutes a particular issue in cross-border dealings, there are many examples of this type of manipulation in a purely domestic context, particularly where tax-exempt entities (including corporations in a loss position) are involved. However, even if finance leases are recharacterized as loans for tax purposes, the scope for manipulation is not entirely removed. Here, the manipulation moves from legal form to the test for what is and what is not a finance lease for tax purposes. The problem is that the characterization of the payments as rents or interest (with repayment of capital) is absolute and there is no apportionment such as might happen in the case of bifurcation. Example 4 below illustrates these points.

Example 4
Tax profile and capital expensing

The facts are the same as in example 2 where Z Co has losses. However, in this case capital expensing is available for the acquisition of the equipment, that is to say, a deduction of 1000 in Year 1. This deduction now becomes the dominant feature in the example instead of the tax treatment of the financing return. As Z Co has losses, it has no use for the capital deduction. It is presumed that Y Co has sufficient tax capacity to fully utilize the capital deduction. If Country A has a corporate tax rate of 30 per cent, the cash flow difference in Year 1 between Z Co claiming the capital deduction and Y Co claiming it is 300 (30 per cent of 1000), in other words, Y Co can save 300 in corporate tax by claiming the deduction, whereas Z Co cannot save any tax (as it has losses).

[30] Supra note 5.

Y Co and Z Co will seek to manipulate the financing of the equipment so that Y Co can claim the capital deduction of 1000. This means that a lease is likely to be used as financing (with Y Co as the owner of the equipment) rather than financing with a loan or share capital (where Z Co would be the owner of the equipment). If Country A accepts the form of the lease, the lease may take the form of a finance lease. If Country A follows the accounting treatment in recharacterizing a finance lease as a loan, then Y Co and Z Co are likely to use a form of lease that will be characterized as an operating lease rather than a finance lease. They will pay particular attention to the criteria for a finance lease and manipulate the terms of the lease to ensure that rechacterization is not triggered.

The reason why 300 can be saved due to the structure of the financing is because of the differing tax profiles of Y Co and Z Co. Y Co is fully taxable, whereas Z Co is effectively exempt in Year 1 due to its losses. This example works in the same way where tax-exempt entities are involved. For example, if local governments are tax exempt, there may be tax arbitrage opportunities in acquiring assets through leases rather than borrowing with direct acquisition. As the rate of capital expensing increases so does the distortion as to the form of financing.

It is widely accepted that rents and royalties are payments for the use of assets, but what exactly amounts to "use" for this purpose? Restrictive covenants often provide for payments for an owner not to use an asset.[31] Restrictive covenants can pertain to tangible assets, but often require the non-exercise of rights with respect to intangible assets. Should payments under restrictive covenants be characterized as rents or royalties (depending on the nature of the underlying asset)? Restrictive covenants are often entered into to enable the beneficiary of the covenant to more effectively or profitably use their own assets or rights. This demonstrates that the use of an asset owned by one person may affect the ability of another person to use an asset owned by the other person.

[31] Restrictive covenants can also pertain to the provision of services, such as where a person undertakes not to work in a specific field, in a specific area and for a specific period of time. See generally E. Reimer, "How Tax Treaties Deal with Income from Omissions," (2006) Vol. 60, No. 3, *Bulletin for International Taxation*, 110 – 118.

As with finance leases, if the tax treatment for payments under restrictive covenants is similar to the tax treatment of rents and royalties generally, then characterization may not be important. However, often that is not the case, for example, where withholding tax applies to rents or royalties but not to payments made under restrictive covenants. Payments made under restrictive covenants can be used as a close substitute for payments of rents and royalties. The choice may be between using another person's asset and paying the person rents or royalties, or paying the other person not to use their asset so that the payer can more effectively use an asset the payer owns or is developing. A lack of consistency in the tax treatment of these different types of payments may give rise to manipulation by tax planners leading to BEPS. The tax profiles of the particular parties are important in this regard.

For reasons described above, rents and royalties are also substitutable for the price paid for assets, and this can give rise to manipulation leading to BEPS. Tax planners will simply compare the tax treatment of a payment as rents or royalties with that for the sale price of an asset. Transactions can be expected to be structured in whichever way produces less tax. So rents or royalties may be paid for what is effectively the sale of an asset. Similarly, the sale price of an asset may embed an element for rents and royalties. Finance leases can be used in either way, depending on the tax treatment, but there are other examples.

A simple example demonstrates these issues, but the issues and tax planning can quickly become complex, particularly in an international setting.[32] Company A owns tangible assets and develops intangible assets both of which are used in the production of goods,[33] which are sold to customers. There are no rents and royalties involved in this (original) scenario even though the sales proceeds do involve, indirectly, part payment for the use of the tangible and intangible assets

[32] See, for example, the discussion in T. Faccio and J. Kadet, "Will Bringing Sales Onshore in the U.K. Lead to Higher Taxes?" (2016) Vol. 82, No. 7, *Tax Notes International*, 679 – 685; and A. Jiménez, "Article 12: Royalties," *IBFD Global Tax Treaty Commentaries* (2015), section 5.1.3.3, available at https://www.ibfd.org/sites/ibfd.org/files/content/pdf/14_119_fol_GTTC_final.pdf.

[33] This example can work in a similar manner where services are involved rather than goods.

by Company A. A full sales price with no related payment of rents and royalties may be the preferred option of tax planners if sales proceeds are taxed more favourably compared to rents and royalties.

However, if rents and royalties are taxed more favourably compared to sales proceeds, it is easy to change this scenario to separate out rents and royalties. In the second version of the example, this can be done, for instance, by introducing another company (presumed to be a subsidiary of Company A) that produces and sells the goods or services but which leases the tangible assets and licenses the intangible assets from Company A. Presuming the subsidiary can deduct the rents and royalties paid to Company A, the business profits arising from the sales proceeds have been reduced compared to the original scenario. If rents and royalties are taxed at reduced rates compared to business profits generally, this scenario gives rise to less tax than the original scenario. This can particularly be the case in an international setting.

Of course, the reverse can also be true, that is, where business profits are taxed less than rents and royalties, and so the original scenario is favoured. Add to this mix the possibility that the tangible or intangible assets owned by Company A might be financed with borrowed funds and part of the rents and royalties may be further split into an interest element. Tax planners might undertake this where interest is tax-preferred compared to rents, royalties and business profits. The situations can quickly become very complex, but follow this basic theme. Therefore, identification of BEPS risks in the context of rents and royalties often involves identifying the circumstances in which these substitutable payments are taxed differently. That particularly involves an investigation of cross-border payments of these types, where there is the most difference in tax treatment and BEPS is most obvious.

Fear of this sort of tax planning has caused some developing countries to impose gross-based taxation on sales proceeds, at least on sales in a business-to-business context. Such taxes can be particularly distorting and therefore targeting them appropriately is problematic. For example, a country may impose a withholding tax on payments for or calculated by reference to natural resources extracted from the country. The point of such a tax is that it does not matter whether the payment is characterized as sales proceeds or a royalty (for example, for use of information pertaining to the existence of the resources and how to extract them), or something else. The withholding tax is imposed in any case. "Overriding royalties" are sometimes taxed in this manner. These are payments to a person who is not the direct holder of an interest in a right to extract natural resources, but which are calculated by reference to extraction of those resources.[34]

Payment for the provision of services can be separated in the same manner. This might happen where Company A retains ownership of the goods until sale to the customer, but contracted with another company to produce the goods (which did not obtain title to the goods) (that is, contract manufacturing). The substance of this third version of the example is effectively the same as the second version, that is to say, one company provides labour to produce the goods whereas the other company provides the relevant assets. The difference is that in the second version, the legal ownership of the goods is with the company providing the labour, whereas in this third version the legal ownership is with the company providing the relevant assets. Whether tax planners prefer this third version to the original scenario or the second version depends on the comparative tax treatment of service fees and that of sales proceeds or rents and royalties.

1.1.3 Allocating rents and royalties

The above discussion has considered the importance of characterizing a payment as a rent or royalty and why differing tax treatments resulting from different characterization might give rise to tax planning and BEPS. The same can be true with respect to the manner in which rents and royalties are allocated, whether to particular persons, activities or time periods. The examples above demonstrate how artificial persons such as companies can be used to manipulate whether to make a payment that constitutes rents or royalties and how the choice to do so can reduce the direct amount of business profits (through a deduction for rents and royalties).

Even where a scenario definitely involves rents and royalties, artificial persons can be used to manipulate tax consequences. This is most obvious in the case of the recipient of rents and royalties. The nature or characteristics of the recipient may change the tax treatment.

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[34] For example, see Australian Draft Tax Ruling TR 2016/D3, available at http://law.ato.gov.au/atolaw/view.htm?docid=%22DTR%2FTR2016D3%2FNAT%2FATO%2F00001%22.

Therefore, changing or manipulating the owner of the asset and so the recipient of rents and royalties can change the tax treatment. For example, there may be tax planning reasons to have rents and royalties received by exempt entities, for example, public entities, entities benefiting from a tax holiday or entities in a loss position. The residence of an entity can also be critically important, particularly where source basis taxation is minimized or avoided.

The nature of the payer of rents and royalties may also be significant. For example, an individual may seek the use of a luxury car. If the individual rents the car directly, there may be no deduction for payment of the rent because the expense is considered to be personal. If the individual uses a car that is rented by a privately held company, the tax consequences may be different. Whether the company is granted a deduction for the rent in whole or in part depends on the circumstances and the tax law in question. The point is that as the paying entity has changed, so may the tax consequences. Similarly, exempt entities may seek to allocate payment of rents and royalties to related taxable entities in order to secure deductions for rents and royalties. From a BEPS perspective, these are matters that need to be monitored.

Rents and royalties also need to be allocated to particular activities of the payer and recipient. This issue arises because countries tax different activities of a person differently. Most concerning from a BEPS perspective is where the payer gets to deduct rents or royalties against a high-taxed activity and the recipient is lowly taxed with respect to the receipt of the rents and royalties. The scope for manipulation and tax planning in this regard requires an investigation into the tax treatment of different activities of different persons. For example, a tax law may distinguish between the employment, business, investment and private activities of a person. Companies may be considered to have only business or investment activities, or perhaps all of a company's activities may be considered to be business in nature. Resident persons may be taxed differently on foreign activities when compared with their domestic activities, and non-residents may be taxed differently depending on the nature of their domestic activities.

All of these differences can incentivize tax planning leading to BEPS. For example, in a number of developing countries, banking and insurance activities are subject to a higher tax rate than other business activities, and the same is often true of extractive industries. These high tax activities may be "ring-fenced" in the sense that losses from other activities cannot be used to reduce profits subject to tax at the higher rate. However, base-eroding payments such as rent and royalties can have the same effect as allowing the use of such losses, that is, the reduction of profits subject to the higher rate. If the rents or royalties are then received by an entity that is effectively not subject to tax on the receipt, the BEPS issues can be substantial. Example 5 below illustrates these points.

Example 5
Tax profile and no depreciation deduction

The facts are the same as in example 1, with two modifications. First, while as a commercial matter the equipment depreciates at a rate of 5 per cent, Country A does not grant any depreciation deduction for tax purposes. This means that profits for tax purposes are inflated in Year 1 by 50 when compared to commercial profits. Whether Y Co or Z Co suffers this inflation depends on who holds the asset. Second, Z Co is subject to a special tax regime under which it is taxable at a rate of 40 per cent, whereas Y Co is subject to the regular corporate tax rate of 30 per cent.

Example 1 initially presumes that Z Co borrows 1000 from Y Co. Z Co has 80 in commercial profits after the deduction of depreciation and interest expense. Denial of a deduction for depreciation increases these profits for tax purposes by 50, to 130. If the interest is not deductible under the EBITDA rules, then the profits are increased to 230. The same is true if Y Co finances Z Co with 1000 of share capital (as in example 2). These taxable profits produce a tax liability for Z Co of 92 (40 per cent of 230). In addition, in the case of loan financing, Y Co may have a tax liability in respect of interest received of 30 (30 per cent of 100).

The situation is different if Y Co buys the equipment and leases it to Z Co. In this situation Z Co pays rent of 150 in Year 1, which is deductible in full. Z Co has taxable profits equal to its commercial profits producing a tax liability of 32 (40 per cent of 80). Y Co now has income equal to the rent and it is not granted a deduction for depreciation. It has a tax liability of 45 (30 per cent of 150). The overall tax liability of both companies is 77 (32 plus 45), a tax saving of 15 (92 less 77) compared with where Z Co is financed with share capital to acquire the asset and 45 (15 plus 30) where Z Co is financed with a loan and subject to the EBITDA limitation. The 15 difference with share capital financing is due to shifting the additional 150 income (financing return plus depreciation denial) from

Z Co to Y Co, producing a saving of 10 per cent because of the lower tax rate of Y Co.

As in example 4, the reason for the tax saving due to the structure of the financing is because of the different tax profiles of Y Co and Z Co, that is, a 30 per cent tax rate versus a 40 per cent tax rate. Both examples demonstrate that taxpayers are likely to manipulate transactions, and especially financing, so as to locate deductions in the entity subject to the highest tax and locate income in the entity subject to the lowest tax. This can also be true within the same entity, where some activities are taxed at a higher rate than others. Tax planning will involve allocating a disproportionate amount of expenses to the high tax activities and a disproportionate amount of income to the low tax ones.

The time at which rents and royalties are recognized for tax purposes can also be significant, particularly if they are recognized at different times by the payer and the recipient. From a BEPS perspective, the greatest concerns arise where the payer can claim a deduction on an accrual basis, but the recipient is taxed only when the payment is received, that is to say, on a cash basis. If payments of rents or royalties are deferred until the end of the lease or licence period, the tax deferral can be substantial, potentially running into years. Business taxpayers, especially companies, often claim deductions on an accrual basis. The cash basis may be available for individuals or in some cases all taxpayers in the context of investment activities. Care must also be taken where the tax liability is only by way of withholding as withholding is often imposed on a cash basis.

1.2 Tax treatment

Presuming that rents and royalties have been identified and that all of the fundamentals regarding the payments have been settled, the specific tax treatment of rents and royalties can affect the risks of BEPS. To this end, as mentioned at section 1.1 above, an overall assessment of the combined tax treatment of the payer and the recipient and a comparison with the treatment of potentially substitutable payments is required.

Regarding the recipient, an initial issue is whether payments of rents and royalties are subject to withholding tax. Administration of income tax can be greatly simplified if all rents and royalties are subject to withholding tax, particularly if interest and service fees are subject to the same level of withholding tax. This is particularly the case from the perspective of the payer and the tax administration. However, it is not the typical practice in developing countries. Often withholding tax on rents and royalties is targeted only at payments to non-residents. In this case, the payer needs to know about the residence of the recipient. Further, often withholding tax is only applied to some types of rents and royalties, for example, rent from immovable property or royalties from intellectual property. These limited withholding taxes necessarily raise difficult classification issues for the payer in determining whether or not withholding is required.

Any withholding tax that is levied on rents and royalties may be a final tax on the gross amount of the payment or may be an interim payment that is creditable against a final tax liability calculated on a different (typically net) basis. As noted in section 1.1, taxes on gross payments can be particularly distorting because people base their financial decisions on net outcomes and the percentage of expenses in deriving certain income can vary dramatically from case to case. Final withholding taxes prompt a number of tax planning responses. A primary response is a gross-up clause in the rental or licensing agreement such that any withholding tax imposed increases the amount of rent or royalties payable. Tax planners also manipulate the quantity of payments so as to reduce the amount subject to withholding, particularly in non-arm's length situations (transfer pricing). The allocation of expenses by the recipient between different activities and related persons can also be manipulated by tax planners so as to ensure that the deductibility of the expenses is not lost (because they are otherwise incurred in deriving a final withholding payment).

Little or no withholding tax can be a major incentive for deriving rent and royalties and can lead to BEPS. This is particularly the case where expenses can be allocated elsewhere. By contrast, a withholding tax that is too high deters deriving rent and royalties and puts pressure elsewhere (for example, on sales proceeds). Creditable withholding taxes are less problematic, but can cause cash flow problems. This is particularly the case where the credit exceeds the ultimate tax liability and the tax administration has difficulty in processing refunds (a common problem in developing countries).

One way to achieve a higher level of neutrality with respect to rents and royalties and so reduce distortions leading to BEPS is by including rents and royalties in general income taxed on a net basis. In this way, substitutable payments are not taxed differently—the primary cause of BEPS. The ultimate amount of tax payable on a net basis can be determined only after reconciliation at the end of the tax year. Most countries require prepayments during the tax year based on an estimate of the tax due at the end of the year (that is to say, an instalment system).

Net basis taxation and instalment systems are not practical in all cases, such as cases involving non-residents without a substantial presence in the country. This drives a wedge between the tax treatment of some taxpayers with respect to the receipt of rents and royalties and the tax treatment of others, thereby increasing risks of BEPS. It also raises issues for the payer in identifying the residence of the recipient and the nature of the payment. An incomplete solution to these issues is to impose withholding tax generally on rents and royalties, targeting cases where the tax is a final tax. For remaining recipients, the withholding tax is creditable, including against liability for instalments.

As discussed above, for the payer there are administrative issues regarding withholding of tax from rents and royalties. The payer's own tax treatment with respect to the payment of rents or royalties is also relevant. Most of the relevant issues have already been discussed. The primary issue from a BEPS perspective is full deductibility of the payment on an accrual basis. This is most likely the case for domestic source payments of rents or royalties made in the context of a domestic business. Any limits on deductibility need to be considered, although the types of limits that are increasingly imposed on interest deductibility are unlikely to apply to rents and royalties (at least outside of finance leases).

Full deductibility aside, more restricted relief for the payment of rents and royalties may also have BEPS effects if the relief more than offsets the taxability of the recipient with respect to the payment. For example, the payment of rents and royalties may be allocated to an activity (for example, investment) where losses are quarantined and cannot be used to reduce profits from other activities. The recognition of rents and royalties may be delayed, such as where they are viewed as being of a capital nature and form part of the cost base of an asset.

In this situation, the payment will be recognized through depreciation, amortization or realization of the asset. Finally, the payment of rents and royalties by the payer may not be recognized at all for tax purposes. This can happen where the payment is attributable to exempt income or income subject to a final withholding tax, or where the payment is attributable to private activities.

1.3 International factors—source rules

Cross-border payments are the most common scenario in which rents and royalties give rise to different tax treatment when compared to substitutable payments, with consequent BEPS risks. Identifying the circumstances in which this may happen requires a brief overview of the different ways in which countries tax cross-border rents and royalties. This in turn involves identifying what amounts to a cross-border payment of rents or royalties and then the potential tax treatment of such payments. Only domestic law issues are considered at this stage. Tax treaty issues are considered in subsequent sections.

A cross-border payment of rents or royalties may be considered to involve a payment sourced in one country and received by a resident of another country. The critical issue for present purposes is domestic law rules that identify the source of rents and royalties.[35] The rule for payment of rent for the use of immovable property is consistent in almost all countries. Such rent is sourced in the country where the immovable property is situated.[36] Source countries vary as to whether domestic source rent from immovable property is taxed to non-residents by way of final withholding tax or net-basis assessment.

Where a final withholding tax is imposed on domestic source rent of non-residents, the tax rate tends to be quite high and therefore the scope for BEPS is minimal. Rather, the BEPS risk arises more in terms of seeking to manipulate the recipient of the rent so as to avoid

[35] Generally, see H. Ault and B. Arnold, eds., *Comparative Income Taxation: A Structural Analysis,* 3rd edition (The Netherlands: Kluwer Law International, 2010), 510–515.

[36] See B. Arnold, *International Tax Primer*, 3rd edition (The Netherlands: Kluwer Law International, 2016), 26; and P. Harris and D. Oliver, *International Commercial Tax* (Cambridge: Cambridge University Press, 2010), 76.

the final nature of the withholding tax. This can be done by inserting a domestic company in between the payment of the rent and the non-resident. Presuming the rent now paid to the domestic company is taxed on a net basis, the company may seek to pay deductible amounts to the non-resident (or related entities) that are subject to lower withholding tax than the rent would be if paid directly to the non-resident. For example, the company may be debt financed and the payments to the non-resident will take the form of interest. Similarly, services fees may be involved or even royalties.

Source rules for rent paid for use of tangible movable property are less consistent from country to country and can be more susceptible to BEPS. Countries commonly follow a rule analogous to that used for immovable property and look to the physical place of use of the tangible property.[37] At the other extreme, some countries do not have an express source rule and rely on court rulings, which may take account of various factors, including place of use, place of contract, residence of the parties and even place of payment. Other rules are possible, including simply relying on residence of the payer or attribution to a local PE.[38]

More importantly, the tax treatment by source countries of rent paid to non-residents for use of tangible movable property varies greatly. Some countries impose withholding taxes, but often on an isolated or fragmented basis. Many countries do not impose withholding tax and simply rely on the PE concept. Non-residents are taxed on rent for the use of tangible movable property only if receipt of the rent is attributable to a local PE. This means that tax planners may seek to avoid the establishment of a PE for a non-resident or at least avoid the attribution of the rent to a local PE (see chapter VII).[39] If the non-resident does avoid having a PE and if the rent is fully deductible to the local payer, the source-country base erosion is substantial. If the rent is not effectively taxed in the non-resident's country, there is a major distortion. The BEPS risk is that the tax advantage attracts many people to tax plan in order to intentionally produce this outcome.

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[37] See B. Arnold, *International Tax Primer*, supra note 36, 26.

[38] See P. Harris and D. Oliver, *International Commercial Tax*, supra note 36, 78.

[39] Supra note 7.

Source rules for royalties for use of intangible assets are also highly inconsistent from country to country. Some countries consider royalties sourced in the country where the intangible asset is used. Others focus on where legal rights to the asset can be enforced or where the asset was created or developed. Others still simply rely on payment of royalties by a resident person or the fact that the royalties are borne by a local PE.[40]

Source countries are more likely to impose withholding tax on domestic source royalties than domestic source rent for the use of movable property. Exactly which payments are subject to withholding tax depends on the manner in which royalty is defined in domestic law. As noted in section 1.1 above, most countries do not apply the simplistic lines of characterization as used for the purposes of this chapter. In particular, some countries encompass within the definition of royalty some payments for the use of tangible movable property, such as the use of certain types of equipment and even some types of payments for services. If other payments for the use of tangible movable property or services are not subject to the same withholding tax, the characterization of a particular payment can become difficult and lead to disputes.

The rate of withholding tax imposed on domestic source royalties is critical in determining the BEPS risks associated with such payments. If the rates are high, then the comments made with respect to rent for the use of immovable property are relevant. Here again the BEPS risk is from the use of local companies to recharacterize the royalties before the funds are paid to the non-resident. If the rates are low or zero, then the comments made with respect to rent for the use of tangible movable property are relevant. Here too the BEPS risk arises from tax planning efforts to avoid attributing the royalties to a local PE. This is often easier for tax planners when dealing with intangible property than with tangible property. A PE is typically a physical place and tangible assets must be used at a particular place, and this use can cause the establishment of a PE. That is not the case with intangible assets, which need not be used at any particular fixed place. Further, a PE is a place of business and so the payment needs to be attributed to a business activity. It is difficult (though not impossible) to lease tangible

[40] See B. Arnold, *International Tax Primer*, supra note 36, 26; and P. Harris and D. Oliver, *International Commercial Tax* , supra note 36, 78.

movable property passively in a cross-border scenario. It is possible to hold intangible assets passively (outside the context of a business) and this of itself will avoid PE status.

The above discussion focused on source-country taxation of cross-border rents and royalties. It also focused on taxation of the recipient, presuming that the payment is deductible locally for the payer. Developing countries also need to be aware of BEPS risks with respect to the payment of foreign sourced rents and royalties. These are often defined by negative implication as any rents or royalties that do not have a domestic source.[41] These risks can be broken down into those associated with respect to the recipient of foreign source rents and royalties and those associated with respect to payment of foreign source rents and royalties.

A country has jurisdiction to tax foreign source rents and royalties where they are derived by a resident person or by a non-resident through a local PE.[42] The BEPS risks in this case are the same as those for other types of foreign source income and typically pertain to the method of foreign tax relief. If the direct receipt of foreign rents or royalties results in local taxation, then tax planning will seek to avoid that tax by rerouting or reclassifying the rents or royalties. This may be the case where there is no foreign tax relief, a deduction for foreign tax or where the foreign tax credit method is used. For example, a non-resident with a local PE may seek to restructure so that the foreign rents or royalties are no longer attributable to the PE. For residents, if profits of a foreign PE are exempt, the resident may seek to restructure so that the foreign rents or royalties are received through a foreign PE.

These situations are particularly concerning from a BEPS perspective where the rents or royalties are not effectively taxed in any other jurisdiction. Potentially more concerning is when this type of

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[41] For example, see P. Harris, "Taxation of residents on foreign source income," in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (New York: United Nations, 2013), 109–171, at 110–111, available at http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf.

[42] However, many countries do not tax foreign source income attributable to a local PE of a non-resident, see H. Ault and B. Arnold, eds., *Comparative Income Taxation: A Structural Analysis*, supra note 35, 498–502.

BEPS risk is added to the BEPS risks with respect to domestic source rents and royalties. The result can be rents or royalties paid between residents being rerouted so that they are paid to a non-resident who then pays them back to residents as foreign source income that is lowly taxed. This is often referred to as a “carousel” (payment out and then back in). Countries need to monitor their tax systems to minimize these sorts of tax planning opportunities.

Payments of foreign source rents or royalties can lead to substantial BEPS issues where they are fully deductible against domestic source income. These BEPS risks are not limited to payments characterized as rents or royalties, and the risks are higher where the recipient of the foreign source rents or royalties is not effectively taxed. This risk of BEPS occurs through permitting a deduction against amounts subject to full tax of amounts over which a country has no source tax jurisdiction. If a country does not monitor this and protect its domestic source tax base, it can find that it becomes a dumping ground for foreign expenses with a consequent substantial loss of the domestic source tax base. The allocation of foreign expenses between domestic and foreign source income is discussed elsewhere.[43]

2. Tax treaty treatment leading to BEPS

Tax treaties are an overlay to domestic tax law. While tax treaties provide for administrative assistance in ways that can prevent tax avoidance and evasion, they primarily restrict countries’ taxing rights.[44] It is this restriction that means that tax treaties themselves can give rise to BEPS risks, no matter how robust a country’s domestic law is. This section focuses on tax treaties, using the domestic law treatment

[43] P. Harris, “Taxation of residents on foreign source income,” supra note 41, at 141–148.

[44] This is particularly true with the rise in importance of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, which now has over 100 signatories and is the primary international mechanism for prevention of tax avoidance and evasion. This convention makes the administrative assistance provisions in tax treaties largely redundant. The OECD-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, is available at http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf.

discussed in section 1 above as background. For this purpose, the United Nations Model Convention is used as a broad representation of tax treaties adopted by developing countries.

Tax treaties incorporate a different structure than that used in the tax laws of most countries. In particular, tax treaties often adopt different approaches to the fundamental issues of identifying and allocating rents and royalties from that discussed in section 1.1 above. These definitional issues can have a dramatic effect on the taxing rights of countries and exposure to BEPS risks. As with the domestic tax law issues, these definitional issues in a tax treaty context are fertile ground for tax planning. Further, especially in the context of rents and royalties, tax treaties place substantial restrictions on the taxing rights of, in particular, source countries. Once again, it is the lack of consistency in the granting of taxing rights between substitutable payments that gives rise to the risk that tax treaties can be used for BEPS purposes.

2.1 Definitional issues

Tax treaties are schedular in that they grant taxing rights based on categories of income. This is most clear in the structure of the United Nations Model Convention and in particular Articles 6–21 (the distributive articles). Within this context, there is one article focused on rents from immovable property (Article 6) and another dedicated to royalties (Article 12). There is no article specifically dedicated to rents from tangible movable property and, where such rents do not fall within Article 6 or 12, residually they fall under the business profits article (Article 7) or the other income article (Article 21). However, for reasons discussed below, some rents from tangible movable property are treated as income from immovable property or royalties. For purposes of identifying BEPS risks, it is critical to identify whether a payment falls within one article or another as the tax treatment with respect to each article varies dramatically.

2.1.1 Which article applies to rents and royalties?

Article 6 applies to "income from immovable property." It is clear that "income" encompasses but is not limited to rent. Issues arise as to whether income can include capital amounts, such as premiums on the grant of a lease. The prevailing view is that it can, provided this is supported by domestic law.[45] Such amounts are highly substitutable with rent and if lease premiums are viewed as falling outside Article 6 they would be subject to different tax treatment under another article (most likely Article 13 on capital gains). As noted previously, it is difference in tax treatment between substitutable payments that leads to BEPS.

It is also clear that "from" encompasses use, and so rent for the use of immovable property falls within the Article. That "use" is covered is confirmed by Article 6 (3). However, "from" is not without limitation. On the one hand, it seems clear that a lease premium is "from" the immovable property or its "use." On the other hand, it seems reasonably clear (though not without doubt) that gains on the disposal of immovable property are not from the immovable property, but rather from the disposal, and Article 13 (1) is therefore the appropriate Article.[46] Further, interest paid on a loan secured on immovable property is not from the immovable property, but rather from the loan.[47] As interest is taxed differently from rent under tax treaties, this can give rise to BEPS risks. More problematic is whether a gain made on the sale of a sublease of immovable property (for example, where rent is accruing on the sublease) is "from" immovable property or its "use."[48]

[45] See E. Reimer and A. Rust, eds., *Klaus Vogel on Double Taxation Conventions*, 4th edition (The Netherlands: Kluwer Law International, 2015), 423; and P. Harris and D. Oliver, *International Commercial Tax*, supra note 36, 126 – 128. One problem with this approach is that Article 6 and its Commentary do not mention premiums. Compare the approach in the definition of "interest" in Article 11 (3), which expressly mentions "premiums." Further, compare the definition of "royalties" in Article 12 (3) referring to "payments," which can clearly cover capital payments.

[46] The definition of "interest" in Article 11 (3) also uses the "income from" formulation. Paragraph 19 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraph 20 of the Commentary on Article 11 of the OECD Model Convention, confirms that profit realized "by the sale" of a debt security "does not enter into the concept of interest."

[47] See paragraph 7 of the Commentary on Article 6 of the United Nations Model Convention. See also H. Pijl, "Interest from Hybrid Debts in Tax Treaties," (2011) Vol. 65, No. 9, *Bulletin for International Taxation*, 482 – 502, at 487.

[48] E. Reimer and A. Rust, eds., *Klaus Vogel on Double Taxation Conventions*, supra note 45, 440, suggest that "'second-tier' earnings … do not fall under Article 6."

"Immovable property" is also a limiting factor with respect to Article 6. Article 6 (2) adopts the domestic law meaning of the country in which the property is situated. Importantly, the definition goes on to include some types of movable property including livestock and agricultural equipment, but ships, boats and aircraft are expressly excluded. Rights to payments for the right to work natural resources are also included. This might include payments of overriding royalties as discussed in section 1.1 above. Even if it does not cover the simple right to work an extractive industry right and so proceeds from the sale of natural resources, the prevailing view is that they are covered by Article 6 (3).[49]

Article 12 applies to royalties. This term is defined in Article 12 (3) by reference to payments "for the use of, or the right to use" a list of items. Most of the items can be accurately described as intangible assets, although certain types of equipment are also included, as discussed below. The inclusion of payments for the use of know-how ("industrial, commercial or scientific experience") demonstrates that the underlying asset need not constitute "property" in a formal legal sense.

The definition of royalties in Article 12 (3) is both narrower and broader than payments for the use of intangible assets. On the one hand, the list does not cover all types of payments for the use of intangible assets. In particular, Article 12 does not comprehensively cover payments for use of data processing-related, customer-related, contract-related, human capital-related or goodwill-related intangible assets.[50] On the other hand, payments for use of industrial, commercial or scientific equipment are treated as royalties; as a consequence, Article 12 covers rent for the use of some types of tangible movable property. There are no definitions of the terms used in this phrase. "Equipment" is a particularly difficult term.[51]

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[49] Ibid., at 455. Payment for the use of pipelines that are treated by domestic law as immovable property also fall within Article 6. See paragraph 18 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 26.1 of the Commentary on Article 5 of the OECD Model Convention.

[50] Compare the list in Article 12 (3) with the list in R. Reilly and R. Schweihs, *Valuing Intangible Assets* (New York: McGraw-Hill, 1999), 19–20.

[51] See United Nations, "Possible Amendments to the Commentary on Article 12 (Royalties)," presented at the twelfth session of the United Nations

The definition of royalties in Article 12 (3) suffers from other definitional difficulties, many of which are discussed in the Commentary on the Article. There is often a difficulty in distinguishing a payment for the use of an intangible asset and payment for services related to the use of an intangible asset. Similarly, it may be difficult to distinguish between the use of an intangible asset and the purchase of a digitized product (such as an electronic book). The difference between use and part alienation is also a difficulty under Article 12 (3). In particular, it is not clear that the definition covers payments by the acquirer of property that are contingent upon the property's use. These issues are similar to those arising under domestic law, but if the wording in the treaty is different from the wording in domestic law (which is most likely) then the outcome may not be the same. The Commentary is less than enlightening on many of these issues.[52]

There are many types of payments for the use of tangible movable property and some payments for the use of intangible assets that fall outside Articles 6 and 12.[53] Some of these payments may fall within

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Committee of Experts on International Cooperation in Tax Matters, Geneva, 11 – 14 October 2016 (E/C.18/2016/CRP.8), available at http://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP8_Royalties.pdf ; and A. Jiménez, "Article 12: Royalties," supra note 32, section 5.1.6.

[52] See, for example, paragraph 12 of the Commentary on Article 12 of the United Nations Model Convention, quoting paragraphs 8 – 17.4 of the Commentary on Article 12 of the OECD Model Convention; paragraph 12 then goes on to note that "[s]ome members of the Committee of Experts" disagree with various aspects of the OECD position. The tension in this area is reflected in the ongoing work of the Committee of Experts, as represented in United Nations, "Possible Amendments to the Commentary on Article 12 (Royalties)," supra note 51; and United Nations, "Taxation of Services," presented at the twelfth session of the United Nations Committee of Experts on International Cooperation in Tax Matters, Geneva, 11 – 14 October 2016 (E/C.18/2016/CRP.1), available at http://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP1_Services.pdf. See generally A. Jiménez, "Article 12: Royalties," supra note 32, section 5.1.

[53] In particular, United Nations, "Possible Amendments to the Commentary on Article 12 (Royalties)," supra note 51, paragraph 21, suggests that "there does not appear to be any compelling reason" why source countries should not be given the right to tax income from the use of "all tangible movable assets."

specialized articles, such as Articles 8 (Shipping, inland waterways transport and air transport), 17 (Artistes and sportspersons) and 18 (Pensions and social security payments). However, most such payments fall within either Article 7 (Business profits) or Article 21 (Other income). It is clear that rents and royalties can, subject to allocation issues, fall into the calculation of business "profits." It is also clear that rents and royalties can constitute an "item of income" for purposes of Article 21.[54]

2.1.2 Special problem areas: finance leases, restrictive covenants and embedded rents and royalties

It is useful to briefly return to the special problems of finance leases, restrictive covenants and embedded rents and royalties discussed in section 1.1 above. Finance leases can involve either tangible or intangible assets. In the case of finance leasing of immovable property, the prevailing view is that Article 6 applies to the payment of rent irrespective of financial reporting treatment.[55] That is, rent payments under a finance lease are "from" the immovable property or for its "use" even if in substance they are partly in the nature of interest.[56] Even presuming Article 11 (Interest) also applies (see the following paragraph), that would not prevent a source country from relying on the broader taxing rights in Article 6. By contrast, where a loan is secured by immovable property, interest payments do not fall within the scope of Article 6, but only Article 11.[57]

Similarly, payments for the use of qualifying assets are still royalties under Article 12 (3), irrespective of whether the payments are

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[54] E. Reimer and A. Rust, eds., *Klaus Vogel on Double Taxation Conventions*, supra note 45, 1544, confirms that rents from tangible movable property fall within Article 21 "to the extent that such income does not fall within the ambit of Article 7."

[55] International Accounting Standard 17 *Leases*, supra note 28, paragraphs 15A–18, specifies circumstances in which a lease of land and buildings constitutes a finance lease.

[56] While it may be suggested that a substance approach be adopted to the interpretation of these terms in Article 6, there is no reason to undertake that to the exclusion of the formal legal consequences.

[57] Paragraph 7 of the Commentary on Article 6 of the United Nations Model Convention.

made under a finance lease.[58] A difficult issue is whether a tax administration may argue that, nevertheless, it can apply Article 11, for example, where the treaty provides greater taxing rights with respect to interest than with respect to royalties.[59] The issue is whether a finance lease can constitute a "debt claim" for the purposes of the definition of interest in Article 11 (2).[60] If Article 11 is not applicable, there is a serious risk that interest withholding tax on debt financing of intangibles will be avoided through finance leasing, that is to say, there is a risk of BEPS. This will happen where a treaty restricts source-country taxation of royalties to a greater extent than it does with respect to interest.

There is a similar risk with respect to finance leasing of tangible movable property. Often the mere leasing of assets to another person for use by the lessee in a country does not amount to a PE of the owner of the asset (no "fixed place of business" within Article 5 (1)).[61] If Article 7 does not give any taxing rights, the source country may try to rely on Article 11. As noted, if a finance lease does not amount to a debt

[58] However, see A. Jiménez, "Article 12: Royalties," supra note 32, section 5.1.6.2.1, referring to the former OECD Commentary on Article 12 of the 1977 OECD Model Convention and suggesting that finance leases do not amount to use of the asset if sale is agreed at the start of the lease.

[59] Paragraphs 19.1 – 19.3 of the Commentary on Article 11 of the United Nations Model Convention are equivocal about whether rent under a finance lease can be treated as being within the definition of interest in Article 11 (3).

[60] Whether a finance lease can constitute a debt claim depends on whether Article 3 (2) applies to that term. If it does, domestic tax law characterization is relevant. If it does not, then a question is whether a substance or form approach should be applied to the interpretation of debt claim. M. Helminen, "Article 11: Interest," *IBFD Global Tax Treaty Commentaries* (2016), section 5.1.1.3.1, available at https://www.ibfd.org/sites/ibfd.org/files/content/pdf/14_119_fol_GTTC_final.pdf; and E. Reimer and A. Rust, eds., *Klaus Vogel on Double Taxation Conventions*, supra note 45, 923, suggests that debt claim has a broad meaning. Reimer & Rust go on at 931 to suggest that the "credit element" of finance lease payments constitutes interest under Article 11 (3). By contrast, Helminen goes on to suggest that Article 3 (2) applies to debt claim.

[61] See paragraph 3 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 8 of the Commentary on Article 5 of the OECD Model Convention.

claim, there is a substantial BEPS risk from using cross-border financing leases to finance the acquisition of assets instead of regular loans.

Payments under restrictive covenants also give rise to difficult characterization issues under tax treaties and consequential BEPS risks.[62] A preliminary issue is whether such payments constitute income, and this is relevant for Articles 6 and 21.[63] Some countries treat some payments under restrictive covenants as capital payments, not income.[64] Presuming this domestic law meaning is applied to income for purposes of the tax treaty through Article 3 (2) (General definitions), neither Article 6 nor Article 21 would apply. Rather, Article 13 would have to be considered. The similar issue in the context of Article 7 is whether the payment constitutes profits of an enterprise.

Presuming payments under restrictive covenants constitute income for tax treaty purposes, there are further characterization issues. Is a payment not to use immovable property income from immovable property or its use under Article 6? This depends on whether "from" and "use" can be interpreted in a broad causative sense. In this sense the payment would be from the immovable property in that without the immovable property the payment would not arise.[65] However, it may also be argued that, more naturally, the payment is from the agreement not to conduct certain activities with

[62] See generally, E. Reimer and A. Rust, eds., *Klaus Vogel on Double Taxation Conventions*, supra note 45, 1543; M. N. Kandev, "Tax treaty issues regarding payments for inaction: a Canadian perspective on restrictive covenants," (2006) Vol. 60, *Bulletin for International Taxation*, 281 – 86; and E. Reimer, "How Tax Treaties Deal with Income from Omissions," supra note 31.

[63] Articles 6, 10, 11 and 21 all refer to "income," whereas Article 12 does not. It only refers to "payments of any kind," which clearly covers payments of a capital nature. See also A. Jiménez, "Article 12: Royalties," supra note 32, section 5.1.2.2.

[64] For example, see the discussion in M. N. Kandev, "Tax treaty issues regarding payments for inaction: a Canadian perspective on restrictive covenants," supra note 62.

[65] E. Reimer, "How Tax Treaties Deal with Income from Omissions," supra note 31, 112, suggests that "even income from omissions is covered by Art. 6 as long as there is a sufficient link to an immovable asset." See also E. Reimer and A. Rust, eds., *Klaus Vogel on Double Taxation Conventions*, supra note 45, 431.

respect to the immovable property, that is to say, the relevant property from which the payment is derived is the personalty in the restrictive covenant and not the immovable property. If a country takes this narrower view (and it is not suggested that it should), restrictive covenants pose a BEPS risk with respect to rent from immovable property.

Further, it is questionable whether payments under a restrictive covenant not to use a qualifying asset can be characterized as a royalty as defined in Article 12 (3). How might such a payment be "for the use of, or the right to use" the asset that is not used?[66] In an appropriate case, and where the treaty includes a substantial withholding tax on royalties, the BEPS risks for payments for restrictive covenants of this type can be substantial. Difficult issues can also arise under Article 7. Failure to use assets may mean that there is insufficient activity for a PE or a business to exist. It also raises questions as to whether the payment is sufficiently connected to activities that do exist.[67]

Rents and royalties embedded in sales proceeds can also give rise to substantial BEPS risks under tax treaties. This is perhaps less so in the context of rents for the use of immovable property. Where the asset sold is immovable property, any embedded rent (for example, accrued rent) is taxable by the source country under Article 13 (1). Whether the part of the purchase price attributable to the embedded rent can nevertheless be taxed under Article 6 is a difficult issue. This could be important to the extent that Article 6 permits taxation of gross rent whereas Article 13 (1) refers to "gains," which is necessarily a net concept.[68]

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[66] E. Reimer, "How Tax Treaties Deal with Income from Omissions," supra note 31, 113 – 114 suggests interpreting use differently in Article 12 (3) and Article 6 (3), and even differently within Article 12 (3) itself depending on the nature of the asset used. The result is that sometimes payments under restrictive covenants not to use intangible assets fall within Article 12 (3) and sometimes they do not. It seems likely that courts in at least some countries will not interpret Article 12 (3) in this fragmented manner.

[67] See E. Reimer, "How Tax Treaties Deal with Income from Omissions," supra note 31, 114 – 116.

[68] It is generally accepted that Article 6 permits taxation on a gross basis; see P. Harris and D. Oliver, *International Commercial Tax*, supra note 36, 129 – 130 and E. Reimer and A. Rust, eds., *Klaus Vogel on Double Taxation Conventions*, supra note 45, 423. However, paragraph 2 of the Commentary on Article 6 of the United Nations Model Convention specifically states that

Rent for the use of immovable property may be embedded in an asset that is not immovable property, such as where immovable property is used in the production of, say, a movable asset. In many cases, use of the immovable property will give rise to a PE as the immovable property is a fixed place where business is conducted. This gives rise to source-country taxing rights under Article 7, although again Article 7 allocates taxing rights on a net basis whereas Article 6 may be considered to permit taxation on a gross basis.

By comparison, payments that constitute royalties under Article 12 (3) can give rise to substantial BEPS issues where they are embedded in the sales price of assets. Assets may be sold to a related party entity in a source country with use of intangible assets (such as brand names and trademarks) embedded or attached. If the selling party does not create a PE in the source country (and often mere sales do not create a PE), then any royalty withholding tax that would have applied had a separate payment been made for use of the intangible asset is avoided.[69] If royalties are exempt under a tax treaty, then the reverse gives rise to BEPS risks. That is, there is an incentive to pay royalties if that can reduce the price paid for assets where the source country would tax the price.[70]

"[i]n taxing income from immovable property, the object should be the taxation of profits rather than of gross income."

[69] See A. Jiménez, "Article 12: Royalties," supra note 32, section 5.1.3.3. The proposed anti-fragmentation rule (proposed Article 5 (4.1)) in OECD BEPS Action 7 will not apply to such a case, see OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report* (Paris: OECD, Paris, 2015), paragraph 15, available at http://www.oecd-ilibrary.org/taxation/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report_9789264241220-en. The same is true of United Nations proposals; see United Nations, "Proposed BEPS-related Changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries," presented at the twelfth session of the United Nations Committee of Experts on International Cooperation in Tax Matters, Geneva, 11–14 October 2016 (E/C.18/2016/CRP.10), 67–69, available at http://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP10_-beps.pdf.

[70] This may happen where the sale of the asset with the embedded royalty is attributable to a source-country PE but the underlying intangible asset with respect to which the royalty is paid is not.

Payments for the use of assets that do not fall within Article 6 or 12 may also give rise to tax planning leading to BEPS. To the extent that an asset is sold from outside into a source country, it may not matter whether the payment for the use of an asset is paid for separately or embedded in the purchase price of an asset. In either case the source country is unlikely to have a right to tax. To the extent that the use of one asset adds value to other assets in the source country (for example, assets manufactured there), the separate payment for use of the first asset may give rise to BEPS risks. This will be the case if the use of the first asset does not give rise to a PE in the source country and the separate payment is deductible for the owner of the other asset. Article 21 (3) (discussed in section 2.2 below) may have a role here.

2.1.3 Allocating rents and royalties under the articles

Tax treaties have little to say about the manner in which amounts are allocated to particular persons.[71] In the same manner as mentioned with respect to domestic law in section 1.1 above, artificial persons such as companies can be used to manipulate whether rents and royalties arise, and this is also true for the purposes of tax treaties. That is, artificial persons can be used to manipulate the form of transactions and therefore which article applies.

Here too, even in scenarios where rents and royalties are obviously involved, artificial persons can be used to manipulate who receives the rent and royalties for purposes of tax treaties. For example, in connecting rents and royalties to persons, Article 6 (Income from immovable property) uses the phrase “income derived by a resident,” Article 7 (Business profits) “profits of an enterprise,” Article 12 (Royalties) “royalties … paid to a resident” and Article 21 (Other income) “items of income of a resident.” All of these can be manipulated, especially in

[71] For example, see J. Wheeler, “Persons qualifying for treaty benefits,” in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries,* supra note 41, 51 – 108, at 76 – 77, which notes by reference to the Commentary on Article 1 that “artificially routing income to a person … should not be an effective method of obtaining treaty benefits.” The discussion in the text presumes routing that falls short of being artificial.

the context of corporate groups.[72] In a multilateral setting in which the tax treaties that a particular source country has concluded with other countries are not uniform, this can give rise to BEPS through treaty shopping.[73] While measures are proposed to restrict the most abusive cases of treaty shopping, there will still be plenty of scope for tax planning in this area with consequent BEPS issues.[74] These issues are further considered under section 3 below.

The situation is somewhat different when the payer of rent and royalties is considered. There are few rules in tax treaties that regulate the tax treatment of the payer. The non-discrimination rules in Article 24 can be important and largely have the effect of protecting the right to a deduction for the payment if that is available in a domestic rather than a cross-border scenario. To the extent applicable, the rules on PEs (Article 24 (3)) and subsidiaries (Article 24 (5)) simply require comparable treatment to that of locally owned entities. Article 24 (4) is somewhat more specific. It can apply to rents and royalties "paid by" a resident of the source country so as to ensure that the payment is "deductible under the same conditions as if [it] had been paid to a resident." This provision is commonly used to support the deduction of rents and royalties leading to BEPS.

Allocation of the payment and receipt of rents and royalties to particular earning activities for the purposes of tax treaties is also largely a matter left to domestic law. However, this allocation does matter when determining which article applies, and so taxing rights under tax treaties. In particular, the allocation of rents and royalties

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[72] J. Wheeler, "Persons qualifying for treaty benefits," supra note 71, at 76, suggests that Article 3 (2) applies when interpreting these terms and so their meaning is essentially a question of domestic tax law.

[73] J. Wheeler, "Persons qualifying for treaty benefits," supra note 71, at 81–84, refers to "conduit structures" and suggests that such a structure "generally consists of income which is paid to the owner of an asset, such as … royalties and rent."

[74] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en.

to a business activity (enterprise) is important for both the recipient and payer irrespective of the type of asset used. So, the taxation of rents for the use of immovable property under Article 6 (for example, on a gross basis) may be tempered by the non-discrimination rule in Article 24 (3) if received through a PE (which requires a business). By comparison, there is no non-discrimination protection for such rent received passively. It is generally accepted that what constitutes a "business" is determined according to domestic law of the country applying the treaty.[75]

By contrast, if royalties are received through a PE in the source country, they are taxed under Article 7 (Business profits) rather than Article 12 (Royalties).[76] This can happen only where the royalties are derived in the context of a business. Similarly, rents and royalties not falling within Article 6 or Article 12 can only fall within Article 7 where they are attributed to a business. In particular, if they are not attributable to a PE, they fall within Article 21.

As for the payer, the non-discrimination rules in Article 24 (3), (4) and (5) apply only to enterprises and so can only apply to payments of rents and royalties attributable to a business. In particular, Article 24 (3) applies only to PEs and does not expressly cover fixed bases referred to in Article 14. An unresolved issue is whether the concepts of PE and fixed base are mutually exclusive. If they are, then there is no protection from discrimination of fixed bases. If a fixed base can simultaneously constitute a PE, then arguably it may be protected by Article 24 (3). This is similar to the issues discussed above with respect to discriminatory taxation under Article 6.

The time at which rents and royalties are recognized for tax treaty purposes is also largely a matter of domestic law. Where the non-discrimination rules in Article 24 (3), (4) and (5) are relevant, they require recognition at the same time as for comparable domestic payments.[77] As for timing for the recipient under the distributive

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[75] See paragraph 15.12 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 10.2 of the Commentary on Article 3 of the OECD Model Convention.

[76] Article 12 (4).

[77] See also J. Wheeler, "Time in Tax Treaties," *IBFD Global Tax Treaty*

rules, the phrases quoted above for allocation under Articles 6, 7, 12 and 21 are also relevant. However, the general nature of these phrases is such that the timing in domestic law should be followed.[78]

2.2 Source and tax treatment

It is the interface between the way in which different categories of rents and royalties (and substitutes for them) are defined for tax treaty purposes and the tax treatment of those different payments that gives rise to BEPS risks from tax treaties. It is the combined tax treatment of the payer and the recipient that needs to be considered to this end. The characterization of rent and royalties and their allocation under tax treaties have been considered in section 2.1 above; the discussion now turns to the tax treatment under tax treaties. First the treatment of the recipient is considered and then the treatment of the payer.

2.2.1 Recipient

Tax treaties of developing countries are typically consistent in their adoption of Article 6. The source rule in Article 6 is the income being "from" immovable property "situated" in the country. This is a difficult source rule to manipulate and source-country BEPS with respect to immovable property is therefore typically a matter of trying to recharacterize the income so that it falls outside Article 6. Further, as full source-country taxing rights are granted under Article 6, source countries can control the rate of tax applicable and typically the tax base (for example, whether on a gross or net basis). The exception is where the immovable property forms part of a PE in the source country, in which case the non-discrimination rule in Article 24 (3) typically requires application of the same rates and same tax base that apply to resident persons.[79]

Commentaries (2015), section 3.3.10, available at https://www.ibfd.org/sites/ibfd.org/files/content/pdf/14_119_fol_GTTC_final.pdf.

[78] For a detailed discussion, see J. Wheeler, "Time in Tax Treaties," supra note 77, sections 3.3.1 and 3.3.2.

[79] See E. Reimer and A. Rust, eds., *Klaus Vogel on Double Taxation Conventions*, supra note 45, 1703; and P. Harris and D. Oliver, *International Commercial Tax*, supra note 36, 128. Compare N. Bammens and F. Vanistendael,

Article 6 does not prevent the residence country of the person deriving the income from taxing that income. However, Article 23 requires the residence country to grant foreign tax relief. Care should be taken in adopting the exemption method under Article 23 A. Under that Article, income that falls within Article 6 cannot be taxed by the residence country (subject to exemption with progression). This is true even if the source country does not tax or taxes at a low rate. In this circumstance there is a BEPS risk for the residence country. Tax planners have an incentive to attribute an artificially high amount of income to the foreign immovable property so as to minimize tax. This risk does not arise if the foreign tax credit method in Article 23 B is used in the tax treaty.

There is more fluidity when Article 12 is considered. Article 12 (5) sources royalties where the payer is resident or, if the royalties are borne by a PE or fixed base, where the PE or fixed base is situated. This rule is separate from the definition of royalties. The source of royalties does not depend on who uses the asset or where the asset is used but simply on the payer. In particular, tax planners are able to manipulate which entity within a corporate group pays royalties and so which country is the source country based on residence of the payer.[80] This source rule is particularly open to manipulation by changing the residence of a payer such as by changing a corporation's place of effective management to trigger the tiebreaker under Article 4 (3).[81] The

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"Article 24: Non-Discrimination," *IBFD Global Tax Treaty Commentaries* (2016), section 2.3.1.1, available at https://www.ibfd.org/sites/ibfd.org/files/content/pdf/14_119_fol_GTTC_final.pdf.

[80] Paragraph 19 of the Commentary on Article 12 of the United Nations Model Convention discusses as an alternative using the country in which the property or right is used.

[81] See P. Harris, "Article 10: Dividends," *IBFD Global Tax Treaty Commentaries* (2016), section 5.2.2.1, available at https://www.ibfd.org/sites/ibfd.org/files/content/pdf/14_119_fol_GTTC_final.pdf, regarding the application of the residence tiebreaker for purposes of determining source of income. Both OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report*, supra note 74, paragraph 48, and United Nations, "Proposed BEPS-related Changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries," supra note 69, 41–45, propose changes to Article 4 (3).

same is true with respect to royalties attributable to a PE, but this is perhaps less open to manipulation.

Article 12 (2) permits a source country to tax royalties, but not exceeding an unspecified percentage of the "gross amount" of the royalties. Developing countries adopt widely different rates for limiting source-country taxation of royalties. The lower the rate, the higher the risk that royalties are used for BEPS purposes, particularly where they are deductible for the payer. The higher the permitted source-country tax rate, the more likely that royalties will be avoided by tax planners, for example, through embedding them in the purchase price of other assets.

Residence countries are less prone to BEPS risks from the receipt of royalties by their residents. Here both Article 23 A and 23 B prescribe the foreign tax credit method. If the source-country taxes within its rights in Article 12, the residence country is required to grant a foreign tax credit for that tax. If tax planners manage to avoid source-country tax, the residence country has a full right to tax the royalties without foreign tax relief. However, that does not mean a residence country must tax. As discussed under section 3, source countries should not presume that a residence country will tax simply because it can.

Article 7 (Business profits) is different from Articles 6 and 12 in that it does not have a classic sourcing rule for any rents or royalties that fall within it, for example, by reference to the use of the asset giving rise to the payment. Article 7 applies to give exclusive taxing rights to profits of an enterprise of a person to the country of residence unless those profits are derived through a PE situated in the other contracting State. Where there is such a PE, the country where the PE is situated may tax the worldwide profits of the business attributable to the PE. For example, rents and royalties sourced in a third country may be attributed to a PE.

The host country of a PE has a full right to tax the profits of the PE under Article 7. This is subject to the non-discrimination rule in Article 24 (3) mentioned above, which may impose important limitations on the rate of tax that can be imposed and the tax base (for example, deductibility of expenses). As with income from immovable property, this full right to tax means that most BEPS risks with respect to Article 7 involve manipulation of the PE concept and attribution of income to a PE in order to avoid host country taxation of rents and royalties. From the perspective of the residence country, providing foreign tax relief in the form of the exemption method under Article 23 A is again a BEPS risk. If the host country of a PE is a low tax jurisdiction, tax planners have an incentive to attribute rents and royalties to the PE so as to avoid residence country tax.

Article 21 (Other income) applies to rents and royalties where they are not "dealt with" by the other distributive articles, including Articles 6, 7 and 12. Determining when rents and royalties are dealt with by another article is a difficult matter. For present purposes, the prevailing view is that this happens when two conditions are met. First, the rents or royalties fall within the definition of income covered by the article, for example, "income from immovable property" for Article 6, "profits" from business for Article 7 or "royalties" for Article 12. Second, the connecting factors must be satisfied.[82] In the context of Articles 6 and 12 this is both that the income is derived by a resident of a contracting State and that the income is sourced in the other contracting State. Article 7 is different in that it applies to any business profits derived by a resident of a contracting State without a necessary source connection.

Where it applies, Article 21 begins (like Article 7) by giving exclusive taxing rights over other income to the contracting State that is the residence country. However, this is qualified by Article 21 (3), which simply provides that other income "arising" in the other contracting State may be taxed there. At first blush this provision may seem to have potential as a defence against BEPS. It seems to permit a source country to tax rents and royalties that it otherwise might not tax under other articles if the payment arises in the source country.[83] However, that is only true where the rents or royalties are not "dealt with" under other articles.

[82] See paragraph 2 of the Commentary on Article 21 of the United Nations Model Convention; and L. Schoueri, "Article 21: Other Income," *IBFD Global Tax Treaty Commentaries* (2015), section 5.1.1.1, available at https://www.ibfd.org/sites/ibfd.org/files/content/pdf/14_119_fol_GTTC_final.pdf.

[83] Regarding the meaning of "arising" in Article 21 (3), see paragraph 9 of the Commentary on Article 21 of the United Nations Model Convention suggesting that this is determined according to domestic law.

If the rents or royalties constitute "profits" of an "enterprise" of a resident of one of the two contracting States, then Article 21 (3) has no application. The rents or royalties are dealt with by Article 7, including by exclusive taxation in the residence country (where there is no PE in the source country). This means that there is a natural tension between the exclusion of source-country taxing rights in Article 7 (in the absence of a PE) and residual source-country taxing rights in Article 21 (3).

Presuming the rents or royalties are not attributable to an enterprise, the scope of other articles must be considered. It is difficult to identify any rent from immovable property situated in one of the two contracting States (and so arising there) that could fall within Article 21 (3), although rent from immovable property in a third country does.[84]

Further, Article 12 provides a rule as regards the circumstances in which royalties arise in a contracting State (Article 12 (5)). Unlike the definition of royalties, this sourcing rule is not expressly limited to the purposes of Article 12. Although contentious, the prevailing view is that Article 12 (5) also regulates when royalties may be considered to arise in a contracting State for purposes of Article 21 (3).[85] In this case, Article 21 (3) grants no additional source-country taxing rights with respect to royalties.

Ultimately, Article 21 (3) can apply only to rents and royalties that are not derived through an enterprise, that are not derived from immovable property and that are not royalties as defined in Article 12 (3). This is a narrow category, so the taxing rights in Article 21 (3) offer little defence for a source country against BEPS. Where Article 21 (3) does apply, the residence country is obliged to provide foreign tax relief for the source county tax under Article 23. As in the case of Articles 6 and 7, where the source-country tax is founded on Article 21 (3), the residence country may be obliged to apply the exemption

[84] Complicated issues surrounding the application of Article 21 (2) and its reference to immovable property are not considered in the present chapter. See L. Schoueri, "Article 21: Other Income," supra note 82, sections 3.1.2.2 and 5.2.1, in this regard.

[85] See L. Schoueri, "Article 21: Other Income," supra note 82, section 5.2.3.1. The doubt is caused by reason of paragraph 2 of the Commentary on Article 21 of the United Nations Model Convention.

method if it has adopted Article 23 A. In such a case, the BEPS risks for the residence country are the same as discussed in the context of Articles 6 and 7.

2.2.2 Payer

BEPS with respect to rents and royalties can be a problem when solely considering the tax treatment of the recipient. However, tax planners are constantly analysing the combined treatment of both the recipient and the payer. In particular, tax treaties cause the greatest BEPS risks for a country from the payment of rents and royalties where two conditions are met. First, where the tax treaty requires that the payment be deductible for the payer. Second, where the tax treaty limits that country's taxing rights with respect to the rents or royalties.

As noted in section 2.1 above, there are few rules in tax treaties that regulate the tax treatment of the payer of rents and royalties. The most important of these appear in Article 24.[86] These are all of a non-discrimination nature in that a deduction must be granted if it is granted in comparable circumstances. Importantly, the requirement to grant a deduction is not prescribed on the condition that the country granting the deduction has a right to tax the recipient of the payment. While Article 24 (3) (regarding PEs) and 24 (5) (regarding subsidiaries) may have some relevance for the present discussion,[87] the focus is on Article 24 (4).

Under Article 24 (4) if a country grants a deduction for rents or royalties paid between residents, it must grant a deduction for rents or royalties paid by a resident of the country to a treaty partner resident. In the case of payments between residents, a country may feel safe in granting the deduction because it knows it can tax

[86] The discussion in the text does not entertain the argument that Article 9 (1) (Associated enterprises) can limit a source country's taxing rights. Compare M. Weiss, "The Impact of Article 9 of the OECD Model on German Taxation," (2016) Vol. 56, *European Taxation*, 51–57, and O. Marres, "Interest Deduction Limitations: when to apply Articles 9 and 24 (4) of the OECD Model," (2016) Vol. 56, *European Taxation*, 2–14.

[87] This might be the case where a particular country uses narrower deduction rules for rents or royalties paid by PEs and subsidiaries of non-residents, irrespective of who receives the rents or royalties.

the recipient (on the basis of residence). This is not the case where the payment is to a non-resident, unless the rents or royalties have a domestic source with respect to which the country is granted substantial taxing rights by the tax treaty. If this is not the case, there is a substantial risk of BEPS.

In the context of rent for the use of immovable property, the risk arises only with respect to rent for the use of foreign immovable property. In this case the risk is the generic risk of BEPS by permitting foreign expenses to reduce the domestic tax base, as discussed in section 1.3 above. The situation is remedied by quarantining deductions for rent for use of foreign immovable property (irrespective of whether paid to a resident or a non-resident) so that such rent can be deducted only in calculating foreign source income.

In the context of royalties, the fact that a resident of a country pays royalties to a treaty partner resident typically causes the royalties to have a source in the country (Article 12 (5)). In this case the source country has a right to tax in order to balance the deduction granted. However, a BEPS risk arises if the source-country taxing right with respect to the royalties is substantially limited, for example, by an exclusion of source-country taxation or a taxation at a low percentage of the royalties under Article 12 (2).

Rents and royalties that do not fall within Article 6 or 12 provide the greatest BEPS risk for source countries. Here, a country may be required to grant a deduction under Article 24 (4) for the payment (presuming a deduction for equivalent payments to residents). This is the case even if the treaty partner recipient does not have a PE in the country and the country therefore does not have a right to tax the rents or royalties (presuming the rents or royalties belong to a business of the recipient and thereby do not fall within Article 21 (3)).

3. Mismatches and third country scenarios leading to BEPS

The present chapter has explained the features of domestic tax law and tax treaties that give rise to BEPS risks through the payment of rents and royalties. BEPS risks increase where rents, royalties and payments that can be substituted for them are taxed differently. Tax planners, somewhat naturally, manipulate transactions to fall within the least taxed category. Working out what is the least taxed category can be quite difficult given the myriad ways in which income can be derived. Even for a single country viewed in isolation, it seems impossible to tax all substitutable payments in an equivalent manner. In this case, the goal must be to achieve the highest level of consistency possible.

When cross-border issues come under consideration, matters become even more complex. The international allocation of taxing rights according to character of income (as reflected in tax treaties) and administrative practicalities often mean that one country reduces its taxation in the expectation that another country will tax. If the other country does not tax, there is a weakness in the system. Tax planners are constantly probing cross-border tax treatment to find the weakest (lowest tax) point for achieving a particular economic goal. Once they find it, the risk is that they will manipulate transactions to funnel them into the low-tax category.

Rents and royalties are as susceptible to this cross-border probing as other payments. They therefore can be the subject of complex tax planning leading to BEPS. One way tax planners have found to reduce tax is by identifying payments that one country views in one way but another country views in another, that is, where there is a mismatch in the nature of the payment. These "hybrid mismatch arrangements" are more fully considered in chapter V,[88] but it is useful to consider them briefly here in the specific context of BEPS risks for the payment of rents and royalties.

The strategy behind hybrid mismatch arrangements is to find a type of payment that is lowly taxed by the country of the payer (for example, deduction with low or no withholding tax) and that the country of the recipient views somewhat differently and as a result also lowly taxes. A similar strategy can be pursued by using an entity in a low-tax third country so that the views of the payer country and the ultimate recipient country differ, thereby leading to the tax reduction. Hybrid mismatch arrangements and use of intermediaries in third countries leading to BEPS are considered in turn in the context of payment of rents and royalties.

[88] Supra note 6.

3.1 Mismatches between source and residence countries

Chapter V outlines income tax fundamentals that give rise to hybrid mismatch arrangements. The present chapter is concerned with rents and royalties, which are payments. This means that mismatches between countries in the fundamental features of rents and royalties can give rise to BEPS. In particular, hybrid entities may be used so that two countries disagree on who is the recipient of rents or royalties.[89] If one country thinks the payment is received by an entity within the tax jurisdiction of the other country and the other thinks the payment is received by an entity within the tax jurisdiction of the first country, then neither country may consider it has jurisdiction to tax the payment.[90]

Further, hybrid entities may be used so that two countries disagree on who makes a payment of rents or royalties. If one country thinks the payment is made by an entity within its tax jurisdiction and the other thinks the payment is made by an entity within its tax jurisdiction, then the result can be two deductions for one payment.[91] Hybrid entities may also be used so that two countries disagree on whether any payment of rents and royalties has been made at all. One country may think that a payment has been made by a taxpayer to a related party and therefore grant a deduction for it. Another country may consider that the related parties are not separate but rather the same taxpayer and that there is no payment because it is made between

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[89] A hybrid entity is an entity that is recognized as a person (including a corporation) and therefore a taxpayer by one country but not by another country.

[90] That is, rents and royalties may be the payment used in hybrid mismatch example 2 discussed in chapter V, supra note 6, sections 1.2 and 1.4. This type of mismatch is the subject of Recommendation 6 (Deductible hybrids payment rule) in OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* (Paris: OECD, 2015), 67, available at http://www.oecd-ilibrary.org/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report_9789264241138-en.

[91] That is, rents and royalties may be the payment used in hybrid mismatch example 3 discussed in chapter V, supra note 6, sections 1.2 and 1.4. This type of mismatch is the subject of Recommendation 4 (Reverse hybrid rule) in OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report*, supra note 90, 55.

parts of the same entity. In this case a deduction may be granted by the one country without an inclusion in income in the other country.[92]

Two countries may also disagree on the time at which a payment of rents or royalties should be recognized. As noted in section 1.2 above, recognition is typically on a cash or accrual basis. If the country of the payer of rents or royalties permits a deduction on an accrual basis, but the country of the recipient recognizes the rents or royalties only on a cash basis, there can be a substantial deferral of tax. There is a particular risk where rents accrue over a number of years.[93] The reverse (country of the payer uses the cash basis and country of recipient the accrual basis) can also be a problem in the case of prepayments of rents and royalties.

Of particular interest to the present discussion are mismatches with respect to whether payments have the character of rents or royalties. The most common circumstance in which this arises is where two countries do not agree on the ownership of an asset, and this may happen where the countries do not agree on the tax effects of a finance lease.[94] One country may follow the legal form and accept the lessor as the owner of the asset for tax purposes and the character of payments under the lease as rent. Another country may treat the lessee as the owner of the asset and payments under the lease as interest and a return of capital.

The risk of BEPS with respect to finance leases depends on the nature of and interaction between each country's tax treatment of the

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[92] That is, rents and royalties may be the payment used in hybrid mismatch example 11 discussed in chapter V, supra note 6, section 1.4. This type of mismatch is the subject of Recommendation 3 (Disregarded hybrid payments rule) in OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report*, supra note 90, 49.

[93] That is, rents and royalties may be the payment used in hybrid mismatch example 5 discussed in chapter V, supra note 6, section 1.2. Timing mismatches are not covered by OECD Action 2.

[94] It can also occur in the context of sale and repurchase agreements (repos) and legal mortgages (transfer of legal title as security). Example 1.24 (Payment included in ordinary income under a CFC regime) in OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report*, supra note 90, 237, is a mismatch where one country accepts the legal form of a lease, but the other country accepts that it is a finance lease.

transaction. There are two types of potential mismatch here. In the first case, the country of the lessee considers the lessor to be the owner of the asset, but the country of the lessor considers the lessee to be the owner of the asset. In the second case, the country of the lessee considers the lessee to be the owner of the asset, but the country of the lessor considers the lessor to be the owner of the asset.

The first case may give rise to BEPS risks where depreciation rates are low in both countries— for example, some countries do not permit depreciation of certain types of buildings or amortization of intangibles. Here, neither country grants depreciation but, equally, neither country taxes a gain on the subsequent disposal of the asset, for example, if it is an appreciating asset.[95] The country of the lessee may grant a full deduction for the rent paid without any limitations such as may apply in the case of payments of interest to non-residents. Further, withholding tax on the outbound payment is a factor, for example, where rent is not subject to withholding tax but interest is. The country of the lessor sees the rents as in part a payment of interest and in part a payment of capital. Example 6 below illustrates these points.

Example 6
Mismatch of ownership and no depreciation deduction

Example 1 is again used as a starting point. However, in this example Z Co is resident in Country A and Y Co is resident in Country B. Neither country grants a deduction for depreciation of the equipment (as in example 5). Y Co provides Z Co with financing in the form of a finance lease (as in example 3). Country A accepts the form of the lease and so accepts Y Co as the owner of the equipment. Country B accepts the accounting treatment and so recharacterizes the lease as a financing arrangement for tax purposes and considers Z Co to be the owner of the equipment.

In Year 1, Country A accepts that Z Co pays rent and grants a deduction for the full amount of 150. Further, it is presumed that the rent is not received by Y Co through a PE situated in Country A and that Article 12

[95] See also the discussion following hybrid mismatch example 9 in chapter V, supra note 6, section 1.3.

of a Country A–Country B tax treaty prohibits Country A from taxing the rent. Accordingly, Country A grants Z Co a deduction for the rent but does not tax the rent to Y Co. By contrast, Country B recharacterizes the rent as interest and a part repayment of capital on a blended loan. This means that Country B taxes only part of the rent received by Y Co, for example, if 50 is treated as a repayment of capital, Country B would tax only 100.

Now presume that by Year 3 the equipment has increased in value due to a supply shortage. The equipment is sold in Year 3 for 1300, that is to say, a profit of 300 over the original cost. As Y Co is the legal owner of the equipment, it receives the sales proceeds. Country A accepts this legal form and as the asset does not form part of a PE that Y Co has in Country A, Country A does not tax the profit. Country B considers that Z Co has disposed of the equipment as owner and treats receipt of the sales proceeds by Y Co as a repayment of the remainder of the loan due from Z Co. Country B may treat the excess 300 as a dividend received by Y Co from its subsidiary Z Co. If dividend relief is granted with respect to that dividend (for example, if the dividend is exempt or granted an underlying foreign tax credit), the 300 may go wholly or partially untaxed, in other words, double non-taxation would occur.

The second case may give rise to BEPS risks where depreciation rates are high in both countries, particularly where capital expensing is available (as in example 4 above). In this case there is effectively a "double dip" for depreciation in both the country of the lessee and the country of the lessor. Payments of rents are treated as part interest and part capital by the country of the lessee and therefore only a limited deduction may be available. In the country of the lessor the entire amount of rent is likely to be treated as taxable. However, as the lessor is the owner, the lessor country might consider that the asset (if it is tangible) creates a PE in the lessee country. In this case, the lessor country might grant foreign tax relief in the form of the exemption system and so not tax the rent.[96] Even if the lessor country taxes the rent, often that is more than offset by the double-dip depreciation deduction.

[96] This is hybrid mismatch example 9 discussed in chapter V, supra note 6, section 1.3.

3.2 Third country scenarios

3.2.1 BEPS risks[97]

Inserting an entity in a third country (intermediary) between the payer of rents and royalties and the recipient can produce results similar to the mismatches discussed in section 3.1 above. In such a case, the rents or royalties are paid to the intermediary, which in turn makes payments to the recipient. That is, the use of an intermediary anticipates back-to-back payments or holdings.

Inserting an intermediary can change all of the fundamental features of a payment of rent and royalties. From the perspective of the country of the payer, it changes the identity of the immediate recipient. From the perspective of the country of the recipient it changes the identity of the immediate payer. Similarly, an intermediary can create a mismatch in the time at which a deduction is available to the payer and the point at which the recipient must account for the payment for tax purposes. An intermediary can create a similar mismatch regarding the character of the payment made and that received by the recipient.

Use of intermediaries to receive rents and royalties poses BEPS risks to countries in two particular ways. These risks are the same as in the case of any other forms of deductible payments, for example, interest and payments for services. The first risk is by way of treaty shopping. An intermediary may be set up in a third country because that country has a tax treaty with the country of the payer that particularly limits the taxing rights of source countries with respect to the payment of rents and royalties.

For example, the country of the payer may have a domestic withholding tax of 25 per cent on royalties paid to non-residents. There may be no tax treaty between the country of the payer and the country of the recipient. If there is a tax treaty between the country of the

[97] See generally OECD, *Addressing the Tax Challenges of the Digital Economy Action 1—2015 Final Report* (Paris: OECD, 2015), paragraphs 191–196, available at http://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en; and P. Harris and D. Oliver, *International Commercial Tax*, supra note 36, 388–415.

payer and a third country that restricts taxation of royalties, for example, to 5 per cent, that may be a reason to have the royalties paid to an intermediary in the third country. The same can be true with respect to rents for the use of tangible movable property if there is a domestic withholding tax that is limited by a particular tax treaty with a third country.

Treaty shopping can also be an issue for the country of the recipient. This will be the case where the form of foreign tax relief granted by the country of the recipient under a tax treaty with a third country is more favourable than that granted under a tax treaty with the country of the payer or under the domestic law. For example, this might happen where the country of the recipient grants a foreign tax credit for payments directly from the payer but under a tax treaty with a third country it grants an exemption for foreign income. In this case, an intermediary in a third country may be used to change the rents or royalties received from the payer country into a payment to the recipient of a type that is exempt under the tax treaty with the third country.

The second risk of BEPS from the use of an intermediary in a third country is where that third country has low tax rates, and particularly where it is a tax haven. The existence of a tax treaty may be irrelevant, for example, if the domestic tax law of the payer country permits the deduction of rents and royalties to the payer but does not tax or lowly taxes the outbound payment. The receipt of the rents and royalties by the intermediary is lowly taxed by the third country. The intermediary then repatriates the rents and royalties to the ultimate recipient with a character that is lowly taxed in the country of the recipient. Dividends often fall into this category, particularly if they are exempt in the country of the recipient. A loan from the intermediary to the recipient is another common form. If repatriation is likely to trigger tax in the recipient country, the funds may stay in the intermediary indefinitely and the intermediary will invest the funds elsewhere.

It is common for the intermediary in the third country to be a company related to the recipient. However, developing countries should be aware that this type of planning can be relevant where a PE is used as an intermediary in the third country. In this case, the recipient sets up a PE in a third country and receives the rents and royalties through that PE. This can give rise to BEPS risks were the recipient country adopts the exemption method of foreign tax relief for the profits of the PE. PEs are not entitled to the benefits of tax treaties. Therefore, any tax treaty between the country of the payer and the country of the recipient continues to apply. This may be relevant where that treaty reduces source-country tax more than any tax treaty between the country of the payer and the third country. Using a PE as an intermediary gives rise to particular BEPS risks where the tax rate in the third country is substantially below that in the country of the recipient.

3.2.2 Possible responses

The BEPS issues arising from tax planning through the use of intermediaries are well known. These are general issues, but ones that are just as serious with respect to rents and royalties as they are with respect to other types of payments. Many of the OECD BEPS actions address some aspects of the issue. However, it seems impossible to address the issue comprehensively. This would require uniformity of taxation of all outbound payments by source countries, and the level of that taxation would have to be at least as much as applies to purely domestic payments of a similar nature. Alternatively, it would require lifting the corporate veil on every corporation in the world and allocating the income to investors, clearly impossible on an administrative basis.

Of relevance to a country of the payer of rents and royalties is OECD BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances.[98] In particular, Action 6 anticipates limiting treaty shopping by restricting access to the benefits of tax treaties.[99] Other Action 6 measures of present relevance include a treaty provision for removing limitations on source-country taxation where a treaty partner resident derives income through a lowly taxed PE in

[98] This is considered in detail in chapter VI, "Preventing tax treaty abuse," by Graeme S. Cooper.

[99] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* , supra note 74, paragraphs 17–26. The proposed United Nations response is more limited; United Nations, "Proposed BEPS-related Changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries," supra note 69, 17–31.

a third country.[100] A similar provision where the residence country subjects royalties and other income to a special low tax regime is under discussion.[101]

Developing countries should take the measures proposed in Action 6 seriously in the context of the payment of rents and royalties. However, developing countries must also remember the ultimate cause of treaty shopping. Treaty shopping results from a lack of uniformity between the treaties that a country concludes and between the uniformity of those treaties and domestic tax law. A developing country would be wise to pursue both Action 6 and an effort to maximize uniformity.

A developing country should also consider that every payment that leaves the country in a manner that is tax preferred compared with the taxation of a resident recipient has the potential to distort. In a fluid world, those payments are attracted to countries with the lowest taxes and in preference to receipt of those payments by a resident. This raises the difficult issue of just how much a developing country should investigate the taxation of rents and royalties in the country of the immediate recipient.

Many of the OECD BEPS actions are targeted at greater transparency and sharing of information (in particular Action 13: Guidance on Transfer Pricing Documentation).[102] Developing countries should take this work seriously, but at the same time should not view it as a definitive answer to the distorting effects of the use of intermediaries.

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[100] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report*, supra note 74, paragraph 52; see also United Nations, "Proposed BEPS-related Changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries," supra note 69, 35–40.

[101] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* , supra note 74, paragraph 81.

[102] This is considered further in chapter X, "Transparency and disclosure," by Diane Ring; see also OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report_9789264241480-en.

Even in the face of electronic advances for the sharing of information, it is unrealistic to believe that limited administrative resources can be used to investigate the tax treatment of every payment of rents and royalties in the country of the recipient. A targeted and focused review strategy is critical.

Source countries should also be aware that some of the other OECD actions may increase the incentive to use rents and royalties to facilitate BEPS. This is particularly the case with respect to Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments.[103] As noted in section 1.1 above, interest payments are highly substitutable with payments of rents and royalties. If one type of payment is taxed more heavily, this can lead to increased use of other types of payments. In particular, Action 4 seeks to impose limits on the deductibility of interest payments. It makes no reference to "rent." [104] If interest is subject to limited deductibility, but rents are fully deductible, that might be a reason to substitute rent for interest payments.

OECD BEPS Action 4 is concerned that the total amount of debt within a corporate group (loans between group members) may exceed the group's total third-party debt and that this is a major source of BEPS.[105] At the extreme, the concern is with corporate groups that have

[103] This is discussed further in chapter IV, supra note 5; see also OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report* (Paris: OECD, 2015), available at http://www.oecd-ilibrary.org/taxation/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report_9789264241176-en.

[104] It does refer to "economic rent," but that is a different matter from that discussed in the present chapter.

[105] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report*, supra note 103, paragraph 18. The position was more explicit in the earlier Discussion Draft, see OECD *Public Discussion Draft, BEPS Action 4: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors* (Paris: OECD, 2014), paragraphs 59 and 253–257, available at https://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-banking-and-insurance-sector.pdf. The Final Report changed focus to consider a group's third party debt as a method of relieving restrictions on interest deductibility rather than tightening them.

sufficient equity to fund the group's worldwide activities, but which then use that equity to make loans to high tax countries where the interest payments on the loans can be used for BEPS purposes. Rents and royalties can be used in precisely the same manner. Equity can be used to acquire or develop assets which are then leased or licensed to group members in high tax countries. Group members in low tax countries are funded with equity to finance the assets they need, including assets purchased to lease or license to group members in high tax countries.

The reason why this substitution may occur if restrictions are placed on interest deductibility is straightforward. Interest is payment for the use of money and money is used to acquire assets that can be used in deriving income. So at a simple level, all rents and royalties comprise two elements. The first element is payment for reduction in value of the asset that is used by reason of that use, effluxion of time or other risk. The second element is payment for the use of money, that is, an interest element for the use of the monetary value of the asset. If this second element is not treated for tax purposes in the same manner as interest, tax planning involving the substitutability of interest and rents and royalties can be expected.

The 2015 Final Report on BEPS Action 4 recognizes this substitutability, but only in part. It recognizes that the interest limitation rules should apply to "the finance cost element of finance lease payments." [106] However, the Report goes on to suggest that the limitation rules should not apply to "operating lease payments" or "royalties." [107] This fails to recognize that all rents and royalties have an interest element. Separating out the interest element in the case of a finance lease may be difficult for some countries, particularly if their tax law respects the legal form of finance leases. However, even if separation of the interest element is attempted, the distinction between finance lease payments and other types of rents and royalties will be fertile ground for tax planning. In the face of interest limitation rules that cover finance leases but not other leases, countries can expect

[106] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report*, supra note 103, paragraph 36.

[107] Ibid., paragraph 39. The importance of the distinction between operating leases and finance leases is highlighted by example 3, paragraph 241.

more disputes about what constitutes a finance lease. Here too, source countries should consider ways in which the tax treatment of interest, rents and royalties can be made uniform.

The response of residence countries to BEPS risks through the use of intermediaries is also a subject of the OECD BEPS actions. In particular, the OECD considers the best response to the use of intermediaries is the adoption of controlled foreign corporation (CFC) rules.[108] A consideration of how these rules might apply to rents and royalties derived by a resident through a foreign intermediary is beyond the scope of this chapter. However, in a globalizing world, developing countries should not underestimate the importance of this issue. All countries have wealthy individuals and, increasingly, those individuals are willing and able to hide their wealth and income behind the corporate veil of foreign entities. Short of a wealth tax applicable to foreign assets, CFC rules are the only mechanism to deal with this issue.

4. Conclusion

Responding to BEPS risks from the payment of rents and royalties requires a deep understanding of the conceptual elements of income taxation. Rents and royalties stand at the interface of the fundamental methods by which resources are provided between persons in an economy. They interface with the provision of services, the provision of finance and the transfer of assets. They raise fundamental questions about the very way in which assets are identified. If tax treatment differs depending on these matters, tax planners operate at the interfaces and manipulate transactions. BEPS is the result. These are conceptual issues and can therefore occur both domestically and in cross-border scenarios.

By their very nature and the rules that apply (such as those in tax treaties), cross-border scenarios are more complex and likely to

[108] OECD, *Designing Effective Controlled Foreign Company Rules, Action 3—2015 Final Report*, supra note 23. In paragraph 28, the OECD notes problems that arise where a country adopts the exemption method for income derived through lowly taxed foreign PEs. It recommends that either the exemption method be denied in such cases or that the rules applicable to controlled foreign corporations be applied.

give rise to differential tax treatment. These scenarios have been the focus of the present chapter. In this context, globalization has intensified the probing of weaknesses in cross-border taxation and the speed with which they are identified and acted upon. It is simply not safe for a country to assume that another country will tax and it is not clear that the OECD BEPS project is sufficient to enable countries to rethink this basic premise. The best defence for a country against BEPS is still the conceptual one, that is to say, increased efforts to minimize the difference in tax treatment of substitutable payments.

Developing countries have as much interest as other countries in minimizing the ways in which the international tax order distorts the allocation of resources. However, they have perhaps an added interest in ensuring that local participants in the local market are not discriminated against. This happens when local firms are subject to higher taxes than foreign firms conducting the same activities, and that can happen when foreign firms manipulate taxation through their tax advisors. Developing countries can achieve much to prevent this through the use of uniform and comprehensive withholding taxes on outbound services, interest, rents and royalties.[109] This can reduce the benefits of receiving these payments through intermediaries in low tax jurisdictions. It also encourages foreign firms to establish a presence in the country that is taxed on a net basis, such as a PE or subsidiary. In this way, a country can achieve an element of neutrality with domestically bound firms.

In the end, addressing BEPS risks with respect to rents and royalties is no different than with respect to other types of deductible payments. Increased sharing of information and identification of abusive practices will and do help. However, they are administratively intense and the targeting of particular measures increases the complexity of the system, adding further administrative costs and allowing scope for abuse. The only way out of this conundrum is increased and

[109] The 2015 Final Reports on the OECD BEPS actions contain little on the use of withholding taxes as a method to limit BEPS. OECD, *Measuring and Monitoring BEPS, Action 11—2015 Final Report*, supra note 23, 157, recognizes that withholding taxes "can influence cross-border tax planning opportunities" and can "discourage profit shifting via strategic allocation of debt and intangible assets."

uniform source-country taxation of rents and royalties, quarantining the deductibility of foreign rents and royalties and current taxation of rents and royalties hidden in intermediaries in tax havens. As rents and royalties are highly substitutable, countries also need to consider these issues with respect to other types of deductible payments and particularly interest and service fees.

Chapter XII

The role of a general anti-avoidance rule in protecting the tax base of developing countries

Brian J. Arnold*

1. Introduction

In most, if not all, income tax systems, taxpayers have the fundamental right to arrange their affairs so as to minimize the amount of tax payable under the law. In other words, there is no obligation — moral or legal — on taxpayers not to take actions to reduce their tax payable. In contrast, the tax authorities need to raise revenue to fund public goods and services in a manner that is fair, neutral or non-distortive, and cost effective. All these tax policy objectives support the idea that, while taxpayers have the right to minimize their taxes, that right should be constrained within reasonable bounds. This tension — between the right of taxpayers to engage in tax planning and the need for the tax authorities to prevent what is perceived to be unacceptable tax avoidance, which undermines the integrity of the tax system — is a fundamental feature of every tax system. It is the source of continual struggle between tax planners who devise new tax-reduction schemes and tax policymakers who devise new rules to counter those schemes.

There are many methods or techniques to control tax avoidance, including:

- Clear tax legislation that is difficult to avoid, and
- Rigorous enforcement to detect and assess tax-avoidance schemes.

However, it is impossible to design and draft tax legislation that is not susceptible to tax planning or to enforce tax laws perfectly. Therefore, although most countries have tried to make their tax legislation apply more broadly and clearly and have increased their enforcement efforts, they have also found it necessary to develop more targeted measures to combat tax avoidance. All countries have

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adopted some specific anti-avoidance rules to prevent certain types of tax avoidance schemes that can be described objectively, such as rules to prevent an individual from assigning income to a related person who is subject to a lower tax rate or rules to deal with wash sales, where property is transferred to realize a loss and then reacquired a short time later. In some countries, the courts have developed judicial anti-avoidance doctrines — such as the sham transaction doctrine, the substance-over-form doctrine, the business purpose test, or the concept of abuse of rights — to control abusive tax avoidance. Some courts have also used a purposive approach to the interpretation of tax statutes to strike down tax-avoidance schemes that are not in accordance with the courts' view of the purpose of the relevant provisions of the legislation.

The experience of most countries has shown that, although specific anti-avoidance rules and judicial anti-avoidance doctrines are useful in controlling tax avoidance, they are far from sufficient. A common problem with specific anti-avoidance rules is that they are often enacted several years after an avoidance scheme has resulted in substantial lost tax revenue; in addition, specific anti-avoidance rules often have the unintended consequence of providing a road map for tax planners to follow in avoiding the rules. Judicial anti-avoidance doctrines also have significant shortcomings: they are often narrowly applied, as in the case of the sham transaction doctrine, or are applied inconsistently, as in the case of the substance-over-form doctrine, and can take decades to be fully developed by the courts.

As a result of the limitations of these methods for countering tax avoidance, a number of countries have adopted statutory general anti-avoidance rules (GAARs) to counter tax avoidance, including cross-border tax avoidance through base erosion and profit shifting (BEPS). This chapter discusses the use of GAARs by developing countries to protect their tax base. The chapter begins with a brief discussion of the meaning of tax avoidance and the distinction between tax avoidance and tax evasion. It then discusses what a GAAR is, whether a GAAR is necessary, and the fundamental tax policy considerations that should be considered in designing and drafting a statutory GAAR. The major features of a statutory GAAR — the conditions for the application of the rule and the exceptions from the rule — are explored in detail with references to the GAARs of selected countries (Canada, China and South Africa), a sample GAAR prepared by the International Monetary Fund (IMF) and the treaty GAAR added to the United Nations Model Double Taxation Convention between Developed and Developing Countries[1] (United Nations Model Convention) in 2017; these GAARs are reproduced in the annex. The relationship between a domestic GAAR and the provisions of a country's tax treaties is obviously an important issue and is discussed along with several important issues that arise in the administration of a GAAR. The chapter ends with a brief conclusion.

Most of the chapters in the present *Handbook* deal with various aspects of the OECD project on BEPS, initiated in 2013, and the 2015 Final Reports on the 15 action items of the BEPS Action Plan. As explained in chapter I of the *Handbook*, the needs of developing countries with respect to BEPS are broader than those of OECD member countries. Consequently, this *Handbook* deals with those action items of most concern to developing countries, plus several other base erosion issues not dealt with by the OECD, such as the use of a statutory GAAR in domestic law as a means of controlling BEPS; statutory GAARs are not included in the OECD action items, but are nevertheless an important potential tool for developing countries to consider for dealing with BEPS and other types of tax avoidance.

2. The definition of tax avoidance and the distinction between tax avoidance and tax evasion

Tax avoidance is difficult to define precisely, although in principle, the distinction between tax avoidance and tax evasion is reasonably clear. Tax evasion is conduct that involves the intentional non-payment or underpayment of tax through fraud, non-disclosure or misrepresentation. Tax evasion is generally a criminal offence punishable by fines or imprisonment. In contrast, tax avoidance involves the reduction of tax by legal means rather than by fraud, non-disclosure or misrepresentation. Thus, tax avoidance is not a criminal offence; however, it may be unsuccessful because statutory anti-avoidance rules or judicial

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

anti-avoidance doctrines apply to counteract an avoidance transaction. Tax avoidance can be divided into two categories: acceptable or legitimate avoidance (sometimes referred to as tax mitigation) and unacceptable or illegitimate tax avoidance. It is sometimes difficult to know in advance whether any particular tax planning strategy is acceptable or unacceptable. Initially, tax professionals use their knowledge of the law and administrative practice to advise taxpayers whether a transaction is likely to fall on one side of the line or the other. The tax authorities must then decide whether to attack the transaction or accept that it reduces tax in accordance with the law. Finally, the courts will ultimately decide whether the transaction is acceptable (within the law) or unacceptable (outside the law).

There is a great deal of confusion about the terms "tax avoidance" and "tax evasion." Obviously, countries often draw the line between tax avoidance and tax evasion and between acceptable and unacceptable tax avoidance differently.

3. What is a general anti-avoidance rule?

Although the term "general anti-avoidance rule" does not have a precise meaning, as its name suggests, it is a rule that applies broadly to all types of transactions and arrangements intended to avoid, reduce or defer tax inappropriately. A GAAR is different from specific anti-avoidance rules, which apply narrowly — for example, only for the purposes of a particular provision or group of provisions, only to certain taxpayers, such as non-residents (back-to-back financing rules), or only to certain transactions, such as transactions between a resident corporation and a non-arm's length non-resident corporation (transfer pricing rules) or surplus-stripping transactions. A GAAR potentially applies to any type of payment or receipt, taxpayer, or transaction.

Some countries that have separate statutes for different types of income taxes, such as personal income tax, corporation income tax and capital gains tax, may have GAARs for each statute. Similarly, some countries may have different GAARs for various parts of a taxing statute, such as capital gains and losses, the taxation of non-residents and the taxation of business income. These GAARs (sometimes referred to as mini-GAARs) may be equivalent to a single GAAR applicable for purposes of the tax legislation generally. Although these mini-GAARs can be tailored to the particular part of the legislation to which they apply, they should be reasonably consistent.

4. Is a GAAR necessary?

Whether a GAAR is necessary must be determined from the particular perspective and circumstances of each country, its tax system and the quality of its courts. Typically, countries adopt a GAAR because their tax revenues have declined as a result of a proliferation of tax avoidance transactions, and their existing statutory anti-avoidance rules and judicial anti-avoidance doctrines prove to be inadequate to deal with the problem. This section presents and briefly describes the arguments for and against a GAAR.

4.1 The extent of abusive tax avoidance

Taxpayers and their advisers may sometimes argue that governments must prove that tax avoidance is a serious problem by quantifying the extent of abusive tax avoidance. Ideally, a government would be able to justify the adoption of a GAAR by showing that abusive tax avoidance results in a substantial loss of tax revenues, and also perhaps that the loss has been increasing. However, this is an impossible task, especially given the difficulty of agreeing on a definition of abusive tax avoidance. Similarly, it is impossible for taxpayers and their advisers to prove that abusive tax avoidance is not a serious problem. The best available evidence about the extent of abusive tax avoidance is usually anecdotal evidence from audit activities and public sources.

4.2 Is a GAAR consistent with the rule of law and constitutional principles?

Taxpayers and their advisers may argue that a GAAR violates a country's constitutional principles or the rule of law. These constitutional principles may include the necessity that tax must be imposed in accordance with proper legal authority and that it must conform to fundamental principles of substantive and procedural justice such as equal treatment, safeguards against abuse of discretionary power, and legal certainty. These arguments are peculiar to each country's constitution and legal system.[2] They are not persuasive, especially in light of the evidence that many countries have enacted GAARs.

4.3 The adequacy of specific anti-avoidance rules

Opponents of a GAAR often argue that a GAAR is unnecessary because a country's existing anti-avoidance rules are sufficient to deal with abusive tax avoidance. This argument is usually supplemented by the argument that the tax authorities should be more aggressive in combating abusive tax avoidance. However, there are two fundamental problems with specific anti-avoidance rules. First, specific rules provide a road map for tax planners to design transactions that will not be caught by the rules, and this inevitably leads to a never-ending cat-and-mouse game between tax authorities and tax advisers. Second, using specific rules to deal with abusive tax avoidance transactions means that the tax authorities are always playing catch-up — as each new abusive transaction is detected, new anti-avoidance rules must be enacted to deal with it. The enactment of such rules takes time, and in the meantime tax revenues are lost. Moreover, this situation rewards taxpayers and tax planners who implement aggressive tax avoidance plans early, before they are detected by the tax authorities.

With respect to the argument that the tax authorities can control abusive tax avoidance effectively simply by enforcing existing rules more aggressively, it is unrealistic to expect this to happen without additional resources dedicated to anti-avoidance enforcement activities. Even if the tax authorities are more aggressive, it is unclear whether a country's courts would support more aggressive enforcement. Finally, it would take many years to determine whether the increased enforcement efforts of the tax authorities were successful in dealing with abusive tax avoidance — all the while running the risk that they might not be successful.

4.4 Uncertainty

The most common argument against a GAAR is that it involves too much uncertainty and that such uncertainty would discourage

[2] Graeme S. Cooper, ed., *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD, 1997).

legitimate commercial transactions. Unquestionably, a GAAR involves a significant amount of uncertainty, and this uncertainty inevitably confers considerable discretion on the tax authorities with respect to the application of the rule. However, the effects of the uncertainty of a GAAR are often wildly exaggerated. It is impossible to determine in advance the impact of a GAAR on commercial transactions, and in any case the impact depends on the form of the GAAR and its application by the tax authorities. Moreover, if the enactment of a GAAR is accompanied by the repeal of some specific anti-avoidance rules that have become unnecessary in the light of the GAAR, the certainty of the tax law may actually be improved.

Most of the arguments with respect to the uncertainty of a GAAR are directed at the application of the rules by the tax authorities. The enactment of most new tax rules involves some (usually temporary) uncertainty. The tax authorities can reduce the uncertainty associated with the adoption of a GAAR by issuing explanatory notes with the new legislation to provide guidance on how the provisions of the GAAR are intended to be interpreted and administrative guidance on how the GAAR will be applied.[3]

4.5 Summary

The argument that a GAAR is necessary is quite simple. The experience of many countries is that specific anti-avoidance rules and other techniques are not effective in controlling tax avoidance. Abusive tax avoidance erodes a country's tax base and reduces public confidence in the tax system. Some type of GAAR is essential for most countries in order to prevent taxpayers from avoiding the obligation to pay the tax that the tax system seeks to impose.

A GAAR can take the form of a judicial rule or a statutory rule. The courts of some countries have developed broad general judicial doctrines, such as the abuse of law concept in civil law countries; a business purpose test, under which transactions that lack a significant business purpose can be disregarded for tax purposes; and the doctrine of economic substance over legal form, under which transactions are taxed in accordance with their economic substance rather than their legal

[3] See section 8 below for a discussion of the administration of a GAAR.

form. The tax systems of these countries may be adequately protected against abusive tax avoidance by these judicial doctrines. However, most countries lack well-developed judicial anti-avoidance doctrines, and therefore the only feasible method for dealing effectively with abusive tax avoidance is the enactment of a statutory GAAR.

5. Major policy considerations in designing a statutory GAAR

This section discusses the major considerations that should be examined in developing a statutory GAAR. These considerations should not be viewed as inflexible recommendations, but rather as guidance on the features of a GAAR that should be carefully studied.

5.1 A GAAR should be broad enough to deal with all forms of abusive tax avoidance

As the word "general" in the term "general anti-avoidance rule" indicates, a GAAR should apply to all types of tax avoidance; otherwise, the rule will be subject to the inadequacies and deficiencies of specific anti-avoidance rules. Thus, a GAAR should potentially apply to all transactions or arrangements that may result in the reduction, avoidance or deferral of tax payable or other relevant amounts, such as instalments of tax.

5.2 A GAAR should distinguish between abusive tax avoidance transactions and legitimate commercial transactions

Although a GAAR is intended to prevent abusive tax avoidance transactions, it is not intended to apply to legitimate commercial transactions. Therefore, a GAAR must distinguish in some manner between the two types of transactions. This distinction is one of the most important features of any GAAR. However, it is extremely difficult to formulate objective criteria for making the distinction because neither abusive tax avoidance transactions nor legitimate commercial transactions can be defined precisely. Various terms are used by countries in their GAARs to describe transactions that are subject to the GAAR: abusive, artificial, impermissible, illegitimate, unacceptable. All these terms are conclusory; they do not provide any objective criteria to determine whether a transaction is abusive or legitimate.

5.3 A purpose test should be objective

Most GAARs involve a purpose test. Typically, the GAAR does not apply to a transaction if the purpose of the transaction (or the taxpayer's purpose in entering into or carrying out the transaction) is a valid commercial or family purpose rather than the avoidance of tax.

A test based on the purpose of a transaction is different from a test based on a taxpayer's motive or intention. A taxpayer's motive or intention is generally irrelevant for tax purposes: tax consequences are generally determined on the basis of what taxpayers actually do rather than why they do it. Moreover, a taxpayer's motives or intentions are subjective; in contrast, tax is generally imposed on the basis of objective facts and results rather than the taxpayer's state of mind. Nevertheless, most tax systems have provisions that depend on a taxpayer's purpose or the purpose of a transaction, such as provisions that allow the deduction of expenses only if they are incurred for the purpose of earning income.[4]

However, it is difficult, if not impossible, to distinguish between abusive tax avoidance transactions and legitimate commercial transactions solely on the basis of the tax results of the transactions, since both types of transactions usually result in the reduction of tax. For this reason, most GAARs are based, at least in part, on the purpose of a transaction. If the purpose of a transaction is exclusively or primarily to reduce or avoid tax, it is potentially subject to the GAAR (if the other conditions for the application of the GAAR are met); in contrast, if the sole or primary purpose of a transaction is something other than

[4] A purpose test rather than a results test (where expenses are deductible only if income actually results from the expenses) is used because, under a results test, expenses would not be deductible if the taxpayer incurs a loss — in other words, a results test would penalize risky business ventures. See, for example, Canada, Income Tax Act, section 18(1)(a): "In computing the income of a taxpayer from a business or property no deduction shall be made in respect of (a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property."

tax avoidance, the GAAR does not apply. The purpose of a transaction should be determined by reference to objective facts and not the taxpayer's subjective intention. Although a taxpayer's testimony as to his or her subjective purpose in carrying out a transaction may be relevant in the determination of the purpose of the transaction, clearly it should not be determinative — taxpayers will always say that their transactions were carried out solely or primarily for non-tax reasons if that is to their benefit.

A purpose test for a GAAR can be drafted either as a condition for the application of the GAAR (for example, the GAAR applies if the primary purpose of a transaction is to reduce tax)[5] or as an exception (for example, the GAAR applies to a transaction unless the primary purpose of the transaction is not to reduce tax).[6] In principle, there is no substantial difference between these two approaches; however, in some countries, the onus of proof with respect to the conditions for the application of a rule and for exceptions to the rule may differ.[7]

Three variations of a purpose test are possible: sole or exclusive purpose, primary or main purpose, or one of the primary or main purposes. A sole or exclusive purpose test (that is, the GAAR applies only if the sole or exclusive purpose of a transaction is to avoid tax) is likely to be of limited effectiveness, since abusive tax avoidance transactions often have both commercial and tax-avoidance purposes.

A primary or main purpose test appears to strike an appropriate balance between abusive tax avoidance and legitimate commercial transactions. However, there are two major difficulties with such a test. First, in many cases, it is necessary to weigh the multiple purposes for a transaction in order to determine its primary purpose; this exercise involves considerable uncertainty. Second, the primary purpose of some transactions may always be something other than tax avoidance despite the fact that those transactions generate significant tax benefits. For example, it can be argued that the primary purpose of

[5] See, for example, annex A.I, Canada, Income Tax Act, section 245(3).

[6] See, for example, annex A.III, South Africa, Income Tax Act No. 58 of 1962, Part IIA, section 80A

[7] The issue of onus of proof with respect to a GAAR is discussed in section 6.4 below.

any financing transaction is the commercial purpose of raising funds to use in a business or to make an investment.[8] Therefore, a GAAR using a primary purpose test might not apply to any financing transaction despite the fact that debt-financing transactions are often used to generate interest deductions that reduce tax inappropriately.

A one of the primary or main purposes test is not subject to this deficiency. However, a one of the primary or main purposes test will extend the scope of a GAAR to many more transactions, since many, if not most, commercial transactions are designed to minimize tax. Therefore, it is more important under a GAAR with a one of the primary purposes test to have an effective exception for legitimate commercial transactions.[9]

5.4 The relationship between a GAAR and other rules, including specific anti-avoidance rules

In some, but not all, circumstances a GAAR must prevail over other statutory provisions — in particular, over specific anti-avoidance rules. The priority accorded to the GAAR is essential, since the fundamental reason for a GAAR is that specific anti-avoidance rules are insufficient to deal with abusive tax avoidance transactions. Therefore, the GAAR should potentially apply in some circumstances even where an avoidance transaction complies with the other provisions of the tax legislation. On the other hand, the GAAR should not necessarily apply to transactions whose purpose is to avoid tax and that comply with all the other tax provisions. For example, most countries have enacted tax incentives to encourage taxpayers to make certain investments. Clearly, a GAAR should not apply to defeat the purpose of these explicit tax incentives despite the fact that the primary purpose, or one of the primary purposes, of a transaction is to reduce tax by means of the tax incentive.

Similarly, in some circumstances, it will be appropriate for the GAAR to supplement a specific anti-avoidance rule in order to prevent

[8] Similarly, the primary purpose of any acquisition of property, such as the shares of a corporation, may reasonably be considered to be to make an investment in the property even though the acquisition may also be made to reduce tax.

[9] See section 6.5 below on an exception or saving provision.

taxpayers from avoiding that rule. However, in other circumstances, the GAAR should not apply to supplement a specific rule. The appropriate result often depends on the nature of the specific anti-avoidance rule. For example, if a country has a specific rule to deny the recognition of gains and losses from so-called wash sales (a sale of property that is accompanied by an acquisition of the same or similar property within a short time before or after the sale), which applies only to a sale and acquisition within a specified number of days, the GAAR arguably should not apply to a sale and acquisition that occurs outside that period. Such a wash-sale rule uses a bright-line test that signals to taxpayers that, as long as they are on the right side of the line, their transactions will be effective. Thus, it is questionable in this situation whether a GAAR should apply to a transaction on the right side of the line because it would undermine the certainty of the bright-line rule.

It is difficult to establish any general rule concerning the relationship between a GAAR and other statutory provisions. Thus, it will be the responsibility of the tax authorities in the first instance, and the courts ultimately, to determine on a case-by-case basis whether the GAAR or another specific provision should prevail.

It may be tempting to provide explicitly that the GAAR prevails over other provisions by including words such as "notwithstanding any other provisions of this Act" in the GAAR. The general anti-abuse rule added to the United Nations Model Convention and the OECD Model Tax Convention on Income and on Capital[10] (OECD Model Convention) in 2017 contains wording to this effect.[11] However, both Model Conventions differ from most countries' domestic legislation in two important respects. First, this type of wording is appropriate in the context of the Model Conventions because their provisions generally limit the taxing rights of the contracting States.[12] Second, if the contracting States do not want the general anti-abuse rule to prevail over a particular provision or provisions of the treaty, they can explicitly

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

[11] See annex A.V, Article 29 (9) of the United Nations Model Convention.

[12] It is well established that tax treaties do not generally confer taxing rights on the parties to the treaty; instead, they limit the taxes levied under their domestic laws.

exclude those provisions from the notwithstanding clause ("notwithstanding any other provision of this Convention, other than …").

5.5 A GAAR should be a provision of last resort

A GAAR is an extraordinary rule that is designed to prevent egregious tax avoidance transactions; a GAAR should not be viewed as a rule to be used frequently and regularly as a basis for the assessment of tax. Therefore, a GAAR should apply only after all the other provisions of a country's tax legislation have been applied; if the application of other provisions results in an abusive tax avoidance transaction being rendered ineffective, there is no need to apply the GAAR. Only if a transaction complies with all of the other provisions of the tax law is it necessary to consider whether the GAAR applies to the transaction.

5.6 The determination of tax consequences if a GAAR applies

If a GAAR applies to a transaction, it is inappropriate simply to disregard or ignore the transaction for the purpose of determining the tax consequences—a GAAR should provide rules for determining the tax consequences where it applies to a transaction. The difficulty in this regard is that it is impossible to prescribe in advance the appropriate tax consequences for every situation that might be subject to a GAAR. As a result, any provision that prescribes consequences must be sufficiently general to allow the tax authorities, subject to review by the courts, to tailor the tax consequences appropriately for each situation. A reasonable approach might be to have a general provision authorizing the tax authorities to determine the tax consequences for the taxpayer and any other relevant persons, together with a list of specific actions, such as disallowing deductions or exemptions, allocating income or gain to any person, determining the character of any amount, and ignoring or disregarding certain tax consequences.

5.7 Taxpayers should be entitled to appeal all aspects of a GAAR

As noted above, a GAAR involves a significant element of uncertainty, and this uncertainty gives considerable discretion to the tax authorities.

To ensure that the tax authorities do not abuse this discretion, it is important for taxpayers to be able to appeal to the courts all aspects of the application of a GAAR, including whether the rule applies and the determination of the tax consequences where it does apply. Transactions subject to a GAAR may involve multiple parties in addition to the particular taxpayer to whom the GAAR is applied. Parties affected by the application of the GAAR should also be granted rights to appeal.

5.8 The relationship between a GAAR and tax treaties

A fundamental principle of the law of treaties is that in the event of a conflict between the provisions of a treaty and the provisions of domestic law, the provisions of the treaty must prevail. Therefore, the critical question with respect to the relationship between a GAAR and tax treaties is whether there is any conflict between a country's GAAR and the provisions of its tax treaties. This issue is discussed in detail in section 7 below.

5.9 Simplicity

Although the interpretation and application of a statutory GAAR involves considerable uncertainty, the wording of the rule itself should be relatively simple. Arguably, a statutory GAAR should not be drafted with the same type of detailed technical provisions that are characteristic of specific anti-avoidance rules.[13] A GAAR that is short and simple is more readily explained to the public and to the judges responsible for applying it.

6. The major features of a statutory GAAR

6.1 Introduction

Typically, a GAAR applies to a transaction or arrangement if three conditions are met:

[13] It is interesting to compare in this regard the South African GAAR (annex A.III), which is quite detailed, and the Canadian and Chinese GAARs (annex A.I and A.II, respectively), which are simply worded.

(a) The transaction or arrangement results in a tax benefit;

(b) The sole purpose, primary purpose or one of the primary purposes of the transaction or arrangement is to obtain the tax benefit; and

(c) The transaction or arrangement frustrates, abuses, defeats or contravenes the underlying purpose of the relevant statutory provisions.

These three conditions, along with the definition of a transaction or arrangement, form the key elements of most GAARs. The considerations involved in the design and drafting of these key elements are discussed below. In addition, the ancillary aspects of the application of a GAAR, such as the determination of the tax consequences, are also discussed briefly. The following discussion of each of the key elements of a GAAR refers to the selected GAARs reproduced in the annex, in order to illustrate the similarities and differences in the various methods used to achieve the desired legislative result.

6.2 The definition of a transaction

As with most tax avoidance provisions, a GAAR must apply to something that results in the reduction or avoidance of tax and, in keeping with the underlying purpose of a GAAR, it should apply to anything that can possibly result in a reduction or avoidance of tax.

Typically, countries use terms such as "transaction," "arrangement" or "scheme" as the basic building block for identifying the target of their GAARs. These terms are usually defined very broadly. For example, the South African GAAR defines the term "arrangement" to mean "any transaction, operation, scheme, agreement or understanding (whether enforceable or not) including all steps therein or parts thereof …"[14] The Indian GAAR uses a similar definition.[15] The Canadian GAAR defines a "transaction" to include "an arrangement or event"; thus, "transaction" has its ordinary meaning and also means

[14] Annex A.III, South Africa, Income Tax Act No. 58 of 1962, Part IIA, section 80L, definition of "arrangement."

[15] India, Income Tax Act, 1961, as amended by Finance Act 2013, Chapter X-A, section 102(1).

an arrangement or event.[16] Perhaps the broadest definition is the definition of the term “scheme” in the IMF sample GAAR, to include “any course of action, agreement, arrangement, understanding, promise, plan, proposal, or undertaking, whether express or implied and whether or not enforceable.”[17]

Regardless of the term used as the basic building block for a GAAR, it is clearly intended to be as broad as possible so as to include any action that may result in tax avoidance. Two basic approaches can be used for this purpose. A general term such as transaction, arrangement or scheme can be defined comprehensively and explicitly or can be left largely undefined, relying on the tax administration and the courts to give the term a broad meaning. There are risks with both approaches. On the one hand, if a general term is defined comprehensively, the courts may be reluctant to apply the GAAR to any action that is not explicitly covered; on the other hand, if a general term is not defined comprehensively and explicitly, the courts may interpret the term narrowly. Under both approaches, the drafters should carefully consider whether omissions or the failure to act, such as the failure to exercise an option in a contract, and events, such as the making of an election, are potentially subject to the GAAR.

It is especially important for the GAAR to apply to a series of transactions. Most sophisticated tax planning arrangements involve multiple transactions that are linked or connected in the sense that all the transactions are necessary in order to achieve the desired tax benefits. However, if the steps in the arrangement are viewed separately without consideration of the arrangement as a whole, none of them may be considered to have the primary purpose of avoiding tax or to be abusive.

It is probably necessary to define a series of transactions or an arrangement to ensure that it is sufficiently broad to cover transactions that are connected in any manner. On the one hand, a series

[16] Annex A.I, Canada, Income Tax Act, section 245(1), definition of “transaction.”

[17] Annex A.IV, IMF sample GAAR, section 5. This definition is based closely on the definition of “scheme” in the Australian GAAR (Income Tax Assessment Act, Part IVA, section 177A(1)).

of transactions or an arrangement can be defined narrowly so that it includes transactions only if there is a binding legal obligation to carry out one transaction if another transaction is carried out. On the other hand, a series of transactions or an arrangement can be defined more broadly to include any transaction that is related or connected to, or carried out in contemplation of, another transaction or transactions. Under this approach, a transaction carried out in anticipation of a future transaction or a transaction carried out in connection with a past transaction would be considered to be part of a series or an arrangement. In summary, the definition of a series of transactions or an arrangement should apply both prospectively and retrospectively.

In any event, the drafters should ensure that the GAAR is potentially applicable to a series of transactions, broadly defined. Many tax avoidance schemes involve a complicated series of transactions where each separate step in the series may be considered to be legitimate when viewed separately, but abusive when viewed in the context of the series as a whole. Alternatively, a series of transactions that may be viewed as a bona fide commercial arrangement as a whole, such as a corporate reorganization, may have steps without any commercial justification that were inserted into the arrangement to produce tax benefits. Therefore, it is critical for a GAAR to apply both to transactions considered separately and transactions that are part of a series considered as a whole.

6.3 The definition of a tax benefit

As noted above, a GAAR is targeted only at transactions, arrangements or schemes that would result in the avoidance of tax in the absence of the application of the GAAR. If there is no avoidance of tax, obviously the GAAR should not apply. Several countries have copied the Australian concept of a "tax benefit"[18] for the purpose of targeting the GAAR at transactions or arrangements that reduce tax. The South African GAAR defines a tax benefit to include "any avoidance, postponement or reduction of any liability for tax."[19] The Canadian definition is even broader:

[18] Australia, Income Tax Assessment Act, Part IVA, section 177C(1), definition of "tax benefit."

[19] Annex A.III, South Africa, Income Tax Act No. 58 of 1962, Part IIA, section 80L, definition of "tax benefit."

> "tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty.[20]

In keeping with a broad definition of the terms "transaction," "arrangement" or "scheme," the term "tax benefit" should also be defined broadly to include all possible tax benefits, including the deferral or postponement of tax. Drafters should also carefully consider extending the definition to include amounts payable other than tax, such as interest on unpaid tax and instalments of tax payable, as well as refunds of tax and other amounts.[21]

The requirement for a transaction, arrangement or scheme to result in a tax benefit is not intended to be a difficult condition to satisfy for the application of a GAAR. In most cases, it should be clear that a transaction challenged by the tax authorities under the GAAR has resulted in a tax benefit; for example, any deduction in computing income, credit against tax payable, exclusion or exemption of an amount from income should clearly be a tax benefit. Theoretically, it is arguable that determining whether a transaction results in a tax benefit requires a comparison with the tax consequences of an alternative transaction. This type of approach involves a difficult counterfactual determination,[22] which could lead, inappropriately, to the conclusion that the GAAR does not apply, without any consideration of the more important issues—namely, the purpose of the transaction and whether the transaction is abusive.

One difficulty that arises with respect to the concept of a tax benefit is where a transaction does not result in any immediate tax

[20] Annex A.I, Canada, Income Tax Act, section 245(1), definition of "tax benefit."

[21] The necessity of dealing with refunds depends on the extent to which a country's tax system provides refunds. Tax refunds can arise for various reasons; for example, a country might provide refundable tax incentives to stimulate investment.

[22] The Australian courts have taken this approach.

saving but has consequences that allow a tax benefit to be realized in the future. For example, if a transaction results in an increase in the cost of property, no tax saving may be realized until depreciation deductions are claimed or the property is sold and the amount of the gain realized on the sale is reduced by the cost of the property. It may be easier for the tax authorities to apply the GAAR at the time that the transaction increases the cost of the property rather than to wait until the tax benefit is realized. Special provisions are necessary to allow the tax authorities to apply the GAAR to a transaction that does not result in any immediate tax benefit but could result indirectly in a tax benefit in the future.

It is unnecessary to quantify the tax benefit for purposes of determining whether the GAAR potentially applies to a transaction. However, if the GAAR applies to a transaction, the primary consequence should be to deny or eliminate the tax benefit that would otherwise result; therefore, it is necessary for this purpose to identify and quantify the tax benefit precisely.

6.4 The purpose test

As noted above, most GAARs contain some type of purpose test: in effect, if the purpose of a transaction or arrangement is something other than getting a tax benefit, the GAAR does not apply. However, if the primary purpose or one of the primary purposes is to obtain a tax benefit, the GAAR applies unless the transaction or arrangement is consistent with the underlying policy of the tax legislation.

The purpose test can be worded in a variety of ways. The South African GAAR potentially applies to "an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit."[23] The purpose test in the Indian GAAR is similar, but refers only to the main purpose of an arrangement.[24] The Chinese GAAR applies to a "business arrangement without a reasonable business purpose."[25] The

[23] Annex A.III, South Africa, Income Tax Act No. 58 of 1962, Part IIA, section 80A.

[24] India, Income Tax Act, 1961, as amended by Finance Act 2013, Chapter X-A, section 96.

[25] Annex A.II, China, Enterprise Income Tax Law, article 47.

purpose test in the IMF sample GAAR refers to where "a person, or one of the persons, who entered into or carried out the scheme, did so for the sole or dominant purpose of enabling the person … to obtain a tax benefit."[26] The Canadian GAAR potentially applies to a transaction that results in a tax benefit "unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit."[27] The New Zealand GAAR is an example of a GAAR that uses a one of the principal purposes test. A tax avoidance arrangement is defined in part to be an arrangement that "has tax avoidance as one of its purposes or effects … if the purpose or effect is not merely incidental."[28] Similarly, the GAAR added to the United Nations and OECD Model Conventions in 2017 uses a one of the main purposes test.[29]

The choice between a main purpose test and a one of the main purposes test should be considered carefully. Various terms can be used to describe the relevant purpose, including main, primary, principal and dominant. There does not appear to be any significant difference in the meaning of these terms — they all mean that the purpose must be one that was a significant reason for the transaction or arrangement and not an ancillary or incidental reason.

A "one of the main purposes test" is relatively easily satisfied. If a transaction or arrangement actually results in a tax benefit, it seems unlikely that none of the main purposes for the transaction or arrangement was obtaining that tax benefit. Most commercial transactions, such as acquisitions, mergers, reorganizations and financings, involve significant tax consequences that the parties invariably take into account. Therefore, the decisive factor as to whether the GAAR applies is whether the transaction or arrangement is contrary to the purpose of the legislation.

In contrast, a "main purpose test" is a more substantial condition for the application of a GAAR. A main purpose test requires not

[26] Annex A.IV, IMF sample GAAR, section 1(c).

[27] Annex A.I, Canada, Income Tax Act, section 245(3).

[28] New Zealand, Income Tax Act 2007, Section BG 1, section OB 1(b), definition of "tax avoidance arrangement."

[29] See annex A.V, Article 29 (9) of the United Nations Model Convention.

only that a purpose of a transaction be a main reason for the transaction (which is also what a one of the main purposes test requires) but also that that purpose be more important than any other purposes for the transaction. Thus, a main purpose test requires the tax authorities and the courts to determine whether a transaction or arrangement has multiple purposes and, if so, to weigh those purposes in order to determine the single purpose that is most important.

A main purpose test does not require one purpose to be more important than all the other purposes combined. For example, if a transaction has three main purposes, and tax avoidance represents 40 per cent of the purposes and the other two reasons represent 30 per cent each (assuming that the weighing of purpose can be quantified precisely in this manner), it should be concluded that the main purpose for the transaction is tax avoidance. However, if a transaction has three main purposes, each of which represents an equal reason for the transaction, it is difficult to conclude that tax avoidance is the main purpose for the transaction, although it is clearly one of the main purposes. Experience indicates that a main purpose text is not usually applied with this type of precision. Typically, for purposes of applying a main purpose test, transactions are considered to have commercial or business purposes and tax avoidance purposes, and the tax authorities and the courts must determine which purpose is more important.

Because the application of a main purpose test involves the weighing of multiple purposes, the onus of proof may be an important factor. Does the taxpayer have the burden of establishing that the main purpose of a transaction was not obtaining a tax benefit, or do the tax authorities have the burden of establishing that the main purpose of the transaction was the avoidance of tax? In many countries, a tax assessment issued by the tax authorities is presumed to be correct unless the taxpayer establishes that the assessment is incorrect.

This general presumption may be sufficient to place the burden of proof on the taxpayer with respect to the determination of the main purpose of a transaction under a GAAR, and can be reinforced by the wording of the purpose test. For example, under the Canadian GAAR, a transaction that results in a tax benefit is potentially subject to the GAAR unless the primary purpose for the transaction is a bona fide purpose other than obtaining the tax benefit.[30] Such a provision could be worded more explicitly to put the burden on the taxpayer: "unless it is established by the taxpayer that the main purpose is a bona fide purpose other than obtaining the tax benefit." The South African GAAR goes even further by establishing an explicit presumption that a transaction resulting in a tax benefit has the sole or main purpose of tax avoidance "unless and until the party obtaining a tax benefit proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement."[31]

It seems appropriate to place the burden of establishing a benign, non-tax purpose for a transaction on the taxpayer because the taxpayer usually has better access to all the relevant information necessary to determine the main purpose or purposes of a transaction.

As discussed above, the purpose or purposes of a transaction or arrangement should be determined on the basis of objective facts and circumstances rather than the subjective intention of taxpayers, who will always be inclined to justify transactions with self-serving evidence. The determination of the purpose of a transaction or arrangement on the basis of objective facts can be reinforced by the wording of the GAAR. For example, the South African GAAR requires the main purpose to be "reasonably considered in light of the relevant facts and circumstances."[32] Under the Canadian GAAR, a transaction is an avoidance transaction unless it "may reasonably be considered" to have been carried out primarily for non-tax purposes.[33] Further, the Chinese, South African and Canadian GAARs refer to the purpose of the transaction or arrangement rather than the taxpayer's purpose. In contrast, the IMF sample GAAR refers explicitly to the purpose of the person or one of the persons who entered into a scheme. Thus, under such wording, it seems more likely that the subjective intention of the taxpayer would not only be relevant, but would also have greater weight.

[30] Annex A.I, Canada, Income Tax Act, subsection 245(3), definition of an "avoidance transaction."

[31] Annex A.III, South Africa, Income Tax Act No. 58 of 1962, Part IIA, section 80G(1).

[32] Ibid.

[33] Annex A.I, Canada, Income Tax Act, subsection 245(3).

6.5 An exception or saving provision

A few GAARs apply without any exceptions or additional conditions if the primary purpose of a transaction is to avoid tax. This is how the IMF sample GAAR is worded, as well as the Australian GAAR on which it is based.[34] However, most statutory GAARs do not apply to all transactions or arrangements that are carried out primarily for the purpose of obtaining a tax benefit; some of these transactions are not subject to the GAAR if they are consistent with and not contrary to the object and purpose of the tax legislation.

This exception or saving provision can be drafted as an added condition for the application of the GAAR, or as an exception. For example, the GAAR added to the United Nations and OECD Model Conventions in 2017 applies if one of the principal purposes of a transaction is obtaining a treaty benefit "unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."[35] The Canadian GAAR applies only if a transaction can reasonably be considered to result in a "misuse" of the relevant provision or in an "abuse" of the provisions of the statute read as a whole.[36] In contrast to these exceptions, one aspect of the South African GAAR is structured as an additional condition: a transaction is covered if its sole or main purpose is to obtain a tax benefit and it "would result directly or indirectly in the misuse or abuse of the provisions of this Act."[37] Although the Chinese GAAR is worded exclusively as a business purpose test, it is intended to apply only to transactions that are contrary to the purpose of the legislation.[38]

A GAAR that relies exclusively on a primary purpose test is likely to apply more broadly than a GAAR that uses both a purpose

[34] Annex A.IV, IMF sample GAAR, section 1. Australia, Income Tax Assessment Act (ITAA), Part IVA, section 177D.

[35] Article 29 (9) of the United Nations and OECD Model Conventions.

[36] Annex A.I, Canada, Income Tax Act, section 245(4).

[37] Annex A.III, South Africa, Income Tax Act No. 58 of 1962, Part IIA, section 80A(C). The other aspects of the South African GAAR require other conditions in addition to a purpose test.

[38] Jinyan Li, *International Taxation in China: A Contextualized Analysis* (Amsterdam: IBFD, 2016), at 479 – 480.

text and an additional condition or exception of some kind. However, there is a serious risk that a GAAR that uses only a primary purpose test may apply to transactions that are not abusive or offensive from a tax policy perspective. This type of GAAR relies on the tax authorities to use their discretion not to apply the GAAR inappropriately. If the tax authorities do not do so, however, the courts would have no basis to stop them from applying the GAAR to transactions that are carried out primarily for the purpose of reducing tax but are not contrary to the underlying object and purpose of the tax legislation. Taxpayers can be expected to strongly oppose the adoption of such a GAAR, and most countries have rejected this type of GAAR.

The major difficulty with an exception or safety valve for a GAAR is how to draft it in a manner that can be applied reasonably by taxpayers, tax authorities and the courts. The South African and Canadian GAARs use the concepts of misuse and abuse.[39] These concepts have been interpreted to mean transactions that frustrate, defeat or contravene the object and purpose of the tax legislation. This meaning is explicit in the exception in the GAAR in the United Nations and OECD Model Conventions (the GAAR applies "unless"). This type of exception or saving provision in a GAAR is effectively a rule of interpretation—the relevant provisions of the tax legislation must be interpreted to determine their object and purpose, and then the transaction or arrangement in question must be assessed to determine whether it is in accordance with or contrary to that object or purpose. If the transaction or arrangement is found to be contrary to the object and purpose of the legislation, the GAAR will apply to deny the tax benefits that would otherwise result.

This type of interpretive approach may be difficult to apply depending on the nature of a country's tax legislation, the approach to statutory interpretation generally and the interpretation of tax statutes in particular. Some countries have a long tradition of interpreting tax legislation literally. For these countries, the application of a purposive approach to determine whether a transaction or arrangement is abusive for purposes of the GAAR will be an unusual exercise for which the tax authorities and the courts may not be adequately

[39] These terms are also used in the Irish GAAR; see Ireland, Income Tax Act, section 811(3)(a)(ii).

prepared. Moreover, if the tax authorities and the courts interpret the provisions of the tax legislation (other than the GAAR) literally, then it would be logically impossible to consider any transaction or arrangement that complies with the literal wording of those provisions to be contrary to any of those provisions considered separately and all of them considered as a whole.

If the GAAR is a provision of last resort, it means that the GAAR is relevant only if a transaction or arrangement complies with all the provisions of the tax legislation other than the GAAR. Therefore, if the GAAR provides an exception for a transaction or arrangement that is consistent with the object and purpose of the provisions of the tax legislation other than the GAAR, and the object and purpose of those provisions is determined by reference to their literal meaning, then any transaction or arrangement that is consistent with the literal meaning of the provisions of the tax legislation other than the GAAR will inevitably be within the exception, and, as a result, the GAAR will be rendered meaningless.

The difficulties with applying an interpretive exception based on the identification of the underlying object and purpose of the tax legislation has led some countries to use alternative exceptions based on more objective factors. For example, the South African GAAR applies in certain situations if the sole or primary purpose of an arrangement is to obtain a tax benefit and the arrangement:

(a) Is carried out by abnormal means; or
(b) Lacks commercial substance; or
(c) Creates rights or obligations that would not normally be created between arm's length persons.[40]

Although detailed rules are provided for determining whether an arrangement lacks commercial substance,[41] no rules are provided regarding the meaning of abnormal means of carrying out arrangements or abnormal rights. To determine whether something is abnormal requires a determination of what is normal, which may produce

[40] Annex A.III, South Africa, Income Tax Act No. 58 of 1962, Part IIA, sections 80A.

[41] Ibid., sections 80C – 80F.

difficulties in this context. For example, if a particular type of tax avoidance is used extensively before the tax authorities identify and attack it using the GAAR, taxpayers have an argument that such transactions have become normal. Conversely, if a taxpayer carries out a novel transaction that is not abusive, but consistent with the underlying purpose of the tax legislation, there is nevertheless a risk that the transaction could be subject to the GAAR because it is abnormal.

Another method for providing more guidance with respect to an exception from or an additional condition for the application of a GAAR based on whether a transaction or arrangement contravenes the object and purpose of the tax legislation, is for the legislation to specify certain factors that the tax authorities and the courts must consider in making that determination. These factors may include the economic substance of the transaction, the manner in which the transaction was carried out, changes in the financial positions of the parties, the relation between the tax saving and the commercial profit on the transaction, and timing aspects of the transaction.[42] These factors can be used to determine the primary purpose of a transaction, as is the case with the IMF sample GAAR and the Australian GAAR.[43] However, these factors are equally or even more relevant for purposes of determining whether a transaction abuses, defeats, frustrates or contravenes the object and purpose of the tax legislation.

6.6 The role of economic substance

In many cases, the most important factor that should be considered in determining whether a transaction is abusive for purposes of a GAAR is its economic substance. As a general observation, it seems clear that

[42] The timing aspects of transactions might include, for example, the length of time that a taxpayer holds an investment. A taxpayer who acquires property (for example, shares of a corporation) and then disposes of it shortly thereafter (for example, after a dividend has been paid) might be considered to have done so for the purpose of receiving the dividend without making a real investment in the corporation.

[43] Australia, Income Tax Assessment Act, Part IVA, section 177D(2) lists eight factors to be considered in determining the "dominant" purpose of a scheme. The Hong Kong GAAR is similar to the Australian GAAR but lists only seven factors (Hong Kong, Inland Revenue Ordinance, section 61A(1)).

income tax should be imposed on the economic substance of transactions. However, in all income tax systems, the legal form of transactions (for example, the treatment of corporations as taxable entities separate from their shareholders) is respected to a certain extent. For tax systems that adhere generally to the legal form of transactions, tax avoidance is relatively easy through the manipulation of the legal form of transactions and arrangements. For purposes of the application of a GAAR, it is important for the tax authorities and the courts to consider the economic substance of the transactions in question.[44] For example, where a taxpayer transfers property with the right to reacquire the property in a short time and at a pre-determined price, in substance the taxpayer has effectively maintained ownership of the property. Although the meaning of economic substance may be imprecise, in general terms it means a consideration of the non-tax consequences of the relevant transactions. For example, if a transaction does not result in any pre-tax profit for a taxpayer or if a taxpayer does not have any risk (or only a limited risk) of loss or possibility of profit, this is an indication that the principal purpose or one of the principal purposes of the transaction was the expected tax benefits. Another relevant factor is the presence of parties to a transaction that are indifferent to tax consequences.

Although the Canadian and Chinese GAARs do not refer explicitly to the concept of economic substance in the legislation, economic substance is intended to play an important role in the application of the GAAR in both countries. The explanatory notes to the Canadian GAAR provide that the GAAR "recognizes that the provisions of the [Income Tax] Act are intended to apply to transactions with real economic substance."[45] The Chinese GAAR applies to business arrangements without a reasonable business purpose. Arrangements without economic substance or arrangements whose economic substance is inconsistent with their legal form will be considered to

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[44] See generally Robert McMechan, *Economic Substance and Tax Avoidance: An International Perspective* (Toronto: Carswell, 2013).

[45] Canada, Department of Finance, Explanatory Notes to Legislation Relating to Income Tax (June, 1988) clause 186. See Jinyan Li, " 'Economic Substance': Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance" (2006) Vol. 54, No. 1 *Canadian Tax Journal*, 23 – 56; and Robert McMechan, supra note 44.

lack a reasonable business purpose.[46] The administrative guidance with respect to the GAAR identifies some key factors in determining whether an intermediary entity lacks economic substance.[47] The IMF sample GAAR refers explicitly to the substance of a scheme for purposes of determining whether the sole or dominant purpose of the scheme was to reduce or avoid tax.[48] However, it does not refer to "economic substance" or provide any guidance on how the substance of a scheme should be determined.

The South African GAAR contains explicit and detailed rules with respect to the role of economic substance in the application of the GAAR. Under one of the operative rules of the GAAR, an arrangement is an impermissible avoidance arrangement if its sole or main purpose is to obtain a tax benefit and it lacks "commercial substance."[49] Further, an arrangement is deemed to lack commercial substance if it has no significant effect on a person's business risks or if its net cash flows and several additional factors are listed as indicating a lack of commercial substance.[50]

6.7 Determination of the tax consequences

A GAAR should specify how the tax consequences should be determined where the GAAR applies to a transaction or arrangement. The Canadian GAAR allows the tax consequences to be determined for any person "as is reasonable in the circumstances" and then provides a variety of specific adjustments that may be made for this purpose.[51] The IMF sample GAAR allows the tax authorities to determine the tax liability of the person who obtained a tax benefit as if the transaction

[46] See Jinyan Li, *International Taxation in China: A Contextualized Analysis*, supra note 38, at 479.

[47] Ibid., at 483 – 484. The factors include whether the entity has sufficient employees, assets and revenue to carry out business activities and whether the entity's existence is transitory.

[48] Annex A.IV, IMF sample GAAR, section 1(c).

[49] Annex A.III, South Africa, Income Tax Act No. 58 of 1962, Part IIA, section 80A(a)(ii).

[50] Ibid., section 80C.

[51] Annex A.I, Canada, Income Tax Act, section 245(2) and (5).

had not been entered into or a reasonable alternative transaction had been entered into; it provides that "compensating adjustments" may be made to the tax liability of other persons affected by the transaction.[52] The South African GAAR allows the tax authorities to determine the tax consequences of any person who participates in a transaction by taking specified actions, including treating the transaction "in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit." [53] In addition, the tax authorities are required to make "compensating adjustments … to ensure the consistent treatment of all parties" to the transaction.[54]

All these provisions are clearly intended to ensure that where the GAAR applies, the tax consequences should be determined reasonably to deny the tax benefit that would otherwise result and to make relieving adjustments in appropriate circumstances for the taxpayer and any other person affected by the application of the GAAR.

7. The relationship between tax treaties and a GAAR

7.1 Introduction

As noted above, the provisions of a tax treaty prevail over the provisions of domestic law in the event of a conflict. This principle — pacta sunt servanda — is enshrined in Article 26 of the Vienna Convention on the Law of Treaties,[55] and it applies to the relationship between a country's GAAR and the provisions of its tax treaties.

The relationship between a domestic GAAR and the provisions of a country's tax treaties depends on how the country's tax authorities and courts interpret tax treaties. For many countries, the Commentary to the United Nations and OECD Model Conventions is influential but not determinative in this regard. The Commentary to both the

[52] Annex A.IV, IMF sample GAAR, section 2.

[53] Annex A.III, South Africa, Income Tax Act No. 58 of 1962, Part IIA, section 80B(1).

[54] Ibid., section 80B(2).

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

United Nations and OECD Model Conventions dealing with the abuse of tax treaties and the relationship between domestic anti-avoidance rules and the provisions of tax treaties has changed significantly over the years. Therefore, the relationship between a domestic GAAR and a particular tax treaty may depend on when the treaty was entered into and what version of the Commentary is considered relevant for purposes of interpreting that treaty. Although the Introduction to the OECD Model Convention takes the position that the current version of the Commentary should be used for the purpose of interpreting all tax treaties, whether they were entered into before or after the current version of the Commentary was published,[56] the courts in some countries, and many commentators, have taken the position that only the version of the Commentary that existed at the time a particular treaty was entered into (and not subsequent versions of the Commentary) are relevant for purposes of interpreting that treaty.[57]

The Commentary to the OECD and United Nations Model Conventions dealing with treaty abuse changed significantly in 2003 and 2011, respectively. In principle, the 2011 changes to the Commentary on Article 1 of the United Nations Model Convention were consistent with the 2003 changes to the Commentary on Article 1 of the OECD Model Convention. The relationship between tax treaties and a domestic GAAR is also affected by the addition of a GAAR to both the United Nations and OECD Model Conventions in 2017 as a result of the OECD project on BEPS.

Some countries with domestic GAARs have taken the extraordinary step of overriding their tax treaties to eliminate the risk that their tax treaties would prevent them from applying their GAARs to deal with abusive tax avoidance transactions. It is arguable whether such treaty overrides constitute breaches of the treaty and violations

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[56] Paragraphs 33 and 34.

[57] See, for example, Michael Lang, *Introduction to the Law of Double Taxation Conventions* (Wien: Linde; Amsterdam: IBFD, 2010), 45 – 48; Frank Engelen, *Interpretation of Tax Treaties under International Law* (Amsterdam: IBFD, 2004), 463 – 72; and David A. Ward and others, *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model* (Toronto: International Fiscal Association (Canadian Branch); Amsterdam: IBFD, 2004), 78 – 111.

of international law. However, in light of the changes to the OECD Commentary in 2003 and, in particular, the addition of a treaty GAAR to the United Nations and OECD Model Conventions in 2017, the prevailing view is that there is no breach of the treaty—the contracting States cannot reasonably be considered to have agreed that their treaty could be used to justify abusive tax avoidance transactions, which would be subject to a domestic GAAR. It should be noted that some countries are unable to override their treaties through changes to domestic law because of constitutional considerations.

The relationship between tax treaties and a domestic GAAR is discussed below with respect to tax treaties entered into before the changes to the OECD Commentary on Article 1 in 2003, tax treaties entered into after those changes were made and tax treaties that contain a GAAR. In addition, the impact of the 2011 changes to the Commentary on Article 1 of the United Nations Model Convention dealing with treaty abuse is also discussed.

7.2 Treaties entered into before the 2003 changes to the OECD Commentary on Article 1

From 1977 until early 2003, paragraph 7 of the Commentary on Article 1 of the OECD Model Convention emphasized that the purpose of bilateral tax treaties was to facilitate international trade and investment by eliminating double taxation. Almost as an afterthought, paragraph 7 added that tax treaties "should not, however, help tax avoidance or evasion." The Commentary went on to acknowledge that taxpayers could exploit differences in countries' tax laws and that such exploitation could be facilitated by the proliferation of bilateral tax treaties. The Commentary, however, appeared to place the onus firmly on countries to adopt domestic anti-avoidance rules to prevent such exploitation and then to preserve the application of these rules in their treaties. Paragraph 7 provided: "Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind [anti-avoidance rules] contained in their domestic laws."

Arguably, the implication of these statements in the Commentary was that, if a treaty did not explicitly allow the application of domestic anti-avoidance rules, such rules could not apply to deny the availability of treaty benefits. Admittedly, the Commentary contained other statements suggesting that tax treaties did not preclude the application of domestic anti-avoidance rules. For example, paragraph 23 of the Commentary on Article 1 indicated that domestic anti-avoidance provisions, including substance-over-form rules and CFC rules, "are part of the basic domestic rules set by national tax law 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." [58] This position was stated to be the view of "the large majority of OECD Member countries." [59]

The pre-2003 Commentary presented the opposing majority and minority viewpoints. According to one view, if domestic anti-avoidance rules were given precedence over treaties, economic double taxation might well result. According to the other view, tax treaties should not be abused and, therefore, treaties should not prevent the application of domestic anti-avoidance rules. Despite the fact that "[i]t is not easy to reconcile these divergent opinions," according to paragraph 24 of the pre-2003 Commentary on Article 1, "it is the view of the wide majority that such rules [domestic anti-avoidance rules], and the underlying principles, do not have to be confirmed in the text of the convention to be applicable." Further, according to paragraph 26, "[t]he majority of Member countries accept counteracting measures as a necessary means of maintaining equity and neutrality of national tax laws in an international environment characterised by very different tax burdens."

Overall, the pre-2003 Commentary on Article 1 dealing with the improper use or abuse of tax treaties was confusing. That Commentary attempted to make it clear that most OECD member countries considered domestic anti-avoidance rules against treaty shopping and other forms of treaty abuse to be consistent with the provisions of tax treaties. That Commentary, however, also seemed to go out of its way to recognize the views of the minority of OECD member countries and

[58] This statement was retained in paragraph 22.1 of the 2003 Commentary on Article 1.

[59] No country entered an observation on this aspect of the Commentary on Article 1 because the Commentary also recognized a dissenting view. The OECD practice is that, if the Commentary recognizes alternative interpretations, countries that accept any of those alternatives are not required to register observations on the Commentary indicating that they do not agree with the positions in the Commentary.

to emphasize the limits imposed by tax treaties on the application of domestic anti-avoidance rules in order for them to be consistent with treaties. Although the Commentary recognized that tax treaties should not be abused and should not preclude the application of domestic anti-avoidance rules, paragraph 10 of the Commentary on Article 1 suggested that "[i]t may be appropriate for Contracting States to agree in bilateral negotiations that … the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention."

7.3 Treaties entered into after the 2003 changes to the OECD Commentary

According to paragraph 9.1 of the 2003 Commentary on Article 1 of the OECD Model Convention, there are two fundamental issues involving tax treaties and tax avoidance:

(a) Whether tax treaties can be interpreted and applied to deny treaty benefits with respect to abusive transactions; and
(b) Whether domestic anti-avoidance rules conflict with, and their application is precluded by, tax treaties.

The 2003 Commentary provides a detailed analysis of these two issues. At the outset, the Commentary notes that for many countries, only the second issue is relevant. According to paragraph 9.2 of the Commentary on Article 1, for these countries, any abuse of a tax treaty is an abuse of domestic law because tax is imposed under domestic law; therefore, the only issue is whether the provisions of tax treaties preclude or restrict the application of domestic anti-avoidance rules. For other countries, abuses of a treaty do not necessarily constitute abuses of domestic law, and therefore the issue is whether tax treaties can be interpreted independently of domestic law to deny treaty benefits with respect to abusive transactions (paragraph 9.3). According to paragraph 9.4 of the Commentary, under either of these two approaches, treaty benefits should not be granted with respect to transactions that constitute an abuse of the treaty. Although the Commentary did not provide a definition of an "abusive transaction," it offered "a guiding principle" in paragraph 9.5 that a transaction should be considered to be abusive where a main purpose of the transaction was to obtain treaty benefits and, in the circumstances, providing treaty benefits would be contrary to the object and purpose of the relevant provisions of the treaty. This guiding principle has been retained in the current Commentary on the OECD Model Convention and has been reproduced in the Commentary on Article 1 of the 2017 United Nations Model Convention.

The guiding principle requires only that one of the main purposes, not that the sole or principal purpose, of a transaction is to obtain treaty benefits, but it also requires that granting treaty benefits in the particular circumstances would be contrary to the object and purpose of the treaty. This second requirement is rather vague.

7.4 Treaties with a GAAR

In 2017, an identical GAAR, reproduced in annex A.V, was added to both the United Nations and the OECD Model Conventions.[60] In essence, the guiding principle included in the 2003 Commentary on Article 1 of the OECD Model Convention and in the 2011 Commentary on Article 1 of the United Nations Model Convention, referred to above, has been incorporated into the text of both Model Conventions as a GAAR. The guiding principle has been retained in the Commentary on Article 1 of both Model Conventions because it remains relevant after 2017 for those bilateral treaties that do not contain a GAAR.

The GAAR provides that treaty benefits should not be granted with respect to a transaction if one of the principal purposes of the transaction is to obtain a treaty benefit, unless granting that treaty benefit is in accordance with the object and purposes of the relevant provisions of the treaty. Thus, the treaty GAAR is a combination of a "one of the principal purposes" test and an exception for transactions that produce treaty benefits that are consistent with the object and purpose of the provisions of the treaty.

The effect of putting the GAAR in the text of the Model Conventions rather than leaving it in the Commentary as a guiding principle is significant. If countries include a GAAR in their treaties, there can be no doubt that the rule is binding on the contracting States.

[60] The GAAR is found in Article 29 (9) of both the United Nations and the OECD Model Conventions. See also chapter VI, "Preventing tax treaty abuse", by Graeme S. Cooper.

In contrast, although statements in the Commentary, including the guiding principle, about the interpretation of tax treaties are considered by the tax authorities and the courts of most countries to have persuasive value and are usually given weight, they are not binding.

As a matter of principle, a country's domestic GAAR and the GAAR included in its tax treaties should be consistent. It would not seem reasonable for a country's domestic law to be given more or less protection against abusive tax avoidance than its tax treaties (that is to say, a stronger or weaker domestic GAAR than the treaty GAAR). If the domestic GAAR and the treaty GAAR are not consistent, then in any situation in which both rules apply, the tax treaty rule will take precedence as a result of the general principle that the provisions of treaties prevail over the provisions of domestic law unless, as noted above, the country has taken the necessary steps to ensure that its domestic GAAR overrides its tax treaties. For example, assume that a country adopts a domestic GAAR similar to the IMF sample GAAR in annex A.IV, which applies if the sole or dominant purpose of a transaction is to obtain a tax benefit and does not contain any safety valve; and that the country enters into tax treaties that contain a treaty GAAR similar to the GAAR in the United Nations Model Convention, which applies if one of the principal purposes of a transaction is to obtain treaty benefits but provides an exception for transactions where the treaty benefits are in accordance with the object and purpose of the treaty. In this situation, the treaty GAAR may apply because one of the principal purposes of a transaction is to obtain treaty benefits, although the domestic GAAR does not apply because the principal purpose of the transaction is not to avoid tax; conversely, the domestic GAAR may apply in circumstances where the treaty GAAR does not apply because the treaty GAAR provides an exception for transactions that are in accordance with the object and purpose of the treaty, whereas the domestic GAAR does not provide any similar exception.

8. Administrative aspects of a GAAR

8.1 Assessment

A GAAR is a provision of last resort and, like any anti-avoidance rule, it must be applied by the tax authorities rather than by the taxpayer, even in a self-assessment system. The application of the GAAR by the tax authorities must be in accordance with the general assessment procedures of each country's tax system; however, some special provisions may be necessary or appropriate with respect to an assessment based on the GAAR. For example, it may be necessary to provide specifically that an assessment may be made on persons other than the taxpayer who enters into or carries out the transaction, and, in this case, the tax authorities should be required to give notice to any person affected by a GAAR assessment. Also, persons other than the taxpayer should be entitled to request the tax authorities to make an assessment and relieving adjustments.[61] In addition, an extended period (statute of limitations) for making a GAAR assessment may be appropriate, especially if the tax authorities adopt a special internal procedure for the application of the GAAR, as discussed below, since such a procedure may take considerable time.

The tax authorities should be entitled to use the GAAR as either the sole or primary basis of assessment or as a secondary basis of assessment. In many cases, the issue will be whether a specific statutory provision can be interpreted to negate the effects of a tax avoidance scheme and, if not, whether the GAAR applies. In such a situation, the specific provisions will be the primary basis for the assessment and the GAAR will be the secondary basis.

8.2 Application of a GAAR by the tax authorities

A broad GAAR is a potentially powerful tool for tax officials to use in combating tax avoidance and, as a result, taxpayers and their advisers are concerned that a GAAR might be applied indiscriminately and used as a threat to impose more tax than is properly owed. As noted above, it is important in designing a GAAR that it should be a provision of last resort, to be applied relatively infrequently and only after all the other provisions of a country's tax legislation; however, this may not be sufficient to allay concerns about a fair, cautious and consistent application of the GAAR by the tax authorities. In response, several

[61] For example, if the GAAR is applied to include an amount in a taxpayer's income that was received by another person, that person should be entitled to request that the tax authorities remove that amount from its income.

countries have adopted special measures with respect to the administration of their GAARs. These special administrative measures are especially important at the time a GAAR is first enacted.

There are several types of special measures that might be established for the administration of a GAAR. First, it makes sense for the tax authorities to provide guidance concerning the interpretation and application of the GAAR for the benefit of both tax officials and taxpayers; it would be desirable for this guidance to include examples illustrating the circumstances in which the GAAR will and will not apply.

Second, the application of the GAAR could be subject to the approval of a committee of senior officials from the tax administration, the ministry of finance (officials responsible for tax policy) and officials responsible for litigating tax cases.[62] Consideration might also be given to allowing private sector tax professionals to participate in the approval process, although concerns about taxpayer confidentiality and conflicts of interest may make such participation undesirable. Under an administrative approval process, an auditor wanting to apply the GAAR would be required to refer the case (a detailed description of the transaction and a discussion of the reasons why the GAAR should apply) to the GAAR approval committee; only if the committee approved the application of the GAAR in a particular case would an assessment based on the GAAR be issued. Such a process would provide some confidence to taxpayers that a GAAR would be applied reasonably and consistently.

An administrative approval process can be either formal or informal. An informal process has the advantage of flexibility; it can be modified as necessary and even withdrawn completely if the application of the GAAR becomes relatively clear. In contrast, a formal process, which requires legislative authority, provides greater certainty to taxpayers.

[62] See, for example, the statutory mechanism for the application of the United Kingdom of Great Britain and Northern Ireland GAAR set out in Schedule 43 to Part 5 of the Finance Act 2013. For more information about the General Anti-Abuse Rule (GAAR) Advisory Panel, see https://www.gov.uk/government/groups/general-anti-abuse-rule-advisory-panel.

Many ancillary issues must be considered and resolved if a country decides to adopt some type of formal or informal approval process for the application of the GAAR, including:

- Should the taxpayer be entitled to make written or oral representations to the committee?
- Should the decisions of the committee (in redacted form to protect taxpayer confidentiality) be made available to the public?
- Some mechanism should be adopted to communicate the decisions of the committee and the reasons for those decisions to tax auditors so that they can learn how to apply the GAAR properly.
- Decisions of the GAAR approval committee should not be subject to any further internal administrative review. However, the decisions of the committee should not have any adverse effect on a taxpayer's rights to appeal the application of the GAAR to the courts.
- Should the committee be required to provide written reasons for its decisions? If written reasons are required, the GAAR approval process is likely to be less flexible and efficient.

Third, an advance income tax rulings process could be adopted to deal with the application of a GAAR to proposed transactions. An advance rulings process, which is sometimes referred to as a "clearance" procedure, allows taxpayers to obtain a binding ruling from the tax authorities as to the tax consequences of proposed transactions. One of the most important differences between an administrative GAAR approval committee, as discussed above, and an advance rulings process is that the GAAR approval committee is initiated and controlled exclusively by the tax administration, whereas an advance rulings process is initiated by the taxpayer.

An advance rulings process that includes the application of the GAAR would allow taxpayers to learn whether the tax authorities would apply the GAAR to a proposed transaction before carrying out the transaction. The ruling would not prevent the taxpayer from carrying out the proposed transaction and then contesting the application of the GAAR in the courts; however, it would give the taxpayer the opportunity to abandon the transaction or modify it to make it more acceptable. An advance rulings process with respect to the application of the GAAR would help to ensure the consistent application of the GAAR to proposed transactions, but only to those proposed transactions for which taxpayers request rulings. Therefore, if taxpayers choose not to request advance rulings that involve the possible application of the GAAR, the advance rulings process may not be effective in ensuring the reasonable and consistent application of the GAAR. Another issue is whether it is desirable for the tax authorities to provide advance rulings with respect to proposed transactions that potentially involve abusive tax avoidance. Some tax authorities may consider it preferable to impose all the risk concerning the application of the GAAR to proposed transactions on taxpayers, with the expectation that the uncertainty will deter taxpayers from undertaking risky transactions.

8.3 Penalty

One of the most controversial issues with respect to the adoption of a GAAR is whether a financial penalty should be imposed when the GAAR applies to a taxpayer's transaction. Tax practitioners usually argue that the imposition of a penalty is inappropriate because the application of a GAAR is uncertain and taxpayers should not be penalized because a court determines after the fact that the taxpayer's transaction was unacceptable. Admittedly, there is sometimes a fine line between abusive tax avoidance and acceptable tax planning. However, one of the purposes of a GAAR is to discourage taxpayers from engaging in aggressive tax planning transactions that they hope will not be found by the courts to be offensive. For many taxpayers, tax avoidance is a matter of a risk/reward analysis: they will carry out avoidance transactions if the tax saving from a transaction outweighs the costs — namely, the tax consequences if the transaction turns out to be ineffective. The costs incurred by a taxpayer if a transaction is found to be subject to the GAAR include the tax payable, interest on the unpaid tax (the cost is reduced if the interest is deductible) and any penalty. If a penalty is not imposed, the only costs incurred by the taxpayer would be the tax payable (which would have been payable even if the taxpayer had not carried out the avoidance transaction) and interest on the unpaid tax (which the taxpayer might be able to offset — for example, by investing the amount of the unpaid tax).

The imposition of a penalty in connection with the application of a GAAR can be justified as reasonable and necessary for the effectiveness of a GAAR. Abusive tax avoidance imposes serious costs on the tax system in terms of the resources devoted to combat it, and, if unchecked, the revenue lost must be borne by other taxpayers. The GAAR penalty could be imposed as a percentage of the tax that was sought to be avoided or could be left to the discretion of the judges.

9. Conclusion

Abusive tax avoidance is a serious problem that erodes a developing country's tax base. Combating abusive tax avoidance necessitates a multifaceted approach involving both legislative anti-avoidance measures and robust enforcement efforts. The experience of many countries indicates that a statutory GAAR in domestic law can be an important tool for developing countries to use against abusive tax avoidance. Such a GAAR can make it possible for countries to deter abusive tax avoidance before it occurs rather than try to attack transactions after they occur and then, if the attack fails, enact specific anti-avoidance rules to deal with abusive transactions.

The design of a GAAR involves several difficult choices with respect to the scope of the rule and the conditions for its application in order to balance the need to combat abusive tax avoidance while, at the same time, not discouraging legitimate commercial transactions. However, several countries have extensive experience with a GAAR and their GAARs can be used as models for other countries in designing a GAAR. These models are remarkably consistent. Although countries may need to modify them to reflect their particular circumstances, they should be cautious about adopting a radically different approach from the approach taken by other countries. Once a country has enacted a GAAR, its effectiveness should be closely monitored and, if necessary, the rules should be amended to ensure that it operates effectively to counter abusive tax avoidance.

Annex

Selected general anti-avoidance rules

A. I

Canada, Income Tax Act, Part XVI (Section 245)

Tax Avoidance

Definitions

(1) In this section:

tax benefit means a reduction, avoidance, or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance, or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty;

tax consequences to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount;

transaction includes an arrangement or event.

General anti-avoidance provision

(2) Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

Avoidance transaction

(3) An avoidance transaction means any transaction:

(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.

Application of subsection (2)

(4) Subsection (2) applies to a transaction only if it may reasonably be considered that the transaction:

(a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of:

(i) this Act,

(ii) the *Income Tax Regulations*,

(iii) the *Income Tax Application Rules*,

(iv) a tax treaty, or

(v) any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in determining any amount that is relevant for the purposes of that computation; or

(b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.

Determination of tax consequences

(5) Without restricting the generality of subsection (2), and notwithstanding any other enactment:

(a) any deduction, exemption, or exclusion in computing income, taxable income, taxable income earned in Canada, or tax payable or any part thereof may be allowed or disallowed in whole or in part,

(b) any such deduction, exemption or exclusion, any income, loss, or other amount or part thereof may be allocated to any person,

(c) the nature of any payment or other amount may be recharacterized, and

(d) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,

in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction.

Request for adjustments

(6) Where with respect to a transaction:

(a) a notice of assessment, reassessment or additional assessment involving the application of subsection 245(2) with respect to the transaction has been sent to a person, or

(b) a notice of determination pursuant to subsection 152(1.11) has been sent to a person with respect to the transaction,

any person (other than a person referred to in paragraph (a) or (b)) shall be entitled, within 180 days after the day of sending of the notice, to request in writing that the Minister make an assessment, reassessment, or additional assessment applying subsection (2) or make a determination applying subsection 152(1.11) with respect to that transaction.

Exception

(7) Notwithstanding any other provision of this Act, the tax consequences to any person, following the application of this section, shall only be determined through a notice of assessment, reassessment, additional assessment or determination pursuant to subsection 152(1.11) involving the application of this section.

Duties of Minister

(8) On receipt of a request by a person under subsection 6, the Minister shall, with all due dispatch, consider the request and notwithstanding subsection 152(4), assess, reassess, or make an additional assessment or determination pursuant to subsection 152(1.11) with respect to that person, except that an assessment, reassessment, additional assessment or determination may be made under this subsection only to the extent that it may reasonably be regarded as relating to the transaction referred to in subsection 6.

A.II

China: Article 47 of the Enterprise Income Tax Law

If an enterprise enters into any business arrangement without a reasonable business purpose that results in a reduction of taxable revenue or income, the tax authority has the power to make adjustments based on reasonable methods.

A "business arrangement without a reasonable business purpose" is defined to mean "arrangements whose main purpose is to reduce, avoid or defer tax payments." Art. 120 EIT Regulations

A.III

South Africa: Income Tax Act No. 58 of 1962

Part IIA

Section 80A Impermissible tax avoidance arrangements

An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and—

(a) in the context of business—

  (i) it was entered into or carried out by means or in a manner which would not normally be employed for *bona fide* business purposes, other than obtaining a tax benefit; or

  (ii) it lacks commercial substance, in whole or in part, taking into account the provisions of section 80C;

(b) in a context other than business, it was entered into or carried out by means or in a manner which would not normally be employed for a *bona fide* purpose, other than obtaining a tax benefit; or

(c) in any context—

  (i) it has created rights or obligations that would not normally be created between persons dealing at arm's length; or

(ii) it would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this Part).

80B Tax consequences of impermissible tax avoidance

(1) The Commissioner may determine the tax consequences under this Act of any impermissible avoidance arrangement for any party by—

(a) disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement;

(b) disregarding any accommodating or tax-indifferent party or treating any accommodating or tax-indifferent party and any other party as one and the same person;

(c) deeming persons who are connected persons in relation to each other to be one and the same person for purposes of determining the tax treatment of any amount;

(d) reallocating any gross income, receipt or accrual of a capital nature, expenditure or rebate amongst the parties;

(e) re-characterising any gross income, receipt or accrual of a capital nature or expenditure; or

(f) treating the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit.

(2) Subject to the time limits imposed by section 99, 100 and 104(5)(b) of the Tax Administration Act [2011], the Commissioner must make compensating adjustments that he or she is satisfied are necessary and appropriate to ensure the consistent treatment of all parties to the impermissible avoidance arrangement.

80C Lack of commercial substance

(1) For purposes of this Part, an avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party (but for the provisions of this Part) but does not have a significant effect upon either the business risks or net cash flows

of that party apart from any effect attributable to the tax benefit that would be obtained but for the provisions of this Part.

(2) For purposes of this Part, characteristics of an avoidance arrangement that are indicative of a lack of commercial substance include but are not limited to—

(a) the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps; or

(b) the inclusion or presence of—

(i) round trip financing as described in section 80D; or

(ii) an accommodating or tax indifferent party as described in section 80E; or

(iii) elements that have the effect of offsetting or cancelling each other.

80D Round trip financing

(1) Round trip financing includes any avoidance arrangement in which—

(a) funds are transferred between or among the parties (round tripped amounts); and

(b) the transfer of the funds would—

(i) result, directly or indirectly, in a tax benefit but for the provisions of this Part; and

(ii) significantly reduce, offset or eliminate any business risk incurred by any party in connection with the avoidance arrangement.

(2) This section applies to any round tripped amounts without regard to —

(a) whether or not the round tripped amounts can be traced to funds transferred to or received by any party in connection with the avoidance arrangement;

(b) the timing or sequence in which round tripped amounts are transferred or received; or

(c) the means by or manner in which round tripped amounts are transferred or received.

(3) For the purposes of this section, the term **"funds"** includes any cash, cash equivalents or any right or obligation to receive or pay the same.

80E Accommodating or tax-indifferent parties

(1) A party to an avoidance arrangement is an accommodating or tax-indifferent party if—

(a) any amount derived by the party in connection with the avoidance arrangement is either—

(i) not subject to normal tax: or

(ii) significantly offset either by an expenditure or loss incurred by the party in connection with that avoidance arrangement or any assessed loss of that party; and

(b) either—

(i) as a direct or indirect result if the participation of that party an amount that would have—

(aa) been included in the gross income (including the recoupment of any amount) or receipts or accruals of a capital nature of another party would be included in the gross income or receipts or accruals of a capital nature of that party;

(bb) constituted a non-deductible expenditure or loss in the hands of another would be treated as a deductible expenditure by that other party;

(cc) constituted revenue in the hands of another party would be treated as capital by that other party; or

(dd) given rise to taxable income to another party would either not be included in gross income or be exempt from normal tax; or

(ii) the participation of that party directly or indirectly involves a prepayment by any other party.

(2) A person may be an accommodating or tax-indifferent party whether or not that person is a connected person in relation to any party.

(3) The provisions of this section do not apply if either—

(a) the amounts derived by the party in question are cumulatively subject to income tax by one or more spheres of government of countries other than the Republic which is equal to at least two-thirds of the amount of normal tax which would have been payable in connection with those amounts had they been subject to tax under this Act; or

(b) the party in question continues to engage directly in substantive active trading activities in connection with the avoidance arrangement for a period of at least 18 months: Provided these activities must be attributable to a place of business, place, site, agricultural land, vessel, vehicle, rolling stock or aircraft that would constitute a foreign business establishment as defined in section 9D(1) if it were located outside the Republic and the party in question were a controlled foreign company.

(4) For the purposes of subsection (3)(a), the amount of tax imposed by another country must be determined after taking into account any applicable agreements for the prevention of double taxation and any assessed loss, credit or rebate to which the party in question may be entitled or any other right of recovery to which that party or any connected person in relation to that party may be entitled.

80F Treatment of connected persons and accommodating or tax-indifferent parties

For the purposes of applying section 80C or determining whether or not a tax benefit exists for purposes of this Part, the Commissioner may—

(a) treat parties who are connected persons in relation to each other as one and the same person; or

(b) disregard any accommodating or tax-indifferent party or treat any accommodating or tax-indifferent party and any other party as one and the same person.

80G Presumption of purpose

(1) An avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining

a tax benefit unless and until the party obtaining a tax benefit proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.

(2) The purpose of a step in or part of an avoidance arrangement may be different from a purpose attributable to the avoidance arrangement as a whole.

80H Application to steps in or parts of an arrangement

The Commissioner may apply the provisions of this Part to steps in or parts of an arrangement.

80I Use in the alternative

The Commissioner may apply the provisions of this Part in the alternative for or in addition to any other basis for raising an assessment.

80J Notice

(1) The Commissioner must, prior to determining any liability of a party for tax under section 80B, give the party notice that he or she believes that the provisions of this Part may apply in respect of an arrangement and must set out in the notice his or her reasons therefor.

(2) A party who receives notice in terms of subsection (1) may, within 60 days after the date of that notice or such longer period as the Commissioner may allow, submit reasons to the Commissioner why the provisions of this Part should not be applied.

(3) The Commissioner must within 180 days of receipt of the reasons for the expiry of the period contemplated in subsection (2)—

(a) request additional information in order to determine whether or not this Part applies in respect of an arrangement;

(b) give notice to the party that the notice in terms of subsection (1) has been withdrawn; or

(c) determine the liability of that party for tax in terms of this Part.

(4) If at any stage after giving notice to the party in terms of subsection (1), additional information comes to the knowledge of the Commissioner, he or she may revise or modify his or her reasons for applying this Part or, if the notice has been withdrawn, give notice in terms of subsection (1).

80L Definitions

For purposes of this Part—

"***arrangement***" means any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property;

"***avoidance arrangement***" means any arrangement that, but for this Part, results in a tax benefit;

"***impermissible avoidance arrangement***" means any avoidance arrangement described in section 80A;

"***party***" means any—

(a) person;

(b) permanent establishment in the Republic of a person who is not a resident;

(c) permanent establishment outside the Republic of a person who is a resident;

(d) partnership; or

(e) joint venture,

who participates or takes part in an arrangement;

"***tax***" includes any tax, levy or duty imposed by this Act or any other law administered by the Commissioner;

"***tax benefit***" includes any avoidance, postponement or reduction of any liability for tax.

A.IV

International Monetary Fund: sample general anti-avoidance rule[a]

Tax avoidance schemes

(1) This section applies when the Tax Authority is satisfied that:
  (a) a scheme has been entered into or carried out;
  (b) a person has obtained a tax benefit in connection with the scheme; and
  (c) having regard to the substance of the scheme, it would be concluded that a person, or one of the persons, who entered into or carried out the scheme did so for the sole or dominant purpose of enabling the person referred to in paragraph (b) to obtain a tax benefit.

(2) Despite anything in this Act, when this section applies, the Tax Authority may determine the tax liability of the person who obtained the tax benefit as if the scheme had not been entered into or carried out, or as if a reasonable alternative to entering into or carrying out the scheme would have instead been entered into or carried out, and can make compensating adjustments to the tax liability of any other person affected by the scheme.

(3) If a determination or adjustment is made under this section, the Tax Authority must issue an assessment giving effect to the determination or adjustment.

(4) An assessment under subsection (3) must be served within 5 years from the last day of the tax year to which the determination or adjustment relates.

(5) In this section:

"***scheme***" includes any course of action, agreement, arrangement, understanding, promise, plan, proposal, or undertaking, whether express or implied and whether or not enforceable;

[a] Christophe Waerzeggers and Cory Hillier, *Introducing a General Anti-Avoidance Rule (GAAR)* Tax Law IMF Technical Note vol. 01/2016 (Washington: International Monetary Fund, 2016).

"***tax benefit***" means:

(a) a reduction in a liability to pay tax, including on account of a deduction, credit, offset or rebate;

(b) a postponement of a liability to pay tax;

(c) any other advantage arising because of a delay in payment of tax; or

(d) anything that causes:

  (i) an amount of gross revenue to be exempt income or otherwise not subject to tax; or

  (ii) an amount that would otherwise be subject to tax not to be taxed.

A.V

Article 29 (9) of the United Nations Model Convention: general anti-abuse rule

9. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

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