

# The Platform for Collaboration on Tax

## The Taxation of Offshore Indirect Transfers— A Toolkit

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

This document has been prepared in the framework of the Platform for Collaboration on Tax (PCT) under the responsibility of the Secretariats and Staff of the four organisations. This report should not be regarded as the officially endorsed views of those organisations or of their member countries.

The toolkit has benefited from comments submitted during two periods of public review, August–October, 2017 and July–September, 2018. The PCT partners wish to express their gratitude for all submissions received.

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## ACRONYMS

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

## GLOSSARY

**Asset:** something of financial value.

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

**Direct Transfer:** the disposition of a direct interest in an asset, in whole or in part.

**Direct Interest:** ownership of a particular asset in which there are no intervening entities between the owner and the asset.

**Entity:** an organization or arrangement such as a company, corporation, partnership, estate, or trust.

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

**Indirect Transfer:** the disposition of an indirect ownership interest in an asset, in whole or in part.

**Intangible Property:** property which has no physical presence, for example, a financial asset such as corporate stock; intellectual property; business goodwill.

**Interest:** effective ownership, in full or in part, of an asset.

**Limitation on benefits:** a tax treaty provision that limits tax treaty benefits to residents of a Contracting State possessing certain characteristics or to whom certain conditions apply.

**Location Specific Rents:** economic returns in excess of the minimum “normal” level of return that an investor requires – “rents”—which are uniquely associated with some specific location (and can thus be taxed without having any effect on the extent or location of the underlying activity or asset).

**Model Tax Convention:** a model that is used as the basis for a *Tax Treaty* negotiated between two countries. There are two primary Models of Tax Conventions, the UN Model, and the OECD Model. The two I Tax Convention Models are largely the same, although they differ in a few significant specifics.

**Multilateral Instrument (MLI):** formally known as the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, it is an instrument developed under Action 15 of the G20-OECD Base Erosion and Profit Shifting Project to facilitate and coordinate changes in treaty arrangements. It is usually referred to as the MLI.

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

**Onshore Indirect Transfer:** any indirect transfer other than offshore.

**Permanent Establishment:** a concept used to determine when an entity of a group has sufficient connection with a country to entitle that country to tax entity's profits that are attributable to that Permanent Establishment in that country.

**Principal purpose test:** a rule under which, if one of the principal purposes of an arrangement is to obtain tax treaty benefits, these benefits are denied unless granting these benefits would be in accordance with

the object and purpose of the provisions of the specific tax treaty.

**Residence Country:** the country in which the person or entity that derives income or capital gain is a resident for tax purposes.

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

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

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

**Tax Treaty:** also known as a Tax Convention or Agreement, a tax treaty, concluded between two or more countries, attributes to a jurisdiction the right to tax the income of an entity or individual that operates in more than one country, so that the income will either not be subject to tax in both countries or, if it is, relief is granted to eliminate double taxation to the extent possible, or to avoid double non-taxation.

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

**Transferor:** person or entity transferring an ownership interest in an asset.

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

## EXECUTIVE SUMMARY

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

**The country in which the underlying asset is located may wish to tax gains realized on such transfers—as is currently the case for direct transfers of immovable assets.** Some countries may wish to apply this treatment to a wider class of assets, to include more those generating location specific rents—returns that exceed the minimum required by investors and which are not available in other jurisdictions. This might include, for instance, telecom licenses and other rights issued by government. The report also recognizes, however, that gains on OITs may be attributable in part to value added by the owners and managers of such assets, and that some countries may choose not to tax gains on OITs.

**The provisions of both the OECD and the UN Model treaties suggest wide acceptance that capital gains taxation of OITs of “immovable” assets can be imposed by the location country.** It remains the case, however, that the relevant model Article 13(4) is found only in around 35 percent of all Double Tax Treaties (DTTs) and is less likely to be found when one party is a low- income resource-rich country. The MLI has increased the number of tax treaties that include Article 13(4) of the OECD MTC. This impact is expected to increase as new parties sign the MLI and amend their covered tax treaties to include the new language of Article 13(4).

**Regardless of what any treaty provides, however, such a taxing right cannot be supported without appropriate definition in domestic law** of the assets intended to be taxed and without a domestic law basis to assert that taxing right.

**There is a need for a more uniform approach to the taxation of OITs by those countries that choose to tax them.** Countries’ unilateral responses have differed widely, in terms of both which assets are covered and the legal approach taken. Greater coherence could enhance tax certainty.

**The report outlines two main approaches to the taxation of OITs by the country in which the underlying asset is located—provisions for which require careful drafting.** It identifies the two main approaches for so doing and provides, for both, sample simplified legislative language for domestic law in the location country. One of these methods (‘Model 1’) treats an OIT as a deemed disposal of the underlying asset. The other (‘Model 2’) treats the transfer as being made by the actual seller, offshore, but sources the gain on that transfer within the location country and so enables that country to tax it. The report expresses no general preference between the two models: the appropriate choice will depend on countries’ circumstances and preferences.

## INTRODUCTION

**This report and toolkit is one of several that respond to a request by the Development Working Group (DWG) of the G20** to the International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), World Bank Group (WBG) and the United Nations (UN)—the partner members of the Platform for Collaboration on Tax—to produce “toolkits” for developing countries for appropriate implementation of responses to international tax issues under the G20/OECD Base Erosion and Profit Shifting (BEPS) project, as well as additional issues of particular relevance to developing countries that the project does not address.

**The issue taken up here is the capital gains tax treatment of offshore indirect transfers of assets (OITs):<sup>1</sup>** the sales, that is, not of underlying assets themselves but, in some other jurisdiction of some entity owning those assets.

**There has been quite widespread concern among developing countries that OITs might be used to avoid, inappropriately, capital gains taxation in the country where those underlying assets are located.** This issue, not covered in the BEPS project, was identified by developing countries as of significance for many of them, especially, but not only, in the extractive industries. Its significance has also been stressed by the IMF (see IMF 2014, which draws on several cases arising in IMF technical assistance work), the OECD (see OECD 2014a and 2014b, which identify high priority international tax issues in low income countries), and the UN.<sup>2</sup> While this issue has long been recognized, it has become of much greater importance in recent years.

**The aim of this report is to provide analysis of and options for the tax treatment of OITs, with a focus on the perspective of developing countries.** It addresses core economic and legal issues, and provides a stock take of the approaches applied in selected countries. The key questions addressed are: (i) What considerations arise in deciding whether such transfers should be taxed in the country in which the underlying asset is located? (ii) To which types of assets do these considerations suggest that any such taxation should apply? (iii) How can such taxation, if adopted, best be designed and implemented as a practical, legal matter?

**The issues at stake are highly complex,** both in terms of the underlying economics and in their legal aspects. In addressing them, this toolkit draws on the existing literature<sup>3</sup> and on IMF technical assistance work with developing countries, and reflects responses to public comments received

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<sup>1</sup> Terms italicized on first use, other than company names, are explained in the glossary.

<sup>2</sup> Treaty-related capital gains tax issues were also identified as a concern by respondents to a UN questionnaire on BEPS priorities for developing countries (Peters, 2015). See also United Nations, 2017, *Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries*, which includes a chapter on OITs: available online at [http://www.un.org/esa/ffd/wp-content/uploads/2018/05/Extractives-Handbook\\_2017.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2018/05/Extractives-Handbook_2017.pdf).

<sup>3</sup> Including notably Tolenado, Bush and Mandelbaum (2017), Burns, Le Leuch and Sunley (2016), Cui (2015), Kane (2018) and Krever (2010).



from business, civil society, and country authorities on the two previous drafts of the report.<sup>4</sup> It does not set out a single, definitive approach suitable in all circumstances. The aim rather is to identify practicable options, with a view to the circumstances of developing countries. Nor does it deal with all the technical issues that arise in this area (in relation for instance to corporate reorganizations and basis adjustments); further detailed guidance in these areas might prove helpful.

**This report is structured as follows.** The next section provides an introduction to OITs, sets out a simplified example to illustrate the issues that their tax treatment raises, and provides an analysis of the economic considerations that inform answers to the questions of whether a country wishes to tax OITs and, if so, of which types and how. Section III describes some recent cases that highlight these concerns, reflecting the variety of current unilateral country rules, and Section IV then focuses on the treatment of OITs as they are currently addressed under the two primary model tax treaties—of the United Nations and the OECD—and discusses the important possibilities created by the OECD’s new Multilateral Instrument (MLI). Section V then considers in detail issues of implementation raised by two existing approaches to the taxation of indirect transfers. The final section presents conclusions. Appendices provide further detail on the empirical analysis and on selected country experiences.

**This report does not provide binding rules or authoritative provisions of any kind, nor does it aim to establish any international policy standard.** Rather, it is intended to describe an international taxation issue of concern to developing countries, and to analyze the approaches applied by selected countries with a view to identifying the pros and cons of these approaches and to provide practicable guidance to them on options for how to address that issue, should they choose to do so. As such, the report represents the analysis and conclusions of the tax staffs of the four partner organizations and does not represent the official views of the organizations’ member countries or Management. Further, the illustrative cases set out in this report are solely provided for the general purpose of illustrating the international taxation issue of focus in this report and the description of those cases should not be relied upon for anything other than that general purpose. The illustrative cases simply reflect general understandings of the arrangements and underlying transactions, based on reported information and written comments received during the consultation process.

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<sup>4</sup> See Appendix 1.

# I. ANALYSING OFFSHORE INDIRECT TRANSFERS

This section explains what an ‘offshore indirect transfer’ (OIT) means—using a simplified example that will be used throughout the toolkit<sup>5</sup>—discusses the revenue implications, and considers key conceptual considerations related to the taxation of OITs.

## A. The Anatomy of Offshore Indirect Transfers

### Definitions and a simple example

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

**A “transfer” is a change in the direct or indirect ownership of an asset, in whole or in part, whether between independent or related parties.** Transfers of ownership may give rise to a taxable capital gain (or loss), and this is at the heart of the concerns in this report. Of course, not all transfers of ownership result in taxable gains (or losses), even aside from the issues discussed herein. Transfers through mergers or acquisitions may not be taxable events, even if the asset has appreciated (or depreciated) in value, if the transaction satisfies domestic tax rules regarding tax-free restructuring or reorganization. Generally, tax-free reorganization rules require substantial continuity of ultimate ownership to obtain the benefit of the postponement of realization of gains at the time of the transaction. This report is not concerned with transfers of this kind.

**Transfers can be ‘direct’ or ‘indirect’:**

- **A direct transfer** involves the disposition<sup>66</sup> of a direct ownership interest in an asset, in whole or in part.
- **An indirect transfer** involves the disposition of an indirect ownership interest in an asset, in whole or in part. It is the underlying asset that is being *indirectly* transferred.<sup>7</sup>

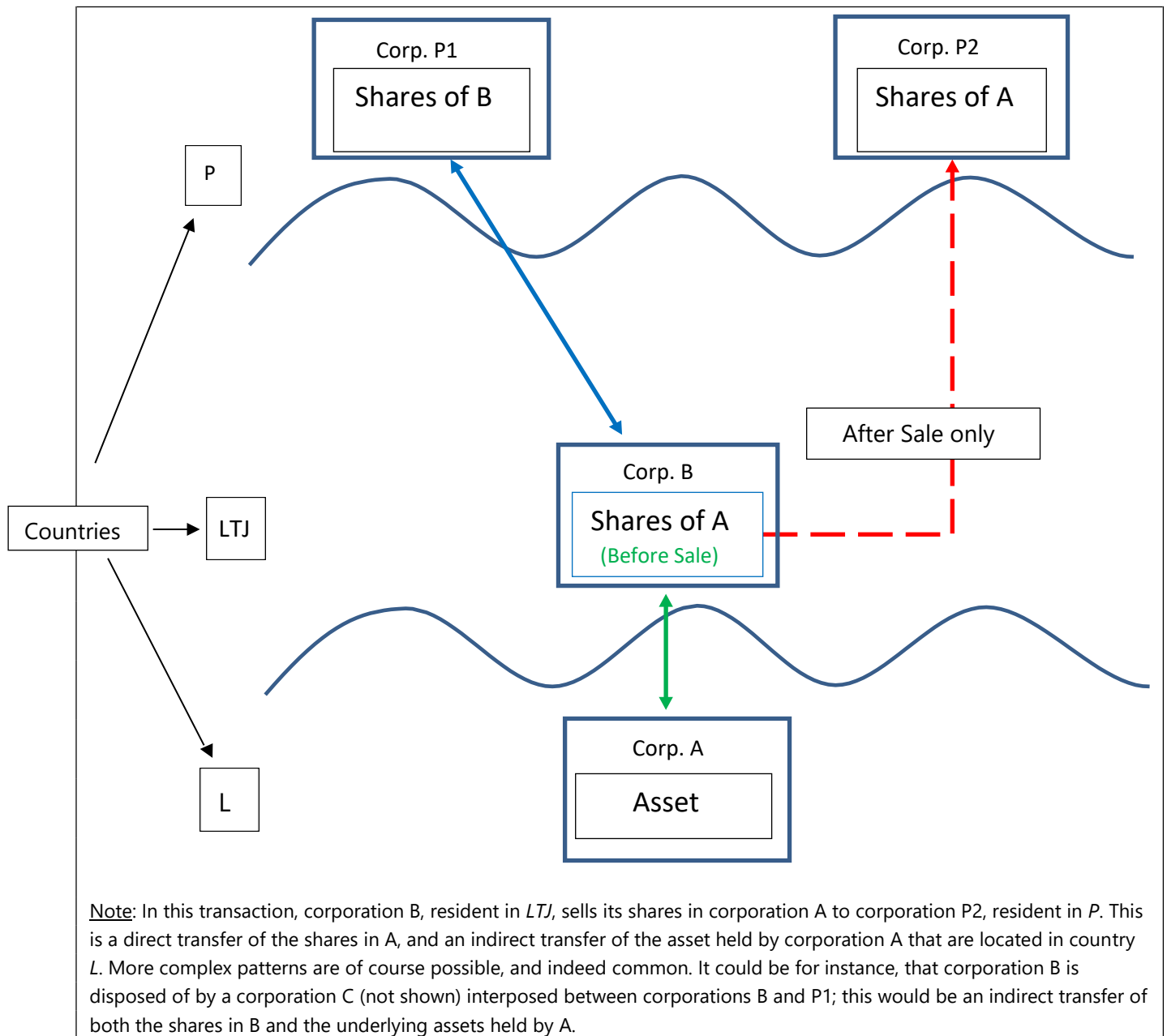
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<sup>5</sup> Of course, corporate structures in the real world are generally far more complex than this example: at any point in the ownership chain there may be multiple owners, and complex cross ownership arrangements are common. The model example, however, serves to bring out as simply as possible the core considerations at issue.

<sup>6</sup> Sales also include installment sales and those subject to an “overriding royalty;” in both cases, a series of payments is made to the seller (transferor) after the transfer takes place. See Burns, Le Leuch, and Sunley (2016).

<sup>7</sup> So, for instance, a direct transfer of shares in a company owning some real asset is an indirect transfer of that underlying real asset.

**Figure 1: Stylized Example of an OIT Structure**



**Tax treaties typically create a distinction between two classes of assets:**

- **Immovable assets:** The definition of this term is a matter for national law, which may or may not be modified by, and for the purposes of, any tax treaties to which the country is a party. The basic rule under the OECD and UN MTCs is that the term "immovable property" has the meaning under the domestic law (tax or other law) of the contracting state in which the

property is located.<sup>8</sup> It typically includes land, buildings, and structures as well as rights related to such property (which may include agricultural, forestry, and mineral rights).<sup>9</sup> As discussed later, the definition of immovable assets *could* also include licenses to provide specific products or services (e.g. telecommunications) to specified geographic locations, although this is not common.

- **Movable assets:** For purposes of this report, by this is meant any asset not classed as immovable. This may include not only other physical property, but intangibles (such as intellectual property or goodwill), and financial assets (e.g., stocks, bonds).

**Under existing arrangements, in both treaties and domestic laws, the location of the asset and the residence of the disposing party (the ‘transferor’) both play a role in determining which taxing jurisdiction (or jurisdictions) may claim the right to tax transfers.** The provisions of various countries’ tax laws in this regard differ widely. For clarity in discussing the complexities of indirect transfers, we define:<sup>10</sup>

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

## Structuring transactions

**The cross-border investments made by individuals or corporate groups may often involve complex ownership structures, which involve more than two jurisdictions.** The existence of such complex ownership structures creates an interplay between the tax laws of different jurisdictions as well as an interaction of the domestic laws of these multiple jurisdictions with the various tax treaties among the jurisdictions involved in such structures. These interactions between the laws and tax treaties concluded by various jurisdictions may have an impact on the ability of countries to exercise their taxing rights. Due to these complex interactions, various outcomes are possible, some of which may lead to double taxation for which there may be no relief under current international norms, while others may lead to double non-taxation.

**Imagine in Figure 1 that the owners of P1 want to realize a capital gain reflecting an increase in the value of the underlying asset; and that the owners of P2 wish to gain control**

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<sup>8</sup> The definition of immovable property in both OECD and UN MTCs provides: *The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources...*

<sup>9</sup> The definition of immovable property is set out in Article 6 of the model treaties.

<sup>10</sup> These terms may have meanings different from those used here in the domestic laws of different countries.

**of that asset.**<sup>11</sup> The tax rules of (at least) four countries come into play in shaping the tax treatment of this transaction (along with any applicable treaties): that in which the underlying asset is located (*L*), that in which the seller is resident (*LTJ*), that in which the parent of the seller (*P1*) is resident (*P*), and that in which the buyer (*P2*) is resident. More complex cases can certainly arise,<sup>12</sup> but this (relatively) simple example captures the key concerns.

**One way to realize the gain would be for *P1* to arrange a direct sale of the asset by corporation *A*.** This will generally create a tax liability for corporation *A* in country *L*, being a straightforward domestic (onshore direct) transfer. And, generally, in such a simple asset transfer case, the basis of the asset would be stepped up to reflect the purchase price.

**The tax efficient strategy for *P1* may be to instead arrange for the sale to be made indirectly by an entity resident in a country (*LTJ*) that applies a zero or low tax rate to capital gains.**<sup>13</sup> In Figure 1, this is shown as the sale by corporation *B*, resident in low tax country *LTJ*, to Corporation *P2*, resident for tax purposes in country *P*, of its shares in corporation *A*. Any tax advantage from eliminating the tax otherwise payable in country *L* may be offset later by taxation under the tax rules of the seller's parent's country *P*. But anything short of immediate taxation in *P*, may not substantially neutralize the tax advantage of selling the asset indirectly in *LTJ* rather than directly in country *L*.

**The transaction also has tax consequences for the purchaser, *P2*,** since the amount paid for the shares<sup>14</sup> of company *A* becomes the *tax basis* relative to which any capital gains (or losses)<sup>15</sup> on a future sale of those shares will be calculated. If the underlying asset is expected to decline in value—as a result of true economic depreciation, perhaps because the underlying asset is a right with some expiration date—the expectation is of a future capital loss; and the value of that for tax purposes will be maximized by locating the loss in an entity located in a high tax jurisdiction (because it generates a deduction with no offsetting charge). If, on the other hand, the underlying asset is expected to increase in value, the tax minimizing strategy is to locate the company which acquires company *A* in a low tax jurisdiction.

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<sup>11</sup> We assume throughout, except where indicated, that buyer and seller are unrelated, and so set aside issues related to transfer pricing.

<sup>12</sup> There may be many further companies interposed along the chain of entities, between *A* and *B*; and title may actually pass in another (fifth) country.

<sup>13</sup> Modern complex ownership structures are not necessarily, or even primarily, designed for tax reduction purposes—rather, commercial considerations often underlie them. Nonetheless, one issue does not preclude the other; where business considerations demand forms of complex and indirect ownership, such structures are presumably designed to be as tax-efficient as possible.

<sup>14</sup> The acquirer might prefer to acquire the asset directly, since immovable property will generally qualify for depreciation allowances and so, in many cases, yield deductions sooner than basis in shares that can be set off against future gains.

<sup>15</sup> Such losses, importantly, may be usable to offset gains on other assets.

**It may be possible for residents of the country in which the underlying asset is located to use this structure for ‘round-tripping.’**<sup>16</sup> Since the same logic applies when the country in which the ultimate owner resides, *P*, is the same as that in which the asset is located, *L*, capital gains tax that would be payable on a domestic sale in *L* can—in the circumstances assumed in Figure 1—be avoided by instead selling indirectly offshore.<sup>17</sup> Any tax benefit from this would be negated, however, if country *L* taxes its residents on capital gains realized by controlled non-resident entities—unless that gain is illegally concealed from the tax authorities in *L*.

**This example is highly stylized:** as discussed in detail below, the tax treatment of indirect transfers in practice will depend on details of both domestic law in the countries involved and any tax treaties between them (which may for instance allow country *L* to tax the sale by company *B*). However, many indirect transfers are in practice structured so as to bring the features assumed in the example of Figure 1 into play.

## B. Revenue Implications

**The revenue issues at stake in considering OITs are complex, and can be quite case-specific.** As throughout this report, the intention here is not to provide an encyclopedic account of all possibilities, but to bring out core considerations. As general background for this and later discussion, Box 1 considers the general nature of capital gains and how they arise.

### Box 1: Sources of Capital Gains

**Capital gains derive in large part from changes, between the initial purchase and sale, in expected future after-tax payments to the owner of the asset.**<sup>/1</sup> Both aspects of this are important:

- While capital gains can sometimes be fully anticipated,<sup>/2</sup> in the cases with which this report is principally concerned they typically arise from unexpected changes in future net distributions, perhaps as a result of a resource discovery or an increase in commodity prices—which in turn are often changes in *location specific rents*, a concept discussed further below.
- Since the value that any actual or potential holder places on an asset can be expected to take into account any future corporate, withholding or other taxes due—including capital gains tax on any future sales—capital gains tax reaches income not taxed by these other instruments. Viewed in one way it is a form of double taxation.

<sup>/1</sup> More precisely, taking the price of an asset to be the present value of expected net distributions to the owner, the capital gain on an asset purchased at time 0 and sold at time *T* is the amount by which net present value of distributions subsequent to *T* expected at time *T* exceeds that expected at time 0, with the latter discounted back to time 0 less (b) the net distributions that were expected at time 0 between then and time *T*. (This is of course a simplification of complex valuation issues: potential investors may have different expectations, for example, and/or may face different tax treatments on distributions.)

<sup>/2</sup> The value of an asset that derives from a certain payment at a fixed date in the future, for instance, will on at that account increase as that date approaches.

<sup>16</sup> Kane (2018) stresses the potential importance of this in relation to indirect transfers.

<sup>17</sup> This has been a concern, for example, with the treaty between India and Mauritius, under which gains realized in the latter on transfers of Indian entities are untaxed. This is widely believed to be one reason why around 25 percent of foreign direct investment in India in recent years has been routed through Mauritius (IMF, CDIS 2010-2015)—though it is unclear how much of this is round-tripping. In May 2016, a protocol amending the treaty was signed. The new article 13 allows taxation of capital gains on the alienation of shares of a company resident of a contracting state to be taxed in that state. Shares purchased prior to April 1, 2017, will continue to be exempted from such tax.

## Revenue effects from the transfer itself

**Consider the two broad possibilities that the owner of an underlying asset on which a capital gain has accrued has for realizing that gain:**

- ***A direct transfer of the underlying asset itself***, which will be subject to tax in country *L*. Within this option, there is a choice as to whether to sell that asset now or in the future, with the latter having the advantage for the taxpayer of deferring the liability on that gain.
- ***An indirect transfer***, selling an entity that owns the underlying asset. The purchaser, we assume for purposes of this comparative analysis, will eventually sell the underlying asset<sup>1819</sup> (or it will expire with zero value).

**In these circumstances—and assuming a constant tax rate—the nominal value of tax receipts in country *L*, cumulated over time, is independent of how the underlying asset is transferred.** In all cases, the underlying asset is eventually sold, and corresponding revenue collected on the accrued gain. (Of course, there may be further changes in the value of the underlying asset, but these simply imply further charges (or losses) to be combined with that initial accrued gain. If the asset expires with zero value, for instance, there is a future capital loss that offsets the gain accrued at the time of sale).<sup>19</sup>

**The revenue issue for country *L* is thus one of timing, rather than the directness or otherwise of the transaction—but the concern can be a very sizable one.** The longer the sale of the underlying asset is postponed, the lower in present value are country *L*'s receipts. This timing effect is a consideration of some importance for governments of lower income countries that face constraints on their borrowing capacity. At six percent interest, for instance, a delay of ten years in receiving revenue of \$1 billion reduces its present value by around \$450 million.

**The question then is whether indirectness can increase the attractions, in tax terms, of deferring sale of the underlying asset.** More generally, does taxation distort an initial owner's choice between, on one hand, a direct sale of the underlying asset today and, on the other, an indirect sale today with direct sale of the underlying asset (by the purchaser) deferred? Appendix B explores this issue. In the stylized setting there, the conclusion is that the possibility of distortion turns on the comparison between the rates at which the gain realized on the indirect sale of an entity will be taxed and (assuming the purchase is financed by borrowing) the rate at which the purchaser can deduct interest income. If the two rates are equal, then the two sale options yield the initial owner exactly the same amount: the tax benefits of deferring sale of the underlying asset are reflected in the price that the purchaser of the shares is willing to pay, and is amplified by the

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<sup>18</sup> Suppose for example that an asset was acquired for 10, has value today of 30 and will, from tomorrow onwards, have a value of 25. A direct sale then leads to a tax base in country *L* of 20 today, and of -5 on any future sale, a cumulative base of 15. An indirect transfer today may create liability in country *L*, but the eventual sale of the asset itself yields tax base of  $25 - 10 = 15$ . Assuming an unchanging tax rate, cumulative revenue in *L* is the same in the two cases.

<sup>19</sup> If this is not the case, comparison with direct sale is moot.

ability to deduct interest paid on the debt incurred to make the purchase; but those tax induced increases in the price at which the entity can be sold increase the initial owner's liability to capital gains tax on the share transfer. If these two tax rates are equal, the benefits of deferral are exactly neutralized by the capital gains tax on the share transfer. If, however, the rate of tax on the share transaction is low relative to the rate at which interest is deducted—a plausible case—then the indirect route, with sale of the underlying asset deferred, is tax-preferred by the initial owner.

**While the revenue issue for the location country is thus essentially one of timing, it is reasonable to conclude that indirect transfers conducted in low tax jurisdictions may have the effect of amplifying tax distortions towards delayed sale of the underlying asset.**

### Effects on other tax payments

**Since company A remains resident in country L, the transfer has no direct impact on country L's future receipts of corporate income tax<sup>20</sup>** (or, in the case of the extractive industries, any royalties or rent tax) from A. (There may be indirect effects from changes in the commercial and financial operations of A as a result of changes in its ultimate ownership, but we leave such effects aside in this discussion.)

**The same is likely to be true, in practice, of L's receipts from any post-sale withholding taxes on dividend, interest or other payments made by corporation A to its new direct owner.** In Figure 1, A's new direct owner P2 is resident in a country different from that of the initial direct owner B. In that case, different withholding tax rates may apply, with consequent effects on country L's revenue. It seems to be more common in practice, however, that the transfer takes the form of the sale of B by a company interposed between B and the initial parent P1. Company B thus remains the direct owner of A, and there is then no change in the withholding taxes payable.<sup>21</sup>

### Relevant taxpayer and ability to pay tax

**Another relevant tax policy and administrative consideration is the perspective of taxpayers who derive the income and their ability to pay the tax.** Any policy decision to levy or not to levy tax on a taxpayer in respect of the income derived from their activities of selling or actively exploiting the assets may need to be carefully considered also from the perspective of the principle of equality and ability to pay the tax.

**The seller who derives the capital gain is disposing of the asset including the related potential future economic benefits.** The capital gain is the excess income earned from the disposal of the asset compared to the seller's initial investment. The seller is thus deriving income in excess of their expenditure while the buyer is incurring an expenditure in acquiring the asset

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<sup>20</sup> Unless, that is, the sale leads to a step up in basis and the asset is depreciable (as it generally would be under Model 1).

<sup>21</sup> It might seem that realizing a lightly taxed capital gain provides a way in which to avoid withholding tax on distributions of previously accumulated retained earnings (on which, being undistributed, no dividend withholding has been collected). But those retained earnings presumably have a value to the purchaser only in so far as they can, at some point, be paid as dividends: at which point the withholding tax will apply. The equity placed in Company A is in a sense trapped, in that the future dividends that ultimately give it value—even if derived from past retentions—will be subject to withholding when paid. On this 'trapped equity' view, see for instance, Auerbach (2002).



from which the buyer expects to earn future economic benefits in excess of the acquisition price. Both the seller and buyer are potential taxpayers in respect of the income they derive due to their activities and actions. The seller is clearly the taxpayer deriving income from the disposal of the asset and based on the ability to pay principle, it is the seller who is in a position to pay the tax on this income. The buyer on the other hand has incurred an expenditure and may only derive income from the future exploitation of this asset, assuming the external circumstances and their ability to exploit the asset effectively will lead to an outcome that the asset will generate income in excess of the expenditures incurred. The buyer thus may be in a position to pay the tax on the future income generated from the asset. Both the seller and buyer are two different taxpayers with potential different abilities to pay the tax at different moments in time.

## C. The Allocation of Taxing Rights on OITs: Equity and Efficiency Considerations

**A threshold question is whether the country in which an asset is located should have primary taxing rights on its indirect transfer abroad—and, if so, to precisely which assets this should apply.** In taking up this question, the analysis here goes beyond the possibility of taxing indirect transfers solely as a back-up method to combat tax avoidance and sets out key considerations in deciding an appropriate allocation of taxation rights on gains realized indirectly on domestic assets.<sup>22</sup>

**Several (inter-related) issues of economic principle come into play**—leaving aside, for the moment, the current practices and legal concepts discussed below. These include: *inter-nation equity*, in assuring an allocation of revenues meeting some notion of fairness between countries; and *efficiency*, in ensuring that assets are used in the most productive ways. Considerations of political economy also have an important role to play in practice—indeed, given the high profile of many OIT cases, they driven many recent developments in this area; but they are not dwelt on here. Beyond some basic matters of practicability, issues of implementation—ensuring that tax is collected at reasonable cost to both tax administrations and taxpayers themselves—are deferred until Section 5 below.

### Inter-Nation Equity

**Views differ on what ‘fairness’ means in the allocation of taxing rights across countries, but three current norms point to some possibility for consensus in relation to the location country’s right to tax OITs:**

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<sup>22</sup> Location countries may, having achieved taxing rights over these transfers, elect not to exercise those rights, or not to do so in full in order to promote their business environment—just as many countries elect to grant tax holidays and exemptions in the hope of attracting foreign investment. Whether such incentives are effective, or necessary, is the topic of an earlier Platform toolkit (“Effective and Efficient Use of Tax Incentives for Investment in Lower Income Countries,” 2015). In any event, countries cannot make such a choice if they do not have the underlying right in the first place.

- Capital gains on onshore direct transfers of tangible assets are taxable by the country in which the asset is located (even though the seller—and, likely, also the purchaser—may be non-resident);
- Dividends received by a parent company abroad may be subject to tax through withholding by the country in which the paying company is resident;<sup>23</sup>
- It is quite widely accepted—as reflected in the model treaties discussed below—that the country in which an ‘immovable’ asset is located is entitled, if it so chooses, to tax gains reflecting increases in the value of that asset—though not all countries do so.

**The first norm points to the view that the country in which an asset is located should be entitled to tax gains associated with it**—at least to the extent that those gains are not attributable to value-enhancement provided from abroad (a natural resource deposit has little value, for instance, until it is ‘discovered’). Establishing the extent of any such contribution, however, could of course be problematic; this point is taken up below.

**The second norm suggests that the right to tax returns to foreign investors in the form of dividends from a domestic source being accepted, so too should be a right to tax them on returns in the form of capital gains associated with a domestic source.** A counterargument is that the asset price and hence the gain reflects accumulated undistributed and expected future after-tax earnings, which the location country could have taxed in the past and may tax in the future through the corporate income and other taxes (rent taxes in the extractives, for instance). The gain, that is, reflects earnings that the location country has in a sense simply chosen not to tax, and hence—almost tautologically—there is no reason for concern if those gains are untaxed. But this counterargument is not wholly compelling, especially in the case of low-capacity countries. Dividend tax rates may be constrained by tax treaties (though that could be interpreted as simply another way in which country *L* has chosen not to tax future earnings). Perhaps more persuasively—a point taken up later—the exploitation of avoidance opportunities may diminish the effective power of the country in which the underlying assets are located to tax earnings as they arise. In the limit, for a country that cannot effectively tax either the earnings of the acquired entity or the dividends paid to a foreign parent, taxing the gain on asset transfers, direct or indirect, may be its surest prospect of raising revenue on the associated earnings.

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

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<sup>23</sup> Except, for example, by the Parent Subsidiary Directive within the European Union (we leave aside specific intra-EU issues in this report) or by domestic legislation or treaty provision in other countries.

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

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

The best way to tax such rents is by a tax explicitly designed for that purpose, and indeed there is extensive experience with a variety of such ‘rent taxes’, including though not only in the extractive industries.<sup>24</sup> These taxes are not, however, invulnerable to profit shifting of various kinds, particularly in lower income countries.<sup>25</sup>

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

- ***A third rationale for the right to tax gains on local immovable property is grounded in the benefit theory of taxation***—i.e., that taxes are in the nature of payments for public services provided by government, which help maintain the value of local economic factors, including local immovable property. This argument is also sometimes used as a rationale for the corporate tax itself—and is not especially compelling, in that gains (or profits) may be a poor proxy for the benefits received.

**In economic terms, the concept of ‘immovability’ might be most meaningfully thought of as proxying for the possibility of location specific rents**—with implications for how the term should be defined. This view suggests an expansive definition of ‘immovability’ capable of capturing at least the most likely sources of significant LSRs. This, however, is much easier said than done: the concept of LSR has not been sufficiently fully developed to be readily captured in legislative language. But while LSRs can be difficult to identify in general, in some cases they are reasonably obvious. They are often associated with government-created rights— notably in the extractive industries and telecoms. Many of the cases that give rise to concerns in relation to

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<sup>24</sup> See for instance several of the contributions in Daniel and others (2010).

<sup>25</sup> See for example, Beer and Loeprick (2017), who find evidence of extensive profit shifting in the sector, with signs that developing countries are especially vulnerable. For evidence of their greater vulnerability to profit shifting more generally, see for instance Crivelli, de Mooij and Keen (2016).

indirect transfers revolve around rights that are explicitly tied to particular locations— with their value being made visible by the transfer itself.<sup>26</sup> LSRs could also arise, for instance, from access to domestic markets, but this can be difficult to gauge and distinguish from rents associated with brand names or intellectual property. And, of course, the fact of a company being resident for tax purposes in a country clearly does not imply that its value substantially derives from LSRs arising there.

**What these considerations suggest is that any definition of immovability that proceeds by positive listing should anticipate, so far as is possible, likely sources of significant LSRs**—and there are signs that, though not expressed in those terms, this is increasingly the case. Definition have come to more commonly include, for instance, not just the right to extract natural resources but the full range of licenses that may be associated with their discovery and development.

**There are two counterarguments to this emphasis on location country taxation:**

- ***Any gain reflects underlying income that the location country has chosen not to tax.*** It may be, however, that the capital gains charge is that country's preferred method of taxing that income—or even, in the case of some developing countries, that when the law was drafted and treaties were signed, the authorities were simply not aware of or focused upon this issue. Otherwise, that future income is at risk of non-taxation, as discussed above, whether for timing reasons, or because of imperfections in other tax instruments, especially in developing countries. This makes taxation of gains a worthwhile, albeit very imperfect, additional tool.

It should be recognized, however, that countries may affirmatively choose—as some have—not to tax such gains on indirect transfers even where they could do so.<sup>27</sup> This may be seen, for instance, correctly or not, to attract foreign investment.

- ***The increased value of the entity sold may reflect in part managerial and other expertise contributed by the seller, beyond what has been recovered in managerial fees, royalties and other explicit payments.*** This suggests that the gain might be properly taxed where the seller resides (so ensuring, in efficiency terms, that the seller's decision as to the country in which it chooses to undertake such value-adding activities is not affected by the tax system). It may indeed be that there are company-specific as well as location-specific rents at work, and one might argue that the latter are naturally taxed where the company is resident.<sup>28</sup> The many countries operating dividend exemption schemes, however, have effectively indicated no desire

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<sup>26</sup> Indeed, this is evident, to some degree, in the national responses to indirect transfer cases, which have focused not on reducing the domestic taxation of direct transfers—as one would expect to be the case if there were no location-specific value to the underlying asset—but to seek to extend taxing rights. Without the existence of LSRs, that is, one would expect low taxation of indirect transfers to spur more intense tax competition in the treatment of gains on transfers rather than, as seems to be the case, the opposite.

<sup>27</sup> The United States, for example, limits the reach of the Foreign Investment in Real Property Act (FIRPTA) to transfers occurring either directly, or at the first tier of ownership of the asset. Norway has affirmatively declined to tax such transfers in the resources sphere.

<sup>28</sup> There are issues here, which we leave aside, as to the relevance of companies' residence as a basis for taxation, given the increasing disconnect between that and the residence of final shareholders.

to do so. More generally, how compelling this argument is may well depend on the circumstances of the case, being less plausible when the selling entity has few substantive functions. Moreover, the possibilities for structuring indirect transfers means there can be no presumption that the jurisdiction in which the gain is realized is that in which the underlying expertise or financing was ultimately provided. Indeed, it can be argued that any such contribution made by the non-resident seller or any other affiliated entity for the benefit of the separate entity, which owns the relevant underlying asset in a foreign jurisdiction, is to be compensated for this contribution in the form of managerial fees, royalties and other payments made at arm's length. One might then think of some form of substance test, though this as always runs the risk of creating its own distortions, with resources allocated simply to meet the requirements of such a test and not for reasons of productivity.

**The weight of argument creates a strong equity case for a presumptive primacy of source country taxing rights in relation to gains on immovable assets, defined to apply to sources of location specific rents.**

## Efficiency

**A general principle of good tax design is that, so far as is practicable, the tax system should not distort investors' decisions:** unless there is good reason to do so, taxation should not lead businesses to change their commercial decisions.<sup>29</sup> The reason for this is that, unless there is good reason to suppose those commercial decisions to be otherwise inappropriate, any such changes mean that resources are being used in ways that are socially inefficient, but are privately profitable only because of taxation.<sup>30</sup>

**While efficiency considerations point firmly to the taxation of rents of various kinds, the literature on efficiency criteria in international taxation provides few practicable insights.**

The prescription that rents are an efficient object of taxation is a very general one. As for other forms of taxation (that is, ones that may distort decisions), there is a large literature on their efficient design in international settings—focusing here on collective rather than national interests. This literature, however, has produced few (if any) agreed practicable policy prescriptions. For example, if the concern is to avoid distorting how parent companies choose to allocate their productive capacities across different countries then residence-based taxation is appropriate<sup>31</sup> (since whatever was the most profitable choice before tax will then also be the most profitable after tax). But if, on the other hand, the concern is to ensure equal within-country treatment of all

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<sup>29</sup> Leaving aside the cross-border issues of interest here, several non-neutralities arise more generally in relation to capital gains taxation (in relation, for instance, to the distortions arising from taxing gains on realization rather than accrual). These are not addressed in the discussion here.

<sup>30</sup> Strictly, it is worth noting, efficiency considerations relate only to the tax rules applied, and are in themselves essentially silent on which country should receive the associated revenue. Revenue sharing on indirect transfers seems a sufficiently remote possibility, however, for it to be ignored here.

<sup>31</sup> Ignoring here the possibility of changing the place of corporate residence.

potentially active companies, wherever they are resident, then source-based taxation is needed.<sup>32</sup> Theory offers little guidance as to which view is the more appropriate from a collective perspective.<sup>33</sup> Two considerations, however, do point to significant efficiency considerations in this context.<sup>34</sup>

**The most fundamental efficiency argument for the country in which assets are located to tax both indirect and direct transfers is as a way to tax LSRs—albeit imperfectly.** The preferability in principle, but limitations in practice, of explicit rent taxes were stressed above. Auctions are another possible tool for rent extraction, and have been widely used, for instance, for petroleum rights; but these can be subject to problems of asymmetric information and thin markets (being rarely used for instance, in relation to hard minerals).<sup>35</sup> On efficiency grounds, as well as those of inter-nation equity, taxing gains can be a useful supplementary device where—as in many developing countries—other methods of taxing LSRs are imperfect.

**One natural requirement for neutrality is that direct and indirect asset transfers be treated identically for tax purposes.** That is, transferring an asset or transferring shares deriving their value from that asset, to the extent that they represent the same transfer of ownership, should—all else equal—attract the same tax treatment. Otherwise there will be an incentive to distort transactions as a result of the differences.

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

## Assessment

**The arguments are not all in one direction, but on balance the analysis above suggests it to**

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<sup>32</sup> This latter is akin to the notion of ‘capital ownership neutrality’ advocated by Desai and Hines (2013).

<sup>33</sup> See for example Appendix VII of IMF (2014).

<sup>34</sup> There are other dimensions of neutrality that should in principle also be considered. These include, for instance, the financing of the entity operating the underlying asset (Company *A* in Figure 1). To the extent that the dividends it pays are taxed more heavily than are capital gains on its sale, this gives a tax incentive to finance the operations of that entity by retaining earnings rather than by injecting new equity—which might, for instance, imply slower growth of its operations (Sinn, 1991). This would be alleviated by taxing dividends and capital gains at the same rate. That does not necessarily mean that both types of income should be taxed by the same country, but is most naturally achieved by the location country taxing gains just as it does dividends. How significant a concern this is, however—compared for instance to what is often a very marked tax preference for debt finance—is unclear.

<sup>35</sup> On both rent taxes and auctioning in the extractive industries, see Daniel, Keen and McPherson (2010).

**be appropriate that countries should have the right to tax capital gains associated with transfers of immovable assets located there, regardless of whether the transferor is resident there or has a taxable presence there.**<sup>36</sup> In equity terms, this mirrors the generally recognized right in relation to direct transfers; in efficiency terms, it provides one route to the taxation of location specific rents—highly imperfect, but potentially valuable when preferred instruments are unavailable or weak—and fosters neutrality between direct and indirect transfers. General agreement on the scope of such a right—and well-developed models of implementation—would help to avoid uncoordinated measures that jeopardize the smooth and consensual functioning of the international tax system and give rise to tax uncertainty.

**The rationale, in terms of economic principle, for limiting this treatment to immovable assets is unclear.** Much current practice is already sharply at odds with this; while primary taxing rights are frequently given to the source country in relation to immovable property but to the residence country in the case of equity participation in other businesses, there are some notable exceptions, such as the cases of Peru and India discussed later. Indeed, Article 13(5) of the UN Model Tax Convention (MTC), discussed in section IV below, extends location country taxation up one tier of ownership, to gains on any company shares.<sup>37</sup>

**What emerges clearly is the importance to the location country of clearly defining ‘immovable assets’.** Considerations of inter-nation equity, efficiency and practicability converge to suggest that the scope could include all assets with the potential to generate significant location-specific rents and over which the government can exercise sufficient control to ensure collection. However, a country may choose a narrower definition.

**Moreover, while the location country may choose not to exercise its right to tax OITs, experience—exemplified by the cases discussed in the next section—shows that not doing so can provoke intense domestic dissatisfaction.** These assets are commonly highly visible, with strong salience for the general public—perhaps reflecting a highly publicized resource discovery, for example—and are often non-renewable resources owned by the nation (in the case of extractive resources) and/or created by the government (in the form of licenses or other rights). And, as will be seen shortly, the sums at stake can be large.

**This dissatisfaction can lead to unilateral legislative actions—which may (and do) differ across countries—that exacerbate tax uncertainty,** with harmful effects for investors, taxpayers and governments.

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<sup>36</sup> Others have reached a similar conclusion. Cui (2015, p.154), for instance, takes the position that “too much of the international tax discussion recent decades has been centered on whether non-residents should be taxed on capital gains, rather than how they are to be taxed.

<sup>37</sup> More precisely, this provision allows state *L* to tax the sales by non-residents of shares in companies resident in *L*. There is no comparable provision in the OECD MTC.



## II. THREE ILLUSTRATIVE CASES

Three highly publicized OITs are described in Boxes 2 to 4:<sup>38</sup> *Vodafone's* purchase of a substantial interest in a mobile phone operator in India, the indirect sale of the Peruvian oil company *Petrotech Peruana*, and the indirect sale by *Zain* of various assets in Africa including a mobile phone operator in Uganda.<sup>39</sup> All of these transactions have (at least so far, as appeals continue) raised the issue of whether multinational groups can ultimately escape taxation of gain on a OIT in the country in which the underlying assets were located, and ensure no or light taxation of the gain elsewhere, by arranging that the transfer be effected as a sale by an entity not resident where the subsidiary holding the underlying asset is located.

### Box 2. India—The *Vodafone* Case

In 2006, *Vodafone* purchased *Hutchison's* participation in a joint venture to operate a mobile phone company in India (the owner of an operating license), for nearly US\$11 billion. This transfer was accomplished by *Hutchison*, a Hong Kong-based multinational, selling a wholly owned Cayman Islands subsidiary holding its interest in the Indian operation to a wholly owned subsidiary of *Vodafone* incorporated, and for tax purposes resident, in the Netherlands. The transaction thus took place entirely outside India, between two non-resident companies. /1

The Indian Tax Authority (ITA) sought to collect over US\$2 billion of tax on the capital gain realized by *Hutchison* on the sale of the Cayman holding company. As per the Indian Law, the purchaser is required to deduct tax at source while making payment to the non-resident seller. Accordingly, the Indian Tax Authority (ITA) held the purchaser, *Vodafone's* Dutch subsidiary, liable for failure to comply with its obligation to withhold tax from the price paid by it to *Hutchison* on the ground that the capital gains realized by the seller were taxable in India. This sparked a protracted court case, with the Supreme Court of India ruling in 2012 in favor of the taxpayer. The Supreme Court denied the ITA's broad reading of the law to extend its taxing jurisdiction to include indirect sales abroad, though it took the view that the transaction was in fact the acquisition of property rights located in India.

The government of India subsequently brought in a clarificatory amendment with retroactive effect to overcome the technical difficulty arising out of the Supreme Court ruling so as to allow taxation of offshore indirect sales and to validate the tax demand raised against the *Vodafone's* Dutch subsidiary. The legality of a retroactive effect of the law was not challenged by *Vodafone* in the Indian courts and instead it has submitted the action of the government of India to arbitration under the India-Netherlands Bilateral Investment Treaty.

/1 See Cope and Jain (2014)

<sup>38</sup> These are three of the largest and best-known instances of this issue. For that reason, their details are also the most public, and the best explored—and they have had perhaps the greatest impact on future actions of the host countries and the broadest ramifications. But experience shows that many other countries face this issue, albeit with less spectacular publicity.

<sup>39</sup> Other examples are in IMF (2014) and Burns, Le Leuch and Sunley (2016).



### Box 3. Peru—The Acquisition of *Petrotech*

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

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

### Box 4. Uganda—The *Zain* Case

In 2010, a Dutch subsidiary of the Indian multinational *Bharthi Airtel International BV* purchased from *Zain International BV*, a Dutch company, the shares of *Zain Africa BV* (also a Dutch company) for US\$10.7 billion, which owned in turn the Kampala-registered mobile phone operator *Celtel Uganda Ltd.* (among other investments in Africa).<sup>/1</sup>

The Uganda Revenue Administration (URA) held *Zain International BV* liable for the corresponding capital gains tax, amounting to US\$85 million. Uganda's Appeals Court ruled—in sharp contrast to the decision of the Supreme Court of India in *Vodafone*—that the URA does have the jurisdiction to assess and tax the offshore seller of an indirect interest in local assets (overturning an earlier ruling by the High Court of Kampala.)<sup>/2</sup> However, the taxpayer interprets the tax treaty between Uganda and the Netherlands as protecting the Netherlands' exclusive right to tax such transaction. This is an issue of some potential significance since some anti-avoidance rules in domestic law could be viewed as supplementary to the treaty, not an override; it is currently unresolved.

<sup>/1</sup> Zain International BV belongs ultimately to the Zain Group, whose main shareholder is the Kuwait Investment Fund.

<sup>/2</sup> See Hearson (2014) and The *East African* "Court gives URA nod to seek taxes on sale of Zain assets in Uganda", September 13, 2014, at <http://www.theeastafrican.co.ke/news/URA-taxes-on-sale-of-Zain-assets-in-Uganda/-/2558/2451578/-/item/0/-/6hm2he/-/index.html>http.

**The amount at stake is in all three cases very large:** that in *Zain* is in the order of 5 percent of total government revenue (and, for example, nearly 50 percent of public spending on health); that in *Vodafone* is around 2 percent of central government revenue (and almost 8 percent of all annual income tax revenues).<sup>40</sup>

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

**In all three cases,<sup>41</sup> the country in which the underlying asset was located lost in court—or at least has not yet clearly won.** The reasons differed, however: insufficiency of the domestic income tax law to reach such transfers in India and Peru; in Uganda, potential override of a treaty (one that does not contain provisions along the lines of Article 13(4), discussed in Section IV below). In all cases, governments and many civil society organizations argued that developing countries had been denied (or had inadvertently denied themselves) a fundamental (and substantial) source of revenue. This was especially problematic politically when it could be shown that the subsidiary being indirectly sold had previously paid little, if any corporate income tax, as was pointed out in the congressional investigation on *Petrotech* ordered in Peru. Public outcry in several of these cases was considerable. In Peru, for example, the transaction became linked with corruption scandals, leading to the dismissal of Prime Minister and Cabinet.

**The cases show that the location country may well respond to defeat or challenge in court by quite sweeping policy changes as in the cases of Peru and Chile, which amended their domestic laws to bring into tax offshore transfers related to all assets located in their countries—not just those deriving value from immovable property located there.** In the case of India, however, a clarificatory amendment was effected in its domestic law with retrospective effect from 1962 (the date of the applicability of the current Income-tax Act) for taxation of OITs.<sup>42</sup> Such unilateral responses are understandable and may reflect different legal systems in different countries.

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<sup>40</sup> Other examples are given in Appendix VI of IMF (2014).

<sup>41</sup> In other cases—*Heritage* in Uganda, *Las Bambas* in Peru, for instance—tax has been recovered by the location country.

<sup>42</sup> Cited by Cui (2015, p.146), the amendment reads: “any share or interest in a company or entity registered or incorporated outside India shall be deemed to be...situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.”

### III. TAX TREATIES AND OFFSHORE INDIRECT TRANSFERS

This section reviews the treatment of OITs envisaged in the model tax treaties,<sup>43</sup> reports on a tentative empirical analysis of current treaty practices and describes the 2017 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (multilateral instrument – MLI). This review makes clear that for indirect transfers, in relation to assets defined as “immovable” under the models, primary taxing rights are accorded by these agreements to the location country.

#### A. OITs in the Model Treaties

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

Table 1. Allocation of Taxing Rights Between Countries on Transfers of Assets Under Model Tax Conventions		
Type of Property	Type of Transfer	
	Offshore Direct	Offshore Indirect
Immovable Assets in Country L	Country L	If more than 50% of value of shares or comparable interests is (directly or indirectly) derived from immovable assets: Country L <sup>1</sup> Otherwise: Country R
Movable Assets in Country L	Seller has PE in Country L to which the assets are allocated: Country L	
	"Substantial" Ownership Interest <sup>/2</sup> UN MTC (Article 13(4): Country L OECD MTC: Country R	
	Other Cases: Country R <sup>3</sup>	

Legend: L = Country where underlying asset is located  
R = Country where seller resides

<sup>1</sup> Allocation of taxing rights to Country L in this case extends to transfers by any entity in the chain of ownership of the assets in country L, regardless of number or location of intervening entities.

<sup>2</sup> "Substantial" ownership interest is defined in the UN MTC as an unspecified percentage of the share of the entity in question. The OECD MTC does not have a similar provision. As a result, the OECD treaty effectively gives the taxing right in these situations to Country R, where the owner (seller) of the ownership interest is resident.

<sup>3</sup> Taxing rights related to ships and aircraft used in international transportation are allocated to the country where the entity with effective management of those assets resides, but the 2017 version of the UN Model will prefer, including for administrative reasons, a test of the country of the residence of the enterprise operating the ships or aircraft, as in the 2017 OECD Model.

<sup>43</sup> Toledano and others (2017) rightly note to the need to ensure that countries’ intended treatment of OITs is not inadvertently undermined by provisions in bilateral investment treaties or concession agreements.

**To avoid double taxation, a treaty will typically award either (i) exclusive taxing rights to the residence state or (ii) a primary taxing right to the state where the asset is located**, with the appropriate relief mechanism in the resident state in order to eliminate double taxation. In the absence of a treaty to that effect, double taxation could occur, though taxpayers would in most cases be able to access the unilateral relief that countries provide in their domestic legislation and, if not having full confidence in this, would presumably consider structuring their transactions to limit their exposure.

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

**Gains on indirect transfers are dealt with in Article 13(4)** of each MTC.<sup>44</sup> In the OECD version, prior to its 2017 update,<sup>45</sup> this reads:

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

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

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

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

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

A sub-clause defines 'principally' by a 50 percent threshold test similar to that in the OECD version.<sup>46</sup>

The 2011 UN version continues:

*In particular:*

*(a) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other*

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<sup>44</sup> The UN MTC has included this provision since its inception in 1980, and the OECD MTC has included one since 2003.

<sup>45</sup> Superseded model treaty provisions remain relevant in that they may be reflected in still-current treaties.

<sup>46</sup> The UN text parallels wording in U.S. domestic law on indirect sales of immovable property and U.S. commentaries to the OECD MTC.

- than a company, partnership, trust or estate engaged in the business of management of immovable property, the property of which consists directly or indirectly principally of immovable property used by such company partnership, trust or estate in its business activities.*
- (b) For the purposes of this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.*

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

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

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

This definition has as its starting point the definition in domestic law, which may vary widely between countries.<sup>47</sup>

**The basic rule for indirect transfers of immovable property has thus been quite similar in the two MTCs, and is now the same.**<sup>48</sup> This similarity reflects a commonality of broad intent in the two provisions. Both allocate the primary right to tax to the country where the immovable property is located, regardless of the residence of the company (or other vehicle) owning that

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<sup>47</sup> Krever (2010) notes that "[a]s a general rule, civil law jurisdictions seem content to limit the meaning of immovable property, at its narrowest going little beyond tangible real estate, while natural-resources-rich common law countries have the broadest definition" (p.223). As an example of an expansive approach, he cites (p.237) the definition of "taxable Australian property" as including "any authority, license, permit or right under an Australian law to mine, quarry or prospect,...a lease of land that allows the lessee to mine, quarry or respect,...an interest in such an authority, license, permit, right or lease...and any rights that are in respect of buildings or other improvements...on the land concerned or are used in conjunction with operations on it." See also Box 10 below and the discussion there.

<sup>48</sup> Until recently, the UN version was broader in applying to forms of title other than shares (the text to this effect, emphasized above, having been introduced in 2001). Under Action 6 of the BEPS work, however, agreement was reached to amend the OECD MTC to eliminate this difference.

One point relating to both is that the 50 percent test relates to the proportion accounted for by the immovable property in the total value of the title being sold, not the share of the gain: so taxing rights may be allocated to a country other than that in which the majority of the gain arises. Some countries see this "blunt" aspect of the rule as an advantage, in discouraging abuse, and as minimizing potentially complex disputes on valuation issues as to property distributed internationally. In any case, domestic law may limit the liability to profits proportionate to the amount of immovable property in the taxing countries, and therefore may not seek to fully exert the treaty taxing rights. Location countries may want to consider the balance of complexity versus "bluntness" in drafting the relevant rules on valuation and apportionment.

property.<sup>49, 50</sup>

**Article 13(5) of the UN MTC (which has no parallel in the OECD MTC) extends the reach of offshore taxation beyond immovable property**, however defined. Before 2017, Article 13(5) of UN MTC read as follows:

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

The 2017 UN Model includes the following changes to Article 13(5) (changes highlighted):

*Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, **or comparable interests, such as interests in a partnership or trust**, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during **the 365 days preceding such alienation**, held directly or indirectly at least per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.*

This allocates to country *L* taxing rights over the gain derived by a non-resident of country *L* from the disposal of shares (or comparable interests) of a company, partnership or trust that is itself resident of country *L*. However, this only applies to offshore *direct* ownership of such entities. For

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<sup>49</sup> The Commentary on the OECD MTC considers other important exclusions, which relate more to implementation complexities than to conceptual issues. For example, it could exclude from taxation alienators having below a certain minimum level of participation in the entity; or the sale of shares of companies listed in an approved stock market, or gains from transfers of shares in a corporate reorganization. Commentary 28.7 to OECD MTC; OECD (2017).

<sup>50</sup> The exclusion from taxation of indirect transfers involving certain types of entities whose property consists principally of immovable property used by them in their business activities as provided in Article 13(4)(a) of the UN MTC prior to 2017 was potentially limiting, but has now been changed. The Commentary to the 2011 UN Model did not address the interpretation of this exclusion and so the scope of its application was unclear. At worst, exempting from tax in the location country an indirect transfer of immovable property (complying with the more than 50 percent value rule) when it involves property that is being principally used in the business activities of the entity sold—including for example a hotel or mine—as Article 13(4)(a) of the UN model treaty may be argued to do—could have resulted in a limitation of taxing rights that the contracting states had not intended, especially for developing countries, as it could have involved sectors in which sizeable economic rents are concentrated. An alternative interpretation commonly put forward was that the “business activities” exclusion only applied where the non-resident seller of the shares used the relevant immovable property in its own business activities as compared to that property being used by the asset owning entity whose shares are being transferred. Due to this uncertainty, the UN Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries itself notes that “...in practice, this provision is not commonly found in treaties negotiated by developing countries... since gains from the alienation of interests in entities that own and run mines, farms, hotels, restaurants, and so forth, are not covered by this paragraph.” United Nations (2016).

that reason, while Article 13(5) may help address certain tax avoidance arrangements (e.g. certain dividend-stripping or change of residence strategies), it is not suitable as a provision to ensure the source taxation of gains on indirect transfers. According to the UN *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*, treaty practice varies with regard to the use of Article 13(5): some countries explicitly exclude gains on listed shares; others restrict the scope to gains realized by individuals who were previously residents of the source State; and many countries do not include this provision at all in their treaties.

## B. OITs and the Multilateral Instrument

**The Multilateral Instrument or “MLI” is the outcome of BEPS Action 15**, which called for the development of a multilateral instrument to implement efficiently BEPS tax treaty related measures. Accordingly, the MLI modifies existing bilateral tax treaties between its parties to meet the BEPS treaty-related minimum standards, that is, the prevention of treaty abuse under BEPS Action 6 and the improvement of the dispute resolution mechanisms under BEPS Action 14. At the same time, the MLI facilitates the implementation of other tax treaty measures developed in the BEPS Project, such as measures against artificial avoidance of permanent establishment status through commissionaire arrangements.

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

**For countries that already have in their tax treaties a provision related to the taxation of capital gains realized from the alienation of shares, the MLI offers two options for enhancing it.** First, Article 9(1) of the MLI allows parties to modify their covered tax treaties by introducing a testing period into Article 13(4). Accordingly, Article 13(4) will refer to a period of 365 days preceding the alienation of shares for determining whether the shares derive their value principally from immovable property. Additionally, Article 9(1) of the MLI offers the parties the possibility to enlarge the scope of Article 13(4) of the OECD MTC by expanding the type of interests covered. As a result, interests comparable to shares, such as interests in a partnership or trust, would be also included in the wording of Article 13(4).<sup>51</sup>

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<sup>51</sup> In the 2014 version of the OECD MTC, the option to cover gains from the alienation of interests in other entities such as partnerships or trusts is provided in paragraph 28.5 of the Commentary on Article 13.



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

**Notably, merely signing the MLI does not mean that the signatory's tax treaties will be modified by the provisions of Article 9 of the MLI.** The MLI allows parties to reserve their right not to apply any of the provisions included in Article 9(1) or not to include the language of Article 9(4).<sup>52</sup> In addition, as explained in Section V, the location country must have enabling provisions in its domestic law for imposing tax on a capital gain derived from an OIT.

**Beyond the specific provisions included in Article 9, Part III of the MLI introduces additional measures to prevent treaty abuse that may also preserve the location country's taxing rights over OIT gains.** In particular, Article 7 of the MLI contains the *principal purpose test* (PPT) and the *limitation on benefits* rule (LOB). These provisions disapply treaty benefits if obtaining those benefits was one of the principal purposes of the relevant arrangement or transaction (the PPT), or if the person claiming treaty benefits, or the transaction they undertake, does not meet certain objective conditions (LOB). This report provides further analysis of the application of general or specific anti-avoidance rules to OITs in Section 5(A).

**Finally, the MLI may also be a future means of addressing further developments in the taxation of OITs.** In this respect, the design of the MLI offers the parties the possibility to amend the instrument in the future through the mechanism established in its Article 33. This mechanism would allow the inclusion of new tax treaty measures to safeguard the taxing rights of the source country in relation to OITs.

**As of March 2020, it is expected that the MLI will modify 104 bilateral tax treaties by adding the requirements in Article 9(1) of the MLI and 336 tax treaties by including the provision of Article 9(4) of the MLI,** bringing all of those treaties into line with the new wording of Article 13(4) of the OECD MTC. This number is expected to increase in the future as new signatories opt for the provisions of Article 9(4) of the MLI.

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<sup>52</sup> In the first round of signing of the MC, in June 2017, half of the participating 69 countries reserved on the relevant provision—meaning that they would not include it in renegotiating their treaties.



## C. Article 13(4) in Practice<sup>53</sup>

**This subsection reports a tentative analysis by the IMF of the inclusion of Article 13(4) in tax treaties as of 2015.** Details are in Appendix D.

**About 35 percent of all DTTs include Article 13(4),<sup>54</sup> with a reference to shares that derive their values indirectly from immovable property (Figure 2).** Around 60% of DTTs contain a provision on capital gains on shares deriving value from immovable property, counting also those without the word ‘indirectly’ (Wijnen and de Goede, 2014).<sup>55</sup>

**The inclusion of Article 13(4) is slightly less common in DTTs that involve low or lower-middle income countries,** at around 31 percent (Figure 1).

**The likelihood that Article 13(4) is included in a treaty<sup>56</sup> is significantly:**

- ***Lower if one of the treaty partners is a resource-rich low-income country,*** by about 6 percentage points. This is a striking finding, and in light of the discussion above, a potentially troubling one.
- ***Lower if one of the treaty partners is a low tax jurisdiction*** by about 13 percentage points. This too is troubling, because these are likely to be cases in which the opportunity to avoid tax in the location country by transferring indirectly is most attractive.
- ***Higher, the greater is the difference between the rates at which capital gains are taxed in the treaty partners.***<sup>57</sup> This, on the other hand, suggests an awareness of the high tax treaty partner to the opportunities for avoidance through OITs. The effect, though, is quite modest: a 10-percentage point difference between capital gains tax rates increases the probability of including Article 13(4) by only about 4-percentage points, on average.
- ***Increasing over time.***

**Almost no countries with multiple treaties have Article 13(4) in all of them—implying a vulnerability through OITs structured to exploit treaty provisions even where the location country *L* was evidently aware of the possibility of imposing tax on such gains.** As shown in Figure 3, several countries, including several developing countries, do not have Article 13(4) in any

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<sup>53</sup> This section, and the underlying analysis (reported in more detail in Appendix D), were prepared by the IMF. Data are as of 2015.

<sup>54</sup> By “including Article 13(4)” is here meant, more precisely, the inclusion of an article akin to 13(4) of the model treaties with an explicit reference to ‘indirectly.’

<sup>55</sup> Wijnen and de Goede (2014) look at about 1,800 DTTs tax treaties and amending protocols concluded during 1997-2013.

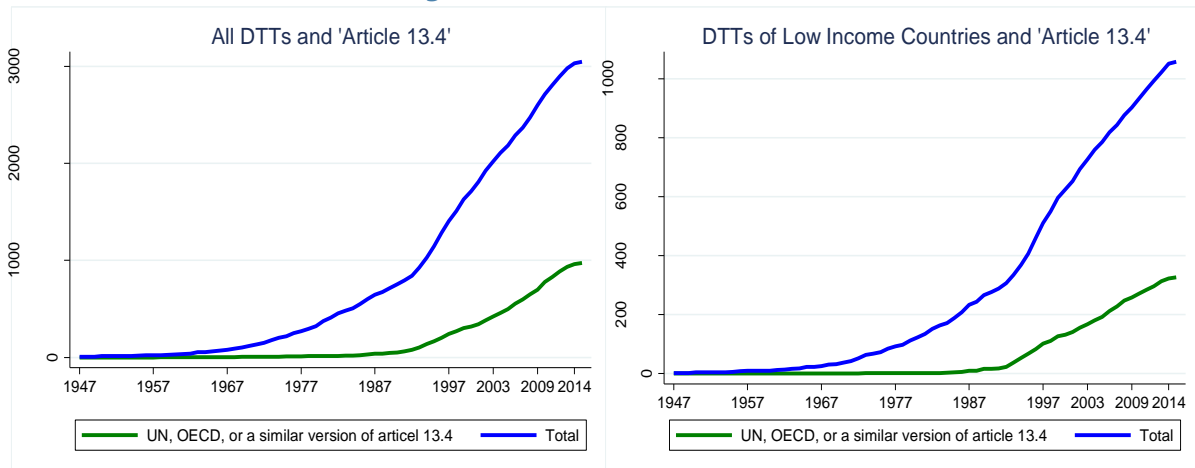
<sup>56</sup> This is of course a backward-looking exercise, so does not necessarily speak to the likelihood of future inclusion.

<sup>57</sup> There is considerable heterogeneity in capital gains tax rates across countries. There are 35 countries that charge no taxes on capital gains of corporations (e.g., Hong Kong, Malaysia, Singapore, and some resource-rich countries such as Bahrain and the UAE). At the other end of the distribution, there were in the sample 10 countries that impose a rate of 35 percent (e.g., Argentina and the United States) and the highest rate is 36 percent in Suriname.

of their treaties.

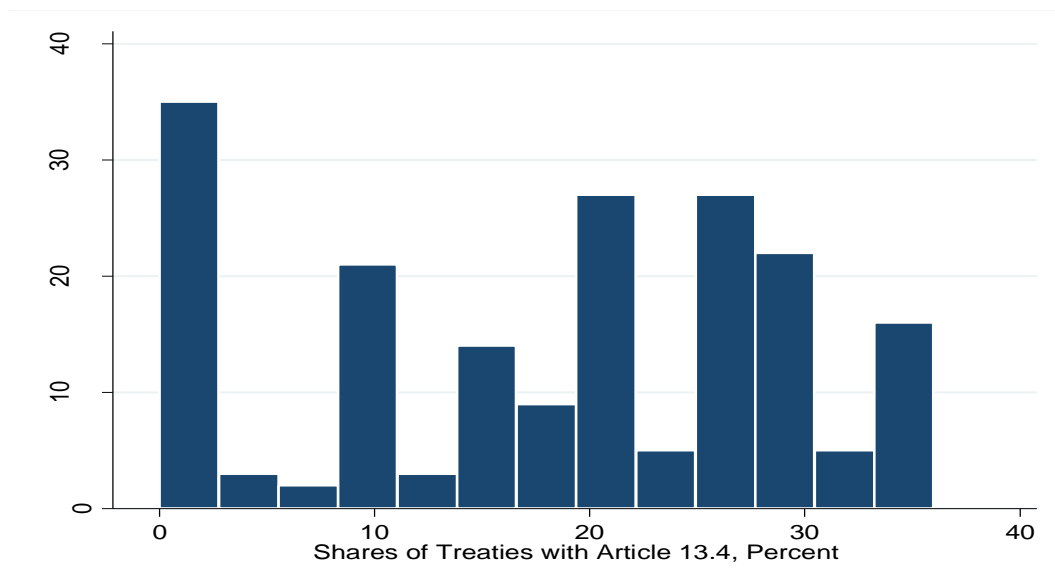
**About 22.5 percent of the universe of treaties include Article 13(5) of the UN model treaty.** There is no clear observed pattern linking the inclusion of Articles 13(4) and 13(5): some treaties include only one, some contain both.

**Figure 2: Article 13(4) in DTTs**



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

**Figure 3: Proportions of Countries' DTTs including Article 13(4)**



## V. IMPLEMENTATION CHALLENGES AND OPTIONS

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

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

**In both model treaties, as seen above, a taxing right arises when over 50 percent of the value of the transferred stock or interest derives from immovable property in the location country.**

In order to determine whether the value of the interest is principally (more than 50 percent) derived from that immovable property, a comparison is ordinarily required to be made of the value that the immovable property (relevant asset) bears to the value of all the property owned by the entity (all assets) without taking into account debts or other liabilities. Selection of values to be used for this purpose is critical. The accounting values are usually based on the historical acquisition costs, rather than the actual market values at the time of disposal of the relevant assets, which are more correctly reflected in the relevant valuation reports, which are made at the time of disposal. Furthermore, the identification of which assets are to be classified as immovable property for this purpose will be determined with reference to the definition in Article 6 of the relevant tax treaty and the domestic law of the country where the property is located. Article 6 paragraph 1 establishes that the movable property, which is accessory to the immovable property is also to be considered as immovable property. Finally, it should be kept in mind that while it is only the value of the assets (not the corresponding liabilities or debts) that is taken into account, the injection of cash or other financial instruments either through loan or equity or even financial assets (such as shares via a repo transaction) shortly before the disposal can significantly affect the 50 percent valuation threshold on the basis that such cash or other property values are taken into account in the process of this determination. This is the reason that the OECD and UN MTCs have been both amended to include the 365-day time test to reduce the risk of such manipulation at or around the time of disposal of the asset, which would otherwise impact the allocation of taxing rights.

**Even where this test is met, since an OIT occurs outside the location country (between a non-resident seller and a buyer who may also be a non-resident), the location country may face**

**significant difficulties in collecting the tax.**<sup>58</sup> This section of the report aims to provide practical guidance in relation to the design of possible legal instruments for imposing a tax liability on the gain, which will subsequently enable the tax authority to enforce and collect the tax. The legal instruments outlined in the section consist mostly of sample domestic legislative provisions. This is because, even if any relevant treaties preserve the location country's taxing rights along the lines of model Article 13(4), it is essential that the location country has enabling provisions of this kind in its underlying domestic law.

## A. Overview of Legal Design and Drafting Principles: Two Models

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

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

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

- **Model 1 (taxation of a deemed direct sale by a resident):** This model seeks to tax the local entity that directly owns the asset in question, by treating that entity as disposing of, and reacquiring, its assets for their market value where a change of control occurs (e.g. because of an offshore sale of shares or comparable interests). This model takes into account the fact that a capital gain has been realized through the indirect transfer, triggered by a change of control. The relevant taxpayer under this model is not the seller entity, which effectively disposes of the shares, but rather the entity which actually owns the assets from which the relevant shares derive their value. Model 1 needs to be supported by a deemed disposal and reacquisition rule of the assets from which the shares actually disposed of derive their value.
- **Model 2 (taxation of the non-resident seller):** This model seeks to tax the non-resident seller of the relevant shares or comparable interests via a non-resident assessing rule. Model 2 must be supported directly or implicitly by **a source of income rule**, which provides that a gain is sourced in the location country when the value of the interest disposed of is derived, directly or indirectly, principally from immovable property located in that country. A source rule relating to gains from the disposal of other assets may also be considered, as discussed above in Section II—including substantial shareholdings in resident companies. A source of income rule may be further supported by **a taxable asset rule** dealing with such matters as whether taxation only applies to disposals of substantial interests (such as

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<sup>58</sup> Toledano and others (2017) cite examples in which the authorities of the location country simply did not know that an indirect transfer had occurred (in one case, even though the government held a 20 percent stake in the transferred entity).

a 10 percent shareholding rule) to exclude from the scope of tax changes in ownership of portfolio investments. The rule can also prescribe whether the entire gain will be subject to tax when the value of the indirect interest is less than wholly derived from local immovable property or, alternatively, whether the gain will be subject to tax on a pro rata basis. Each legal design option under this rule is discussed and explained further below.

The two Models are not necessarily mutually exclusive. However, if both were to be adopted an ordering rule would need to be clearly established to ensure they do not both apply at the same time.

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

- (a) Notification/reporting and information exchange mechanisms (e.g. domestic reporting requirements supplemented, where appropriate, by international information exchange arrangements);
- (b) Withholding tax mechanisms (e.g. on payment of the purchase price);
- (c) Mechanisms imposing a tax payment obligation on a relevant local entity (e.g. as agent of the non-resident seller); and/or
- (d) Other legal protections such as restricting the registration, renewal or validity of relevant underlying assets (e.g. extractive licenses) unless applicable notification requirements have been met and/or until it is demonstrated that either: no tax is payable; the relevant tax has been paid; or satisfactory arrangements have been made for the payment of that tax.

**A General Anti-Avoidance Rule (GAAR) could be applied as a rule of last resort to tax a gain from an OIT in appropriate circumstances.** However, this sort of rule can be quite difficult for countries with weak administrative capacity to apply successfully. Some countries have adopted taxing mechanisms that operate in a similar way to a specific anti-abuse rule by seeking to, in effect, collapse the multiple tier holding structure and treat the ultimate non-resident seller of the interests as the seller of the local assets, who realizes a gain with a local source. This is the type of approach adopted in China. The successful application of such a rule ultimately depends on: (i) the design and drafting of the particular anti-abuse rule, which is often less rules-based and more discretionary in its application; and (ii) the capacity of the tax authority to appropriately apply such a specific anti-abuse rule in an even handed and predictable way.<sup>59</sup> This type of rule would only reach the gain in question if intentional tax avoidance regarding the transaction could be shown. Such rules would therefore not provide that the gain in question should be taxed as a matter of principle on the basis of a substantive right to tax in the location country and would be much more limited in scope.

**The sample domestic legislative provisions set out throughout this section are general in**

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<sup>59</sup> See Waerzeggers and Hillier (2016).

**nature and in the form of simplified rules-based legal provisions.** Importantly, they do not take into account the individual circumstances of any particular tax system, nor have they been adapted for all relevant circumstances (e.g. corporate reorganizations) and other common concessions that typically apply (e.g. under a capital gains tax regime, in circumstances when it is considered appropriate to defer the recognition of taxable gain). The simplified legislative provisions also do not deal comprehensively with more complex issues such as minority shareholders, joint venture arrangements, valuation difficulties, treatment of losses, listed securities, and other double taxation issues that might arise under a given set of circumstances. Further, unless there are strong reasons to do otherwise, either model should only be implemented on a prospective (and not retroactive) basis (e.g. to transactions taking place after the change is announced, as opposed to applying to tax years before the announced change), and appropriate transitional arrangement could also be considered (such as deeming the market value cost base of relevant assets to be that at the time of commencement of the new taxing model). The ultimate set of provisions to be adopted in the location country to enable it to tax OITs would need to take into account the specific legal tradition and system, as well as the political and administrative structure and fiscal policies of the country concerned.

**These sample legislative provisions have been designed and drafted to prevent legal double taxation by the location country**—that is, to prevent the gain on an asset transfer being taxed twice by the location country in the hands of the same taxpayer. This reflects common international practice in this context. Consideration could also be given to designing and drafting legislative provisions that limit double taxation in the sense of the same gains being taxed multiple times in the hands of different taxpayers through realizations of gains on intermediate shareholdings through multiple tiers of indirect ownership. To achieve this, the tax cost of relevant assets (e.g. each intermediate shareholding) must be reset (stepped-up) to market value each time a relevant taxable realization occurs or, alternatively, the law can provide for the non-recognition of a gain on each intermediate asset.<sup>60</sup> Even though provisions of this kind would be more comprehensive, they would also be more complex to apply and administer, and so are not reflected in the sample domestic legislative provisions set out in this section. For the purposes of the sample provisions provided in this section, the location country is referred to, as above, as Country L.

## **B. Model 1: Taxing the Local Resident Asset-Owning Entity under a Deemed Disposal Model**

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

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<sup>60</sup> The latter is the method of implementation used for the Chinese provision.

allocation rules). This approach has been adopted in a number of source countries, such as Nepal, Ghana and Tanzania.

**A sample set of legislative provisions underpinning this domestic deemed disposal model is set out in Box 5.**

**Box 5: Change in Control**

- (1) Subsection (3) applies when the direct or indirect ownership of an entity mentioned in subsection (2) changes by more than 50 percent as compared with that ownership at any time during the previous three years.
- (2) An entity to which subsection (1) applies is an entity in respect of which, at any time during the 365 days preceding the relevant change in underlying ownership, more than 50 percent of the value of the shares or comparable interests issued by that entity is derived, directly or indirectly, from immovable property in Country L.
- (3) Where this subsection applies, the entity is treated as:
  - (a) realizing all its assets and liabilities immediately before the change;
  - (b) having parted with ownership of each asset and deriving an amount in respect of the realization equal to the market value of the asset at the time of the realization;
  - (c) reacquiring the asset and incurring expenditure of the amount referred to in paragraph (b) for the acquisition;
  - (d) realizing each liability and is deemed to have spent the amount equal to the market value of that liability at the time of the realization; and
  - (e) re-stating the liability for the amount referred to in paragraph (d).

**The application of this model can be summarized as follows:**

- The model operates to tax the unrealized gain in the hands of the local asset owning entity. That entity will typically be a resident of the location country, giving that country the right to tax on both a residence basis and a source basis. The model seeks to tax the accrued gain on the entire asset when a change of control occurs from the sale of interests whose value is principally (e.g. more than 50 percent) derived from the asset—the local immovable property. Losses should also be recognized where there are no accrued gains, and should be subject to appropriate loss utilization rules (as applicable). The taxation of unrealized capital gains derived by tax residents is not uncommon. The most recent example of taxing the unrealized capital gains of corporate taxpayers is the EU’s exit taxation rule, which is being implemented by all 28 EU Member States.<sup>61</sup>
- The tax liability is triggered by a change of control, irrespective of whether that change occurs because of an offshore or onshore sale of shares or comparable interests. A technical direct or indirect change of ownership because of a corporate reorganization should not trigger the tax liability. This should be further clarified by including clearly drafted

<sup>61</sup> This rule was introduced as a part of EU Anti-Tax-Avoidance Directive, which was adopted in June 2016. This rule triggers taxation on unrealized capital gains in cases of transfer of corporate tax residence or in the cases of transfer of assets or commercial activities from one jurisdiction to another. To eliminate the potential double taxation, this rule also provides for a step-up of the value of assets subject to this rule and for a possibility of temporary deferral or gradual partial fulfillment of this tax liability to address the liquidity concerns.

exceptions with respect to cases that are not intended to trigger the tax liability rule.

- The tax liability is also triggered irrespective of the size of the interest that is sold, but, importantly, only to the extent the relevant sale brings about the relevant change in control (i.e. by more than 50 percent), whether by itself or when accumulated with previous sales. That is, no de minimis threshold is set—for example, by saying that the tax liability would only be triggered if the sale giving rise to the change of control amounts to a sale of an interest of 10 percent or more in the asset. This is done to limit tax avoidance opportunities (e.g. staggered sell-downs) which would arise if a significant interest threshold were adopted under this model.
- Change of control is determined by reference to direct or indirect ownership, which enables the tracing through of intermediate holding entities between the local asset owning entity and the ultimate issuer of the shares which are the subject of the actual sale. A person can enjoy the benefits of ownership either on the basis of economic/beneficial or legal ownership to the asset. The relevant provision could further include definitions of what is meant by the terms 'ownership' or 'change of ownership' for the purposes of this provision to ensure that the term ownership is not interpreted too narrowly (i.e. strictly formalistically). This model could be otherwise easily circumvented by creating structures involving changes of economic or beneficial ownership, while the legal ownership remains vested with the same legal entities.
- Where a change of control occurs, the model treats the local asset owning entity as disposing of its assets for their market value. The market value of the local assets which are deemed to be sold could be determined administratively using assumptions and adjustments based on the price at which the actual shares are sold, on the basis that their value is derived from the value of the local assets. An apportionment rule could be adopted and applied so that the price paid for the shares (assuming the share sale occurs on arm's length terms) is appropriately allocated amongst the assets held by the local entity. In practice, it is recognized that these valuation exercises are complex to undertake, particularly where relevant assets relating to the underlying immovable property derive their value from commodity prices, centrally provided inputs (e.g. management and technical expertise) and other group shareholdings. Additionally, the location country may support its domestic legislation based on Model 1 by imposing a reporting obligation of the price of the shares to the resident entity. For the purposes of determining the market value, it is important to note that the assets of the entity should be valued as a bundle of assets forming a business as going concern, which would also allow value to be reflected in cases where that value is not clearly attributable to any specific asset recognized in the financial statements (which follow a more narrow approach to the recognition of assets on the balance sheet). If only the individual assets identified on the financial statements were taken into consideration, significant value of the assets of the company will not be recognized for tax purposes and the tax policy objective of this measure may not be achieved. This may require special tax accounting rules and guidance on how to deal with



the asset revaluation as well as the subsequent taxation treatment, including depreciation/amortization of the relevant asset categories going forward.

- However, the nature of the disposal is only a deemed (as compared to an actual) disposal for tax purposes. Therefore, the local asset owning entity will still be the legal owner of the assets after the disposal is deemed to take place. In order to protect against double taxation, the model treats the local asset owning entity as reacquiring the assets for their market value. This means that its tax cost in those assets is stepped up to market value—which is important to ensure that double taxation does not arise in the location country in the event that another subsequent change of control occurs. The effect of the step up is thus to neutralize the double taxation in the location country. It also effectively leads to the outcome that, over time, potential international economic double taxation is mitigated—not by immediate relief for the same taxpayer, but by mitigating the economic effects of this potential international double taxation on the side of the entity owning the relevant assets, when the stepped-up values of assets are taken into account for the determination of their tax base through depreciation, amortization or other deductions related to the values of those relevant assets.
- Liabilities are also reset under this model for ease of administration. This means that the entire balance sheet is reset instead of resetting only the assets of the local asset owning entity, which would otherwise leave liabilities to be recognized at their historic value and complicate compliance. No gain or loss on a liability would be expected to be realized in the ordinary case under this model where the market value of that liability was equal to its face value.

**As noted above, the model constitutes a simplified set of legislative provisions** that do not deal with more complex issues such as corporate reorganizations, minority shareholders, joint venture arrangements, valuation difficulties, listed securities, and the treatment of losses. The ultimate set of provisions to be adopted in the location country will need to be adapted to reflect the individual circumstances of the country concerned, including its domestic and international tax policy settings. Such set of provisions could contain carve out rules, which would address the legitimate concerns – e.g. various listing scenarios where the change of ownership is triggered by an IPO, where the original shareholders may not derive direct benefit in the form of income realized from the sale of shares, but rather where the objective is to raise capital for further development of underlying projects. If this Model were to apply in such a scenario the new shareholders would see the value of their investment immediately drop by the proportion of the tax triggered by the IPO.

### **Enforcement/collection rules**

**Under this model, the local asset owning entity remains subject to the ordinary compliance rules applicable to resident taxpayers**, with no need for specific enforcement and collection rules—or reliance on assistance in collection through treaties—to combat the significant

difficulties in collecting the tax where transactions take place between two non-residents. Under this model, the tax authority of the location country can use the full suite of its enforcement tools against the local asset owning entity (e.g. apply penalties for a failure to file and pay tax in respect of the deemed gain, and activate the usual enforcement instruments at its disposal, such as seizing or freezing the local assets and potentially selling them to settle an outstanding tax liability). Model 1 does, however, require clear and potentially detailed administrative guidance to establish the relevant valuation method or administrative approach to determine the relevant market values to ensure that there is clarity and certainty for taxpayers and clear guidance for tax administrations on how to administer it.

### **Pros and cons of Model 1**

#### **The key advantages of this model are:**

- Greater ability to enforce and collect the tax liability as the taxable gain is deemed to have been realized by the local asset owning entity (as compared to a non-resident). This means that the tax authority can use the full suite of its enforcement tools against the local asset owning entity.
- Double taxation in the location country should not arise when another subsequent change of control occurs, as the basis of the local assets which are deemed to be disposed of is stepped up to market value in the hands of the local asset owning entity.
- The gain under the deemed disposal model consists of a locally sourced gain realized by a local resident entity. Therefore, the taxing right of the location country should not be affected by a tax treaty.

#### **The key disadvantages of this model are:**

- Some may argue that there would still be tax treaty limitations if a tax treaty were in place, on the grounds that the imposition of the tax is in substance source country taxation triggered by an offshore sale of interests (e.g. shares). However, it is now firmly established that countries are not restricted with respect to the taxation of their own tax residents, as was also confirmed by the recent changes to the OECD and UN MTCs—namely the introduction of paragraph 3 to Article 1, which confirms the general principle that the Convention does not restrict a Contracting State's right to tax its own residents except where this is intended and lists the provisions with respect to which that principle is not applicable.<sup>62</sup>
- Furthermore other treaty anti-abuse provisions such as those reflected in the BEPS minimum standard to counter treaty shopping may be considered in cases where the indirect transfer is motivated by tax avoidance objectives. This could include a limitation on benefits (LOB) article and/or principal purpose test (PPT), ideally in a tax treaty or, if

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<sup>62</sup> For details see Commentary to Article 1 paragraph 3 of OECD and UN MTCs

appropriate, as a domestic law override of a tax treaty, if the non-resident seller is a company situated in a treaty country for the purpose of obtaining treaty benefits (assuming there are no constitutional limitations to doing so through domestic law).

- There could be possible double taxation as the residence country of the offshore seller of the transferred interest could tax the gains realized by that seller from the sale. And if so, there would be no foreign tax relief available in the country of the seller, because the tax liability in the location country arises for the local asset owning entity, and not the offshore seller, who under this model is not taxed at all by the country of location/source. However, these double taxation concerns would not arise where the residence country of the offshore seller operates under a territorial system of taxation or otherwise excludes such foreign gains from its domestic tax base (e.g. through a participation exemption, or because the residence country is a no or low tax jurisdiction). There is a current trend by residence countries to adopt—or move towards—a more territorial system of taxation. In the cases where this Model does give rise to international double taxation, it needs to be pointed out that this would be a case of economic double taxation—involving a selling entity on one side (possibly itself involving multiple countries) —and the entity owning the relevant assets on the other side. While under current international norms there is no special mechanism for the elimination of this type of economic double taxation, it should be noted that the affected countries could still engage in bilateral negotiations in the context of the MAP procedure as foreseen under Article 25 paragraph 3 of the OECD and UN MTCs. Furthermore, as noted previously, the economic effect of this economic double taxation will be mitigated over time by the benefit provided through the step up in the values of the relevant assets in the jurisdiction applying this Model.
- Since the entity that directly owns the asset does not receive the money from the transfer of the shares or comparable interests, difficulties may arise regarding the effective collection of taxes when that entity lacks the liquidity required to pay the tax liability. Practically speaking, however, it is expected that the parties (particularly the purchaser) would take steps to ensure that the local asset-owning entity had sufficient funds to discharge its tax liability, in order to prevent the tax authority from taking enforcement action against locally held assets. (This could be, for instance, by getting the seller to agree to put the local asset-owning entity in funds (e.g. via a loan) and requiring the seller to give a direction to the purchaser to pay a portion of the purchase price directly to the local asset-owning entity on settlement of the sale transaction to advance that loan). The negative impact on liquidity from imposing an immediate tax liability could be addressed by a short-term deferral of the payment obligation, which could be deferred or spread over a 3 to 5-year period to enable the taxpayer to meet their payment obligation—which may be substantial—in particular to address any concerns regarding ability to pay given that the income was actually derived by the non-resident seller.
- This approach undermines the separate legal entity distinction between the local asset

holding entity and its relevant tiers of parent entities. Further, absent overarching shareholder agreements, this approach would also result in continuing minority shareholders becoming exposed to the underlying tax liability in circumstances where that tax liability is triggered through the sale by a majority shareholder of their own controlling shareholding. However, those continuing minority shareholders would also benefit from the step up to market value of the local assets (including any depreciable assets) in the hands of the local asset owning entity.

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

**The merits of Model 1—relative ease of enforcement and simplicity of the necessary basis adjustment—can be especially appealing for lower capacity countries.** Under this model, it should be noted, the source rules of the location country *L* need to be designed and drafted in a manner that would not result in the OIT that triggered a change of control having a source in Country *L*. Alternatively an ordering rule would need to be established to make it clear in which situation the source rule would apply and in which situations the deemed disposal rule would apply to ensure that the two rules do not apply at the same time. Otherwise, if the actual sale of the offshore interests were held to be sourced in Country *L*, double taxation would arise on the same transaction in the same location as a result of both deemed resident taxation and actual non-resident taxation in Country *L*. A tax liability rule which is designed and drafted to impose the primary tax liability on the non-resident seller of the relevant interest instead of on the local asset owner (under a non-resident taxation model) is discussed hereafter in the context of Model 2.

## C. Model 2: Taxing the Non-resident Seller

**Under this model,<sup>63</sup> Country *L* seeks to impose tax on the non-resident seller on the basis that the transfer gives rise to a gain with a local source in Country *L*.** Where countries have resolved to tax OITs, this model (or a variation thereof) has been the one most commonly adopted. Under this model, the source rules become critical for triggering the tax liability in the location country. This is because a non-resident is ordinarily<sup>64</sup> only subject to taxation on income derived from sources in the particular location country. By way of example, a sample source rule along the lines shown in Box 5 below could be considered when seeking to impose a liability on a non-resident in respect of a gain realized on the sale of an indirect interest in immovable property situated in the location country *L*.

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<sup>63</sup> See also Toledano and others (2017) on the design and implementation of Model 2.

<sup>64</sup> The assumption here is that the tax system of the location country is structured using international norms like those embodied in the model treaties—but included in the location country's domestic law/source of income rules.

#### Box 6: Source rule

The following amounts are derived from sources in Country L:

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

**As noted above, the source rule may be combined with a taxable asset rule.** The practice as embodied in Article 13(4) of the OECD and UN Model MTCs is to allow the taxation of the entire gain when the value of the indirect interest is principally (e.g. more than 50 percent) derived from local immovable property. Where this is the case, reliance may simply be placed on the source rule (above). Alternatively, a taxable asset rule may confirm and support this treatment by similarly providing that the entire gain is taxable when the value of the indirect interest is principally (e.g. more than 50 percent) derived from local immovable property. The taxable asset rule could alternatively be designed and drafted to apply on a proportionate basis (e.g. taxing only those gains attributable to the local immovable property, as distinct from the entire gain), or on a modified *pro rata basis* where a lower threshold is met (e.g., 20 percent of the gain is derived from local immovable property rather than 50 percent or more). For example, a modified *pro rata* mechanism of this nature has been adopted in Kenya for the extractives sector. Where such a lower threshold is adopted, it would generally be appropriate to impose tax only on a proportionate basis. A sample set of domestic legislative provisions demonstrating the two approaches is outlined in Box 7 below.

#### Box 7: Taxable asset rule: Full and pro rata taxation

- (1) The chargeable income of a person includes gains from the realization of shares or comparable interests, if, at any time during the 365 days preceding the realization, more than 20 percent of the value of the shares or other interests is derived, directly or indirectly through one or more interposed entities, from immovable property in Country L.
- (2) For the purposes of subsection (1), the amount of the gain to be include in chargeable income is -
  - (a) if the shares or other interests derive, or derived at any time during the 365 days preceding the realization, more than 50 percent of their value, directly or indirectly, from immovable property in Country L, the full amount of the gain; or
  - (b) in any other case, the amount computed according to the following formula:  
$$A \times B/C$$

where-

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

**The development and application of any domestic legislative provisions will need to take into account any existing tax treaty obligations.** However, as discussed above, the taxing right over gains realized on offshore indirect transfers which are principally (e.g. more than 50 percent) derived from local immovable property is generally preserved in Article 13(4) of the OECD and UN MTCs. Both MTCs permit the location country to capture gains from the sale of relevant interposed holdings at different tier levels. It is important that the domestic legislative provisions of the location country be designed and drafted to preserve this taxing right over relevant interests which derive more than 50 percent of their value, directly or indirectly, from immovable property in the location country as permitted by the MTCs. As noted above, the valuation aspects of determining this 50% threshold are critical and practical tax administration guidance may be needed to establish which assets are to be treated as immovable property for the purposes of this provision and also what valuation methods should be used and to what extent cash and cash equivalents are to be taken into account, especially if injected into company shortly before the disposal. For these purposes a time test would be appropriate, as foreseen in the Article 13(4) of the OECD and UN MTCs, to prevent abusive transactions to dilute the proportionate value of the immovable property.

**There is also a question as to whether the taxable asset rule should define—and potentially narrow—the scope of the interest which is to be subject to tax.** Three further options arise in this regard: (i) imposing a tax liability in relation to the disposal of all interests (including even interests representing less than a de minimis interest in the asset), as long as the value of the interest disposed of derives more than half its value from that asset; or (ii) imposing liability only on the disposal of more significant interests (e.g. interests of 10 percent or more of the asset); and/or (iii) whether a back-up threshold based on the nominal value of the interest should also apply (e.g. apply the rule only to interests with a value of \$1 million or more). For example, if a percentage of interest threshold were to be adopted, a 10 percent threshold could be considered as it is the international norm for distinguishing between a non-portfolio and portfolio investment. If adopted, such thresholds could help minimize compliance costs and ease administration. However, implementing a threshold interest requirement needs to be carefully drafted so as to preserve the policy intent of the threshold and combat tax avoidance opportunities through staggered sell-downs (i.e. selling multiple parcels of shares each comprising an interest of less than 10 percent).

**Finally, countries may provide exemptions to the application of Article 13(4) of the OECD and UN MTCs to certain capital gains for different reasons.** As explicated in the Commentary on Article 13(4) of the OECD MTC, these exemptions may refer to gains derived from the alienation of: (i) shares of companies listed on a stock exchange; or (ii) shares in the course of a corporate reorganization; or (iii) shares which derive their value from immovable property where a business is carried on; or (iv) shares held by pension funds; or (v) a small investor's interest in a Real Estate Investment Trust (REIT). Further, to the extent that a loss arises (instead of a gain), that loss could also be recognized in Country *L* and be subject to appropriate loss utilization rules.

## Enforcement/collection rules

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

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

## Withholding

**Several countries use a withholding mechanism to collect tax with respect to a non-resident seller's gain.** A specific withholding tax regime can be designed and drafted to apply to payments to a non-resident seller. Withholding taxes can represent all or a portion of the tax liability (or possibly an estimate) of the recipient of the payment. The tax must be withheld from the payment by the payer and paid to the tax authority in the location country.

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

**The withholding tax regime could be designed to exclude withholding in certain circumstances in order to minimize compliance costs.** This could include, for example, transactions below a predetermined de minimis threshold (an option noted above); transactions related to listed securities on a stock exchange; transactions wherein a clearance certificate is

obtained from the tax authority in Country *L* to confirm that no amount is required to be withheld in the particular circumstances (for example because the asset is being sold for a loss etc.). A sample withholding tax regime is shown in Box 8.

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



### Box 8: Enforcement/collection rule: Withholding tax

- (1) A person must withhold tax at the prescribed rate when-
  - (a) the person pays an amount to another person (recipient) in acquiring shares or comparable interests; and
  - (b) more than 50 percent of the value of the shares or comparable interests referred to in paragraph (a) is derived, directly or indirectly through one or more interposed entities, from immovable property in Country L.
- (2) The person (withholding agent) must pay the amount to the tax administration on or before the day that the withholding agent becomes the owner of the shares or comparable interests and must file a statement in the manner and form prescribed.
- (3) A withholding agent who fails to withhold tax in accordance with this section must nevertheless pay the tax that should have been withheld in the same manner and at the same time as tax that is withheld.
- (4) Where a withholding agent fails to withhold tax from a payment as required by this section-
  - (a) the recipient is jointly and severally liable with the withholding agent for the payment of the tax to the tax administration; and
  - (b) the tax is payable by the recipient immediately after the withholding agent becomes the owner of the shares or comparable interests.
- (5) A withholding agent who withholds tax under this section and pays the tax to the tax administration is treated as having paid the amount withheld to the recipient for the purposes of any claim by the recipient for payment of the amount withheld.
- (6) A withholding agent who fails to withhold tax under this section but pays the tax that should have been withheld to the tax administration in accordance with subsection (3) is entitled to recover an equal amount from the recipient.
- (7) The recipient is treated as having paid any tax-
  - (a) withheld from the payment under this section; or
  - (b) paid in accordance with subsections (3) or (4).
- (8) A recipient is entitled to a tax credit in an amount equal to the tax treated as paid under subsection (7) for the year of assessment in which the payment is derived.

### Notification and agency taxation

**In the absence of adopting a withholding tax regime, two other enforcement and collection measures may be considered** for the purpose of putting the tax authority in the best position to be aware of the disposal and then being able to subsequently enforce and collect the tax. These involve designing and imposing the following two obligations:

- (a) a notification/reporting obligation; and

(b) a payment obligation for an entity in the location country as agent for the non-resident.

**The notification/reporting obligation is important not only for raising an assessment, but also for exploring other available avenues for recovery of any unpaid tax on the transfer,** such as through an Assistance in the Collection of Taxes article under applicable tax treaties or through the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters. Further, imposing a payment obligation on a resident person or entity as agent for the non-resident enables the tax authority to use the full suite of its enforcement tools against that resident. Legislative mechanisms of this kind have recently been adopted in Kenya and Fiji for the extractives sector. A sample set of legislative provisions is set out in Box 9. For illustrative purposes, they are shown as triggered with respect to holdings of non-portfolio interests of 10 percent or more.

**Box 9: Enforcement/collection rule: Notification and agency taxation of non-portfolio interests**

- (1) Subsection (3) applies when the direct or indirect ownership of an entity mentioned in subsection (2) changes by 10 per cent or more.
- (2) An entity to which subsection (1) applies consists of an entity in respect of which, at any time during the 365 days preceding the relevant change in the direct or indirect ownership, more than 50 percent of the value of the shares or comparable interests issued by that entity is derived, directly or indirectly, from immovable property in Country L.
- (3) Where this subsection applies, the entity:
  - (a) must immediately notify the tax administration, in writing, of the change; and
  - (b) is liable, as agent for any non-resident disposing of the interest to which the notice under paragraph (a) relates, for tax payable by the non-resident under this Act in respect of the disposal.
- (3) Subsection (3)(b) does not apply to the disposal of shares quoted in any official list of a recognized stock exchange in Country L.\*
- (4) Any tax paid by the entity on behalf of a non-resident under subsection (3) is to be applied against the tax liability of the non-resident under this Act.

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

**Pros and cons of Model 2**

**The key advantages of Model 2 are:**

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

**The key disadvantages are:**

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

## **D. Defining “Immovable” Property**

**In all of the foregoing approaches, an appropriate definition of “immovable property” is critical for the effective application of the chosen tax liability rule and associated enforcement and collection rules.** A definition of “immovable property” with appropriate clarity will be equally relevant for Model 1 and Model 2, and each of those models is capable of having even greater reach in circumstances where that definition is extended to cover a broader category of “immovable property” than is traditionally the case. A sample definition of “immovable property” is set out in Box 10 below:

### **Box 10: Sample definition of immovable property**

“Immovable property” includes\* a structural improvement to land or buildings, an interest in land or buildings or an interest in a structural improvement to land or buildings, and also includes the following—

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

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

**Confining the definition of immovable property to traditional notions of real property in the form of land and buildings may be thought too restrictive.** Such a narrow definition would not be sufficient to enable Country *L* to trigger its taxing right over gains made in the context of extractive industries, such as gains from licenses to explore for, develop, and exploit natural resources located in Country *L*. Countries should therefore consider defining immovable property in their domestic laws to include at least:

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

**The domestic law definition of immovable property will also be important in the context of the application of a tax treaty.** This is because the basic rule under the OECD and UN MTCs, as stressed earlier, is that the term “immovable property” has the meaning under the domestic law (tax or other law) of the contracting state in which the property is located. The relevant provisions in the OECD and UN MTCs also establish that property that is accessory to the immovable property is to be treated as immovable property for the purposes of the application of the tax treaty provisions. This is important for determining the proportionate value of the indirect transfer that is derived from the immovable property, and is critical for the application of both Models. Furthermore, the definition also provides that rights to immovable property, including rights to economic benefits such as usufruct and payments derived from immovable property, are to be treated as immovable property, which could be equally important for the purposes of valuation and application of the relevant provisions. Some countries have also especially reserved the right to modify the relevant definition of immovable property to include for instance shares of companies which derive their value from immovable property. Such broader definition is clearly aimed at addressing the policy concerns raised by indirect transfers.<sup>65</sup>

**The definition could be further extended to cover a broader category of “immovable property” that Country *L* might think it appropriate to tax.** As argued above, this could include—for example—gains arising in relation to location specific rents clearly linked to national assets, such as from licenses to exploit public goods (e.g., electric, gas, or other utilities; telecommunications and broadcast spectrum and networks etc.).<sup>66</sup>

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<sup>65</sup> See reservations expressed by countries to the OECD MTC, which can be found in paragraphs 5-19 of the Commentaries to the Article 6 of the OECD MTC.

<sup>66</sup> It may be that an enhanced ability to tax rents generated by government restrictions would have an adverse effect in encouraging the imposition of such restrictions. This is a reasonable and significant concern. Such incentives already exist, however: Auriol and Warlters (2005) find evidence that governments in lower income countries tend to create barriers so as to concentrate profits in easily-taxed large firms. The prior practical issue, in any case, may be securing revenue where such the granting of such rights is used to regulate major natural monopolies.

**Consideration could be given to extending the definition even further, to cover rights to receive variable or fixed payments in relation to extractive industry rights or government issued rights with an exclusive and territorial quality.** This would also ensure that gains relating to any subsequent assignments derived from those underlying rights granted by or on behalf of the government of Country *L* would also remain within Country *L*'s tax base. It is clearly the case, however, that the concept of location specific rents is much easier to conceive of in economic terms than it is to convey in legal language. This is an area in which further thought is needed. In addition, it will also be important that a country complies with its good faith obligations with respect to the interpretation of tax treaties if that country decides to expand its definition of immovable property when existing tax treaties are in force. Although a country may change the definition of a term used in its domestic legislation which is also used in treaty provisions but which is not specifically defined for the purposes of the treaty, countries should ensure that any modifications or extensions are compatible with the context—and negotiated position—of their existing tax treaties that may be in force at the time of any modification or extension. Treaty partners should consult with each other in this regard.

## VI. CONCLUSIONS

**This report and toolkit concludes that it is appropriate that location countries have the right to tax OITs, at least for assets that are likely to embody, primarily and substantially, location specific economic rents, including those traditionally thought of as “immovable”** (The former might include, for instance, natural resources, both the physical assets and associated rights; and the rights to location specific telecom or other licenses). This is so, moreover, regardless of whether equivalent tax in regard to the transfer would be paid elsewhere. That is, the reasoning behind this presumption implies that such taxation could apply not only as an anti-avoidance device to combat “double non-taxation,” but rather could constitute a fundamental aspect of the country’s tax laws.

**The rationale for this approach—which would in effect place the approach adopted in Article 13(4) of both model tax treaties on a firmer economic basis—rests on several pillars.** In equity terms, it mirrors a quite generally recognized right in relation to direct transfers of immovable assets. In efficiency terms, it provides a backstop to the taxation of location specific rents which, especially in low income countries, other instruments may be able to achieve only imperfectly, and also fosters neutrality between direct and indirect transfers. And it responds to political pressures in the case of the sale of salient national assets which have led to uncoordinated measures that jeopardize the smooth and consensual functioning of the international tax system and can give rise to tax uncertainty.

**This is not to say that location countries should always tax related OITs.** They may have good reasons—depending, for example, on their capacity, revenue needs and desire to attract foreign investment—to choose not to, as some countries now do.

**The provisions of both MTCs suggest quite wide acceptance of the principle that capital gains taxation of OITs of “immovable” assets be allocated primarily to the country in which they are located.** As of 2015, however, Article 13(4) appeared in only around 35 percent of all DTTs, and was less likely to be found when one party is a low-income resource rich country. To date, the MLI has had a positive impact by increasing the number of tax treaties that effectively include Article 13(4) of the OECD MTC. This impact is expected to increase, as new parties may decide to negotiate or re-negotiate treaties based on the 2017 OECD and UN formulations of that provision and/ or to sign the MLI and modify their covered tax treaties to include the new language of Article 13(4).

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

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

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

**Countries are responding to the issues they have encountered in respect of OITs in very different ways.** The measures they have adopted differ both in terms of which assets are covered (immovable property, narrowly or broadly defined; other assets like telecoms; intangibles such as corporate stock issued in regard to a domestic company but held by a non-tax resident), and in terms of the method used to impose the tax as a legal matter.

**A more uniform, coordinated and coherent approach to the taxation of OITs, where countries choose to tax them, can make a substantial contribution to coherence in international tax arrangements and enhanced tax certainty.** This report and toolkit is intended to help progress to those ends.

## Appendix A. Consultations

The first draft of this report was posted for public comment from August through late October, 2017, in English, French and Spanish. During that time, extensive written comments from 18 private sector organizations, civil society groups, country governments, and individuals were received and posted by the Platform online:

<b>BIAC</b>	The Business and Industry Advisory Committee at OECD
<b>BMG</b>	Base Erosion and Profit Shifting Monitoring Group (a consortium of 7 civil society organizations)
<b>CBI</b>	Confederation of British Industry (London)
<b>China</b>	State Administration of Taxation, P.R. China
<b>Deloitte LLP</b>	(London)
<b>ICC</b>	International Chamber of Commerce
<b>India</b>	(Government)
<b>ITIC</b>	International Tax and Investment Center (US and other)
<b>Jubilee USA</b>	An alliance of 700 faith groups (US)
<b>KPMG</b>	KPMG International (UK)
<b>Philip Baker</b>	(UK)
<b>PwC</b>	PricewaterhouseCoopers International Limited (London)
<b>Repsol</b>	(Spain)
<b>Sergio Guida</b>	CPA (Italy)
<b>SVTDG</b>	Silicon Valley Tax Directors Group (US)
<b>TEI</b>	Tax Executives Institute (US)
<b>TPED</b>	Transfer Pricing Economists for Development (Paris and Vienna)
<b>USCIB</b>	United States Council for International Business (US)



The second draft of this report was posted for public comment from July through September, 2018. During that time, additional written comments from 11 groups<sup>1</sup> were received and posted by the Platform online:

<b>BDI</b>		The German Business Representation, Brussels
<b>BIAC</b>	*	The Business and Industry Advisory Committee at OECD
<b>BMG</b>	*	Base Erosion and Profit Shifting Monitoring Group (a consortium of 7 civil society organizations)
<b>E &amp; M</b>		Ernest & Martin (CPAs, Nairobi, Kenya)
<b>HSC</b>		Hardeep Singh Chawla (Advocates, New Delhi, India)
<b>ICC</b>	*	International Chamber of Commerce
<b>India</b>	*	(Department of Revenue, Foreign Tax Research Director)
<b>ITIC</b>	*	International Tax and Investment Center (US and other)
<b>PwC</b>	*	PricewaterhouseCoopers International Limited (London)
<b>Repsol</b>	*	("A Global Energy Company," Madrid, Spain)
<b>SG</b>		(Sergio Guida, CPA Italy)

**Both sets of comments are online:**

First set, August – October 2017

<http://documents.worldbank.org/curated/en/929161512460494261/pdf/121890-WP-PUBLIC-4-12-2017-15-45-0-ConsolidatedcommentsOIT.pdf>

Second set, July – September 2018

<http://documents.worldbank.org/curated/en/160931539636220558/pdf/128321-v3-ConsolidatedcommentsOITToolkitRound.pdf>

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<sup>1</sup> \*indicates that comments were also received on first version

## Appendix B. Comparing Direct and Indirect Transfers<sup>1</sup>

Suppose the underlying asset, traded directly, has market price  $P_0 = 0$  (for simplicity) when acquired by the initial owner, price  $P_1$  in period 1, and price  $P_2 = (1 + \pi)P_1$  in period 2.

If the owner sells the asset itself in period 1, this yields income, net of the capital gains tax in the location country charged at rate  $G$ , of

$$P_1 - G(P_1 - P_0) = (1 - G)P_1. \quad (1)$$

Alternatively, the owner might sell the shares of the company owning the underlying asset in period 1, yielding net receipts, assuming the shares to have initially had zero value,<sup>2</sup> of

$$V_1 - Z(V_1 - V_0) = (1 - Z)V_1. \quad (2)$$

where  $Z$  is the rate of tax levied on the share transaction in the jurisdiction in which the company sold is resident. To determine the share price  $V_1$ , suppose that in period 2: (i) the company sells the underlying asset, incurring tax in the location country, and distributes the net proceeds to the owner, (ii) the owner sells the shares of the company acquired (from which the asset has been removed) at stock price  $V_2$  and (iii) the owner repays (with deduction of interest at tax rate  $T$ ) the debt incurred to finance the acquisition of the shares in period 1. This gives net cashflow in period 2 to the purchaser of

$$P_2 - G(P_2 - P_0) + V_2 - Z(V_2 - V_1) - \{1 + (1 - T)R\}V_1 \quad (3)$$

where  $R$  denotes the pre-tax rate of interest. Setting the expression in (3) to zero, recalling that  $P_0 = 0$  and assuming the company has no other underlying assets, so that  $V_2 = 0$ , the largest amount that the purchaser is willing to pay to acquire the firm in period 1 is thus

$$V_1 = \frac{(1 - G)P_2}{1 - Z + (1 - T)R}. \quad (4)$$

Substituting from (4) into (2), the net receipts from an indirect sale in period 1 are thus

$$\frac{(1 - Z)(1 - G)(1 + \pi)P_1}{1 - Z + (1 - T)R}, \quad (5)$$

Comparing this with (1), the indirect sale therefore yields more to the initial owner of the underlying asset than does the direct sale if and only if

<sup>1</sup> The analysis here is related to that in Kane (2018).

<sup>2</sup> Along the lines discussed in Box 1, the assumption is thus that the asset acquired value unexpectedly after the trading in share in period.

$$\frac{(1 - Z)(1 - G)(1 + \pi)P_1}{1 - Z + (1 - T)R} > (1 - G)P_1 \quad (6)$$

which reduces to the condition that

$$(1 - Z)\pi > (1 - T)R . \quad (7)$$

Some observations that follow from this result:

- The rate of capital gains tax on sale of the underlying asset,  $G$ , is immaterial to the comparison. This is the counterpart of the point highlighted in the text that the issue for the location country (in respect of the gain on the underlying asset) is essentially one of timing, given that the tax will be paid at some point.
- If the price of the underlying asset increases at the pre-tax rate of interest  $R$ , then the initial owner prefers indirect sale to direct if and only if  $Z < T$ , meaning that capital gains on the share sale is taxed at a lower rate than interest is deductible to the purchaser.
- If no tax is payable on capital gains in share transactions ( $Z = 0$ ) and the rate at which the price of the underlying asset increases is equal to or exceeds the general rate of inflation, then the indirect sale is preferred by the investor so long as the real after-tax interest rate  $(1 - T)R - \pi$  is strictly positive.

## Appendix C. Examples of Country practices

There is considerable diversity in countries' approaches to taxing OITs. Many OECD countries naturally follow their MTC, but not all. Mexico's approach, for instance, is closer to the UN MTC: it taxes capital gains realized by foreign residents on the transfer of shares issued by domestic companies, regardless of where the title is passed, if more than 50 percent of the value of these shares derives from immovable property situated in Mexico.<sup>1</sup> Other countries deviate from both the OECD and the UN MTC. The U.S., Peru and China, to name a few, exemplify this diversity. For instance, the transfer in the Zain case described in Box 3 (p.23) would not be taxed in the U.S., but would be in Peru, and might or might not be in China.

### United States: Dispositions of U.S. real property held by foreign investors

#### Weaknesses of a pure residence taxation model

The U.S. income tax originally followed the premise that, in the absence of a U.S. trade or business, business profits of foreign residents should be taxed in their place of residence, defined in the case of individuals by a physical presence test (at least 183 days during 12 consecutive months). However, the law allowed numerous avenues to avoid the U.S. capital gains tax when there was a U.S. trade or business. For example, the payment for the sale of an asset could be timed to occur after the entity engaged in the U.S. trade or business had been liquidated, so that the capital gain would be realized when the foreign resident had no U.S. business to be connected to. Also, foreign residents could exchange the U.S. property for another of the same kind abroad and this would not qualify as a realization of a capital gain.<sup>2</sup> Alternatively, the foreign resident could hold the property in a domestic (or foreign) corporation and sell the stock of the corporation instead of the underlying property; in other words, it could avoid the tax through an indirect sale (either onshore or offshore).<sup>3</sup>

#### The farmers' lobby

Of particular concern was that foreign investors could have a resident tax status during the operational stage of the business, obtain a net income basis tax regime for that period of time, minimizing taxable profits (through expense deductions), and switch to a non-resident tax status when selling the appreciated asset, avoiding the capital gains tax at that point.<sup>4</sup> Assuming that foreign investors paid no (or little) capital gains tax abroad on the sale of the U.S. property, they would have an advantage over U.S. businesses. Farming lobbies in the U.S. made this point

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<sup>1</sup> Ley del ISR (Mexico), art 161.

<sup>2</sup> Brown (2004), p.297.

<sup>3</sup> Petkun (1982), p.13

<sup>4</sup> Presumably the value of the asset could reflect undistributed accounting profits.

forcefully in the late seventies,<sup>5</sup> claiming that "... foreign investors in U.S. farmland get such good breaks they often can afford to outbid American farmers who want to expand their holdings".<sup>6</sup> The National Farmers Union was particularly concerned about tax treaties that granted additional avenues to avoid the capital gains tax. In their view, for example, the treaty being renegotiated with the UK at the time would contain "... a provision which would invite large-scale state income tax avoidance by foreign interests dealing in oil, grain, and commodities or investing in U.S. farmland".<sup>7</sup> The issue at hand was that the treaty prevented the U.S. from taxing foreign investors on the gain from the disposition of U.S. capital assets.<sup>8</sup>

### **U.S. tax on capital gains obtained by nonresidents**

The current Foreign Investment Real Property Act (FIRPTA) was enacted in 1980 to remove the perceived competitive advantage favoring foreign investors in the U.S. real property market.<sup>9</sup> Under this law non-resident aliens would no longer be able to avoid U.S. tax on gains upon the direct sale of real property in the U.S. The statute defines real property as mines, wells and other natural deposits, ownership of land (or improvements), and options to acquire land,<sup>10</sup> and it taxes the sale of all directly held U.S. real property interests (RPIs), including those held by foreign residents, not just those for which the taxpayer received net basis taxation.<sup>11</sup> It does not include, however, stock regularly traded on an established securities market, regardless of how much of its value may be represented by U.S. real estate holdings.<sup>12</sup>

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

1. Direct interests in real property located in the U.S.;
2. Interests in a domestic corporation which holds substantial U.S. real property<sup>13</sup>;
3. Interests in domestic or foreign partnerships, trusts or estates with U.S. real property.

Also, FIRPTA overrode treaties that exempt foreign residents from a capital gains tax on their U.S. RPIs in any of those three cases. FIRPTA does not alter the basic principle governing U.S. taxation

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<sup>5</sup> Petkun (1982), p.14

<sup>6</sup> *Spokane Daily Chronicle*, May 8, 1978. See also Brown (2004), p.298.

<sup>7</sup> Citing an unpublished working paper by the US Department of Agriculture, the press explained that, for example, a "... German investor often possesses the advantage of escaping from all capital gains taxes and does not relinquish the privilege of being treated identically with U.S. taxpayers in other respects"; meaning that the German investor did not get taxed on its gross operational income if it had consistently been considered as a passive foreign investor. *Spokane Daily Chronicle*, May 8, 1978

<sup>8</sup> Petkun (1982), p. 27

<sup>9</sup> FIRPTA principal provision: IRC, S 897.

<sup>10</sup> Note that in the U.S. landowners also own what lies underground beneath their property.

<sup>11</sup> Brown (2004), p. 305.

<sup>12</sup> Petkun (1982), p.21.

<sup>13</sup> A 'real property holding corporation' is defined as holding majority real property, which is marked to market.

of non-residents: all gains (and losses) from dispositions of directly held U.S. RPIs are treated as income effectively connected with a U.S. business and the foreign investor disposing of a U.S. RPI is deemed to be engaged in a U.S. business and thus taxed accordingly.

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

## Peru

After the contentious case of Petrotech (described in Box 2), Peru passed legislation taxing all OITs, not just those whose value arises from immovable property located in Peru. The sale of an interest of any nonresident company whose value results at least 50 percent from shares of companies residing in Peru would be taxed in Peru. At least 10 percent of the parent foreign resident assets must be transferred for the tax to take effect<sup>1485</sup>, thus, sales of retail investors abroad would not be affected.

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

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

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

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

.....

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

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

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

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<sup>14</sup> The first condition was introduced with the Law No. 29663, February 2001; the second condition with Law No.29757, July 2011. Peru's domestic legislation taxing OITs can be overridden by double taxation treaties.

## China

China's approach to taxation of capital gains on transfers of interests differs in being structured as an anti-abuse provision. The general rule is that the gain on direct transfers of assets located in China is taxed at a 25 percent rate and offshore indirect transfers are equally taxed when involving the sale of immovable property located in China. In other cases, the taxation right on the indirect transfer of equity investment is sourced to the location of the investing enterprise. This means that a nonresident enterprise which owns another nonresident holding company which in turn invests in a Chinese company would not be taxed in China on the gain resulting from the transfer of shares of the holding company; the capital gain is sourced in the location of the holding company.<sup>15</sup>

However, if the holding company is situated in a jurisdiction where the effective tax burden is lower than 12.5 percent or where offshore income is not taxed, the Chinese tax authority may disregard the overseas holding company and re-characterize the indirect transfer as a direct one if it determines that there is no reasonable commercial purpose to the offshore transaction other than avoiding the Chinese tax.<sup>16</sup>

Considerations determining whether a transaction fails the reasonable business purpose test include, for example, if i) the value of the asset directly transferred derives at least 75 percent (directly or indirectly) from Chinese taxable property; ii) the nonresident enterprise does not undertake substantive functions and risks; the tax consequence of the indirect transfer in the foreign country is less than the Chinese tax payable if the sale had been made directly.<sup>17</sup><sup>92</sup>

The Chinese approach to indirect transfers of assets is relatively defensive and discretionary: it taxes OITs when it deems that they have been structured to avoid the Chinese tax, without being taxed commensurately by another jurisdiction.

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<sup>15</sup> Rule originally established in Notice No. 698, December 10, 2009 and replaced by Public Notice (2015) 7

<sup>16</sup> Article 47 EIT Law. Some exceptions apply, for example, sale of shares in the stock exchange.

<sup>17</sup> Wei (2015).

## APPENDIX D. ARTICLE 13(4) IN PRACTICE—AN EMPIRICAL ANALYSIS

This Appendix, prepared by the IMF, describes and explores the presence or absence of Article 13(4) in (essentially the universe of) double tax treaties, as of 2015.<sup>1</sup> It also looks at country characteristics that affect the likelihood of including this provision in a DTT. This preliminary analysis by the IMF will inform further work by the members of the PCT to identify trends and vulnerabilities of the global tax treaty network in relation to IOTs. The analysis, which was undertaken by the IMF, is tentative.

### Data and Variables

This preliminary analysis covers 3,046 DTTs—which is almost the entire universe of active DTTs in 2015. Of these, 2,979 were recovered from the International Bureau of Fiscal Documentation (IBFD); the rest were recovered by internet search or from the ActionAid tax treaties dataset.<sup>2</sup>

About 35 percent of these treaties (973) include a specific provision that entitles a country to tax gains from alienation of the capital stock of an entity the property of which consists directly or indirectly principally of immovable property located in that country. We are unable, however, to distinguish meaningfully between adoption of UN and OECD versions. Importantly, a comprehensive review of other relevant distributive rules in the covered agreement has not been undertaken. In some treaties in which Article 13(4) as defined in this section is absent other types of provisions may provide the location country a right to tax. Conversely, other treaties that include the provisions of Article 13(4) may include important exceptions to those provisions, such as those described in section V.C.

Further, about 35 percent of the treaties concluded by least one resource-rich country include Article 13(4) as defined in this section (291 of 834 treaties) (Figure A1). Additionally, about 38 percent of the treaties concluded by at least one low tax jurisdiction include Article 13(4) (Figure C.1).

In modelling the likelihood of Article 13(4) being included in a treaty (conditional on the existence of a treaty) we make use of the following variables (summary statistics being in Table C.1):

- *Article 13(4)*, the dependent variable, is a dummy equal to one if a DTT includes article 13(4) and the word “indirectly” (using the UN or the OECD version or similar variants), and zero otherwise.

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<sup>1</sup> If a treaty contains this provision, in some cases of course it appears under a different number in the treaty (e.g., 13.2, 13.5, or 14.4). Further, it should be emphasized that, in this analysis, if a provision on the treatment of gains from immovable property is present in a DTT but does not explicitly state the word “indirectly”, it is not referred to as Article “13(4)”.

<sup>2</sup> At <http://www.ictd.ac/datasets/action-aid-tax-treaties-datasets>



- *Resource-rich low-income* is a dummy equal to one if at least one party is a low-income or lower middle-income resource-rich country (as defined by the income classification of the World Bank and if revenues from resources exceed 10 percent).
- $CGT_i - CGT_j$  is the difference (in absolute value) between the concluding countries' tax rates on capital gains. If a country's tax code distinguishes between *CGT* for corporations and for personal tax purposes, we use the corporate *CGT*. The source is country reports published by Ernst and Young and Deloitte. A larger difference in *CGT* makes the use of a DTT for tax planning more attractive.
- *Low tax* is a dummy equal to one if the jurisdiction is a low tax jurisdiction in the sense of being included in the list of Hines and Rice (1994). There are 454 DTTs that involve such countries (almost 1/6 of the total).
- *Low tax*  $\times$  *Low Income Res.* is an interaction term between *Resource-rich low-income* and *Low tax*. This variable enables us to test whether the role of low tax jurisdictions depends on the income level of the partner country. The idea is that *Low tax* can have an impact on *Article 13(4)* only if (i.e., conditional on the observation that) one signing country is a low-income country, but not if that country is an advanced economy. It is ultimately an empirical question whether or not this is the case.
- *Year* is the year of concluding the treaty. Essentially, it is a trend variable spanning from 1947 to 2015.

**Table D1: Descriptive Statistics**

VARIABLES	N	mean	SD	min	max
<i>Article 13(4)</i>	3,046	0.319	0.466	0	1
<i>Year</i>	3,046	1997	12.51	1947	2015
$CGT_i - CGT_j$	2,993	11.05	8.512	0	35
<i>Low tax</i>	3,046	0.149	0.356	0	1
<i>Resource-rich low-income</i>	3,044	0.105	0.306	0	1
<i>Low tax</i> $\times$ <i>Low Income Res</i>	3,044	0.00591	0.0767	0	1

## Analysis and Results

Table D2 presents estimation results from two models using *Article 13(4)* as the dependent variable: A Linear Probability Model (LPM) in columns (1) to (3) and a logit model in columns (4) to (6). The results are discussed in the text.

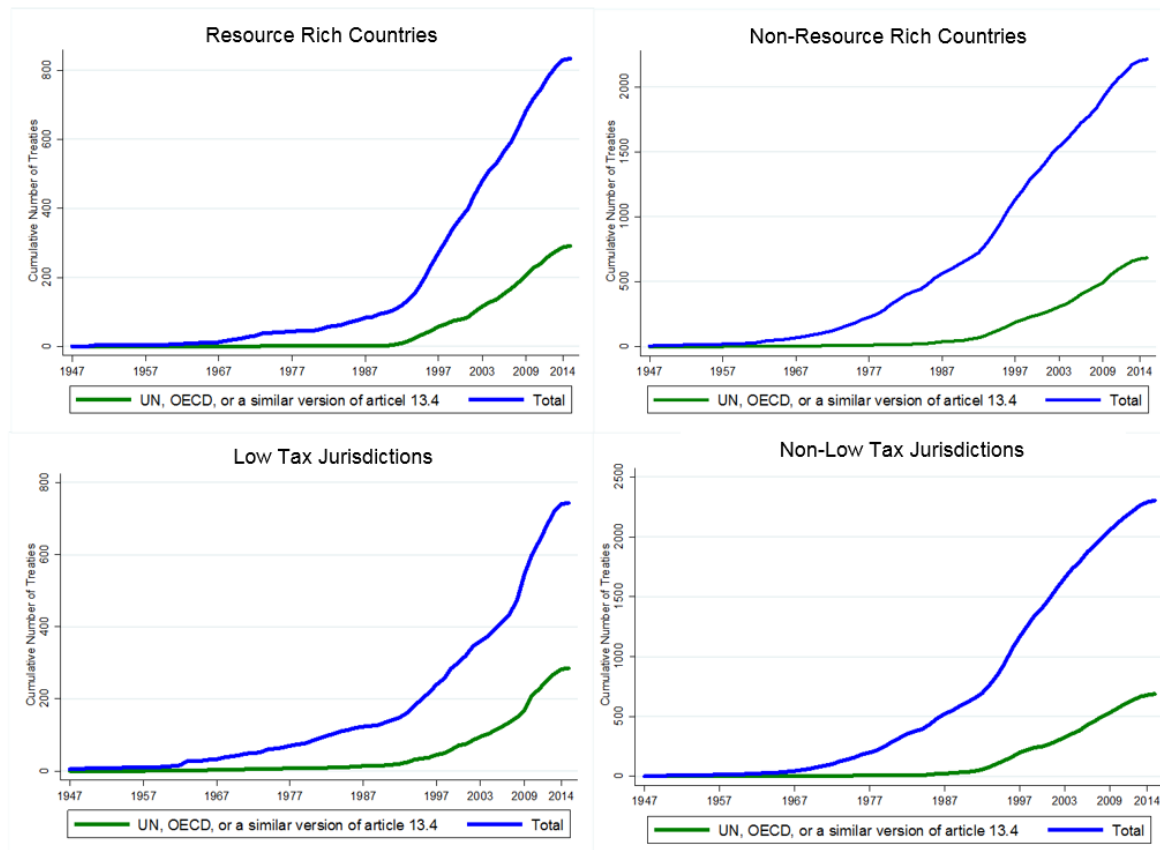
**Table D2: The Likelihood of Including 13(4) in a DTT, Estimation Results**

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

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

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

**Figure D1: Article 13(4) in DTTs with Resource-Rich Countries or low tax jurisdictions**



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