



THE OECD'S PROJECT ON HARMFUL TAX PRACTICES

# **CONSOLIDATED APPLICATION NOTE**

## **GUIDANCE IN APPLYING THE 1998 REPORT TO PREFERENTIAL TAX REGIMES**



## TABLE OF CONTENTS

CHAPTER I: INTRODUCTION .....	6
CHAPTER II: TRANSPARENCY AND EXCHANGE OF INFORMATION .....	9
A. Introduction .....	9
B. Transparency .....	10
i) The existence of relevant and reliable information .....	10
a) Books and records.....	10
b) Information on identity of legal and beneficial owners and other persons.....	10
c) Information on preferential regimes and their application to particular taxpayers .....	12
ii) Access to the information .....	13
C. Exchange of Information.....	14
i) Legal mechanisms for exchange of information .....	14
ii) Type of exchange of information.....	14
iii) Limitations on exchange of information.....	14
a) Trade, business and other secrets .....	15
b) Reciprocity.....	15
c) Primary reliance on domestic sources of information.....	16
d) Attorney-client privilege.....	16
e) Public policy (ordre public) .....	16
iv) Protection of the confidentiality of the information provided .....	16
v) Administrative practices for effective exchange.....	17
D. Examples of regime-specific information .....	17
CHAPTER III: RING FENCING .....	20
A. Introduction .....	20
B. Relevance of ring fencing in analysing preferential regimes .....	20
i) Ring fencing in general .....	20
ii) A regime may explicitly or implicitly exclude resident taxpayers from taking advantage of its .....	22
benefits .....	22
iii) Enterprises which benefit from the regime may be explicitly or implicitly prohibited .....	24
from operating in the domestic market.....	24
C. Guidance.....	26
CHAPTER IV: TRANSFER PRICING .....	28
A. Introduction .....	28
B. Relevance of transfer pricing to the application of the factors in the 1998 Report that .....	28
identify harmful preferential regimes.....	28
C. General guidance for preferential regimes with transfer pricing aspects .....	30
i) Importance of the TP Guidelines.....	30
ii) Guidance from the TP Guidelines.....	31
a) Selection and application of transfer pricing methods.....	32
1. Impact on the low effective tax rate factor .....	32

Selection of a transfer pricing method .....	32
2. Impact on the other key factors.....	35
3. Conclusion on the selection and application of transfer pricing methods .....	36
b) Safe harbours .....	37
1. Impact on the low effective tax rate factor .....	37
2. Impact on the other key factors.....	38
3. Conclusion on safe harbours .....	39
c) Administration aspects of transfer pricing rules .....	40
1. Impact on low or no effective tax rate .....	40
2. Ring fencing.....	41
3. Transparency.....	41
4. Exchange of information.....	41
5. Conclusion on administration of transfer pricing rules and practices.....	41
d) Advance transfer pricing rulings and advance pricing arrangements (APAs).....	43
D. Specific guidance for generic categories of regime.....	43
i) Regimes containing no specific transfer pricing provisions.....	43
ii) Regimes containing specific transfer pricing provisions .....	43
a) Regimes that apply some type of cost plus method .....	43
b) Regimes that apply some type of resale price method.....	45
c) Regimes allowing a downward transfer pricing adjustment.....	45
d) Regimes that determine a “turn” or “spread” for intra-group intermediary activities .....	45
e) Regimes that apply to activities carried on through a permanent establishment (PE).....	46
CHAPTER V: RULINGS .....	47
A. Introduction .....	47
B. Nature and types of rulings.....	47
C. General guidance for rulings regimes.....	49
i) Application of the key factors for identifying and assessing harmful preferential tax regimes .....	49
ii) General guidance on rulings regimes in respect of the key factors in the 1998 Report .....	50
a) No or low effective tax rates .....	50
b) Ring fencing.....	52
c) Lack of transparency.....	52
d) Exchange of information .....	53
D. Guidance on specific types of rulings .....	54
i) General rulings on transfer pricing issues .....	54
ii) Advance Tax Rulings (ATRs) on transfer pricing issues (other than APAs).....	56
iii) APAs.....	58
CHAPTER VI: HOLDING COMPANY REGIMES AND SIMILAR PREFERENTIAL TAX REGIMES .....	61
A. Introduction .....	61
B. Typical features of holding company regimes and similar preferential tax regimes.....	61
i) Holding companies and portfolio investments .....	61
ii) Multinationals and possible multiple taxation .....	62
iii) Double taxation relief and tax conventions.....	62
iv) Recognition of different approaches to double tax relief .....	63
v) Tax effect of the participation exemption and foreign tax credit methods.....	63
vi) Specific holding company legislation .....	63
vii) Qualifying conditions for the operation of holding company regimes .....	64
viii) Typical considerations in choosing a holding company location .....	65

C.	Application of the factors in the 1998 Report to holding company regimes.....	65
i)	Introduction .....	65
ii)	Applying the key factors .....	66
a)	No or low effective tax rates.....	66
b)	Ring fencing.....	67
c)	Lack of transparency.....	70
d)	Exchange of information .....	70
iii)	Applying the other factors.....	71
CHAPTER VII: FUND MANAGEMENT .....		73
A.	Introduction .....	73
B.	General background on fund management structures .....	73
C.	Application of the factors of the 1998 Report to fund management regimes.....	74
i)	Introduction .....	74
ii)	Key factors .....	75
a)	No or low effective tax rate .....	75
b)	Ring fencing.....	75
c)	Lack of transparency.....	76
d)	Exchange of information .....	76
iii)	Other factors.....	76
CHAPTER VIII: SHIPPING .....		78
A.	Introduction .....	78
B.	Outline of the general aspects of the shipping industry and relevant regimes .....	78
i)	Non-tax factors.....	79
a)	Regulation.....	79
b)	Registration.....	79
c)	Manning costs .....	81
d)	Cabotage .....	82
ii)	Corporate tax on shipping .....	82
a)	Description of shipping regimes .....	84
b)	Level of tax.....	84
c)	Qualifying vessel/activities.....	84
d)	Eligibility/strategic management and control.....	85
e)	Trading area restrictions .....	85
f)	Scope of taxation .....	85
g)	Anti-avoidance provisions .....	85
iii)	International tax aspects.....	86
C.	Application of factors in the 1998 Report to shipping regimes.....	86
i)	Introduction .....	86
ii)	No or low effective tax rates .....	86
iii)	Ring fencing.....	87
iv)	Lack of transparency .....	88
v)	Exchange of information .....	89
vi)	Other factors.....	89
D.	Conclusions and guidance .....	90
i)	Introduction .....	90
ii)	Guidance .....	90
a)	Ring fencing.....	90
b)	Transparency.....	91
c)	Exchange of information.....	91

APPENDIX: AGREEMENT ON EXCHANGE OF INFORMATION ON TAX MATTERS.....	92
I. INTRODUCTION.....	92
II. TEXT OF THE AGREEMENT.....	94
III. COMMENTARY.....	104

## CHAPTER I: INTRODUCTION

1. In 1998, the OECD established a framework to counter the spread of harmful tax practices with respect to geographically mobile activities, such as financial and other service activities, by the adoption of the report "*Harmful Tax Competition: An Emerging Global Issue*" (the "1998 Report"). Recommendation 15 of the 1998 Report provides Guidelines that set out a general framework within which OECD member countries having approved the 1998 Report can implement a common approach to identifying and eliminating their harmful preferential regimes by April 2003. Recommendation 15 also established the Forum on Harmful Tax Practices ("the Forum"), to implement the Guidelines and other Recommendations in the Report.

2. Chapter II of the 1998 Report identifies four key factors for the purpose of identifying and assessing harmful preferential tax regimes. The key factors (or key criteria) are:

- a) No or low effective tax rates.
- b) "Ring fencing" of regimes.
- c) Lack of transparency.
- d) Lack of effective exchange of information.

3. The first key factor – low or zero effective tax rate on the relevant income – is a gateway criterion to determine those situations in which an analysis of the other key criteria is necessary. The presence of a low or zero tax rate alone does not make a preferential tax regime harmful.

4. The Report also refers to eight "other" factors that may assist in identifying and assessing harmful preferential tax regimes. The eight "other" factors are not additional criteria but rather spell out in more detail some of the key principles and assumptions that are implicit in the key factors themselves.

5. The 1998 Report does not itself identify as harmful either specific preferential regimes or categories of such regimes, but provides an analytical framework within which such an evaluation can take place. In this regard, paragraph 59 of the 1998 Report notes that ". . . any evaluation should be based upon an overall assessment of each of the key factors . . . and, where relevant, the other factors referred to in section (a) below."

6. In June 2000, the Committee on Fiscal Affairs (the "CFA") reported to the Ministerial Council ("the Council") on its progress in identifying and eliminating harmful tax practices ("*Towards Global Cooperation: Progress in Identifying and Eliminating Harmful Tax Practices*"). That Report (the "2000 Report") includes a list of 47 OECD member country regimes, grouped under 9 categories, which the Forum has identified as potentially harmful. The Council adopted recommendations on implementing the proposals contained in the 1998 Report, including an instruction by the Council to the CFA to:

Carry out work through the Forum on Harmful Tax Practices and, where appropriate, through other subsidiary bodies of the Committee, to develop guidance (application notes) to assist member and non-member countries in assessing whether their potentially harmful regimes are, or could be applied to be, actually harmful, and in determining how to remove the harmful features of the regimes, in order to meet their commitments under Recommendation 15 of the 1998 Report to remove harmful features of harmful preferential regimes by April 2003.

7. As stated in paragraph 13 of the 2000 Report:

This guidance (application notes) would be provided on a generic basis (i.e. not referring to specific country regimes) and would be equally applicable to any regime of the category or type being addressed. The application notes will illustrate what features, generically, would be problematic for particular categories or types of regimes under the relevant factors of the 1998 Report.

8. Further, as noted in paragraph 15 of the 2000 Report:

Member countries will be assisted by the application notes in making the assessment whether potentially harmful regimes are, or could be applied to be, actually harmful, and then in determining how to remove the harmful features of such harmful preferential regimes, in order to meet their commitments to eliminate the harmful features of harmful preferential regimes by April 2003.

9. As noted in the quote from paragraph 13 of the 2000 Report above, the application notes are not intended to address the specific aspects of particular preferential regimes. Rather the application notes provide guidance to assist in the evaluation of existing or future<sup>1</sup> preferential regimes on a generic basis. The guidance provided in the application notes is intended to help countries assess whether any one or more of the relevant factors are present. The application notes do not discuss the implications of such an assessment.

10. The Forum<sup>2</sup> has developed the following seven application notes: Transparency and Effective Exchange of Information, Ring Fencing, Transfer Pricing, Rulings, Holding Companies and Similar Preferential Regimes, Fund Management, and Shipping. These application notes have been consolidated and are contained in Chapters II through Chapter VIII.

11. The assessment of particular preferential regimes may require the application of more than one Chapter. In such cases, the preferential regime must be assessed in accordance with each of the relevant Chapters to determine whether it contains harmful elements. For example, where the transfer pricing aspects of a preferential regime under review are implemented by means of a ruling, Chapters IV and V must be considered.

12. The application notes are intended to provide guidance only in assessing preferential regimes that apply to income from geographically mobile activities. They do not apply to preferential regimes designed

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1. See paragraphs 24 and 25 of the 2000 Report concerning the dynamic nature of the evaluation process.

2. Luxembourg and Switzerland abstained from approving the 1998 Report.

to attract investment in plant, building and equipment. Such preferential regimes are outside the scope of the 1998 Report.<sup>3</sup>

13. Paragraph 15 of the 2000 Report states that "[t]he application notes also are expected to assist co-operative jurisdictions and other non-member economies in eliminating their harmful tax practices." The assistance provided in the application notes, while providing useful guidance to jurisdictions that have made commitments to transparency and effective exchange of information, should not be understood as expanding the standards to which the jurisdictions have agreed to adhere in their commitments or that may result from any other work undertaken jointly with the Committee on Fiscal Affairs. In addition, the application notes should prove useful in analysing preferential regimes in other non-OECD economies.

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3. See paragraph 6 of the 1998 Report.

## CHAPTER II: TRANSPARENCY AND EXCHANGE OF INFORMATION

### A. Introduction

14. This Chapter discusses the criteria of transparency and effective exchange of information. It focuses on particular transparency and exchange of information practices within the scope of the 1998 Report. Transparency and effective exchange of information are closely linked concepts because lack of transparency can prevent the effective exchange of information. This Chapter looks at both factors and, in particular, discusses the importance of:

- the existence of relevant and reliable information;
- the legal ability of a State to obtain information for the purposes of transmitting it to the State requesting the information;
- legal mechanisms permitting the exchange of information;
- adequate safeguards to protect the confidentiality of the information exchanged; and
- administrative measures to ensure that the exchange of information will function effectively.

15. Parts B and C of this Chapter provide guidance on transparency and effective exchange of information. Part D provides examples of the types of information that countries should be able to obtain and provide with respect to the particular types of preferential regimes identified in the 2000 Report.

16. The jurisdictions that have made commitments to co-operate with the OECD have made a substantial contribution in this field through their participation in the Global Forum Working Group on Effective Exchange of Information (the “Working Group”). The Working Group was established to develop a model legal instrument that could be used to establish effective exchange of information. Its work has informed the development of this Chapter and the instrument is in the Appendix to this document.

17. The transparency and information exchange practices described in this Chapter should not be viewed as undermining the legitimate role of bank secrecy in protecting the financial privacy of a bank’s customer. See generally the 2000 OECD Report “*Improving Access to Bank Information for Tax Purposes.*” Unauthorised disclosure of bank information could jeopardise the financial welfare of the clients of a bank or otherwise pose a threat to such clients. For this reason, as discussed further in this Chapter, access to bank information is to be provided only in the context of legitimate civil or criminal tax investigations, and any information provided must be protected from inappropriate disclosure by strict confidentiality rules.

## **B. Transparency**

18. Lack of transparency may arise in two broad contexts: (1) in the way in which a regime is designed and administered, including favourable application of laws and regulations, negotiable tax provisions, and a failure to make widely available administrative practices; and (2) the existence of provisions such as secrecy laws or inadequate ownership and other information requirements that prevent (or would prevent) effective exchange of information. The first point, including the specific exchange of information aspects, is also dealt with in the Chapters on rulings and transfer pricing, below.

19. Exchange of information can only be effective where it is combined with a regulatory framework that seeks to ensure that (1) relevant and reliable information exists and (2) the requested State has the ability to obtain the information for purposes of information exchange.

### *i) The existence of relevant and reliable information*

20. If the information needed to respond to a request is not required by local law to be maintained for tax, regulatory or commercial reasons, or is not required to be retained for a reasonable period, it may not be available for exchange at the time a request is made for the information.

#### *a) Books and records*

21. Companies and other persons are generally required to keep books and records for tax, commercial, regulatory or other reasons. However, the value of books and records will depend on their reliability. Information is more likely to be reliable if there is some external check on the information. For example, if companies are required to keep books and records but there is no requirement to file a tax return based on those records, no obligation to file statements of account with a regulatory body, or no requirement for annual external audits, the company may have no incentive to keep accurate records in accordance with internationally accepted accounting practices. As a result, the information may be unreliable for purposes of applying the tax laws of a country requesting the information.

22. In the context of analysing record keeping requirements, rules about minimum retention periods for those books and records should also be assessed. In many business sectors, like the banking sector, regulators have established minimum record retention requirements for regulatory purposes. For example, the Financial Action Task Force (“FATF”) has addressed this issue in Recommendation 10 of its Forty Revised Recommendations, which establishes a minimum retention period of five years for financial institutions. Similarly, in order to be able to substantiate information reported on tax returns, taxpayers generally must retain relevant information until the statute of limitations applicable to that tax year has expired.

#### *b) Information on identity of legal and beneficial owners and other persons*

23. Effective exchange requires the existence of information on companies, partnerships, trusts, foundations and other persons. If such information is not required to be kept for tax, regulatory, commercial or other reasons, it may not be available for exchange at the time an information request is received. The information should cover the type of information that other countries might legitimately expect to receive in response to a request. Information should be available on all persons that come within

the territorial jurisdiction of a given country. Countries should ensure that such information is either maintained or obtainable by the authorities and can be exchanged upon request.<sup>4</sup>

24. In connection with companies and partnerships, countries should ensure that information is obtainable on the legal owners, who will very often also be the beneficial owners. A legal ownership interest in a partnership includes any form of interest, whether general or limited, capital or profit.

25. However, the availability of information concerning ownership should not stop with legal ownership. In some cases a legal ownership position may be subject to a nominee or similar arrangement. Where the legal owner acts on behalf of another person as a nominee or under a similar arrangement, such other person, rather than the legal owner, will often be the beneficial owner. An example of a nominee arrangement is a nominee shareholding arrangement where the legal title-holder that also appears as the shareholder of record acts as agent for another person. In these cases, and in other cases where the legal owner is not (or is just partly) the economic owner, information should be obtainable by the authorities on the economic owner(s) in addition to information on the legal owner(s). In this way, a treaty partner is able to apply its rules on beneficial ownership irrespective of the precise juridical or economic interpretation of its beneficial ownership definition.

26. In connection with trusts and foundations, information should be obtainable on the identity of settlors, founders, trustees, members of a foundation council, beneficiaries and any other person who is in a position to direct how assets or revenue of the trust or foundation are to be dealt with. The term “foundation council” should be interpreted very broadly to include any person or body of persons managing the foundation or otherwise having the authority to act on behalf of the foundation. Information should also be obtainable with respect to persons that are substantially similar to trusts or foundations. However, it is recognised that where a trust, foundation or similar arrangement supports a general cause and does not have an identified group of persons as beneficiaries only limited information on beneficiaries may exist. Nevertheless even where such arrangements exist, information regarding the identity of persons directing the use of assets or distribution of revenue should be maintained or be obtainable. In addition, information on the persons benefiting from such uses and distributions should be maintained or be obtainable for the purposes of exchange of information.

27. Most organisational structures will be classified as a company, a partnership, a trust, a foundation or a person similar to a trust or foundation. However, there might be entities or structures for which information might be legitimately requested but that do not fall in any of these categories. For instance, an investment vehicle may be of a purely contractual nature. In these cases, information should be obtainable on any person with a right to share in the income or gain of the structure or in the proceeds from any sale or liquidation.

28. Ensuring the availability of updated ownership information, for information exchange purposes, might prove difficult with respect to publicly traded companies and collective investment funds where changes in ownership are very frequent. This Chapter therefore recognises that in these cases a more liberal standard can be applied. This standard is set out in detail in the model instrument developed by the Working Group (see Appendix) and applies equally for purposes of this Chapter.

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4. This Chapter does not address the mechanisms that may be used to obtain ownership information. The OECD Report “*Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes*” (OECD 2001) sets forth a “menu” of different options for obtaining and sharing beneficial ownership and control information.

*c) Information on preferential regimes and their application to particular taxpayers*

29. Some countries require an authorisation, license, ruling or similar administrative act for the application of a special regime. If the guidance provided in Chapter V on rulings does not apply to this type of regime and if the administration has discretionary powers to apply the special regime, the decisions, additional conditions and underlying information should be maintained. Underlying information includes information provided by the taxpayer to qualify for the benefits of the regime.

30. Moreover, information on the application of a preferential regime to a particular taxpayer should be maintained. This information should include information on income as well as any deductions, provisions, depreciation, etc, which lower the taxable profit. In addition, information should be maintained on the rate on which the taxable income is taxed, which should include any reduction of the normal tax rate at which the taxable income is taxed. Information about the distribution of dividends and interest paid on shareholder loans should also exist. Information on the number of staff and qualification of staff of the entity including their employment contracts should be kept. As far as documentation in connection with regimes involving the selection or application of transfer pricing methods or that are implemented through rulings, the guidance in the Chapters on transfer pricing and rulings should be taken into account.

31. Countries should use the guidance set out in the box below to assess whether a preferential regime that meets the no or low tax criterion lacks transparency because relevant information is not maintained or is not obtainable.

The following features are likely to result in a lack of transparency:

1. The country's authorities, the persons concerned, or third parties subject to its jurisdiction do not maintain, or could not obtain information on:

- Ownership (both legal and beneficial) of companies, partnerships and other persons.
- Books and records of companies, partnerships and other persons.
- Trusts and foundations (e.g., type, identity of settlors, trustees, members of foundation council, beneficiaries).
- The movement of assets.
- The identity of managers of collective investment funds.
- Ownership of bank accounts and transactional information.
- Reserves, insurance premiums paid and gains arising on life insurance in the case of insurance and re-insurance companies.
- Details of transactions with related parties.

2. A country has no requirement for filing tax returns, for filing financial accounts with a regulatory body or for external audits of accounts, and has no other adequate filing or auditing requirement that would ensure the reliability of books and records.

3. The tax, commercial or regulatory requirements do not ensure that books and records are retained for a reasonable period. A record retention period of five years or more would be considered a reasonable period.

4. The administration of a country has discretionary power to grant a preferential regime, but decisions, additional conditions and underlying information are not maintained by the authorities or by persons subject to its jurisdiction.

5. A person benefits from a preferential regime granted by a country but the information described in paragraphs 29 and 30 is not maintained by the authorities of such country or by persons subject to its jurisdiction.

*ii) Access to the information*

32. If the relevant information is kept, a tax or other appropriate authority should have the legal ability to obtain such information. Thus, tax authorities or other appropriate authorities should have adequate information gathering powers to be able to obtain information for purposes of information exchange. Such information gathering powers are, however, constrained by jurisdictional limitations. Thus, a requested State is not obligated to provide information which is neither held by its authorities nor is in the possession or control of persons who are within its territorial jurisdiction.

33. In the context of a request for information relating to a criminal tax matter, information should be obtainable without regard to whether the conduct being investigated would constitute a crime under the laws of the requested State if it occurred in the requested State.

34. In the context of a civil or criminal tax matter, the requested State should be able to obtain the information whether or not the requested State has a need for the information for its own tax purposes. A requirement of a domestic tax interest could impede effective exchange of information, particularly where the requested State has no income tax. For instance, a preferential regime can imply that the profits are exempted from taxes. The country offering the exemption may determine that it does not need any information on a person benefiting from the regime for its own purposes. A similar determination may be made by a country that does not levy taxes on business profits. Nevertheless, the information may still be relevant to another country (e.g., the country of residence of the parent company).

35. Countries should use the guidance set out in the box below to assess whether a preferential regime that meets the no or low tax criterion lacks transparency because of the lack of access to information.

The following features are likely to result in a lack of transparency:

- A country cannot obtain and provide, in response to a specific request, information in criminal tax matters unless the conduct being investigated would constitute a crime under the laws of the requested country if it occurred there.
- A country cannot obtain and provide information in response to a specific request unless it also needs the information for its own tax purposes.
- A country cannot obtain and provide the information described in the box following paragraph 31 in response to a specific request.

## **C. Exchange of Information**

36. Exchange of information requires a legal mechanism for providing the information to another State for tax administration purposes. Such legal mechanism should be coupled with adequate safeguards to protect the confidentiality of the information exchanged. Finally, there should be administrative measures to ensure that the exchange of information functions effectively.

### ***i) Legal mechanisms for exchange of information***

37. In general, information exchange occurs pursuant to a bilateral or multilateral treaty or an agreement that explicitly authorises the exchange of information for tax purposes. The model instrument developed by the Working Group (see Appendix) provides an appropriate legal framework for exchange of information. Countries may choose whatever instruments they deem most appropriate to permit information exchange. The important point is not the use of a specific instrument but the existence of an effective mechanism for information exchange.

38. In order to have effective exchange with respect to preferential regimes that meet the low or no effective tax rate factor, the scope of the agreement should be broad so that the scope itself does not become an obstacle to exchange. For example, an agreement limited to exchange with respect to criminal matters only would result in very limited exchange. In some cases, it is difficult to determine without the information located in the foreign jurisdiction whether the acts committed by the taxpayer would constitute a criminal act or would be a lesser offence.

### ***ii) Type of exchange of information***

39. Exchange of information generally occurs in one of three different forms: upon request, spontaneous or automatic.<sup>5</sup> Effective exchange of information within the meaning of the 1998 Report does not require automatic exchange of information.

40. Effective exchange of information within the meaning of the 1998 Report is limited to information exchange upon request except in the situations described in the Chapters on transfer pricing and rulings. Information exchange upon request does not cover mere “fishing expeditions.”

### ***iii) Limitations on exchange of information***

41. Although a broad scope is encouraged, it is recognised in all treaties and agreements for exchange of information that there may be circumstances where it may be inappropriate to require the provision of information. For instance, Article 26 of the OECD Model Tax Convention refers to a number of limitations on the obligation to provide information, including that contracting states are not obligated to carry out administrative means at variance with their laws and administrative practice, supply information not obtainable under their laws or in the normal course of administration, or supply information that would disclose trade or certain other secrets, or be contrary to public policy (ordre public).

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5. See Commentary to Article 26, paragraph 9 of the OECD Model Tax Convention for details.

*a) Trade, business and other secrets*

42. As stated in the Commentary to Article 26 of the OECD Model Tax Convention, these secrets should not be interpreted in too wide a sense. Before invoking such rules a country should carefully weigh if the interests of the taxpayer really justify their application. Otherwise, it is clear that too wide an interpretation would in many cases impede effective exchange of information.

43. Furthermore, financial information, including books and records do not generally constitute a trade, business or other secret. However, in certain exceptional cases books and records may benefit from protection by secrecy rules. For instance a request for financial information could be denied if the response to the request would reveal a proprietary pricing model of a bank or other financial institution.

44. Rules on trade, business and other secrets have their main application where the provision of information in response to a request would reveal protected intellectual property created by the holder of the information or a third person. For instance, a bank might hold a pending patent application for safe keeping or a trade process might be described in a loan application. In these cases the requested State may decline any portion of a request for information that would reveal information protected by patent, copyright or other intellectual property laws.

*b) Reciprocity*

45. Very generally, the principle of reciprocity, in this context, provides that a requested State is not required to obtain and provide information that the applicant State would not be able to obtain under similar circumstances under its own laws for purposes of enforcing its own tax laws.

46. The principle of reciprocity is intended to prevent the applicant State from circumventing its domestic law limitations by seeking information from the other Contracting State, thus, making use of greater powers than it possesses under its own laws. For instance, most countries recognise under their domestic laws that information cannot be obtained from a person to the extent such person can claim the privilege against self-incrimination. A requested State may, therefore, refuse to exchange information if the applicant State would have been precluded by its own self-incrimination rules from obtaining the information under similar circumstances.

47. Furthermore, the principle of reciprocity is intended to balance the administrative burdens assumed by the Contracting States. It is recognised that replying to a request for information, especially in situations where the information is not needed by the authorities of the State providing the information, might impose a burden on the resources of such state.

48. The principle of reciprocity has no application where the legal system or administrative practice of only one country provides for a specific procedure. For instance, a country requested to provide information could not point to the absence of a ruling regime in the country requesting information and decline to provide information on its ruling regime based on a reciprocity argument. Similarly, if one country does not have either a formal or an informal Advance Pricing Agreements (“APA”) practice it is not precluded by the reciprocity requirement from seeking information on APA’s entered into by the authorities of other countries. Of course, where the requested information itself is “not obtainable under the laws or in the normal course of the administration”<sup>6</sup> of the requesting State, a requested State may decline such a request.

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6. Article 26, paragraph 2, sub-paragraph b) OECD Model Tax Convention. See also the accompanying commentary at paragraph 15.

*c) Primary reliance on domestic sources of information*

49. It is expected that the regular sources of information available under the internal taxation procedure should be relied upon before information is sought from another state. Thus, any country may decline a request for information -- without failing the effective exchange of information criterion -- if the state requesting the information has not pursued all means available in its own territory, provided such means would not give rise to disproportionate difficulties.

*d) Attorney-client privilege*

50. The attorney-client privilege generally attaches to information that constitutes a confidential communication between a client and an attorney, solicitor or other admitted legal representative. While the scope and the coverage of the privilege might differ among states, it should not be overly broad so as to hamper effective exchange of information. For a general description of the attorney-client privilege, see the Commentary to Article 7 of the Agreement on Exchange of Information on Tax Matters in the Appendix.

*e) Public policy (ordre public)*

51. The issue of public policy should rarely arise in connection with information requests. Generally, public policy can only be invoked in extreme cases in which the provision of information would contradict the vital interests of the State itself. For instance, a case of public policy would arise if a tax investigation in the State requesting information was motivated by political or racial persecution. Reasons of public policy might also be invoked where the information constitutes a state secret, for instance sensitive information held by secret services the disclosure of which would be contrary to the vital interests of the requested State.

52. Countries should use the guidance set out in the box below to assess whether a preferential regime that meets the no or low tax criterion lacks effective exchange of information.

The following features are likely to result in a lack of effective exchange of information:

- A country has no legal mechanism for exchange of information.
- A country exchanges information only in connection with criminal tax matters.
- The legal mechanism for exchange of information is rendered ineffective by overly broad secrecy, attorney-client privilege or public policy rules or practices.

*iv) Protection of the confidentiality of the information provided*

53. At the national level, tax administrations are required to provide a high degree of confidentiality to information received or gathered about a taxpayer for tax purposes. Without this assurance, it could be difficult for tax authorities to obtain the information needed to carry out the tax laws. This “tax secrecy” is of even greater importance in the international context and forms the basis of mutual trust between nations. Exchange of information is a highly sensitive issue for taxpayers and their governments, and their willingness to provide information could be adversely affected if it was thought that information provided might be used for purposes other than those for which it was exchanged. Given this legitimate concern, tax

secrecy is an essential component of an exchange of information instrument. In order to ensure the confidentiality of a taxpayer's affairs, measures must be implemented at the national level to prevent protected information that has been gathered for tax purposes from being disclosed to unauthorised persons or from being used for impermissible purposes. At the same time, adequate provision must be made to allow disclosure of the information to be made to persons, including courts and administrative bodies, involved in the administration and enforcement of the tax laws.

54. Where a country has no effective measures to protect the confidentiality of information received from another country, the latter country may refuse to exchange information. In such a case the refusal to exchange information concerning a preferential regime that meets the no or low tax factor does not indicate a failure to comply with the effective exchange of information criterion.

v) *Administrative practices for effective exchange*

55. In addition to establishing the legal mechanisms to allow a State to make and respond to a request for information, the states should have administrative procedures in place to ensure the smooth operation and handling of requests and responses. For example, procedures should exist for prompt review of incoming and outgoing requests to make sure that the request satisfies the terms of the convention and includes sufficient information for the request to be carried out. Thus, in the absence of unusual circumstances, a state requested to provide information should, within 60 days, notify the competent authority of the state requesting information of any deficiencies in a request. Similarly, and again in the absence of unusual circumstances, the competent authority of the requested state should notify the competent authority of the requesting state if it is unable to obtain and provide the requested information within 90 days from the receipt of the request. Such notification should include the reasons for the inability, the nature of the obstacles or the reasons for a refusal.

56. The laws in some countries require notification of the taxpayer affected by an information request before the information is provided to the country requesting the information. Such notification requirements are not inconsistent with effective exchange of information. However, the notification rules should be such that they do not frustrate the efforts of the country seeking the information. For instance, notification rules should permit exceptions from prior notification (e.g., in cases in which the information request is of a very urgent nature or the notification is likely to undermine the chances of success of the investigation conducted by the country requesting the information).

57. Countries should use the guidance set out in the box below to assess whether a preferential regime that meets the no or low tax criterion lacks effective exchange of information because of inadequate administrative procedures.

The following feature is likely to result in a lack of effective exchange of information:

- A country has inadequate administrative procedures in place to ensure the prompt and efficient handling of, and responses to, requests for exchange of information.

**D. Examples of regime-specific information**

58. This Part provides examples of the types of information that countries should be able to obtain and provide with respect to the categories of preferential regimes identified in the 2000 Report.

### ***Insurance regimes***

- Premiums paid to the company and insurance benefits paid by the company.
- Contents of the contracts on the bases of which the premiums are paid, like the identity of the policyholders, the risks insured, and the duration of the contracts.
- Reserves, appropriations to the reserves, and the impact on the taxable income of appropriations to the reserves.

### ***Financing and Leasing***

- Loans granted by the company and interest received on these loans.
- Contents of the contracts on the bases of which the loans were granted, like the identity of the borrower, the reason for the loan and the duration of the contracts.
- Reserves, appropriations to the reserves, and the impact on the taxable income of appropriations to the reserves.
- The portfolio investments and other investments.
- Tangible and intangible assets provided to other companies.
- Holding activities.

### ***Fund Managers***

- Reserves, appropriations to the reserves, and the impact on the taxable income of appropriations to the reserves.
- The portfolio investments and other investments.
- The distribution of profits.
- Related party transactions, in particular information on services fees or other fees paid to or received from related parties.

### ***Banking***

- Borrowing and lending activities and other financial activities.
- Deposits accepted from clients and the contents of the contracts on which these deposits were accepted, such as the identity of the client, interest due on the deposit and the duration of the contract.
- Reserves, appropriations to the reserves, and the impact on the taxable income of appropriations to the reserves.
- The portfolio investments and other investments.

### ***Headquarters regimes***

- Functions performed by the headquarters to the group (copies of relevant agreements).
- Operating expenses of the headquarters.
- The headquarters regime, conditions fulfilled, granted duration of the regime, etc.
- Cancellation of the headquarters regime if any and reasons for it.

### ***Distribution Centres***

- Detailed activities performed by the distribution centre.
- Copies of relevant agreements between the distribution centre and the group members.
- Prices invoiced to companies of the group in compensation of the activities performed.

- Operating expenses of the distribution centre.
- Risks borne by the distribution centre.
- Conditions fulfilled to obtain authorisation for a distribution centre regime, granted, duration, etc.
- Cancellation of the distribution centre regime, if any, and reasons for it.

#### ***Service Centres***

- Nature of services provided by the service centre.
- Relevant agreements between the service centres and the group members.
- Risks borne by the service centre.
- Cancellation of the service centre regime if any and reasons for it.

#### ***Shipping Companies***

- Flag of the ships.
- Contracts of haulage.
- Contracts of management including crew management, commercial management, where services are provided to a ship's owner by a management company.
- Registration documents including details of ship mortgages and any parallel registrations.
- Financial accounts, books and records, including information to identify intra-group transactions and to verify their compliance with the arm's length principle.

#### ***Holding Companies***

- Organisational structure of group.
- Amount of dividends received and capital gains or losses realised.
- Distribution of income.

## CHAPTER III: RING FENCING

### A. Introduction

59. Ring fencing is a key factor under the 1998 Report. This Chapter determines whether ring fencing is present. It does not discuss the implications of such an assessment. Part B, below, discusses the relevance of ring fencing in analysing preferential regimes. Part C provides guidance on whether a regime is ring-fenced.

### B. Relevance of ring fencing in analysing preferential regimes

#### *i) Ring fencing in general*

60. The 1998 Report is concerned with geographically mobile activities such as financial and other service activities. The 1998 Report, however, does not prevent a country from providing a preferential tax rate to encourage an activity in a particular sector of its economy even if the preference involves geographically mobile activities. There is a distinction between a preferential regime and one that is ring-fenced. A preferential regime will be considered to be ring-fenced only where it excludes resident taxpayers from the benefits of the regime or where the enterprise qualifying for the regime does not have access to the domestic market. This analysis is based on several considerations, as set out below.

61. Countries may reduce effective tax rates on the income from geographically mobile activities to attract new investment, stimulate particular types of business activity, or maintain existing domestic activity. The hope is that the tax revenue foregone will be compensated by an increase in the desired activity. Despite these objectives, a reduction of the effective tax rate may result in a net revenue loss. Continued reductions of the effective tax rate are even more likely to result in less revenue for the government.

62. If, however, a country partly or fully ring fences the application of a low effective rate of tax, then the domestic tax base of the country providing the low rate will not be affected. The lower tax rate applied will primarily or only have an impact on the tax bases of foreign countries from which the geographically mobile financial or other service activity is attracted. In this case, ring-fenced regimes will have little or no cost<sup>7</sup> to the country offering the regime and thus there is no inherent limit on their use. This may lead to a proliferation of ring-fenced regimes which in turn might interfere with each country's sovereign right to determine its own tax policy, including the decision to tax such income.<sup>8</sup> It is for this

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7. There may be a dead-weight loss to the extent that the investment would have been made anyway without the benefit of the incentive or insofar as the reduced rate applies to activities already being carried out in the country.

8. See paragraph 41 of the 1998 Report.

reason that the 1998 Report establishes ring fencing as one of the key criteria for identifying harmful tax practices.

63. While the impact of ring-fenced regimes may be addressed, to some extent, by domestic tax rules such as rules related to transfer pricing, thin capitalisation, and controlled foreign company provisions provided that the regime is transparent and the country of the ring-fenced regime exchanges information with the countries affected by such regimes, ring-fenced regimes put additional pressure on these provisions. The design, monitoring and enforcement of such rules requires more government involvement and indirectly increases the cost to all taxpayers. The complexity of the rules is sometimes such that they become difficult to apply and enforce. Furthermore such rules add significantly to the compliance burden of all taxpayers operating internationally irrespective of whether or not they are seeking to exploit any foreign tax benefits. Many countries also face the dilemma that if they apply these rules more aggressively or on a broader basis than other countries, they may damage the competitiveness of their own businesses. As a result, the 1998 Report includes an approach that addresses the issue in the country granting the ring-fenced regime. Under this approach, a framework of international co-operation has been established under which potentially harmful tax practices are reviewed so that their harmful features may be removed by the sponsoring country.

64. At the same time, the approach agreed in the 1998 Report is not intended to interfere with the general tax policy decisions of any country. A great diversity of approaches are used in designing international tax systems. Countries take different approaches to the taxation of cross-border income flows, to the relief of double taxation and to the taxation of residents and non-residents. In general, countries only tax non-residents on domestic source income, whereas they often tax residents on a world-wide basis. Countries also take different approaches to the relief of double taxation in the case of their residents and the extent to which they exercise jurisdiction to tax non-residents.

65. Countries can distinguish between residents and non-residents in the general structure of their tax systems, decide what threshold should apply for source base taxation of non-residents and fashion double taxation relief measures on the basis of their own general policy concerns without implicating the ring fencing criterion. The 1998, 2000 and 2001 Reports acknowledge that there is no particular reason why countries should have the same level and structure of tax – these are essentially political decisions for national governments. Therefore, ring fencing is not implicated in connection with general structural features of a country's system of taxation or with measures designed to eliminate or mitigate double taxation.<sup>9</sup> For instance, no ring fencing issue arises simply because:

- a country uses a territorial system of taxation and exercises taxing jurisdiction only with respect to domestic source income;
- a country taxes residents on world-wide income but non-residents only on domestic source income;
- a country, in working out its structural approach to the taxation of non-residents, exercises its source based taxing rights differently with respect to different kinds of income.

66. The concept of ring fencing applies only to regimes that deviate from the general structure of the tax system in the country concerned. In other words, the 1998 Report is targeted at special tax regimes in a limited number of sectors.

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9. For any measure to constitute a measure "designed to eliminate or mitigate double taxation" it must have some features to ensure that it only applies where double taxation may arise. See for example in the context of holding company regimes the discussion at paragraph 244.

67. There are two different ways in which a regime may be ring-fenced:

- A regime may explicitly or implicitly exclude resident taxpayers from taking advantage of its benefits.
- Enterprises which benefit from the regime may be explicitly or implicitly prohibited from operating in the domestic market.

68. Before turning to a detailed discussion of the two forms of ring fencing, it should be noted that the mere absence of domestic operators in the preferred sector or the absence of an existing domestic market for the services qualifying for the preferential regime does not constitute ring fencing. There must be a deliberate legal restriction, or other restriction with similar effect, on access to the domestic market, i.e., access must be denied or residents must be excluded from taking advantage of the preferential regime. What is at issue, therefore, is whether there are measures that a country takes to protect itself from the potentially harmful effects of its own preferential regime and not a requirement that there should be a domestic market or domestic users for the preferred activities. In short, the 1998 Report is not concerned with situations where enterprises qualifying for a preferential regime are permitted to operate in the domestic market but in practice do not. In contrast, implicit ring fencing involves the development of criteria the effect of which is to restrict the benefits to non-residents or foreign transactions or activities.

69. The following sections discuss the two different forms of ring fencing described in the 1998 Report.

*ii) A regime may explicitly or implicitly exclude resident taxpayers from taking advantage of its benefits*

70. If residents are not allowed to invest in a preferential tax regime or if their participation is restricted, the regime will be fully or partially isolated from the domestic economy. Access to a regime can be restricted in different ways. The most straight-forward way is to explicitly prohibit residents from establishing entities under the regime. Ring fencing in this form is uncommon in OECD member countries.

71. Residents can also be implicitly excluded from a preferential tax regime through the governing qualifying criteria. For example, eligibility for the benefits of a regime may require that the composition of corporate groups be such that primarily or only foreign-owned groups qualify for the regime. Another example is where favourable rulings are given only to foreign-owned firms thus effectively limiting the benefits of the regime created by the ruling to non-residents.

72. Finally, residents might implicitly be excluded from investing in the regime by measures which neutralise the benefits for residents. Hence, if there are specific tax disincentives that have a similar effect to legal restrictions for residents, then the regime may be ring-fenced. For example, if a regime were to treat an entity as transparent with respect to income attributable to domestic owners, thus subjecting them to current taxation on the entity's income, whilst providing for an entity level tax at a preferential rate to the extent income was attributable to foreign ownership, the regime may be ring-fenced. Ring fencing issues may also arise where a system imposes entity level taxation on the portion of any income attributable to resident shareholders but grants a zero or low effective tax rate on the entity level profits attributable to foreign shareholders.

73. In all these cases, however, the ring fencing analysis needs to take into account the structural context of any such provisions to make an assessment of whether or not the regime is ring-fenced.<sup>10</sup> For example, if an entity is treated as transparent for tax purposes, there is no ring fencing issue simply because, as a result of the rules generally applicable to non-residents, non-resident owners might not be taxed on the foreign income of the entity. There are many examples in member countries and elsewhere of regimes that exempt from tax foreign income that has been allocated to, or considered received by, a non-resident as a result of that particular non-resident's interest in a domestic entity. For example, some member countries do not tax non-resident partners in partnerships established under their laws in respect of the partnership's foreign source income. Such partnerships are not ring-fenced: they are transparent for tax purposes and the taxation of their partners reflects the distinction that is made between the taxation of residents and non-residents. Similarly, no ring fencing issue exists simply because a country as part of its general system of taxation taxes dividends and capital gains of its residents but does not tax (or taxes differently) dividends and capital gains of non-residents. Again, such a distinction simply reflects the different rules for taxing residents and non-residents on their income from shareholdings in resident companies.<sup>11</sup>

74. Furthermore, no issue of ring fencing arises if a particular preferential regime is not open to residents but the country granting the regime provides an equivalent preferential regime that is available to its residents. Thus, a separation of foreign and domestic ownership for non-tax reasons does not by itself run counter to the ring fencing criterion.<sup>12</sup> Finally, the ring fencing criterion is not implicated to the extent that a measure is designed to eliminate or mitigate double taxation.

75. The following examples illustrate the principles discussed in paragraphs 70 through 74.

- Example 1: Country A imposes a general income tax at a rate of 30 percent. It also provides a preferential regime for certain group-financing activities under which income from such services is taxed at 5 percent. The preferential regime is available only to entities directly or indirectly owned by non-residents of Country A. The regime is ring-fenced.
- Example 2: Same as Example 1 except that there are no express ownership restrictions. However, access to the preferential regime is governed by criteria that indirectly exclude domestically owned enterprises. Thus, resident taxpayers are implicitly excluded from the benefits of the regime through the use of the governing criteria and therefore the effect of the restriction is the same as the direct ownership restriction in Example 1. The regime is ring-fenced.
- Example 3: Same as Example 1 except that purely domestic-owned groups are permitted to structure their activities to qualify for the preferential regime. The regime is not ring-fenced. Further, as long as domestically-owned entities are not excluded from the regime, it does not matter whether, in fact, any domestically-owned entity actually takes advantage of the preferential regime.

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10. See, for example, the discussion in connection with holding companies under paragraph 240.

11. This case must be distinguished from the case (discussed in more detail in paragraph 241 and following) where the income is received by one and the same resident holding company but the taxation differs depending on whether the income relates to a shareholding in a domestic or foreign company.

12. See the discussion in paragraph 77 below.

*iii) Enterprises which benefit from the regime may be explicitly or implicitly prohibited from operating in the domestic market*

76. If enterprises benefiting from the regime are not allowed to do business in the local economy, the country providing the regime effectively protects itself from the effects of its own regime. The most straightforward way to deny access to the domestic market is to explicitly prohibit entities established under the preferential regime from operating in the domestic market. The prohibition may be based on explicit legal restrictions or it may be based on implicit factors of similar effect. For instance, an example of implicit ring fencing would be a case where a preferential tax regime is only granted through the issuance of a ruling and the ruling is granted only to enterprises trading in the non-domestic market. Another example would be cases where the ability to operate domestically is restricted, or made more cumbersome, through the requirement that entities qualifying under the regime do business only in foreign denominated currencies.

77. Of course, countries may wish to protect their domestic markets for many reasons that have nothing to do with tax and which are, therefore, outside the scope of the 1998 Report. For instance, countries might wish to limit the number of banks in the domestic market, reserve parts of their insurance market for domestic insurers or keep the domestic shipping trade to ships flying the domestic flag. Such restrictions do not in themselves raise any ring fencing issues. In these cases the ring fencing analysis looks to the taxation of the “restricted” transaction involving the domestic market and compares it with the “unrestricted” transaction that does not involve the domestic market. Only where the “restricted” transactions are subject to a less favourable tax treatment than the “unrestricted” transactions is there a potential for ring fencing.

78. Qualifying entities can also be implicitly excluded from operating in the domestic market by limiting the applicability of the preferential regime to transactions not involving the domestic market. For example, the low effective rate may be restricted to transactions with an international aspect, such as those carried out with foreign parties. The tax advantages granted under the regime are then neutralised insofar as qualifying entities carry on business in the domestic market.

79. A variation on this theme in an intra-group context is to restrict domestic market access by treating domestic intra-group transactions in a less beneficial way than foreign intra-group transactions.<sup>13</sup> For example, a rulings regime that provides beneficial treatment may be applied only to transactions with associated enterprises abroad or a transfer pricing method may be applied in a particularly beneficial way to such enterprises. The Chapter on transfer pricing provides specific guidance on those transfer pricing aspects of preferential regimes that raise particular concerns with regard to ring fencing.<sup>14</sup>

80. The starting point for analysing a regime is to determine the relevant activity. A regime is not ring-fenced because it is preferential, even if it applies particularly advantageous tax rules only to a particular sector. It is therefore important to recognise the distinction between a preferential regime and one that is ring-fenced. The 1998 Report does not seek to discourage countries from maintaining or introducing preferential regimes, i.e., a lower rate for some particular activity. For example, a preferential rate applied to all income from financial services, both domestic and foreign, does not run afoul of the ring fencing criterion under the 1998 Report. Below the level of the financial services sector in general there may be other logical divisions into which financial service activities could be divided, e.g., insurance, banking or fund management. Again, there are no ring fencing implications in preferential regimes for any one of these activities. In connection with shipping, distinctions can easily be made for instance between

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13. See paragraph 90.

14. Chapter IV on transfer pricing discusses the application of the ring fencing criterion to (a) the selection and application of transfer pricing methods, (b) safe harbours and (c) administrative aspects.

fishing and transportation of goods or passengers. Within the insurance sector life insurance, reinsurance, general insurance and captive insurance could be distinguished. However, a regime may be ring-fenced if entities benefiting from the regime are not permitted unrestricted access to the domestic market.

81. Once the relevant activity has been determined, the next step in the analysis is to determine whether transactions or activities that do not involve the domestic market are taxed more favourably than similar transactions or activities that involve the domestic market. In this connection, it is important to note that different mechanisms may be used to provide effectively the same rate of taxation with respect to domestic and foreign activities. Thus, features of the tax system other than just the preferential regime in question may need to be considered in determining if transactions not involving the domestic market are more favourably taxed. See Example 9 below.

82. In certain limited cases the domestic market for a certain activity might be significantly different from the international market for such activity. A different taxation of what, in effect, are different activities would then not raise a ring fencing issue. Such a case is discussed in the Chapter on shipping.

83. The following examples illustrate the analysis:

- Example 1: Country A taxes banking activities at a general income tax rate of 30 percent. Country A operates a special regime that taxes income from banking transactions and services with residents of countries other than country A at an effective rate of 5 percent. To qualify for the regime entities need to apply for a license. Both resident entities and branch operations of non-resident entities are eligible for such licenses. The special regime does not permit any entity licensed under the regime to transact business with residents of Country A. In the absence of the special regime, the world-wide income of the resident entity and the income attributable to the branch activities would be subject to tax in country A at the general rate. The regime is ring-fenced.
- Example 2: Same as Example 1 except that entities in the regime can transact business with residents of Country A but there are specified limits on the amount of business it can transact with such residents. Up to the specified limit, income generated in the domestic market qualifies for the preferential rate of 5 percent. The regime is partly insulated from the domestic market and is therefore ring-fenced.
- Example 3: Same as Example 1 except that there is no regulatory prohibition for entities in the regime from transacting with residents of Country A. However, any income from such transactions is subject to income tax at the general rate of 30 percent while income from transactions with non-residents is taxed at the 5 percent rate. The regime is ring-fenced.
- Example 4: Country A imposes a general income tax at a rate of 30 percent. However, Country A uses a territorial system of taxation and generally exercises taxing jurisdiction only with respect to domestic source income. As a result, foreign source income, including foreign source income from providing services, is not subject to tax in Country A. The regime is not ring-fenced.
- Example 5: The facts are the same as Example 4. However, in order to attract certain asset management activities, Country A introduces a special regime and treats income derived from asset management activities qualifying under the regime, which otherwise would be treated as domestic source, as foreign source and thus exempt, if performed for non-residents. The regime is ring-fenced.

- Example 6: Country A imposes a general income tax at a rate of 30 percent. Country A taxes resident entities on a world-wide basis but taxes non-residents only on domestic source income. In determining its source based taxing rules, Country A has developed different rules for different types of income (certain kinds of income are subject to withholding taxes, others are not subject to tax and certain types of income are only taxed where a permanent establishment is present). The ring fencing criterion is not implicated and the regime is not ring-fenced.
- Example 7: Country A imposes a general income tax at a rate of 30 percent. Country A taxes resident entities on a world-wide basis. Country A's tax system includes rules designed to mitigate or eliminate double taxation on foreign source income. As a result Country A does not tax certain foreign source income. The ring fencing criterion is not implicated and the regime is not ring-fenced.<sup>15</sup>
- Example 8: Country A imposes a general income tax at a rate of 30 percent but taxes income from captive insurance activities at a preferential rate of 5 percent. The 5 percent rate applies to income from the insurance or reinsurance of both domestic and foreign risks. The regime is not ring-fenced.
- Example 9: Country A imposes a general corporate income tax at a rate of 30 percent. Country A operates a preferential regime that taxes profits from the reinsurance of foreign risks at a preferential rate of 5 percent. Country A provides a separate preferential regime which allows a deduction for reserves for the reinsurance of domestic risks which also results in an effective rate of 5 percent. The regime is not ring-fenced.
- Example 10: Country A imposes a general corporate income tax at a rate of 30 percent. Country A operates a regime that taxes international shipping income at a preferential rate of 5 percent. The regime does not include certain domestic shipping activities (taxed at the standard rate), such as river and harbour ferries that are not comparable to the international shipping activities. The regime is not ring-fenced.

### C. Guidance

84. Countries should use the guidance set out in the box below to assess whether their preferential regimes that meet the no or low tax criterion are ring-fenced.

*A. A preferential regime explicitly or implicitly excludes resident taxpayers from taking advantage of the preferential rates applying under the regime.*

- A preferential regime is likely to be ring-fenced if residents are explicitly precluded from taking advantage of the preferential regime.
- In addition, a preferential regime is likely to be ring-fenced if residents are implicitly precluded from taking advantage of a preferential regime. A preferential regime may be implicitly ring-fenced through the governing qualifying criteria (e.g., group characteristics) or through neutralisation of benefits for resident taxpayers.

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15. For a more detailed discussion of this point in connection with holding companies see Chapter VI.

*B. Enterprises which benefit from the preferential regime are explicitly or implicitly prohibited from operating in the domestic market.*

- A preferential regime is likely to be ring-fenced if entities benefiting from the regime are explicitly prohibited from operating in the domestic market and entities engaged in the same activities in the domestic market are subject to a less favourable effective tax rate.
- In addition, a preferential regime is likely to be ring-fenced if entities benefiting from the regime are implicitly prohibited from operating in the domestic market (e.g., the preferential rate does not apply to the extent that transactions are carried out in the domestic market).

Ring fencing is not implicated under A or B, however, if the measure is part of the general structural features of a country's tax system or if the measure is designed to eliminate or mitigate double taxation. In addition, ring fencing is not implicated where an equivalent benefit is provided to domestic transactions or residents even though the mechanism for providing the benefit may be different.

## CHAPTER IV: TRANSFER PRICING

### A. Introduction

85. This Chapter discusses transfer pricing issues in connection with harmful tax practices. The Chapter is not intended to replace or amend the 1995 OECD Transfer Pricing Guidelines, as amended and supplemented (“the TP Guidelines”). Rather, it uses the TP Guidelines in determining whether any of the key factors of the 1998 Report are present. Part B addresses the relevance of transfer pricing in the context of the criteria found in the 1998 Report. Part C provides a detailed analysis as to how transfer pricing practices could raise issues with respect to the relevant factors described in the 1998 Report. Part D provides more specific guidance by describing how the general guidance in Part C should be applied to particular generic categories of regimes.

### B. Relevance of transfer pricing to the application of the factors in the 1998 Report that identify harmful preferential regimes

86. Transfer pricing concerns the prices, terms and conditions in place in transactions between associated enterprises. Transfer pricing regimes seek to ensure that, for tax purposes, those prices, terms and conditions are in accordance with the arm’s length principle of Article 9 of the OECD Model Tax Convention. Transfer pricing regimes typically apply only to cross-border transactions, but regimes vary according to their scope. For example, the definition of “associated enterprise” varies between regimes.

87. Transfer pricing may be a feature of a number of types of regimes. The most common is a general transfer pricing regime which is designed to be of general application to a wide range of cross-border transactions. Thus, for example, a general regime may specify that cross-border transactions between associated enterprises must accord with the arm’s length principle. However, in a variety of ways, a general transfer pricing regime may be adapted to particular transactions or to categories of transactions. For example, a regime may provide specific guidance that is directed at transactions in a particular industry. Also, the general transfer pricing rules may be applied in a particular way to a particular sector by means of specific legislation, guidance, rulings, deeming provisions or administrative practice. In addition, transfer pricing may be a feature of other regimes, that is, regimes that are in place in addition to a general transfer pricing rule. For example, a headquarters regime may include specific rules that define the taxable profit, deriving from transactions with associates, of a headquarters company. Such rules concern transfer pricing. The scope of this Chapter includes all these types of regimes.

88. This Chapter addresses not only the statutory characteristics of regimes that feature transfer pricing, but also the manner in which those regimes are implemented and applied in practice. Thus the scope of the Chapter encompasses the following:

- general transfer pricing rules, designed to be of application to a wide range of transactions;
- the manner in which those rules are in practice implemented and applied generally;

- the application of a rule in specific circumstances, industries or sectors, whether by means of rulings, guidance, statutory provision or administrative practice;
- other regimes that incorporate rules that define transfer pricing between associated enterprises or which define or otherwise affect the tax base of enterprises derived from transactions with associates.

### ***Impact of transfer pricing practices on the key factors of the 1998 Report***

89. Transfer pricing practices may have an impact on the first key factor, no or low effective tax rates, through the tax base issue. As noted in the 1998 Report (paragraph 61), “a zero or low effective tax rate may arise . . . because of the way in which a country defines the tax base to which the rate is applied.” The application of transfer pricing rules will affect the computation of the tax base for any regime with transactions between associated enterprises. Accordingly, a failure to adhere to international transfer pricing principles is likely to arrive at a tax base resulting from intra-group transactions that differs from that which would have been arrived at had the arm’s length principle been applied. This will be vitally important to the evaluation of whether the preferential regime meets the gateway criterion because this difference may result in a lowering of the tax base and therefore of the effective tax rate.

90. Transfer pricing practices may have an impact on the second key factor, ring fencing, if any benefits available under a transfer pricing regime are explicitly or implicitly restricted to foreign-owned enterprises or if enterprises which benefit from a regime are explicitly or implicitly prohibited from operating in the domestic market. This access could be effectively denied if transactions between taxpayers benefiting from the regime and associated enterprises abroad were treated in a more beneficial way than similar transactions with associated enterprises in the domestic market. Particular care has to be taken in applying the ring-fencing criterion in such situations as transfer pricing rules are not generally applied to domestic transactions.

91. Transfer pricing practices could also have an impact on the third key factor, lack of transparency. As noted in paragraph 63 of the 1998 Report, a lack of transparency may arise in a number of ways, including favourable administrative rulings or a failure to enforce laws through, for example, a deliberately lax audit policy. The result in each case is that the conditions of applicability, and/or the manner of the application of tax regulations, are not clear either to other taxpayers or to other tax authorities. Such a situation could arise, for example, if a system of advance transfer pricing rulings in respect of intra-group services does not in practice result in a consistent application of the relevant regulations to all taxpayers. If, for whatever reason, there are in practice differences in the manner in which the regulations are applied to different taxpayers such that there is an inequality of treatment of taxpayers in similar circumstances, the regime will not be transparent because its actual conditions of applicability to taxpayers will not be clear to other taxpayers or other authorities.

92. The fourth key factor, exchange of information, is relevant to transfer pricing practices in a different way. The existence of a regime with a low or zero effective tax rate may encourage taxpayers to shift profits into the low or zero effective rate regime by not following transfer pricing principles in respect of intra-group transactions. In the context of transfer pricing practice, the ability or willingness of the preferential regime jurisdiction to *effectively* exchange information in respect of intra-group transactions and in respect of intra-group relationships will be vitally important for other jurisdictions affected by that regime to be able to enforce their transfer pricing rules. As noted in paragraph 64 of the 1998 Report, the ability or willingness of a country to provide relevant information to other countries is a key factor in deciding upon whether the effect of a regime operated by that country has the potential to cause harmful effects.

93. Consequently, when evaluating a transfer pricing regime, particular attention should be paid not just to whether the regime adheres to international transfer pricing principles but also to whether the regime permits *effective* exchange of information in respect of intra-group transactions. In this context, and for the purposes of this Chapter, three conditions are necessary for *effective* exchange of information. First, relevant information on intra-group transactions should be available to the country of the preferential regime. Second, there must be no impediments to the exchange of that information under the terms of the relevant double taxation agreement or other relevant instruments authorising exchange of information. Third, the country must actually exchange that information in practice.

94. Transfer pricing practices are clearly the dominant feature of a number of the 47 member country preferential regimes identified as potentially harmful in the 2000 Report, for example headquarters, distribution centres, services centres, and group financing regimes. For such regimes, the most significant impact of transfer pricing practices is on the gateway criterion of “no or low effective tax rate” factor. Preferential regimes with significant transfer pricing aspects and without an explicitly low nominal tax rate can only give rise to a low effective tax rate due to the impact of transfer pricing practices on the determination of the tax base resulting from intra-group transactions. The guidance in this Chapter in relation to the tax base issue will be of importance to establishing whether the gateway criterion is met and is the main focus of the Chapter.

95. If the gateway criterion of a no or low effective tax rate is met, an analysis of the other key criteria is necessary. This Chapter provides guidance as to how the other key factors should be applied to transfer pricing practices. That guidance applies not just to preferential regimes that are focused on intra-group transactions but also to all preferential regimes where there is the possibility for intra-group transactions to occur under the regime.

96. Finally, it should be noted that many of the regimes under review apply equally not only to the carrying on of an activity between associated enterprises but also where an activity is carried on through a permanent establishment (PE). The first issue will be whether the PE is subject to a low effective tax rate because of the way the tax base is defined. As with transactions between associated enterprises, it is the arm’s length principle that provides the internationally accepted benchmark for determining the appropriate arm’s length remuneration, albeit that in the PE situation that principle is described by Article 7 of the OECD Model Tax Convention and not by Article 9. A failure to follow the arm’s length principle described by Article 7 is likely to result in a distortion of the tax base and the possibility of a low effective tax rate. This is analogous to the situation found between associated enterprises and so, unless stated otherwise, the guidance in this Chapter may also be helpful, by analogy, to PEs.<sup>16</sup>

## **C. General guidance for preferential regimes with transfer pricing aspects**

### ***i) Importance of the TP Guidelines***

97. Transfer pricing rules, whether generally applicable to all transactions or applicable only in particular circumstances, define, for tax purposes, the pricing to be used in transactions between associated enterprises (“intra-group transactions”). In doing so, they often play the key role in determining the tax base of enterprises that conduct transactions with associated enterprises. International transfer pricing principles are based around the arm’s length principle of Article 9 of the OECD Model Tax Convention. The TP Guidelines, set out how countries are to apply those principles which “have been chosen by OECD member countries as serving the dual objectives of securing the appropriate tax base in each jurisdiction

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16. Working Party 6 is currently reviewing Article 7, as well as the commentary to that article, and its relationship to the Transfer Pricing Guidelines.

and avoiding double taxation, thereby minimising conflict between tax administrations and promoting international trade and investment.”<sup>17</sup>

98. Recognition of the importance of the TP Guidelines in connection with the project on harmful tax competition can be found in Chapter III of the 1998 Report, which contains recommendations for counteracting harmful tax practices. Recommendation 6 relates to transfer pricing and states:

*“Recommendation concerning transfer pricing rules: that countries follow the principles set out in the OECD’s 1995 Guidelines on Transfer Pricing and thereby refrain from applying or not applying their transfer pricing rules in a way that would constitute harmful tax competition.”*

99. An issue arises as many of the regimes with transfer pricing aspects identified in the 2000 Report as being potentially harmful were created before the 1995 TP Guidelines were published. In such cases, countries would have had to rely on the 1979 Report on Transfer Pricing and Multinational Enterprises (“the 1979 Report”) for guidance as to the application of the arm’s length principle when designing the aspect of their preferential regime that relates to intra-group transactions. Although the arm’s length principle remains unchanged, there have been changes in the guidance as to how that principle can be applied reliably in practice. It will be necessary to review such regimes under the 1995 TP Guidelines, as amended and supplemented.

100. If countries apply the transfer pricing aspects of their preferential regimes in a manner consistent with the TP Guidelines, the tax base resulting from intra-group transactions will not be distorted and so the regime will not result in a “low or no effective tax rate” by reason of transfer pricing practices. Where, for whatever reason, transfer pricing is not in accordance with the arm’s length principle, then the tax base is very likely to be distorted.

101. A regime that does not follow the guidance given in the TP Guidelines departs from the internationally accepted way of determining an arm’s length remuneration with respect to intra-group transactions and may result in a low effective tax rate. If the preferential regime is one without an explicitly low nominal tax rate, an evaluation would have to be made as to whether the regime’s deviation from the TP Guidelines distorts the tax base in such a way as to result in a low effective tax rate. Such a regime is considered to result in a low effective tax rate unless it can be demonstrated by the country with the regime that, taken as a whole, the quantum of the tax base in respect of intra-group transactions for enterprises benefiting from the preferential regime is likely to be greater than or broadly equivalent to the quantum that would have arisen following an application of the TP Guidelines. If such a demonstration is not made, an evaluation of the regime under the other three key factors of the 1998 Report would then be necessary. The following paragraphs discuss those parts of the TP Guidelines that are of particular relevance in assessing the key criteria.

## ***ii) Guidance from the TP Guidelines***

102. This section identifies issues in the TP Guidelines that are likely to be of special significance when evaluating whether a preferential regime exhibits any of the key factors of a harmful preferential regime. The following issues appear to be the most relevant:

- a) Selection and application of transfer pricing methods.
- b) Safe harbours.

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17. TP Guidelines paragraph 7 of the Preface.

- c) Administration aspects.
- d) Advance transfer pricing rulings and Advance Pricing Arrangements (APAs).

103. The first three issues identified above are discussed in detail below, both with respect to the guidance in the TP Guidelines and with respect to their impact on the evaluation of the key factors of the 1998 Report. The fourth issue is dealt with in detail in the Chapter on rulings (Chapter V).

a) *Selection and application of transfer pricing methods*

1. Impact on the low effective tax rate factor

104. Transfer pricing methods are the means by which the arm's length principle is applied in practice. Considerable guidance on the application of that principle is found in Chapter I of the TP Guidelines. In particular, it is noted at 1.15 that “[a]pplication of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable”. Paragraphs 1.19 - 1.35 describe the factors (characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies) that determine comparability and that need to be taken into consideration when applying transfer pricing methods. To arrive at arm's length pricing of intra-group transactions the appropriate transfer pricing method must be chosen and applied reliably in accordance with the comparability standard of Chapter I of the TP Guidelines.<sup>18</sup>

**Selection of a transfer pricing method**

105. The 1995 Guidelines describe a number of transfer pricing methods in Chapters II and III that may be used to determine an arm's length price or margin.<sup>19</sup> These are:

- Comparable uncontrolled price method.
- Resale price method.
- Cost plus method.
- Transactional profit split method.
- Transactional net margin method.

106. As noted at paragraph 1.68 of the TP Guidelines, “[t]he methods set forth in Chapters II and III establish whether the conditions imposed in the commercial or financial relations between associated

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18. The comparability standard is described in the TP Guidelines as follows: “To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g., price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.”

19. “However, in some cases it may be necessary to apply methods not described in the TP Guidelines. Such methods may be acceptable provided they satisfy the arm's length principle in accordance with the 1995 Guidelines and, in particular, the guidance on use of such methods at paragraphs 1.68- 1.70”.

enterprises are consistent with the arm's length principle.” Consequently, the appropriate selection, and proper application, of those methods will be vital in ensuring the application of the arm's length principle and correct determination of an arm's length remuneration for the functions performed. The Guidelines also advise on the relative reliability of each of the methods. They advise that, while in some cases the choice of method may not be straightforward, generally it will be possible to select one method that is apt to provide the best estimation of the arm's length price (paragraph 1.69). Moreover, they also express a preference for higher degrees of comparability and a more direct and closer relationship to the transaction (paragraph 1.70). They take the view that the traditional transactional methods (comparable uncontrolled price, resale price and cost plus methods) are the most direct means of establishing whether commercial and financial relations between associated enterprises are arm's length and that only where such methods cannot be reliably applied may it become necessary to consider the other methods (paragraph 3.50).

107. A no or low effective tax rate issue may arise if the transfer pricing method that is prescribed, or that may be used, is not the most reliable method available. This is particularly a concern where certainty of tax treatment accompanies the use of a less reliable method. In this case, the desire for certainty may encourage taxpayers to use the less reliable method.

108. There are three particular situations where the provision of certainty by tax authorities could adversely affect the choice of method and may result in a no or low effective rate of tax. The first situation is where the Comparable Uncontrolled Price method<sup>20</sup> ("CUP") could be applied reliably but the regime prescribes another method. Paragraph 2.7 states that “[w]here it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP method is preferable over all other methods” and the use of another method may result in a no or low effective tax rate.

109. The second situation where a low or no effective tax rate issue may arise is where a traditional transactional method could be applied reliably in accordance with the TP Guidelines, but the regime only provides some degree of certainty to taxpayers using a transactional profit method. This issue will be of particular importance where the regime provides certainty for some kind of “cost plus” or “resale price” method. The cost plus and resale price methods described in Chapter II of the TP Guidelines use an analysis of gross margins rather than net margins. As noted in paragraph 2.41, “[t]he distinction between gross and net margin analyses may be understood in the following terms. In general, the cost plus method will use margins computed after direct and indirect costs of production, while a net margin method will use margins computed after operating expenses of the enterprise as well.” As noted in paragraph 3.26, “[t]he transactional net margin method examines the net profit margin relative to an appropriate base (e.g., costs, sales, assets) that a taxpayer realises from a controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods.”

110. This distinction between using gross, as opposed to net, margins for the cost plus and resale price method was not so clear in the 1979 Report. One of the major changes in the 1995 Guidelines is the clarification that the traditional transaction methods in Chapter II, cost plus and resale price, use a gross margin analysis. Methods that use a net margin analysis are profit methods. As noted in paragraph 3.1, “[t]he only profit methods that satisfy the arm's length principle are those that are consistent with the profit split method or the transactional net margin method as described in these Guidelines.” Further, the TP Guidelines note that such methods should only be used, “in cases where traditional transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all.”<sup>21</sup> So issues may arise where

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20. TP Guidelines paragraphs 2.6 -2.13

21. TP Guidelines paragraph 3.50

“cost plus” or “resale price” regimes *require* the use of a net margin method, rather than permit its use where traditional cost plus or resale price methods cannot be applied reliably. As noted in paragraph 3.53, “there are substantial concerns regarding the use of the transactional net margin method”, particularly if the guidance in applying the comparability standard to that method at paragraphs 3.34-3.40 is not followed. Again there may be considerable difficulties in fulfilling the comparability standard if a profit method has been prescribed by the tax authority rather than chosen by the taxpayer.

111. The third situation where a no or low effective tax rate issue may arise is where a method not found in the TP Guidelines is prescribed by a regime. Some methods labelled “cost plus” or “resale price” appear to be neither traditional transaction methods within the meaning of Chapter II of the TP Guidelines nor transactional net margin methods within the meaning of Chapter III of the TP Guidelines. As can be seen from paragraph 1.68, although, “*MNE*<sup>22</sup> *groups (emphasis added)* retain the freedom to apply methods not described in this Report to establish prices” it is necessary that “those prices satisfy the arm's length principle in accordance with these Guidelines”. Further, in paragraph 1.70 it is stated that, “. . . any method should be permitted where its application is agreeable to the members of the MNE group involved with the transaction or transactions to which the methodology applies *and also to the tax administrations in the jurisdictions of all those members.*” (*Emphasis added*). Therefore, although it is accepted that methodologies other than those included in the TP Guidelines may on occasion be the most effective means of arriving at an arm’s length result, the prescription of such methods by tax authorities may implicate the no or low effective rate criterion.

#### **Application of transfer pricing method**

112. The application of a method in a manner inconsistent with the guidance in the TP Guidelines has the potential to lower the tax base resulting from intra-group transactions where the application of a method in a manner consistent with the TP Guidelines would result in a higher level of profit. In particular, Chapter I of the TP Guidelines provides considerable detail on the concepts of functional and comparability analysis, which are essential in order to apply reliably any transfer pricing method. For example, the TP Guidelines require that the margins in a cost plus or resale price regime are set by making a comparison with the margins on transactions undertaken by independent enterprises performing similar functions (taking into account assets used and risks assumed) under comparable conditions and after making any necessary adjustments to account for any material differences. An incorrect application of a method makes it unlikely that the comparability standard will be satisfied, and the tax base resulting from intra-group transactions may be reduced.

113. As noted above, issues arise where the preferential regime effectively prescribes the type of method, e.g., cost plus, that can be applied. An issue may also arise where the regime seeks to prescribe the way the transfer pricing method has to be applied, particularly where an attempt is made to simplify the transfer pricing method. For example, a simplified cost plus method may set a range of acceptable margins on costs that are not based on the factual, functional and comparability analysis and therefore may result in a reduction of the tax base. These issues are compounded where a regime both effectively prescribes the type of method and the way that method has to be applied. Issues may arise particularly in three situations that are discussed in more detail below.

114. The first situation is where the regime prescribes a certain fixed margin (say 5%) for the cost plus or resale price method. Prescribing a single fixed margin to cover all taxpayers and a wide range of services may result in a reduction of the tax base.

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22. Multinational Enterprises.

115. Some regimes try to minimise the above problem by providing for a fixed range of margins (say 5-10%) rather than a single figure. One of the major developments in the 1995 TP Guidelines as compared to the 1979 Report was the introduction of the concept of the arm's length range.<sup>23</sup> In particular it is noted that, "because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable." However, the second situation where issues can arise is where the range provided is not an arm's length range. In order for a range to reflect the arm's length principle, margins have to be set by reference to the margins that would be earned in comparable transactions entered into by independent enterprises performing similar functions. Issues can arise where the comparability standard of Chapter I of the TP Guidelines is not met. For example, where the range of margins is set without a sufficiently detailed examination of the margins earned by independent enterprises from comparable transactions or where the prescribed range can be applied to transactions that are not comparable as described in Chapter I of the TP Guidelines.

116. The third situation where issues can arise is where the fixed range of margins is prescribed prospectively for a number of years, e.g., under a ruling procedure, and there is no mechanism to adjust the range to reflect changes in facts and circumstances. Even if a factual, functional and comparability analysis in accordance with the TP Guidelines is undertaken so that the prescribed range is an arm's length range at the start of the period, changes in facts and circumstances may mean the range may result in an allocation of less than an arm's length amount, for example, an arm's length range that is set in advance may fail to take into account changes that would require a higher margin. It is for this reason that the concept of critical assumptions was developed for APAs so as to ensure that the arm's length principle was being applied throughout the duration of the APA.

117. Issues may also arise where a method is applied under the regime in a manner that differs from the guidance on the application of that method in the TP Guidelines. For example, where the regime describes a method as a "cost plus method" but the cost base is reduced because only some of the costs incurred in earning the gross profit are included in the costs to be marked-up. This is likely to lead to a lower tax base resulting from intra-group transactions where the amount of mark-up applied to the reduced cost base is similar to the amount of the mark-up applied by independent enterprises to the full cost base when undertaking comparable transactions.

## 2. Impact on the other key factors

118. As discussed in Part B, the selection and application of methods can also have an impact on the other key factors of the report. This will be relevant where the selection and/or application of a method not in accordance with the TP Guidelines has resulted in a low or no effective tax rate.

119. The selection, or application, of a method could result in ring fencing. There are two main ways in which this could occur. First, a particular transfer pricing method that provides beneficial treatment could only be applied to enterprises that are foreign-owned or could be applied in a particularly beneficial way only to such enterprises. For example, a service company regime may prescribe a modified cost plus method to determine the tax base of enterprises that benefit from the regime in such a way as to understate the tax base in comparison to that which would result from the application of the arm's length principle in accordance with the TP Guidelines. If this method is available only for service activities carried out by subsidiaries of foreign enterprises, then ring fencing is present. Second, ring fencing may be present if the selection or application of transfer pricing methods results in a more beneficial treatment of transactions with associated enterprises abroad than the treatment accorded to comparable transactions in the domestic

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23. TP Guidelines 1.45-1.48

market. In the example above, the determination of the cost base in a beneficial manner may apply only in respect of transactions with associated enterprises abroad and not to transactions in the domestic market of the country providing the regime.

120. Transparency issues might also arise. This could occur in a number of ways. One way would be if the conditions under which a particular method that results in a no or low effective rate are not set forth or are applied in such a manner that the conditions of applicability are not clear and are not made publicly available.

121. As noted in paragraph 67 of the 1998 Report, there are a number of factors (including absence of general audit requirements) that reflect a difficulty in obtaining information necessary to enforce statutory laws and which may make it difficult for *effective* exchange of information to occur. These problems are likely to arise where the regime applies methods not found in the TP Guidelines, or applies simplified transfer pricing methods with margins, or ranges of margins, prescribed by the tax authority. For example, a method that applies a fixed *margin* to total costs would not require the taxpayer to consider whether any *transactions* with non-resident associated enterprises were at arm's length prices. Instead the taxpayer would merely apply the appropriate margin in relation to all the costs of its operations.

122. The simplified nature of such methods is likely to mean that there would be little or no useful information available about transactions with non-resident associated enterprises in the jurisdiction of the regime. This would mean that the tax authority operating the regime would not have information on intra-group transactions readily available in order to be able to exchange that information in response to a valid request from another tax authority. Consequently, such a regime has the potential to result in a lack of effective exchange of information within the meaning of the 1998 Report. However, this would not result in an actual lack of effective information exchange provided the tax authority administering the regime would be able to obtain relevant information about transactions with non-resident associated enterprises and would be able to provide that information to other jurisdictions under the relevant tax treaty or tax information exchange agreement.

### 3. Conclusion on the selection and application of transfer pricing methods

123. The guidance in the box below should be used to assess whether those regimes with transfer pricing aspects meet the no or low tax criterion and to assess whether the other key criteria are implicated by the selection or application of a transfer pricing method.

### **General Guidance on selection and application of methods**

The following feature may result in a reduction of the tax base, and therefore a low or no effective tax rate:

- A preferential regime that is not based on the guidance in the TP Guidelines on selection and application of transfer pricing methods.

In particular, the following features may produce such an effect:

- Effective prescription of a transfer pricing method by a tax authority under a regime without the analysis consistent with the TP Guidelines necessary to ascertain that this method provides, for the individual enterprise concerned, a reliable estimation of an arm's length price.
- Application of a fixed margin, or of a range of margins, that are fixed in advance and that do not require adjustment according to changes in facts and circumstances.
- Application of simplified transfer pricing methods that are not based on the factual, functional and comparability analysis necessary to verify that the results of applying that method are in accordance with the arm's length principle.
- Application of a transfer pricing method in a manner that differs from the guidance on the application of that method in the TP Guidelines.

Where, for whatever reason, the regime results in a low effective tax rate, the following features are likely to implicate the other key criteria:

- The ring fencing criterion is likely to be implicated if the benefits that derive from the application of a transfer pricing method are explicitly or implicitly denied to domestically-owned enterprises.
- The ring fencing criterion is likely to be implicated if selection or application of transfer pricing methods that apply to transactions with associated enterprises abroad result in a lower effective tax rate on those transactions as compared to comparable domestic transactions.
- The transparency and exchange of information criteria are likely to be implicated if the conditions for application of a particular method that results in a no or low effective rate are not set forth or are not applied in such a manner that the conditions of applicability are clear to taxpayers or other tax authorities in other countries.
- The transparency and effective exchange of information criteria are likely to be implicated if information on relevant intra-group transactions is not available and cannot be provided to the tax authority of the other country to ascertain or verify that the transfer prices are in accordance with the arm's length principle.

#### *b) Safe harbours*

##### 1. Impact on the low effective tax rate factor

124. Safe harbours are discussed at Section E of Chapter IV of the TP Guidelines (paragraphs 4.94 to 4.123). Safe harbours can support legitimate tax administration objectives such as simplifying compliance

for eligible taxpayers in determining arm's length conditions, providing assurance to a category of taxpayers that the price charged or received on controlled transactions will be accepted by the tax administration without further review, and relieving the tax administration from the task of conducting further examination and audits of taxpayers with respect to transfer pricing. As noted at paragraph 4.97 of the TP guidelines, however, “[t]he provision of safe harbours raises significant questions about the degree of arbitrariness that would be created in determining transfer prices by eligible taxpayers, tax planning opportunities, and the potential for double taxation resulting from the possible incompatibility of safe harbours with the arm’s length principle.”

125. Section E analyses the factors supporting the use of safe harbours and also the problems presented by safe harbours. Of particular relevance in the present context is the statement at paragraph 4.121 that “[t]hey may also have a negative impact on the tax revenues of the country implementing the safe harbour as well as on the countries whose associated enterprises engage in controlled transactions with taxpayers electing a safe harbour. More important, safe harbours are generally not compatible with the enforcement of transfer prices consistent with the arm’s length principle.” The analysis concludes at paragraph 4.123 that “the use of safe harbours is not recommended.” Consequently a regime that provides a safe harbour is potentially not adhering to international transfer pricing principles.

126. A safe harbour could result in a low effective tax rate if it were set at a different level to that which would be found for similar transactions between independent enterprises. As noted at 4.107 of the TP Guidelines, “[s]afe harbours are likely to be arbitrary since they rarely fit exactly the varying facts and circumstances even of enterprises in the same trade or business. This arbitrariness could be minimised only with great difficulty by devoting a considerable amount of skilled labour to collecting, collating and continuously revising a pool of information about pricing and pricing developments.”

## 2. Impact on the other key factors

127. A safe harbour has the potential to result in ring fencing. For example, transactions with non-residents could benefit from a safe harbour that, for whatever reason, is not applicable to transactions on the domestic market. Alternatively, the conditions of applicability of the safe harbour may discriminate between resident and non-resident based groups. In either case, the effect is likely to be to isolate the domestic economy from the effects of the safe harbour.

128. A safe harbour also has the potential to lack transparency. This could occur, in particular, if the conditions of applicability of the safe harbour are not clear and are not made available to all taxpayers and to other tax authorities. This is likely to mean that other taxpayers are prevented from invoking the same conditions or that other tax authorities are unaware of the terms of the safe harbour and so may not be able to apply their own transfer pricing rules to transactions that are covered by the safe harbour.

129. The problems of ensuring *effective* exchange of information, described above in relation to the application of methods not found in the TP Guidelines or to the application of simplified transfer pricing methods, apply equally to safe harbours. In particular the application of a safe harbour may obviate the need for a taxpayer to maintain, or the tax authority to obtain, detailed information about transactions that fall within its scope. The result may be that the tax authority does not have available to it the detailed information on the relevant intra-group transactions that may be needed by other tax authorities to ascertain or verify that the terms of those transactions are in accordance with the arm's length principle.

### 3. Conclusion on the safe harbours

130. In the context of regimes with transfer pricing aspects, the guidance in the box below should be used to assess those regimes that use safe harbours for intra-group transactions.

#### **General Guidance on safe harbours**

A regime that applies a safe harbour may result in a reduction of the tax base and therefore a low or no effective tax rate.

In particular, the following features may produce such an effect:

- The safe harbour does not produce an arm's length price, or an arm's length range, in respect of transactions that come within its scope of application.
- The safe harbour is not based on a thorough comparison with comparable transactions undertaken by independent enterprises under comparable conditions (including, where necessary, the taking into account of appropriate adjustments for material, functional or other differences).
- Taxpayers can apply the safe harbour even though their transactions are not comparable to the transactions undertaken by independent enterprises on which the safe harbour is based.
- The tax authority that provides for the safe harbour is not able to obtain sufficient information to verify that the activities of the entity equate to those for which the safe harbour is applicable.
- The same safe harbour applies to a wide range of business activities and functions.
- The safe harbour is not reviewed periodically to ensure that it maintains reliability over time.

Where, for whatever reason, a safe harbour results in a low or no effective tax rate, the following features are likely to implicate the other key factors:

- The ring fencing criterion is likely to be implicated if the benefits that derive from the application of a safe harbour are explicitly or implicitly denied to domestically-owned enterprises or the safe harbour applies to transactions with associated enterprises abroad with the result that such transactions are subject to a lower effective tax rate than comparable domestic transactions.
- The transparency criterion is likely to be implicated if the conditions of applicability of the safe harbour are not clear and not made publicly available.
- The exchange of information criterion is likely to be implicated if the tax authority operating the safe harbour regime is unable to obtain and exchange sufficient information on relevant intra-group transactions for other tax authorities to be able to ascertain or to verify that the transactions covered by the safe harbour are in accordance with the arm's length principle.

*c) Administration aspects of transfer pricing rules*

1. Impact on low or no effective tax rate

131. The TP Guidelines detail the level of analysis appropriate to ensure a sufficient level of reliability of uncontrolled transactions used as comparables. They envisage that an analysis is carried out to establish the degree of comparability of uncontrolled transactions and to make appropriate adjustments to establish arm's length conditions. They state that "[i]n all cases adjustments must be made to account for differences between the controlled and uncontrolled situations that would significantly affect the price charged or return required by independent enterprises. Therefore, in no event can unadjusted industry average returns themselves establish arm's length conditions" (paragraph 1.16). The TP Guidelines state that, in determining whether controlled and uncontrolled transactions or entities are comparable, "comparison of the functions taken on by the parties is necessary" (paragraph 1.20). This comparison should be based on a functional analysis, which seeks to compare the economically significant activities and responsibilities undertaken by the independent and associated enterprises.

132. The TP Guidelines thus envisage that the necessary analysis is undertaken in order to establish that the most appropriate method is employed. They further envisage that a functional analysis of the tested enterprise is undertaken in order to establish that comparables are sufficiently reliable. Failure to maintain this level of analysis may mean that the arm's length principle is not properly applied and may result in a low or no effective rate of tax. There are a number of reasons why such a failure may occur. Tax authorities may not have procedures that require an effective audit of the transfer pricing of enterprises in their jurisdiction. Even if such procedures are in place, effective audit may in practice not occur without the resources or the means to carry it out. Further, it may be very difficult to carry out effective audit if the tax authority is unable to obtain sufficient information to identify relevant intra-group transactions and verify that the transfer pricing of those transactions is in accordance with the arm's length principle.<sup>24</sup>

133. In short, a transfer pricing regime, whether general or specific, may lead to no or low taxation if it is not in practice implemented to the standard envisaged in the TP Guidelines. This would include:

- the method applied under the regime (whether adopted by a taxpayer or prescribed by the authority) is not based on the analysis consistent with the TP Guidelines necessary to ensure that the method provides a reliable estimation of an arm's length price;
- the tax authority is unable to ascertain that the appropriate method is applied properly and that the comparables selected are sufficiently reliable;
- in practice the tax authority does not audit returns, or does not audit them in sufficient depth, to ensure that the taxpayer's pricing is in accord with the arm's length principle;
- the tax authority is not able to obtain sufficient information concerning relevant transactions in order to be able to verify that the transfer prices are in accordance with the arm's length principle.

134. Tax authorities should have administrative procedures, and adequate resources, in place to ensure that transfer pricing is in accordance with the arm's length principle as envisaged in the TP Guidelines.

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24. Chapter V of the TP Guidelines provides guidance on documentation requirements for tax administrations to take into account in developing rules and procedures on documentation to be obtained from taxpayers in connection with a transfer pricing enquiry.

## 2. Ring fencing

135. Issues may also arise where the transfer pricing rules discriminate in their application between different taxpayers or types of taxpayers. This could occur in a number of ways. It may be explicit in the rules of the regime. Alternatively, it may occur in practice if, for example, the rules of the regime are vague or allow for a high level of discretion in their application. For example, auditors may be able in practice to apply transfer pricing regulations in a way that is advantageous to foreign-owned enterprises and is in practice denied to domestically-owned enterprises or to transactions in the domestic market.

## 3. Transparency

136. Issues with transparency are likely to arise where transfer pricing administrative practices are not published or are not made widely available. Further issues arise where the rules of the regime are not clear or can be applied in practice in an inconsistent manner. For example, tax officials may have the discretion to administer the regime in a way that departs from the normal and proper application of the relevant legislation. Failure to set forth clearly the conditions for applicability of rules of the system to individual taxpayers can allow for individually negotiated tax burdens, which obscures the impact of the system on the taxpayer. Where it is not clear that administrative practices are available to all taxpayers that are in similar circumstances, this may lead to a lack of transparency.

137. If the rules as applied in practice deviate from the TP Guidelines, this may have an impact on transparency as the relevant information on the intra-group transactions is unlikely to be readily available. This issue may be overcome if the jurisdiction of the preferential regime is nevertheless able and willing to obtain that information in practice and to exchange it (see sub-section below).

## 4. Exchange of information

138. Exchange of information is important in the context of transfer pricing to enable tax authorities to assess whether MNEs overstate their profits in entities enjoying the benefits of a preferential regime.

139. In cases where a regime provides for an effective low rate of taxation, MNEs will have an incentive to shift profit into entities benefiting from that regime. The most likely way in which this may be achieved is through transfer pricing. Improperly shifting profit into the low tax regime by means of transfer pricing will, of course, be at the expense of another jurisdiction. Without effective exchange of information about relevant intra-group transactions, it may be difficult for the treaty partner to use its transfer pricing rules to protect its own tax base.

140. Difficulties are likely to arise in two main areas. First, the tax authority wishing to invoke its transfer pricing legislation may need sufficient information, for example on the beneficial ownership of shares, to determine whether the enterprise located in the preferential regime is an associated enterprise so that transfer pricing legislation can be applied. Second, information may be needed to be able to evaluate whether a transaction with an enterprise benefiting from the preferential regime reflects the arm's length principle. For example, where an insurance premium is paid to an associated enterprise subject to a preferential regime, information may be needed as to the ability of the associated enterprise to meet any insurance claim.

## 5. Conclusion on administration of transfer pricing rules and practices

141. In the context of regimes with transfer pricing aspects, the guidance in the box below should be used to assess those regimes in relation to the administration of transfer pricing rules and practices.

### **General Guidance on administrative aspects**

The preferential regime that is not administered in a manner consistent with the TP Guidelines may result in a reduction of the tax base and therefore a low or no effective tax rate.

In particular, the following features may produce such an effect:

- Regimes that are not based on the analysis necessary to ensure that the method used provides a reliable estimation of an arm's length price consistent with the TP Guidelines.
- Regimes that are not based on the analysis necessary to ensure that the method employed to determine an arm's length transfer price is applied in a manner consistent with the TP Guidelines and in accordance with the arm's length principle.
- Regimes where taxpayers' returns are not audited in sufficient depth (or at all) and with sufficient frequency to ensure that a reliable method is used and that it is applied in the manner specified in the Guidelines.

Where, for whatever reason, the administrative aspects result in a low effective tax rate, the following administrative features are likely to implicate the other key factors:

- The ring fencing criterion is likely to be implicated if the transfer pricing rules are administered in such a way that the benefits that derive from the application of transfer pricing rules are explicitly or implicitly denied to domestically-owned enterprises and/or are administered in such a way that transactions with associated enterprises abroad result in a lower effective tax rate on those transactions as compared to comparable domestic transactions.
- The transparency criterion is likely to be implicated if the transfer pricing rules are not clear and are not publicly available.
- The transparency criterion is likely to be implicated if the transfer pricing rules are not administered in a consistent fashion with respect to similarly situated taxpayers.
- The transparency criterion is likely to be implicated if the information required to verify compliance with the arm's length principle, as described in the TP Guidelines, is not available to the country providing the preferential regime.
- The transparency criterion is likely to be implicated if there are inadequate documentation requirements or information powers that can be applied to identify the intra-group transactions that fall within the regime and to obtain the information necessary to verify that the transfer pricing of those transactions is in accordance with the arm's length principle.
- The effective exchange of information criterion is likely to be implicated if relevant information on intra-group transactions is not available for exchange in response to a valid request from another tax administration.
- The transparency criterion is likely to be implicated if relevant information on the ownership of an enterprise is not available to the country providing the regime so it cannot be readily determined whether, and to what extent, the enterprise has associated enterprises in other countries.
- The exchange of information criterion is likely to be implicated if information is not exchanged in those cases where the requested state does not need for the information for its own tax purposes.

*d) Advance transfer pricing rulings and advance pricing arrangements (APAs)*

142. The general guidance in this Chapter, for example on the application of transfer pricing methods, should be applied to transfer pricing issues that are the subject of an advance transfer pricing ruling or an APA. That should ensure that advance transfer pricing rulings or APAs cannot be applied in a manner that would lead to a lowering of the tax base. Matters specifically related to rulings and APAs and to the other key factors in the 1998 Report are dealt with in Chapter V.

**D. Specific guidance for generic categories of regime**

143. Transfer pricing is of more relevance to particular categories of regimes than to others because of the greater incidence of intra-group transactions in some categories of regimes. The discussion below considers those regimes where transfer pricing is of particular relevance. However, the guidance in this Chapter should be followed for any regime where intra-group transactions may occur.

*i) Regimes containing no specific transfer pricing provisions*

144. Many of the regimes that have been identified as potentially harmful contain no specific provision concerning transfer pricing, for example banking and insurance regimes. For the majority of these, the low or no effective tax rate is effected by an explicitly low rate of tax rather than an artificial definition of the tax base. For these regimes, where intra-group transactions are involved, for the most part the country's general transfer pricing rules apply in the same way as they do to transactions outside the regime in question. In such cases, the general guidance in this Chapter should apply. In such cases, MNEs will have an incentive to overstate profits in the regime's jurisdiction, often by means of transfer pricing. Alternatively, where the regime is contained in a PE, companies will have an incentive to over-allocate profit to that PE where the profits of the PE are exempted by the country of the head office. In both cases, it is important in particular that the guidance concerning exchange of information in this Chapter is adhered to in order to allow other countries to use their transfer pricing regimes to protect their own tax bases.

*ii) Regimes containing specific transfer pricing provisions*

145. A number of regimes contain specific rules concerning the pricing of intra-group transactions. These may be adaptations of the general transfer pricing rules or specific rules unique to the regime. In some instances the regime is implemented through rulings. The rulings aspects of such regimes are dealt with in Chapter V. The rest of this Chapter looks in detail at categories of regimes where transfer pricing issues are particularly important and provides supplementary guidance to that already contained in section C.

*a) Regimes that apply some type of cost plus method*

146. A number of regimes define the tax base of a participating entity by means of a type of cost plus method. This is true of many of the headquarters, distribution centre and service centre regimes, but also applies to particular financing and leasing regimes and rulings on foreign sales corporations. In all these cases, the preferential regime stipulates a method for determining the tax base of the participating entity. This is a transfer pricing issue because the stipulated method determines the tax base of entities that conduct transactions with associated enterprises. There is a potential, if not a likelihood, that the tax base

determined by the stipulated method will differ from that which would have been the case had the arm's length principle been applied in accordance with the TP Guidelines. If the stipulated method produces a lower tax base than would a proper application of the arm's length principle, then there will be a low or no effective tax rate by reason of a failure to apply international transfer pricing standards.

147. A number of issues arise that have already been discussed in general in section C (ii)(a) above. The first issue that arises is whether a cost plus method is the appropriate method to use in the given circumstances of each of the entities participating in the regime. The TP Guidelines advise that a CUP is the most direct and thus reliable method of ascertaining an arm's length price. Only if such a direct method is not available should a gross margin method such as cost plus be employed.

148. The second issue concerns the costs to be marked up. In some cases, the cost base includes all costs. In other cases specified costs are excluded from the cost base. In general, the TP Guidelines envisage the method to apply a mark-up to the direct and indirect costs of production, thus producing a gross margin from which operating expenses are deducted to arrive at the net margin. However, the TP Guidelines recognise that because of the variations in accounting practice among countries, it is difficult to draw any precise lines between the three categories of costs (direct and indirect costs and operating expenses).

149. The third issue concerns the mark-up to be applied. Some regimes specify the mark-up or range of mark-ups to be applied. The TP Guidelines make it clear that the mark-up to be applied should be based on those earned in comparable uncontrolled transactions. "The cost plus mark-up of the supplier in the controlled transaction should ideally be established by reference to the cost plus mark-up that the same supplier earns in comparable uncontrolled transactions. In addition, the cost plus mark-up that would have been earned in comparable transactions by an independent enterprise may serve as a guide." (Paragraph 2.33).

#### Conclusion on cost plus methods

150. In the context of regimes with transfer pricing aspects, the guidance in the box below should be used to assess those regimes in relation to the use of cost plus methods.

The following feature may result in a reduction of the tax base, and therefore a low or no effective tax rate:

- A cost plus method that is not based on the guidance in the TP Guidelines on selection of methods and the application of the cost plus method.

The following features may produce such an effect:

- A cost plus regime that is not based upon the analysis consistent with the TP Guidelines that is necessary to ensure that a comparable uncontrolled price is unavailable.
- Where the regime does not require taxpayers to compute the cost base in accordance with the TP Guidelines. This means that in general all the direct and indirect costs of production should be included in the cost base to be marked up.
- Where the level of mark up is not ascertained on a case-by-case basis nor derived from the level of mark up that would be earned in comparable uncontrolled transactions.
- Where a specified mark up, or a range of mark ups, is not ascertained in accordance with the general standards for safe harbours described above.

*b) Regimes that apply some type of resale price method*

151. The conclusions described above for the application of a cost plus method apply, with the necessary modifications, to the application of types of resale price methods.

*c) Regimes allowing a downward transfer pricing adjustment*

152. A number of preferential regimes identified as potentially harmful in the 2000 Report allow negative as well as positive adjustments to the profit recorded in the accounts in order to arrive at the taxable profit. This is true of particular headquarters, distribution centre and service centre regimes as well as rulings on informal capital. In such cases, if the measure of profit for taxation purposes, as computed according to the rules of the regime, is less than the profit recorded in the accounts, then the former is taken as the tax base. This contrasts with common transfer pricing practice, which frequently allows the transfer pricing rules to make only positive adjustments to accounting profit, except where a corresponding downward adjustment is required to avoid double taxation under the mutual agreement procedure of an applicable tax treaty. That is, if the measure of profit according to the application of the transfer pricing rules is less than the accounts measure, then no adjustment to the latter is made in order to arrive at the profit for taxation purposes.

153. A regime that provides for negative adjustments to profit has the potential to result in no or low taxation and MNEs will have an incentive to shift profits, through their transfer pricing practices, into the regime. This incentive exists where the downward adjustment is predictable, for example where it is part of a ruling or other administrative practice. In such cases, effective exchange of information is particularly important in order to give other countries the opportunity to apply their transfer pricing rules. In many cases the affected country will not be able to determine that such an adjustment has been made because, for example the adjustment is made in a domestic tax computation without being reflected in an enterprise's accounts or it is made retrospectively.

154. Thus, where a downward adjustment occurs as part of a ruling or other administrative practice, the guidance on spontaneous exchange provided in the Chapter on rulings applies.

155. It is recalled that spontaneous exchange regarding downward adjustments on a case-by-case basis is an appropriate and useful practice. See, for example, Article 7 of the OECD-Council of Europe Convention on Mutual Administrative Assistance in Tax Matters.

*d) Regimes that determine a “turn” or “spread” for intra-group intermediary activities*

156. These regimes generally apply to companies that both pay and receive items such as royalties, management fees and interest in the course of performing an intra-group intermediary activity. Problems may arise in two respects. The first is that the method prescribed by the regime does not provide a reliable estimation of an arm's length price consistent with the TP Guidelines (see section C(ii)(a) concerning the selection of transfer pricing methods). The second is where, in the application of the method, the rules do not attempt to determine the arm's length price for the payments made or received but instead specify the profit to be earned in the form of a “turn” or a “spread”. A regime may determine that the profit should be a “turn” comprising a certain percentage of the royalties or management fees involved in the intermediary activity or may determine the profit as a “spread” between interest paid and interest charged in the context of an intra-group financing activity. For example, a group finance company may borrow from an associated enterprise at 5.0 % and relend the same amount to another group company. The regime might specify an acceptable reward for such activities (a “spread”) of 0.2%. In this case, the acceptable interest rate on the loan made to the group company would be determined under the regime to be 5.2%.

157. Particular issues arise where the “turn” or “spread” is fixed or is determined according to a predetermined sliding scale based on the amount of royalties, management fees or loans involved in the intermediary activity. This raises similar issues to that already described in connection with the use of methods that use predetermined margins or range of margins (section C(ii)(a) and with the use of safe harbours (section C(ii)(b)). Such regimes are unlikely to result in an arm’s length result where the royalties, management fees or intra-group interest are not priced on arm’s length terms or where the “turn” or “spread” does not reflect the functions performed, assets used and risks assumed in the performance of the intra-group intermediary activity.

Conclusion on regimes that determine a “turn” or “spread” for intra-group intermediary activities

158. In the context of regimes with transfer pricing aspects, the guidance in the box below should be used to assess those regimes that use a “turn” or a “spread” for intra-group activities.

The following features of a regime that applies a “turn” or a “spread” may result in a low effective tax rate:

- The method prescribed by the regime does not provide a reliable estimation of an arm’s length price consistent with the TP Guidelines.
- A “spread” or “turn” that is applied to payments in respect of royalties, management fees, loans etc. that are not at arm’s length prices.
- Where the amount of the “spread” or “turn” is determined in a manner that does not follow the general guidance given in this Chapter and, in particular, where the spread is not based on a comparison with the spread earned from comparable transaction between independent enterprises performing comparable functions (taking into account assets used and risks assumed) under comparable conditions.

*e) Regimes that apply to activities carried on through a permanent establishment (PE)*

159. In order to ensure that the tax base of the PE is not distorted, it will be important that the tax base of the enterprise is appropriately allocated between the PE and the other parts of the enterprise. This requires that the tax base is computed in a manner consistent with guidance in Article 7 of the OECD Model Tax Convention, including the arm’s length principle described by Article 7(2). The guidance in this Chapter on the application of the arm’s length principle of Article 9 may be helpful in ensuring that the tax base is appropriately determined.<sup>25</sup>

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25. Currently, the CFA is examining the extent to which the guidance in the TP Guidelines on the application of the arm’s length principle of Article 9 can be applied, by analogy, in the PE context.

## CHAPTER V: RULINGS

### A. Introduction

160. This Chapter discusses rulings. Part B generally addresses the nature of rulings. Part C discusses the relevance of ruling regimes in the context of the criteria found in the 1998 Report and provides a detailed analysis as to how rulings practices could be problematic with respect to the relevant factors described in the 1998 Report. It also provides general guidance as to what would constitute harmful features of the rulings aspects of a preferential regime. Part D provides more specific guidance by describing how the general guidance in Part C should be applied to rulings regimes that involve transfer pricing.

### B. Nature and types of rulings

161. For the purposes of this Chapter, a ruling is defined to be any advice, information or undertaking provided by a tax authority to a specific taxpayer or group of taxpayers concerning their tax situation and on which they are entitled to rely. However, this Chapter applies only to rulings covering activities within the scope of the 1998 Report i.e., geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Whilst the terms of a ruling are binding on a tax authority, this is typically subject to the condition that the facts on which the ruling is based have been accurately presented and that the taxpayer abides by the terms of the ruling. This definition is wide and includes:

- General rulings;
- Advance tax rulings;
- Advance pricing arrangements (APAs).

162. *General rulings* apply to groups or types of taxpayers or activities, rather than to a specific taxpayer. They typically provide guidance on the position of the tax authority concerned on such matters as the interpretation of law and administrative practice<sup>26</sup> and on their application to taxpayers generally or to a specified group of taxpayers or specified activities. This guidance applies to all taxpayers that engage in activities or undertake transactions that fall within the scope of the ruling. Such rulings are typically published and are available to be applied by taxpayers to their relevant activities or transactions without the taxpayers concerned being required to make an application for a ruling.

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26. Law and administrative practice, in the context of this Chapter, includes statutory law (including relevant treaty provisions), case law, regulations, administrative instructions and practice.

163. *Advance tax rulings* are specific to an individual taxpayer and provide a binding determination of the tax consequences of a proposed transaction. They frequently determine whether, and in some cases, how, particular law and administrative practice will be applicable to a proposed transaction undertaken by a specific taxpayer. Such rulings may also provide a determination of whether or how a general ruling applies to the facts and circumstances of a particular taxpayer. Typically, the taxpayer concerned will make an application for a ruling before undertaking the transaction concerned, although some regimes provide guidance to taxpayers after a transaction has been carried out but in advance of filing a return which reflects the transaction. The ruling will provide a binding determination of the tax consequences of the relevant transaction, assuming that the facts are as described in the advance tax ruling request. Such rulings are tailor made for the taxpayer concerned as they take into account the factual situation of the taxpayer and are thus not directly applicable to other taxpayers. (Although, when published in anonymised or redacted form, such rulings may provide guidance to taxpayers with similar facts and circumstances.) This category of ruling includes for example rulings on transfer pricing matters that fall short of an advance pricing arrangement.

164. *Advance pricing arrangements*. An APA is defined in the TP Guidelines as “an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of time.”<sup>27</sup> They provide taxpayers with certainty about how transfer pricing rules apply to future transactions within the scope of the APA. They normally do this by determining an appropriate set of criteria (e.g., method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing. The TP Guidelines distinguish APAs from other rulings procedures, such as advance tax rulings, in the following way:

“The APA differs from the classic ruling procedure, in that it requires the detailed review and to the extent appropriate, verification of the factual assumptions on which the determination of legal consequences is based, before any such determinations can be made. Further the APA provides for a continual monitoring of whether the factual assumptions remain valid throughout the course of the APA period” (1999 Annex to TP Guidelines, paragraph 3).

165. APAs may be unilateral, bilateral or multilateral. Bilateral and multilateral APAs (referred to as MAP APAs in the 1999 Annex to the TP Guidelines) are concluded between two or more tax authorities under the mutual agreement procedure of the applicable tax treaties. Typically, the associated enterprises applying for an APA provide documentation to the tax authorities concerning the industry, markets and countries to be covered by the agreement, together with details of their proposed methodology, any transactions that may serve as comparables, and a functional analysis of the contribution of each of the relevant enterprises. Because APAs govern the methodology for the determination of transfer prices for future years, they necessitate assumptions or predictions about future events.

166. Guidance on the administration of APAs and the conduct of MAP APAs is provided in the TP Guidelines at Chapter 4.F and the 1999 Annex respectively. This Guidance represents internationally accepted principles for the conduct of APAs which are relevant for the analysis contained in this Chapter and are addressed specifically in Part D below.

167. Typically, rulings regimes constitute an administrative procedure to provide a process for determining the manner in which tax law and administrative practice applies to particular taxpayers or transactions. In doing this, a rulings regime will address at least one of the following issues:

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27. APAs may determine the attribution of profit in accordance with Article 7 as well as transfer pricing between associated enterprises. Such APAs are also within the scope of this Chapter.

- The first is to determine how the relevant law and administrative practice applies to the taxpayer or transactions in question. For example, where a rulings process applies to transfer pricing issues, such a process may determine which transfer pricing method is the most appropriate to the specific facts and circumstances of the taxpayer and transactions in question and how that method is to be applied.
- The second is to determine which taxpayers are subject to the relevant tax law and administrative practice. General rulings will frequently specify the conditions of applicability to taxpayers. In such cases, taxpayers fulfilling those conditions may obtain the benefit of the ruling without the need for further action. In other cases, including advance tax rulings, a regime will not apply to any particular taxpayer unless and until that taxpayer has applied for and been granted a ruling. In both cases, the ruling serves to determine which taxpayers are within the scope of a particular tax regime.

168. This Chapter recognises that rulings are a useful tool for tax administrations and taxpayers and that they have many positive features for both. Rulings provide an important and useful facility for taxpayers to obtain certainty about the tax treatment of proposed transactions. The increasing complexity of transactions, and of modern tax systems, makes the role of rulings all the more important. Indeed taxpayers might be discouraged from entering into innovative transactions if the tax consequences are too uncertain. Furthermore it is recognised that rulings frequently provide a framework for ensuring compliance with law and administrative practice in a manner that is resource efficient for both the taxpayer and tax authorities concerned. Rulings regimes will often minimise the potential for post-filing disputes between taxpayers and authorities and the necessity of recourse to the courts. Rulings can also contribute to a consistent treatment of taxpayers engaging in similar activities and transactions.

169. Rulings practices can, however, also be used to attract internationally mobile capital to a jurisdiction and they have the potential to do this in a manner that contributes to, or constitutes, harmful tax practice, as defined according to the criteria in the 1998 Report. Indeed, rulings are a feature of a number of the preferential regimes that the Forum has identified as potentially harmful. This is the case, for example, for many of the headquarters, distribution centre and service centre regimes as well as informal capital and FSC regimes. The next section addresses rulings in the context of harmful tax practices.

## **C. General guidance for rulings regimes**

### *i) Application of the key factors for identifying and assessing harmful preferential tax regimes*

170. This section identifies features of rulings regimes that may raise issues in the context of harmful tax practices and provides guidance on how such issues may be avoided. It applies to all the types of rulings described in Part B above. The guidance is supplemented with further guidance in Part D below which applies specifically to particular categories of rulings.

171. This analysis makes a distinction between the rulings aspects and other features of a regime and addresses only the former. For example, a headquarters regime may contain two aspects: a rulings aspect that determines the taxpayers to which the regime will apply and substantive law or regulations that define the tax base of entities within the scope of the regime. The analysis below addresses only the rulings aspect, though the substantive aspects may fall within the scope of other Chapters.

ii) *General guidance on rulings regimes in respect of the key factors in the 1998 Report*

a) *No or low effective tax rates*

172. There are four possible situations in which a system of rulings has the potential to create a low or no effective tax rate.

173. The first situation occurs where the rulings regime applies the relevant law and administrative practice in a manner that departs from their normal application. In such cases the law and administrative practice in question are applied to the taxpayer(s) benefiting from the ruling in a different way than they are applied to other taxpayers that have not had the benefit of the ruling. For example, the rulings process may directly determine the amount of taxable profit or the amount of tax to be paid, rather than address the application of a particular law or administrative practice. In these cases the ruling procedure may have the potential to provide special concessions to particular taxpayers that represent a departure from the normal tax base and tax rates. This may occur if it is an explicit feature of the regime. Alternatively, in practice the implementation of the rulings regime may allow tax officials the discretion to apply the relevant tax law and administrative practice in a way that departs from the normal law and administrative practice in question.

174. The second situation is where tax officials apply the rulings regime on the basis of insufficient factual information to be able to reliably ascertain or verify that the rulings are granted in accordance with the regime's terms and conditions and that they properly apply the relevant law and administrative practice. In many cases, the proper application of tax law and administrative practice will depend on the specific facts and circumstances of the taxpayer concerned and of the relevant transactions. For example, in the transfer pricing context, a ruling may be granted on the basis of inadequate factual information concerning the relevant transactions. Without sufficient factual information,<sup>28</sup> there is the potential that the ruling could apply the tax law and administrative practice in an inappropriate manner. This has the potential to give rise to a low effective rate of tax for the taxpayer that is the subject of the ruling. This will be of particular concern where the ruling addresses the tax base of the taxpayer, that in turn is determined by transfer pricing between associated enterprises or between different parts of the same enterprise.

175. The third situation occurs where a ruling is available or granted on the basis of information supplied by the taxpayer but there is no effective audit process in place to subsequently verify that the information supplied by the taxpayer was complete and accurate. For general rulings, it is normally up to the taxpayer to determine whether the particular facts and circumstances for which a ruling is sought meet the conditions for application of that ruling. ATRs, on the other hand, are typically granted on the basis of information presented by the taxpayer. It is important in both cases that the rulings regime provides for an effective audit process to subsequently verify the accuracy and completeness of the facts and circumstances on which the ruling was availed or granted. If it is determined that the taxpayer has benefited from a ruling on the basis of inaccurate or incomplete information, so that the conditions of applicability of the ruling were not properly met or the ruling applies the relevant law and practice wrongly, then the ruling should be subject to revocation or cancellation.

176. The fourth way in which a ruling has the potential to give rise to a low effective tax rate is if it remains valid despite a change in the conditions on which it was granted or in the factual circumstances

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28. Guidance on balancing the need of tax authorities to obtain information and the compliance burden on business in providing that information in the context of transfer pricing is contained in Chapter V of the TP Guidelines.

and assumption on which it was based. A ruling typically determines how specific tax law and administrative practice applies to the facts and circumstances of transactions to be carried out by a taxpayer or group of taxpayers. Tax law and practice frequently changes. Furthermore, the facts and circumstances taken into account in granting a ruling are also liable to change over time. Changes in either the statutory or factual background have the potential to result in a ruling no longer representing a valid application of the relevant law and administrative practice and in these circumstances there is a potential for an unchanged ruling to effectively result in a no or low effective rate of tax.

177. Countries with rulings regimes should use the guidance in the box below to assess whether the regime results in a no or low effective tax rate.

The following features may result in a low or no effective tax rate:

- Rulings that are not in accordance with the country's tax law and administrative practice and are not restricted to determining how that law and administrative practice applies to particular transactions.
- Rulings that determine the amount of tax payable but do not make this determination in accordance with the relevant law and administrative practice, including rulings that allow a taxpayer to negotiate with the tax authorities directly in terms of the amount of tax payable or the amount of taxable income or profit without regard to the normal and proper application of law and administrative practice.
- Rulings regimes that provide for discretion to be exercised in a manner that is not in accordance with the normally applicable law and administrative practice and where discretion is not limited to determining how the law and administrative practice applies to the particular facts and circumstances of a taxpayer.
- No administrative procedures are in place to ensure that rulings are granted in a consistent manner and in accordance with the law and administrative practice and to ensure that any discretion is exercised fully in accordance with normal law and administrative practice.
- Rulings that are granted on the basis of insufficient factual information about the taxpayer or transaction(s) in question so that the tax authority is unable to ensure that the relevant law and administrative practice is properly and fully complied with.
- Rulings that are not subject to administrative procedures to subsequently verify that the factual basis on which they were granted was complete and accurate.
- Rulings that are not cancelled or revoked if the taxpayer makes a misrepresentation or omission in applying for the ruling that calls into question the validity of the ruling.
- Rulings that are valid for an unlimited period or are valid for a limited period but are not subject to revocation, cancellation or revision if the relevant law and administrative practice changes or if the assumptions upon which the ruling was based cease to be valid.
- Rulings that are not subject to administrative procedures to verify that they are applied only in accordance with their terms and conditions.

*b) Ring fencing*

178. Rulings provide an obvious means by which ring fencing can be achieved where they determine which taxpayers fall within the scope of a tax regime. For example, ring fencing is likely to be present if a preferential regime is available only through rulings and such rulings are limited, whether by law or by administrative practice, to non-resident taxpayers or foreign-owned enterprises or to enterprises trading only outside the domestic market.

179. Countries with a rulings regimes that meets the low or no effective tax rate criterion should use the guidance set out in the box below in order to assess whether the regime is ring-fenced.

The following features are likely to result in ring fencing:

- A preferential regime is granted only through the issuance of rulings and such rulings are only issued to non-resident taxpayers or foreign-owned enterprises.
- A preferential regime is granted only through the issuance of rulings and such rulings are only issued with respect to activities or transactions carried on outside the domestic market.

*c) Lack of transparency*

180. The transparency of a preferential regime provides two important safeguards. Firstly, full transparency of the application and availability of a regime will make it difficult for a tax authority to provide different treatment to taxpayers in the same or similar circumstances. Secondly, if the details of the availability and application of a preferential regime are fully transparent, then other tax authorities will be made aware of the existence of the regime, and its application to their taxpayers or to enterprises associated with their taxpayers, and will then be in a position to take any necessary steps to protect their own tax base.

181. Rulings have the potential to prevent full transparency of a regime. There are two ways in which a rulings regime can cause, or contribute to, a lack of transparency. The first way is if the conditions of applicability of a rulings regime are not clear or available to all taxpayers and other tax authorities. The second is if the regime has the potential to provide rulings in a manner that departs from the normal application of law and administrative practice. In both these ways, a system of rulings could be used to attract foreign investment by granting special concessions in a manner not consistent with general law and administrative practice or by granting rulings only to certain taxpayers and not to all taxpayers in similar circumstances.

182. Countries with a rulings regime that meets the low or no effective tax rate criterion should use the guidance set out in the box below to assess whether the regime is non-transparent.

The following features are likely to result in a lack of transparency:

- Rulings issued other than in accordance with the country's tax law and administrative practice.
- Where the conditions of applicability, and the conditions for denying, revoking, cancelling or revising rulings are not clear and publicly available in such a manner that they may be invoked against the tax authorities.
- Where, as a result of either law or practice, a ruling is not equally available to all taxpayers that can satisfy the conditions for the issuance of the ruling.
- Where the policy related aspects and circumstances (interpretation of the law and administrative practice) underlying the conclusion of the rulings, or the refusal to conclude rulings, are not made publicly available.
- Where the tax administration granting the ruling does not respond favourably to a valid request (under Article 25 of the OECD Model Tax Convention or an equivalent article in a DTA) from another tax administration affected by the ruling to enter into MAP discussions or enter into a MAP APA in circumstances where the guidance in the TP Guidelines indicates a MAP would be appropriate.<sup>29</sup>
- Where the tax authority does not notify other tax authorities on a timely and spontaneous basis of the existence of a ruling where the tax authority is aware that it affects residents in the other country (e.g., an advance tax ruling or unilateral APA that provides for a downward adjustment that would not be directly reflected in the company's financial accounts).

*d) Exchange of information*

183. Exchange of information is important to enable tax authorities to assess whether MNEs overstate their profits in entities enjoying the benefits of a preferential regime.

184. Exchange of information between tax authorities, in accordance with the relevant article of the tax treaty or other relevant instruments authorising the exchange of information between them, is especially important in the context of rulings. There are two reasons for this. The first is that the tax authorities of other countries are unlikely to be aware of a ruling that affects them unless notified by the country granting the ruling.

185. The second is that the other countries involved will need detailed information about the transactions within the scope of a ruling in order to take effective action to protect their own tax bases. MNEs have an incentive to overstate their profit in the country providing a preferential tax regime. One common way to do this is by means of their intra-group transfer pricing. In doing this, their profit in the other affected country will be understated. Exchange of information in respect of a preferential regime provides an opportunity for the other countries involved to protect their own tax bases through the application of transfer pricing rules based on international transfer pricing principles. In this context, the ability or willingness of the country with the preferential regime to exchange information will be vitally important for other countries affected by that regime to be able to enforce their transfer pricing rules.

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29. For example, see paragraph 4.159 of the TP Guidelines which outlines a number of situations in which the use of an APA may be inappropriate and paragraphs 19 and 20 of the Annex on conducting APAs under the MAP procedure, which discuss circumstances in which a MAP APA would be appropriate.

186. Countries with a rulings regime that meets the low or no effective tax rate criterion should use the guidance set out in the box below to assess whether the regime lacks effective exchange of information.

The following features are likely to result in a lack of effective exchange of information:

- Where the tax authorities of countries that provide rulings are not able or not willing to provide the relevant information concerning their rulings regimes, including copies of rulings and other details of their application to individual taxpayers, in response to a valid request by another tax authority.
- Where the tax authorities of countries that provide tax rulings are not able to provide the relevant information in an effective manner in response to a valid request.

#### **D. Guidance on specific types of rulings**

187. This part focuses specifically on rulings regimes that address transfer pricing between associated enterprises.

188. Transfer pricing is the subject of Chapter IV, which provides general guidance on transfer pricing regimes, whether or not they are implemented through rulings. The guidance below addresses only the rulings aspects of regimes that determine transfer pricing between associated enterprises and is in addition to the general guidance above.

##### *i) General rulings on transfer pricing issues*

189. A number of regimes identified in the 2000 Report as potentially harmful provide general rulings on issues related to transfer pricing. These rulings are frequently in the form of a published statement that provides guidance on how transfer pricing rules apply to specified groups of taxpayers or activities. Such rulings may, for example, provide an interpretation of general transfer pricing rules in the context of these taxpayers or activities. Alternatively, they may provide for specific transfer pricing methods, or safe harbours, that are applicable only to those taxpayers or activities that fall within the scope of the ruling. The terms of the ruling are generally available to any taxpayer that conforms to the conditions of applicability, which are normally set out in the ruling.

190. A number of general rulings affect the determination of the tax base of enterprises within the scope of the ruling. This is true of some of the headquarters, distribution centre and service centre regimes, but also applies to particular financing and leasing regimes and rulings on foreign sales corporations. In all these cases, the general ruling stipulates a method that determines or affects the tax base. This is a transfer pricing issue because the method stipulated by the ruling affects the tax base of enterprises that conduct transactions with associated enterprises. There is a potential, if not a likelihood, that the tax base determined or influenced by the stipulated method will differ from that which would have been the case had the arm's length principle been applied in accordance with the TP Guidelines.

191. General rulings on transfer pricing issues will generally include all or some of the following features:

- A statement of which groups of taxpayers, or activities, fall within the scope of the ruling.
- A statement of a particular method, or of methods, that may be used to determine the computation of the tax base of enterprises that apply the ruling.

- A statement of acceptable margins (often in the form of a safe harbour) that may be applied to transactions undertaken by enterprises that apply the ruling.

192. Transparency and exchange of information are particularly important in the context of rulings that determine transfer pricing or a tax base. This is because such rulings are likely to have a direct effect on the tax base of associated enterprises in other countries and it is important that these other countries are able to access the information needed to be able to protect their own tax bases. Transparency of a regime ensures that other countries are aware of the rulings regime and its application to particular taxpayers. Effective exchange of information enables other countries to take any necessary steps to protect their own tax base by means of the application of internationally accepted transfer pricing principles. In this context, and for the purposes of this Chapter, three general conditions are necessary for *effective* exchange of information. First, relevant information on intra-group transactions should be available to the country of the regime. Second, there must be no impediments to the exchange of that information under the terms of the relevant double taxation agreement or other relevant instruments authorising exchange of information. Third, the country must actually exchange that information in practice. Effective exchange would allow verification by the other country involved that the application of a ruling to a taxpayer is fully in accordance with Article 9 (or, where relevant, Article 7) of the OECD Model Tax Convention.

*Conclusion on general rulings involving transfer pricing*

193. Countries with general rulings regimes should use the guidance set out in the box below, in addition to the guidance at section C above, to assess those regimes with respect to the key criteria.

The following features may result in a no or low effective tax rate:

- Where any method specified in a general ruling for determining transfer pricing between associated enterprises or for determining the tax base of an enterprise does not accord with the guidance in Chapter IV on transfer pricing.
- Where a safe harbour specified in a general ruling does not accord with the guidance on safe harbours in Chapter IV on transfer pricing.
- Where administrative procedures are not put in place to verify that taxpayers apply a general ruling only in accordance with the conditions of applicability of the general ruling.

The following features are likely to implicate the other key criteria:

- The ring fencing criterion is likely to be implicated where any part of a general ruling that determines which taxpayers or activities fall within the scope of the ruling does not accord with the guidance in Chapter III on ring fencing above.
- The transparency and effective exchange of information criteria are likely to be implicated where sufficient information concerning the relevant transactions is not available to the country providing the ruling to enable effective exchange of relevant information to take place.
- The transparency and effective exchange of information criteria are likely to be implicated where details of the general rulings regime, including the application of the regime to particular taxpayers, are not available, on request, to the tax authorities of the other countries concerned.

ii) *Advance Tax Rulings (ATRs) on transfer pricing issues (other than APAs)*

194. Advance tax rulings provide a determination for a specific taxpayer of the tax consequences of a proposed transaction. Whilst sharing some features with APAs (which are discussed at iii), below) ATRs on transfer pricing matters can be distinguished from APAs in a number of ways. Indeed the TP Guidelines acknowledge that APAs differ from “traditional” or “classic” rulings on transfer pricing:

“The APA differs from the classic ruling procedure, in that it requires the detailed review and to the extent appropriate, verification of the factual assumptions on which the determination of legal consequences is based before any such determination can be made. Further, the APA provides for a continual monitoring of whether the factual assumptions remain valid throughout the course of the APA period” (paragraph 3 1999 Annex).

“APAs, including unilateral ones, differ in some respects to more traditional private rulings that some tax administrations issue to taxpayers. An APA generally deals with factual issues, whereas more traditional private rulings tend to be limited to addressing questions of a legal nature based on facts presented by the taxpayer. The facts underlying a private ruling request may not be questioned by the tax administration, whereas in an APA the facts are likely to be thoroughly analysed and investigated. In addition, an APA usually covers several transactions, several types of transactions on a continuing basis, or all of a taxpayer’s international transactions for a given period of time. In contrast, a private ruling request usually is binding only for a particular transaction.” (paragraph 4.133).

195. In comparison to APAs, ATRs, when they address transfer pricing, tend to apply to less complicated transactions or sets of transactions. Like classic rulings, but unlike APAs, there is not normally a requirement that a detailed review and verification of the factual background needs to be completed before the ruling can be granted. Whilst there are clear advantages (to tax administrations and taxpayers alike) of ATRs on transfer pricing issues, there is also a danger that they could provide certainty without proper regard to whether they provide for the most reliable estimation of an arm’s length price consistent with the TP Guidelines. This will be a particular problem in the case of more complex transactions or where the ruling addresses a number of different transactions. Indeed, ATRs may not, for that reason, be suited to complex or multiple transactions. Even for smaller and less complex transactions, however, it is important that an ATR accords with the TP Guidelines. The guidance on general rulings (on transfer pricing) above is thus equally applicable to ATRs on transfer pricing.

196. As noted in the previous paragraph, one of the key distinctions between an APA and an ATR is the requirement that a detailed assessment and verification of the factual background to the relevant transactions is undertaken before an APA is granted. Further, the associated enterprises seeking an APA are normally expected to provide comprehensive details of the relevant transactions and their proposed methodology. The TP Guidelines give the following guidance on this matter:

“The co-operation of the associated enterprises is vital to a successful APA negotiation. For example, the associated enterprises ordinarily would be expected to provide the tax administrations with the methodology that they consider most reasonable under the particular facts and circumstances. The associated enterprises should also submit documentation supporting the reasonableness of their proposal, which would include, for example, data relating to the industry, markets, and countries to be covered by the agreement. In addition, the associated enterprises may identify uncontrolled businesses that are comparable or similar to the associated enterprises’ businesses in terms of the economic activities performed and the transfer pricing conditions, e.g. economic costs and risks incurred, etc., and perform a functional analysis as described in Chapter 1 of this Report” (Paragraph 4.134).

197. As noted above, this contrasts with an ATR where there is no requirement that a detailed assessment and verification of the factual background to the relevant transactions is undertaken before it is granted. As a consequence, however, an ATR should provide less certainty to a taxpayer than an APA. An APA will provide a high degree of certainty to a taxpayer, as long as the information presented by the taxpayer is factually correct and complete and the critical assumptions remain valid. An ATR, on the other hand, should be subject to an effective audit process that permits there to be a subsequent verification that the facts as originally presented by the taxpayer were correct and, in the light of those facts, that the ruling has been properly and appropriately granted.

198. A taxpayer seeking an ATR will typically present to the tax authority a factual description of the transactions intended to be the subject of the ruling. As stated above, if a ruling is granted on the basis of this description, it is important that the tax authority has in place an effective audit process in order to be able to verify that the actual transactions are in accordance with the factual description originally presented by the taxpayer. It is equally important that, at the time it is issued, the ATR reflects the results of the analysis, consistent with the TP Guidelines, that is necessary to ensure the application of the arm's length principle to the transactions as presented by the taxpayer. Guidance on the selection and application of transfer pricing methods is given in Chapter IV. Similarly, any safe harbour specified in an ATR, or given effect to in an ATR regime, should accord with the guidance on safe harbours in Chapter IV to ensure that it provides a reliable measure, consistent with the TP Guidelines, of the arm's length price (or arm's length range) on the facts presented by the taxpayer.

199. Further, there will have to be a verification that the factual circumstances remain materially unaltered since the granting of the ATR so that the ATR can continue to be applied without modification. An ATR regime should provide for revocation or cancellation if it is determined that the conditions for applicability of an ATR are not properly met. The revocation or cancellation should be retrospective where the conditions for applicability were not met when the ATR was granted. However, where the conditions for applicability were met when the ATR was granted but cease to be met subsequently, for example due to a change in facts and circumstances, the revocation or cancellation of the ATR can be made prospectively, i.e., from the time that the conditions failed to be met.

200. Another important feature of ATRs is that they are unilateral in nature, i.e., they are generally granted without informing or involving other interested jurisdictions. This is particularly relevant where ATRs determine transfer pricing issues between associated enterprises engaging in cross-border transactions. Such rulings are likely to have a direct effect on the tax base of associated enterprises in other jurisdictions and, without details of rulings that affect them, the jurisdictions concerned will not be in a position to take any necessary steps to protect their own tax base. It is thus vital that such regimes provide for effective exchange of information in respect of the intra-group transactions that are subject to the ruling.

201. In this context, the three conditions necessary for *effective* exchange of information described above are relevant. In particular, to allow effective exchange of information in cases where an ATR involves transfer pricing, sufficient information should be available to the country providing the ruling, and sufficient analysis of the transactions involved should be carried out, to enable verification by the other country involved that the ruling is fully in accordance with Article 9 (or, where relevant, Article 7) of the OECD Model Tax Convention.

#### *Conclusion on advance tax rulings on transfer pricing issues*

202. Countries with ATR regimes should use the guidance set out in the box below, in addition to the guidance at section C above, to assess those regimes with respect to the key criteria.

The following features may result in a no or low effective tax rate:

- Where administrative procedures are not in place to verify that taxpayers apply ATRs only in accordance with their terms and conditions.
- When a tax administration enters into an ATR in respect of numerous and complex transfer pricing issues to the extent that the ATR is unlikely to give proper regard to whether it provides for the most reliable estimation of an arm's length price consistent with the TP Guidelines.
- Where a tax administration enters into an ATR on the basis of a description of relevant transactions presented by the taxpayer that does not reflect the analysis consistent with the TP Guidelines that is necessary to ensure that the result of the ATR is in accordance with the arm's length principle and, in particular, does not reflect the guidance in Chapter IV on the selection and application of methods.
- Where a safe harbour, specified or given in an ATR, does not accord with the guidance on safe harbours contained in Chapter IV.
- Where, subsequent to the granting of an ATR concerning transfer pricing, there is no effective audit process in place in order to be able to verify the factual basis on which the ruling was granted and that the ATR continues to provide a reliable application of the arm's length principle to those transactions.
- Where, on examination of the factual circumstances of the relevant transactions, it is ascertained that the ATR does not provide a reliable application of the arm's length principle to those transactions, and the ATR is not cancelled or revoked.

The following features are likely to implicate the other key criteria in cases where a preferential regime meets the low or no effective tax rate criterion:

- The transparency and effective exchange of information criteria are likely to be implicated where the tax authority is not willing to notify other tax authorities concerned on a timely and spontaneous basis of the existence of an ATR that affects residents in their country.
- The transparency and effective exchange of information criteria are likely to be implicated where the tax authority is not able nor willing to provide the relevant information related to the ATR, including a copy of the ATR and relevant background material, in response to a valid request by another tax authority.
- The transparency and effective exchange of information criteria are likely to be implicated when information about transactions within the scope of a ruling is not available to the tax authority to verify that the ATR is in accordance with the arm's length principle as stated in Article 9 (or, where relevant, Article 7) of the OECD Model Tax Convention.

### *iii) APAs*

203. The TP Guidelines (at Chapter IV and the 1999 Annex) establish broad guidance for countries to follow in issuing APAs.

204. A number of recommendations concerning APAs are set out in Chapter IV, F(v) of the Guidelines. The following are particularly relevant in the context of harmful tax practices:

- Generally, APAs should deal with the appropriate transfer pricing methodology, not the actual transfer prices.
- Wherever possible, APAs should be concluded on a bilateral or multilateral basis.
- Tax authorities should ensure that all taxpayers have equal access to APAs.
- The level of inquiry should be adjusted to reflect the size of international transactions involved.
- With respect to bilateral APAs, the same information should be provided to each tax authority at the same time and the agreed-upon methodology should be in accordance with the arm's length standard.
- The reliability of predictions must be examined carefully.

205. In addition, Chapter IV, F(i) also makes the point that when a tax administration receives an application for a unilateral APA it should inform the competent authorities of other interested jurisdictions as early as possible in order to determine whether they are willing and able to consider a bilateral or multilateral arrangement.

206. The 1999 Annex to the TP Guidelines provides further guidance to tax administrations on how to conduct mutual agreement procedures (MAPs) involving APAs. The main recommendations are:

- The process should be administered in a non-adversarial, efficient and practical fashion that requires the co-operation of all the participating parties.
- Confirmation or agreement between the taxpayer and the tax administration is necessary in order to give effect to the MAP APA in each of the participating jurisdictions.
- The MAP APA needs to be conducted in a neutral manner. In particular the process should be neutral as regards the residence of the taxpayer, the jurisdiction in which the request for the MAP APA was initiated, the audit or examination status of the taxpayer and the selection of taxpayers in general for audit or examination.
- An APA proposal should provide the information and documentation necessary to explain the facts relevant to the proposed methodology and to demonstrate its application in accordance with the appropriate article of the relevant treaty. This should include a discussion of the availability and use of comparable pricing and a full description of the chosen methodology.
- Taxpayers and tax administrations should identify critical assumptions upon which the methodology is based, the breach of which would trigger renegotiation of the agreement. Where possible, these should be based on observable, reliable and independent data.
- Effective monitoring mechanisms should be put in place to establish that the taxpayer is abiding by the terms and conditions of the agreement and that the critical assumptions have been met.

207. APAs may be unilateral, bilateral or multilateral. The TP Guidelines recommend that, wherever possible, APAs should be concluded on a bilateral or multilateral basis. In such circumstances, both, or all, the countries involved in the APA will be aware of the existence of the ruling concluded in each country.

This provides a safeguard that ensures that the agreement is in accordance with international transfer pricing principles and serves to prevent an APA from being used by any one country to provide preferential terms to taxpayers. All countries then will be in a position to protect their own tax bases. This safeguard is lost, however, in the case of a unilateral APA. For this reason, it is important that a country granting a unilateral APA that results in a no or low effective tax rate informs the other countries affected (to the extent that the countries have entered into a tax treaty or other relevant instrument authorising the exchange of information between them) of the existence of the APA. Further, the country granting the unilateral APA should, upon request, provide the relevant information about the transactions covered by the APA that is necessary for the countries affected by the APA to verify that the results of those transactions are in accordance with the arm's length principle.

### **Conclusion on APAs**

208. Countries with APA regimes should use the guidance set out in the box below, in addition to the guidance at section C above, in order to assess those regimes.

- An APA regime may result in a no or low effective tax rate if it does not conform to the guidance set out in the TP Guidelines at Chapter IV and the 1999 Annex.

The following features are likely to implicate other key factors:

- The transparency and effective exchange of information criteria are likely to be implicated when a tax administration concluding a unilateral APA does not then advise on a timely and spontaneous basis the tax administration(s) of the associated enterprises affected by the APA of the existence of the APA.
- The effective exchange of information criterion is likely to be implicated where a tax administration concluding an APA does not make available, on request, and to the extent provided for under the relevant treaty or other relevant instruments authorising the exchange of information, the relevant information about the transactions covered by the APA that is necessary for the countries affected by the APA to verify that the results of those transactions are in accordance with the arm's length principle.

## **CHAPTER VI: HOLDING COMPANY REGIMES AND SIMILAR PREFERENTIAL TAX REGIMES**

### **A. Introduction**

209. This Chapter discusses holding company regimes and similar preferential tax regimes. Part B below describes some of the typical features of holding company regimes and similar preferential tax regimes. Part C applies the relevant factors set out in Chapter 2, section III of the 1998 Report to holding company regimes and similar preferential tax regimes.

210. The Chapter on transfer pricing relates directly to corporations whose main purpose is to function as headquarters companies, provide legal and tax services, conduct financial and treasury operations and/or hold intangibles and that guidance is also applicable to holding companies which carry out these or similar activities.

211. This Chapter focuses only on the core aspect of holding companies -- the holding of shares in other companies. This Chapter will use the term "holding company regimes" in a very broad sense, including any taxation regime applicable to income from, or arising in connection with, shareholdings in companies. This Chapter will, therefore, use the term "holding company" to include both holding company regimes and "similar preferential tax regimes" within the meaning of the 2000 Report.

### **B. Typical features of holding company regimes and similar preferential tax regimes**

212. This Part discusses the main features of holding company regimes and similar preferential tax regimes. It looks at the economic functions of holding companies and the related issue of double or multiple taxation. It briefly describes the rationale for, and the operation of, the two recognised methods of granting tax relief (the exemption and credit methods). Finally, it summarises the main qualifying conditions used by various countries to limit the applicability of the relevant tax benefits to appropriate situations and it discusses the main tax considerations in deciding on the location of a holding company.

#### *i) Holding companies and portfolio investments*

213. Multinational enterprises will usually be structured in the form of various separate legal entities. The shares of these corporations will normally be held by one or more companies interposed between the operating companies and the ultimate parent company. These intermediate companies may hold participations in the group as a whole or in subsidiaries grouped by region or country.

214. Participations of this kind – where the holding company holds a significant interest in the operating companies – are fundamentally different from the situation where a company holds a small number of shares in a company, probably as part of an overall portfolio of shares held for investment or

trading purposes. Tax systems therefore generally distinguish between portfolio and investment companies on the one hand, and holding companies on the other.

215. Holding companies serve important international business and economic purposes. From the perspective of international business, multinational enterprises use holding companies to organise their assets, liabilities and activities in a manner that increases the optimal functioning of the internal governance structure of the enterprise. In addition, the use of holding companies facilitates the efficient acquisition and disposition of business units.

216. Holding companies may, in addition, engage in activities which, while they are related to their overall management interest, do not relate directly to their primary function of holding substantial interests in subsidiaries. These may include the provision of group services, the operation of the group treasury and the holding of group intangibles.<sup>30</sup>

*ii) Multinationals and possible multiple taxation*

217. Multinational enterprises that manage participations in foreign subsidiaries using one or more holding companies may be subject to multiple taxation. Assuming a single tier of holding companies, profits earned by an operating subsidiary in country A will be distributed to a holding company in country B, then to the parent corporation in country C and finally to the ultimate shareholders across the globe. The profits may be subject to corporation tax when earned by the operating subsidiary and then to withholding tax when distributed to the holding company. They may be taxed again in the hands of the holding company and subject to withholding tax when paid to the parent corporation. The parent may be chargeable to tax on their receipt and withholding tax may again be chargeable when they are distributed to the ultimate shareholders, who may be liable to tax on receipt.

*iii) Double taxation relief and tax conventions*

218. Multiple taxation may make the operation of international economic activity through separate legal entities uneconomic, so countries act either collectively and/or unilaterally to reduce the effect of double taxation on the operation of cross-border economic activity. Collective action for the relief of double taxation in respect of profits distributed to shareholders generally takes place bilaterally through the operation of tax treaties. Taxing rights in this situation are allocated between the source and residence countries. Where the dividend is distributed to a shareholder who holds a substantial interest, the relevant tax convention will generally enable the recipient state to tax the income but may also allow the source state to impose withholding tax at a reduced rate on the dividend, in addition to the tax on the profit from which the dividend is paid. If the source state does apply withholding tax under a double tax convention then the residence state may provide relief so as to avoid double taxation of the dividend income. The recipient state may provide an appropriate tax credit or may exempt the income from a tax charge. In addition, the residence country may under the convention, or unilaterally, provide relief by allowing a credit for the underlying tax (the tax on the profits out of which the dividend is distributed). Nevertheless, such avoidance of double taxation is not always perfect. In certain cases additional tax is levied on the transmission of a dividend from one country to another.

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30. Guidance on these activities is provided in Chapter IV dealing with transfer pricing.

*iv) Recognition of different approaches to double tax relief*

219. This Chapter recognises that the exemption and credit methods of double tax relief are both equally valid approaches to the problem of double taxation. Indeed, the OECD Commentary to the Model Tax Convention (paragraphs 12-17 of the Commentary on Articles 23A and 23B) endorses both methods of relieving double taxation.<sup>31</sup>

220. Whether a country chooses an exemption or a credit method to deal with the potential double taxation of foreign investment is a free political choice of each country and will depend on the economic and fiscal policies being pursued, practical considerations (such as compliance and administration costs), and other objectives. Countries may decide to treat domestic and foreign income in the same way by taxing all business profits at the same rate and eliminating double taxation by granting a tax credit for foreign taxes paid (capital export neutrality). Alternatively, they may decide that the domestic tax treatment should not affect companies doing business abroad and encourage foreign investment by exempting income received from abroad (capital import neutrality). Few countries, however, have pure credit or exemption systems. Most adopt a mixed system, either exempting income or allowing tax credits, depending on the circumstances (e.g., how the treaty rules apply, whether the income is active or passive, whether the entity is controlled by the shareholder, and/or the level of underlying tax).

*v) Tax effect of the participation exemption and foreign tax credit methods*

The participation exemption method

221. The participation exemption method eliminates double taxation by ensuring that dividends and/or capital gains are not taxed in the hands of the recipient corporation. But under progressive tax systems they may be taken into account for determining the tax rates chargeable on the income. The tax charge on the recipient corporation is therefore the total of the underlying corporation tax along with any foreign withholding tax charged by the source country.

The foreign tax credit method

222. The foreign tax credit method, on the other hand, operates by including all dividends and capital gains within the total profits of the recipient corporation and taxes them at the normal domestic rate. A tax credit for the underlying corporation tax (indirect credit relief) and withholding taxes (direct credit relief) is then available to be set off against the corporation tax chargeable. Typically no refund is given to the extent the total foreign burden exceeds the tax burden on the income in the country of the recipient.

*vi) Specific holding company legislation*

223. Specific holding company legislation sometimes applies in addition to the normal credit and exemption methods for the relief of double taxation. Under holding company regimes, holding companies under specific circumstances will be exempted from residence country tax on their income and gains received from foreign subsidiaries.

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31. Both methods also have been endorsed by the EU Parent-Subsidiary Directive (Council Directive 90/435/EEC of 23 July 1990).

224. Holding company legislation may also eliminate withholding tax on outgoing dividends, which the holding company pays to its shareholders. Alternatively, relief from withholding tax may be left to the application of the relevant tax treaty or other international arrangement.

*vii) Qualifying conditions for the operation of holding company regimes*

225. Most holding company regimes contain some qualifications regarding their applicability. They commonly require conditions to be met as to the chargeable level of foreign tax and the degree of participation of the recipient in the paying corporation. They may also limit either the activities carried on by the subsidiary or the types of income which are eligible for exemption. These can be summarised as follows.

Level of foreign tax

226. Holding company regimes are often predicated on the principle that the profits underlying the dividend or capital gain are liable to corporation tax in the source country. Countries use one or more of the following criteria to establish whether the income/gain qualifies for the operation of the regime.

- Is the non-resident corporation “subject to tax” in the foreign country?
- Is the rate of tax in relation to the income qualifying for the operation of the regime above a certain minimum threshold?
- Is the paying corporation resident in a country with which the recipient country has a double tax treaty?
- Is the payer corporation resident in a country on a specified list?
- Is the income taxed under CFC legislation or similar anti-abuse provisions in the country where the holding company is situated?
- Is the amount of underlying tax paid by the paying corporation comparable to the amount of tax chargeable in the recipient country?

Share ownership

227. Holding company regimes generally distinguish between portfolio and direct investments. This distinction is usually based on one of the following:

- the percentage of shares held,
- the percentage of voting power represented by the shareholding,
- the total number of shares held, or
- a comparison of the business activities of the company in which the equity investment is made with the business activities of the group as a whole.

228. Holding company regimes also usually contain anti-abuse rules prohibiting the use of transitional arrangements to satisfy the ownership conditions. These may require that the shares be held for a certain minimum period.

#### Limitations on kinds of income received from/qualifying income earning activities of the subsidiary

229. Most holding company regimes are not designed to exempt dividends paid out of passive or investment income. But it may be difficult to measure the dividends paid out of qualifying business income in practice as it requires the operation of two sets of rules establishing the nature of the underlying income and matching the qualifying income with the dividend paid to the receiving corporation. The overall policy goal is accomplished in some countries by

- requiring non-resident corporations to have a substantial business in their country of residence and carry out qualifying activities, or
- restricting the exemption to dividends received from corporations that derive a certain proportion of their income from qualifying business activities.

#### *viii) Typical considerations in choosing a holding company location*

230. An international corporate structure that consists of the ultimate parent, an intermediate holding company, and operating subsidiaries in various countries is common. Many factors are considered in determining the optimum location for a holding company operation. Some of these are not directly related to tax, but the fiscal regime applying in the holding company location is also an important consideration. A fiscal regime which

- does not tax the income of the holding company;
- permits access to an extensive network of tax treaties that restrict taxation in the jurisdictions in which the holding company invests; and
- permits the distribution of the holding company profits to its non-resident shareholders at a low or no tax cost

has attractive fiscal location parameters for the establishment of holding companies. Evidently, other factors, such as free and unobstructed remittance of dividends, adequately trained workforce and stability are also important.

### **C. Application of the factors in the 1998 Report to holding company regimes**

#### *i) Introduction*

231. The 1998 Report focuses on geographically mobile activities. The holding of shares requires little if any significant activities and mainly involves legal and tax considerations. However, it should be noted that multinational enterprises may have real substance in the country of the holding company. The location of a holding function is extremely mobile and falls within the scope of the 1998 Report. This Chapter applies the relevant factors set out in the 1998 Report to generic aspects of holding company regimes.

232. In addition to the four key factors, the 1998 Report suggests other factors that can assist in identifying harmful tax practices. Factors with particular relevance to holding company regimes are: "an artificial definition of the tax base" and "access to a wide network of treaties".<sup>32</sup>

*ii) Applying the key factors*

*a) No or low effective tax rates*

233. As described in paragraph 61 of the 1998 Report, a regime may give rise to a low or zero effective tax rate "because the schedule rate itself is very low or because of the way in which the regime defines or influences the tax base to which the rate is applied." A low or zero effective rate of tax is not in itself harmful. Rather, this factor is a gateway criterion to determine those situations in which an analysis of the other criteria is necessary.

234. The no or low effective tax rate factor is applied by reference to the taxes imposed on the relevant income by the country granting the regime. The "relevant income" in the case of holding companies is the income related to its "holding activities," i.e., dividends and capital gains (jointly referred to as "income from shareholdings").<sup>33</sup> The question is, then, whether this income is subject to a no or low effective tax rate in the hands of the holding company. Very often the country granting the holding company regime will tax income from shareholdings at a low or no effective tax rate. For instance, a no or low effective tax rate may result from an exemption of the income under a participation exemption system or under the application of the special rules of a specific holding company regime. Alternatively, a no or low effective tax rate can result from the application of a foreign tax credit system where foreign tax credits shield the income from domestic taxation. Thus, the no or low effective tax rate factor may be present equally in connection with exemption systems as well as tax credit systems.

235. Good arguments can be made for determining the no or low tax rate factor not just by reference to the tax imposed at the level of the holding company ("entity level approach") but to include in the analysis the level of tax imposed on the underlying income out of which the dividend is paid ("parent-subsidiary approach"). For several reasons, this Chapter follows the entity level approach. First, the parent subsidiary approach raises complex issues and significant practical difficulties because it requires establishing a combined effective tax rate for income that may flow through many corporate tiers in many different jurisdictions. Second, the 1998 Report generally refers to the level of tax on the respective entity.<sup>34</sup> Finally, the important analytical considerations inherent in the parent-subsidiary approach can be adequately addressed in connection with the discussion of the ring fencing factor as well as the other factor "artificial definition of the tax base."

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32. This Chapter does not include a substantive discussion of the additional factor "access to a wide network of treaties" because the issue of access to treaties in connection with harmful tax practices is being addressed separately by Working Party 1.

33. Often holding companies are also engaged in other related activities such as group financing, cash management or other intra-group services. Regarding such activities relevant guidance can be found mainly in Chapters III, IV and V.

34. See paragraph 61 of the 1998 Report: "A zero or low effective rate may arise because the schedule rate itself is very low or because of the way in which a country defines the tax base to which the rate is applied."

236. It is worth emphasising that the no or low tax factor in itself does not pass judgement on whether or not a regime is harmful. Rather, as noted above, this factor is a gateway criterion to determine those situations in which an analysis of the other criteria is necessary. Indeed, this Chapter recognises that many OECD member countries apply a no or low effective tax rate to certain income earned by holding companies as a result of a policy that seeks to avoid double taxation.

237. In addition, holding company regimes might also assist in the creation of a no or low tax rate on income other than income from shareholdings. For instance, a holding company regime may allow the inclusion of income other than income from shareholdings and as a result does not tax such other income. Furthermore, a no or low tax rate on other income may be created if the rules exempting dividends are not aligned with the rules governing a shareholders' basis in his shares. For instance, where dividend distributions that are exempted from tax do not affect the basis of the shareholder in the shares, a subsequent disposal of the shares might create an artificial capital loss. Finally, a no or low tax rate on other income may be created where losses are deductible but capital gains on the same participation are exempt.

238. However, these features may create a "no or low effective tax rate" on income other than income from shareholdings and they are therefore not further discussed in the generic assessment contained in this Chapter. The "low or no effective tax rate" possibly created on "other income" will have to be tested separately with respect to the scope of the 1998 Report and the factors identified in the 1998 Report in order to determine whether the resulting taxation regime is potentially or actually harmful. These determinations will be made in the course of evaluating actual regimes.

#### *b) Ring fencing*

239. As explained in Chapter III, ring fencing can take two different forms: residents may be prohibited from taking advantage of the regime or entities that benefit from the regime may be precluded from operating in the domestic market. Ring fencing is not implicated in connection with general structural features of a country's system of taxation or with any measure designed to eliminate or mitigate double taxation.

#### Exclusion of residents from the benefits of the regime

240. Under the first prong of the ring fencing test, a holding company regime is ring-fenced if resident taxpayers are explicitly or implicitly excluded from taking advantage of the holding company regime or similar provisions. This would be the case, for instance, if, by law or administrative practice, a no or low tax rate would be granted only to foreign-owned holding companies. However, as explained in the Chapter on ring fencing, an assessment of the features of a regime must take into account the structural context of the regime. For instance, a country might have a full imputation system whereby corporate double taxation on both domestic and foreign source income is avoided by providing a full tax credit for corporate level tax to the resident shareholder. Thus, under such a system corporate earnings would generally only be subject to one layer of tax at the level of the resident shareholder. In order not to disadvantage non-resident shareholders, such country may refund the tax credit to the non-resident shareholder or the country could decide to impose a low or no effective tax rate at the corporate level on the portion of the entity's income attributable to the non-resident shareholders. In such a case, where the measure effectively tries to put resident and non-resident shareholders on an equal footing rather than implicitly excluding resident shareholders from taking advantage of a preferential regime, no ring fencing issue arises.

## Restrictions of access of the regime to the domestic economy

241. The second prong of the ring fencing criterion examines whether the entity benefiting from the preferential regime has access to the domestic economy. In connection with holding company regimes, the second prong requires an examination of whether the benefits that are available for foreign source dividends or capital gains are available, in an appropriate form, also for domestic source dividends or capital gains.<sup>35</sup> As explained in Chapter III, a key step in the ring fencing analysis is to determine whether transactions or activities that do not involve the domestic market are taxed more favourably than similar transactions or activities that involve the domestic market. In this connection, it is important to note that different mechanisms may be used to provide broadly equivalent taxation with respect to domestic and foreign activities. Thus, features of the tax system beyond the preferential regime in question may need to be considered in determining if transactions not involving the domestic market are more favourably taxed.

242. The taxation of foreign source dividends and capital gains is not more favourable than the taxation of domestic source dividends and capital gains simply because the foreign source income is not taxed in exactly the same way as the domestic source income. There are various instances where different rules apply to foreign and domestic source dividends. For instance, foreign source dividends might be exempt from taxation whereas tax credits may be available with respect to domestic source dividends. Alternatively, foreign source dividends might carry tax credits whereas domestic source dividends may give rise to a tax deduction at the level of the holding company. Furthermore, domestic source dividends might be “disregarded” for tax purposes where the payer and the recipient of the dividend are part of the same consolidated group or effectively treated as a single taxpayer under a similar concept. In these cases, the application of different technical mechanisms does not result in ring fencing if domestic and foreign source dividends and capital gains are subject to broadly equivalent taxation. See Example 1 in paragraph 245.

243. In addition, the ring fencing criterion is not concerned with measures that are part of a country’s general system of taxation. Thus, for instance, where a country does not tax foreign source capital gains or foreign source dividends as part of a taxation system that only taxes domestic source income (e.g., a territorial system of taxation), ring fencing issues do not arise.

244. Furthermore no case of ring fencing arises if the non-taxation of foreign source capital gain or foreign source dividends is a measure designed to eliminate or mitigate double taxation. It is generally recognised that the low or non-taxation of capital gain resulting from the alienation of shares by a holding company can be seen as a measure to eliminate or mitigate double taxation (in the same way as the low or non-taxation of dividends in the hands of the holding company). Measures designed to eliminate or mitigate double taxation can not constitute ring fencing. In addition, the ring fencing criterion does not require a country to eliminate or mitigate double taxation on domestic source income or gains simply because it chooses to do so with respect to foreign source income or gains. However, in order for any measure to be treated as a measure to eliminate or mitigate double taxation, the measure must ensure that the benefits are available only in cases where double taxation may arise. The holding company regime must, therefore, provide for the operation of effective measures to achieve this objective. Such measures may include, for instance, subject to tax clauses,<sup>36</sup> controlled foreign company legislation (or similar rules that apply at the time of distribution of dividends or disposition of shares), the use of exemption methods in

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35. For purposes of this section, any reference to foreign source dividends/capital gains means dividends paid from, or gain from the alienation of, shares in a foreign company, and any reference to domestic source dividends/capital gain means dividends paid from, or gain from the alienation of, shares in a domestic company.

36. Such clauses might be part of exemption methods in domestic law or part of income tax treaties.

the context of income tax conventions following the OECD Model Tax Convention, or the use of anti-abuse measures. In any event, each case must be considered on its merits.

245. The following examples illustrate the ring fencing analysis in connection with holding companies:

- Example 1: Country A imposes a general income tax rate of 30 percent. Resident companies are subject to tax on their world-wide income. In the domestic context, intra-group dividends are disregarded under country A's consolidation rules whereas the same dividends in the cross-border context carry foreign tax credits. Although the measures applied to domestic source dividends and foreign source dividends are different, both measures are designed to eliminate or mitigate double taxation. The regime is not ring-fenced.
- Example 2: Country A imposes a general income tax rate of 30 percent. Capital gain of corporate taxpayers falls within the income tax and is generally taxed at the 30 percent rate. Capital gain from the alienation of shares in a foreign company is exempt from tax whereas capital gain from the alienation of shares in a domestic company is subject to tax at the 30 percent rate. The capital gains exemption applies to the disposition of shares in any foreign company without any restrictions of the type referred to in paragraph 244. The tax exemption of capital gain from the disposition of shares in foreign companies is not part of Country A's general system of taxation. Finally, the exemption of capital gain does not constitute a measure designed to eliminate or mitigate double taxation. The regime is ring-fenced.
- Example 3: Country A imposes a general income tax rate of 30 percent. Resident companies are subject to tax on their world-wide income. In order to mitigate double taxation on domestic source dividends, resident holding companies are permitted to claim a tax credit in the amount of the underlying tax. Foreign source dividends are exempt from tax in the hands of the holding company. The exemption is unconditional and none of the measures of a type referred to in paragraph 245 are present. The differences in the taxation of domestic source and foreign source dividends are not just technical in nature. The credit system used in the domestic context is designed to mitigate or eliminate double taxation of intra-company profit distributions. It ensures that the non-taxation of dividends at the holding company level is tied to the taxation of the underlying profit at the subsidiary level. The exemption of foreign source income is not a measure designed to eliminate or mitigate double taxation because there are no measures to ensure that the exemption is available only in cases where double taxation may arise. Further, the exemption of foreign source dividends is not part of Country A's general system of taxation (e.g., Country A does not generally exempt domestic and foreign source dividends from taxation nor does it generally exempt foreign source income). The regime is ring-fenced.
- Example 4: Country A imposes a general income tax rate of 30 percent. Resident companies are subject to tax on their world-wide income. Country A's rules provide for partial relief from double taxation on domestic source dividends but fully exempts foreign source dividends. The exemption applicable to foreign source dividends is available only for dividends paid by foreign companies covered by an income tax convention. Country A's income tax conventions follow the OECD Model Tax Convention in that they seek to use the exemption method only as a method to eliminate or mitigate double taxation. The treaty-based exemption of foreign source dividends qualifies as a measure designed to eliminate or mitigate double taxation. The regime is not ring-fenced.

246. The guidance in the box below should be used to assess holding company regimes that meet the no or low effective tax rate criterion with respect to ring fencing.

The following features are likely to result in ring fencing of holding company regimes:

- Resident taxpayers are explicitly or implicitly excluded from taking advantage of the holding company regime.
- Foreign source dividends or capital gains (i) are subject to more favourable taxation relative to the taxation of domestic source dividends or capital gains, with the result that only income in the former category is subject to a no or low effective tax rate, and (ii) the measures applicable to foreign source dividends or capital gains are not part of the country's general system of taxation and are not measures designed to eliminate or mitigate double taxation.

*c) Lack of transparency*

247. The transparency of a holding company regime provides two important safeguards. First, full transparency protects taxpayers in the same or similar circumstances from being treated differently. Second, if the availability and application of a preferential regime are fully transparent, then other tax authorities can take steps to protect their own tax bases.

248. The administration and enforcement of a holding company regime is likely to be non-transparent if the statutory provisions and regulations are favourably applied in particular circumstances. It will not be transparent, for example, if there is an opportunity for resident companies holding participations in non-resident subsidiaries to negotiate their own tax bases or tax rates, or if the statutory provisions relating to the qualifications for the operation of the regime are not enforced consistently.

249. Where holding company regimes are based on rulings provided by the tax authorities, the guidance in the Chapter on rulings applies.

250. The guidance in the box below should be used to assess holding company regimes that meet the no or low effective tax rate criterion with respect to transparency.

The following features are likely to result in a lack of transparency for holding companies:

- Statutory provisions and regulations are favourably applied in particular circumstances.
- Statutory provisions relating to the qualifications for the operation of the regime are not enforced consistently.
- Holding companies can negotiate the applicable tax base or tax rates.

*d) Exchange of information*

251. A country's unwillingness or inability to exchange information concerning holding company regimes with other countries is an important indicator of the existence of harmful tax practices.

252. Many countries have a particular interest in information on foreign holding companies. By definition, holding companies do not engage in an active trade or business and holding companies are therefore the archetype of entities to which controlled foreign corporation and/or foreign investment fund legislation applies. Even where a country does not have such legislation it might be seeking information on holding companies for purposes of determining whether a company should be disregarded or treated as a nominee or agent. Finally, countries might be seeking information on foreign holding companies for purposes of applying their thin capitalisation or similar rules. In the context of tax treaties, countries might be seeking information on holding companies for purposes of applying rules that limit the ability of persons to claim the benefits of such tax treaty.

253. Information on holding companies available for exchange should include ownership information as well as relevant financial information. For more details, see Chapter II on transparency and effective exchange of information.

254. Where such information is not available or is available but is not exchanged, other countries may not be able to enforce their own tax laws with the potential result of the erosion of their tax bases. For instance, deductions might be allowed that would have been disallowed under thin capitalisation or similar rules if full information had been available. CFC legislation might result in current taxation of the shareholder of a foreign holding company if the resident country had known about the identity of the shareholder.<sup>37</sup> A treaty benefit may have been disallowed had the country been able to verify the information provided by a taxpayer. All these examples show that the lack of effective information exchange is a key indicator of harmful tax practices in connection with holding companies.

255. The guidance in the box below should be used to assess holding company regimes that meet the no or low effective tax criterion with respect to exchange of information.

The following features are likely to result in a lack of effective exchange of information

- A country does not exchange information on the ownership of holding companies.
- A country does not exchange financial information relating to holding companies.
- A country does not otherwise comply with the guidance in Chapter II dealing with transparency and effective exchange of information.

**iii) Applying the other factors**

256. In addition to the key factors, the 1998 Report identified certain other factors that may assist in identifying harmful tax practices. In substance these factors do not so much add additional factors to the key criteria but rather spell out in more detail some of the basic principles and assumptions implicit in the key criteria.

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37. Regarding the gathering of information to enforce CFC rules in OECD member countries, see Controlled Foreign Company Legislation (OECD 2000), Chapter VI, page 85 et. seq.

*Artificial definition of the tax base*

257. The tax laws in most countries have various provisions that narrow the tax base. This is particularly true in connection with holding company regimes. While many such provisions have legitimate purposes, certain provisions may exceed what is necessary to achieve the stated tax policy goal. Paragraph 69 of the 1998 Report illustrates this point as follows:

“ These provisions may include unconditional rules for the avoidance of double taxation (using either the exemption or credit method) that go beyond the ordinary scope of the instruments to avoid double taxation - economic as well as judicial - (e.g., unconditional participation exemption or capital gains rules, full credit)... .”

258. Paragraph 69 makes clear that these issues may arise both under exemption systems as well as under credit systems. In connection with a credit system the concept of the artificial definition of a tax base includes any artificial computation that reduces the domestic tax charge.

259. The language in paragraph 69 of the 1998 Report suggests that measures to eliminate or mitigate double taxation should be coupled with safeguards or anti-abuse measures that ensure that such measures are available only in cases where double taxation may arise. Where such safeguards or anti-abuse measures are lacking, a measure with a stated policy purpose of avoiding double taxation may constitute an “artificial definition of the tax base.”

260. This point is already addressed in the ring fencing discussion. The “artificial definition of the tax base” factor informs the ring fencing discussion but otherwise does not have any independent relevance in connection with holding company regimes.

## CHAPTER VII: FUND MANAGEMENT

### A. Introduction

261. This Chapter discusses fund management regimes. It considers the circumstances under which a fund management regime meets the criteria of the 1998 Report. The scope of this Chapter is limited to regimes that apply to the income earned by fund managers from the management of the fund. It does not address the taxation of the income or gains of the fund itself or of the investors in a fund. Part B below provides some general background on the structure of fund management arrangements. Part C applies the relevant factors set out in Chapter 2, section III of the 1998 Report to fund management regimes.

### B. General background on fund management structures

262. A fund manager is a legal or natural person that provides management services, including the decisions on investments, to an investment fund or its investors. Arrangements between the fund, its investors and the fund manager can take many different forms but most arrangements fall within one of the following four categories:

- The fund is set up as a trust with the trustee being independent of the fund manager.
- The fund is set up as a limited partnership with either the general partner or a limited partner, under separate authority, making the investment decisions. The investment decisions may be based on advice received from a separate advisory company.
- The fund is set up as a corporation with the fund manager acting pursuant to the terms of a service contract and/or as an authorised corporate director of the corporation.
- The fund does not take on a separate legal character of its own, but arises from the pooling of investors' funds by the fund manager with the fund manager acting pursuant to a service contract between itself and each investor.

263. In exchange for its services the fund manager receives compensation that is computed on the basis of a pre-agreed formula. In its most basic version the compensation is computed as a percentage of the average value of net assets under management. For example, using a percentage of average net assets is by far the most commonly used compensation methodology among U.S. mutual funds. The "percentage of net asset" approach may be refined by adding elements of a performance bonus and a poor performance penalty to the basic formula. In certain cases, the compensation is fully contingent on performance and does not contain any fixed components. For instance, in the hedge fund context it is not uncommon that the fund manager is entitled to 20 percent of the increase in the net asset value of the fund. Conversely, if the value of the fund remains unchanged or decreases over the relevant period, the compensation is zero. In most cases such a compensation structure is achieved through the use of a partnership where the fund

manager is granted an interest in the profits of the partnership that exceeds its capital account (often referred to as a “carried interest”).

264. The structure of the fund and the fund manager might be rather complex, especially in cases where the fund manager is entitled to a carried interest. For instance, in the venture capital context, it would not be uncommon to see the fund raising vehicle(s) set up as a partnership(s) in the country(ies) where investments are expected to be made or in a third, tax neutral country (the “Investment Partnership”). The Investment Partnership would have two separate legal entities involved in the management of the Investment Partnership. These entities might be the general partners of the Investment Partnership or they may be limited partners that have separately been granted management authority. The first entity (the “Advisor”) reviews potential investment opportunities and provides investment proposals to the second entity. The second entity (the “Carried Interest Vehicle”) retains the authority to make all investment decisions and is ultimately responsible vis-à-vis the investors for the overall performance of the fund. The Advisor receives a fee in exchange for its advisory services. The Carried Interest Vehicle, as the ultimate decision maker shares in the profits of the Investment Partnership.

265. While it is fairly typical that the advisory vehicle and the carried interest vehicle are separate legal entities, there are numerous variations on the structure described in the preceding paragraph. For instance, the advisory entity might not be a partner in the partnership but operate under a separate service contract with the entity holding the carried interest. The entity holding the carried interest might then charge an additional management fee to the partnership and pass it on to the advisory entity.<sup>38</sup>

266. Often the carried interest vehicle will be resident in a jurisdiction that does not tax its income. The advisory entity may be resident in the country where investments are expected to be made or in a third country, depending on where the required professionals reside. In certain cases, there might be a chain of advisory companies, each with a separate service agreement.

267. In certain jurisdictions (and for certain fund products) a fund investor is required to pay an initial charge when buying into the fund in addition to any annual charges that might apply. An initial charge of 3-5 percent for equity funds and 1.5- 3 percent for bond funds is not uncommon. In certain cases, a fund with an initial charge may carry a lower annual charge. These charges are separate from any carried interest the fund manager might have in the fund.

## **C. Application of the factors of the 1998 Report to fund management regimes**

### ***i) Introduction***

268. This section applies the factors of the 1998 Report to fund management regimes. Fund management is a geographically mobile activity and, therefore, falls within the scope of the 1998 Report. The 1998 Report identifies four key factors and in addition suggests eight other factors that can assist in identifying harmful tax practices. The additional factors with particular relevance to fund management regimes include:

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38. In addition to the issue of the arm’s length nature of any advisory fee paid or received by or from related parties these structures raise a number of international tax issues. For instance, the carried interest vehicle might become tax resident in a third country if effective management is conducted from within such country. Alternatively, the totality of the activities conducted by the fund advising and managing entities might create a taxable presence in form of a permanent establishment. However, these issues are beyond the scope of the 1998 Report and, hence, are not addressed in this Chapter.

- Negotiable tax rate or tax base.
- Existence of secrecy provisions.

**ii) Key factors**

*a) No or low effective tax rate*

269. As prescribed in paragraph 61 of the 1998 Report a regime may give rise to a low or zero effective tax rate, “because the schedule rate itself is very low or because of the way in which the regime defines or influences the tax base to which the rate is applied.” A fund management regime may cross the low or no effective tax threshold either directly or indirectly. For instance, a country may simply exempt fund management income from its income tax. Alternatively, a country’s tax laws may grant special relief for fund managers with the effect of reducing significantly, and in some instances eliminating, the tax base to which the statutory rate is applied.

270. In cases in which a services fee is paid between related parties, guidance in the Chapter on transfer pricing may be relevant to determining whether a regime gives rise to a low or zero effective tax rate.

*b) Ring fencing*

271. As described in section III, ring fencing may take one of two forms: (i) the explicit or implicit exclusion of resident taxpayers from the regime and (ii) the explicit or implicit prohibition on operating in the domestic market.

272. The first variation of ring fencing would be met if, for instance, resident taxpayers would not be allowed to hold an equity interest in a fund management entity. The criterion would also be met if residents were permitted to hold an equity interest in a fund management entity, but the taxation of income from the fund management activity would discriminate against resident shareholders. As explained in more detail in Chapter III, no discrimination exists simply because a country taxes its resident shareholders but does not tax non-resident shareholders. Furthermore, the ring fencing element is primarily tested at the level of the fund management income, not at the level of the income resulting from distributions of such income. If, however, other disincentives for resident investors exist, for example, high levels of taxation for distributions out of the entity relative to the general taxation of dividends for resident taxpayers, then the regime may effectively be ring-fenced.

273. Ring fencing at the fund investor level does not constitute a form of ring fencing that falls within the scope of this Chapter. Whether or not a country limits access to the fund to non-residents has no bearing on the question of whether or not the fund management regime constitutes a harmful tax practice.

274. Countries with a fund management regime that meets the low or no effective tax rate criterion should use the guidance set out in the box below to assess whether the regime may be ring-fenced.

The following features are likely to result in ring fencing:

- The regime does not permit residents to hold an equity interest in the person performing the services.
- The regime provides for a less favourable taxation of the fund management income for residents as compared to non-residents.
- The regime otherwise does not comply with the guidance provided in the Chapter on ring fencing.

*c) Lack of transparency*

275. Under the 1998 Report non-transparency is a broad concept that includes among other things, favourable application of laws and regulations, negotiable tax provisions, and a failure to make administrative practices widely available.

276. In connection with fund management a tax regime will be treated as non-transparent if the effective tax rate is negotiable or if statutory rules on the tax rate or the tax base are not applied consistently. A tax regime would not be regarded as non-transparent simply because the taxation varies depending on a set of predetermined conditions provided the conditions can be invoked against the authorities and the details of the regime, including its application to a particular taxpayer, are available to the tax authorities of other countries concerned.

277. Finally, fund management regimes will also be deemed non-transparent if the fund manager is exempted from book and record keeping obligations or otherwise fails to comply with the guidance provided in other Chapters.

*d) Exchange of information*

278. A country's unwillingness or inability to exchange information regarding fund management regimes is an important indicator of the existence of harmful tax practices.

279. A fund management regime will fail the effective exchange of information factor if it does not comply with the guidance provided in Chapter II on transparency and exchange of information and, where pertinent, Chapters IV and V.

*iii) Other factors*

280. In addition to the key factors, there are a number of supplementary factors that assist in identifying harmful tax practices. In substance, these factors do not so much add additional factors to the key criteria but rather spell out in more detail some of the key principles and assumptions implicit in the key criteria.

281. A negotiable tax rate or tax base. As already discussed above, a negotiable tax rate or tax base constitutes an element of non-transparency. A negotiable tax rate or tax base might raise particular issues in connection with the provision of sufficient information to enable countries to apply their controlled foreign corporation rules. The issue will be exacerbated if the negotiable feature is combined with a lack of effective information exchange.

282. Existence of secrecy provisions. Restrictions on the right of the authorities to obtain information or to exchange information, because e.g., the financial results of the fund management activities are classified as a trade secret and held ineligible for exchange, constitutes a very significant aspect of a harmful tax practice.

## CHAPTER VIII: SHIPPING

### A. Introduction

283. This Chapter discusses shipping regimes. As the 2000 Report recognised, the analysis of shipping is complex given the particularities of the activity. This Chapter was developed so as to take into account and be consistent with the particularities of the shipping industry.

284. Part B below describes some general aspects of the shipping industry and relevant regimes. Part C applies the relevant factors set out in Chapter 2, section III of the 1998 Report in a generic way to shipping regimes to determine what elements may contribute to harmful tax practices. Finally, Part D provides more specific guidance by describing how the factors described in Part C should be applied to shipping regimes.

### B. Outline of the general aspects of the shipping industry and relevant regimes

285. This Chapter examines tax regimes that apply to maritime transport operations. Because of the cost advantages available to operators from other countries, many OECD member countries have taken initiatives to support their maritime sectors in the face of declining market shares. These initiatives have been variously attributed to the economic importance of the industry, the need to maintain employment or maritime know-how and defence or strategic concerns. Typically they extend beyond purely fiscal measures. It is important, therefore, to acknowledge at the start that the success of any country's approach to shipping policy depends on more than that policy's fiscal dimension. An integrated or package approach is usually required to address other, sometimes inter-linked, factors such as vessel registration, regulatory arrangements, manning requirements and seafarer training. A competitive fiscal environment does, however, appear to be the critical factor in these initiatives. In the introduction to its 1997 "Community guidelines on State aid to maritime transport"<sup>39</sup> the European Union (EU) Commission stated that:

"The competitive difference between ships registered in the Community and those registered outside especially those operated under flags of convenience,<sup>40</sup> depends primarily on fiscal costs. This is because the cost of capital is essentially the same world-wide and equally there is no difference in the technology available. The fiscal costs (corporate taxation and wage related liabilities in respect of seafarers), have been shown by different studies to be the critical and distortive factor".

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39. Published in the Official Journal: OJ C 205, 5.07. 1997

40. The International Transport Workers Federation distinguishes a flag of convenience from other open registers according to certain criteria, the most important of which is that a majority of vessels registered are foreign owned or controlled.

286. A recent study undertaken for the OECD's Maritime Transport Committee<sup>41</sup> also concluded that,

“The effective tax rate faced by a shipping company is one of the most important factors determining its competitiveness, as well as determining the location of its operational base in the longer term”.

287. Part B (i) of this Chapter provides an overview of non-tax factors that affect the shipping industry. Part B (ii) provides a summary of the tax incentives available to shipping companies within OECD member countries and some of the conditions attaching to them that may be relevant to the application of the criteria to shipping incentives. Part B (iii) provides a brief overview of some international aspects of the taxation of shipping profits.

*i) Non-tax factors*

*a) Regulation*

288. Shipping is regulated by a number of international bodies and conventions. For example, the United Nations Convention on the Law of the Sea establishes the obligation that all ships are required to be registered under the flag of one country.<sup>42</sup> The International Maritime Organisation (IMO), a specialised UN agency dealing with maritime matters, provides a range of international conventions and protocols that lay down, among other things, safety and environmental standards for the shipping industry. The International Labour Organisation (ILO) has established the International Seafarers Code concerning working conditions at sea. Other ILO conventions relate to training and certification of seamen. A number of other international bodies have also established conventions and regulations in the maritime transport area.

*b) Registration*

289. In choosing where to register a ship, owners can select between various types of registers. These registers are variously described as traditional registers, open registers and second registers. These designations are often overlapping and not clearly defined.

290. Traditional registers typically impose a number of requirements that must be met regarding the ownership and crews of registered vessels. For example, the owner may be required to be a citizen of the country concerned or of certain other specified countries, e.g., EU countries in the case of EU Registers. In the case of a company, the company may be required to be incorporated in the country concerned or certain other specified countries. In short, there must be a real link between the owner of the vessel and the flag. Similarly, crews must meet certain criteria as regards training or nationality or both (this is often the case for second registers as well, except that crew nationality requirements may be relaxed) and may benefit from collective national wage agreements. Accordingly, it is usually more expensive to operate ships on traditional registers and as such these registers offer few economic advantages unless trade on particular routes is restricted to ships entered in them. Countries sometimes require vessels to be traditionally registered in order to trade between their ports. This practice – known as cabotage – is described in more detail at paragraphs 298 and 299 below. Scheduled passenger transport between domestic ports and foreign ports may also be confined to vessels entered on traditional registers.

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41. Analysis of Selected Maritime Support Measures – Econ Centre for Economic Analysis [DSTI/DOT/MTC(2001)1].

42. Article 92

291. Open registers are those which offer their maritime flag to owners from other countries. Over half the world's shipping is now registered in countries other than the real country of beneficial ownership.<sup>43</sup> The advantages of registering in jurisdictions operating such registers relate to ease of registration, fiscal incentives (or, in many cases, the absence of any direct taxation at all) and flexible manning arrangements, such as the absence of restrictions on crew nationality. By "flagging out," that is by registering in a country other than the ship owner's country of residence, ship owners may be able to get access to lower cost labour, avoid higher national taxes and, in some cases, avoid more stringent regulatory environments. Moreover, because ship owners operate in conditions where national boundaries are largely irrelevant, it is relatively easy to register abroad thus avoiding onerous domestic systems.<sup>44</sup>

292. Significant savings can, therefore, be made by ship owners registering with open registers and countries operating such registers have experienced large increases in registry numbers. According to Lloyd's Register, seven out of ten of the world's top shipping registers are open registers. As open registers have expanded, there has been a corresponding decline in other registers. As a result, a number of OECD countries interested in promoting their shipping sectors have acted to support them by introducing special tax regimes such as "tonnage tax" regimes and measures to reduce manning costs in order to prevent further flagging out and to attract ships back to their registers. Tonnage taxes may be contrasted with ordinary corporation tax regimes in that such taxes are calculated on the basis of a notional profit related to the tonnage of a ship rather than accounting or commercial profits. They are payable irrespective of whether a profit or loss has been made.<sup>45</sup>

293. It is important to emphasise that "flagging out" does not necessarily imply a loss of standards. Some open registers are recognised as "quality" registers and are known for their efficient services and high operational and environmental control standards. In other cases, the capacity for monitoring the ongoing use and operation of registered vessels may be limited. The registration procedures themselves, in the case of some open registers, may also present dangers. One important distinction between open and traditional or second registers, described below, is that the former generally do not require a significant economic or ownership nexus between the vessel and the registering jurisdiction. The latter normally require that the strategic or commercial management of the vessel take place in the jurisdiction or that the owners have connections there. The quality of information kept in the register is likely to be higher with traditional registers and second registers because managers or owners may be more likely to comply with obligations to notify the register of changes in basic data if they are resident in the jurisdiction. More importantly, vessels on open registers are sometimes owned by special types of companies, such as international business companies ("IBC's"), formed in the registering jurisdiction. Such structures can present particular concerns because the beneficial owners of such companies can be difficult to determine.

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43. According to statistics compiled by the UNCTAD, between 1980 and 1999 the share of world's tonnage in major open-register countries increased from 31.1% to 48.1%. In the same period, the share of developed market-economy countries dropped from 51.3% to 25.4%. The ECON study for the OECD's Maritime Transport Committee estimated that the share of the world's tonnage in open registers was about 50% by 2000.

44. The ECON study states that:

"Over the past few decades the OECD shipping industry has faced increasing competitive pressure from shipping in non-OECD countries. In addition to flag competition from open registers, a number of non-OECD countries have developed shipping industries that benefit from low taxes and wage levels. Companies operating under such conditions may be able to accept lower freight rates, placing those that operate under "normal" tax regimes and higher costs at a disadvantage. "

45. Two approaches are used to arrive at tonnage taxes. In the first, a derived income is calculated based on net tonnage. This is taxed at the ordinary corporate rate. In the second, the tonnage tax is a straight fee calculated according to gross tonnage.

In addition, IBCs and similar vehicles are generally subject to more lax accounting requirements and are usually exempt from requirements to file or audit accounts.

294. Second registers are similar to open registers but are set up mainly to prevent flagging out of domestically owned ships or to encourage such ships back. They attract mainly domestically owned vessels but are not confined to such vessels. In some cases, access to the second register may be conditioned on trading area restrictions, such as a prohibition on transport between domestic ports of the registering country. Normally entry into such registers requires a significant economic or ownership link with the country concerned. For example, in order to register a vessel in the Danish International Shipping (DIS) register, the vessel must be Danish owned, EU or EEA owned or owned by a foreign company in which Danish subjects or companies have a significant share and influence. In the latter case, the foreign ship owner must also have a Danish representative. Similarly, entitlement to register in the Register Kerguelen (TAAF) – the French second register – is dependent on the nationality and residence of the owner (French, EU or EEA) and the operation and use of the vessel must be controlled from France. Other OECD countries also offer second registers. The largest such register is Norway’s International Ship Register (NIS). The latter was established to offer a flexible and commercially attractive alternative to the open register. Both Norwegian and foreign owned vessels are admitted to the NIS but a foreign owner has to entrust a significant proportion of the ship management to a Norwegian company and appoint a Norwegian representative.

295. Second registers and direct taxation measures, such as tonnage tax systems, need not be linked in a formal way, though they sometimes complement each other. The DIS, Kerguelen and NIS registers referred to above do not provide for any special provisions in relation to the taxation of shipping profits. The advantage of second registers relate to greater flexibility in manning arrangements and, sometimes, a more favourable treatment of seafarers’ income, for example special deductions for income tax purposes for crew members or a reimbursement of crew members’ income tax. The development of second registers predates the recent wave of tonnage tax regimes particularly within the EU. Typically, such registers were developed to make countries’ flags more attractive by reducing manning costs. But experience has shown that this is often not enough to halt the decline in traditional registers, leading to pressure in a number of OECD countries to introduce tonnage tax systems.

### *c) Manning costs*

296. In practice, shipping policies often involve a balance between promoting the competitiveness of locally based shipping companies and employment of nationals in the maritime sector. These two goals are complimentary in that promoting locally based shipping tends to create jobs for national seafarers. However there is a trade off between employment conditions and shipping company competitiveness. Employment conditions that are “too favourable” to national seafarers can be counterproductive by reducing local companies’ competitiveness and in turn the number of jobs available for nationals due to layoffs or relocation of shipping companies. On the other hand, if remuneration or other conditions are eroded because of competition from “low cost” crews, the attractiveness of a career at sea declines. Most OECD countries have allowed locally based companies access to low cost manning through the use of open registers.<sup>46</sup> This allows shipping companies to realise significant savings on operating costs but at the expense of undermining the attractiveness of careers at sea for their nationals and the risk that some or all

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46. The ECON study estimated rough average cost savings of around US\$750,000 annually for use of a full “low cost” crew for a large ship employing 24 seafarers, compared with using an entirely Western European crew. This represents up to 10% of the typical amount of equity employed by a shipping company in a vessel of this size. For a small ship with a crew of 10 the savings could amount to around US\$ 350,000, or up to 30% of the equity employed.

of the shipping companies' business may also move abroad. Increasingly, OECD countries now offer access to low cost manning via second registers that typically relax manning conditions and thereby reduce costs. Access to low cost manning under traditional registers is less usual, as these are often subject to strict manning conditions.

297. Manning cost flexibility, that is a reduction in taxes or social security charges related to the wages of national or resident seafarers, is another measure aimed at strengthening employment possibilities in countries where social security arrangements for companies or their employees are otherwise too onerous. But savings due to flexibility measures generally amount to only a fraction of the savings to be had from full low-cost manning. Around half of OECD countries have such measures. In some cases these savings may go directly to the shipping company. The EU also recognises that the employment of European seafarers is adversely affected by the cost competitiveness of crews from low-wage third countries. Its guidelines on state aid to the maritime sector address this situation by permitting a reduction to zero of tax and social charges for seafarers.

#### *d) Cabotage*

298. Traditionally, many nations have applied some controls on commercial shipping engaged on their domestic trades. This practice known as “cabotage” may be defined as “the reservation of a country’s domestic shipping trades to ships flying the national flag of that state,” and it may apply to coastal or deep-sea voyages, as well as shipments on inland waterways. Ships engaged on cabotage trades have variously been required to be:

- manned by the country’s own citizens;
- wholly or majority owned by domestic nationals;
- built at domestic shipyards; or
- registered under the country’s national flag.

299. In return for meeting such requirements, owners operating ships on cabotage routes do not have to compete with foreign flag vessels. In addition, some countries also provide fleet subsidies or other financial benefits. Cabotage is widely practised, both by OECD and non-OECD countries. The main purposes of retaining this policy in many cases are to preserve employment at domestic shipyards and maritime know-how necessary in cases of external emergencies. These are often the same reasons given for providing preferential tax treatment in the shipping sector.

#### *ii) Corporate tax on shipping*

300. The effective rate of tax on a shipping company is a key factor in determining its competitiveness and, in the longer term, the location of its operational base. In an ordinary tax regime, the effective rate is made up of the nominal tax rate and the depreciation and other deduction rules that apply.<sup>47</sup> In the case of a tonnage tax, the effective rate depends on the rate of tax and the amount of profits imputed to each ship based on the set rate per ton or the fee per ton. It is important to understand that for some countries the imposition of a tonnage tax regime would not significantly alter the level of tax paid by the shipping sector.

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47. The ECON study concluded that the rate of depreciation, the availability of anticipated depreciation and the treatment of book profits on sale of ships were more important than nominal tax rates.

The ECON report to the Maritime Committee on Selected Maritime Support Measures concluded that effective annual tax rates over the life of shipping projects under OECD regular taxation regimes was in some cases lower than that faced by projects operating under tonnage tax regimes.<sup>48</sup> The unweighted average income tax equivalent of tonnage taxes in the countries examined was found to be about 3.7%, though it fell to 1.5% if the two countries with the highest tonnage tax rates (Greece and Norway) were excluded. The corresponding rate in non-OECD countries was around 1%. However, to achieve such rates under regular taxation systems, it must be possible during the early years of a project to consolidate losses with positive income from other projects, suggesting that large or diversified companies were best placed to take advantage of the lowest rates offered by OECD regular tax regimes.

301. A report on the tonnage tax in the UK reached similar results.<sup>49</sup> It concluded that a tonnage tax would not significantly affect the level of tax payments by shipping companies but that it nevertheless had structural advantages for UK shipping over the standard corporation tax system. These included:

- benefits to the profit and loss account and balance sheet because of the absence of a deferred tax liability;
- certainty and clarity about costs and liabilities; and
- the possibility to undertake investment on a commercial basis rather than on the basis of tax considerations.

302. The UK Report also suggests that small or medium size companies may have less opportunity to exploit the regular tax system than large ones, again confirming the OECD's conclusions.

303. It may also be that a straightforward comparison of tax levels understates the comparative advantage of tonnage tax systems. The reason is that in the absence of adequate anti-avoidance provisions, it may be possible to reduce the cost of funds on ships subject to tonnage taxes, and thus enhance profitability, by exporting capital allowances outside the regime, to lessors for example. These possibilities also arise in the case of shipping regimes that provide for a reduction in corporate taxes in respect of profits from international shipping.

304. The recent wave of tonnage tax systems in OECD countries, even in some countries that would otherwise have been considered as offering low effective rates by virtue of favourable depreciation provisions, might therefore be explained by a combination of factors. These include the certainty and predictability such regimes offer ship owners, the lower tax burden afforded to small and medium size companies and the revision of the EU's state aid guidelines in 1997 as a result of the perceived inadequacy of its earlier attempts to respond to international competition in the shipping industry. The "Community guidelines on State aid to maritime transport" allow for the reduction to zero of taxation and social charges for seafarers and for corporate tax on shipping activities. Since these Guidelines were published, a number of EU countries have introduced tonnage tax regimes and others appear to be in the process of developing them. Three EU countries have introduced or announced the introduction of such regimes since the 2000 Report was published.

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48. Analysis of Selected Maritime Support Measures DSTI/DOT/MTC(2000)1.

49. Independent Inquiry into a Tonnage Tax – A Report by the Lord Alexander of Weedon QC.

*a) Description of shipping regimes*

305. The shipping regimes identified as potentially harmful in the 2000 Report have many features in common. This similarity results, at least in part, because six of the eight regimes are EU based and thus potentially subject to the EU's state aid guidelines while another is subject to European Free Trade Association Surveillance Authority (ESA) disciplines which are similar in effect to the EU guidelines. There are three key elements in the EU guidelines so far as shipping incentives are concerned, all of which have implications for the assessment of whether a regime is harmful. First the guidelines permit a reduction to zero of corporate taxes on shipping activities. Second, as a rule, the ship must be entered in a member state's register in order to qualify for the incentive. Exceptionally, preferential tax treatment may apply on the basis of a purely economic link (i.e., flag neutrality) subject to necessary safeguards and monitoring.<sup>50</sup> Finally, the fiscal advantage must be restricted to shipping activity. Hence in a case where the ship owning company also engages in other activities transparent accounting is required to prevent spillover to non-shipping related activities.

306. While many of these schemes, particularly tonnage tax schemes, are similar in principle, they sometimes differ in important details. Key features of the different schemes that may be relevant to the application of the criteria may be summarised under the following headings.

*b) Level of tax*

307. The main approaches to shipping incentives are tonnage taxes, a reduction in corporate taxes attributable to profits from shipping and accelerated or anticipated depreciation. The latter two approaches tend to be of more general application than tonnage taxes or reduced rates which are often conditioned on specific eligibility criteria such as those described in the following paragraphs of this Chapter. The extent of the reduction in corporate taxes varies from case to case. In one case a complete exemption is given. Other schemes are less generous as far as the level of tax is concerned. In so far as the incentive is granted by way of a reduction in corporation tax, the reduction in some cases is in the order of 80% or 90%, giving rise to a "true" nominal rate of tax below 10%. In at least two cases, the nominal rate appears to be 10% or higher. It would seem, by extension from the ECON study for the Maritime Committee, that the effective rate of tax in the case of most of the tonnage tax schemes examined is in low single figures though two of these schemes provide only for a deferral of tax rather than an outright reduction.

*c) Qualifying vessel/activities*

308. Preferential shipping regimes are usually confined to sea going vessels. Typically they include vessels engaged in the carriage of passengers or cargo, but they vary in their application to specialised vessels such as vessels engaged in oil or gas exploration and exploitation. Fishing vessels are usually excluded as are vessels confined to inland waterways such as river ferries even where these are engaged in international traffic.

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50. Fiscal incentive schemes apply to ships entered in Member countries' registers but exceptionally may also apply to an entire fleet operated by a ship owner established within a Member state provided that "the strategic and commercial management of all ships concerned is effectively carried out from within the territory and that this activity contributes substantially to economic activity and employment within the community."

*d) Eligibility/strategic management and control*

309. Many of the schemes examined are flag neutral but, in line with the EU guidelines referred to above, may require that strategic management and control of the ship be undertaken from the country concerned in the event that the qualifying ship is not registered there. In one case the exercise of strategic management and control appears to be a condition for entry into the scheme irrespective of where the ship is registered. In general, the starting point for many of these schemes seems to be that benefits are restricted to ships entered on the domestic register, and thus satisfying certain local or, in the case of the EU, regional ownership requirements. Ships entered on other registers only qualify if they satisfy a local activity test. In one case, however, exemption is given to non-residents only, i.e. foreign incorporated shipping companies trading through a permanent establishment provided that the home country provides a reciprocal exemption. In principle, this treatment appears to reflect that suggested in Article 8 of the OECD Model Tax Convention.

*e) Trading area restrictions*

310. Preferential tax treatment under some shipping regimes is given only to ships used in international trade or international traffic. But this type of restriction is more a feature of tonnage tax systems or regimes based on preferential rates than regimes based on generous depreciation provisions, which tend to have general application. Where such restrictions apply, some regimes appear to exclude all coastal traffic and others only certain routes so that ships engaged in domestic traffic apart from these routes qualify for the regime. In all cases, however, qualifying shipping activities include the transport of goods or persons between domestic ports and foreign ports or between foreign ports. Similarly, the regimes examined usually do not impose any restrictions on access to domestic markets in the sense that they restrict transactions with domestic enterprises or transactions in domestic currency. But again there are exceptions.

*f) Scope of taxation*

311. The scope of taxation in the case of the regimes examined typically includes income from ships owned and operated by the qualifying company together with income from boats chartered in. Income from the long-term finance leasing of vessels is within the scope of one of the schemes examined and bareboat chartering out of ships is included in at least one as well, but on a time limited basis. Similarly income from ship management is included in one case, but there are restrictions on the number of ships managed, expressed as a multiple of the ships owned or chartered in. Presumably this is to ensure that the regime applies to shipping companies as opposed to ship management companies. Dividend income is also included in one scheme where the dividends arise from overseas shipping subsidiaries.

*g) Anti-avoidance provisions*

312. Anti-avoidance is an area where there appear to be some differences between the various schemes. The importance of anti-avoidance provisions has to do with the fact that the incentives given to shipping companies reduce their tax rates to extremely low levels. As a consequence there is an incentive for the company to seek to allocate expenses such as interest expenses or deductions in respect of depreciation to higher rate taxpayers outside of the scheme. This might be done, for example, by allocating group interest expenses to other group companies that are taxed at higher rates. Some of the schemes examined appear to have strict rules in relation to the allocation of funding costs and also impose limits on the availability of depreciation allowances to lessors and even on the kinds of leases that are permitted into the scheme. In other cases a more relaxed approach appears to be taken.

*iii) International tax aspects*

313. The basic approach of Article 8 of the OECD Model Tax Convention is that profits from the operation of ships in international traffic should be taxable only in the country of effective management of the enterprise. This will normally be the country of residence of the enterprise. But there are circumstances where the Contracting State in which the place of effective management is located is not the State of which the enterprise operating the ship is resident. Some States therefore prefer to confer exclusive taxing rights on the State of residence.

314. Where shipping income is not treaty protected or otherwise exempted under domestic law, it is the practice of some countries, including a few OECD countries, to tax foreign shipping companies that trade to their ports on gross transportation income.

315. Shipping income appears to be specifically included within the scope of some countries' controlled foreign corporation ("CFC") provisions, and excluded from the scope of others. Conditions under which the CFC provisions apply vary. In short, there does not appear to be a consistent approach to the treatment of shipping income for CFC purposes in OECD countries.

**C. Application of factors in the 1998 Report to shipping regimes**

*i) Introduction*

316. The maritime transport sector falls directly within the category of geographically mobile activities. This Chapter applies the relevant factors set out in the 1998 Report to generic aspects of shipping regimes.

317. In addition to the four key factors, the 1998 Report suggests other factors that can assist in identifying harmful tax practices. The factors with particular relevance to shipping regimes are:

- An artificial definition of the tax base.
- Failure to adhere to international transfer pricing principles.
- Existence of secrecy provisions.

*ii) No or low effective tax rates*

318. As explained in paragraph 61 of the 1998 Report, a zero or low effective tax rate may arise "because the schedule rate itself is very low or because of the way in which a country defines the tax base to which the rate is applied." Thus, whether a country uses features such as a reduction of the corporate tax rate, favourable depreciation provisions or applies a tonnage tax regime is irrelevant for purposes of determining whether a regime meets the "no or low tax rate" criterion.

319. Although it is not the only factor influencing location decisions, international shipping companies are generally drawn to countries that operate favourable fiscal regimes. This has led to the situation where a large percentage of the world's fleet operates with little or no direct tax on its activities. A wide variety of tax-reducing measures, including low tax rates and preferential depreciation treatments, are employed to achieve this outcome. As a result, it would now appear to be common for countries, including OECD countries, to create a low tax or substantially tax-free environment to attract and retain shipping

investment. Although many of these regimes, arguably, respond to the lack of competitiveness of countries' shipping sectors, the low tax factor is not concerned with a country's motive for introducing a particular regime. However, the application of this factor alone does not determine if a regime is harmful. Accordingly, a preferential low tax regime for the shipping sector is not of itself problematic under the 1998 Report.

**iii) Ring fencing**

320. Ring fencing may take one of two forms: (i) the explicit or implicit exclusion of resident taxpayers from the regime and (ii) the explicit or implicit prohibition from operating in the domestic market.

321. The first variation of ring fencing -- exclusion of resident taxpayers from the regime -- would be met if, for instance, resident taxpayers were not allowed to hold an interest in ship-owning companies qualifying for the preferential regime, if the benefits of the regime were neutralised for such investors, or if residents did not otherwise qualify for the preferential regime. As explained in Chapter III on ring fencing, ring fencing would not be present either in this form or in its second variation, discussed below, where an exemption from tax for non-residents is part of the general structure of a country's tax system or if it arises in connection with a measure to mitigate or eliminate double taxation such as a double taxation convention or other rules providing for reciprocal exemption from tax.

322. The second variation of ring fencing -- prohibition from operating in the domestic market -- may be met if enterprises qualifying for the preferential tax regime are either prohibited, by the regime, from operating in the domestic market or the regime denies the preferential tax rate in respect of domestic market operations. However, a number of different cases need to be distinguished. First the ring fencing criterion would be met if the regime only applies for shipping trades between two ports or points outside the country granting the regime. However, as explained in more detail in the Chapter on ring fencing, no ring fencing issue arises where the country granting the regime does not have a domestic market, for example, a landlocked country, and what might otherwise be construed as ring fencing is only the result of geographical circumstances.

323. Second, as explained in paragraphs 298 and 299 some regimes are restricted to ships engaged in international trade or international traffic thus excluding some of their domestic market from the regime. It should be understood, however, that the ring fencing criterion is not implicated if the income from both international traffic and purely domestic traffic is subject to a zero or low effective tax rate. As stated in the Chapter on ring fencing, the protection of the domestic market (e.g., cabotage) is not relevant for the purposes of the ring fencing criterion if international activities are not taxed more favourably than domestic activities. Furthermore, when analysing whether taxation is more favourable, it is irrelevant whether the zero or low effective rate of tax is achieved through the same mechanism (e.g., a tonnage tax applies to income from both international and domestic shipping) or through a different mechanism (e.g., the low tax on income from international routes results from the operation of a tonnage tax whereas on the low tax rate income from domestic routes results from favourable depreciation rules).

324. Third, the non-extension of benefits available for international shipping to domestic shipping does not raise a ring fencing issue in the many cases where these two segments of the shipping industry are different in a substantive way. The ring fencing analysis is only concerned with a different tax treatment of the same or similar activities. As the Chapter on ring fencing makes clear, ring fencing is not concerned with cases where a preferential tax rate is granted for one particular activity but not granted for another, different, activity. Where the activities being compared are substantively different and the necessary comparability is lacking, a difference in tax treatment does not raise a ring fencing issue.

325. In undertaking a comparability analysis, in the case of shipping activities, a number of factors are relevant in determining whether activities, particularly international and domestic activities, are different, thus allowing for a different taxation treatment without offending the ring fencing criterion. These fall into two broad groups. In general, the first group of factors looks to the type of ship involved or the kinds of operation it engages in to determine if a different activity is involved. Such factors include:

- Whether the vessel is seagoing. The operation of fjord, river or harbour ferries, of vessels on inland waterways or Inshore Traffic Zones are distinct activities from that of operating seagoing vessels. It is also possible to distinguish vessels under a specified amount of gross registered tons under this heading.
- Whether vessels are engaged in the transportation of goods and passengers. Fishing vessels, dredgers and research vessels can be distinguished in this regard as can vessels which are used purely to provide accommodation, such as flotels.
- Whether vessels are engaged in servicing particular industries such as the offshore oil and gas industry.
- Whether different types of ships are involved and whether there are different requirements as regards crew training and qualifications. For example, specialist vessels such as factory ships or pipe laying ships are engaged in distinct activities from ships engaged in the transportation of goods and passengers.

326. The second group of factors recognises that there are in some countries natural features that uniquely affect the domestic shipping market and thus distinguish it from the international shipping market. Due consideration must therefore be given to these country specific situations arising from geographically specific structural disadvantages that result in public service needs. Such situations include cases where:

- transportation by sea or other waterways is an integral part of the otherwise land based domestic transportation infrastructure (e.g., ferries);
- provision of maritime public services is made under contract or as part of licensing requirements due to particular public service needs in relation to transport capacity, frequencies and fares, especially in less developed regions.

**iv) *Lack of transparency***

327. Under the 1998 Report, lack of transparency includes among other things, favourable application of laws and regulations, negotiable tax provisions, and a failure to make widely available administrative practices. Transparency requires that the jurisdiction offering the preferential regime be in a position to obtain ownership information on ship-owning entities formed in the jurisdiction and that the authorities can obtain the information necessary to verify that cross-border transactions between entities benefiting from the preferential regime and associated enterprises accord with the arm's length principle. The method of computing profits by reference to tonnage may present difficulties in this regard if, for example, information on gross margins or other transactional data is not available because of relaxed reporting or record keeping requirements. The issue here is whether tax authorities in the jurisdiction providing the regime can obtain the relevant information on intra-group transactions in order to ensure that the arm's length principle is being observed, even if transfer pricing issues might not be expected to occur with the same intensity in this sector as it might in some others. Shipping regimes would therefore be considered

non-transparent if shipping companies are exempted from book and record keeping obligations. See also the more general guidance in Chapter II.

328. Transparency also requires that there are no non-transparent features in a country's tax system such as rules that depart from established laws or the ability to negotiate the effective rate of tax to be applied in a particular case. In connection with shipping activities, a tax regime will be treated as lacking transparency if the effective tax rate is negotiable or if statutory rules on the tax rate or the tax base are not applied consistently. A tax regime does not lack transparency simply because the taxation varies depending on a set of predetermined conditions provided the conditions can be invoked against the authorities and the details of the regime, including its application to a particular taxpayer, are available to the tax authorities of other countries concerned. Finally, where shipping regimes involve the use of rulings, the guidance given in the Chapter on rulings should be followed.

v) *Exchange of information*

329. A country's unwillingness or inability to exchange information regarding enterprises qualifying for shipping regimes is an important indicator of the existence of harmful tax practices. Information on the regime and its application to a particular taxpayer is of particular importance in cases in which the shipping operation is conducted through a subsidiary or a member of a multinational group. The countries of associated enterprises may need such information to determine the application of their CFC legislation or to apply their transfer pricing provisions effectively.

330. With respect to effective exchange of information, a shipping regime should follow the guidance provided in Chapter II, and where pertinent, Chapters IV and V.

vi) *Other factors*

331. In addition to the key factors, there are a number of factors which may assist in identifying harmful tax practices in respect of shipping regimes. In essence, these factors do not so much add additional criteria but spell out in more detail some of the key principles and assumptions that are implicit in the key factors themselves.

332. An artificial definition of the tax base. This factor relates to the no or low effective tax rate criterion. Examples of provisions that may result in an artificial definition of the tax base are rules that allow costs to be deducted even though the corresponding income is not taxable, rules that allow deductions for deemed expenses that are not actually incurred, and rules that permit overly generous reserve charges or otherwise restrict the tax base for particular operations. Similarly if an incentive is over broad in that it does more than is necessary to achieve stated goals, there may be a greater cause for concern.

333. An issue with respect to costs is whether the deductibility of costs should be restricted if shipping income is exempt or taxed at very low rates. In the absence of restrictions, enterprises subject to more substantial taxation, for example financial institutions, may be able to benefit from schemes to transfer deductible costs to them for use against other income. This issue, however, does not have particular relevance in the shipping area because the no or low tax criterion will generally be met without regard to this issue. The transferability of deductible costs may have relevance, however, if it creates a low tax environment in another sector of geographically mobile activity. In that case, the criterion of the 1998 Report would have to be applied to that sector to determine whether there are harmful tax practices.

334. Failure to adhere to international transfer pricing principles. As already discussed above tonnage tax regimes may give rise to particular concerns in the context of transfer pricing because tax is computed on the basis of a notional profit rather than accounting profit or commercial results. This may lead to the problems with transparency and effective exchange of information discussed above where such regimes also allow for relaxed reporting and record keeping requirements. Further, in some circumstances this has the potential to result in a no or low tax rate in associated enterprises or in non-shipping business of the same enterprise. For example, transfer pricing could facilitate the shifting of profit from associated enterprises in the regime country into the shipping entity. Alternatively, profit could be shifted from non-shipping business to shipping business within the same entity. If this is achieved, again most likely through transfer pricing, then there is a potential that there will be a low effective tax rate. These problems can be largely avoided if the arm's length principle is incorporated into tonnage tax or other shipping regimes to the extent that these are not already covered by a country's existing transfer pricing provisions. In principle, so long as there is a requirement to use arm's length values for transactions within tonnage tax regimes and adequate information is available to ensure that these can be verified no special issues would appear to arise in relation to the application of the arms length principle to such regimes.

335. Existence of secrecy provisions. This factor relates to exchange of information. The existence of secrecy laws that would prevent access to relevant information in the case of a shipping regime would be an important indicator that such a regime was harmful.

## **D. Conclusions and guidance**

### *i) Introduction*

336. Around the world, shipping companies appear to be dealt with as a special case in that they are treated particularly favourably by the tax systems of many countries, including those of OECD member countries. The 1998 Report is neutral in so far as countries wish to give tax breaks to their shipping sectors. It does suggest, however, certain features that should be considered in order to conform such incentives with its criteria. Countries should use the guidance set out below to reduce the possibility that their regimes are evaluated as harmful.

### *ii) Guidance*

#### *a) Ring fencing*

337. As explained in Chapter III, ring fencing can take one of two forms: (i) an explicit or implicit exclusion of resident taxpayers from the regime or (ii) an explicit or implicit prohibition from operating in the domestic market. Ring fencing is not implicated, where the benefits available for international shipping are not extended to domestic shipping, in the many cases where domestic and international shipping activities are substantively different. The following features of preferential shipping regimes are likely to result in ring fencing:

- The benefits of the regime are explicitly or implicitly denied to residents of the country offering the regime. Ring fencing is not implicated, however, if the measure is part of the general structural features of a country's tax system or if the measure is designed to mitigate or eliminate double taxation (such as a double taxation convention or other rules providing for reciprocal exemption from tax).

- A comparison, in accordance with paragraphs 324 et seq., of the facts and circumstances shows that domestic and international shipping activities are substantively the same and only international shipping activities or transactions are subject to a zero or low effective rate of tax.

*b) Transparency*

338. Lack of transparency in the context of preferential shipping regimes arises mainly in the context of access to ownership and financial information. The following features of a preferential shipping regime are likely to result in a lack of transparency:

- The regime does not comply with the guidance provided in the Chapter on transparency and effective exchange of information.
- The regime does not comply with guidance concerning transparency in the Chapters on transfer pricing and, where pertinent, the Chapter on rulings. In particular, as regards transfer pricing, there should be sufficient information available to the tax authorities of the regime to be able to identify intra-group transactions with the regime entity and to obtain the information necessary to verify that the transfer pricing of those transactions is in accordance with the arm's length principle.

*c) Exchange of information*

339. An unwillingness or inability to exchange information regarding preferential shipping regimes is an important indicator of the existence of harmful tax practices. The following features of a preferential shipping regime are likely to result in a lack of effective exchange of information:

- The authorities are unable or unwilling to obtain and exchange information including financial information, ownership information and other commercial information, such as registration details, that may be relevant to a specific request regarding a taxpayer benefiting from the regime, taking into account international treaties.
- The regimes does not otherwise comply with the guidance provided in the Chapter on transparency and effective exchange of information.

## APPENDIX: AGREEMENT ON EXCHANGE OF INFORMATION ON TAX MATTERS

### I. INTRODUCTION

1. The purpose of this Agreement is to promote international co-operation in tax matters through exchange of information.

2. The Agreement was developed by the OECD Global Forum Working Group on Effective Exchange of Information (“the Working Group”). The Working Group consisted of representatives from OECD Member countries as well as delegates from Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino.

3. The Agreement grew out of the work undertaken by the OECD to address harmful tax practices. See the 1998 OECD Report “*Harmful Tax Competition: An Emerging Global Issue*” (the “1998 Report”). The 1998 Report identified “the lack of effective exchange of information” as one of the key criteria in determining harmful tax practices. The mandate of the Working Group was to develop a legal instrument that could be used to establish effective exchange of information. The Agreement represents the standard of effective exchange of information for the purposes of the OECD’s initiative on harmful tax practices.

4. This Agreement is not a binding instrument but contains two models for bilateral agreements drawn up in the light of the commitments undertaken by the OECD and the committed jurisdictions. In this context, it is important that financial centres throughout the world meet the standards of tax information exchange set out in this document. As many economies as possible should be encouraged to co-operate in this important endeavour. It is not in the interest of participating economies that the implementation of the standard contained in the Agreement should lead to the migration of business to economies that do not co-operate in the exchange of information. To avoid this result requires measures to defend the integrity of tax systems against the impact of a lack of co-operation in tax information exchange matters. The OECD members and committed jurisdictions have to engage in an ongoing dialogue to work towards implementation of the standard. An adequate framework will be jointly established by the OECD and the committed jurisdictions for this purpose particularly since such a framework would help to achieve a level playing field where no party is unfairly disadvantaged.

5. The Agreement is presented as both a multilateral instrument and a model for bilateral treaties or agreements. The multilateral instrument is not a “multilateral” agreement in the traditional sense. Instead, it provides the basis for an integrated bundle of bilateral treaties. A Party to the multilateral Agreement would only be bound by the Agreement vis-à-vis the specific parties with which it agrees to be bound. Thus, a party wishing to be bound by the multilateral Agreement must specify in its instrument of ratification, approval or acceptance the party or parties vis-à-vis which it wishes to be so bound. The Agreement then enters into force, and creates rights and obligations, only as between those parties that have mutually identified each other in their instruments of ratification, approval or acceptance that have been deposited with the depositary of the Agreement. The bilateral version is intended to serve as a model for bilateral exchange of information agreements. As such, modifications to the text may be agreed in bilateral agreements to implement the standard set in the model.

6. As mentioned above, the Agreement is intended to establish the standard of what constitutes effective exchange of information for the purposes of the OECD's initiative on harmful tax practices. However, the purpose of the Agreement is not to prescribe a specific format for how this standard should be achieved. Thus, the Agreement in either of its forms is only one of several ways in which the standard can be implemented. Other instruments, including double taxation agreements, may also be used provided both parties agree to do so, given that other instruments are usually wider in scope.

7. For each Article in the Agreement there is a detailed commentary intended to illustrate or interpret its provisions. The relevance of the Commentary for the interpretation of the Agreement is determined by principles of international law. In the bilateral context, parties wishing to ensure that the Commentary is an authoritative interpretation might insert a specific reference to the Commentary in the text of the exchange instrument, for instance in the provision equivalent to Article 4, paragraph 2.

## II. TEXT OF THE AGREEMENT

### MULTILATERAL VERSION

The Parties to this Agreement, desiring to facilitate the exchange of information with respect to taxes have agreed as follows:

### BILATERAL VERSION

The government of \_\_\_\_\_ and the government of \_\_\_\_\_, desiring to facilitate the exchange of information with respect to taxes have agreed as follows:

#### Article 1

##### Object and Scope of the Agreement

The competent authorities of the Contracting Parties shall provide assistance through exchange of information that is foreseeably relevant to the administration and enforcement of the domestic laws of the Contracting Parties concerning taxes covered by this Agreement. Such information shall include information that is foreseeably relevant to the determination, assessment and collection of such taxes, the recovery and enforcement of tax claims, or the investigation or prosecution of tax matters. Information shall be exchanged in accordance with the provisions of this Agreement and shall be treated as confidential in the manner provided in Article 8. The rights and safeguards secured to persons by the laws or administrative practice of the requested Party remain applicable to the extent that they do not unduly prevent or delay effective exchange of information.

#### Article 2

##### Jurisdiction

A Requested Party is not obligated to provide information which is neither held by its authorities nor in the possession or control of persons who are within its territorial jurisdiction.

#### Article 3

##### Taxes Covered

### MULTILATERAL VERSION

1. This Agreement shall apply:
  - a) to the following taxes imposed by or on behalf of a Contracting Party:
    - i) taxes on income or profits;

### BILATERAL VERSION

1. The taxes which are the subject of this Agreement are:
  - a) in country A, \_\_\_\_\_;

ii) taxes on capital;

iii) taxes on net wealth;

iv) estate, inheritance or gift taxes;

b) to the taxes in categories referred to in subparagraph a) above, which are imposed by or on behalf of political sub-divisions or local authorities of the Contracting Parties if listed in the instrument of ratification, acceptance or approval.

2. The Contracting Parties, in their instruments of ratification, acceptance or approval, may agree that the Agreement shall also apply to indirect taxes.

3. This Agreement shall also apply to any identical taxes imposed after the date of entry into force of the Agreement in addition to or in place of the existing taxes. This Agreement shall also apply to any substantially similar taxes imposed after the date of entry into force of the Agreement in addition to or in place of the existing taxes if the competent authorities of the Contracting Parties so agree. Furthermore, the taxes covered may be expanded or modified by mutual agreement of the Contracting Parties in the form of an exchange of letters. The competent authorities of the Contracting Parties shall notify each other of any substantial changes to the taxation and related information gathering measures covered by the Agreement.

b) in country B, \_\_\_\_\_.

2. This Agreement shall also apply to any identical taxes imposed after the date of signature of the Agreement in addition to or in place of the existing taxes. This Agreement shall also apply to any substantially similar taxes imposed after the date of signature of the Agreement in addition to or in place of the existing taxes if the competent authorities of the Contracting Parties so agree. Furthermore, the taxes covered may be expanded or modified by mutual agreement of the Contracting Parties in the form of an exchange of letters. The competent authorities of the Contracting Parties shall notify each other of any substantial changes to the taxation and related information gathering measures covered by the Agreement.

## Article 4

### Definitions

#### MULTILATERAL VERSION

1. For the purposes of this Agreement, unless otherwise defined:

a) the term “Contracting Party” means any party that has deposited an instrument of ratification, acceptance or approval with the depositary;

#### BILATERAL VERSION

a) the term “Contracting Party” means country A or country B as the context requires;

b) the term “competent authority” means the authorities designated by a Contracting Party in its instrument of acceptance, ratification or approval;

b) the term “competent authority” means

i) in the case of Country A,  
\_\_\_\_\_;

ii) in the case of Country B,  
\_\_\_\_\_;

c) the term “person” includes an individual, a company and any other body of persons;

d) the term “company” means any body corporate or any entity that is treated as a body corporate for tax purposes;

e) the term “publicly traded company” means any company whose principal class of shares is listed on a recognised stock exchange provided its listed shares can be readily purchased or sold by the public. Shares can be purchased or sold “by the public” if the purchase or sale of shares is not implicitly or explicitly restricted to a limited group of investors;

f) the term “principal class of shares” means the class or classes of shares representing a majority of the voting power and value of the company;

g) the term “recognised stock exchange” means any stock exchange agreed upon by the competent authorities of the Contracting Parties;

h) the term “collective investment fund or scheme” means any pooled investment vehicle, irrespective of legal form. The term “public collective investment fund or scheme” means any collective investment fund or scheme provided the units, shares or other interests in the fund or scheme can be readily purchased, sold or redeemed by the public. Units, shares or other interests in the fund or scheme can be readily purchased, sold or redeemed “by the public” if the purchase, sale or redemption is not implicitly or explicitly restricted to a limited group of investors;

i) the term “tax” means any tax to which the Agreement applies;

j) the term “applicant Party” means the Contracting Party requesting information;

k) the term “requested Party” means the Contracting Party requested to provide information;

l) the term “information gathering measures” means laws and administrative or judicial procedures that enable a Contracting Party to obtain and provide the requested information;

m) the term “information” means any fact, statement or record in any form whatever;

n) the term “depository” means the Secretary-General of the Organisation for Economic Co-operation and Development;

*This paragraph would not be necessary*

o) the term “criminal tax matters” means tax matters involving intentional conduct which is liable to prosecution under the criminal laws of the applicant Party;

p) the term “criminal laws” means all criminal laws designated as such under domestic law irrespective of whether contained in the tax laws, the criminal code or other statutes.

2. As regards the application of this Agreement at any time by a Contracting Party, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that Party, any meaning under the applicable tax laws of that Party prevailing over a meaning given to the term under other laws of that Party.

## **Article 5**

### **Exchange of Information Upon Request**

1. The competent authority of the requested Party shall provide upon request information for the purposes referred to in Article 1. Such information shall be exchanged without regard to whether the conduct being investigated would constitute a crime under the laws of the requested Party if such conduct occurred in the requested Party.

2. If the information in the possession of the competent authority of the requested Party is not sufficient to enable it to comply with the request for information, that Party shall use all relevant information gathering measures to provide the applicant Party with the information requested, notwithstanding that the requested Party may not need such information for its own tax purposes.

3. If specifically requested by the competent authority of an applicant Party, the competent authority of the requested Party shall provide information under this Article, to the extent allowable under its domestic laws, in the form of depositions of witnesses and authenticated copies of original records.

4. Each Contracting Party shall ensure that its competent authorities for the purposes specified in Article 1 of the Agreement, have the authority to obtain and provide upon request:

a) information held by banks, other financial institutions, and any person acting in an agency or fiduciary capacity including nominees and trustees;

b) information regarding the ownership of companies, partnerships, trusts, foundations, “Anstalten” and other persons, including, within the constraints of Article 2, ownership information on all such persons in an ownership chain; in the case of trusts, information on settlors, trustees and beneficiaries; and in the case of foundations, information on founders, members of the foundation council and beneficiaries. Further, this Agreement does not create an obligation on the Contracting Parties to obtain or provide ownership information with respect to publicly traded companies or public collective investment funds or schemes unless such information can be obtained without giving rise to disproportionate difficulties.

5. The competent authority of the applicant Party shall provide the following information to the competent authority of the requested Party when making a request for information under the Agreement to demonstrate the foreseeable relevance of the information to the request:

(a) the identity of the person under examination or investigation;

(b) a statement of the information sought including its nature and the form in which the applicant Party wishes to receive the information from the requested Party;

(c) the tax purpose for which the information is sought;

(d) grounds for believing that the information requested is held in the requested Party or is in the possession or control of a person within the jurisdiction of the requested Party;

(e) to the extent known, the name and address of any person believed to be in possession of the requested information;

(f) a statement that the request is in conformity with the law and administrative practices of the applicant Party, that if the requested information was within the jurisdiction of the applicant Party then the competent authority of the applicant Party would be able to obtain the information under the laws of the applicant Party or in the normal course of administrative practice and that it is in conformity with this Agreement;

(g) a statement that the applicant Party has pursued all means available in its own territory to obtain the information, except those that would give rise to disproportionate difficulties.

6. The competent authority of the requested Party shall forward the requested information as promptly as possible to the applicant Party. To ensure a prompt response, the competent authority of the requested Party shall:

a) Confirm receipt of a request in writing to the competent authority of the applicant Party and shall notify the competent authority of the applicant Party of deficiencies in the request, if any, within 60 days of the receipt of the request.

b) If the competent authority of the requested Party has been unable to obtain and provide the information within 90 days of receipt of the request, including if it encounters obstacles in furnishing the information or it refuses to furnish the information, it shall immediately inform the applicant Party, explaining the reason for its inability, the nature of the obstacles or the reasons for its refusal.

## **Article 6**

### **Tax Examinations Abroad**

#### **MULTILATERAL VERSION**

1. A Contracting Party may allow representatives of the competent authority of another Contracting Party to enter the territory of the first-mentioned Party to interview individuals and examine records with the written consent of the persons concerned. The competent authority of the second-mentioned Party shall notify the competent authority of the first-mentioned Party of the time and place of the meeting with the individuals concerned.

2. At the request of the competent authority of a Contracting Party, the competent authority of another Contracting Party may allow representatives of the competent authority of the first-mentioned Party to be present at the appropriate part of a tax examination in the

#### **BILATERAL VERSION**

1. A Contracting Party may allow representatives of the competent authority of the other Contracting Party to enter the territory of the first-mentioned Party to interview individuals and examine records with the written consent of the persons concerned. The competent authority of the second-mentioned Party shall notify the competent authority of the first-mentioned Party of the time and place of the meeting with the individuals concerned.

2. At the request of the competent authority of one Contracting Party, the competent authority of the other Contracting Party may allow representatives of the competent authority of the first-mentioned Party to be present at the appropriate part of a tax

second-mentioned Party.

3. If the request referred to in paragraph 2 is acceded to, the competent authority of the Contracting Party conducting the examination shall, as soon as possible, notify the competent authority of the other Party about the time and place of the examination, the authority or official designated to carry out the examination and the procedures and conditions required by the first-mentioned Party for the conduct of the examination. All decisions with respect to the conduct of the tax examination shall be made by the Party conducting the examination.

examination in the second-mentioned Party.

3. If the request referred to in paragraph 2 is acceded to, the competent authority of the Contracting Party conducting the examination shall, as soon as possible, notify the competent authority of the other Party about the time and place of the examination, the authority or official designated to carry out the examination and the procedures and conditions required by the first-mentioned Party for the conduct of the examination. All decisions with respect to the conduct of the tax examination shall be made by the Party conducting the examination.

## **Article 7**

### **Possibility of Declining a Request**

1. The requested Party shall not be required to obtain or provide information that the applicant Party would not be able to obtain under its own laws for purposes of the administration or enforcement of its own tax laws. The competent authority of the requested Party may decline to assist where the request is not made in conformity with this Agreement.

2. The provisions of this Agreement shall not impose on a Contracting Party the obligation to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process. Notwithstanding the foregoing, information of the type referred to in Article 5, paragraph 4 shall not be treated as such a secret or trade process merely because it meets the criteria in that paragraph.

3. The provisions of this Agreement shall not impose on a Contracting Party the obligation to obtain or provide information, which would reveal confidential communications between a client and an attorney, solicitor or other admitted legal representative where such communications are:

(a) produced for the purposes of seeking or providing legal advice or

(b) produced for the purposes of use in existing or contemplated legal proceedings.

4. The requested Party may decline a request for information if the disclosure of the information would be contrary to public policy (*ordre public*).

5. A request for information shall not be refused on the ground that the tax claim giving rise to the request is disputed.

6. The requested Party may decline a request for information if the information is requested by the applicant Party to administer or enforce a provision of the tax law of the applicant Party, or any requirement connected therewith, which discriminates against a national of the requested Party as compared with a national of the applicant Party in the same circumstances.

## **Article 8**

### **Confidentiality**

Any information received by a Contracting Party under this Agreement shall be treated as confidential and may be disclosed only to persons or authorities (including courts and administrative bodies) in the jurisdiction of the Contracting Party concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Agreement. Such persons or authorities shall use such information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. The information may not be disclosed to any other person or entity or authority or any other jurisdiction without the express written consent of the competent authority of the requested Party.

## **Article 9**

### **Costs**

Incidence of costs incurred in providing assistance shall be agreed by the Contracting Parties.

## **Article 10**

### **Implementation Legislation**

The Contracting Parties shall enact any legislation necessary to comply with, and give effect to, the terms of the Agreement.

## **Article 11**

### **Language**

*This article may not be required.*

Requests for assistance and answers thereto shall be drawn up in English, French or any other language agreed bilaterally between the competent authorities of the Contracting Parties under Article 13.

## **Article 12**

### **Other international agreements or arrangements**

*This article may not be required*

The possibilities of assistance provided by this Agreement do not limit, nor are they limited by, those contained in existing international agreements or other arrangements between the Contracting Parties which relate to co-operation in tax matters.

## Article 13

### Mutual Agreement Procedure

1. Where difficulties or doubts arise between two or more Contracting Parties regarding the implementation or interpretation of the Agreement, the competent authorities of those Contracting Parties shall endeavour to resolve the matter by mutual agreement.

2. In addition to the agreements referred to in paragraph 1, the competent authorities of two or more Contracting Parties may mutually agree:

a) on the procedures to be used under Articles 5 and 6;

b) on the language to be used in making and responding to requests in accordance with Article 11.

3. The competent authorities of the Contracting Parties may communicate with each other directly for purposes of reaching agreement under this Article.

4. Any agreement between the competent authorities of two or more Contracting Parties shall be effective only between those Contracting Parties.

5. The Contracting Parties may also agree on other forms of dispute resolution.

1. Where difficulties or doubts arise between the Contracting Parties regarding the implementation or interpretation of the Agreement, the competent authorities shall endeavour to resolve the matter by mutual agreement.

2. In addition to the agreements referred to in paragraph 1, the competent authorities of the Contracting Parties may mutually agree on the procedures to be used under Articles 5 and 6.

4. *The paragraph would not be necessary.*

## Article 14

### Depositary's functions

1. The depositary shall notify all Contracting Parties of:

a. the deposit of any instrument of ratification, acceptance or approval of this Agreement;

b. any date of entry into force of this Agreement in accordance with the provisions of Article 15;

*The article would be unnecessary*

c. any notification of termination of this Agreement;

d. any other act or notification relating to this Agreement.

2. At the request of one or more of the competent authorities of the Contracting Parties, the depositary may convene a meeting of the competent authorities or their representatives, to discuss significant matters related to interpretation or implementation of the Agreement.

## **Article 15**

### **Entry into Force**

1. This Agreement is subject to ratification, acceptance or approval. Instruments of ratification, acceptance or approval shall be submitted to the depositary of this Agreement.

2. Each Contracting Party shall specify in its instrument of ratification, acceptance or approval vis-à-vis which other party it wishes to be bound by this Agreement. The Agreement shall enter into force only between Contracting Parties that specify each other in their respective instruments of ratification, acceptance or approval.

3. This Agreement shall enter into force on 1 January 2004 with respect to exchange of information for criminal tax matters. The Agreement shall enter into force on 1 January 2006 with respect to all other matters covered in Article 1.

For each party depositing an instrument after such entry into force, the Agreement shall enter into force on the 30<sup>th</sup> day following the deposit of both instruments.

1. This Agreement is subject to ratification, acceptance or approval by the Contracting Parties, in accordance with their respective laws. Instruments of ratification, acceptance or approval shall be exchanged as soon as possible.

2. This Agreement shall enter into force on 1 January 2004 with respect to exchange of information for criminal tax matters. The Agreement shall enter into force on 1 January 2006 with respect to all other matters covered in Article 1.

4. Unless an earlier date is agreed by the Contracting Parties, the provisions of this Agreement shall have effect

- with respect to criminal tax matters for taxable periods beginning on or after 1 January 2004 or, where there is no taxable period, for all charges to tax arising on or after 1 January 2004;
- with respect to all other matters described in Article 1 for all taxable periods beginning on or after January 1 2006 or, where there is no taxable period, for all charges to tax arising on or after 1 January 2006.

In cases addressed in the third sentence of paragraph 3, the Agreement shall take effect for all taxable periods beginning on or after the sixtieth day following entry into force, or where there is no taxable period for all charges to tax arising on or after the sixtieth day following entry into force.

3. The provisions of this Agreement shall have effect:

- with respect to criminal tax matters for taxable periods beginning on or after 1 January 2004 or, where there is no taxable period, for all charges to tax arising on or after 1 January 2004;
- with respect to all other matters described in Article 1 for all taxable periods beginning on or after January 1 2006 or, where there is no taxable period, for all charges to tax arising on or after 1 January 2006.

## Article 16

### Termination

1. Any Contracting Party may terminate this Agreement vis-à-vis any other Contracting Party by serving a notice of termination either through diplomatic channels or by letter to the competent authority of the other Contracting Party. A copy shall be provided to the depositary of the Agreement.

2. Such termination shall become effective on the first day of the month following the expiration of a period of six months after the date of receipt of the notification by the depositary.

3. Any Contracting Party that terminates the Agreement shall remain bound by the provisions of Article 8 with respect to any information obtained under the Agreement.

### Termination

1. Either Contracting Party may terminate the Agreement by serving a notice of termination either through diplomatic channels or by letter to the competent authority of the other Contracting Party.

2. Such termination shall become effective on the first day of the month following the expiration of a period of six months after the date of receipt of notice of termination by the other Contracting Party.

3. A Contracting Party that terminates the Agreement shall remain bound by the provisions of Article 8 with respect to any information obtained under the Agreement.

In witness whereof, the undersigned, being duly authorised thereto, have signed the Agreement.

### **III. COMMENTARY**

#### **Title and Preamble**

1. The preamble sets out the general objective of the Agreement. The objective of the Agreement is to facilitate exchange of information between the parties to the Agreement. The multilateral and the bilateral versions of the preamble are identical except that the multilateral version refers to the signatories of the Agreement as “Parties” and the bilateral version refers to the signatories as the “Government of \_\_\_\_\_.” The formulation “Government of \_\_\_\_\_” in the bilateral context is used for illustrative purposes only and countries are free to use other wording in accordance with their domestic requirements or practice.

#### **Article 1 (Object and Scope of Agreement)**

2. Article 1 defines the scope of the Agreement, which is the provision of assistance in tax matters through exchange of information that will assist the Contracting Parties to administer and enforce their tax laws.

3. The Agreement is limited to exchange of information that is foreseeably relevant to the administration and enforcement of the laws of the applicant Party concerning the taxes covered by the Agreement. The standard of foreseeable relevance is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting Parties are not at liberty to engage in fishing expeditions or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer. Parties that choose to enter into bilateral agreements based on the Agreement may agree to an alternative formulation of this standard, provided that such alternative formulation is consistent with the scope of the Agreement.

4. The Agreement uses the standard of foreseeable relevance in order to ensure that information requests may not be declined in cases where a definite assessment of the pertinence of the information to an on-going investigation can only be made following the receipt of the information. The standard of foreseeable relevance is also used in the Joint Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters.

5. The last sentence of Article 1 ensures that procedural rights existing in the requested Party will continue to apply to the extent they do not unduly prevent or delay effective exchange of information. Such rights may include, depending on the circumstances, a right of notification, a right to challenge the exchange of information following notification or rights to challenge information gathering measures taken by the requested Party. Such procedural rights and safeguards also include any rights secured to persons that may flow from relevant international agreements on human rights and the expression “unduly prevent or delay” indicates that such rights may take precedence over the Agreement.

6. Article 1 strikes a balance between rights granted to persons in the requested Party and the need for effective exchange of information. Article 1 provides that rights and safeguards are not overridden

simply because they could, in certain circumstances, operate to prevent or delay effective exchange of information. However, Article 1 obliges the requested Party to ensure that any such rights and safeguards are not applied in a manner that unduly prevents or delays effective exchange of information. For instance, a bona fide procedural safeguard in the requested Party may delay a response to an information request. However, such a delay should not be considered as “unduly preventing or delaying” effective exchange of information unless the delay is such that it calls into question the usefulness of the information exchange agreement for the applicant Party. Another example may concern notification requirements. A requested Party whose laws require prior notification is obliged to ensure that its notification requirements are not applied in a manner that, in the particular circumstances of the request, would frustrate the efforts of the party seeking the information. For instance, notification rules should permit exceptions from prior notification (*e.g.*, in cases in which the information request is of a very urgent nature or the notification is likely to undermine the chance of success of the investigation conducted by the applicant Party). To avoid future difficulties or misunderstandings in the implementation of an agreement, the Contracting Parties should consider discussing these issues in detail during negotiations and in the course of implementing the agreement in order to ensure that information requested under the agreement can be obtained as expeditiously as possible while ensuring adequate protection of taxpayers’ rights.

### **Article 2 (Jurisdiction)**

7. Article 2 addresses the jurisdictional scope of the Agreement. It clarifies that a requested Party is not obligated to provide information which is neither held by its authorities nor is in the possession or control of persons within its territorial jurisdiction. The requested Party’s obligation to provide information is not, however, restricted by the residence or the nationality of the person to whom the information relates or by the residence or the nationality of the person in control or possession of the information requested. The term “possession or control” should be construed broadly and the term “authorities” should be interpreted to include all government agencies. Of course, a requested Party would nevertheless be under no obligation to provide information held by an “authority” if the circumstances described in Article 7 (Possibility of Declining a Request) were met.

### **Article 3 (Taxes Covered)**

#### *Paragraph 1*

8. Article 3 is intended to identify the taxes with respect to which the Contracting Parties agree to exchange information in accordance with the provisions of the Agreement. Article 3 appears in two versions: a multilateral version and a bilateral version. The multilateral Agreement applies to taxes on income or profits, taxes on capital, taxes on net wealth, and estate, inheritance or gift taxes. “Taxes on income or profits” includes taxes on gains from the alienation of movable or immovable property. The multilateral Agreement, in sub-paragraph b), further permits the inclusion of taxes imposed by or on behalf of political sub-divisions or local authorities. Such taxes are covered by the Agreement only if they are listed in the instrument of ratification, approval or acceptance.

9. Bilateral agreements will cover, at a minimum, the same four categories of direct taxes (*i.e.*, taxes on income or profits, taxes on capital, taxes on net wealth, and estate, inheritance or gift taxes) unless both parties agree to waive one or more of them. A Contracting Party may decide to omit any or all of the four categories of direct taxes from its list of taxes to be covered but it would nevertheless be obligated to respond to requests for information with respect to the taxes listed by the other Contracting Party (assuming the request otherwise satisfies the terms of the Agreement). The Contracting Parties may also agree to cover taxes other than the four categories of direct taxes. For example, Contracting Party A may list all four direct taxes and Contracting Party B may list only indirect taxes. Such an outcome is likely where the two Contracting Parties have substantially different tax regimes.

### *Paragraph 2*

10. Paragraph 2 of the multilateral version provides that the Contracting Parties may agree to extend the Agreement to cover indirect taxes. This possible extension is consistent with Article 26 of the OECD Model Convention on Income and on Capital, which now covers “taxes of every kind and description.” There is no equivalent to paragraph 2 in the bilateral version because the issue can be addressed under paragraph 1. Any agreement to extend the Agreement to cover indirect taxes should be notified to the depositary. Paragraph 2 of the bilateral version is discussed below together with paragraph 3 of the multilateral version.

### *Paragraph 3*

11. Paragraph 3 of the multilateral version and paragraph 2 of the bilateral version address “identical taxes”, “substantially similar taxes” and further contain a rule on the expansion or modification of the taxes covered by the Agreement. The Agreement applies automatically to all “identical taxes”. The Agreement applies to “substantially similar taxes” if the competent authorities so agree. Finally, the taxes covered by the Agreement can be expanded or modified if the Contracting Parties so agree.

12. The only difference between paragraph 3 of the multilateral version and paragraph 2 of the bilateral version is that the former refers to the date of entry into force whereas the later refers to the date of signature. The multilateral version refers to entry into force because in the multilateral context there might be no official signing of the Agreement between the Contracting Parties.

13. In the multilateral context the first sentence of paragraph 3 is of a declaratory nature only. The multilateral version lists the taxes by general type. Any tax imposed after the date of signature or entry into force of the Agreement that is of such a type is already covered by operation of paragraph 1. The same holds true in the bilateral context, if the Contracting Parties choose to identify the taxes by general type. Certain Contracting Parties, however, may wish to identify the taxes to which the Agreement applies by specific name (*e.g.*, the Income Tax Act of 1999). In these cases, the first sentence makes sure that the Agreement also applies to taxes that are identical to the taxes specifically identified.

14. The meaning of “identical” should be construed very broadly. For instance, any replacement tax of an existing tax that does not change the nature of the tax should be considered an “identical” tax. Contracting Parties seeking to avoid any uncertainty regarding the interpretation of “identical” versus “substantially similar” may wish to delete the second sentence and to include substantially similar taxes within the first sentence.

## **Article 4 (Definitions)**

### *Paragraph 1*

15. Article 4 contains the definitions of terms for purposes of the Agreement. Article 4, paragraph 1, sub-paragraph a) defines the term “Contracting Party”. Sub-paragraph b) defines the term “competent authority.” The definition recognises that in some Contracting Parties the execution of the Agreement may not fall exclusively within the competence of the highest tax authorities and that some matters may be reserved or may be delegated to other authorities. The definition enables each Contracting Party to designate one or more authorities as being competent to execute the Agreement. While the definition provides the Contracting Parties with the possibility of designating more than one competent authority (for instance, where Contracting Parties agree to cover both direct and indirect taxes), it is customary practice to have only one competent authority per Contracting Party.

16. Sub-paragraph c) defines the meaning of “person” for purposes of the Agreement. The definition of the term “person” given in sub-paragraph c) is intended to be very broad. The definition explicitly mentions an individual, a company and any other body of persons. However, the use of the word “includes” makes clear that the Agreement also covers any other organisational structures such as trusts, foundations, “Anstalten,” partnerships as well as collective investment funds or schemes.

17. Foundations, “Anstalten” and similar arrangements are covered by this Agreement irrespective of whether or not they are treated as an “entity that is treated as a body corporate for tax purposes” under sub-paragraph d).

18. Trusts are also covered by this Agreement. Thus, competent authorities of the Contracting Parties must have the authority to obtain and provide information on trusts (such as the identity of settlors, beneficiaries or trustees) irrespective of the classification of trusts under their domestic laws.

19. The main example of a “body of persons” is the partnership. In addition to partnerships, the term “body of persons” also covers less commonly used organisational structures such as unincorporated associations.

20. In most cases, applying the definition should not raise significant issues of interpretation. However, when applying the definition to less commonly used organisational structures, interpretation may prove more difficult. In these cases, particular attention must be given to the context of the Agreement. *Cf. Article 4, paragraph 2.* The key operational article that uses the term “person” is Article 5, paragraph 4, sub-paragraph b), which provides that a Contracting Party must have the authority to obtain and provide ownership information for all “persons” within the constraints of Article 2. Too narrow an interpretation may jeopardise the object and purposes of the Agreement by potentially excluding certain entities or other organisational structures from this obligation simply as a result of certain corporate or other legal features. Therefore, the aim is to cover all possible organisational structures.

21. For instance an “estate” is recognised as a distinct entity under the laws of certain countries. An “estate” typically denotes property held under the provisions of a will by a fiduciary (and under the direction of a court) whose duty it is to preserve and protect such property for distribution to the beneficiaries. Similarly a legal system might recognise an organisational structure that is substantially similar to a trust or foundation but may refer to it by a different name. The standard of Article 4, paragraph 2 makes clear that where these arrangements exist under the applicable law they constitute “persons” under the definition of sub-paragraph c).

22. Sub-paragraph d) provides the definition of company and is identical to Article 3, paragraph 1 sub-paragraph b) of the OECD Model Convention on Income and on Capital.

23. Sub-paragraphs e) through h) define “publicly traded company” and “collective investment fund or scheme.” Both terms are used in Article 5 paragraph 4, sub-paragraph b). Sub-paragraphs e) through g) contain the definition of publicly traded company and sub-paragraph h) addresses collective investment funds or schemes.

24. For reasons of simplicity the definitions do not require a minimum percentage of interests traded (*e.g.*, 5 percent of all outstanding shares of a publicly listed company) but somewhat more broadly require that equity interests must be “readily” available for sale, purchase or redemption. The fact that a collective investment fund or scheme may operate in the form of a publicly traded company should not raise any issues because the definitions for both publicly traded company and collective investment fund or scheme are essentially identical.

25. Sub-paragraph e) provides that a “publicly traded company” is any company whose principal class of shares is listed on a recognised stock exchange and whose listed shares can be readily sold or purchased by the public. The term “principal class of shares” is defined in sub-paragraph f). The definition ensures that companies that only list a minority interest do not qualify as publicly traded companies. A publicly traded company can only be a company that lists shares representing both a majority of the voting rights and a majority of the value of the company.

26. The term “recognised stock exchange” is defined in sub-paragraph g) as any stock exchange agreed upon by the competent authorities. One criterion competent authorities might consider in this context is whether the listing rules, including the wider regulatory environment, of any given stock exchange contain sufficient safeguards against private limited companies posing as publicly listed companies. Competent authorities might further explore whether there are any regulatory or other requirements for the disclosure of substantial interests in any publicly listed company.

27. The term “by the public” is defined in the second sentence of sub-paragraph e). The definition seeks to ensure that share ownership is not restricted to a limited group of investors. Examples of cases in which the purchase or sale of shares is restricted to a limited group of investors would include the following situations: shares can only be sold to existing shareholders, shares are only offered to members of a family or to related group companies, shares can only be bought by members of an investment club, a partnership or other association.

28. Restrictions on the free transferability of shares that are imposed by operation of law or by a regulatory authority or are conditional or contingent upon market related events are not restrictions that limit the purchase or sale of shares to a “limited group of investors”. By way of example, a restriction on the free transferability of shares of a corporate entity that is triggered by attempts by a group of investors or non-investors to obtain control of a company is not a restriction that limits the purchase or sale of shares to a “limited group of investors”.

29. The insertion of “readily” reflects the fact that where shares do not change hands to any relevant degree the rationale for the special mention of publicly traded companies in Article 5, paragraph 4, sub-paragraph b) does not apply. Thus, for a publicly traded company to meet this standard, more than a negligible portion of its listed shares must actually be traded.

30. Sub-paragraph h) defines a collective investment fund or scheme as any pooled investment vehicle irrespective of legal form. The definition includes collective investment funds or schemes structured as companies, partnerships, trusts as well as purely contractual arrangements. Sub-paragraph h) then defines “public collective investment funds or schemes” as any collective investment fund or scheme where the interests in the vehicle can be readily purchased, sold, or redeemed by the public. The terms “readily” and “by the public” have the same meaning that they have in connection with the definition of publicly traded companies.

31. Sub-paragraphs i, j) and k) are self-explanatory.

32. Sub-paragraph l) defines “information gathering measures.” Each Contracting Party determines the form of such powers and the manner in which they are implemented under its internal law. Information gathering measures typically include requiring the presentation of records for examination, gaining direct access to records, making copies of such records and interviewing persons having knowledge, possession, control or custody of pertinent information. Information gathering measures will typically focus on obtaining the requested information and will in most cases not themselves address the provision of the information to the applicant Party.

33. Sub-paragraph m) defines “information”. The definition is very broad and includes any fact, statement or record in any form whatever. “Record” includes (but is not limited to): an account, an agreement, a book, a chart, a table, a diagram, a form, an image, an invoice, a letter, a map, a memorandum, a plan, a return, a telegram and a voucher. The term “record” is not limited to information maintained in paper form but includes information maintained in electronic form.

34. Sub-paragraph n) of the multilateral version provides that the depositary of the Agreement is the Secretary General of the OECD.

35. Sub-paragraph o) defines criminal tax matters. Criminal tax matters are defined as all tax matters involving intentional conduct, which is liable to prosecution under the criminal laws of the applicant Party. Criminal law provisions based on non-intentional conduct (*e.g.*, provisions that involve strict or absolute liability) do not constitute criminal tax matters for purposes of the Agreement. A tax matter involves “intentional conduct” if the pertinent criminal law provision requires an element of intent. Sub-paragraph o) does not create an obligation on the part of the applicant Party to prove to the requested Party an element of intent in connection with the actual conduct under investigation.

36. Typical categories of conduct that constitute tax crimes include the wilful failure to file a tax return within the prescribed time period; wilful omission or concealment of sums subject to tax; making false or incomplete statements to the tax or other authorities of facts which obstruct the collection of tax; deliberate omissions of entries in books and records; deliberate inclusion of false or incorrect entries in books and records; interposition for the purposes of causing all or part of the wealth of another person to escape tax; or consenting or acquiescing to an offence. Tax crimes, like other crimes, are punished through fines, incarceration or both.

37. Sub-paragraph p) defines the term “criminal laws” used in sub-paragraph o). It makes clear that criminal laws include criminal law provisions contained in a tax code or any other statute enacted by the applicant Party. It further clarifies that criminal laws are only such laws that are designated as such under domestic law and do not include provisions that might be deemed of a criminal nature for other purposes such as for purposes of applying relevant human rights or other international conventions.

## *Paragraph 2*

38. This paragraph establishes a general rule of interpretation for terms used in the Agreement but not defined therein. The paragraph is similar to that contained in the OECD Model Convention on Income and on Capital. It provides that any term used, but not defined, in the Agreement will be given the meaning it has under the law of the Contracting Party applying the Agreement unless the context requires otherwise. Contracting Parties may agree to allow the competent authorities to use the Mutual Agreement Procedure provided for in Article 13 to agree the meaning of such an undefined term. However, the ability to do so may depend on constitutional or other limitations. In cases in which the laws of the Contracting Party applying the Agreement provide several meanings, any meaning given to the term under the applicable tax laws will prevail over any meaning that is given to the term under any other laws. The last part of the sentence is, of course, operational only where the Contracting Party applying the Agreement imposes taxes and therefore has “applicable tax laws.”

## **Article 5 (Exchange of Information Upon Request)**

### *Paragraph 1*

39. Paragraph 1 provides the general rule that the competent authority of the requested Party must provide information upon request for the purposes referred to in Article 1. The paragraph makes clear that the Agreement only covers exchange of information upon request (*i.e.*, when the information requested relates to a particular examination, inquiry or investigation) and does not cover automatic or spontaneous exchange of information. However, Contracting Parties may wish to consider expanding their co-operation in matters of information exchange for tax purposes by covering automatic and spontaneous exchanges and simultaneous tax examinations.

40. The reference in the first sentence to Article 1 of the Agreement confirms that information must be exchanged for both civil and criminal tax matters. The second sentence of paragraph 1 makes clear that information in connection with criminal tax matters must be exchanged irrespective of whether or not the conduct being investigated would also constitute a crime under the laws of the requested Party.

### *Paragraph 2*

41. Paragraph 2 is intended to clarify that, in responding to a request, a Contracting Party will have to take action to obtain the information requested and cannot rely solely on the information in the possession of its competent authority. Reference is made to information “in its possession” rather than “available in the tax files” because some Contracting Parties do not have tax files because they do not impose direct taxes.

42. Upon receipt of an information request the competent authority of the requested Party must first review whether it has all the information necessary to respond to a request. If the information in its own possession proves inadequate, it must take “all relevant information gathering measures” to provide the applicant Party with the information requested. The term “information gathering measures” is defined in Article 4, paragraph 1, sub-paragraph l). An information gathering measure is “relevant” if it is capable of obtaining the information requested by the applicant Party. The requested Party determines which information gathering measures are relevant in a particular case.

43. Paragraph 2 further provides that information must be exchanged without regard to whether the requested Party needs the information for its own tax purposes. This rule is needed because a tax interest requirement might defeat effective exchange of information, for instance, in cases where the requested Party does not impose an income tax or the request relates to an entity not subject to taxation within the requested Party.

### *Paragraph 3*

44. Paragraph 3 includes a provision intended to require the provision of information in a format specifically requested by a Contracting Party to satisfy its evidentiary or other legal requirements to the extent allowable under the laws of the requested Party. Such forms may include depositions of witnesses and authenticated copies of original records. Under paragraph 3, the requested Party may decline to provide the information in the specific form requested if such form is not allowable under its laws. A refusal to provide the information in the format requested does not affect the obligation to provide the information.

45. If requested by the applicant Party, authenticated copies of unedited original records should be provided to the applicant Party. However, a requested Party may need to edit information unrelated to the

request if the provision of such information would be contrary to its laws. Furthermore, in some countries authentication of documents might require translation in a language other than the language of the original record. Where such issues may arise, Contracting Parties should consider discussing these issues in detail during discussions prior to the conclusion of this Agreement.

#### *Paragraph 4*

46. Paragraph 4, sub-paragraph a), by referring explicitly to persons that may enjoy certain privilege rights under domestic law, makes clear that such rights can not form the basis for declining a request unless otherwise provided in Article 7. For instance, the inclusion of a reference to bank information in paragraph 4, sub-paragraph a) rules out that bank secrecy could be considered a part of public policy (*ordre public*). Similarly, paragraph 4, sub-paragraph a) together with Article 7, paragraph 2 makes clear that information that does not otherwise constitute a trade, business, industrial, commercial or professional secret or trade process does not become such a secret simply because it is held by one of the persons mentioned.

47. Sub-paragraph a) should not be taken to suggest that a competent authority is obliged only to have the authority to obtain and provide information from the persons mentioned. Sub-paragraph a) does not limit the obligation imposed by Article 5, paragraph 1.

48. Sub-paragraph a) mentions information held by banks and other financial institutions. In accordance with the Report *“Improving Access to Bank Information for Tax Purposes”* (OECD 2000), access to information held by banks or other financial institutions may be by direct means or indirectly through a judicial or administrative process. As stated in the report, the procedure for indirect access should not be so burdensome and time-consuming as to act as an impediment to access to bank information. Typically, requested bank information includes account, financial, and transactional information as well as information on the identity or legal structure of account holders and parties to financial transactions.

49. Paragraph 4, sub-paragraph a) further mentions information held by persons acting in an agency or fiduciary capacity, including nominees and trustees. A person is generally said to act in a "fiduciary capacity" when the business which he transacts, or the money or property, which he handles, is not his own or for his own benefit, but for the benefit of another person, as to whom he stands in a relation implying and necessitating confidence and trust on the one part and good faith on the other part. The term "agency" is very broad and includes all forms of corporate service providers (*e.g.*, company formation agents, trust companies, registered agents, lawyers).

50. Sub-paragraph b) requires that the competent authorities of the Contracting Parties must have the authority to obtain and provide ownership information. The purpose of the sub-paragraph is not to develop a common "all purpose" definition of ownership among Contracting Parties, but to specify the types of information that a Contracting Party may legitimately expect to receive in response to a request for ownership information so that it may apply its own tax laws, including its domestic definition of beneficial ownership.

51. In connection with companies and partnerships, the legal and beneficial owner of the shares or partnership assets will usually be the same person. However, in some cases the legal ownership position may be subject to a nominee or similar arrangement. Where the legal owner acts on behalf of another person as a nominee or under a similar arrangement, such other person, rather than the legal owner, may be the beneficial owner. Thus the starting point for the ownership analysis is legal ownership of shares or partnership interests and all Contracting Parties must be able to obtain and provide information on legal ownership. Partnership interests include all forms of partnership interests: general or limited or capital or profits. However, in certain cases, legal ownership may be no more than a starting point. For example, in

any case where the legal owner acts on behalf of any other person as a nominee or under a similar arrangement, the Contracting Parties should have the authority to obtain and provide information about that other person who may be the beneficial owner in addition to information about the legal owner. An example of a nominee is a nominee shareholding arrangement where the legal title-holder that also appears as the shareholder of record acts as an agent for another person. Within the constraints of Article 2 of the Agreement, the requested Party must have the authority to provide information about the persons in an ownership chain.

52. In connection with trusts and foundations, sub-paragraph b) provides specifically the type of identity information the Contracting Parties should have the authority to obtain and provide. This is not limited to ownership information. The same rules should also be applied to persons that are substantially similar to trusts or foundations such as the “Anstalt.” Therefore, a Contracting Party should have, for example, the authority to obtain and provide information on the identity of the settlor and the beneficiaries and persons who are in a position to direct how assets of the trust or foundation are to be dealt with.

53. Certain trusts, foundations, “Anstalten” or similar arrangements, may not have any identified group of persons as beneficiaries but rather may support a general cause. Therefore, ownership information should be read to include only identifiable persons. The term “foundation council” should be interpreted very broadly to include any person or body of persons managing the foundation as well as persons who are in a position to direct how assets of the trust or foundation are to be dealt with.

54. Most organisational structures will be classified as a company, a partnership, a trust, a foundation or a person similar to a trust or foundation. However, there might be entities or structures for which ownership information might be legitimately requested but that do not fall into any of these categories. For instance, a structure might, as a matter of law, be of a purely contractual nature. In these cases, the Contracting Parties should have the authority to obtain and provide information about any person with a right to share in the income or gain of the structure or in the proceeds from any sale or liquidation.

55. Sub-paragraph b) also provides that a requested Party must have the authority to obtain and provide ownership information for all persons in an ownership chain provided, as is set out in Article 2, the information is held by the authorities of the requested State or is in the possession or control of persons who are within the territorial jurisdiction of the requested Party. This language ensures that the applicant Party need not submit separate information requests for each level of a chain of companies or other persons. For instance, assume company A is a wholly-owned subsidiary of company B and both companies are incorporated under the laws of Party C, a Contracting Party of the Agreement. If Party D, also a Contracting Party, requests ownership information on company A and specifies in the request that it also seeks ownership information on any person in A’s chain of ownership, Party C in its response to the request must provide ownership information for both company A and B.

56. The second sentence of sub-paragraph b) provides that in the case of publicly traded companies and public collective investment funds or schemes, the competent authorities need only provide ownership information that the requested Party can obtain without disproportionate difficulties. Information can be obtained only with “disproportionate difficulties” if the identification of owners, while theoretically possible, would involve excessive costs or resources. Because such difficulties might easily arise in connection with publicly traded companies and public collective investment funds or schemes where a true public market for ownership interests exists, it was felt that such a clarification was particularly warranted. At the same time it is recognised that where a true public market for ownership interests exists there is less of a risk that such vehicles will be used for tax evasion or other non-compliance with the tax law. The definitions of publicly traded companies and public collective investment funds or schemes are contained in Article 4, paragraph 1, sub-paragraphs e) through h).

## *Paragraph 5*

57. Paragraph 5 lists the information that the applicant Party must provide to the requested Party in order to demonstrate the foreseeable relevance of the information requested to the administration or enforcement of the applicant Party's tax laws. While paragraph 5 contains important procedural requirements that are intended to ensure that fishing expeditions do not occur, subparagraphs a) through g) nevertheless need to be interpreted liberally in order not to frustrate effective exchange of information. The following paragraphs give some examples to illustrate the application of the requirements in certain situations.

### 58. Example 1 (sub-paragraph (a))

Where a Party is asking for account information but the identity of the account holder(s) is unknown, subparagraph (a) may be satisfied by supplying the account number or similar identifying information.

### 59. Example 2 (sub-paragraph (d)) ("is held")

A taxpayer of Country A withdraws all funds from his bank account and is handed a large amount of cash. He visits one bank in both country B and C, and then returns to Country A without the cash. In connection with a subsequent investigation of the taxpayer, the competent authority of Country A sends a request to Country B and to Country C for information regarding bank accounts that may have been opened by the taxpayer at one or both of the banks he visited. Under such circumstances, the competent authority of Country A has grounds to believe that the information is held in Country B or is in the possession or control of a person subject to the jurisdiction of Country B. It also has grounds to believe the same with respect to Country C. Country B (or C) can not decline the request on the basis that Country A has failed to establish that the information "is" in Country B (or C), because it is equally likely that the information is in the other country.

### 60. Example 3 (sub-paragraph (d))

A similar situation may arise where a person under investigation by Country X may or may not have fled Country Y and his bank account there may or may not have been closed. As long as country X is able to connect the person to Country Y, Country Y may not refuse the request on the ground that Country X does not have grounds for believing that the requested information "is" held in Country Y. Country X may legitimately expect Country Y to make an inquiry into the matter, and if a bank account is found, to provide the requested information.

61. Sub-paragraph d) provides that the applicant Party shall inform the requested Party of the grounds for believing that the information is held in the requested Party or is in the possession or control of a person within the jurisdiction of the requested Party. The term "held in the requested Party" includes information held by any government agency or authority of the requested Party.

62. Sub-paragraph f) needs to be read in conjunction with Article 7, paragraph 1. In particular, see paragraph 77 of the Commentary on Article 7. The statement required under sub-paragraph f) covers three elements: first, that the request is in conformity with the law and administrative practices of the applicant Party; second, that the information requested would be obtainable under the laws or in the normal course of administration of the applicant Party if the information were within the jurisdiction of the applicant Party; and third, that the information request is in conformity with the Agreement. The "normal course of administrative practice" may include special investigations or special examinations of the business accounts kept by the taxpayer or other persons, provided that the tax authorities of the applicant Party would make similar investigations or examinations if the information were within their jurisdiction.

63. Sub-paragraph g) is explained by the fact that, depending on the tax system of the requested Party, a request for information may place an extra burden on the administrative machinery of the requested Party. Therefore, a request should only be contemplated if an applicant Party has no convenient means to obtain the information available within its own jurisdiction. In as far as other means are still available in the applicant Party, the statement prescribed in sub-paragraph g) should explain that these would give rise to disproportionate difficulties. In this last case an element of proportionality plays a role. It should be easier for the requested Party to obtain the information sought after, than for the applicant Party. For example, obtaining information from one supplier in the requested Party may lead to the same information as seeking information from a large number of buyers in the applicant Party.

64. It is in the applicant Party's own interest to provide as much information as possible in order to facilitate the prompt response by the requested Party. Hence, incomplete information requests should be rare. The requested Party may ask for additional information but a request for additional information should not delay a response to an information request that complies with the rules of paragraph 5. For possibilities of declining a request, see Article 7 and the accompanying Commentary.

#### *Paragraph 6*

65. Paragraph 6 sets out procedures for handling requests to ensure prompt responses. The 90 day period set out in subparagraph b) may be extended if required, for instance, by the volume of information requested or the need to authenticate numerous documents. If the competent authority of the requested Party is unable to provide the information within the 90 day period it should immediately notify the competent authority of the applicant Party. The notification should specify the reasons for not having provided the information within the 90 day period (or extended period). Reasons for not having provided the information include, a situation where a judicial or administrative process required to obtain the information has not yet been completed. The notification may usefully contain an estimate of the time still needed to comply with the request. Finally, paragraph 6 encourages the requested Party to react as promptly as possible and, for instance, where appropriate and practical, even before the time limits established under sub-paragraphs a) and b) have expired.

### **Article 6 (Tax Examinations Abroad)**

#### *Paragraph 1*

66. Paragraph 1 provides that a Contracting Party may allow representatives of the applicant Party to enter the territory of the requested Party to interview individuals and to examine records with the written consent of the persons concerned. The decision of whether to allow such examinations and if so on what terms, lies exclusively in the hands of the requested Party. For instance, the requested Party may determine that a representative of the requested Party is present at some or all such interviews or examinations. This provision enables officials of the applicant Party to participate directly in gathering information in the requested Party but only with the permission of the requested Party and the consent of the persons concerned. Officials of the applicant Party would have no authority to compel disclosure of any information in those circumstances. Given that many jurisdictions and smaller countries have limited resources with which to respond to requests, this provision can be a useful alternative to the use of their own resources to gather information. While retaining full control of the process, the requested Party is freed from the cost and resource implications that it may otherwise face. Country experience suggests that tax examinations abroad can benefit both the applicant and the requested Party. Taxpayers could be interested in such a procedure because, it might spare them the burden of having to make copies of voluminous records to respond to a request.

## *Paragraph 2*

67. Paragraph 2 authorises, but does not require, the requested Party to permit the presence of foreign tax officials to be present during a tax examination initiated by the requested Party in its jurisdiction, for example, for purposes of obtaining the requested information. The decision of whether to allow the foreign representatives to be present lies exclusively within the hands of the competent authority of the requested Party. It is understood that this type of assistance should not be requested unless the competent authority of the applicant Party is convinced that the presence of its representatives at the examination in the requested Party will contribute to a considerable extent to the solution of a domestic tax case. Furthermore, requests for such assistance should not be made in minor cases. This does not necessarily imply that large amounts of tax have to be involved in the particular case. Other justifications for such a request may be the fact that the matter is of prime importance for the solution of other domestic tax cases or that the foreign examination is to be regarded as part of an examination on a large scale embracing domestic enterprises and residents.

68. The applicant Party should set out the motive for the request as thoroughly as possible. The request should include a clear description of the domestic tax case to which the request relates. It should also indicate the special reasons why the physical presence of a representative of the competent authority is important. If the competent authority of the applicant Party wishes the examination to be conducted in a specific manner or at a specified time, such wishes should be stated in the request.

69. The representatives of the competent authority of the applicant Party may be present only for the appropriate part of the tax examination. The authorities of the requested Party will ensure that this requirement is fulfilled by virtue of the exclusive authority they exercise in respect of the conduct of the examination.

## *Paragraph 3*

70. Paragraph 3 sets out the procedures to be followed if a request under paragraph 2 has been granted. All decisions on how the examination is to be carried out will be taken by the authority or the official of the requested Party in charge of the examination.

## **Article 7 (Possibility of Declining a Request)**

71. The purpose of this Article is to identify the situations in which a requested Party is not required to supply information in response to a request. If the conditions for any of the grounds for declining a request under Article 7 are met, the requested Party is given discretion to refuse to provide the information but it should carefully weigh the interests of the applicant Party with the pertinent reasons for declining the request. However, if the requested Party does provide the information the person concerned cannot allege an infraction of the rules on secrecy. In the event that the requested Party declines a request for information it shall inform the applicant Party of the grounds for its decision at the earliest opportunity.

## *Paragraph 1*

72. The first sentence of paragraph 1 makes clear that a requested Party is not required to obtain and provide information that the applicant Party would not be able to obtain under similar circumstances under its own laws for purposes of the administration or enforcement of its own tax laws.

73. This rule is intended to prevent the applicant Party from circumventing its domestic law limitations by requesting information from the other Contracting Party thus making use of greater powers than it possesses under its own laws. For instance, most countries recognise under their domestic laws that

information cannot be obtained from a person to the extent such person can claim the privilege against self-incrimination. A requested Party may, therefore, decline a request if the applicant Party would have been precluded by its own self-incrimination rules from obtaining the information under similar circumstances.

74. In practice, however, the privilege against self-incrimination should have little, if any, application in connection with most information requests. The privilege against self-incrimination is personal and cannot be claimed by an individual who himself is not at risk of criminal prosecution. The overwhelming majority of information requests seek to obtain information from third parties such as banks, intermediaries or the other party to a contract and not from the individual under investigation. Furthermore, the privilege against self-incrimination generally does not attach to persons other than natural persons.

75. The second sentence of paragraph 1 provides that a requested Party may decline a request for information in cases where the request is not made in conformity with the Agreement.

76. Both the first and the second sentence of paragraph 1 raise the question of how the statements provided by the applicant Party under Article 5, paragraph 5, sub-paragraph f) relate to the grounds for declining a request under Article 7, paragraph 1. The provision of the respective statements should generally be sufficient to establish that no reasons for declining a request under Article 7, paragraph 1 exist. However, a requested Party that has received statements to this effect may still decline the request if it has grounds for believing that the statements are clearly inaccurate.

77. Where a requested Party, in reliance on such statements, provides information to the applicant Party it remains within the framework of this Agreement. A requested Party is under no obligation to research or verify the statements provided by the applicant Party. The responsibility for the accuracy of the statement lies with the applicant Party.

#### *Paragraph 2*

78. The first sentence of paragraph 2 provides that a Contracting Party is not obliged to provide information which would disclose any trade, business, industrial, commercial or professional secret or trade process.

79. Most information requests will not raise issues of trade, business or other secrets. For instance, information requested in connection with a person engaged only in passive investment activities is unlikely to contain any trade, business, industrial or commercial or professional secret because such person is not conducting any trade, business, industrial or commercial or professional activity.

80. Financial information, including books and records, does not generally constitute a trade, business or other secret. However, in certain limited cases the disclosure of financial information might reveal a trade business or other secret. For instance, a requested Party may decline a request for information on certain purchase records where the disclosure of such information would reveal the proprietary formula of a product.

81. Paragraph 2 has its main application where the provision of information in response to a request would reveal protected intellectual property created by the holder of the information or a third person. For instance, a bank might hold a pending patent application for safe keeping or a trade process might be described in a loan application. In these cases the requested Party may decline any portion of a request for information that would reveal information protected by patent, copyright or other intellectual property laws.

82. The second sentence of paragraph 2 makes clear that the Agreement overrides any domestic laws or practices that may treat information as a trade, business, industrial, commercial or professional secret or trade process merely because it is held by a person identified in Article 5, paragraph 4, sub-paragraph a) or merely because it is ownership information. Thus, in connection with information held by banks, financial institutions etc., the Agreement overrides domestic laws or practices that treat the information as a trade or other secret when in the hands of such person but would not afford such protection when in the hands of another person, for instance, the taxpayer under investigation. In connection with ownership information, the Agreement makes clear that information requests cannot be declined merely because domestic laws or practices may treat such ownership information as a trade or other secret.

83. Before invoking this provision, a requested Party should carefully weigh the interests of the person protected by its laws with the interests of the applicant Party. In its deliberations the requested Party should also take into account the confidentiality rules of Article 8.

### *Paragraph 3*

84. A Contracting Party may decline a request if the information requested is protected by the attorney-client privilege as defined in paragraph 3. However, where the equivalent privilege under the domestic law of the requested Party is narrower than the definition contained in paragraph 3 (*e.g.*, the law of the requested Party does not recognise a privilege in tax matters, or it does not recognise a privilege in criminal tax matters) a requested Party may not decline a request unless it can base its refusal to provide the information on Article 7, paragraph 1.

85. Under paragraph 3 the attorney-client privilege attaches to any information that constitutes (1) “confidential communication,” between (2) “a client and an attorney, solicitor or other admitted legal representative,” if such communication (3) “is produced for the purposes of seeking or providing legal advice“ or (4) is “produced for the purposes of use in existing or contemplated legal proceedings.”

86. Communication is “confidential” if the client can reasonably have expected the communication to be kept secret. For instance, communications made in the presence of third parties that are neither staff nor otherwise agents of the attorney are not confidential communications. Similarly, communications made to the attorney by the client with the instruction to share them with such third parties are not confidential communications.

87. The communications must be between a client and an attorney, solicitor or other admitted legal representative. Thus, the attorney-client privilege applies only if the attorney, solicitor or other legal representative is admitted to practice law. Communications with persons of legal training but not admitted to practice law are not protected under the attorney-client privilege rules.

88. Communications between a client and an attorney, solicitor or other admitted legal representative are only privileged if, and to the extent that, the attorney, solicitor or other legal representative acts in his or her capacity as an attorney, solicitor or other legal representative. For instance, to the extent that an attorney acts as a nominee shareholder, a trustee, a settlor, a company director or under a power of attorney to represent the company in its business affairs, he can not claim the attorney-client privilege with respect to any information resulting from and relating to any such activity.

89. Sub-paragraph a) requires that the communications be “produced for the purposes of seeking or providing legal advice.” The attorney-client privilege covers communications by both client and attorney provided the communications are produced for purposes of either seeking or providing legal advice. Because the communication must be produced for the purposes of seeking or providing legal advice, the privilege does not attach to documents or records delivered to an attorney in an attempt to protect such

documents or records from disclosure. Also, information on the identity of a person, such as a director or beneficial owner of a company, is typically not covered by the privilege.

90. Sub-paragraph b) addresses the case where the attorney does not act in an advisory function but has been engaged to act as a representative in legal proceedings, both at the administrative and the judicial level. Sub-paragraph b) requires that the communications must be produced for the purposes of use in existing or contemplated legal proceedings. It covers communications both by the client and the attorney provided the communications have been produced for use in existing or contemplated legal proceedings.

#### *Paragraph 4*

91. Paragraph 4 stipulates that Contracting Parties do not have to supply information the disclosure of which would be contrary to public policy (*ordre public*). “Public policy” and its French equivalent “*ordre public*” refer to information which concerns the vital interests of the Party itself. This exception can only be invoked in extreme cases. For instance, a case of public policy would arise if a tax investigation in the applicant Party were motivated by political or racial persecution. Reasons of public policy might also be invoked where the information constitutes a state secret, for instance sensitive information held by secret services the disclosure of which would be contrary to the vital interests of the requested Party. Thus, issues of public policy should rarely arise in the context of requests for information that otherwise fall within the scope of this Agreement.

#### *Paragraph 5*

92. Paragraph 5 clarifies that an information request must not be refused on the basis that the tax claim to which it relates is disputed.

#### *Paragraph 6*

93. In the exceptional circumstances in which this issue may arise, paragraph 6 allows the requested Party to decline a request where the information requested by the applicant Party would be used to administer or enforce tax laws of the applicant Party, or any requirements connected therewith, which discriminate against nationals of the requested Party. Paragraph 6 is intended to ensure that the Agreement does not result in discrimination between nationals of the requested Party and identically placed nationals of the applicant Party. Nationals are not identically placed where an applicant state national is a resident of that state while a requested state national is not. Thus, paragraph 6 does not apply to cases where tax rules differ only on the basis of residence. The person’s nationality as such should not lay the taxpayer open to any inequality of treatment. This applies both to procedural matters (differences between the safeguards or remedies available to the taxpayer, for example) and to substantive matters, such as the rate of tax applicable.

## **Article 8 (Confidentiality)**

94. Ensuring that adequate protection is provided to information received from another Contracting Party is essential to any exchange of information instrument relating to tax matters. Exchange of information for tax matters must always be coupled with stringent safeguards to ensure that the information is used only for the purposes specified in Article 1 of the Agreement. Respect for the confidentiality of information is necessary to protect the legitimate interests of taxpayers. Mutual assistance between competent authorities is only feasible if each is assured that the other will treat with proper confidence the information, which it obtains in the course of their co-operation. The Contracting Parties must have such safeguards in place. Some Contracting Parties may prefer to use the term “secret”, rather than the term “confidential” in this Article. The terms are considered synonymous and interchangeable for purposes of this Article and Contracting Parties are free to use either term.

95. The first sentence provides that any information received pursuant to this Agreement by a Contracting Party must be treated as confidential. Information may be received by both the applicant Party and the requested Party (*see*, Article 5 paragraph 5).

96. The information may be disclosed only to persons and authorities involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to taxes covered by the Agreement. This means that the information may also be communicated to the taxpayer, his proxy or to a witness. The Agreement only permits but does not require disclosure of the information to the taxpayer. In fact, there may be cases in which information is given in confidence to the requested Party and the source of the information may have a legitimate interest in not disclosing it to the taxpayer. The competent authorities concerned should discuss such cases with a view to finding a mutually acceptable mechanism for addressing them. The competent authorities of the applicant Party need no authorisation, consent or other form of approval for the provision of the information received to any of the persons or authorities identified. The references to “public court proceedings” and to “judicial decisions” in this paragraph extend to include proceedings and decisions which, while not formally being “judicial”, are of a similar character. An example would be an administrative tribunal reaching decisions on tax matters that may be binding or may be appealed to a court or a further tribunal.

97. The third sentence precludes disclosure by the applicant Party of the information to a third Party unless express written consent is given by the Contracting Party that supplied the information. The request for consent to pass on the information to a third party is not to be considered as a normal request for information for the purposes of this Agreement.

## **Article 9 (Costs)**

98. Article 9 allows the Contracting Parties to agree upon rules regarding the costs of obtaining and providing information in response to a request. In general, costs that would be incurred in the ordinary course of administering the domestic tax laws of the requested State would normally be expected to be borne by the requested State when such costs are incurred for purposes of responding to a request for information. Such costs would normally cover routine tasks such as obtaining and providing copies of documents.

99. Flexibility is likely to be required in determining the incidence of costs to take into account factors such as the likely flow of information requests between the Contracting Parties, whether both Parties have income tax administrations, the capacity of each Party to obtain and provide information, and the volume of information involved. A variety of methods may be used to allocate costs between the Contracting Parties. For example, a determination of which Party will bear the costs could be agreed to on a case by case base. Alternatively, the competent authorities may wish to establish a scale of fees for the

processing of requests that would take into account the amount of work involved in responding to a request. The Agreement allows for the Contracting Parties or the competent authorities, if so delegated, to agree upon the rules, because it is difficult to take into account the particular circumstances of each Party.

#### **Article 10 (Implementing Legislation)**

100. Article 10 establishes the requirement for Contracting Parties to enact any legislation necessary to comply with the terms of the Agreement. Article 10 obliges the Contracting Parties to enact any necessary legislation with effect as of the date specified in Article 15. Implicitly, Article 10 also obliges Contracting Parties to refrain from introducing any new legislation contrary to their obligations under this Agreement.

#### **Article 11 (Language)**

101. Article 11 provides the competent authorities of the Contracting Parties with the flexibility to agree on the language(s) that will be used in making and responding to requests, with English and French as options where no other language is chosen. This article may not be necessary in the bilateral context.

#### **Article 12 (Other International Agreements or Arrangements)**

102. Article 12 is intended to ensure that the applicant Party is able to use the international instrument it deems most appropriate for obtaining the necessary information. This article may not be required in the bilateral context.

#### **Article 13 (Mutual Agreement Procedure)**

##### *Paragraph 1*

103. This Article institutes a mutual agreement procedure for resolving difficulties arising out of the implementation or interpretation of the Agreement. Under this provision, the competent authorities, within their powers under domestic law, can complete or clarify the meaning of a term in order to obviate any difficulty.

104. Mutual agreements resolving general difficulties of interpretation or application are binding on administrations as long as the competent authorities do not agree to modify or rescind the mutual agreement.

##### *Paragraph 2*

105. Paragraph 2 identifies other specific types of agreements that may be reached between competent authorities, in addition to those referred to in paragraph 1.

##### *Paragraph 3*

106. Paragraph 3 determines how the competent authorities may consult for the purposes of reaching a mutual agreement. It provides that the competent authorities may communicate with each other directly.

Thus, it would not be necessary to go through diplomatic channels. The competent authorities may communicate with each other by letter, facsimile transmission, telephone, direct meetings, or any other convenient means for purposes of reaching a mutual agreement.

*Paragraph 4*

107. Paragraph 4 of the multilateral version clarifies that agreements reached between the competent authorities of two or more Contracting Parties would not in any way bind the competent authorities of Contracting Parties that were not parties to the particular agreement. The result is self-evident in the bilateral context and no corresponding provision has been included.

*Paragraph 5*

108. Paragraph 5 provides that the Contracting Parties may agree to other forms of dispute resolution. For instance, Contracting Parties may stipulate that under certain circumstances, e.g., the failure of resolving a matter through a mutual agreement procedure, a matter may be referred to arbitration.

**Article 14 (Depositary's Functions)**

109. Article 14 of the multilateral version discusses the functions of the depositary. There is no corresponding provision in the bilateral context.

**Article 15 (Entry into Force)**

*Paragraph 1*

110. Paragraph 1 of the bilateral version contains standard language used in bilateral treaties. The provision is similar to Article 29, paragraph 1 of the OECD Model Convention on Income and on Capital.

*Paragraph 2*

111. Paragraph 2 of the multilateral version provides that the Agreement will enter into force only between those Contracting Parties that have mutually stated their intention to be bound vis-à-vis the other Contracting Party. There is no corresponding provision in the bilateral context.

### *Paragraph 3*

112. Paragraph 3 differentiates between exchange of information in criminal tax matters and exchange of information in all other tax matters. With regard to criminal tax matters the Agreement will enter into force on January 1, 2004. Of course, where Contracting Parties already have in place a mechanism (*e.g.*, a mutual legal assistance treaty) that allows information exchange on criminal tax matters consistent with the standard described in this Agreement, the January 1, 2004 date would not be relevant. See Article 12 of the Agreement and paragraph 5 of the introduction. With regard to all other matters the Agreement will enter into force on January 1, 2006. The multilateral version also provides a special rule for parties that subsequently want to make use of the Agreement. In such a case the Agreement will come into force on the 30<sup>th</sup> day after deposit of both instruments. Consistent with paragraph 2, the Agreement enters into force only between two Contracting Parties that mutually indicate their desire to be bound vis-à-vis another Contracting Party. Thus, both parties must deposit an instrument unless one of the parties has already indicated its desire to be bound vis-à-vis the other party in an earlier instrument. The 30-day period commences when both instruments have been deposited.

### *Paragraph 4*

113. Paragraph 4 contains the rules on the effective dates of the Agreement. The rules are identical for both the multilateral and the bilateral version. Contracting Parties are free to agree on an earlier effective date.

114. The rules of paragraph 4 do not preclude an applicant Party from requesting information that precedes the effective date of the Agreement provided it relates to a taxable period or chargeable event following the effective date. A requested Party, however, is not in violation of this Agreement if it is unable to obtain information predating the effective date of the Agreement on the grounds that the information was not required to be maintained at the time and is not available at the time of the request.

## **Article 16 (Termination)**

115. Paragraphs 1 and 2 address issues concerning termination. The fact that the multilateral version speaks of “termination” rather than denunciation reflects the nature of the multilateral version as more of a bundle of identical bilateral treaties rather than a “true” multilateral agreement.

116. Paragraph 3 ensures that the obligations created under Article 8 survive the termination of the Agreement.