

G20 DEVELOPMENT WORKING GROUP

A REPORT ON THE ISSUES ARISING FROM THE INDIRECT TRANSFER OF ASSETS TO IDENTIFY POLICY OPTIONS TO TACKLE ABUSIVE CASES, WITH PARTICULAR REFERENCE TO DEVELOPING COUNTRIES

CONCEPT NOTE

Mandate

1. In December 2013, in line with the Group of Twenty (G20) St Petersburg Development Outlook, the G20 Development Working Group (DWG) called upon the Organisation for Economic Development and Co-operation (OECD) to report on the impact of base erosion and profit shifting (BEPS) in developing countries.

2. As part of the consultation process for the aforementioned report, a number of developing countries expressed concerns about the taxation of indirect transfer of assets. This was reflected in a report to the G20 DWG, where the OECD and the co-operating international organisations identified a number of ‘other high priority BEPS issues for developing countries’. One of them concerns the taxation of indirect transfers of assets. The report recognises the complexity and importance of this issue which may have a significant impact on the tax revenues of developing countries, in particular those which have foreign held state concessions, such as in the extractive industries.

3. The IMF Policy Paper “Spillovers in International Corporate Taxation,” referred to in this report, stressed the importance for several developing countries, especially but not only in relation to natural resources, of the possibility for foreign residents to avoid taxation on capital gains in the country where assets are located by means of an indirect transfer of these assets in situations where a direct transfer of such assets would be liable to tax in that country. As brought forth by some recent high profile and contentious cases, other jurisdictions and taxpayers themselves may believe that there should be no tax liability in that country upon such indirect transfers. The IMF Policy Paper also notes that developing countries which have domestic laws allowing the taxation of capital gains on indirect transfers may face considerable difficulty as a practical matter in applying such provisions; foreign transactions may be hard to detect, and collecting the tax from foreign parties may be far from easy.

4. The DWG requested that the OECD and the IMF work together to develop a report (hereafter referred to as ‘the report’) on the issues arising from the indirect transfer of assets. The International Monetary Fund and the OECD will jointly deliver the report, using each organisation’s experience, expertise and mandate, in close consultation with the World Bank and the UN. The work will build upon previous work of these organisations, including the aforementioned IMF policy paper.

CONTENT

A Report on the Issues Arising from the Indirect Transfer of Assets to Identify Policy Options to Tackle Abusive Cases, with Particular Reference to Developing Countries (OECD/IMF led)

5. The Report is in response to Recommendation 15 set out by the Development Working Group in Response to the 2014 reports on Base Erosion and Profit Shifting and Automatic Exchange of Tax Information for Developing Economies which state that the DWG calls on the OECD and the IMF “... *to report on whether further analysis on this issue is needed to identify policy options to tackle abusive cases, with particular reference to developing countries.*”

6. Drawing on existing evidence and input from ongoing consultation with developing countries, business and NGOs, this note will be developed into a two-part report. The first part will analyse the policy considerations relating to the tax treatment of indirect transfers of assets in the context of the issues raised by developing countries. This analysis will include a general description of the economic and policy considerations related to the tax treatment of capital gains. The second part will describe concrete options for these countries to enact and administer effective rules to tax such capital gains.

Scope

7. The first aim of the report is to set out and analyze key issues faced by developing countries in determining a policy on the taxation of capital gains on the direct and indirect transfer of assets, both in domestic and international settings. An orderly conceptual analysis is essential to determine under what circumstances such transfers should—and could-- be taxed.

8. Within this framework, the report will focus in particular on three aspects of indirect transfers of interests that are key for developing countries, with some emphasis on particularly affected sectors such as extractives industries:

- The need for legislation on indirect transfer of interests to be consistent with the country’s general rules on taxing income from capital and capital gains.
- The relation between the international tax framework and tax policy goals, including the protection of the tax base and the prevention of double taxation.

- Effective administrative measures that would allow countries to identify indirect transfers of assets and to tax them.

Output

9. Annex 1 contains a draft outline for the final report, subject to further insights to be gained during consultations and the drafting process. Annex 2 describes the process for developing the final report.

ANNEX 1 – Draft Outline of the Report

Introduction

The introduction will set out the mandate as discussed above.

Part I

A – Economic and Policy considerations

This first part will provide an overview of the economic and policy considerations relevant to the taxation of capital gains, looking into the economic consequences of taxing both direct and indirect transfers, and how they relate. A survey of economic literature can assist in identifying any existing work on the macroeconomic effects of different approaches to the taxation of capital gains on the direct and indirect transfer of assets in the hands of non-residents. Existing work may be complemented with new economic analyses.

In particular this section will include a discussion of the following issues: -

- ***General consistency between taxation of capital gains and the income tax regime***

This part will include a general account of the economic and policy considerations related to the tax treatment of capital gains. A discussion of the relevant considerations will include the following questions:

- *Under what circumstances should capital gains on indirect transfer of corporate assets be taxed?*

Taxing capital gains inevitably entails a tension between the policy choices underlying tax systems, including the prevention of economic double taxation, and the protection against abuses. Undistributed business profits taxed under CIT would technically be taxed again when a business is sold if those profits explain (part or all) of the capital gain. On the other hand, capital gains may result for reasons different than taxed undistributed profits; and even more important, various things, including changes in expectations of future profits, better information, or the existence of untaxed profits can generate capital gains. Further, profits may be formally exempted in some cases or taxpayers may shift profits to related parties to avoid the tax. In these cases it is important to ensure that it is possible to capture such untaxed profits in the base at the time of the realisation of such profits, including through taxation of the disposal of the asset itself.

- *How are capital gains typically taxed?*

The tax treatment of capital gains varies among countries, according to the policy choices underlying their tax systems. Some countries tax capital gains (either by: a) including the gain in the income tax base with all other earnings of the taxpayer, and applying the corresponding rate schedule - global income tax system -, or by b) keeping the gain separate from all other income and—frequently- taxing it at a lower rate - schedular capital gains tax system). Other countries do not tax capital gains in general or have introduced specific exceptions: the choice tends to differ depending upon several reasons (e.g. the nature of the assets and/or the taxpayer, whether the assets are directly or indirectly transferred, whether countries aim at targeting specific cases deemed to be abusive etc.). Policy considerations that may affect the tax treatment of capital gains also include considerations related to the relief of economic double taxation. There are arguments for and against each approach, and different regimes interact differently with international tax arrangements.

- *Indirect vs direct sale of asset*

An asset can be transferred directly (changing property title to the asset itself) or indirectly, by selling the titles that represent or subsume ownership of that (e.g. shares of a holding company). Any attempt to achieve tax neutrality between these two forms of transfers requires consideration of the tax consequences of both the transfer of the asset and of the shares in entities through which the asset is held, including consideration of the fact that these transfers do not take place at the same time. Achieving such neutral treatment is no easy task, especially in a cross-border context. There are both conceptual and practical problems to achieve neutrality across borders. The problems are particularly great when such transactions may result in double non-taxation.

• ***Taxing transfers of assets in a cross-border context***

This part will describe the policy rationale and actual practices regarding the allocation of taxing rights on transfer of assets in a cross-border setting. This analysis will include the application of domestic law to cases where two jurisdictions claim the right to tax when the asset is sold by a foreign resident--the country where the indirect ownership right is held, and the source country where the asset is located.

In such a case, if a double tax convention exists, it would generally provide measures to avoid double taxation by allocating taxing rights between the contracting states. Most conventions follow the outline of the UN/OECD model tax conventions, and therefore typically allocate the right to tax gains from the transfer of assets as follows:

- to the State of Source where the assets transferred are included in the business property of a permanent establishment (PE) in that State;
- to the State of Source, where the asset transferred constitutes immovable property situated in the source country, or company shares deriving more than 50 per cent of their value directly or indirectly from such immovable property;
- [UN Model only] to the State of Source where the assets transferred represent a participation of more than a certain percentage of the shares of a company resident of the State of source.
- To the State of residence in all other cases

Where the country of residence does not levy tax on the capital gain –for example, in a low tax or ring-fenced jurisdiction or when an exemption is applicable to prevent economic double taxation– the last rule creates opportunities for abuse since no tax will be charged either in the State of source or the State of residence. The report will consider the meaning of “abusive” within the context of the discussion of tax principles. Where there is no double tax convention, domestic laws would govern. Countries must, against this theoretical background, determine the appropriate approach in such cases.

B – Specific challenges faced by developing countries

This second section will provide a more detailed overview of issues and challenges faced by developing countries on the basis of case studies, complemented by examples of legislation implemented and applied by developing and –where relevant- developed countries to address these challenges. It will report on the following specific challenges from two main perspectives - 1. Policy and legislation (design of domestic legal frameworks; interaction of domestic law with tax treaties, bilateral investment treaties, tax incentive regimes); and 2. Practical/Administrative (obtaining information, enforcement, collection.): -

- **Information**

Countries need to have sufficient information to identify indirect transfers. Areas of consideration to address this challenge include the use of international administrative assistance (e.g. Exchange of Information Agreements) and Transfer Pricing documentation requirements (e.g. master file).

- **Collection**

Many countries that have provisions taxing indirect transfers of interest have no mechanism to enforce the tax, or even for the foreign resident to comply voluntarily with the provisions. Establishing these institutional procedures is essential to make the system operational, and can be strengthened by improving international administrative assistance (exchange of information and mutual collection assistance). An option, for example, is obtaining membership of the Multilateral Convention on Mutual Administrative Assistance.

- **Issues specific to extractive industries**

Extractive industries are particularly important for many developing countries, as they may generate a large proportion of public revenues and the assets involved can be substantial relative to the size of the economy. This is also a particularly complex industry and international tax rules have some specific provisions relating to it. The ways in which such assets are transferred can also be quite particular, as joint ventures are common in the industry, for example.

Part I will also look into other assets that are dependent on government concessions, for example in the telecom industry.

Part II

The focus will be on offering practical solutions based on the insights provided in Part I. This second part will likely examine

A – Direct Tax Law Solutions

Design features of domestic tax law regimes for the taxation of gains on indirect transfers of assets

- Scope:

- Objective Scope –

- Types of (underlying) assets –

- Typically immovable property, exploration/exploitation rights (natural resources),
- Ownership interests in source State resident companies engaged in regulated industries (*e.g.* telecommunications)?
- Shares of source State resident companies (*cf.* UN Model Article 13(5)) and movable property of a source State trade or business, , subject to the findings in Part I.

- Ownership threshold(s) for the application of the regime (including how to establish direct and indirect interests)?

- Exceptions (*e.g.* business restructuring, transfers qualifying for non-recognition treatment in the residence State)?

- Personal scope

- Persons subject to tax (*tax limited to non-residents?*).

- Relation with international law:

- Tax treaties (*describing in particular the role of Article 13(4)*).
- Bilateral investment treaties (*impact of tax clauses*).
- Investment agreements with non-resident investors.
- Calculation of the tax base:
 - Which costs can be taken into account?
 - Valuation (including issues related to farm-out arrangements)
- Provision for the avoidance of double taxation (*cf. Calculation of the tax base*)
- Relation with other provisions of domestic law (*e.g. investment incentive regimes, tax holidays*).
- Making domestic tax rules tax-planning proof
 - Identifying pitfalls, building on country experience
- How to address the specific challenges developing countries face in applying domestic tax law regimes for the taxation of gains on indirect transfers of assets:
 - Challenges in obtaining information on indirect transfers
 - The role of Exchange of Information agreements.
 - Relevance of Transfer Pricing documentation requirements
 - Challenges in enforcement/collection
 - The role of the Assistance in Collection provisions in tax treaties
 - The multilateral Convention on Mutual Administrative Assistance in Tax Matters
 - Alternative approaches to collection, for example –
 - imposing a withholding obligation on the buyer/transferee;
 - treating a resident party as the agent for the non-resident transferor;
 - deeming a resident to have made the transfer; or
 - introducing regulatory requirements that make approval for transfer conditional on payment of the tax).

B - Other approaches to the issues raised by indirect transfers

Alternative approaches could be explored, such as:

- Address round-tripping by source State residents through CFC(-like) rules (Action 3).
- Non-income levies (transfer taxes).
- Ownership requirements (*for example prohibition on non-resident ownership of direct or indirect interests in certain assets*).
- Regulatory or licensing limitations (*for example prohibition on indirect sale of certain assets unless tax requirements have been met*).

Part III– Conclusions and Next Steps

This concluding chapter will formulate next steps, aimed at identifying policy options for the taxation of indirect transfers of assets.

ANNEX 2 – Process

Guiding Principles

The above work should draw directly on developing country experience through existing case studies, surveys, interviews and examples gained from developing countries during consultations (see below). The report should reflect and address the challenges faced by a diverse range of developing countries and presented by a range of business sectors.

The G20 recognises that tax policy is at the core of countries' sovereignty, and each country has the right to design its tax system in the way it considers most appropriate. The report should not seek one solution to the issue of indirect transfers of assets but offer options for countries to consider and adopt as each country considers appropriate.

Consultations

The international organisations will consult key stakeholders (developing country tax authorities, regional tax administration forums, NGOs, business, academia) during the development of this report, through leveraging existing international events, drawing on their membership/partnership networks, or requesting written or verbal comments. The international organisations will invite stakeholders, including the DWG and the G20 Finance Track, to comment on the draft of the report, as specified in the below timeline.

Outputs and Timelines

The key reporting dates for the scoping paper and the toolkits are specified below.

Key reporting dates:

- Agreement of the Concept Note by G20 Turkish Presidency, DWG co-chair and DRM co-facilitators (June 2015).
- Presentation of the Concept Note to the DWG (June 2015).
- May-October: Continued consultation with developing countries, with private sector as appropriate, regional tax organizations and wider public.
- For first meeting DWG in 2016: International organisations submit draft report to G20 Presidency, DWG co-chair and DRM co-facilitators, taking account of comments.
- Finalize: March 2016.