The Platform for Collaboration on Tax – a joint initiative of the IMF, OECD, UN and World Bank releases discussion draft on taxation of offshore indirect transfers – invites comments by 25 September, 2017

August 17, 2017

In brief

On 01 August, 2017, the Platform for Collaboration on Tax issued a discussion draft on the taxation of offshore indirect transfers of local assets, and has invited comments by 25 September, 2017 on various aspects in the draft.

The draft analysis alternative options and recommends taxing the local asset owning entity deeming that it disposes the assets at market value and reacquires them at same value.

In detail

Introduction

An Offshore Indirect Transfer (OIT) is the transfer of an entity located in one country that owns indirectly an "immovable" asset located in another country, by a person who is non-resident of the country where such asset is located. The tax treatment of such OITs is a critical tax issue for developing countries, as the popular perception is that multinational groups are minimising or even escaping their tax liability through OIT arrangements.

The Platform for Collaboration on Tax (a joint initiative of the IMF, OECD, UN and WBG), [1] issued a discussion draft on 1 August, 2017 (the report) inviting comments by 25 September, 2017. The purpose is to help developing countries tackle the complexities of taxing OITs of assets. The report provides analysis, options and recommendations for the tax treatment of OITs.

Brief on the report

Section I of the report is an introductory section and. this section states that the developing countries have identified that the treatment of OITs is not covered by Base Erosion and Profit Shifting (BEPS) project and the IMF, OECD and UN stress its significance. This section discusses that OITs involve highly technical complex issues and the aim is to identify practical options for developing countries. OIT's effect the source country more than the residence country having a crucial impact in the taxation of the source country.

Section II of the report provides guidance on what constitutes an OIT, its revenue implications and key considerations in allocating taxing rights in relation to OITs.

This section provides that an "indirect ownership interest" is an arrangement under which

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

there is at least one intervening entity between the owner and the asset under consideration. An indirect transfer involves the disposal of indirect ownership interest in an asset, whereas direct transfer involves disposal of a direct ownership. "Offshore transfers" are transfers in which the transferor is a tax resident in a different country from which the asset under consideration is located, and the transferor does not have a permanent establishment in the country in which such asset is located. All other types of transfers are onshore transfers.

In case of OITs, the revenue implications could arise due to transfer itself and/ or effects on other tax payments owing to change in ownership of the entity holding assets.

The principle of inter-nation equity (assuring allocation of revenues meeting fairness between countries), efficiency (ensuring assets are used in the most productive ways) and political economy (avoiding political dissatisfaction, which can lead to sweeping unilateral legislative actions) are key consideration while determining if the country in which asset is located should have primary taxing rights on its indirect transfer abroad.

This section concludes that the different arguments based on the above principle favour allocating taxing rights for capital gains associated with the transfer of assets to the country where the underlying asset is located. This class of assets extends beyond a narrow notion of immovable assets to include more those generating location specific rents (returns that exceed the minimum required by investors and that are not available in other jurisdictions). This may include telecom licenses or other rights such as natural source interactive rights issued by the government. The report provides sample language for a broad definition of immovable asset later.

In reference to Article 13(4)[2] of OECD MC and Article 13(5)[3] of UN MC, it is noted that currently, primary taxing rights are given to the source country in relation to immovable assets but to the residence country in the case of equity participation in other businesses. It was noted that the rationale, in limiting the right of the source country to only immovable assets is unclear. Thereby, it is emphasised that the location country should define the immovable asset in an expansive manner (in both the treaty and domestic law).

Section III of the report describes some recent cases[4] (including the Vodafone case in India) and highlights the concerns that multinational tax groups, by arranging their affairs, can ultimately escape taxation in the country in which the underlying assets were located. In all the narrated cases, the country in which the underlying asset was located, lost in court- or at least has not yet obviously won. It is also noted that the location country may well respond to defeat in court with sweeping policy changes (e.g., in India the law has been amended retrospectively since 1962 to bring OITs under taxation).

Section IV of the report, after discussing article 13(4) in the OECD and UN conventions, suggests that there is acceptance on allocation of capital gain taxation of OITs of immovable assets to the location country. This section also discusses that the Multilateral Convention[5] has positive impact in dealing with OITs by incorporating article 13(4) in treaties where it does not exist or enlarging its scope in tax treaties where it does exist.

The next section outlines two main approaches for enforcing of taxation of OITs by the country in which the asset is located.

The first approach seeks to tax the local entity that directly owns the asset, by treating that entity as disposing of the assets at their market value, and reacquiring such assets at the same value.

The second approach seeks to tax the non-resident seller of the relevant shares or comparable interest via a non-resident assessing rule. This approach treats the transfer as made by the actual seller offshore, but sources the gain on that transfer within the location country and enables the country to tax it.

A suggested legislative language for domestic law in the location country for both the approaches is provided. Advantages and disadvantages of both the approaches have been discussed in detail and for the relative ease of enforceability, and the logic and simplicity of basis adjustment it implies, the report favours the

[2] Article 13(4) of OECD convention: Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

[3] Article 13(5) of UN convention: "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."

[4] The following three highly publicised OITs are narrated: India- the Vodafone case; Peru – The acquisition of Petrotech; and Uganda – The Zain case.

[5] Multilateral Convention popularly known as MLI is the outcome of BEPS Action 15, to implement the BEPS tax treaty related measures efficiently.

method of deemed disposal (the first approach).

The concluding section reports that at least in case of an asset that embodies location specific economic rents (e.g., natural resources, physical assets and rights; rights to location specific telecom/ licenses/ businesses) and other immovable property assets the taxing rights should be primarily allocated to the source country. It also notes the need for a uniform approach to the taxation of OITs.

As there is wide acceptance of allocating capital gains taxation rights of OITs of “immovable” asset to the location country, the key issue is the appropriate definition of “immovable.” Further, it discusses that the taxing right of the location country can be supported by appropriate definition in domestic law of the assets intended to be taxed.

Question to be addressed

The comments needs to be provided inter alia, on how the following aspects in the report have been dealt with: (i) The rationale(s) for taxing OITs? (ii) Clarity on the principle for taxing OITs? (iii) Definition of an OIT? (iv) Discussion on source and residence taxation? (v) Expansion in the definition of immovable property? (vi) The concept of location-specific rents? (vii) Suggestions on other implementation approaches (viii) Preference for the “deemed disposal” method? (ix) Is there adequate representation of the complexities in the taxation of international transactions?

The takeaways

Considering the merits and demerits of both the approaches, the report suggests that taxing the local asset owning entity under a deemed disposal method is appropriate for tackling tax issues in OITs. However, India has already enacted a different approach of taxing the non-resident seller.

This is draft paper and may undergo subsequent changes. Also, since this would require changes to domestic law each country would need to look at its own policy etc. The success of the suggested approach may depend on how many countries adopt this.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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