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The Platform for Collaboration on Tax

Submitted by email: GlobalTaxPlatform@worldbank.org

October 20, 2017

Ref: DISCUSSION DRAFT: THE TAXATION OF OFFSHORE INDIRECT TRANSFERS – A TOOLKIT

Dear Members of the Platform for Collaboration on Tax,

BIAC is pleased to have the opportunity to comment on the Discussion Draft: The Taxation of Offshore Indirect Transfers – A Toolkit (the "Discussion Draft") issued on 1 August 2017. However, in our view, the Discussion Draft (which "continues to be commented on and reviewed by the Platform partners") still requires substantial work and should be further refined and then released again for additional public comment.

We are concerned that the focus of the Discussion Draft appears to be more on encouraging countries to take the decision to tax Offshore Indirect Transfers (OITs), than it is on encouraging and facilitating a uniform approach for consistent and equitable implementation once countries have made the complex policy decision to tax OITs. We believe whether OITs should be taxed or not (and whether that should be within or outside of a treaty framework) is a matter for sovereign nations to decide based upon their own policy objectives and should thus not be considered in the context of a "toolkit". Nevertheless, the Discussion Draft proposes potentially significant shifts in taxing rights for "source" and "residence" countries. Decisions on significant shifts in taxing rights ought to be debated among countries in the appropriate multilateral forum and not resolved by guidance of this type issued without debate among the countries. Our understanding of what the toolkits were meant to be was that they should be a box of tools – or a "how to" manual – to ensure that developing countries (in particular) could design tax rules to were clear, administrable, and as simple as possible in order to enhance certainty and (we assume) economic growth in those countries. Put slightly differently, they were to be the practical guide to implementing some of the complex BEPS decisions that could otherwise overburden some tax authorities. They were not, however, intended to articulate new tax policy considerations and recommendations as this document appears to do.

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Just to highlight a number of specific concerns in the document, which we spell out in more detail in the attachment, we would note:

- When advising on the options to tax, sufficient consideration should be given to ensure maximum neutrality and symmetry in dealing with offshore indirect transfers. Furthermore, there should be a focus on ensuring that economic decisions are not distorted by tax rules. Various issues are very relevant to consider in relation to indirect transfers, including (for example), how to determine the potential capital gain, how to ensure a step up in asset value, whether deferral is possible, how to limit the scope to ensure most effective taxation whilst avoiding unintended taxation and how to deal with offshore indirect capital losses. In our view, these important issues have not been adequately addressed in the Discussion Draft.

- In particular, too little attention is given to the difficult area of valuation. We recommend that further thought be given to the situations where the inherent value of assets will be realised through locally generated (taxable) profits rather than ever increasing capital gains. We have outlined high-level responses to some of the questions raised by the Discussion Draft to illustrate our specific concerns, but hope to have an opportunity for further, more detailed responses to a revised discussion draft.
- The Toolkit must also avoid the inference that all companies seek to aggressively avoid taxes. This perception would encourage countries to introduce far broader measures than may be necessary in order to protect their tax bases (e.g. imposing taxation on indirect transfers only in abusive cases, thus allowing them to focus their attention on tax abuse while limiting unintended consequences to investments). More targeted anti-abuse measures could be achieved (or complemented) by advance rulings. Under such regimes, the appropriate considerations would differ from those put forward in the Discussion Draft (for example, burden of proof, motive vs main benefits, etc).
- Finally, we note that demands for tax that are not clearly supported by underlying tax law will be problematic for companies to comply with, so it imperative that such laws are clear. Payment of undue taxes could result in such taxes being non-creditable at best, and expose businesses to anti-bribery and corruption concerns, at worst. So, it is imperative that all such issues are considered further.

Notwithstanding our general concerns, we have answered the questions posed in the Discussion Draft in Appendix I.

Again, we thank you for the opportunity to comment on this Discussion Draft, but encourage you to issue another draft for discussion and look forward to the opportunity to provide additional comments when the Toolkit has been fully commented on and reviewed by the Platform partners.

Sincerely,

Will Morris

Will Morris, Chair
BIAC Tax Committee

Appendix I: Responses to Questions

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

As a general matter, we question why the Toolkit should address the rationale for taxing OITs, except to the extent that the policy rationale behind each country's sovereign decision to tax is relevant to implementation.

Notwithstanding this, BIAC does not believe that the Toolkit does effectively address the rationale(s) for taxing OITs of assets. The Discussion Draft assumes that the "source" country has the primary right to tax the gain on the underlying property and does not discuss the rationale for residence based taxation of that property. It misstates the current treaty rule – where tax treaties exist, the country of residence generally has the right to tax all income and gains other than where explicitly provided for in the treaty. We believe that the political economy argument focuses on a few high-profile cases that are not representative of the vast majority of asset transfers, whether direct or indirect. Such might be more appropriately dealt with narrower targeted rules.

Additionally, we do not believe that indirect transfer taxation should be promoted as a method to finance public spending and stimulate growth. In countries where capital gains taxation is present, introduced or expanded, it is likely less transfers of ownership will occur regarding prospects, potentially leaving them under-developed (either in efficiency or time). For example, transfers to ensure the most appropriate party is involved in the prospect may not occur where the tax cost of transfer is too high. The capital gains tax will likely also be grossed up in the calculations for the transfer, making the prospects relatively more expensive and equally reducing their ability to be transferred.

Overall, investors look to after-tax cash flows, and therefore the tax burden, whilst not in itself conclusive, will always be a factor that impacts investment decisions. Tax systems are often specifically designed to encourage investment and increase employment. As capital is constrained, investors will compare alternatives, typically considering total retained cash. Especially for extractive industries, corporate taxation and capital gains taxation are only part of the overall burden that affects retained cash (e.g. royalties and signing bonuses bring forward the timing of taxation, potentially before any prospect becomes profitable). Having a capital gains tax and/or an indirect capital gains tax can further frontload the timing of taxation, pushing the point of return of investment further back. If a local system is already frontloaded, policy makers need to consider whether to introduce or expand their capital gains taxation in that context. In addition, introducing capital gains taxation ignores the economic double taxation of taxing the future income stream upfront on a disposal, and then again as the new owner realises income and pays tax (and other economic contributions to society) in the country where the asset is located. Indirect capital gains taxes further increase that risk of double taxation.

It would therefore seem to be more important for policy makers in developing countries to be fully informed (in a balanced fashion) and made aware of pros and cons of OITs in order to end up with predictable and clear tax systems. Having a tax regime that is based on the consistent and predictable application of principles-based tax rules can help to promote and attract investment. Principles and rules should be transparent, proportionate, administrable, fair, reasonably certain, conducive to timely determination of results and avoid double taxation of profits or non-deduction of costs. Trying to tax transactions ad hoc, in contravention to agreed taxing rights should be discouraged. Clearly presenting pros and cons of capital gains taxation seems like a better approach to allow countries to make an informed decision on how to approach this in a manner that achieves their aims.

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

In our view, the two proposals are clear in their general outlines, but as noted below in our response to Question 9 many difficult issues are ignored or treated cursorily.

For example, the focus of taxation for OITs should remain centred on immovable property (e.g. mining rights and land) which should capture the assets capable of generating significant location-specific rents in that country, but should not extend to the value created attributable to historic intellectual property and knowhow developed by a group outside of the local country. The Discussion Draft notes on page 21 that "[t]he increased value of the entity sold may reflect in part managerial and other expertise contributed by the seller, beyond what has been recovered in managerial fees, royalties and other explicit payments." However, the guidance addressing this counterargument is considerably limited. This notion of increased value is particularly relevant for any group that may provide substantial technical and engineering expertise into a project, which is often not available in the local country and this topic (along with the other topics notes in our response to Question 9), appear to be largely glossed over.

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

We do not believe that the definition of an OIT of assets is satisfactory. The example deals with the simplest of cases and the rules would need to adopt and define many thresholds if these rules are to be practical in application. For example, the definition of an OIT of assets in the Discussion Draft fails to include or even discuss the possibility of exemptions for reorganisations where no economic disposal takes place. The importance of appropriate exemptions in such circumstances cannot be overstated. Special consideration must be given to excluding internal reorganisations where there is no indirect change in control as it is quite common for assets to be indirectly transferred to other parts of a commonly-controlled group in order to meet other corporate objectives and improve coordination and efficiency in the identification and development of local assets.

The Draft Discussion touches on the exemptions considered by the OECD MTC such as:

> *"…it could exclude from taxation alienators holding below a certain minimum level of participation in the entity; or the sale of shares of companies listed in an approved stock market, or gains from transfers of shares in a corporate reorganization."*

We believe the Toolkit should go further and make clear recommendations on how a country could introduce sensible exemptions into domestic legislation to address such scenarios. For example, we understand that such reorganisation provisions are missing from recently enacted laws in Namibia designed to target OITs where there is an underlying interest in a mineral license or right to mine minerals. By making the need for such provisions explicit in the Toolkit, it is more likely that there will be consistent implementation across taxing jurisdictions.

The Toolkit simply fails to address a number of critical issues including how to address listed companies and how to deal with Joint Venture partners of a company transferring its ownership. With regards to listed companies, when countries consider expanding their capital gains taxation to indirect transfers, all share transfers could create concerns. Shares in some companies may change hands frequently so when assessing whether >50% of ownership has changed during any time period, it would create uncertainty on how to consider normal day to day trading of a company's shares.

In the event of a Joint Venture partner transferring its ownership, at what point is a capital gains tax triggered when only one partner transfers, either all or part of its ownership, whether or not in a phased sale? Additionally, who is liable and how would a step up in basis work in a JV scenario? Finally, how do the proposed approaches envisage funding to be made available to a JV?

These outstanding questions should clearly support the need for this Discussion Draft to be further refined and released for additional public comment.

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

We do not believe the discussion regarding source and residence taxation in this context is balanced or robustly argued, and, as noted above, we are concerned that this question is raised in a Toolkit aimed at assisting with implementation rather than as a discussion between the related sovereign nations. In addition to the points raised in our response to Question 1, this discussion is lacking in providing developing countries with the proper guidance and tools to address double taxation where the possibility of both source and residence taxation exists. A discussion of this topic is of little value without practical recommendations for arriving at a solution.

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

BIAC does not believe that the suggested possible expansion of the definition of immovable property is reasonable. The Discussion Draft abandons the treaty definition of immovable property and advocates an expansive definition of immovable property, which the draft itself acknowledges would be difficult to capture in legislative language. This is a prescription for uncertainty and double taxation.

The definition of immovable property is a critical issue and the policy objective for a country wishing to ensure a taxing right over gains realised on finite mineral resources sourced in that country is understandable (notwithstanding the view that this value is better taxed through levies on output as it is extracted, than through a capital gains tax). However, we believe strongly that the proportion of the gain realised by a non-resident upon which a given country is permitted to tax, is restricted only to that portion related to immovable property in that given country. We would not consider telecommunications and broadcast spectrum / networks assets to be immovable property in this sense. We also note that the telecommunications and extractives industries are already subject to a wide range of taxes, including industry specific taxes in many cases designed to meet local policy objectives.

Taxing the immovable property of an extractive should capture most, if not all, of the assets within a mining operation that generate significant location-specific rents in that country. An expansion of immovable property to target other assets could risk overstepping the reach of the source country by incorrectly permitting the taxation of value that was generated in the non-resident's country, or a third country where the group may have investments.

Through attaching the non-resident capital gain to the value of appropriately defined immovable property, this ensures that the non-resident capital gain is limited to the amount which is clearly local country sourced. It is often the case that reliance on double taxation treaties is required to arrive at this position, as often the source country will already try to assert a taxing right over a whole gain made by a non-resident on an OIT where only a percentage of that gain is attributable to underlying immovable property in the source country.

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

We do not find the concept of location-specific rents helpful in addressing these issues. As the Discussion Draft acknowledges, access to a local market could be considered to generate location specific rents. A concept that is intended to be interpreted expansively and that is poorly defined will be interpreted in ways that will reduce certainty and deter investment.

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

We have no specific comments at this time related to alternative implementation approaches as we do not believe the Discussion Draft has adequately addressed the underlying principles that should be first considered by countries in deciding whether to tax OITs (if, indeed, that is deemed an appropriate starting point for such a Toolkit). We would like to take this opportunity, however, to stress that a revised Discussion Draft should make it clear that proposed legislation be applied only on a forward-looking basis. The commercial projects at issue are often very long-term in nature and are entered into a view of the tax treatment over the entire life of a project. Therefore, we strongly believe that new domestic provisions should not have retroactive or retrospective effect, and this could be achieved through the inclusion of grandfathering provisions to support certainty and stability on tax treatment of existing long-term projects (including those critical for the economy such as natural resource exploitation and infrastructure).

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

Before discussing the two proposed Models, the Discussion Draft should deal with considerations of symmetry and neutrality in a more broad sense. Such aspects help to address double taxation concerns in many capital gains tax systems and should be made available in the Toolkit.

Whilst the Toolkit recognises that transfers of assets – either directly or indirectly – can generate capital gains as well as capital losses, none of the options deal with what to do when indirect transfers/offshore indirect transfers result in a loss. The summary several times emphasises the need for neutrality between direct and indirect transfers of capital gains. Various capital gains tax systems actually exist that provide tax neutrality for share transactions, provided the profit generating assets remain in the country. Although the Toolkit supports tax neutrality in principle, it does not provide enough detail on such or other approaches that actually induce tax neutrality.

Symmetry in tax treatment is also not developed in the Toolkit. Generally, tax policy that taxes capital gains allows deductibility of losses. If the Platform intends to make the case that where capital gains are taxed, indirect capital gains should also be taxed, then it must at least detail how to deduct indirect capital losses to limit the taxation to double taxation rather than multiple taxation.

We do not believe the Toolkit, as currently drafted, provides the detail and analysis necessary to support a preference for either Model 1 or Model 2. We look forward to an additional opportunity for public comment to address this question following refinement of the Discussion Draft. At a high-level, however, we note several specific issues that would need to be addressed regarding Model 1 (taxation of a deemed direct sale by a resident) and Model 2 (taxation of the non-resident seller):

- Under Model 1, the tax charge is levied upon the underlying in-country investment being purchased. This runs counter to the principal that a capital gain tax should be levied upon the person making that capital gain (i.e., the investor making the disposal). It seems logical that the tax liability on a capital gain is directly suffered by the entity making a disposal and receiving proceeds, which it can use to settle that liability.

- Model 2 appears to better address (albeit does not eliminate) the risk of double taxation by attaching the capital gains tax on OITs to the non-resident person making the disposal. Indeed, the Discussion Draft appears to acknowledge this deficiency with Option 1, but provides no reasonable solution.

- Under Model 1, it is not clear that an investor would receive any protection under a double tax treaty. Investors should be able to rely upon treaties to ensure that they are not taxed in both states on the same gain. We do not see any economic difference between double taxation of the same legal entity, and double taxation of the same gain in two separate legal entities.

- The calculation under the 'deemed disposal' method of Model 1 is fairly untargeted, and is calculated upon all assets of the local company. This may allow tax authorities to inappropriately tax value changes on company assets which fall far outside the traditional definition of immovable property. For example, for an extractive asset this could include stockpiles of extracted resources included within inventory, mining equipment, or even non-mining assets.

- Model 1 and Model 2 both present considerable issues related to determining the value of the actual gain. The Toolkit seems to correctly imply that the gain should be considered (rather than the proceeds). However, further clarification is required on what assets the gains taxation should apply to, and how they are to be allocated and valued. It is important here to have generally accepted source material. For example, the Discussion Draft references a study by *Beer and Loeprick* but the approach to that study is problematic, leading to results that are not consistent with the experience of multinational oil and gas companies and valuators.

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

BIAC does not believe the Discussion Draft adequately represents the complexities in the taxation of these international transactions. The simplified example that forms the basis of the analysis contained in the Discussion Draft ignores the complexities involved in determining whether the transaction should be subject to tax. The Discussion Draft also ignores or provides limited commentary on critical topics such as the difficulties dealing with minority shareholders, valuation issues, foreign exchange, the tax base, the treatment of losses, and how economic multiple-taxation should be avoided.

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