The Platform for Collaboration on Tax

DISCUSSION DRAFT:
The Taxation of Offshore Indirect Transfers—A Toolkit

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International Monetary Fund (IMF)
Organisation for Economic Co-operation and Development (OECD)
United Nations (UN)
World Bank Group (WBG)

This discussion draft has been prepared in the framework of the Platform for Collaboration on Tax under the responsibility of the Secretariats and Staff of the four organisations. The draft continues to be commented on and reviewed by the Platform partners, and may not necessarily reflect the final views of all the relevant Secretariats and Staffs. All considered it useful, including as part of that process of comment and review, to make the draft more widely available now to gain the benefit of wider input and advice. Neither this draft nor the final report should be regarded as the officially endorsed views of those organisations or of their member countries.

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EXECUTIVE SUMMARY

The tax treatment of 'offshore indirect transfers' (OITs)—in essence, the sale of an entity owning an asset located in one country by a resident of another—has emerged as a significant issue in many developing countries. This has been identified as a concern in IMF technical assistance work and scoping by the OECD, and was not covered by the G20-OECD project on Base Erosion and Profit Shifting (BEPS). In relation to the extractive industries, OITs are also the subject of work at the UN.

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

The report finds a strong case in principle, for a wide class of assets, for the taxation of such transfers by the country in which the asset is located. This class extends beyond a narrow notion of immovable assets to include more widely those generating location specific rents—returns that exceed the minimum required by investors and which are not available in other jurisdictions. This might include, for instance, telecom licenses and other rights issued by government. Translating this concept into legal text is not easy, but the report provides illustrative language for a sufficiently broad definition of immovable assets.

The provisions of both the OECD and the UN Model treaties suggest wide acceptance that capital gains taxation of OITs of "immovable" assets be primarily allocated to the location country. It remains the case, however, that Article 13(4) is found only in around 35 percent of all Double Tax Treaties (DTTs), and is less likely to be found when one party is a low income resource rich country. To date, the Multilateral Convention has had a positive impact on this percentage by increasing the number of tax treaties that effectively include Article 13(4) of the OECD MTC. This impact is expected to be higher in the future as new parties may sign the MC and amend their covered tax treaties to include the new language of Article 13(4).

Whatever treaties may or may not come into play, however, such a taxing right cannot be supported without appropriate definition in domestic law of the assets intended to be taxed and without a domestic law basis to assert that taxing right.

The report outlines two main approaches for enforcing of taxation of OITs by the country in which the asset is located—provisions for which require careful drafting. It identifies the two main approaches for so doing and again provides sample simplified legislative language for domestic law in the location country for both. One of these methods treats such an OIT as a deemed disposal of the underlying asset. The other treats the transfer as being made by the actual seller, offshore, but sources the gain on that transfer within the location country and so enables that the country to tax it. For relative ease of enforceability, and the logic and simplicity of basis adjustment it implies, the report favors the method of deemed disposal.

ACRONYMS

BEPS	Base Erosion and Profit Shifting
CGT	Capital Gains Tax
DTT	Double Tax Treaty
DWG	Development Working Group of the G20
GAAR	General Anti Avoidance/Abuse Rule
IMF	International Monetary Fund
MTC	Model Tax Convention
LOB	Limitation on Benefits
LSR	Location specific rents
MC	Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (Multilateral Instrument)
OECD	Organization for Economic Co-operation and Development
OIT	Offshore Indirect Transfer
PE	Permanent Establishment
SAAR	Specific Anti-Avoidance/Abuse Rule
UN	United Nations
WBG	World Bank Group

GLOSSARY

Asset: Something of financial value.

Commissionaire arrangement. An agreement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of the products. __

Direct Transfer. The disposition of a direct interest in an asset, in whole or in part.

Direct Interest. Ownership in regard to any particular asset in which there are no intervening entities between the owner in question and the asset in question.

Entity. An organization or arrangement such as a company, corporation, partnership, estate, or trust.

Immovable Assets. See discussion in text.

Indirect Interest. Ownership interest in an asset in which there is at least one intervening entity in the chain of ownership between the asset in question and the owner in question.

Indirect Transfer. The disposition of an indirect ownership interest in an asset, in whole or in part.

Intangible Property. For purposes of this report, this term is defined herein as property which has no physical presence, for example, a financial asset such as corporate stock; intellectual property; business goodwill.

Interest. Effective ownership, in full or in part, of an asset.

Limitation on benefits. A treaty provision that seeks to limit tax treaty benefits to genuine residents of the other contracting state.

Location Specific Rents. Economic returns in excess of the minimum "normal" level of return that an investor requires – "rents"—which are uniquely associated with some specific location, and can thus be taxed without in theory having any effect on the extent or location of the underlying activity or asset.

Model Tax Convention. A model (or template) that can be used as the basis for an actual *Tax Treaty* negotiated between two countries. There are two primary Model Tax Conventions, one prepared by the UN, and one prepared by the OECD. The two Model Tax Conventions are largely the same, although they differ in a few significant specifics.

Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS. Instrument developed under Action 15 of the G20-OECD Base Erosion and Profit Shifting Project to facilitate and coordinate changes in treaty arrangements.

Offshore Indirect Transfer. An indirect transfer in which the transferor of the indirect interest is resident in a different country from that in which the asset in question is located.

Onshore Indirect Transfer. Any indirect transfer other than offshore

Permanent Establishment. A concept used to determine when an entity has sufficient connection with a country to allow that country to subject to tax the entity's net business profits attributable to that Permanent Establishment in that country.

Principal purpose test. A rule under which if one of the main purposes of an arrangement is to obtain tax treaty benefits, these benefits would be denied unless that granting these benefits would be in accordance with the object and purpose of the provisions of the specific tax treaty. ___

Residence Country. The country in which the person or entity that derives income is a resident for tax purposes.

Round Tripping. Describes a chain of transactions in which the beginning and end of the chain are in the same country (and normally with the same taxpayer), but intermediate transactions take place through other entities located outside the country.

Source Country. The country within which income or gain is deemed to arise. Sometimes referred to here as the 'location' country.

Tax Basis. The original value of an asset for purposes of taxation. Tax basis is typically the original purchase price (plus direct purchase expenses), minus (for business assets) any deduction for depreciation that has been taken by the business for income tax purposes.

Tax Treaty. Also known as a Tax Convention or Agreement. A tax treaty, which is usually concluded between two or more countries, prescribes which country has the right to tax the income of an entity or individual that operates in more than one country, so that the income will either not be subject to tax in both countries or, if it is, relief is granted to eliminate double taxation to the extent possible.

Transfer of an interest. A change in the ownership interest of an asset, in whole or in part, whether between independent or related parties.

Transferor: Person or entity transferring an ownership interest in an asset.

Withholding Tax. As used here, this refers to a tax levied by a source country at a flat rate on the gross amount of dividends, interest, royalties, and other payments made by residents to non-residents.

INTRODUCTION

This report and toolkit provides analysis and options and recommendations for the tax treatment of *offshore indirect transfers* [1] (OITs). It is prompted by concerns with the possibility that by selling interests indirectly (that is, by selling entities that own assets which have risen in value, rather than the assets themselves), investors can avoid capital gains taxation in the country where those underlying assets are located. In assessing appropriate responses to this issue, the toolkit addresses several questions: (i) Should such transfers be taxed in the country in which the underlying asset is located (ii) To what types of assets should such taxation of indirect transfers apply? (iii) Should taxation of such transfers be applied by the country in which the assets are located only as a back-up, anti-tax avoidance device, or should it constitute a fundamental aspect of that country's tax structure? and (iv) How can such taxation best be designed and implemented as a practical, legal matter?

The report and toolkit responds to a request by the Development Working Group (DWG) of the G20 to the International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), World Bank Group (WBG) and the United Nations (UN)—the partner members of the Platform for Collaboration on Tax—collectively to produce "toolkits" for developing countries for appropriate implementation of responses to international tax issues under the G20/OECD Base Erosion and Profit Shifting (BEPS) project, as well as additional issues of particular relevance to developing countries that the project does not address. Although as will be seen, residence countries may also be affected by avoidance through OITs, to a large extent the issue is one that affects source countries more deeply. The treatment of OITs—not covered in the BEPS project—was indeed identified by developing countries as of particular significance for many of them, especially in the extractive industries but with application more widely. Its significance has also been stressed by the IMF (see IMF 2014, which draws on several cases arising in IMF technical assistance work), the OECD (see OECD 2014a and 2014b, which identify high priority international tax issues in low income countries), and the UN.[2] While this issue has sometimes come to the fore in the past, it has become of much greater importance in recent years.

The issues at stake are technically highly complex, in terms of both the underlying economics and in their legal aspects. In addressing them, this toolkit draws on the existing literature,[3] IMF technical assistance work with developing countries, and a series of consultations with government authorities from multiple countries ([to be listed in Appendix 1 of the final

[1] Terms italicized on first use, other than company names, are explained in the glossary.

[2] Treaty-related capital gains tax issues were also identified as a concern by respondents to a UN questionnaire on BEPS priorities for developing countries (Peters, 2015).

[3] Including notably Burns, Le Leuch and Sunley (2016), Cui (2015) and Krever (2010).

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

This draft report is structured as follows. The next section provides an introduction to OITs, sets out a stylized example illustrating the essential concerns and issues their tax treatment raises, and provides an analysis of the economic considerations that inform answers to the question of where such transfers should be taxed. Section III describes some recent cases that highlight these concerns, reflecting the variety of current unilateral country rules, and Section IV then focuses on the treatment of this issue under the two primary model tax treaties—of the United Nations and the OECD—and discusses the important possibilities created by the OECD's MC. Section V then considers in detail issues of implementation raised by different approaches to the taxation of indirect transfers. The final section presents conclusions and summarizes recommendations Appendices provide supplementary technical information. Appendices provide further detail on the empirical analysis and of selected country experiences.

ANALYSING OFFSHORE INDIRECT TRANSFERS

This section explains what is meant by an 'offshore indirect transfer' (OIT)—using a stylized example that will be used throughout the toolkit—discusses the revenue implications, and considers key conceptual questions in the allocation of taxing rights in relation to OITs.

A. The Anatomy of Offshore Indirect Transfers

Definitions and structure

By an *indirect ownership interest* is meant, for purposes of this toolkit, an arrangement under which there is at least one intervening entity between the owner and the asset in question. A *direct interest*, in contrast, is one in which there are no intervening entities. Figure 1 illustrates a stylized[4] three-tiered ownership structure. In the terminology just established, Corporation A has a "direct" interest in "Asset"; Corporation B and its 'parent' Corporation P1 both have "indirect" interests in "Asset." Moving up the tiers, Corporation B, has a direct interest in the shares of Corporation A, and Corporation P1 has an indirect interest therein.

A "transfer" is a change in the ownership interest in an asset, in whole or in part, whether between independent or related parties. Transfers of ownership may give rise to a taxable capital gain (or loss), and this is at the heart of the concerns in this report.[5] For purposes of this analysis, transfers can be direct or indirect:

- ***A direct* transfer** involves the disposition[6] of a direct ownership interest in an asset, in whole or in part.
- ***An indirect* transfer** involves the disposition of an indirect ownership interest in an asset, in whole or in part. It is the underlying asset that is being *indirectly* transferred.[7]

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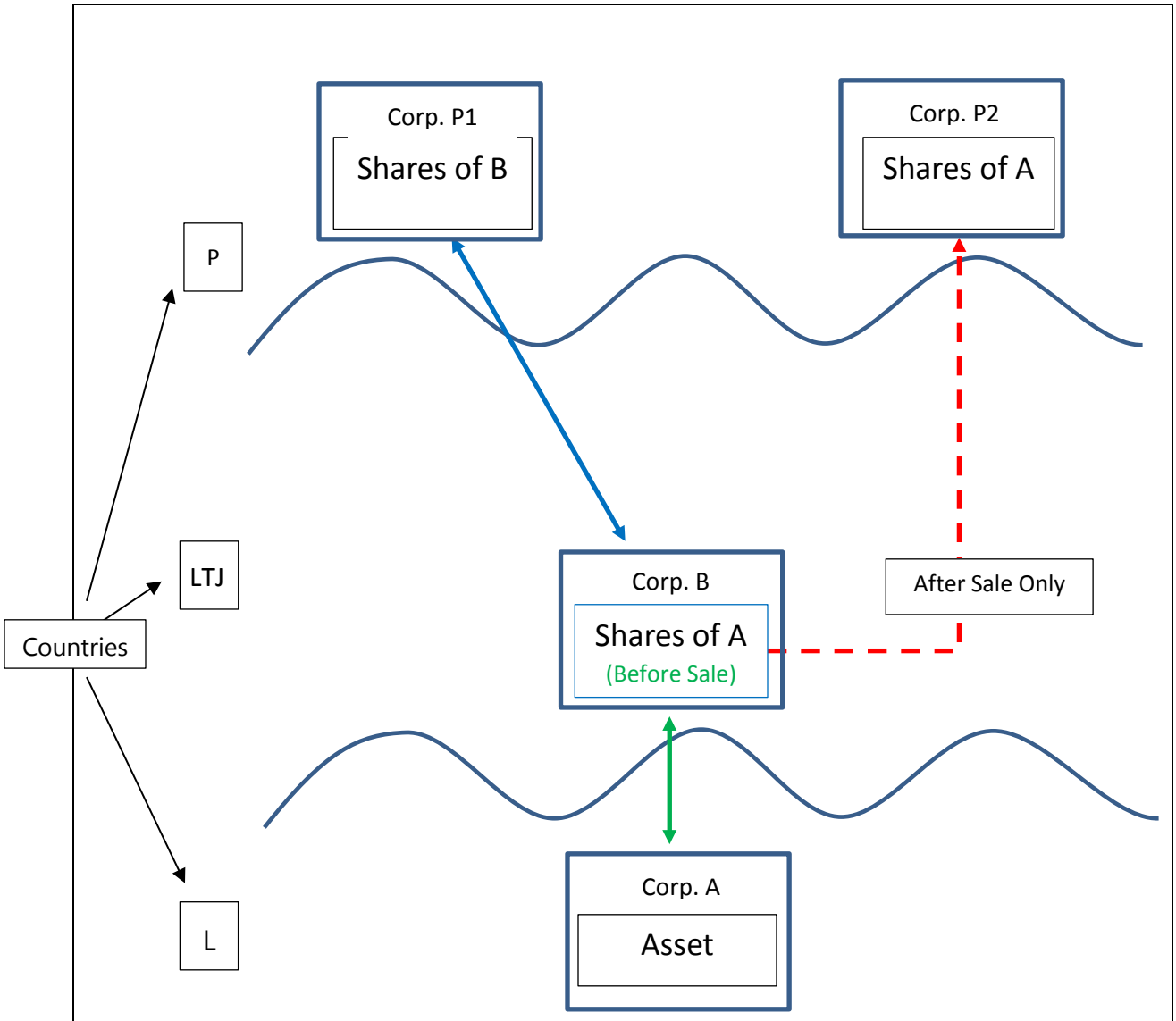
[4] Ownership structures are not necessarily as simple as drawn: at any point in the ownership chain there may be multiple owners, and complex cross ownership arrangements are common.

[5] Not all transfers of ownership interest result in taxable gains (or losses). If an asset is sold for its taxable basis (typically the original purchase price) there would be neither gain nor loss, even if the event is taxable. Transfers through mergers or acquisitions may not be taxable events, even if the asset has appreciated (or depreciated) in value if the transaction satisfies domestic tax rules regarding restructuring or reorganization. Generally, tax free reorganization rules require that there be very substantial continuity of ultimate ownership to obtain the benefit of the postponement of realization of gains at the time of the transaction. Further, other than within the EU, cross-border reorganizations are generally not tax-free. Given these factors, such provisions do not appear to offer the opportunity for significant abusive avoidance of the taxation of gains on local assets of the kind recommended here in, when beneficial ownership is actually substantially transferred.

[6] In addition to sales, other means of asset disposal include gifts, mergers, acquisitions, or business reorganizations. Sales also include installment sales and those subject to an "overriding royalty;" in both cases, a series of payments is made to the seller (transferor) after the transfer takes place. See Burns, Le Leuch, and Sunley (2016).

Figure 1: Stylized Example of an OIT Structure



Note: In this transaction, corporation B, resident in *TH*, sells it shares in corporation A to corporation P2, resident in *P*. This is a direct transfer of the shares in A, and an indirect transfer of the asset held by corporation A that are

[7] So, for instance, a direct transfer of shares in a company owning some real asset is an indirect transfer of that real asset.

located in country *L*. More complex patterns are of course possible, and indeed common. It could be for instance, that corporation B is disposed of by a corporation C (not shown) interposed between corporations B and P1; this would be an indirect transfer of both the shares in B and the underlying assets held by A.

Tax treaties typically create a distinction between two classes of asset that is critical for this report.

- ***Immovable*** assets*:* The precise definition of this term is a matter for national law, which may or may not be modified by and for the purposes of any tax treaties to which the country is a party. It typically includes land, buildings, and structures as well as rights related to such property (which may include agricultural, forestry, and mineral rights).[8] As discussed later, the definition of immovable assets *could* also include licenses to provide specific products or services (e.g. telecommunications) to specified geographic locations, although this is not common.
- ***Movable*** **assets:** Any asset not classed as immovable. This may include not only other physical property, but intangibles (such as intellectual property or goodwill), and financial assets (e.g., stocks, bonds).

The location of the asset and the residence of the disposing party (the 'transferor') both play a role in determining which taxing jurisdiction (or jurisdictions) may claim the right to tax transfers, under the (widely differing) provisions of various countries' tax laws. For clarity in discussing the complexities of indirect transfers we define, for the purposes of this toolkit:[9]

- ***Offshore*** **transfers** are transfers in which the transferor is resident for tax purposes in a different country from that in which the asset in question is located, and the transferor does not have a *permanent establishment* in the country in which the asset in question is located.
- ***Onshore*** **transfers** are all other transfers.

Imagine in Figure 1 that the owners of *P1* want to realize a capital gain reflecting an increase in the value of the underlying asset; and that the owners of *P2* wish to gain control of that asset.[10] The tax rules of (at least) four countries come into play in shaping the tax treatment of this transaction (along with any applicable treaties): that in which the underlying asset is located (*L*), that in which the seller is resident (LTJ), that in which the parent of the seller

[8] The definition of immovable property is set out in Article 6 of the model treaties.

[9] These terms may have meanings different from those used here in the domestic laws of different countries.

[10] We assume throughout, except where indicated, that buyer and seller are unrelated, and so set aside issues related to transfer pricing and the treatment of corporate reorganizations that arise if they are related.

(P1) is resident (*P*), and that in which the buyer (P2) is resident. More complex cases can certainly exist,[11] but this simple example captures the key concerns.

One way to realize the gain would be for *P1* to arrange a direct sale of the asset by corporation A—but this will generally be taxable in country *L*, being a straightforward domestic (onshore direct) transfer.

The tax efficient strategy for *P1* may then be to arrange for the sale to be made indirectly by an entity resident in a country (LTJ) that applies a low tax rate to capital gains. In Figure 1, this is shown as the sale by corporation B, resident in low tax country LTJ, to Corporation P2, resident for tax purposes in country *P*, of its shares in corporation A, a country *L* corporation that directly holds the asset located in *L*. Any tax advantage from eliminating the tax otherwise payable in *L* may be offset later under the tax rules of the seller's parent's country *P*; anything short of immediate taxation in *P*, however, is unlikely to substantially neutralize the tax advantage of selling the asset indirectly in LTJ rather than directly in *L*.

The transaction also has tax consequences for the purchaser, *P2,* since the amount paid for the shares[12] of company *A* becomes the *tax basis* relative to which any capital gains (or losses)[13] on a future sale of those shares will be calculated. If the underlying asset is expected to decline in value—as a result of true economic depreciation, perhaps because the underlying asset is a right with some expiration date—the expectation is of a future capital loss; and the value of that for tax purposes will be maximized by locating the loss in an entity located in a high tax jurisdiction (because it generates a deduction with no offsetting charge). If, on the other hand, the underlying asset is expected to increase in value, the tax minimizing strategy is to locate the company which acquires company *A* in a low tax jurisdiction.

This structure can also be used for '*round-tripping*' by residents of the country in which the underlying asset is located. Since the same logic applies when the country in which the ultimate owner resides, *P*, is the same as that in which the asset is located, *L*, capital gains tax that would be payable on a domestic sale in *L* can—in the circumstances assumed in the figure—be avoided by instead selling indirectly offshore.[14] Any tax benefit from this would be negated, however, if

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[11] There may be many further companies interposed along the chain of entities (perhaps for tax planning purposes, between *A* and *B* if, as in some cases, country *L* taxes gains up to the first tier of ownership); and title may actually pass in another (fifth) country.

[12] The acquirer might prefer to acquire the asset directly, since immovable property will generally qualify for depreciation allowances and so, in many cases, yield deductions sooner than basis in shares that can be set off against future gains.

[13] Such losses, importantly, may be usable to offset gains on other assets.

[14] This has been a concern, for example, with the treaty between India and Mauritius, under which gains realized in the latter on transfers of Indian entities are untaxed. This is widely believed to be one reason why around 25 percent of foreign direct investment in India in recent years has been routed through Mauritius (IMF, CDIS 2010-2015)—though it is unclear how much of this is round-tripping. In May 2016, a protocol amending the treaty was

country *L* taxes its residents on capital gains realized by controlled non-resident entities—unless that gain is illegally concealed from the tax authorities in *L*.

This example is highly stylized: as discussed in detail below, the tax treatment of indirect transfers in practice will depend on details of both domestic law in the countries involved and any tax treaties between them (which may for instance allow country *L* to tax the sale by company *B*). Not coincidentally, however, many indirect transfers are indeed structured so as to bring precisely the features assumed in the example of Figure 1 into play.

Revenue Implications

It helps to begin by setting out the mechanical revenue implications of the stylized example of Figure 1 above.

Revenue effects from the transfer itself

Capital gains derive in large part from changes—between initial purchase and the sale—in expected after-tax payments to the owner of the asset.[15] Both aspects of this are important:

- While capital gains can be fully anticipated,[16] in the cases with which this report is principally concerned they typically arise from unexpected changes in future net distributions, perhaps as a result of a resource discovery or increase in commodity prices—which in turn are often changes in *location specific rents*, a concept discussed further below.

- Since the value that any actual or potential holder places on an asset can be expected to take into account any future corporate, withholding or other taxes due—including capital gains tax on any future sales—capital gains tax reaches income not taxed by these other instruments. Viewed in one way it is a form of double taxation. More economically relevant, however, it is a way to capture changes in earnings that would otherwise be untaxed.

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signed. The new article 13 will allow taxation of capital gains on the alienation of shares of a company resident of a contracting state to be taxed in that state; the applicable rate will be 10 percent beginning 2019. Shares purchased prior to April 1, 2017, will continue to be exempted from such tax.

[15] More precisely, taking the price of an asset to be the present value of expected net distributions to the owner, the capital gain on an asset purchased at time 0 and sold at time T is the amount by which net present value of distributions subsequent to T expected at time T exceeds that expected at time 0, with the latter discounted back to time 0 less (b) the net distributions that were expected at time 0 between then and time T. (This is of course a simplification of complex valuation issues: potential investors may have different expectations, for example, and/or may face different tax treatment on distributions.)

[16] The value of an asset that derives from a certain payment at a fixed date in the future, for instance, will on at that account increase as that date approaches.

A full view of the revenue impact of taxing capital gains requires recognizing the impact of *basis adjustment*[17] on future sales. The price paid for an asset sold today (an increase in which increases capital gains tax liability) creates basis of the same amount, which becomes an exactly equal deduction in calculating the capital gain on a future sale (an increase in which reduces future tax liability). So if, for instance, a future sale[18] will be taxable in the same jurisdiction as today's sale, and at the same tax rate, then the total nominal (undiscounted) revenue raised from the capital gains tax over time will be zero: that is, the same as if there had been no sale, or no capital gains tax. Importantly, however, while the cumulative revenue raised is then zero in nominal terms, the present discounted value of that revenue stream will be positive (because the future reduction in revenue has lower present value than today's increase).[19] This timing effect is a consideration of some importance for governments of lower income countries that face constraints on their borrowing capacity.

Failing to tax OITs thus means foregoing a timing gain in taxing otherwise untaxed income—which can be a sizable loss. The revenue issue is 'only' a matter of timing in the sense that, so long as basis adjustment is effectively provided for any future sales of the same asset, todays' purchase price creates an equal future deduction. But this timing effect may be highly material. At six percent interest, for instance, the net present value of a revenue gain of $1 billion today combined with a loss of $1 billion in ten years is nearly $450 million.

Effects on other tax payments

Since company *A* remains resident in country *L*, the transfer has no direct impact on country *L*'s future receipts of corporate income tax (or, in the case of the extractive industries, any royalties or rent tax) from *A*. (There may be indirect effects from changes in the commercial and financial operations of A as a result of changes in its ultimate ownership, but we leave such effects aside in this discussion.)

The same is likely to be true, in practice, of *L*'s receipts from any post-sale withholding taxes on dividend, interest or other payments made by corporation *A* to its new direct owner. In Figure 1, *A*'s new direct owner *P2* is resident in a country different from that of the initial direct owner *B*. In that case, different withholding tax rates may apply, with consequent effects on country *L*'s revenue. More common, in practice, is that the transfer will take the form

[17] We do not address in this report the full set of issues that basis adjustment raises for capital gains taxation in general, but take up some specifics when comparing alternative approaches to the taxation of OTIs in Section VI.

[18] Assumed, for simplicity, to have been acquired at zero price.

[19] In effect, the taxpayer reaps the benefit of the income that would be earned on the deferred tax amount.

of the sale of *B* by a company interposed between *B* and the initial parent *P1*. Company *B* thus remains the direct owner of *A*, and there is then no change in the withholding taxes payable.[20]

[20] It might seem that realizing a lightly taxed capital gain provides a way in which to avoid withholding tax on distributions of previously accumulated retained earnings (on which, being undistributed, no dividend withholding has been collected). But those retained earnings presumably have a value to the purchaser only in so far as they can, at some point, be paid as dividends: at which point the withholding tax will apply. The equity placed in Company A is in a sense trapped, in that the future dividends that ultimately give it value—even if derived from past retentions—will be subject to withholding when paid. On this 'trapped equity' view, see for instance, Auerbach (2002).

B. How Should Taxing Rights on OITs be Allocated?

The key questions of principle are whether or not the country in which an asset is located should have primary taxing rights on its indirect transfer abroad—and, if so, to precisely which assets this should apply. Several (inter-related) issues of economic principle come into play in addressing these—leaving aside, for the moment, the current practices and legal concepts discussed below. These include: ***inter-nation equity***, in assuring an allocation of revenues meeting some notion of fairness between countries; ***efficiency***, in ensuring that assets are used in the most productive ways; and, not least, ***political economy***—which, given the high profile of many OIT cases, has driven many recent developments in this area. Beyond some basic matters of practicability, issues of implementation—ensuring that tax is collected at reasonable cost to both tax administrations and taxpayers themselves—are deferred until Section 5 below.

Inter-Nation Equity

Views differ on what 'fairness' means in the allocation of taxing rights across countries, but three current norms point to some possibility for consensus in relation to OITs:

- Capital gains on onshore direct asset transfers are taxable by the country in which the asset is located (even though the seller—and, likely, also the purchaser—may be non-resident);
- Dividends received by a parent company abroad may be subject to tax through withholding by the country in which the paying company is resident;[21]
- It is widely accepted—as reflected in the model treaties discussed below—that the country in which an 'immovable' asset is located is entitled to tax gains reflecting increases in the value of that asset

The first norm points to a view that the country in which an asset is located should be entitled to tax gains associated with it—unless, perhaps, a substantial part of those gains are attributable to value-enhancement provided from abroad (a natural resource deposit has little value, for instance, until it is 'discovered'). Establishing the extent of any such contribution, however, could of course be problematic; this point is taken up below.

The second norm suggests that, the right to tax returns to foreign investors in the form of dividends from a domestic source being accepted, so too should be a right to tax them on returns in the form of capital gains associated with a domestic source. A counterargument is that the asset price and hence the gain reflects accumulated undistributed and future after-tax earnings, which the location country could have taxed in the past and may tax in the future

[21] Except, for example, by the Parent Subsidiary Directive within the European Union (we leave aside specific intra-EU issues in this report) or by domestic legislation or treaty provision in other countries.

through the corporate income and other taxes (rent taxes in the extractives, for instance). The gain, that is, reflects earnings that the location country has in a sense simply chosen not to tax. But this is not wholly compelling. Dividend tax rates may be constrained by tax treaties—though that could be interpreted as simply another way in which country *L* has chosen not to not to tax future earnings. Perhaps more persuasively—a point taken up later—the exploitation of avoidance opportunities may diminish the effective power of the country in which the underlying assets are located to tax future earnings. In the limit, for a country that cannot effectively tax either the earnings of the acquired entity or the dividends paid to a foreign parent, taxing the gain on asset transfers, direct or indirect, may be its only prospect of raising revenue on the associated earnings.

The third norm highlights the importance of the concept of 'immovability,' and the question of why it should matter for tax purposes whether an asset is movable or not. The distinction is not one that comes naturally to economists, who simply conceive of assets as things that have value because they have the potential to generate income—putting intangibles like patents, or a brand name, on a par with, for instance, natural resources. There appear to be three possible rationalizations—related, but distinct—for the importance given to the distinction:

- ***Pragmatically, immovability facilitates the collection of tax***, since the asset can be seized in the event of non-payment, with no risk of its fleeing abroad.

- ***Immovability of an asset implies that its value reflects, to some degree, its location***. That value may, more precisely, reflect *location specific rents* (LSRs): receipts, that is, which are in excess of the minimum "normal" return that the investor requires, with these 'rents' being uniquely associated with a particular location. LSRs are in principle an ideal object for taxation, in the sense that they can be taxed (at up to 100 percent, in principle) without causing any relocation or cessation of activity, or any other distortion—and so provide a fully efficient tax base (dominated, on efficiency grounds, only by taxes that serve to correct some externality). While this in itself is an efficiency argument (not speaking directly to the question of which government should receive the revenue), in practice there is also widespread if usually implicit recognition that it is appropriate for revenue from taxing what are manifestly LSRs to accrue to the government of the place of location. The most obvious examples of such assets are often thought of—and in the resource case generally are—owned collectively by the nation.

  The best way to tax such rents is by a tax explicitly designed for that purpose, and indeed there is extensive experience with a variety of such 'rent taxes', including though

not only in the extractive industries.[22] These taxes are not, however, invulnerable to profit shifting of various kinds, not least in lower income countries.[23]

The ability to tax capital gains arising from changes in the value of such rents can therefore be a useful backstop when the implementation of such taxes is imperfect—though clearly inferior to an ability to effectively tax them as they accrue. —

- ***A third rationale for the right to tax gains on local immovable property is grounded in the benefit theory of taxation***—i.e., that taxes are in the nature of payments for public services provided by government, which help maintain the value of local economic factors, including local immovable property.

In economic terms, the concept of 'immovability' might be most meaningfully thought of as proxying for the possibility of location specific rents—with implications for how the term should be defined. This view suggests an expansive definition of 'immovability' capable of capturing at least the most likely sources of significant LSRs. This, however, is much easier said than done: the concept of LSR has not been sufficiently fully developed to be readily captured in legislative language. But while LSRs can be difficult to identify in general, in some cases they are reasonably obvious. They are often associated, in particular, with government-created rights—notably in the extractive industries and telecoms. Many of the cases that give rise to concerns in relation to indirect transfers revolve around rights that are explicitly tied to particular locations—with their value being made visible by the transfer itself.[24] LSRs could also arise, for instance, from access to domestic markets, but this can be difficult to gauge and distinguish from rents associated with brand names or intellectual property. And of course the fact of a company being resident for tax purposes in a particular country clearly does not imply that its value substantially derives from LSRs arising there.

What these considerations suggest is that any definition of immovability that proceeds by positive listing should anticipate, so far as is possible, likely sources of significant LSRs—and there are signs that, though not expressed in those terms, this is increasingly the case, Definitions have come to more commonly include, for instance, not just the right to extract

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[22] See for instance several of the contributions in Daniel and others (2010).

[23] See for example, Beer and Loeprick (2015), which finds evidence of extensive profit shifting in the sector, with signs that developing countries are especially vulnerable.

[24] Indeed, this is evident, to some degree, in the national responses to indirect transfer cases, which have focused not on reducing the domestic taxation of direct transfers—as one would expect to be the case if there were no location-specific value to the underlying asset—but to seek to extend taxing rights. Without the existence of LSRs, that is, one would expect low taxation of indirect transfers to spur more intense tax competition in the treatment of gains on transfers rather than, as seems to be the case, the opposite.

natural resources but the full range of licenses that may be associated with their discovery and development.

There are two counterarguments to this emphasis on source country taxation:

- ***Any gain reflects underlying income that the source country has chosen not to tax.*** It may be, however, that the capital gains charge is that country's preferred method of taxing that income. Otherwise, that future income is at risk of non-taxation,whether (as discussed above) for timing reasons, or because of imperfections in other tax instruments, especially in developing countries. This makes taxation of gains a worthwhile, albeit very imperfect, additional tool.

- ***The 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***. This suggests that the gain might therefore be properly taxed where that latter entity resides (so ensuring, in efficiency terms, that the seller's decision as to the country in which it chooses to undertake such value-adding activities is not affected by the tax system). It may indeed be that there are company-specific as well as location-specific rents at work, and one might argue that the latter are naturally taxed where the company is resident.[25] The many countries operating dividend exemption schemes, however, have effectively indicated no desire to do so. More generally, how compelling this argument is may well depend on the circumstances of the case, being less plausible when the selling entity has few substantive functions. Moreover, the possibilities for structuring indirect transfers means there can be no presumption that the jurisdiction in which the gain is realized is that in which the underlying expertise or financing was ultimately provided. One might then think of some form of substance test, though this as always runs the risk of creating its own distortions, with resources allocated simply to meet the requirements of such a test and not for reasons of productivity.

Neither counterargument seems to outweigh the equity case for a primacy of source country taxing rights in relation to gains on immovable assets, widely defined.

Efficiency

A general principle of good tax design is that the tax system should, so far as is practicable, not distort investors' decisions: unless there is good reason to do so, taxation

[25] We leave aside here issues as to the relevance of companies' residence as a basis for taxation, given the increasing disconnect between that and the residence of final shareholders.

should not lead businesses to change their commercial decisions.[26] The reason for this is that any such changes mean that resources are being used in ways that are socially efficient, but are privately profitable only because of taxation. [27]

While efficiency considerations point firmly to the taxation of rents of various kinds, beyond that the literature on specific efficiency criteria to guide international tax arrangements provides few practicable insights. The prescription that rents are an efficient object of taxation is a very general one. As for other forms of taxation (that is, ones that may distort decisions), there is a large literature on their efficient design in international settings—focusing here on collective rather than national interests—which has produced few (if any) agreed prescriptions. For example, the argument above on productive contributions coming from residence countries points to residence taxation if the objective is not to distort how companies choose to allocate those contributions across different countries; but it points to source-based taxation if the objective is to ensure equal treatment of potential providers of such contributions from all countries.[28] Theory offers little guidance as to which view is the more appropriate from a collective perspective,[29] Two considerations, however, do point to significant efficiency considerations in this context.[30]

Location specific rents

The most fundamental efficiency argument for the country in which assets are located to tax both indirect and direct transfers is as a way to tax LSRs—albeit imperfectly. The preferability in principle, but limitations in practice, of explicit rent taxes was stressed above, and need not be elaborated further. Auctions are another possible tool for rent extraction, and have

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[26] Leaving aside the cross-border issues of interest here, several non-neutralities arise more generally in relation to capital gains taxation (in relation, for instance, to the distortions arising from taxing gains on realization rather than accrual). These are not addressed in the discussion here.

[27] Strictly, it is worth noting, efficiency considerations relate only to the tax rules applied, and are in themselves essentially silent on which country should receive the associated revenue. Revenue sharing on indirect transfers seems sufficiently remote a possibility, however, for it to be ignored here.

[28] This latter is akin to the notion of 'capital ownership neutrality' advocated by Desai and Hines (2013).

[29] See for example Appendix VII of IMF (2014). S

[30] There are other dimensions of neutrality that should in principle also be considered. These include, for instance, the financing of the entity operating the underlying asset (Company *A* in Figure 1). To the extent that the dividends it pays are taxed more heavily than are capital gains on its sale, this gives a tax incentive to finance the operations of that entity by retaining earnings rather than by injecting new equity—which might, for instance, imply slower growth of its operations (Sinn, 1991) This would be alleviated by taxing dividends and capital gains at the same rate. That does not necessarily mean that both types of income should be taxed by the same country, but is most naturally achieved by the location country taxing gains just as it does dividends. How significant a concern this is, however—compared for instance to what is often a very marked tax preference for debt finance—is unclear.

been widely used, for instance, for petroleum rights; but these can be subject to problems of asymmetric information and thin markets (being rarely used for instance, in relation to hard minerals).[31] On efficiency grounds, as well as those of inter-nation equity, taxing gains can be a useful supplementary device where—as in many developing countries—other methods of taxing LSRs are imperfect.

Neutrality between direct and indirect transfers

One natural requirement for neutrality is that direct and indirect asset transfers be treated identically for tax purposes. That is, transferring an asset or transferring shares deriving their value from that asset, to the extent that they represent the same transfer of ownership, should—all else equal—attract the same tax treatment. Otherwise there will be an incentive for businesses to artificially structure sales so as to use the more tax-favored method—as is seen in practice.

Given the current norm that the country *L in* which immovable assets are located has the right to tax direct transfers, such neutrality is most likely to be achieved by taxation of indirect transfers in L. In principle, neutrality along this dimension could instead be achieved by the location country forgoing any claim to tax either direct or indirect transfers, leaving this instead to the country in which the seller is resident. This, however, simply seems unlikely to happen—and it may be undesirable that it should, if this is a less distorting source of revenue for *L* than the available alternatives. That leaves the simplest route to neutrality: taxation of indirect transfers by the country in which the asset is located.

Political economy

Experience—exemplified by the cases discussed in the next section—is that inability of the country in which the underlying asset is located to tax indirect transfers can provoke intense domestic dissatisfaction, and may harm efforts to build up a tax-paying culture among individuals and corporations. These assets are commonly highly visible, with strong salience for the general public—perhaps reflecting a highly publicized resource discovery, for example—and are often finite resources owned by the nation (in the case of extractive resources) and/or created by the government (in the form of licenses or other rights). And, as will be seen shortly, the sums at stake can be large.

This dissatisfaction, as those cases also show, can lead to sweeping unilateral legislative actions—which may (and do) differ across countries. National responses have not been based on any common set of principles, and so risk creating their own distortions and spillover effects on other countries, amplifying the uncertainty that taxpayers face in arranging their affairs.

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[31] On both rent taxes and auctioning in the extractive industries, see Daniel, Keen and McPherson (2010).

Assessment

The arguments are not all in one direction, but on balance favor allocating taxing rights with respect to capital gains associated with transfers of immovable assets to the country in which the assets are located, regardless of whether the transferor is resident there or has a taxable presence there.[32] In equity terms, this mirrors the generally recognized right in relation to direct transfers; in efficiency terms, it provides one route to the taxation of location specific rents—highly imperfect, but potentially valuable when preferred instruments are unavailable or weak—and fosters neutrality between direct and indirect transfers. Not least, it can pre-empt the evident risk of domestic political pressures leading to uncoordinated measures that jeopardize the smooth and consensual functioning of the international tax system and give rise to tax uncertainty.

The rationale, in terms of economic principle, for limiting this treatment to immovable assets is unclear. Much current practice is already sharply at odds with this; while primary taxing rights are frequently given to the source country in relation to immovable property but to the residence country in the case of equity participation in other businesses, there are some notable exceptions, such as the cases of Peru and India discussed later. Indeed, Article 13(5) of the UN Model Tax Convention (MTC), discussed in section IV below, extends similar treatment to gains on company shares.[33] (More precisely, it allows state *L* to tax the sales by non-residents of shares in companies resident in L.) This, however, might be possible for taxpayers to avoid, by interposing a holding company not resident in *Y,* subject to the possible operation of any relevant domestic anti-avoidance provisions that are preserved by a treaty. It would seem that Article 13(5) is generally not needed as long as the definition of "immovable property" in both any applicable treaty under Article 13(4), and especially in domestic law, is sufficiently broad.

What emerges clearly is the importance to the location country of defining 'immovable assets' in a sufficiently expansive manner. Considerations of inter-nation equity, efficiency and practicability converge in suggesting the inclusion of all assets with the potential to generate significant location-specific rents and over which the government can exercise sufficient control to ensure collection.

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[32] Others have reached a similar conclusion. Cui (2015, p.154), for instance, takes the position that "too much of the international tax discussion recent decades has been centered on whether non-residents should be taxed on capital gains, rather than how they are to be taxed."

[33] There is no comparable provision in the OECD MTC.

THREE ILLUSTRATIVE CASES

Box 1. India—The *Vodafone* Case

In 2006, *Vodafone* purchased *Hutchison*'s participation in a joint venture to operate a mobile phone company in India (the owner of an operating license), for nearly US$11 billion. This transfer was accomplished by *Hutchison*, a Hong Kong-based multinational, selling a wholly owned Cayman Islands subsidiary holding its interest in the Indian operation to a wholly owned subsidiary of *Vodafone* incorporated, and for tax purposes resident, in the Netherlands. The transaction thus took place entirely outside India, between two non-resident companies.[34]

The Indian Tax Authority (ITA) sought to collect US$2.6 billion tax on the capital gain realized by Hutchison on the sale of the Cayman holding company. Given that *Hutchison* no longer had assets in India after the transaction, the ITA sought to collect the tax from the purchaser, *Vodafone's* Dutch subsidiary, arguing that it had the obligation to withhold the tax from the price payable to the seller. This sparked a protracted court case, with the Supreme Court of India ruling in 2012 in favor of the taxpayer. The Supreme Court denied the ITA's broad reading of the law to extend its taxing jurisdiction to include indirect sales abroad, though it took the view that the transaction was in fact the acquisition of property rights located in India.

The government of India subsequently changed the law to allow taxation of offshore indirect sales and tried to apply the new provision retroactively, in a second attempt to collect the tax from *Vodafone's* Dutch subsidiary. The legality of a retroactive effect of the law was subsequently submitted to arbitration by the taxpayer under the India-Netherlands Bilateral Investment Treaty[35]. (The treaty was unilaterally terminated by India in December 2016, but this does not affect ongoing disputes). Several years after their appointment, arbitrators selected by the parties finally agreed on choosing a chairman

[34] See Cope and Jain (2014).

[35] The disputed liability had increased to 3.7 billion by 2012, adding interest charges and penalties: *Financial Times*, **"**Vodafone's India tax battle to resume**,"** 9 May 2012.

of the tribunal. [36] The relevance of this tribunal on tax matters is still a matter of dispute.

Three highly publicized OITs are described in Boxes 1 to 3: *Vodafone*'s purchase of a substantial interest in a mobile phone operator in India, the indirect sale of the Peruvian oil company *Petrotech Peruana*, and the indirect sale by *Zain* of various assets in Africa including a mobile phone operator in Uganda.[37] All of these transactions have (at least so far, as appeals continue) raised the issue of whether multinational groups can ultimately escape taxation in the country in which the underlying assets were located, and ensure no or light taxation of the gain, by arranging that the transfer be effected as a sale by an entity not resident where the subsidiary holding the underlying asset is located.

Box 2. Peru—The Acquisition of *Petrotech*

In 2009, *Ecopetrol Colombia* and *Korea National Oil Corp* purchased a Houston-based company (*Offshore International Group Inc*.) whose main asset was *Petrotech Peruana* (the license-holder), a company incorporated and resident in Peru and the third largest oil producer there, for approximately US$900 million, from *Petrotech International*, a Delaware incorporated company. Since Peru's income tax law at the time did not have a specific provision taxing offshore indirect sales, the transaction remained untaxed there. The potential foregone tax revenue for Peru was estimated at US$482 million. *Petrotech international,* a resident of the U.S.A., would be taxed in the U.S. on the corresponding capital gain.

The case triggered a Congressional investigation in Peru that eventually led to a change in the law.[38] Currently, all offshore indirect sales of resident companies are taxed in Peru, regardless of the proportion that immovable property belonging to the Peruvian subsidiary may represent in the total value of the parent company (Article 10, Income Tax Act, Peru; see Box A.1, Appendix B,). Some limitations apply: the portion of the parent company subject to sale must derive its value at least 50 percent from Peruvian assets, and at least 20 percent of the Peruvian assets must be transferred in order for the transaction to be taxable in Peru.

Box 3. Uganda—The *Zain* Case

In 2010, a Dutch subsidiary of the Indian multinational *Barthi Airtel International BV* purchased from *Zain*

[36] *The Economic Times*, "Vodafone tax arbitration: Presiding judge to be named shortly," Sept. 2016.

[37] Other examples are in IMF (2014) and Burns, Le Leuch and Sunley (2016).

[38] Interestingly, the Commission investigating the case noted that *Petrotech* (originally a state owned oil company, privatized in 1993) eroded its tax base for years by overpaying service charges to domestic related parties not subject to oil royalties.

International BV, a Dutch company, the shares of *Zain Africa BV* (also a Dutch company) for US$10.7 billion, which owned in turn the Kampala-registered mobile phone operator *Celtel Uganda Ltd*. (among other investments in Africa). [39] The Uganda Revenue Administration (URA) held *Zain International BV* liable for the corresponding capital gains tax, amounting to US$85 million. Uganda's Appeals Court ruled—in sharp contrast to the decision of the Supreme Court of India in *Vodafone*—that the URA does have the jurisdiction to assess and tax the offshore seller of an indirect interest in local assets (overturning an earlier ruling by the High Court of Kampala.)[40] However, the taxpayer interprets the tax treaty between Uganda and the Netherlands as protecting the Netherlands' exclusive right to tax such transaction. This is an issue of some potential significance since some anti-avoidance rules in domestic law could be viewed as supplementary to the treaty, not an override. This issue is currently unresolved in the Zain dispute.

The amount at stake is in all three cases very large: that in *Zain* is in the order of 5 percent of total government revenue (and nearly 50 percent of public spending on health); that in *Vodafone* is around 2 percent of central government revenue (and almost 8 percent of all annual income tax revenues).[41]

Another common feature is that the indirectly transferred asset in question was a business whose value derived from a concession granted by the government of the country in which the underlying asset is located. Value is thus manifestly tied to particular jurisdictions, and largely consists of what are recognizably location-specific rents deriving from some government-issued license.

In all three cases,[42] the country in which the underlying asset was located lost in court—or at least has not yet obviously won. The reasons differed, however: insufficiency of the domestic income tax law to reach such transfers in India and Peru, potential override of a treaty (one that does not contain provisions along the lines of Article 13.4, discussed in Section IV below) in Uganda. In all cases, governments and many civil society organizations argued that developing countries had been denied (or had inadvertently denied themselves) a fundamental (and substantial) source of revenue. This was especially problematic politically when it could be shown that the subsidiary being indirectly sold had previously paid little, if any corporate income tax, as

[39] Zain International BV belongs ultimately to the Zain Group, whose main shareholder is the Kuwait Investment Fund.

[40] See Hearson (2014) and The *East African* "Court gives URA nod to seek taxes on sale of Zain assets in Uganda", September 13, 2014, at http://www.theeastafrican.co.ke/news/URA-taxes-on-sale-of-Zain-assets-in-Uganda/-/2558/2451578/-/item/0/-/6hm2he/-/index.htmlhttp.

[41] Other examples are given in Appendix VI of IMF (2014).

[42] In other cases—*Heritage* in Uganda, *Las Bambas* in Peru, for instance—tax has been recovered by the location country.

was pointed out in a congressional investigation on *Petrotech* ordered in Peru. Public outcry in several of these cases was considerable. In Peru, for example, the transaction became linked with corruption scandals, leading to the dismissal of Prime Minister and Cabinet.

The cases show that the location country may well respond to defeat in court by quite sweeping policy changes. India, for instance, not only changed its domestic law to bring OITs into tax[43] but sought to apply this retrospectively to 1962 (the date of the current income tax act). Peru and Chile amended their domestic laws to bring into tax offshore transfers related to all assets located in their countries—not just those deriving value from immovable property located there. Such unilateral responses are understandable and may reflect different legal systems in different countries. Not least because of their diversity, however, they risk introducing even more incoherence and uncertainty in international taxation than already exists, for no apparent gain.

[43] Cited by Cui (2015, p.146), the amendment reads: "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."

TAX TREATIES AND OFFSHORE INDIRECT TRANSFERS

This section reviews the treatment of OITs envisaged in the model tax treaties, reports on an empirical analysis of current treaty practices, and describes the 2017 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

OITs in the Model Treaties

Treaty practices, for both moveable and immovable assets, are summarized in Table 1. (The practices of specific countries, of course, may be quite different)

Table 1. Allocation of Taxing Rights Between Countries on Transfers of Assets Under Model Tax Conventions

Type of Property	**Type of Transfer**	
	Offshore Direct	**Offshore Indirect**
Immovable Assets in Country *L*	Country *L*	If more than 50% of value of transfer is (directly or indirectly) derived from immovable assets: Country *L*[44] Otherwise: Country *R*
Movable Assets in Country *L*	Seller has PE in Country *L* to which the assets are allocated: Country *L*	Seller has PE in Country *L* to which the assets are allocated: Country *L*
	"Substantial" Ownership Interest[45]: UN MTC: Country *L* OECD MTC: Country *R*	
	Other Cases: Country *R*[46]	
Legend: *L* = Country where underlying asset is located *R* = Country where seller resides		

Where two countries have a claim to tax the capital gain arising from the transfer, they may by treaty establish which has the primary right to tax, with the appropriate relief mechanism in the other in order to avoid double taxation. In the absence of a treaty to that effect, double taxation may occur, though taxpayers would presumably avoid structuring transactions in ways subject to such treatment. Such structures would make use of countries that, while having the right to tax, grant an exemption to the transaction in question—which itself could result in non-taxation.

Both MTCs provide that direct transfers of immovable property may be taxed by the country in which that property is located (Article 13(1); identical language).

Gains on indirect transfers are dealt with in Article 13(4) of each MTC.[47] In the OECD version, prior to its 2017 update, this reads:

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[44] Allocation of taxing rights to Country *L* in this case extends to transfers by any entity in the chain of ownership of the assets in country L, regardless of number or location of intervening entities.

[45] "Substantial" ownership interest is defined in the UN MTC as percent of the share of the entity in question. The OECD MTC does not have a similar provision. As a result, the OECD treaty effectively gives the taxing right in these situations to Country *R*, where the owner (seller) of the ownership interest is resident.

[46] Taxing rights related to ships and aircraft used in international transportation are allocated to the country where the entity with effective management of those assets resides, but the 2017 version of the UN Model will prefer, including for administrative reasons, a test of the country of the residence of the enterprise operating the ships or aircraft, as in the 2017 OECD Model.

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

The 2017 update of the OECD MTC will include the following amended version of Article 13(4):

Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 percent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

In the 2011 version of the UN treaty, the core provision of Article 13(4) is that:

Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State.

A sub-clause defines 'principally' by a 50 percent threshold test similar to that in the OECD version. [48]

The 2001 UN version continues:

In particular:

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

(b) For the purposes of this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.

The 2017 version of the UN Model will, however, have the same language as the 2017 version of the OECD Model, reflecting a blending of the previous provisions from both models, including adaptations designed to prevent abuse.

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[47] The UN MTC has included a provision since its inception in 1980, and the OECD MTC has included one since 2003.

[48] The U.N. text parallels wording in U.S. domestic law on indirect sales of immovable property and U.S. commentaries to the OECD MTC.

In both MTCs, the definition of immovable property is first found in Article 6:

> *The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ..."*

Clearly, this leaves much scope for more precise definition in domestic law, which varies quite widely.[49]

[49] Krever (2010) notes that "[a]s a general rule, civil law jurisdictions seem content to limit the meaning of immovable property, at its narrowest going little beyond tangible real estate, while natural-resources-rich common law countries have the broadest definition" (p.223). As an example of an expansive approach, he also cites (p.237) the definition of "taxable Australian property" as including "any authority, license, permit or right under an Australian law to mine, quarry or prospect,…a lease of land that allows the lessee to mine, quarry or respect,….an interest in such an authority, license, permit, right or lease…and any rights that are in respect of buildings or other improvements…on the land concerned or are used in conjunction with operations on it." See also Box 9 below and the discussion there.

The basic rule for indirect transfers of immovable property is thus quite similar in the two MTCs.[50] This similarity reflects a commonality of broad intent in the two provisions. Both allocate the primary right to tax to the location country when a transfer by a non-resident occurs in the other state,[51] but restrict this possibility to the specific case when the transfer is directly or indirectly of 'immovable property.'[52]

The exclusion from taxation of indirect transfers involving certain types of entities whose property consists principally of immovable property used by them in their business activities as provided in Article 13(4)(a) of the UN MTC could potentially be limiting—but will be removed from the 2017 UN Model Article. The Commentary to the 2011 UN Model did. not address the interpretation of this exclusion and so the scope of its application is unclear. At worst, exempting from tax in the location country an indirect transfer of immovable property (complying with the more than 50 percent value rule) when it involves property that is being principally used in the business activities of the entity sold—including for example a hotel or mine—as Article 13(4)(a) of the UN model treaty may be argued to do—may go too far in limiting taxing rights, especially for developing countries, as it could involve sectors in which sizeable economic rents are concentrated. [53] Under this interpretation, an entity principally holding immovable property consisting of mines and other facilities would be excluded from taxation under the indirect transfer provision on the basis that those assets are being actively used in its business activities. This would mean that there would not be any allocation of taxing

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[50] Until recently, the UN version was broader in applying to forms of title other than shares (the text to this effect, emphasized above, having been introduced in 2001). Under Action 6 of the BEPS work, however, agreement was reached to amend the OECD MTC to eliminate this difference. There are, however, arguably aspects which deserve consideration (on which Krever (2010) elaborates):

- The limitation to 'shares' risks excluding from tax interests in companies held other than in the form of shares: for instance, as convertible debt or options. Opinions may vary as to whether such instruments should be treated in the same way as share interests, and the coverage of the term "shares" may vary between treaties, as a term which may be defined by reference to domestic law concepts.
- The 50 percent test relates to the proportion accounted for by the immovable property in the total value of the title being sold, not the share of the gain: so taxing rights may be allocated to a country other than that in which the majority of the gain arises. Some countries see this "blunt" aspect of the rule as an advantage, in discouraging abuse, and as minimizing potentially complex disputes on valuation issues as to property distributed internationally. In any case, domestic law may limit the liability to profits proportionate to the amount of immovable property in the taxing countries, and therefore may not seek to fully exert the treaty taxing rights.

[51] Since the articles place no explicit limits on that power to tax, it must be interpreted that the country may do so even if the indirect sale takes place in the other State

[52] The OECD MTC considers other important exclusions, which relate more to implementation complexities than to conceptual issues. For example, 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. Commentary 28.7 to OECD MTC; OECD (2010).

[53] Exclusion considered in same commentary 27.8

rights to the location country on an indirect transfer of interest in such immovable property. Further, to exclude natural resources and the rights to work them from the scope of tax would on its face seem to run directly counter to the language of Article 6. An alternative interpretation commonly put forward is that the "business activities" exclusion only applies where the actual non-resident seller of the shares uses the relevant immovable property in its own business activities as compared to that property being used by the asset owning entity whose shares are being transferred. This interpretation would better preserve the broader application of the indirect transfer provision. Due to this uncertainty, the UN itself notes that "...in practice, this provision is not commonly found in treaties negotiated by developing countries... since gains from the alienation of interests in entities that own and run mines, farms, hotels, restaurants, and so forth, are not covered by this paragraph." [54]

Article 13(5) of the UN MTC (which has no parallel in the OECD MTC) extends the reach of offshore taxation beyond immovable property, however defined (as noted in Section II above):

> "*Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, may be taxed in that other state if the alienator, at any time during the 12-month period preceding such alienation, held directly or indirectly at least ___ percent (the percentage is to be established thorough bilateral negotiations) of the capital of that company*."

This allocates to country *L* taxing rights to gain on the disposal of shares by a non-resident of country *L* arising on shares of a company itself resident in country *L*. However, this treaty provision extends only to shares in companies resident in *L*. That is, it only applies to offshore *direct* ownership in such companies. As noted above, this requirement makes Article 13(5) rather easy to plan around. According to the UN Manual, practice varies widely with regard to this provision. Some countries explicitly exclude gains on listed shares; many countries do not include this provision at all because it is too hard to enforce—even limited as it is in scope. A strong case can be made that Article 13(5) is unnecessary if the definition of gains covered in Article 13(4) is sufficiently broad to include those arising on location specific rents clearly linked to national assets—such as telecommunication licenses—as well as traditional "immovable assets," such as real estate.

[54] United Nations (2016).

Article 13.4 in Practice[55]

About 35 percent of all DTTs include Article 13.456 with an explicit reference to gains that derive their values indirectly from immovable properties (Figure 2). The percentage of DTTs that contain a provision for capital gains from shares deriving value from immovable property, counting also those without the word 'indirectly,' is about 60 percent (Wijnen and de Goede, 2014).57

The inclusion of Article 13.4 is slightly less common in DTTs that involve low or lower-middle income countries, at around 31 percent (Figure 1). This is a noticeably lower proportion than in previous work by Hearson (2016), who finds that, in a sample of 537 DTTs involving developing countries, about 51 percent contain a provision regarding capital gains from shares in immovable property. The difference reflects the use here of a larger sample (close to the universe) and our imposed search criterion for 'indirectly'.

The likelihood that Article 13.4 is included in a treaty[58] is significantly:

- ***Lower if one of the treaty partners is a resource-rich low-income country***, by about 6 percentage points. This is a striking finding, and in light of the discussion above, a troubling one. Examples of DTTs that involve resource-rich low-income countries and omit Article 13.4 include Uganda-Mauritius (concluded in 2003), Malawi-Norway (2009), Trinidad and Tobago-Brazil (2008).
- ***Lower if one of the treaty partners is a low tax jurisdiction,***[59] by about 13 percentage points. This too is troubling, in the sense that these are likely to be cases in which the opportunity to avoid tax in the location country by transferring indirectly is most attractive.
- ***Higher, the greater is the difference between the rates at which capital gains are taxed in the treaty partners.***[60] This, on the other hand, suggests an awareness of the high tax

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[55] The details underlying the analysis in this section are in Appendix C. Data are as of 2015.

[56] By "including Article 13.4" is here meant, more precisely, the inclusion of an article akin to 13.4 of the model treaties with an explicit reference to 'indirectly.'

[57] Wijnen and de Goede (2014) look at about 1,800 DTTs tax treaties and amending protocols concluded during 1997-2013.

[58] This is of course a backward-looking exercise, so does not necessarily speak to the likelihood of future inclusion.

[59] In the sense of being included in the list of Hines and Rice (1994).

[60] There is considerable heterogeneity in capital gains tax rates across countries. There are 35 countries that charge no taxes on capital gains of corporations (e.g., Hong Kong, Malaysia, Singapore, and some resource-rich

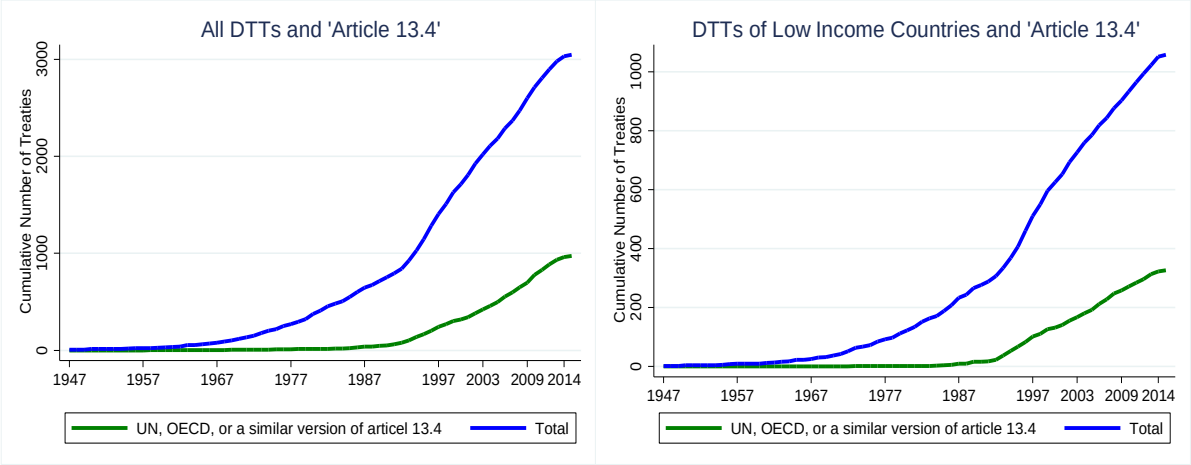
treaty partner to the opportunities for avoidance through OITs. The effect, though, is quite modest: a 10-percentage point difference between capital gains tax rates increases the probability of including Article 13.4 by only about 4-percentage points, on average.

- ***Increasing over time.***

Almost no countries with multiple treaties have Article 13.4 in all of them—implying a vulnerability through OITs structured to exploit treaty provisions. As shown in Figure 3, several countries do not have Article 13.4 in any of their treaties (it appears in none of Gambia's seven, for example) or have it only in relatively few (less than 20 percent, for instance, for Kuwait, Nigeria, and Papua New Guinea).

About 22.5 percent of the universe of treaties include Article 13.5 of the UN model treaty. There is no clear observed pattern linking the inclusion of Articles 13.4 and 13.5: some treaties include only one, some contain both.

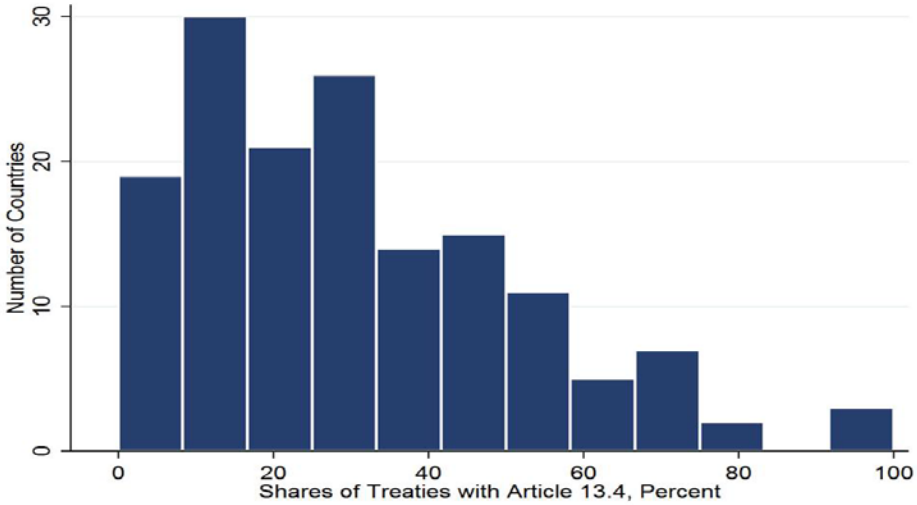
Figure 2: Article 13.4 in DTTs



Note: low-income countries are lower middle-income resource-rich country as defined by the income classification of the World Bank. Annex A describes the DTTs.

countries such as Bahrain and the UAE). At the other end of the distribution, there are 10 countries that impose a rate of 35 percent (e.g., Argentina and the United States) and the highest rate is 36 percent in Suriname.

Figure 3: Proportions of Countries' DTTs including Article 13.4



OITs and the Multilateral Convention

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (also known as the Multilateral Instrument or "MLI") is the outcome of BEPS Action 15, which called for the development of a multilateral instrument to implement efficiently BEPS tax treaty related measures. Accordingly, the Multilateral Convention modifies existing bilateral tax treaties between Convention parties to meet the BEPS treaty-related minimum standards, i.e., the prevention of treaty abuse under BEPS Action 6 and the improvement of the dispute resolution mechanisms under BEPS Action 14. At the same time, the MC facilitates the implementation of other tax treaty measures developed in the BEPS Project, e.g. measures against artificial avoidance of permanent establishment status through *commissionnaire arrangements*.

For countries party to the Convention lacking a provision in their existing tax treaties equivalent to Article 13(4) of the 2017 OECD MTC, Article 9(4) of the MC effectively incorporates such a provision into their tax treaties, which are modified by the MC under international law, unless the country opts out of Article 9(4). By opting for this provision, the jurisdiction in which immovable property is situated would be allowed to tax capital gains realised by a resident of the treaty partner jurisdiction from the alienation of shares of companies that derive more than 50 per cent of their value from such immovable property.

For countries that already have in their tax treaties a provision related to the taxation of capital gains realised from the alienation of shares, the MC offers two options for enhancing such provision. First, Article 9(1) of the MC allows parties to modify their covered tax treaties by introducing a testing period into Article 13(4). Accordingly, Article 13(4) will refer to a period of 365 days preceding the alienation of shares for determining whether the shares derive their value principally from immovable property. Additionally, Article 9(1) of the MC offers the parties the possibility to enlarge the scope of Article 13(4) of the OECD MTC by expanding the

type of interests covered. As a result, interests comparable to shares, such as interests in a partnership or trust, would be also included in the wording of Article 13(4)[61].

Unlike a protocol that amends a single tax treaty, the MC modifies all existing tax agreements identified by the various treaty partner countries signing the MC. In particular, the provisions of Article 9 of the MC shall apply, when relevant, in place of or in the absence of provisions of the relevant tax treaties on gains from the alienation of shares or other comparable interests, unless the signatory has opted not to apply Article 9.

Notably, merely signing the MC does not mean that the signatory's tax treaties will effectively include the provisions of Article 9 of the MC. The MC allows parties signing the convention to reserve their right not to apply any of the provisions included in Article 9(1) or not to include the language of Article 9(4)[62] when their covered tax treaties already contain a provision of this type. [63] In addition, as explained in Section V of this toolkit, the location country must have enabling provisions in its domestic law for effectively imposing tax with respect to a capital gain derived from an OIT.

Beyond the specific provisions included in Article 9, Part III of the MC introduces additional measures to prevent treaty abuse that may also be relevant to preserve the taxing rights of the location country in an OIT situation. In particular, Article 7 of the MC contains the so-called *principal purpose test* and the *limitation on benefits* provisions ('LOB'). Those measures allow parties to a covered tax treaty to deny treaty benefits if obtaining those benefits was one of the principal purposes of the relevant transaction or when a resident of a contracting state does not meet the conditions established under the LOB. This toolkit provides further analysis of the application of general or specific anti-avoidance rules to OITs in Section 5(A).

Finally, the MC may also be a future means of addressing further developments on the taxation of OITs. In this respect, the design of the MC offers the parties the possibility to amend the instrument in the future through the mechanism established in its Article 33. This mechanism would thus allow the inclusion of new tax treaty measures to safeguard the taxing rights of the source country in relation to OITs. To date, the MC has effectively amended a substantial number

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[61] In the 2014 version of the OECD MTC, the option to cover gains from the alienation of interests in other entities such as partnerships or trusts is provided in paragraph 28.5 of the Commentary on Article 13.

[62] Article 9(4) of the MC states that: "For purposes of a Covered Tax Agreement, gains derived by a resident of a Contracting Jurisdiction from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting Jurisdiction if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property (real property) situated in that other Contracting Jurisdiction."

[63] In the first round of signing of the MC, in June, 2017, half of the participating 69 countries reserved on the relevant provision—meaning that they would not include it in renegotiating their treaties.

of tax treaties that now incorporate the new language of Article 13(4) and this number is expected to increase in the future as new signatories opt for the provisions of Article 9 of the MC.

IMPLEMENTATION CHALLENGES AND OPTIONS

The fundamental legal/structural issue with OITs is that contractually the underlying asset does not change hands, so there is formally no capital gain directly realized in respect of it in the country where it is located. What changes hands is stock or a comparable interest in an entity that holds the asset either directly or indirectly, but the stock or interest is—in the cases in question—held and transferred in another country, either in the country of residency of the seller or in a third country. Various situations can then occur.

This section outlines the implementation options and challenges associated with the taxation of OITs. It focuses on the taxation of gains relating to immovable property (including mining rights) situated in a source country (location country). This section also offers some guidance in relation to the taxation of gains relating to a substantial shareholding in a company resident in the location country.

In both model treaties, as seen above, a taxing right arises when over 50 percent of the value of the transferred stock or interest derives from immovable property in the location country. In order to determine whether the value of the interest is principally (more than 50 percent) derived from that immovable property, a comparison is ordinarily required to be made of the value that the immovable property (relevant asset) bears to the value of all the property owned by the entity (all assets) without taking into account debts or other liabilities.

Even where this test is met, since an OIT occurs outside the location country, between a non-resident seller and a buyer who may also be a non-resident, the location country may face significant difficulties in collecting the tax. This section of the report aims to provide practical guidance in relation to the design of possible legal instruments for imposing a tax liability on the gain, which will subsequently enable the tax authority to enforce and collect the tax. The legal instruments outlined in the section consist mostly of sample domestic legislative provisions. This is because, even if any relevant treaties preserve the location country's taxing rights along the lines of model Article 13(4), it is essential that the location country has enabling provisions of this kind in its underlying domestic law.

Overview of Legal Design and Drafting Principles: Two Models

It is critically important that the domestic tax law framework contain an indirect transfer taxing rule as well as appropriate enforcement rules to collect the resulting liability. A treaty cannot create such taxing rights or enforcement mechanisms if they do not exist in domestic law.

There are a number of key design aspects to consider when seeking to tax an OIT. Each aspect has its own legal design considerations and sensitivities in the context of a location country with a tax system that conforms to the existing international norms of residence and source. The key aspects can be summarized as follows:

1. ***Designing the tax liability rule***: There are two common models in this regard:

(a) ***Model 1 (taxation of a deemed direct sale by a resident)***: This model seeks to tax the local entity that directly owns the asset in question, by treating that entity as disposing of, and reacquiring, its assets for their market value where a change of control occurs (e.g. because of an offshore sale of shares or comparable interests). This Model 1 is favored in this report for reasons of enforcement and basis adjustment logic and simplicity.

(b) ***Model 2 (taxation of the non-resident seller)***: This model seeks to tax the non-resident seller of the relevant shares or comparable interests via a non-resident assessing rule.

This Model 2—although more commonly adopted by countries seeking to tax OITs—can give rise to greater enforcement challenges and has more complex design options than Model 1. Model 2 must be supported directly or implicitly by a ***source of income rule***. This source of income rule provides that a gain is *sourced* in the location country when the value of the interest disposed of is derived, directly or indirectly, principally from immovable property located in that country. A source rule relating to gains from the disposal of other assets may also be considered, as discussed above in Section II—including substantial shareholdings in resident companies. A source of income rule may be further supported by ***a taxable asset rule*** dealing with such matters as whether taxation only applies to disposals of substantial interests (such as a 10 percent shareholding rule) to exclude from the scope of tax changes in ownership of portfolio investments. The rule can also prescribe whether the entire gain will be subject to tax when the value of the indirect interest is less than wholly derived from local immovable property or, alternatively, whether the gain will be subject to tax on a pro rata basis. Each legal design option under this rule is discussed and explained further below.

2. ***Designing the enforcement/collection rules.*** These rules are critical as they support the enforcement and collection of the resulting tax liability. They can include one or more of the following:

(a) Notification/reporting and information exchange mechanisms (e.g. domestic reporting requirements supplemented, where appropriate, by international information exchange arrangements);

(b) Withholding tax mechanisms (e.g. on payment of the purchase price);

(c) Mechanisms imposing a tax payment obligation on a relevant local entity (e.g. as agent of the non-resident seller); and/or

(d) Other legal protections such as restricting the registration, renewal or validity of relevant underlying assets (e.g. extractive licenses) unless applicable notification requirements have been met and/or until it is demonstrated that either: no tax is payable; the relevant

tax has been paid; or satisfactory arrangements have been made for the payment of that tax.

A General Anti-Avoidance Rule (GAAR) could be applied as a rule of last resort to tax a gain from an OIT in appropriate circumstances. However, this sort of rule can be quite difficult for countries with weak administrative capacity to apply successfully. Some countries have adopted taxing mechanisms that operate in a similar way to a *specific* anti-abuse rule by seeking to, in effect, collapse the multiple tier holding structure and treat the ultimate non-resident seller of the interests as the seller of the local assets, who realizes a gain with a local source. This is the type of approach adopted in China. The successful application of such a rule ultimately depends on: (i) the design and drafting of the particular anti-abuse rule, which is often less rules-based and more discretionary in its application; and (ii) the capacity of the tax authority to appropriately apply such a specific anti-abuse rule in an even handed and predictable way.[64] This type of rule would only reach the gain in question if intentional tax avoidance regarding the transaction could be shown. Such rules would therefore not provide that the gain in question should be taxed as a matter of principle on the basis of a substantive right to tax in the location country and would be much more limited in scope.

The sample domestic legislative provisions set out throughout this section are general in nature and in the form of simplified rules-based legal provisions. Importantly, they do not take into account the individual circumstances of any particular tax system, nor have they been adapted for all relevant circumstances (e.g. corporate reorganizations) and other common concessions that typically apply (e.g. under a capital gains tax regime, in circumstances when it is considered appropriate to defer the recognition of taxable gain). The ultimate set of provisions to be adopted in the location country to enable it to tax OITs would need to take into account the specific legal tradition and system, as well as the political and administrative structure and fiscal policies of the country concerned.

These sample legislative provisions have been designed and drafted to prevent legal double taxation by the location country—that is, to prevent the gain on an asset transfer being taxed twice by the location country in the hands of the same taxpayer. This reflects common international practice in this context. Consideration could also be given to designing and drafting legislative provisions that limit economic double taxation—in the sense of the same gains being taxed multiple times in the hands of *different* taxpayers through realizations of gains on intermediate shareholdings through multiple tiers of indirect ownership. To achieve this, the tax cost of relevant assets (e.g. each intermediate shareholding) must be reset (stepped-up) to market value each time a relevant taxable realization occurs or, alternatively, the law can provide for the non-recognition of a gain on each intermediate asset.[65] Even though provisions of this

[64] See Waerzeggers and Hillier (2016).

[65] The latter is the method of implementation used for the Chinese provision.

kind would be more comprehensive, they would also be more complex to apply and administer, and so are not reflected in the sample domestic legislative provisions set out in this section. For the purposes of the sample provisions provided in this section, the location country is referred to, as above, as Country *L*.

Model 1: Taxing the Local Resident Asset-Owning Entity under a Deemed Disposal Model

This model seeks to tax the local asset owner on the basis that the asset it holds has undergone a change of control because of an offshore sale of an entity that owns the local asset owner, directly or indirectly. Under this model, the tax liability with respect to the gain realized by the non-resident seller is (unilaterally) triggered for the local resident asset-owning entity under a specific set of domestic legislative provisions, without primary reliance on the international source of income or broader international taxation rules (such as tax treaty allocation rules). This approach has been adopted in a number of source countries, such as Nepal, Ghana and Tanzania.

A sample set of legislative provisions underpinning this domestic deemed disposal model is set out in Box 4.

Box 4: Change in Control

(1) Subsection (3) applies when the direct or indirect ownership of an entity mentioned in subsection (2) changes by more than 50 percent as compared with that ownership at any time during the previous three years.

(2) An entity to which subsection (1) applies is an entity in respect of which, at any time during the 365 days preceding the relevant change in underlying ownership, more than 50 percent of the value of the shares or comparable interests issued by that entity is derived, directly or indirectly, from immovable property in Country *L*.

(3) Where this subsection applies, the entity is treated as:

(a) realizing all its assets and liabilities immediately before the change;
(b) having parted with ownership of each asset and deriving an amount in respect of the realization equal to the market value of the asset at the time of the realization;

(c) reacquiring the asset and incurring expenditure of the amount referred to in paragraph (b) for the acquisition;

(d) realizing each liability and is deemed to have spent the amount equal to the market value of that liability at the time of the realization; and

(e) re-stating the liability for the amount referred to in paragraph (d).

The application of this model can be summarized as follows:

- The model operates to tax the unrealized gain in the hands of the local asset owning entity. That entity will typically be a resident of the location country, giving that country the right to tax on both a residence basis and a source basis. The model seeks to tax the accrued gain on the entire asset when a change of control occurs from the sale of interests whose value is principally (e.g. more than 50 percent) derived from the asset—the local immovable property.

- The tax liability is triggered by a change of control, irrespective of whether that change occurs because of an offshore or onshore sale of shares or comparable interests.

- The tax liability is also triggered irrespective of the size of the interest that is sold to bring about the relevant change in control. That is, no threshold of ownership of the asset is set—for example, by saying that the tax liability would only be triggered if the change of control arises from the sale of an interest of 10 percent or more in the asset. This is done to limit tax avoidance opportunities which would arise if a significant interest threshold were adopted under this model.

- Change of control is determined by reference to direct or indirect ownership, which enables the tracing through of intermediate holding entities between the local asset owning entity and the ultimate issuer of the shares which are the subject of the actual sale.

- Where a change of control occurs, the model treats the local asset owning entity as disposing of its assets for their market value. The value of the local assets which are deemed to be sold could administratively be determined using assumptions and adjustments based on the price at which the actual shares are sold, on the basis that their value is derived from the value of the local assets. An apportionment rule could be adopted and applied so that the price paid for the shares (assuming the share sale occurs on arm's length terms) is appropriately allocated amongst the assets held by the local entity. Additionally, the location country may support its domestic legislation based on Model 1 by imposing a reporting obligation of the price of the shares to the resident entity.

- However, the nature of the disposal is only a deemed (as compared to an actual) disposal for tax purposes. Therefore, the local asset owning entity will still be the legal owner of the assets after the disposal is deemed to take place. In order to protect against double taxation, the model treats the local asset owning entity as reacquiring the assets for their market value. This means that its tax cost in those assets is stepped up to market value—which is important to ensure that double taxation does not arise in the location country in the event that another subsequent change of control occurs.

- Liabilities are also reset under this model for ease of administration. This means that the entire balance sheet is reset instead of resetting only the assets of the local asset owning entity, which would otherwise leave liabilities to be recognized at their historic value and complicate compliance. No gain or loss on a liability would be expected to be realized in the ordinary case under this model where the market value of that liability was equal to its face value.

Enforcement/collection rules

Under this model, the local asset owning entity remains subject to the ordinary compliance rules applicable to resident taxpayers, with no need for specific enforcement and collection rules—or reliance on assistance in collection treaties—to combat the significant difficulties in collecting the tax where transactions take place between two non-residents. Under this model, the tax authority of the location country can use the full suite of its enforcement tools against the local asset owning entity (e.g. apply penalties for a failure to file and pay tax in respect of the deemed gain, and activate the usual enforcement instruments at its disposal, such as seizing or freezing the local assets and selling them to settle an outstanding tax liability).

The key advantages of this model are:

- Greater ability to enforce and collect the tax liability as the taxable gain is deemed to have been realized by the local asset owning entity (as compared to a non-resident). This means that the tax authority can use the full suite of its enforcement tools against the local asset owning entity.

- Double taxation in the location country should not arise when another subsequent change of control occurs, as the basis of the local assets which are deemed to be disposed of is stepped up to market value in the hands of the local asset owning entity.

- The gain under the deemed disposal model consists of a locally sourced gain realized by a local resident entity. Therefore, the taxing right of the location country should not be affected by a tax treaty.

The key disadvantages of this model are:

Some may argue that there would still be tax treaty limitations if a tax treaty were in place, on the grounds that the imposition of the tax is in substance source country taxation triggered by an offshore sale of interests (e.g. shares). However, some consider that this argument could be materially countered by adopting a limitation on benefits (LOB) article, either in a tax treaty or as a domestic law override of a tax treaty, if the non-resident seller is a company situated in a treaty country for the purpose of obtaining treaty benefits (assuming there are no constitutional limitations to doing so through domestic law). An LOB rule can take many forms, but an increasingly common formulation is to require 50 percent or more of the ownership of the resident of the other contracting state to be held by an individual or individuals who are themselves residents of that other contracting state before becoming eligible to access tax treaty benefits. However, countries take different views about the ability to effectively administer an LOB domestically.

- There could be possible double taxation as the residence country of the offshore seller of the transferred interest could tax the gains realized by that seller from the sale. And if so, there would be no foreign tax relief available in the country of the seller, because the tax

liability in the location country arises for the local asset owning entity, and not the offshore seller, who under this model is not taxed at all by the country of location/source.

- Since the entity that directly owns the asset does not receive the money from the transfer of the shares or comparable interests, difficulties may arise regarding the effective collection of taxes when that entity lacks the liquidity required to pay the tax liability. Practically speaking, however, it is expected that the parties (particularly the purchaser) would take steps to ensure that the local asset-owning entity had sufficient funds to discharge its tax liability to prevent the tax authority from taking enforcement action against locally held assets.

- This approach undermines the separate legal entity distinction between the local asset holding entity and its relevant tiers of parent entities.

- This approach, as a practical matter, requires the local asset-holding entity to monitor changes in its own ownership.

Model 1 is favored in this report for reasons of enforcement and basis adjustment logic and simplicity. Under this model, the source rules of the location country (Country L) would need to be designed and drafted in a manner that would *not* result in the OIT that triggered a change of control having a source in Country *L*. If the actual sale of the offshore interests were held to be sourced in Country *L,* double taxation would arise on the same transaction in the same location as a result of both *deemed* resident taxation and *actual* non-resident taxation in Country L. A tax liability rule which is designed and drafted to impose the primary tax liability on the non-resident seller of the relevant interest instead of on the local asset owner (under a non-resident taxation model) is discussed hereafter in the context of Model 2.

Model 2: Taxing the Non-resident Seller

Under this model, Country *L* seeks to impose tax on the non-resident seller on the basis that the transfer gives rise to a gain with a local source in Country *L*. Where countries have resolved to tax OITs, this model (or a variation thereof) has been the one more commonly adopted. Under this model, the source rules become critical for triggering the tax liability in the location country. This is because a non-resident is ordinarily[66] only subject to taxation on income derived from sources in the particular location country. By way of example, a sample source rule along the lines shown in Box 5 below could be considered when seeking to impose a liability on a non-resident in respect of a gain realized on the sale of an indirect interest in immovable property situated in the location country *L*.

[66] Assuming that the tax system of the location country is structured using international norms like those embodied in the model treaties—but included in the location country's domestic law/source of income rules.

Box 5: Source rule

The following amounts are derived from sources in Country L:

(a) A gain arising from the alienation of:

(i) immovable property in Country L;

(ii) shares or comparable interests, if, at any time during the 365 days preceding the alienation, more than 50 percent of the value of the shares or other interests is derived, directly or indirectly through one or more interposed entities, from immovable property in Country L;

As noted above, the source rule may be combined with a taxable asset rule. The practice as embodied in Article 13(4) of the OECD and UN Model MTCs is to allow the taxation of the entire gain when the value of the indirect interest is principally (e.g. more than 50 percent) derived from local immovable property. Where this is the case, reliance may simply be placed on the source rule (above). Alternatively, a taxable asset rule may confirm and support this treatment by providing that the entire gain is taxable when the value of the indirect interest is principally (e.g. more than 50 percent) derived from local immovable property. The taxable asset rule could alternatively be designed and drafted to apply *on a pro rata basis* where a lower threshold is met (e.g., 20 percent rather than 50 percent or more). For example, a pro rata mechanism of this nature has been adopted in Kenya for the extractives sector. Where such a lower threshold is adopted, it would generally be appropriate to impose tax only on a proportionate basis. A sample set of domestic legislative provisions demonstrating the two approaches is outlined in Box 6 below.

Box 6: Taxable asset rule – full and pro rata taxation

(1) The chargeable income of a person includes gains from the realization of shares or comparable interests, if, at any time during the 365 days preceding the realization, more than 20 percent of the value of the shares or other interests is derived, directly or indirectly through one or more interposed entities, from immovable property in Country L.

(2) For the purposes of subsection (1), the amount of the gain to be include in chargeable income is-

(a) if the shares or other interests derive, or derived at any time during the 365 days preceding the realization, more than 50 percent of their value, directly or indirectly, from immovable property in Country L, the full amount of the gain; or

(b) in any other case, the amount computed according to the following formula:
A × **B/C**

where-
A is the amount of the gain;
B is the value of the shares or other interests derived, directly or indirectly, from immovable property in Country L; and
C is the total value of the interest.

The development and application of any domestic legislative provisions will need to take into account any existing tax treaty obligations. However, as discussed above, the taxing right over gains realized on offshore indirect transfers which are principally (e.g. more than 50 percent) derived from local immovable property is generally preserved in Article 13(4) of the OECD and UN MTCs. Both MTCs permit the location country to capture gains from the sale of relevant interposed holdings at different tier levels. It is important that the domestic legislative provisions of the location country are designed and drafted to preserve this taxing right over relevant interests which derive more than 50 percent of their value, directly or indirectly, from immovable property in the location country as permitted by the MTCs.

There is also the further question of whether the taxable asset rule should define—and potentially narrow—the scope of the interest which is to be subject to tax. Three further considerations arise in this regard: (i) whether a tax liability should arise in relation to the disposal of all interests (including interests even representing less than a de minimis interest in the asset), as long as the value of the interest disposed of derives more than half its value from that asset; or (ii) whether the rule should apply only to the disposal of more significant interests (e.g.

interests of 10 percent or more of the asset); and/or (iii) whether a back-up threshold based on the nominal value of the interest should apply (e.g. apply the rule only to interests with a value of $1 million or more). For example, if a percentage of interest threshold were to be adopted, a 10 percent threshold could be considered as it is the international norm for distinguishing between a non-portfolio and portfolio investment. If adopted, such thresholds could help minimize compliance costs and ease administration. However, implementing a threshold interest requirement needs to be carefully drafted so as to preserve the policy intent of the threshold and combat tax avoidance opportunities through staggered sell-downs (i.e. selling multiple parcels of shares each comprising an interest of less than 10 percent).

Finally, countries may provide exemptions to the application of Article 13(4) of the OECD and UN MTCs to certain capital gains for different reasons. As explicated in the Commentary on Article 13(4) of the OECD MTC, these exemptions may refer to gains derived from the alienation of: (i) shares of companies listed on a stock exchange; or (ii) shares in the course of a corporate reorganization; or (iii) shares which derive their value from immovable property where a business is carried on; or (iv) shares held by pension funds; or (v) a small investor's interest in a REIT.

Enforcement/collection rules

Non-residents subject to tax in Country *L* under this method would normally be required to file tax returns in Country *L* where a taxable gain is realized in relation to the OIT. However, compliance with this obligation could be expected to be low. Even though the tax authority in Country *L* has certain enforcement instruments at its disposal (as noted above), these can be difficult to apply in the case of a tax liability of a non-resident (as compared to a tax liability of a resident), particularly when the sale proceeds from disposing of the interest have left, or were never in, the location country, and there are no other assets directly owned by the transferring offshore entity in the location country to meet or secure the tax liability. Therefore, appropriate supplemental enforcement and collection mechanisms need to be designed, drafted and implemented for this situation.

Certain legal protections can be developed to support the enforcement and collection efforts of the tax authority, as well. Measures of this kind could consist of restricting the registration, renewal or validity of relevant underlying assets (e.g. extractive licenses) by governmental registration bodies or other registration and issuing entities, unless applicable notification requirements have been met and/or sufficient evidence has been furnished to demonstrate that either no tax is payable, the relevant tax has been paid, or satisfactory arrangements have been made for the payment of that tax.

Withholding

Several countries use a withholding mechanism to collect tax with respect to a non-resident seller's gain. A specific withholding tax regime can be designed and drafted to apply to payments to a non-resident seller. Withholding taxes can represent all or a portion of the tax

liability (which could be an estimate) of the recipient of the payment. The tax must be withheld from the payment by the payer and paid to the tax authority in the location country.

A withholding tax regime may be designed to impose a withholding tax of either a final or non-final nature. A final withholding tax represents the final tax liability for the person receiving the payment withheld upon. Final withholding tax regimes are common for gross payments of dividends, interest and royalties made to non-residents. In contrast, a non-final withholding tax is collected as an estimate of the recipient's final income tax liability. The recipient is ordinarily still required to file a return and pay any outstanding balancing amount after claiming a credit for the amount of tax withheld (or receive a refund, if the withheld amount exceeds the tax due). Typically, a withholding tax regime applicable to OITs would be designed as a non-final regime. A withholding tax regime applies to OITs in a number of jurisdictions, including the U.S., Canada, India, China and Australia.

The withholding tax regime could be designed to exclude withholding in certain circumstances in order to minimize compliance costs. This could include, for example, transactions below a predetermined de minimis threshold; transactions related to listed securities on a stock exchange; transactions wherein a clearance certificate is obtained from the tax authority in Country *L* to confirm that no amount is required to be withheld in the particular circumstances (for example because the asset is being sold for a loss etc.). A sample withholding tax regime is shown in Box 7.

There are a number of issues in relation to the adoption of a withholding tax regime in the context of OITs. For example, if the purchaser is also a non-resident then similar non-compliance risks arise. As noted, the withholding tax can only be collected as an estimate of the seller's final income tax liability (as the actual quantum of the seller's gain is unlikely to be known by the purchaser) and so withholding necessarily increases the compliance burden for the purchaser (who is subject to the withholding obligation) and the seller (who needs to file a tax return and determine any outstanding balancing amount or refund after claiming a credit for the amount of the tax withheld)—although this burden could be manageable. In this regard, it is often considered that the risk of non-compliance with a withholding tax obligation in the context of OITs (particularly where the purchaser is also a non-resident) is minimized by the likelihood that a prudent third party purchaser will not acquiesce or facilitate the avoidance of the seller's tax liability (and therefore is more likely to comply with its withholding tax obligation). Further, a failure to withhold would expose the purchaser to penalties and potential seizure of the local asset by the tax authorities, and would also result in the seller making a windfall gain if the purchaser was unable to recover the penalty amount from the seller. In this sense, the withholding tax mechanism creates an interest in the purchaser as to the tax compliance of the seller in respect of the transaction.

Box 7: Enforcement/collection rule – withholding tax

(1) A person must withhold tax at the prescribed rate when:

(a) the person pays an amount to another person (recipient) in acquiring shares or comparable interests; and

(b) more than 50 percent of the value of the shares or comparable interests referred to in paragraph (a) is derived, directly or indirectly through one or more interposed entities, from immovable property in Country *L*.

(2) The person (withholding agent) must pay the amount to the tax administration on or before the day that the withholding agent becomes the owner of the shares or comparable interests and must file a statement in the manner and form prescribed.

(3) A withholding agent who fails to withhold tax in accordance with this section must nevertheless pay the tax that should have been withheld in the same manner and at the same time as tax that is withheld.

(4) Where a withholding agent fails to withhold tax from a payment as required by this section-

(a) the recipient is jointly and severally liable with the withholding agent for the payment of the tax to the tax administration; and

(b) the tax is payable by the recipient immediately after the withholding agent becomes the owner of the shares or comparable interests.

(5) A withholding agent who withholds tax under this section and pays the tax to the tax administration is treated as having paid the amount withheld to the recipient for the purposes of any claim by the recipient for payment of the amount withheld.

(6) A withholding agent who fails to withhold tax under this section but pays the tax that should have been withheld to the tax administration in accordance with subsection (3) is entitled to recover an equal amount from the recipient.

(7) The recipient is treated as having paid any tax-

(a) withheld from the payment under this section; or

(b) paid in accordance with subsections (3) or (4).

(8) A recipient is entitled to a tax credit in an amount equal to the tax treated as paid under subsection (7) for the year of assessment in which the payment is derived.

Notification and agency taxation

In the absence of adopting a withholding tax regime, two other enforcement and collection measures may be considered for the purpose of putting the tax authority in the best

position to be aware of the disposal and then being able to subsequently enforce and collect the tax. These involve designing and imposing the following two obligations:

(a) a notification/reporting obligation; and
(b) a payment obligation for an entity in the location country as agent for the non-resident.

The notification/reporting obligation is important not only for raising an assessment, but also for exploring other available avenues for recovery of any unpaid tax on the transfer, such as through an Assistance in the Collection of Taxes Article under applicable tax treaties or though the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters. Further, imposing a payment obligation on a resident person or entity as agent for the non-resident enables the tax authority to use the full suite of its enforcement tools against that resident. Legislative mechanisms of this kind have recently been adopted in Kenya and Fiji for the extractives sector. A sample set of legislative provisions is set out in Box 8. For illustrative purposes, they are shown as triggered with respect to holdings of non-portfolio interests of 10 percent or more.

Box 8: Enforcement/collection rule – notification and agency taxation of non-portfolio interests

(1) Subsection (3) applies when the direct or indirect ownership of an entity mentioned in subsection (2) changes by 10 per cent or more.

(2) An entity to which subsection (1) applies consists of an entity in respect of which, at any time during the 365 days preceding the relevant change in the direct or indirect ownership, more than 50 percent of the value of the shares or comparable interests issued by that entity is derived, directly or indirectly, from immovable property in Country *L*.

(3) Where this subsection applies, the entity:

  (a) must immediately notify the tax administration, in writing, of the change; and
  (b) is liable, as agent for any non-resident disposing of the interest to which the notice under paragraph (a) relates, for tax payable by the non-resident under this Act in respect of the disposal.

(3) Subsection (3)(b) does not apply to the disposal of shares quoted in any official list of a recognized stock exchange in Country *L*.*

(4) Any tax paid by the entity on behalf of a non-resident under subsection (3) is to be applied against the tax liability of the non-resident under this Act.

***** This exclusion reflects that relevant parties are unlikely to be in a position to establish by legal agreement how the ultimate burden of the tax is to be borne by them where the shares are sold on a stock exchange.

Pros and cons of Model 2

The key advantages of Model 2 are:

- It more closely preserves the separate legal entity distinction between the local asset owning entity and its relevant holding entity/parent.
- Relief of double taxation is preserved in the country of residence of the seller, as foreign tax relief should remain available because the offshore seller is primarily liable for the tax payable sourced in the location country on the gain realized from the sale.

The key disadvantages are:

- Reduced ability to enforce and collect the tax liability as the taxable gain is realized by the non-resident seller (as compared to a local entity under the deemed disposal model)—although this could be aided by using the withholding/agency collection mechanism.
- The agency approach assumes that the direct owner in country *L* can always make itself aware when there has been a transaction resulting in a 10 percent or greater change in the underlying ownership of the entity.
- Double taxation can effectively arise on a subsequent sale of interests in other entities that indirectly hold the assets because shares or interests in those entities are not stepped up to market value.[67] However, this is a general feature that typically arises when there are multiple tiered holding structures, whether domestic or cross-border.
- Even with appropriate domestic legislation, under this model the taxing right of the location Country *L* could (unless there was a treaty override) still be limited by an applicable tax treaty, if the relevant treaty does not include an article similar to Article 13(4) of the OECD or UN Model MTC.

Defining "Immovable" Property

In all of the foregoing approaches, an appropriate definition of "immovable property" is critical for the effective application of the chosen tax liability rule and associated enforcement and collection rules. A definition of "immovable property" with appropriate

[67] It is assumed that the shares actually transacted will receive a market value tax basis under the tax law of Country *L* equal to the amount paid by the purchaser for those shares. This prevents effective double taxation if that purchaser was to subsequently sell those same shares.

breadth will be equally relevant for Model 1 and Model 2**,** and each of those models is capable of having even greater reach in circumstances where that definition is extended to cover a broader category of "immovable property" than is traditionally the case. A sample minimal definition of "immovable property" is set out in Box 9 below:

Box 9: Minimal definition of immovable property

"immovable property" includes* a structural improvement to land or buildings, an interest in land or buildings or an interest in a structural improvement to land or buildings, and also includes the following–

(a) a lease of land or buildings;

(b) a lease of a structural improvement to land or buildings;

(c) an exploration, prospecting, development, or similar right relating to land or buildings, including a right to explore for mineral, oil or gas deposits, or other natural resources, and a right to mine, develop or exploit those deposits or resources, from land in, or from the territorial waters of, Country L; or

(d) information relating to a right referred to in paragraph (c).

***** This definition has been drafted on an inclusive basis and presupposes that it would cover within the ordinary meaning of "immovable property" all traditional notions of real property (e.g. land, buildings and mines etc.).

The above definition is considered to be a minimum domestic law definition of immovable property for the purpose of taxing OITs under either Model 1 or Model 2. Confining the definition of immovable property to traditional notions of real property in the form of land and buildings is too restrictive. Such a narrow definition would not be sufficient to enable Country *L* to trigger its taxing right over common gains made in the context of extractive industries, such as gains from licenses to explore for, develop, and exploit natural resources located in County *L*. Countries should therefore define the meaning of immovable property in their domestic laws to include at least:

- Real property (in the narrower sense);
- Mineral, petroleum, and other natural resources; and
- Rights (such as those embodied in licenses) to explore for, develop, and exploit natural resources, as well as information relating to those rights.

A robust and sufficiently broad definition of immovable property will also be important in the context of the application of a tax treaty. This is because the basic rule under the OECD and UN MTCs is that the term "immovable property" has the meaning under the domestic law (tax or other law) of the contracting state in which the property is located.

However, the minimum definition could be further extended to cover a broader category of "immovable property" that it would be appropriate for Country *L* to seek to tax. As

argued above, this could include—for example—gains arising in relation to location specific rents clearly linked to national assets, such as from licenses to exploit public goods (e.g., electric, gas, or other utilities; telecommunications and broadcast spectrum and networks etc.).[68] An extended definition of "immovable property" could be achieved by adding paragraph (e) to the sample minimum definition, as set out in Box 10 below:

Box 10: Extended definition of immovable property

"immovable property" includes…

…

(e) A right granted by or on behalf of the government (whether or not embodied in a license) to be a supplier or provider of:

(i) goods (such as radioactive material);

(ii) utilities (such as electricity or gas); or

(iii) other services (such as telecommunications and broadcast spectrum and networks),

countrywide or within a geographic area of Country L.

Consideration could be given to extending the definition even further, to cover rights to receive variable or fixed payments in relation to extractive industry rights or government issued rights with an exclusive quality. This would also ensure that gains relating to any subsequent assignments derived from those underlying rights granted by or on behalf of the government of Country *L* would also remain within Country *L*'s tax base. It is clearly the case, however, that the concept of location specific rents is much easier to conceive of in economic terms than it is to convey in legal language. This is an area in which further thought is needed.

[68] It may be that an enhanced ability to tax rents generated by government restrictions would have an adverse effect in encouraging the imposition of such restrictions. This is a reasonable and significant concern. Such incentives already exist, however: Auriol and Warlters (2005) find evidence that governments in lower income countries tend to create barriers so as to concentrate profits in easily-taxed large firms. The prior practical issue, in any case, may be securing revenue where such rights are needed to regular major natural monopolies.

CONCLUSIONS

The central conceptual issue raised by OITs is that of how taxing rights should be allocated between the country where the underlying asset is located and others involved in the transaction—should the country in which the asset is located have primary taxing rights on an indirect transfer of its ownership that takes place outside the location country?

This report and toolkit concludes that, at least in the case of an asset that embodies location specific economic rents (e.g., natural resources physical assets and rights; rights to location specific telecom licenses/businesses) and other immovable property assets, the answer is "yes" This is so, moreover, regardless of whether equivalent tax in regard to the transfer would be paid elsewhere. That is, the rule should not apply only as an anti-avoidance device to combat "double non-taxation," but rather should constitute a fundamental aspect of the international tax architecture—in which rights to tax gains arising on such assets when subject to an indirect transfer offshore would be primarily allocated to the location/source country.

The rationale for this conclusion rests on several pillars. In equity terms, it mirrors a quite generally recognized right in relation to direct transfers of immovable assets. In efficiency terms, it provides a backstop to the taxation of location specific rents which other instruments may be able to achieve only imperfectly, and also fosters neutrality between direct and indirect transfers. And it responds to quite justified domestic political pressures—in the case of the sale of salient national assets—which pressures, experience shows, can lead to uncoordinated measures that jeopardize the smooth and consensual functioning of the international tax system and can give rise to tax uncertainty.

Existing responses to this issue by various countries embody differing approaches, suggesting a need for a more uniform approach. Current responses differ both in terms of which assets are covered (immovable property, narrowly or broadly defined; other assets like telecoms; intangibles such as corporate stock issued in regard to a domestic company but held by a non-tax resident), and in terms of the method used to impose the tax as a legal matter.

The provisions of both MTCs suggest quite wide acceptance of the principle that capital gains taxation of OITs of "immovable" assets be primarily allocated to the location country. It remains the case, however, that Article 13(4) is found only in around 35 percent of all DTTs, and is less likely to be found when one party is a low-income resource rich country. To date, the Multilateral Convention has had a positive impact on this percentage by increasing the number of tax treaties that effectively include Article 13(4) of the OECD MTC. This impact is expected to be higher in the future as new parties may decide to negotiate or re-negotiate treaties based on the 2017 OECD and UN formulations that paragraph, and/ or to sign the MC and modify their covered tax treaties to include the new language of Article 13(4).

The report also stresses, however, that, whatever treaties may or may not come into play, such a taxing right cannot be supported without appropriate definition in domestic law of the assets intended to be taxed, and without a domestic law basis to assert that taxing right. Sample legislation for such rules was provided in the text.

A key issue in that context is the appropriate definition of "immovable." The concept is not one that is especially meaningful in economic or even administrative terms. The analysis here suggests that a more useful conceptual approach is to focus on and aim to capture within the definition those assets whose value derives in large part from location specific rents. While it would be preferable to tax such rents directly—as indeed countries are routinely advised to do—, imperfections in the design and implementation of these can leave a valuable backstop function for taxation of the gains associated with increases in the value of such rents. This view of the underlying economics points towards a sufficiently expansive definition of immovable assets to include a wide range of transfers related to rights bestowed by government that are capable of generating substantial income.

The central practical issue raised by OITs is enforcement of taxation by the country in which the asset is located—provisions for which require careful drafting. The report outlines the two main approaches for so doing—which in legal terms are quite different—and provides, again, sample simplified legislative language for domestic law in the location country for both. One of these methods—favored in this report for reasons of enforcement and basis adjustment logic and simplicity—treats such an OIT as a deemed disposal of the underlying asset. The other treats the transfer as taking place by the actual seller, offshore, but sources the gain on that transfer within the location country—thus permitting the country to tax it.

APPENDIX A. CONSULTATIONS

[For final report]

APPENDIX B. COUNTRY PRACTICES—SOME EXAMPLES

There is considerable diversity in countries' approaches to taxing OITs. Many OECD countries naturally follow their MTC, but not all. Significantly, Mexico's approach is closer to the UN MTC: it taxes capital gains realized by foreign residents on the transfer of shares issued by domestic companies, regardless of where the title is passed, if more than 50 percent of the value of these shares derives from immovable property situated in Mexico.[69] Other countries deviate from both the OECD and the UN MTC. The U.S., Peru and China, to name a few, exemplify this diversity. For instance, the transfer in the Zain case described in Box 3 (p.23) would not be taxed in the U.S., but would be in Peru, and might or might not be in China.

U.S. taxation of dispositions of U.S. real property held by foreign investors

Weaknesses of a pure residence taxation model

The U.S. income tax originally followed the premise that, in the absence of a U.S. trade or business, business profits of foreign residents should be taxed in their place of residence, defined in the case of individuals by a physical presence test (at least 183 days during 12 consecutive months). However, the law allowed numerous avenues to avoid the U.S. capital gains tax when there was a U.S. trade or business. For example, the payment for the sale of an asset could be timed to occur after the entity engaged in the U.S. trade or business had been liquidated, so that the capital gain would be realized when the foreign resident had no U.S. business to be connected to. Also, foreign residents could exchange the U.S. property for another of the same kind abroad and this would not qualify as a realization of a capital gain[70]. Alternatively, the foreign resident could hold the property in a domestic (or foreign) corporation and sell the stock of the corporation instead of the underlying property; in other words, it could avoid the tax through an indirect sale (either onshore or offshore).[71]

The farmers' lobby

Of particular concern was that foreign investors could have a resident tax status during the operational stage of the business, obtain a net income basis tax regime for that period of time, minimizing taxable profits (through expense deductions), and switch to a non-resident tax status

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[69] Ley del ISR (Mexico), art 161.

[70] Brown (2004), p.297.

[71] Petkun (1982), p.13

when selling the appreciated asset, avoiding the capital gains tax at that point.[72] Assuming that foreign investors paid no (or little) capital gains tax abroad on the sale of the U.S. property, they would have an advantage over U.S. businesses. Farming lobbies in the U.S. made this point forcefully in the late seventies.[73] Indeed, they claimed that "… foreign investors in U.S. farmland get such good breaks they often can afford to outbid American farmers who want to expand their holdings".[74] The National Farmers Union was particularly concerned about tax treaties that granted additional avenues to avoid the capital gains tax. In their view, for example, the treaty being renegotiated with the UK at the time would contain "… a provision which would invite large-scale state income tax avoidance by foreign interests dealing in oil, grain, and commodities or investing in U.S. farmland".[75] The issue at hand was that the treaty prevented the U.S. from taxing foreign investors on the gain from the disposition of U.S. capital assets.[76]

U.S. tax on capital gains obtained by nonresidents

The current Foreign Investment Real Property Act (FIRPTA) was enacted in 1980 to remove the perceived competitive advantage favoring foreign investors in the U.S. real property market.[77] Under this law non-resident aliens would no longer be able to avoid U.S. tax on gains upon the direct sale of real property in the U.S. The statute defines real property as mines, wells and other natural deposits, ownership of land (or improvements), and options to acquire land[78], and it taxes the sale of all directly held U.S. real property interests (RPIs), including those held by foreign residents, not just those for which the taxpayer received net basis taxation.[79] It does not include, however, stock regularly traded on an established securities market, regardless of how much of its value may be represented by U.S. real estate holdings.[80]

FIRPTA taxes gain on disposition of the following defined U.S. RPIs:

1. Direct interests in real property located in the U.S.;

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[72] Presumably the value of the asset could reflect undistributed accounting profits.

[73] Petkun (1982), p.14

[74] *Spokane Daily Chronicle*, May 8, 1978. See also Brown (2004), p.298.

[75] Citing an unpublished working paper by the US Department of Agriculture, the press explained that, for example, a "… German investor often possesses the advantage of escaping from all capital gains taxes and does not relinquish the privilege of being treated identically with U.S. taxpayers in other respects"; meaning that the German investor did not get taxed on its gross operational income if it had consistently been considered as a passive foreign investor. *Spokane Daily Chronicle*, May 8, 1978

[76] Petkun (1982), p. 27

[77] FIRPTA principal provision: IRC, S 897.

[78] It should be noted that in the U.S. landowners also own what lies underground beneath their property.

[79] Brown (2004), p. 305.

[80] Petkun (1982), p.21.

2. Interests in a domestic corporation which holds substantial U.S. real property[81];
3. Interests in domestic or foreign partnerships, trusts or estates with U.S. real property.

Also, FIRPTA overrode treaties that exempt foreign residents from a capital gains tax on their U.S. RPIs in any of those three cases.[82] FIRPTA does not alter the basic principle governing U.S. taxation of non-residents: all gains (and losses) from dispositions of directly held U.S. RPIs are treated as income effectively connected with a U.S. business and the foreign investor disposing of a U.S. RPI is deemed to be engaged in a U.S. business and thus taxed accordingly.

Importantly, however, a foreign corporation can hold U.S. real property and the disposition of its stock by a foreign investor is not subject to U.S. tax; FIRPTA does not reach foreign indirect sales of U.S. property held by a foreign corporation.[83]

Indirect effect of FIRPTA on foreign investors

According to some analysts, the fact that nonresident investors are not taxed on the capital gains from disposing shares in a foreign corporation holding U.S. real property does not mean that FIRPTA left a loophole.[84] The argument in essence is that transferring a foreign holding company that owns an appreciated U.S. RPI without paying the corresponding capital gains tax transfers the tax contingency to the purchaser, who will inherit the original cost basis of the asset. Assuming that the underlying asset will eventually be directly disposed of in the local market in a subsequent transfer, the purchaser will consequently discount the price of the foreign shares representing indirect ownership of the U.S. RPI.

In the understanding that foreign corporations are restricted in their ability to transfer U.S. RPIs without recognizing taxable gain, the buyer of the foreign stock will pay a lower price to take into account the future tax liability; "this pricing adjustment, if it occurs, will result in imposing the U.S. income tax on the seller indirectly".[85] In the words of another analyst: "… while the sale of stock in a foreign corporation holding U.S. realty is not taxable under FIRPTA, the foreign seller can be expected to bear an indirect tax due to receipt of a reduced sales prices reflecting the corporation's future tax liability."[86]

Peru

[81] A 'real property holding corporation' is defined as holding majority real property, which is marked to market.

[82] Starting 4 years after the enactment of FIRPTA in 1980, before article 13 (4) was introduced in the MTC.

[83] Petkun (1982), p. 23; see also Doernberg (2012), p.112.

[84] Petkun (1982), p. 23.

[85] Petkun (1982), p. 23.

[86] Brown (2004), p. 299.

After the contentious case of Petrotech (described in Box 2) , Peru passed legislation taxing all OITs, not just those whose value arises from immovable property located in Peru. The sale of an interest of any nonresident company whose value results at least 50 percent from shares of companies residing in Peru would be taxed in Peru. At least 10 percent of the parent foreign resident assets must be transferred for the tax to take effect[87], thus, sales of retail investors abroad would not be affected.

Box A.1: Peru's Income Tax Law on offshore indirect sales of assets

Art. 10.- "... *it is also income from Peruvian source:*

e) That obtained from the indirect sale of shares or participations representing capital of legal persons residing in Peru. An indirect sale occurs when shares of participations representing the capital of a non-resident legal person that, in turn, is the owner - directly or through one or more intermediaries- of shares or participations representing the capital of a legal person resident in Peru, if ... concurrently ...

1. In any of the twelve months prior to the sale, the market value of the shares ...of the resident entity ... represent ... at least fifty percent of the market value of all shares ... of the non-resident entity.

.....

2. In any period of twelve months, shares sold by the non-resident... represent at least ten percent of the capital of the non-resident entity.

An indirect sale also occurs when a non-resident entity issues new shares ...resulting from an increase in subscribed capital, new capital contributions ...or a reorganization that diminishes their value below the market benchmark.

In all cases, whenever the share sold, or the new shares issued ... belong to an entity residing in low tax jurisdiction; it will be treated as an indirect sale."

China

China's approach to taxation of capital gains on transfers of interests is different because it is structured as an anti-abuse provision. The general rule is that the gain on direct transfers of assets located in China is taxed at a 25 percent rate and offshore indirect transfers are equally taxed when involving the sale of immovable property located in China. In other cases, the

[87] The first condition was introduced with the Law No. 29663, February 2001; the second condition with Law No.29757, July 2011. Peru's domestic legislation taxing OITs can be overridden by double taxation treaties.

taxation right on the indirect transfer of equity investment is sourced to the location of the investing enterprise. This means that a nonresident enterprise which owns another nonresident holding company which in turn invests in a Chinese company, would not be taxed in China on the gain resulting from the transfer of shares of the holding company; the capital gain is sourced in the location of the holding company.[88]

However, if the holding company is situated in a jurisdiction where the effective tax burden is lower than 12.5 percent or where offshore income is not taxed, the Chinese tax authority may disregard the overseas holding company and re-characterize the indirect transfer as a direct one if it determines that there is no reasonable commercial purpose to the offshore transaction other than avoiding the Chinese tax.[89]

Considerations determining whether a transaction fails the reasonable business purpose test include, for example, if i) the value of the asset directly transferred derives at least 75 percent (directly or indirectly) from Chinese taxable property; ii) the nonresident enterprise does not undertake substantive functions and risks; the tax consequence of the indirect transfer in the foreign country is less than the Chinese tax if the sale has been done directly.[90]

The Chinese approach to indirect transfers of assets is relatively defensive and discretionary: it taxes OITs when it deems they have been structured to avoid the Chinese tax, while not taxed commensurately by another jurisdiction

[88] Rule originally established in Notice No. 698, December 10, 2009 and replaced by Public Notice (2015) 7.

[89] Article 47 EIT Law. Some exceptions apply, for example, sale of shares in the stock exchange.

[90] Wei (2015).

APPENDIX C. ARTICLE 13.4 IN PRACTICE—AN EMPIRICAL ANALYSIS

This Appendix describes and explores the presence or absence of Article 13.4 in (essentially the universe of) double tax treaties as of 2015.[91] It also looks at country characteristics that affect the likelihood of including this provision in a DTT.

Data and Variables

The analysis covers 3,046 DTTs—which is almost the entire universe of active DTTs. Of these, 2979 were recovered from the International Bureau of Fiscal Documentation (IBFD); the rest were recovered by internet search or from the ActionAid tax treaties dataset.[92]

About 35 percent of these treaties (973) include a provision that entitles the source country to tax gains from alienation of capital stock of an entity the property of which consists directly or "indirectly" principally of immovable property. we are unable to distinguish meaningfully between adoption of UN and OECD versions.

Further, about 35 percent of the treaties that involve at least one resource-rich country include article 13.4 as defined in this section (291 of 834 treaties) (Figure A1). Additionally, about 38 percent of the treaties that involve at least one low tax jurisdiction include Article 13.4 (Figure C.1).

In modelling the likelihood of Article 13.4 being included in treaty (conditional on the existence of a treaty) we make use of the following variables (summary statistics being in Table C.1):

- *Article 13.4*, the dependent variable, is a dummy equal to one if a DTT includes article 13.4 and the word "indirectly" (using the UN or the OECD version or similar variants), and zero otherwise.
- *Resource-rich low-income* is a dummy equal to one if at least one signing country is a low-income or lower middle-income resource-rich country (as defined by the income classification of the World Bank and if revenues from resources exceed 10 percent).
- $CGT_i - CGT_j$ is the difference (in absolute value) between the concluding countries' tax rates on capital gains. If a country's tax code distinguishes between *CGT* for corporations and for personal tax purposes, we use the corporate *CGT*. The source is country reports

[91] If a treaty contains this provision, in some cases it appears under a different number in the treaty (e.g., 13.2, 13.5, or 14.4). Further, it should be emphasized that, in this analysis, if a provision on the treatment of gains from immovable property is present in a DTT but does not explicitly state the word "indirectly", it is not referred to as Article "13.4".

[92] At http://www.ictd.ac/datasets/action-aid-tax-treaties-datasets

published by Ernst and Young and Deloitte. A larger difference in *CGT* makes the use of a DTT for tax planning more attractive.

- *Low tax* is a dummy equal to one if the jurisdiction is a low tax jurisdiction in the sense of being included in the list of Hines and Rice (1994). There are 454 DTTs that involve such countries (almost 1/6 of the total).[93]

- *Low tax* × *Low Income Res.* is an interaction term between *Resource-rich low-income* and *Haven*. This variable enables us to test whether the role of low tax jurisdictions depends on the income level of the partner country. The idea is that *Low tax* can have an impact on *Article 13.4* only if (i.e., conditional on the observation that) one signing country is a low-income country, but not if that country is an advanced economy. It is ultimately an empirical question whether or not this can be the case.

- *Year* is the year of concluding the treaty. Essentially, it is a trend variable spanning from 1947 to 2015.

Table C1: Descriptive Statistics

VARIABLES	N	mean	SD	min	max
Article13.4	3,046	0.319	0.466	0	1
Year	3,046	1997	12.51	1947	2015
$CGT_i - CGT_j$	2,993	11.05	8.512	0	35
Low tax	3,046	0.149	0.356	0	1
Resource-rich low-income	3,044	0.105	0.306	0	1
Low tax × *Low Income Res*	3,044	0.00591	0.0767	0	1

[93] The list includes 50 jurisdictions: Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, Bermuda, Cayman Islands, Cook Islands, Costa Rica, Cyprus, Djibouti, Dominica, Gibraltar, Grenada, Guernsey, Ireland, Isle of Man, Jersey, Jordan, Lebanon, Liberia, Lichtenstein, Luxembourg, Macao, Maldives, Malta, Marshall Islands, Mauritius, Micronesia, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, Samoa, San Marino, Singapore, St. Kitts and Nevis, St. Lucia, St. Martin, Vincent and the Grenadines, Switzerland, Tonga, Turks and Caicos Islands, Vanuatu, and Virgin Islands (British).

Analysis and Results

Table A2 presents estimation results from two models using *Article 13.4* as the dependent variable: A Linear Probability Model (LPM) in columns (1) to (3) and a logit model in columns (4) to (6). The results, shown in Table C.2, are discussed in the text.

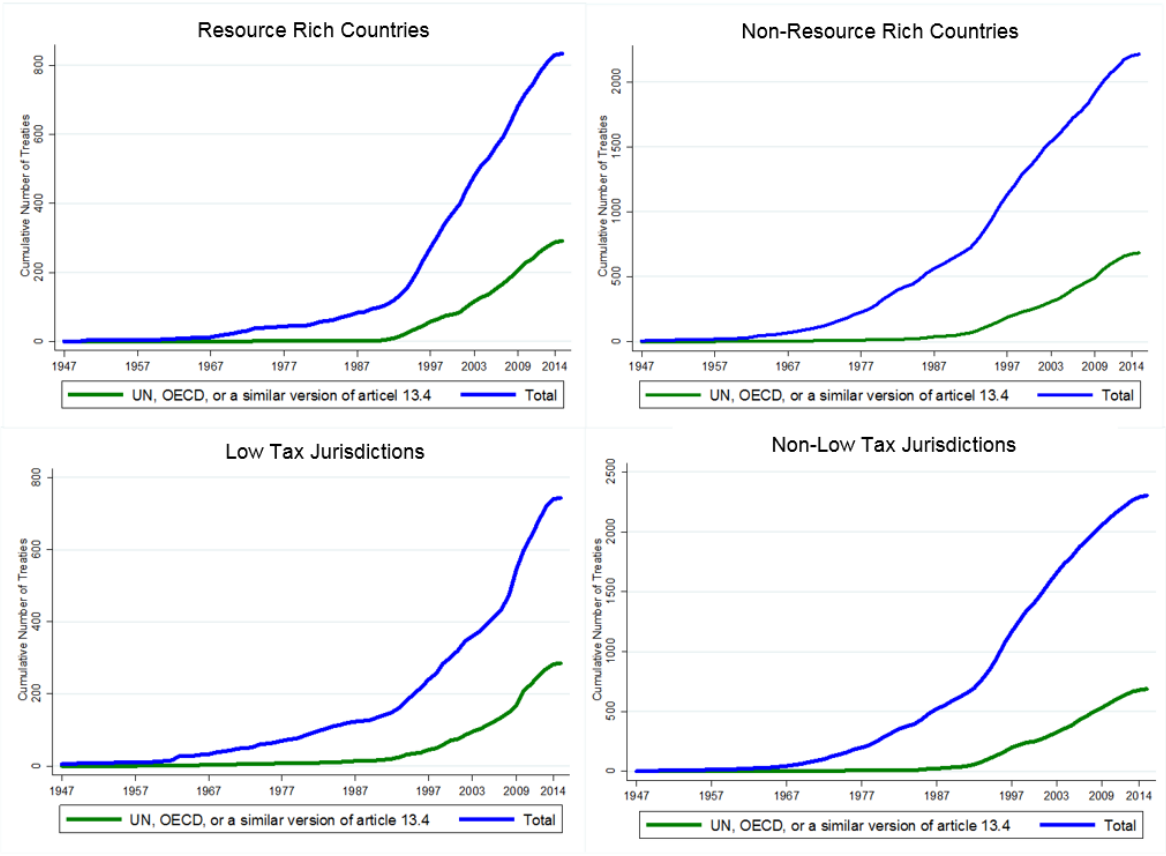
Table C.2: The Likelihood of Including 13.4 in a DTT, Estimation Results

	(1)	(2)	(3)	(4)	(5)	(6)
The Dependent Variable			*Article13.4*			
Model		LPM			Logit	
Resource-rich low-income	-0.0592**	-0.0593**	-0.0657**	-0.065**	-0.064**	-0.079***
	(0.026)	(0.026)	(0.0276)	(0.027)	(0.027)	(0.027)
CIT_i-CIT_j		0.0030***	0.0042***		0.0021**	0.0037***
		(0.000)	(0.000)		(0.0009)	(0.001)
Low tax			-0.133***			-0.164***
			(0.024)			(0.024)
Low tax × *Resource-rich low-income*			-0.162*			-0.164
			(0.084)			(0.146)
Year	0.0136***	0.0135***	0.0141***	0.017***	0.016***	0.017***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
Constant	-26.88***	-26.76***	-27.80***	-180.5***	-177.4***	-195.8***
	(1.063)	(1.072)	(1.092)	(9.628)	(9.609)	(10.64)
Observations	3,044	2,971	2,971	3,044	2,971	2,971
R^2	0.134	0.135	0.146			

Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1

As estimated coefficients in non-linear models cannot be interpreted as marginal effects, columns (4) to (6) display marginal effects (except for the constant).

Figure C.1: Article 13.4 in DTTs with Resource-Rich Countries or low tax jurisdictions



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