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The Platform for Collaboration on Tax

Submitted by email: GlobalTaxPlatform@worldbank.org

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Ref: DRAFT VERSION 2: THE TAXATION OF OFFSHORE INDIRECT TRANSFERS – A TOOLKIT

Dear Members of the Platform for Collaboration on Tax,

Business at OECD (BIAC) is pleased to have an opportunity to comment on the DRAFT Version 2: The Taxation of Offshore Indirect Transfers – A Toolkit issued on 16 July 2018 (the "Revised Toolkit"). We welcome the revision of the previous discussion draft and the effort made by the Platform for Collaboration on Tax (the "Platform") to provide further clarification and guidance.

We were pleased to find a clear statement as to the purpose and status of the Revised Toolkit, namely that it does "not purport to provide binding rules or authoritative provisions of any kind nor does it aim to establish an international tax policy standard of any kind."[1] We welcome many of the changes made, including the removal of the explicit endorsement of the Model 1 option; the recognition that countries may affirmatively choose not to tax gains on offshore indirect transfers (OITs); the softened language around expanding the application of taxation of OITs to a wider class of assets; and, the reduction of the focus on political pressures.

However, we still have several substantive concerns with the Revised Toolkit as drafted. Most notably, by making the Revised Toolkit a more "general" document, it unfortunately does not address the complexities of common scenarios (e.g., reorganisations, minority owners, etc.) faced in practice. This could result in rules being implemented without full consideration of the complex issues involved. This in turn could result in inconsistent and incoherent rules, and in double taxation, increased uncertainty, more disputes, less investment and lower economic growth.

Again, we thank you for the opportunity to comment on the Revised Toolkit, reiterate our welcome for many elements of the Revised Toolkit and look forward to the opportunity to engage further before the document is finalised, especially on adding some more detail. More extensive comments on the Revised Toolkit are attached.

Sincerely,

Will Morris

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Chair BIAC Tax Committee

[1] See Revised Toolkit, page 11.

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General Comments

The Revised Toolkit takes the explicit position that such guidance is "general in nature and in the form of simplified rules-based legal provisions" and does "not deal comprehensively with more complex issues."[2] We understand that it is impractical and likely impossible to address all the difficulties that may arise under every fact pattern that may apply with regards to OITs. However, the Revised Toolkit should, at a minimum, emphasise the importance of dealing with these technical issues and provide some guidance on the ways in which they could be addressed and the implications of the policy decisions around these options. In our view, providing a complete picture (including all relevant considerations) is critical to providing developing countries with a practical understanding of the full implications of their policy choices.

We believe that general guidance on the two proposed models is less relevant and helpful than considering necessary design features that would help deal with economic and juridical double taxation. The lack of such aspects – step-up in basis, options for a deferral or spread of capital gains taxation, ensuring credit systems in countries for taxes already paid, etc. – greatly undermines the value of the Revised Toolkit, especially to resource limited Tax Administrations that will be relying on such guidance. We therefore consider that the Revised Toolkit will be a missed opportunity if it is not revised to take such areas into account.

It is critical that the Platform add additional commentary regarding the technical difficulties of dealing with (inter alia) minority interests, corporate reorganisations, treatment of losses, listed shares, group takeovers and valuation. Additional commentary on these items is provided in our specific comments section below.

Additional Specific Comments

Oversimplification

As noted above, while it may be impossible to address all the difficulties that may arise with certain, specific issues, the guidance should emphasise the importance of dealing with those issues, including by using the word "should" instead of "could" throughout the draft when discussing policy choices where there should be a clear preference for addressing an issue (acknowledging, however, that different policy choices might be made by individual countries). The examples and analysis only deal with very simplistic scenarios that are unlikely to reflect the realities of reorganisations (share/asset sales) within large international groups or transformational acquisitions of an international global business.

When discussing various options for a local disposition, the Revised Toolkit does not address business or legal consequences at any length. While it is true that tax considerations are likely considered in such analyses, tax considerations are only part of the picture and are likely to be less important than business consideration. For example, businesses are not normally disposing of an asset or business to simply recognise gain. Normally, such dispositions are driven by the business as

[2] See Revised Toolkit, page 40.

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it believes the operations no longer fit within the group's strategic priorities, or it would be more economically efficient (and deliver the best value to their shareholders and other stakeholders) if another actor were to continue the activities. Also, sellers and buyers have different interests when it comes to a sale or purchase respectively. The buyer may prefer a carve-out of assets, so that it acquires only and exactly what it wants (or limits its potential legal exposure) – whereas the seller may want to dispose of an entire business for legal liability, contracting or simplicity purposes. Moreover, where there is a transformation acquisition, the buyer is acquiring a global business, far from a single asset/assets acquisition (e.g., hundreds of entities in different jurisdictions) – normally also involving thousands of shareholders selling millions of shares through a public offer in the stock-exchange, approval from different national and international agencies, and various business integration plans. In our view, these concerns are much more likely to drive the structure of the ultimate deal versus the specific tax considerations. However, such considerations are entirely absent from the guidance.

Business at OECD believes that adding in the business considerations that influence the structure of the arrangement and dealing more comprehensively with tax policy design would support limiting the application of OIT rules to the cases in which taxes are likely to play an important role in structuring the transaction or where tax considerations are likely to be more important or create distortive results.

Currently the Revised Toolkit mentions reorganisations and states that the report is not concerned with transfers of this kind.[3] However, we believe the guidance should provide additional clarity by including another subsection to covering reorganisations in Box 5: Change in Control.[4] Similarly, treatment of minority shareholders is mentioned, but not addressed in any level of detail. In our view, publicly-traded stock, reorganizations or group takeovers should be categorically excluded from taxation and there ought to be thresholds to application to avoid certain unreasonable burdens. These types of provisions would highlight the need to consider such exemptions and perhaps serve as acknowledgement that such exceptions are sensible and warranted.

We would welcome additional thought and guidance on the question of value and calculation of gain/loss on the OIT. This is an incredibly complicated process of, at a high-level, determining (1) what assets are subject to the OIT regime, (2) calculating the tax basis of such assets, and (3) determining the applicable value of such assets. Often these immovable assets are part of a larger business operation that is being transferred. On this point, we believe further thought should be given to the situations where the inherent value of assets will be realised through locally generated (taxable) profits.

For the sake of clarity and a comprehensive guidance for developing countries, the guidance cannot leave unexplained these issues as they are core areas of interest for stakeholders, including Tax Authorities. Another area of particular concern is section "C: The Allocation of Taxing Rights on OITs:

[3] See Revised Toolkit, page 12.
[4] For example, an additional subsection could be added to Box 5 providing that subsection 3 does not apply to the extent the change in direct or indirect ownership would satisfy country L provisions concerning corporate reorganisations if the transaction were a domestic transaction.

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Equity and Efficiency Considerations."[5] In this section, the Revised Toolkit appears to only refer to taxing "gains" when explaining concepts as "fairness," "efficiency," etc. We find that this section should include the tax treatment of the issues previously mentioned (reorganisations, etc.) as many of the arguments used to favour and recommend taxation of OITs could also apply to these items. For example, the guidance should note that not all transfers give rise to gains, and transfers that give rise to losses should be treated in the same manner as gains. Tax certainty in this respect plays a crucial role and further guidance and acknowledgement would be welcomed on all such items.

Growth and Double Taxation

The Revised Toolkit asserts that the sample models have been designed to deal with and prevent double taxation by the location country.[6] However, in our view, the analysis does not adequately deal with economic double taxation "in the sense of the same gains being taxed multiple times in the hands of different taxpayers through realisations of gains on intermediate shareholders through multiple tiers of indirect ownership."[7] In capital intensive businesses (e.g., extractives, infrastructure, manufacturing, etc.), introducing or expanding capital gains taxation is expected to limit opportunities for investors to rationalise portfolios. If investors cannot dispose of assets because of taxation of the gains, then they may be locked into suboptimal investments, which slows growth. This is further aggravated (with economic distortions expected) when capital gains taxation is introduced or expanded without sufficient consideration and guidance regarding the elimination of double taxation.

Further, as a general matter, the analysis dismisses double taxation at the residence country by noting that some jurisdictions are moving towards territorial-based taxation systems such that its risk is reduced.[8] However, if there is widespread adoption of Model 1 or 2 and Article 13(4) and 13(5) of the UN Model, then it is quite likely that double or multiple taxation of the same gains may occur. As a consequence, in our view, the utility of Model 1 is overstated as adoption of Model 1 would create a significant risk of double or multiple taxation. Alternatively, the utility of Model 2 is understated, as the reduced (albeit not eliminated) risk for double taxation is not highlighted as a benefit.

Further, the issue of double taxation is potentially aggravated by suggestions of overriding existing treaties (breaking agreements previously made in tax treaties). Different countries' domestic laws view the interaction between treaties and domestic law differently, but treaties have historically been entered into for the avoidance of double taxation to increase cross border trade, investment and jobs (and more recently – as part of a global effort comprising changes to treaties and domestic laws – also to protect countries against double non-taxation). We strongly recommend that the guidance not endorse a treaty override as an appropriate avenue for implementing an OIT. Several references are currently included in the disadvantages sections[9] of the guidance. The guidance should acknowledge that the suggested Models may not be consistent with existing treaties and, if

[5] See Revised Toolkit, pages 18-25.
[6] See Revised Toolkit, page 40.
[7] See Revised Toolkit, page 41.
[8] See Revised Toolkit, page 44.
[9] See Revised Toolkit, pages 44 and 51.

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so, treaties should be renegotiated before a contrary domestic law could be implemented with respect to a contrary treaty. Along with this additional language we also suggest complete removal of references to overriding treaties.

We believe these potential issues could be lessened by encouraging countries to work cooperatively in designing any new laws with both the Platform and stakeholders (including business) impacted by any law changes. Transparency as part of the legislative process is important to the perceived legitimacy of the ultimate law, striking a balance, and drafting clear and simple rules. As shown by the OECD's Co-operative Tax Compliance initiative bringing together Tax Administrations and taxpayers, in transparent fashion, often provides quicker and better results for all stakeholders.

In any case, more guidance should be included on options to deal with double taxation, both for asset holder countries and for investor countries. Options could include sourcing rules, explicit exemptions, clarity on the availability of foreign tax credits , deferral of taxation (which would then be spread over the asset life of the transferred assets), step up in tax basis or others.

Tax Certainty

While some helpful changes were made, our members are still concerned with some of the definition and analysis around location specific rents ("LSRs"). We welcome that the language regarding the class of assets subject to OIT rules has been somewhat narrowed.[10] However, there is still significant ambiguity as the Revised Toolkit retains references to LSRs. The concept of an economic rent is not one that economists have universally defined and the examples/general analysis outlined do not provide any clarity on this point as to what could and should constitute an economic rent.

With the same aim, our view is that the paragraph at the bottom of page 53 of the Revised Toolkit, concerning expanding the definition of immovable property, should be deleted. The Revised Toolkit, as admitted, is general guidance to assist developing countries to implement policies that are internationally accepted. This paragraph is recommending further thought on expanding the definition of immovable property and raises the real issue of unilateral expansion of the definition. As also expressed above, the guidance should avoid suggesting treaty overrides – creating a definition that conflicts with the negotiated position could override the negotiated position. This is, therefore, inappropriate and should be deleted.

It should be noted, that in many countries the definition of immovable property is established in non-tax regulations (e.g., Civil Code) and the transfer of immovable property may trigger other types of taxes besides income taxation (e.g., transfer tax, stamp duties, VAT, local taxation, etc.) as well as legal issues (e.g., registration in the Property Registry), so a wide definition of immovable property for tax purposes could lead to a lack of harmonized legal framework and more burdensome administrative and tax procedures.

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[10] The language "the report finds a strong case in principle, for a wide class of assets, for the taxation of such transfers by the country in which is the asset is located" was removed from the executive summary of the Revised Toolkit. We also welcomed the general changes to the body of the document (e.g., removal of "definition in a sufficiently expansive manner" from page 24, etc.) on this point.

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Further, the Revised Toolkit goes on to make a general statement that "LSRs … can be taxed (at up to 100 percent, in principle) without causing any relocation or cessation of activity, or any other distortion."[11] This statement, in our view, is clearly and demonstrably inaccurate, as any taxation of OITs impacts both the average rate and the marginal effective tax rate of an investment. While the former affects the location decision, the latter affects the size of investment. If an OIT or any other sale of immovable property is taxed at a higher rate than a sale of a foreign investment this will impact the choice of investment. In addition, economic theory and empirical evidence demonstrate that barriers to exit – e.g., caused by an extremely high taxation of capital gains in case of disinvestment – are barriers to entry. Consequently, investment in certain industries or products could be lower (e.g., telecommunication infrastructure) if taxed at an overly high rate. Accordingly, we encourage a more careful wording when describing and characterising LSRs, also considering transactions such as the previously referred transformational acquisitions taking place in stock exchanges where the acquisition of listed shares supersedes the location of the immovable property or assets. Further, since the guidance concedes that "the concept of LSR has not been sufficiently fully developed to be readily captured in legislative language,"[12] the draft should contribute to the definition by making explicit exclusions for sources that do not constitute a LSR.

A clarification that a taxing right for the country where the underlying asset is located cannot be supported without an appropriate definition in domestic law of both the taxable asset <u>and</u> the domestic law basis to assert that taxing right should be explicitly expressed in the guidance. This enables contracting partners to take taxation into account in their negotiations.

We strongly reject the application of a general anti abuse rule ("GAAR") for the taxation of OITs. A GAAR traditionally is designed, by its very nature, to be extremely broad, with few indicators whether taxes will be due or not. The wide application of GAAR inevitably would lead to tax treaty override and, consequently, be in breach with customary international law.

We were encouraged by the reduction of focus on politic pressures in this area – including removal of the separate section on this topic from the prior draft. As with any tax initiative, *Business at OECD* wants government to act based on all the facts according to applicable tax policy considerations. The introduction of pure politics in this area often makes for bad policy and inappropriate rules.

Lastly, we welcome the basic advice added regarding the application of OITs.[13] First, the guidance states that "unless there are strong reasons to do otherwise" either model should only be implemented on a prospective basis. We agree that retroactivity is negatively viewed from both a legal and tax policy perspective, such that we would suggest going a step further by deleting the caveat as currently drafted.

[11] See Revised Toolkit, page 20.
[12] See Revised Toolkit, page 21.
[13] See Revised Toolkit, page 40.

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Right to Tax / Not Tax

We welcome that the Revised Toolkit contains less biased language in favour of taxing OIT by recognising that some countries may knowingly choose not to tax gains derived from OIT. On this point, we believe the guidance could further develop and explain the rationale (pros and cons) behind such decision as it is currently viewed through the lens of taxation.

In our view, there are still several misleading and incomplete assertions when referring to the tax treatment of OITs.[14] The Revised Toolkit should put more emphasis on the fact that not taxing an OITs does not mean that gains will remain untaxed in country L (per illustrated examples), as the guidance implicitly suggests currently. In this respect, earnings derived from the asset will still be taxed in country L as earned (including future income reflected in the current gain and any future, incremental appreciation.

Taxation Regimes / Compliance

Page 48 of the Revised Toolkit addresses withholding ("WHT") regimes. The Revised Toolkit should further explain that the nature of a WHT is a means of tax collection consistent with an allocation of taxing rights to source and residence countries, rather than an independent tax. In this respect, taxes based on gross revenue can be distortive compared to net income taxes (especially if there is no corresponding law or treaty agreement to give credit), giving rise to complex issues regarding price negotiation between purchaser and seller, tax relief or asset valuation (e.g., if an existing loan is subrogated). This is particularly distortive where the WHT is not simply a collection mechanism, but instead represents the final tax due (as WHT is levied on the entire proceeds even though the asset transfer may result in either minimal gain or a loss). Countries should, therefore, seek for less distortive WHT mechanisms that have some correspondence between the amount of tax and net income.[15]

Our members take their compliance and tax obligations seriously and fully comply with respective tax laws. However, when discussing enforcement and collection, the Revised Toolkit states that "compliance with this obligation could be expected to be low." We strongly recommend that the Revised Toolkit remove implications that a majority of businesses would ignore their tax obligations, as such is simply not shown in practice.[16] Similarly, in the discussion of the pros and cons of Model 1 and 2, we would encourage a similar softening of the language around this point – which, as drafted, appears to provide significant deference to Model 1.

In any case, we would like to see a recommendation included that countries add a model calculation to their legislation on how to calculate and determine any additional taxation. Especially in the case

[14] For example, we believe that certain language could be changed to eliminate this bias. Current examples of inaccurate misleading statements are the uses of: "tax advantage" (page 15), "tax benefit" (page 16), "untaxed" (Box 1 in page 16), "chosen not to tax" (page 22), "dissatisfaction" (page 25) "avoid tax" (page 34). In these situations, the actual situation is simply a deferral of tax versus an elimination of tax.
[15] As an ancillary point, we would also suggest that group takeovers be included within the mentioned exclusions from WHT.
[16] Reports have shown high compliance of large MNEs when it comes to non-resident reporting.

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of certain industries that are often already subject to additional taxation (e.g., extractives), the determination of the gain and filing requirements are unclear and would benefit from a model calculation.

Specific Comments per Questions Outlined

1. Has the draft better clarified the economic rationale for taxing such transfers by offshore indirect owners?

Some helpful revisions were made in this area as noted above. However, what is largely missing is an initial overview and pros and cons on capital taxation, which is a front loading of taxation on future revenues, as well as pros and cons on OIT taxation specifically. As it could limit the opportunities for portfolio rationalisation with investors as well as opportunities for countries to have the more appropriate and active investors for the source country, these considerations should be assessed. For example, when capital gains are due, the price charged for the asset may be a grossed-up one to ensure return on capital, which will limit the transferability of local assets and the ability to attract new investors.

Moreover, when discussing the pros and cons of Models 1 and 2, on pages 43-44 and 51, respectively, such are primarily discussed from the point of view of the tax authorities with respect to tax enforcement and collection (rather than of a broader range of considerations including good tax policy or economics).

Further, there are many non-tax responses to addressing high returns (e.g., an exclusive license or right), and using the tax system as an alternative to address them may not be optimal. If other non-tax methods are being used, then we would question whether tax-based solutions should be layered on top of existing rules or are appropriate at all.

2. The new draft does not express a preference for either of the described legislative approaches to taxing these transfers—is this made clear?

We agree that the Revised Toolkit does not explicitly express a preference for either of the described legislative approaches (i.e., Model 1 and 2), and we welcome the changes made, specifically to the Executive Summary and the detailed discussion of Models 1 and 2.

However, despite taking a more open-minded approach in the Executive Summary and removing explicit recommendations for Model 1, the Revised Toolkit still implies a preference for the Model 1 approach. In our view, this implicit favouritism is shown in the pros and cons discussions on pages 43-44 and 51, as significant issues with Model 1 (e.g., double taxation) are quickly dismissed, whereas improper considerations (e.g., lack of compliance in reporting) are in the spot light for Model 2, as noted above.

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3. Does the draft adequately reduce any perceived emphasis on such offshore transfers as constituting tax avoidance, and make clear that the economic rationale for so taxing them is not as an anti-avoidance device?

In our view, the Revised Toolkit has a reduced emphasis on tax avoidance.[17] However, as detailed above, there are still flaws within the analysis, including oversimplification, a narrow view of tax policy drivers, and broad, counter-productive language.[18]

[17] For example, the acknowledgement in a footnote on page 15 of the Revised Toolkit that "complex ownership structures are not necessarily or even primarily designed for tax reduction purposes—rather, commercial considerations" is a helpful step towards recognising common business operating needs.
[18] See supra note 14.

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