Tax Treaty Monitor
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In this article, the author discusses the effectiveness of various instruments for exchange of information in tax matters, with particular focus on South African developments.

1. Introduction

With the increase in cross-border capital flows as a result of advances in technology and the globalization of trade and investments, tax administrations around the world face challenges in enforcing their tax laws. Countries normally require taxpayers to disclose the details of their income and investments to their tax authorities, but the possibility of intentional mis- or under-declaration can be very high when it comes to offshore investments. This has the effect of undermining the residence basis of taxation that is applied by some countries to tax the worldwide income of their residents. Since countries’ tax authorities cannot easily monitor their residents’ investments offshore, the opportunities of tax avoidance\(^1\) and evasion\(^2\) can be widespread. To address these challenges, some countries have had to come up with responses that are not only dependent on their domestic legislation but also on international cooperation with other countries’ tax administrations. International cooperation requires that a country’s tax administrations work together with the tax administrations of other countries to come up with measures that give them the capacity to enforce their national tax laws on their residents’ cross-border investments. In this way, countries could be able to maintain sovereignty over their own tax bases and ensure the correct allocation of taxing rights among countries.

One of the forms of international cooperation that countries employ today is to exchange information on tax matters regarding international investments of taxpayers. This ensures that taxpayers do not hide their income and assets in tax-haven and low-tax jurisdictions and that they pay the right amount of tax in the right country. There is, however, not much literature on the effectiveness of exchange of information measures in preventing international tax avoidance or illicit tax evasion. Over the last decade, the exchange of information on tax matters between national tax authorities has emerged as one of the central issues in international tax policy discussions. This chapter discusses the effectiveness of the various instruments employed internationally to ensure exchange of information on tax matters and the challenges these instruments pose.

2. Exchange of Information on Tax Matters: Overview of Historical Developments

One of the earliest recorded legal instruments to enforce exchange of information on tax matters is the first bilateral tax treaty that was concluded in 1872 between the United Kingdom and Switzerland (Canton of Vaud)\(^3\) for the prevention of double taxation in respect of death duties.\(^4\) The treaty was concluded on the basis of exchange of information by the two countries to address the imposition of succession or legacy duties by one country on the citizens of the other country dying in that country.\(^5\) It is, however, notable that efforts at international exchange of information between countries were very minimal during the 19th and 20th centuries. Countries were reluctant to exchange tax information with other countries and countries’ tax administrations were too “heterogeneous, informal and over-secretive.”\(^6\)

Efforts by countries to cooperate through exchange of information on tax matters appear to have come to the forefront from the late 1990s, after the OECD issued its

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\(^1\) Tax avoidance involves using perfectly legal methods of arranging one’s affairs to pay less tax. This is done by utilizing loopholes in tax laws and exploiting them within legal parameters.

\(^2\) Tax evasion is illegal. It is entails non-compliance with tax laws and includes activities like the falsification of tax returns and books of account that are deliberately undertaken by a taxpayer to avoid the payment of the tax which the law charges upon his income.

\(^3\) Declaration relative to Succession or Legacy Duties on Property of British Subjects Dying in the Canton of Vaud or of Citizens of the Canton of Vaud Dying in the British Dominions (27 Aug. 1872).


\(^6\) M. Stewart, Transnational Tax Information Exchange Networks: Steps Towards a Globalized Legitimate Tax Administration, 4 World Tax J. 2 (2012), Journals IBFD.
1998 report on Harmful Tax Competition. In this report, the OECD noted that tax-haven jurisdictions and harmful preferential tax regimes have harmful tax practices that may lead to the depletion of other countries’ tax bases. The OECD pointed out that harmful tax practices are encouraged by the fact that these jurisdictions lack transparency and effective exchange of information with other countries concerning the benefits taxpayers receive from the tax havens. This lack of transparency and effective exchange of information is one of the factors that attracts taxpayers to place their assets in these jurisdictions with the confidence that their business activities will not be disclosed to the tax authorities back home.

In order to counter such harmful tax practices, the 1998 OECD Report recommended that countries should have rules concerning the reporting of international transactions and foreign operations of resident taxpayers and that countries should exchange any information obtained under such rules. In 2002, the OECD issued a list of countries that lacked transparency and effective exchange of information. It called upon the listed countries to reform or they would be regarded as uncooperative tax havens that present a threat not only to the tax systems of developed and developing countries but also to the integrity of international financial systems. The jurisdictions that made a commitment to reform (Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino), worked alongside the OECD in developing international standards of transparency and information exchange on tax matters under the direction of OECD’s Global Forum on Taxation.

The Global Forum’s mandate was to provide an inclusive forum for achieving high standards of transparency and exchange of information in a way that is equitable and permits fair competition among all countries. In a nutshell, the standards of transparency and exchange of information on tax matters that were formulated by the Global Forum require:

- exchange of information on request where it is "foreseeably relevant" to the administration and enforcement of the domestic laws of a treaty partner;
- no restrictions on exchange of information because of banking secrecy or other domestic tax interest requirements;
- respect for taxpayer’s rights; and
- strict confidential information exchange.

These standards are now embodied in the Agreement on Exchange of Information on Tax Matters (2002) and its commentary, which serves as a basis for several Tax Information Exchange Agreements (commonly referred to as TIEAs) entered into between countries. The standards are also embedded in article 26 of the OECD Model (2010) and article 26 of the UN Model (2011). The standards of exchange of information as set out in these and other instruments are discussed below.

3. International Instruments That Foster Exchange of Information in Tax Matters

Countries generally cannot exchange information in tax purposes, unless there is a legal instrument or mechanism for doing so. The legal authority to exchange information may be achieved through the following legal instruments:

- bilateral exchange of information through bilateral tax treaties;
- bilateral exchange of information through TIEAs;
- exchange of information through multilateral agreements;
- regional instruments that permit exchange of information;
- unilateral domestic legislation that allows for exchange of information.

These different instruments of exchanging information have individual accents because of the factors that influenced their origins, but save from a few pertinent differences, they are all crafted using similar language and are highly comparable in a number of respects. To prevent unnecessary repetition of similar issues, the first two instruments are discussed in some detail but only the pertinent issues in the other instruments are discussed.

4. Exchange of Information through Bilateral Tax Treaties

4.1. Introductory text

The preamble to most tax treaties usually states that the purpose of the relevant treaty is "the avoidance of double taxation and the prevention of fiscal evasion." The latter purpose refers to the use of the bilateral treaty to prevent taxpayers from concealing income derived from their international investments. For treaties based on the OECD Model and the UN Model, article 26 (which is essentially

8. According to the OECD, a tax haven jurisdiction is one which actively makes itself available for the avoidance of tax that would have been paid in high-tax countries.
9. According to the OECD, harmful preferential tax regimes, occur in both tax-haven and high-tax jurisdictions. Harmful tax regimes are characterized by having no or low effective tax rates on income; the regimes are ring-fenced and there is a general lack of transparency and effective exchange of information with other countries.
10. OECD, Harmful Tax Competition, supra n. 7, at para. 75.
11. Id., at para. 79.
13. OECD Agreement on Exchange of Information on Tax Matters para 2 of the introduction (18 Apr. 2002), Models IBFD.
17. OECD Model Tax Convention on Income and on Capital (22 July 2010), Models IBFD.
18. UN Model Tax Convention on Income and on Capital (1 Jan. 2011), Models IBFD.
the same in both models) provides for exchange of information in tax matters between the contracting states about the investments of a contracting state’s residents in the other contracting state. To avoid unnecessary reference to both models, this article refers to only the OECD Model (2010). In effect, article 26 expands the reach of domestic law in the sense that it gives powers to the contracting states to exchange information on tax matters, which does not generally exist under domestic law. The analysis immediately below sets out basic workings of article 26 of the OECD Model (2010), and the next section examines whether this exchange of information article is effective in preventing tax avoidance and evasion.

Article 26(1) of the OECD Model (2010) provides that the competent authorities of the contracting states shall exchange information that is foreseeably relevant for carrying out the provisions of a tax treaty or to the administration or enforcement of the domestic laws. The contracting states are not at liberty to engage in “fishing expeditions” or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer. Article 26(1) has a wide scope as it provides for exchange of information on taxes of every kind and description: even for the taxes imposed by the states’ political subdivisions or local authorities.

Although article 26 does not contain details about the processes of information exchange, the Commentary on Article 26(1) of the OECD Model (2010) provides that information can be exchanged in the following three ways (or a combination of the three). Firstly, information can be exchanged “upon request”, if there is a specific case in mind. However, the regular sources of information available under the internal taxation procedures of the requesting state should first be exhausted before a request for information is made to the other state. Beyond exchange of information upon request, article 26 also provides for automatic exchange of information. In this case, information about one or various categories of income that is sourced in one contracting state and received in the other contracting state is transmitted systematically to the other state. This article also provides for spontaneous exchange of information in cases where a state acquires information through certain investigations, which it supposes to be of interest to the other state. Article 26 also provides that the contracting states may use other techniques to obtain information which may be relevant to both contracting states. Such techniques include the use of: simultaneous examinations, tax examination abroad, and industry-wide exchange of information.

Article 26(1) makes it clear that exchange of information is not limited to information exchange about residents of the contracting states. Even though article 1 of OECD Model (2010) provides that the tax treaty applies only to residents of the contracting states, information exchange may include particulars about non-residents. This may cover information about a third country’s resident if it is foreseeably relevant to the requesting state’s tax administration, even though such information may have no relevance to the third country resident’s tax position.

Exchange of information is not limited to the administration or enforcement of taxes. It can also deal with criminal matters as long as they relate to tax crimes and the information exchanged is not contrary to the tax treaty. The information that can be exchanged is also not limited to taxpayer-specific information. Information may be exchanged on other “sensitive information related to tax administration and compliance improvement, for example analysis techniques or tax avoidance or evasion schemes”.

Article 26(2) requires that each country’s administration treats the information it receives “as secret” and with proper confidence in the same manner as information obtained under the domestic laws of the requested state. Although information may be disclosed to courts and other administrative bodies concerned with the assessment or collection of taxes, and the prosecution thereof, such court or administrative bodies are not at liberty to disclose any other information that is not part of the proceedings. In the same vein, contracting state may not disclose information to a third country unless there is an express provision in the bilateral tax treaty between the contracting states allowing such disclosure.

Article 26(3) provides certain limitations to the exchange information by the requested state:

- A contracting state is not obliged to carry out administrative measures at variance with its laws and administrative practices or those of the other contracting state. If a country has taxpayer notification procedural laws, such notification procedures should not be applied in a manner that would frustrate the requesting state by causing undue delays to the effective exchange of information. Exceptions should also be granted to such notification procedures if the information request is very urgent or if the notification is likely to undermine the investigation conducted by the requesting state.

- A contracting state is not obliged to supply information which is not obtainable under its laws or administrative practices or those of the other contracting state. Thus a contracting state cannot take advantage of the information system of the other contracting state if this is wider than its own system.

- A contracting state is not obliged to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or disclose information which would be contrary to public policy. The OECD Commentary (2010), however, provides that trade secrets should not be taken in too wide a sense. Furthermore, the protection of profession confidential communications does not attach to documents or records delivered to an attorney or solicitor in an attempt to protect such documents or records from disclosure required by law. In the case of the obligation not to disclose infor-
mation that is contrary to public policy, this would cover a request of information motivated by political, racial, religious persecution and information that constitutes a state secret, which if disclosed would be contrary to the vital interests of the requested state.

Article 26(4) states that if information is requested by a contracting state, the other contracting state shall use its information gathering measures to obtain the requested information, even though that state may not need such information for its own tax purposes. Thus, a contracting state cannot decline to supply information solely because it has no domestic interest in such information.

Article 26(5) makes it clear that the exchange of information is mandatory. The article states that a contracting state may not decline to supply information solely because the information is held by a bank, a financial institution, a nominee or any person acting in an agency or a fiduciary capacity or because the information relates to ownership interests in a person. Thus, article 26(5) overrides article 26(3) to the extent that article 26(3) would permit a requested state to decline supplying information on grounds of banking secrecy. As noted above, article 26(5) makes it mandatory to exchange information held by ‘nominees’, ‘agents’ and ‘fiduciaries’ as well as ‘ownership information’. For example, if a contracting state had a law under which all information held by a fiduciary was treated as a ‘professional secret’, that state cannot use such law as a basis for declining to provide information to the other contracting state.

4.2. Challenges to effective exchange of information on the basis of article 26 of the OECD Model (2010)

When the standards of exchange of information on tax matters were introduced in the OECD Model (2003), some countries, such as Austria, Belgium, Luxembourg and Switzerland, had reservations about these standards. However, many other countries have signed treaties that include article 26. In 2004, the standards were endorsed by the G20 Finance Ministers and Central Bank Governors at their meeting in Berlin. It should, however, be noted that the exchange of information article, as it stood in the OECD Model (2003), was revised and broadened in the OECD Model (2005). This implies that the terms of the exchange of information article in the various tax treaties vary significantly depending on the version of the OECD Model those treaties were modelled on. Treaties based on the OECD Model (2003) have narrow information exchange clauses, while those based on the OECD Model (2005) (and later versions) have broader ones. The extent of the clauses often depends on the date of negotiation of the tax treaty and the preferences of the contractive states. For example, the OECD Model (2003) referred to the exchange of information that is “necessary”. This was changed since the OECD Model (2005) to refer to exchange of information that is “foreseeably relevant”. Thus, countries with treaties signed before 2005 have exchange of information clauses that are limited to the exchange of information that is “necessary” for specific taxes and sometimes only for the purposes of that specific tax treaty. For example, article 26(1) of South Africa’s treaties with countries such as Luxembourg (1998), China (2000) and article 25(1) of the treaty with India (1996) (worded in a similar manner) refers to exchange of information as is “necessary”.

The change from exchange of information that is “necessary” to exchange of information that is “foreseeably relevant” was intended to “provide for exchange of information in tax matters to the widest possible extent”. The use of the term “necessary” in the OECD Model (2003) posed some uncertainties for countries since the term “necessary” was not defined in the OECD Model (2003) and reference to the domestic tax laws of the contracting states to define the term (as required under article 3) did not resolve the matter since not all countries have a meaning of the term in their domestic tax laws. Although the current tax treaty standard of exchanging information that is “foreseeably relevant” prevents fishing expeditions, it, nevertheless, creates a hindrance to exchange of information since it effectively implies that a country’s tax authorities have to already know what they are looking for before they can ask for it. The requests must show reasonable cause, in that they need to be based on evidence that the particular enterprise or individual is evading taxes. However, this hinders information exchange as tax authorities do not often have all the relevant details of a particular case and may limit the number of requests that can be made.

Most countries’ older tax treaties that are based on the OECD Model (2003) do not contain the provision overriding bank secrecy, as set out in article 26 of the OECD Model (2005) and its later versions. Some older treaties also limit the forms of information exchange. For instance the treaties South Africa signed with Luxembourg (1998), China (2000) and India (1996) refer to exchange of information for ‘the taxes covered by the Convention’. Article 26 of the OECD Model (2010) refers to ‘taxes of every kind and description imposed on behalf of the contracting states, or of their political subdivisions or local authorities’. Older tax treaties need to be re-negotiated to include the current standards of exchange of information. However, the negotiation and renegotiation of tax treaties is often

22. OECD, Overview of the OECD’s Work on Countering International Tax Evasion, supra n. 14, at para. 2.
23. OECD, Implementing the Tax Transparency Standards, supra n. 15, at para. 22.
24. OECD Model Tax Convention on Income and on Capital (15 July 2005), Models IBFD.
slow, cumbersome and linked to various economic and political pressures. This implies that some treaty provisions will contain fragmented and varying clauses of the OECD standard of exchange of information in tax matters for some time. It is trite that the OECD advocates for the dynamic interpretation of treaties that takes into account the ongoing national and international developments in tax law, rather than the static approach of interpreting treaties in accordance with the contents of its terms at the time they were concluded. However, the OECD acknowledges that where the latest version of the OECD Model is “different in substance” from the previous version, the previous version has to be applied in interpreting the treaty. As the current provisions relating to exchange of information are “different in substance” to the OECD Model (2003), the dynamic interpretation of the treaty would not apply. Since the OECD Model is not legally binding and it is the treaty that is a binding contract between the two states, many states are in the process of renegotiating their tax treaties or adding protocols incorporating an updated article 26 clause.

Article 26(3) acknowledges that some countries have notification procedures which are used to protect taxpayer rights. Although article 26 provides that countries should not use these procedures to frustrate exchange of information and that countries can include exceptions to these procedures, this does not detract from the fact that these procedures often result in the “tipping off” of tax evaders who may appeal the process as a delay tactic, while the relevant assets are transferred to another jurisdiction. If the specific agreement between the contracting states does not cover exceptions to override the notification procedures, such procedures can be used to defeat the request for information, especially where chains of asset ownership stretch over a number of jurisdictions. If a “beneficial owner” in one jurisdiction becomes aware of an investigation, he may sell his company shares to new layers of corporate owners, thus disappearing from the records as beneficial owner, and extending the chain of ownership into other jurisdictions. If a tax authority has to repeat this through a number of jurisdictions, this would tantamount to defeating the task of pursuing tax evaders and it would discourage tax administrators from starting enquiries.

Article 26 provides for exchange of information upon request, automatic exchange of information, spontaneous exchange of information, and includes other methods, such as: simultaneous examinations, tax examination abroad and industry-wide exchange of information. It is laudable that exchange of information in article 26 of the OECD Model (2010) goes beyond exchange of information on request, which is the most obvious and basic starting point of a request for information. Before exchange of information upon request can be commenced, the requesting state’s internal taxation procedures should be exhausted. This “exhaustion principle” has been criticized for being counterproductive in cases of fraud. A strict interpretation of the exhaustion principle in the information gathering stage may hinder effective exchange of information and delay. It has been recommended that some discretionary freedom in applying this principle should be included in the Commentary on Article 26.

Regarding the effectiveness of the other methods of exchange of information (automatic and spontaneous exchange of information), there has been little analysis to date about the efficiency of these methods in exposing illicit cross border capital flows. Thus, although automatic exchange of information has been hailed as the reason for the increase in exchange of information especially among developed countries and is considered to be the effective way for tax authorities to obtain comprehensive data about income earned by domestic residents in foreign banks, there has been little analysis to date about the efficiency of automatic exchange of information. Generally, it requires heavy dependency on technological, computing and administrative capacity, which includes: registries of beneficial ownership and/or beneficiaries, comprehensive taxpayer identification numbers and mandatory reporting of income payments. Generally, most developed countries have the conditions in place that can ensure automatic exchange of information, but most developing countries do not, which makes automatic exchange of information between some developed and developing countries difficult. There is concern that when information is exchanged automatically, the potential for error in exchanging large quantities of taxpayer information globally possesses risks of breaching the confidentiality provisions. The transfer of data across borders may also create operational complexities due to country differences, such as differences in legal systems, languages, time-zones and financial year ends. These matters make it unclear as to how effective automatic exchange of information is going to be.

4.3. Progress on negotiating bilateral tax treaties with the exchange of information article in South Africa

South Africa is taking measures to ensure that the standards of exchange of information are incorporated in its bilateral tax treaties. It has signed protocols to its old tax treaties with a number of countries which incorporate standards on exchange of information into the relevant tax treaties.

The effectiveness of information exchange in South Africa’s tax treaties was recently pronounced on in the case of CSARS v. Werner van Kets (2012). In this case, the Australian Tax Office (ATO) requested the South African Revenue Service (SARS) to provide certain information in terms of article 25 of the Australia-South Africa

31. Stewart, supra n. 6, at p. 175.
33. ZA: Western Cape High Court, 22 Nov. 2011. CSARS v. Werner van Kets 2012 (3) SA 399 (WCC).
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5. Tax Information Exchange Agreements

5.1. Introductory remarks

After the 1998 OECD Report pointed out that international harmful tax practices are encouraged by the lack of effective exchange of information, in 2002, the OECD’s Global Forum developed a Model Agreement on Exchange of Information on Tax Matters (the “OECD TIEA Model”). Since then, this model has been used as a basis for negotiating TIEAs. The TIEAs provide a forum to exchange information even if a tax treaty is not in place. As most tax havens do not levy income taxes, they often do not sign tax treaties, so TIEAs can be used as a legal instrument to ensure exchange of information with tax havens in the absence of a bilateral tax treaty. The signing of TIEAs could also be advantageous for some developing countries that wish to be aligned with the standards of exchange of information without necessarily signing a tax treaty that would bind them to restrictive bilateral treaty provisions, like the provisions that require source countries to levy reduced withholding taxes on dividends, interest and royalties. Such countries could also desire to sign TIEAs instead of tax treaties to prevent the depletion of their tax bases if the treaty is abused by third country residents through treaty shopping schemes.

The analysis immediately below explains the workings of the OECD TIEA Model. It should be noted that a number of provisions in the OECD TIEA Model are similar to those in article 26 of the OECD Model (2010). The similarities are merely pointed out and emphasis is placed on the differences. Thereafter, the next section examines whether exchange of information under the TIEAs is effective in preventing fiscal evasion.

The OECD TIEA Model is not a binding instrument. It contains two models: one for negotiating bilateral agreements and the other for negotiating multilateral agreements, all based on the standards of tax information exchange. Its purpose is to foster exchange of information in tax matters that will assist the contracting parties to administer and enforce their tax laws.

35. ZA: Income Tax Act (ITA) 1962, National Legislation IBFD.
36. Sec. 1 ITA 1962.
37. “Tax treaty shopping” is a tax avoidance scheme that refers to the use of tax treaties by residents of a non-treaty country in order to obtain tax treaty benefits that are not supposed to be available to them. See A.W. Oguttu, Curbing ‘Treaty Shopping’: The Beneficial Ownership Provision Analysed from a South African Perspective, XI Southern Africa Com. & Intl. L. J. (2007).
Just like article 26 of the OECD Model (2010), article 1 of the OECD TIEA Model provides for the exchange of information that is “foreseeably relevant”. Contracting parties are not at liberty to engage in fishing expeditions or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer. Before sending a request, a requesting country should use all means available in its own territory to obtain the information except where those would give rise to disproportionate difficulties.

Unlike article 26 of the OECD Model (2010), which is wide in its scope and provides for exchange of information on taxes of every kind and description (even for the taxes imposed by the states’ political subdivisions or local authorities), information exchanged in terms of article 1 of the OECD TIEA Model is limited to the administration and enforcement of the domestic laws of the contracting parties regarding the taxes covered by the TIEA. This is further pointed out in article 3 of the OECD TIEA Model, which provides that the TIEA only deals with the taxes with respect to which the contracting parties agree to exchange information in accordance with the provisions of the TIEA.

Just like article 26 of the OECD Model (2010), the Commentary on Article 1 of the OECD TIEA Model provides that where a requested state has procedural laws or practices that provide for the right to notify taxpayers about the information exchange, such procedural laws should not be used to “unduly prevent or delay” the exchange of information. Article 1 of the OECD TIEA Model also provides that the agreement can include exceptions to the notification procedures if the information request is very urgent or if the notification is likely to undermine the investigation conducted by the requesting state.

Article 2 of the OECD TIEA Model provides that the requested party is not obligated to provide information which is neither held by its authorities nor in the possession or control of persons within its territorial jurisdiction. However, the requested party’s obligation to provide information is not, “restricted by the residence or the nationality of the person to whom the information relates or by the residence or the nationality of the person in control or possession of the information requested”.

Unlike article 26 of the OECD Model (2010), which provides for information exchange to the widest possible extent, article 5 of the OECD TIEA Model is limited to providing exchange of information upon request. This is typically the case where one country’s competent authority asks for particular information that relates to an examination, inquiry or investigation of a taxpayer’s tax liability for specified tax years. Automatic or spontaneous exchange of information is not covered in the OECD TIEA Model.

Just like article 26(1) of the OECD Model (2010), article 5(1) of the OECD TIEA Model provides for information exchange for both civil and criminal tax matters. Information in connection with criminal tax matters must be exchanged irrespective of whether or not the conduct being investigated would also constitute a crime under the laws of the requested party.

Article 5(2) of the OECD TIEA Model provides that if the information in the possession of the competent authority of the requested state is not sufficient to enable it to comply with the request for information, the requested state shall use all relevant information gathering measures to provide the requesting state with the information requested. The article refers to information “in its possession” rather than “available in the tax files”. This is because some contracting states that do not impose direct taxes may not have tax files. Like article 26 of the OECD Model (2010), article 5(2) of the OECD TIEA Model further provides that information must be exchanged without regard to whether the requested state needs the information for its own tax purposes. Thus, information must be exchanged even where the requested state does not impose an income tax or the request relates to an entity that is not subject to taxation within the requested state.

Article 5(3) of the OECD TIEA Model provides that if specifically requested, the requested state must provide information in the format specifically requested by a requesting state where this is needed to satisfy its evidential or other legal requirements. The information could for instance be requested in the form of depositions of witnesses or authenticated copies of original records. However, a requested state may decline to provide the information in the specific form requested if such form is not allowable under its laws. A refusal to provide the information in the format requested does not affect the obligation to provide the information.

Like article 26 of the OECD Model (2010), article 5(4)(a) of the OECD TIEA Model states that each contracting state shall ensure that its competent authorities have the authority to obtain and provide information “held by banks, other financial institutions, and any person acting in an agency or fiduciary capacity including nominees and trustees”. This provision ensures that banking secrecy cannot be used as the basis for declining a request for exchange of information, and neither can bank secrecy be considered a part of public policy. Just like article 26 of the OECD Model (2010), article 5(4)(b) of the OECD TIEA Model provides that each contracting state shall exchange information regarding the ownership of companies, partnerships, trusts, foundations and other persons. This would also include exchanging information on all persons in the ownership chain of these entities. In the case of trusts, this would entail information about the settlors, trustees and beneficiaries. In the case of foundations, this would mean exchanging information about the founders, members of the foundation council and beneficiaries. In the case of partnerships, information can be exchanged on all forms of partnership interests. With regard to companies, the legal and beneficial owner of the company shares will usually be the same person but where the legal owner acts on behalf of another person as a nominee or other similar arrangement, such other person, rather than the legal owner, may be the beneficial owner. In that case, infor-
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Like article 26(3) of the OECD Model (2010), article 5(7) of the OECD TIEA Model provides that the requested state is not obliged to provide information:

- that the request would not be able to obtain under its own laws;
- which would disclose any trade, business, industrial, commercial or professional secret or trade process (bank information as referred to in article 5(4) is not to be treated as secret);
- which would reveal confidential communications between a client and an attorney, solicitor or other admitted legal representative;
- if its disclosure would be contrary to public policy.

Like article 26 of the OECD Model (2010), article 8 of the OECD TIEA Model requires that exchange of information must be treated confidentially and may only be disclosed to persons or authorities (such as courts and administrative bodies) only for the purposes of assessment or collection of taxes, the enforcement, prosecution or the determination of appeals in relation thereto.

Unlike article 26 of OECD Model (2010), which is silent on who bears the costs of exchange of information, article 9 of the OECD TIEA Model “allows the Contracting Parties to agree upon rules regarding the costs of obtaining and providing information in response to a request”. The commentary on Article 9 explains that normally the general costs incurred in the ordinary course of administering the domestic tax laws of the requested state when responding to a request for information should be borne by the requested state. Such costs would for instance cover the costs for routine tasks such as obtaining and providing copies of documents. However, flexibility is required to allocate costs between the contracting states taking into account factors such as: the likely flow of information requests between the states, whether both states have income tax administrations, the capacity of each state to obtain and provide information and the volume of information involved. Alternatively, the competent authorities may wish to establish a scale of fees for the processing of requests that would take into account the amount of work involved in responding to a request.

Article 10 of the OECD TIEA Model requires the contracting states to enact legislation necessary to comply with the terms of the TIEA. The article also obliges the contracting states to refrain from introducing new legislation that is contrary to their obligations under the TIEA.

5.2 Challenges to effective exchange of information using TIEAs

Generally, tax havens do not sign tax treaties, so the signing of TIEAs is the mechanism for ensuring that these jurisdictions comply with the exchange of information standards. However, initially, the progress in signing TIEAs was slow. Many tax haven jurisdictions and offshore financial centres, such as Andorra, Liberia, Liechtenstein, Marshall Islands, Monaco, Hong Kong and Singapore, refused to endorse the standards. One of the reasons why these jurisdictions refused to cooperate with information exchange was the concern that taxpayers would shift their funds from the cooperative jurisdictions to the non-cooperating ones. Consequently, the OECD embarked on on-going dialogue with various jurisdictions to implement these standards to achieve a level playing field where no party is unfairly disadvantaged and to prevent the migration of businesses to uncooperative tax havens. In 2006, the OECD issued a report which assessed the legal and administrative frameworks required to achieve a ‘global level playing field’ to ensure transparency and effect exchange of information for tax purposes. The 2007 follow-up assessment reports show that a number of tax havens had made commitments to implement the OECD’s standards of transparency and information exchange. However, the OECD noted that a great deal of work needed to be done to ensure that all jurisdictions accept these standards and that those that made commitments to accept the standards follow through and implement them. At the April 2009 G20 Summit, the G20 countries announced that the “era of banking secrecy was over” and they urged tax havens to sign at least 12 TIEAs; otherwise they would face economic sanctions. In its 2010 Progress Report, the OECD stated that all countries in the Global Forum had committed to and “substantially implemented” the “internationally agreed tax standard” for

42. Such countries include: Monaco, San Marino and Uruguay.
43. OECD. Overview of the OECD’s Work on Countering International Tax Evasion, supra n. 14, at para. 2.
TIEAs. The OECD also succeeded in getting these standards endorsed by all major financial centres, which also identified steps they would take to enable the implementation of the standards. By June 2013, over 800 TIEAs had been signed, primarily between developed countries and tax havens or offshore finance centres. Many jurisdictions that were identified in 2000 as non-cooperative tax havens have signed TIEAs with various OECD member countries. Jurisdictions such as Aruba, Bahrain, Bermuda, British Virgin Islands, Cayman Islands, Jersey, Guernsey, the Isle of Man and the Netherlands Antilles, have substantially implemented the exchange of information standards. Others, such as Antigua and Barbuda, and Gibraltar, have made good progress in signing TIEAs.

The increase in signing TIEAs can be alluded to pressure exerted on tax haven jurisdictions by the G20 countries in the aftermath of the 2007 global financial crisis that increased governmental concern about the depletion of their tax bases. This was further augmented by the exposure of tax evasion scandals involving UK and US taxpayers who had hidden their assets in Liechtenstein, Luxembourg and UBS banks. There is now a widespread recognition that all jurisdictions need to implement the international standards of transparency and exchange of information for tax purposes if international tax evasion is to be tackled effectively.

To assess how effectively countries have implemented the international standards of transparency and exchange of information on tax matters, the Global Forum formed a peer review group mechanism. The peer reviews, which began in 2010, are performed by assessment teams made up of representatives from Global Forum member jurisdictions and the Global Forum Secretariat. The review teams conduct systematic examinations and assessments of jurisdictions’ legal and regulatory frameworks that deal with transparency and exchange of information for tax purposes. The ultimate goal is to help jurisdictions effectively implement the international standards of transparency and exchange of information for tax purposes. The outcomes of the review process are public in nature and the recommendations are communicated through formal peer review reports and informal dialogue with the peer jurisdictions. By April 2012, the Global Forum had published reviews of a number of jurisdictions that evaluated whether their national laws allow transparency and international exchange of tax information.

Despite the above developments, there are various issues that compromise the effectiveness of the TIEAs and the Global Forum’s peer review process. Just like article 26 of the OECD Model (2010), article 1 of the OECD TIEA Model also provides for the exchange of information that is “foreseeably relevant”. Once again, although this standard prevents fishing of information, its main hindrance is that countries’ tax authorities effectively have to know what they are looking for before they can ask for it. The OECD TIEA Model creates an even more daunting obligation on the requesting state’s tax authorities. Article 5(5) thereof, which sets out the procedures for handling requests, requires that the requesting state must provide the identity of a particular person, a statement on the information sought, a description of the particular tax purpose, the grounds for believing that the information is in possession of the requested state, and also the name and address of a person in possession of the information. These requirements make major obstacles in the way of making requests. Countries may request for information if they have well documented suspicion that a taxpayer is evading taxes. By requiring taxpayer-specific information before exchange of information can be made, there is an assumption that the problem of global tax evasion lies with specific individuals. However, it is a bigger systematic problem that deprives countries of hundreds of billions of dollars of revenue every year. Thus, requiring only foreseeably relevant information to be exchanged is not a substantial deterrent to tax evaders. A study by Johannesen and Zucman (2012) indicates that the requirement to place a request for information only after a country has all the specific information about the taxpayer is extremely hard and that the volume of information that can be obtained is limited.

The above matters are compounded by the fact that in the TIEAs information can only be exchanged ‘upon request’. This standard of exchanging information is the basic starting point of information requests, but it is not an effective

46. OECD, Countering Offshore Tax Evasion, supra n. 38, at p 14.
48. For example: TIEAs between: Netherlands and Guernsey (2008), Germany and Jersey (2008), Cayman Islands and Norway (2009), Cayman Islands and Sweden (2009).
49. OECD, Countering Offshore Tax Evasion, supra n. 38, at p 15.
52. OECD, Implementing the Tax Transparency Standards, supra n. 15, at para. 9.
53. OECD, Countering Offshore Tax Evasion, supra n. 38, at p. 15.
54. OECD, Implementing the Tax Transparency Standards, supra n. 15, at para. 11.
55. Id.
56. OECD, Tax Evasion: Pressure to End Tax Evasion Grows as the Global Forum Publishes New Reviews (2012) available at www.oecd.org/document/20/0,3746,en_21571361_44315115_50070740_1_1_1_1_1,00.
58. Id.
deterrent for curbing tax evasion and preventing the vast illicit flows of global offshore portfolio investments. The effectiveness of this method is hampered by the fact that domestic procedures of the requesting states must first be exhausted before a request for information is made to the other state. Due to the inherent restriction of this approach, intentional exchanges of information upon request are relatively rare and based on reciprocity. For instance, in the United States, the Government Accountability Office revealed that between 2006 and 2010, the United States placed 894 requests for information, but the statement of the US Senate showed that more than 19,000 US residents have undeclared bank accounts in Swiss banks. These statistics clearly show that the exchange of information upon request detects only a small fraction of the tax evasion problem. When developing the OECD TIEA Model in 2002, it was agreed that, for purposes of implementing the commitments made by tax haven jurisdictions, exchange of information on request would be sufficient. This was perhaps to acknowledge the major step forward that exchange of information on request would imply for those jurisdictions concerned. Although the supporters of the "upon request" standard may argue that a small probability of detection from tax havens is a major step forward from no exchange of information at all, this standard is inadequate in addressing the magnitude of the problem of global tax evasion. One critic sarcastically notes that "needless to say, tax havens are delighted with this standard and will proudly boast about being compliant with the OECD requirements." With the current rate at which taxes are evaded or avoided internationally, exchanging of information upon request sets the bar way too low. It should ideally play a supporting role to other methods, such as the spontaneous and automatic information exchange, which are widely recognized as more effective tools for tackling tax evasion. Critics of the effectiveness of TIEAs have noted that by ruling out automatic information exchange in the TIEAs, the problem of undetected tax evasion and illicit cross-border financial flows remains largely unaddressed. Indeed, there is scant evidence of any deterrent effect on tax evaders due to the standard set out in the TIEAs with the result that the TIEAs have not failed to exert pressure on tax evaders to declare their offshore investments. Critics further assert that the TIEAs merely help with obtaining proof of misconduct, but not in revealing the misconduct in the first place. Thus, they do not address the core problem of tax evasion and tax avoidance and they are not an effective means of ensuring policy change in tax-haven jurisdictions. Although the OECD considers the signing of TIEAs as a key policy instrument in the fight against tax evasion, there is little evidence about their effectiveness. A study conducted by Johannesen and Zucman (2012) with data sourced from the Bank of International Settlements on the effectiveness of TIEAs in curbing tax evasion shows that tax evaders responded moderately to the nature of TIEAs. The study showed that, after a TIEA had been signed, most tax evaders did not seem to perceive the possibility of their tax evasion being detected. Furthermore, tax evaders who responded did not repatriate their funds to their countries of residence but transferred the funds to tax havens that had no treaty with their home country, leaving roughly unchanged the funds held globally in tax havens. Another study by Huizinga and Nico- deme (2004) also indicated that the signing of TIEAs had no effect on cross-border bank deposits.

Article 5(7) of the OECD TIEA Model (just like article 26 of the OECD Model (2010)) provides certain circumstances under which a contracting state will not be obliged to provide information. If a jurisdiction refuses to exchange information in a bilateral tax treaty context, disputes can be resolved by using legal means or by administrative action, such as arbitration. There is, however, no clear recourse available in the TIEAs. If a country does not cooperate in exchanging of information, the only recourse the other country has is to lodge a complaint with the OECD Global Forum. This is, however, essentially a political costly process. The OECD Global Forum has no legal enforcing powers. If a country does not fully implement the standards, the OECD has no power to impose sanctions on such a country. Individual countries have to decide what actions they consider necessary to ensure the effective enforcement of their tax laws. Countries may, for instance, exert diplomatic pressure or refuse to reciprocate to that country’s future requests.

Article 9 of the OECD TIEA Model “allows the Contracting Parties to agree on the costs of obtaining and providing information in response to a request”. The competent authorities may also “establish a scale of fees for the processing of requests that would take into account the amount of work involved in responding to a request”. However, these open avenues for determining the costs for information exchange pose some challenges. The fact that the competent authorities can determine the scale of fees for processing requests depending on the amount of work

62. This is in line with OECD, Improving Access to Bank Information for Tax Purposes (OECD 2000), which also focuses on exchange of information on request.
63. OECD, Countering Offshore Tax Evasion, supra n. 38, at p. 13.
64. Meintz, supra n. 37, at p. 6.
65. Id., at p. 19.
66. Id., at p. 4.
67. Id.
68. Id.
70. Id.
71. Id.
72. Id.
74. Meintz, supra n. 37, at p. 16.
75. OECD, Countering Offshore Tax Evasion, supra n. 38, at p. 15.
76. Id.
77. Keen & Lighthart, supra n. 60, at p. 84.
involved implies that a competent authority may decline a request where the requesting party does not agree to pay the costs of providing the assistance. If jurisdictions are allowed to ask for fees for exchanging information, this may open opportunities for corruption and lack of transparency.\textsuperscript{79}

The main mechanism that the Global Forum has to assess with respect to the effectiveness of the TIEAs is the peer review process.\textsuperscript{80} The Tax Justice Network notes that: \textsuperscript{81}

one of the problems with the Peer Review Process is that as long as only peers are reviewing peers, there is a danger that “group-think” may lead to situations of collective blindness, and may even lead to situations in which mutual favours are exchanged among reviewers by not reviewing too harshly.

This is a particular risk when one secrecy jurisdiction is reviewing another. There is also the risk that the process may lack the necessary element of objectivity, which could significantly undermine its credibility.\textsuperscript{82} These reviews would be more meaningful if independent experts from universities and civil society had a role in the peer review processes.\textsuperscript{83} Participation of civil society and independent experts would help to overcome biased outcomes.

In addition, the stages of the peer review process have been criticized for being unfair. The reviews normally follow two phases. In phase one, the legal and administrative rules of the relevant country are analysed for compliance with the standard. Where a jurisdiction is found to have too many elements not in place during the phase-one review, the peer review report will indicate that a country will not move to phase two of the review. The countries that went through phase-one reviews and were barred from moving to phase two in November 2011 are: Antigua and Barbuda, Barbados, Belgium, Botswana, Brunei, Liechtenstein, Panama, Seychelles, Switzerland, Trinidad and Tobago, Uruguay and Vanuatu. Of these countries, only Belgium and Switzerland are OECD members.\textsuperscript{84} However, some countries were selected to do a combined phase-one and phase-two review, without clear justification. These countries are: Australia, Canada, Denmark, France, Germany, Ireland, Isle of Man, Italy, Japan, Jersey, Mauritius, the Netherlands, New Zealand, Norway, Spain, the United Kingdom and the United States.\textsuperscript{85} Apart from Mauritius, all these are OECD member countries or their dependent territories. By allowing these countries to be reviewed in a combined review, the Global Forum effectively foregoes the possibility of exerting political pressure on these countries to amend their laws. Despite being approved for a combined phase-one and phase-two review, a study by the Tax Justice Network showed that the reviews of some countries (such as Ireland) that had been found compliant do not adequately expose the beneficial ownership of entities.\textsuperscript{86} Inadequate reviews are not going to be effective in unveiling tax evasion.

The OECD has been encouraging developing countries to become members of the Global Forum. To become part of the Global Forum and undergo reviews, they must create the legal and administrative environment to comply with the OECD standards. This can be quite costly from the developing country point of view, as it implies that resources have to be diverted from more pressing domestic tax concerns to training personnel to carry out the peer reviews. This challenge is compounded by the fact that issues relating to the cost of tax information exchange have not been properly addressed by the OECD Global Forum. The OECD TIEA Model provides that the general costs incurred in the ordinary course of administering the domestic tax laws of the requested state when responding to a request for information should be borne by the requested state.\textsuperscript{87} Although the OECD TIEA Model allows for flexibility in allocating costs between the contracting parties by taking into account factors such as the volume of information involved,\textsuperscript{88} the cost of information requests normally falls on the requested state. Often it is the smaller and poorer developing countries (like tax haven jurisdictions) that will be required to provide information to rich developed countries, so that those rich countries can preserve their tax base. Such developing countries are less likely to need tax information from rich countries. Perhaps if the developed countries, which seek the information, pay for the costs of the exchange of information borne by developing countries, such as tax haven countries, this could be a way in which the tax haven jurisdiction could be encouraged to engage in exchange of tax information measures.

Criticisms have been raised that many tax haven countries appear to be coerced into signing the exchange of information agreements for fear of being labelled as uncooperative. In practice, however, it is not clear how these countries benefit from information exchange. It is argued that the standards of exchange of information tend to operate in the interests of wealthier or more powerful states rather than developing countries.\textsuperscript{89} The standards seem to place emphasis on whether the residents of developed countries have invested in tax havens and whether the tax haven can access information about those foreign investments and hand that information over to the tax authorities of the developed countries. This emphasis is rather misguided, as the developed countries are the largest absorbers of cash coming out of tax havens. It has been observed that funds cannot remain in tax havens and be productive; they must be reinvested into rich and stable economies in the world.\textsuperscript{90} Thus, the problem of retaining illicit financial flows is one that rests mainly with developed countries rather than

\begin{itemize}
  \item \textsuperscript{79} Meinzer, supra n. 57, at p. 18.
  \item \textsuperscript{80} Id., at p. 5.
  \item \textsuperscript{81} Id., at p. 12.
  \item \textsuperscript{82} Id.
  \item \textsuperscript{83} Id.
  \item \textsuperscript{84} Id., at p. 11.
  \item \textsuperscript{85} Id., at p. 10.
  \item \textsuperscript{86} Id., at pp. 14-15.
  \item \textsuperscript{87} Para. 98 OECD TIEA Model: Commentary on Article 9 (2002).
  \item \textsuperscript{88} Para. 99 OECD TIEA Model: Commentary on Article 9 (2002).
  \item \textsuperscript{89} Stewart, supra n. 6, at p. 138; Meinzer, supra n. 57.
  \item \textsuperscript{90} R.S. Avi-Yohan, Prepared Testimony of Reuven S. Avi-Yohan, Irwin I Cohen Professor of Law, University of Michigan Law School Before the US Senate Permanent Subcommittee on Investigations, Hearing on Offshore Transactions para. (e) (1 Aug. 2006).
\end{itemize}
with tax havens. Developing countries and emerging economies suffer a great loss of revenue from undeclared funds deposited abroad by their wealthy residents.91 However, for the developing countries, the Global Forum’s standards and the peer reviews do little in strengthening their tax systems or in unveiling or curtailing the illicit financial flows to developed countries.92 A study by Keen and Lig- thart (2006)93 on exchange of information by a number of developed countries in Europe showed that these countries exchanged information to fellow EU countries where their residents are known to migrate but that they supplied a negligible amount of information to developing countries. Furthermore, it showed that the level of development of a country and physical distance between countries were major determinants of the intensity of information sharing.94 Braithwaite and Drahos (2000)95 argue that the TIEAs have failed to achieve genuine international cooperation that would enable the allocation and collection of tax revenues across states, since they operate in the interests of capital rather than of government and citizens.

The effectiveness of the TIEAs has also been questioned due to the lack of effective accountability as regards the data exchanged. A study conducted by Keen and Ligth- art (2006)96 shows that it was known very little about the extent, nature or effectiveness of international information sharing by 2006. Thus, it was necessary for the OECD Global Forum to come up with means of ensuring transparency and accountability for their work by coming up with comprehensive reports on the statistics, data collected and the effectiveness of processes.97 In 2010, the Global Forum came up with a peer review mechanism to ensure the effective implementation of the exchange of information standards, which would also ensure that policy makers and members of the public to get feedback about the evaluation of the TIEAs and the peer review process.98 However, effective accountability of the peer review process has been questioned for being biased towards OECD member states, some of which are tax haven jurisdictions or have dependencies that are tax haven jurisdictions.99 The Tax Justice Network notes that “no comprehensive statistics are provided about the volumes or types of information being exchanged”.100 Although the peer review reports provide some statistics relating to the numbers of requests and timeliness of responses,101 the reports on the combined phase-one and phase-two reports “do not show signs of serious effort to statistically capture and display the practice of information exchange in a comprehensive manner”. The reports do not cover “any systematic tables on the number of requests, the proportion which has been answered in what time, where they

came from, what taxes they related to, and the amounts involved”.102 The reviews lack any measure to compare the number of and amounts involved in the requests, as well as the economic ties with the countries for which information exchange has taken place. In addition, no comprehensive statistics are published about on-site inspections of supervisors, or fines and penalties imposed as a consequence of misconduct by trustees or company service providers. Without such data, meaningful comparative analyses of the scope, depths and effectiveness of the OECD peer review process is not going to be possible.103 John Christensen, the director of Tax Justice Network, said: “The Global Forum has wasted a golden opportunity for tackling tax havens. They set the standards too low, and then followed the time-worn approach of having a flawed peer review process. The Global Forum now needs to bring independent experts from civil society into the reviews to both strengthen the standards and rebuild the credibility of the entire process.”104

5.3. Developments in signing TIEAs in South Africa

In line with the OECD exchange of tax information campaign, South Africa has signed “Customs Agreements on Mutual Administrative Assistance” with some countries to encourage: the exchange of information, surveillance, investigations and visits by revenue officials.105 For many years, South Africa’s calls on a number of tax havens to sign similar agreements were ignored. However, with pressure from world leaders for tax havens to change their financial and fiscal regulations that were partly to blame for the global financial crisis,106 a number of tax havens became willing to engage in TIEAs with South Africa.107 Since 2010, South Africa has signed TIEAs with the Bahamas (2011), Bermuda (2011), Cayman Islands (2011), Guernsey (2011), Jersey (2011) and San Marino (2011).108 National Treasury is also involved in negotiations with other tax havens to enter into similar agreements and a number of tax haven jurisdictions have signalled an interest to engage in such negotiations.109 These agreements will enable SARS to have access to information about South African taxpayers’ investments in those jurisdictions.110 It is hoped that South Africans will no longer be able to hide their investments in tax haven jurisdic-

91. Keen & Ligthart, supra n. 60, at p. 85.  
92. Meintz, supra n. 57, at p. 5.  
93. Keen & Ligthart, supra n. 60, at p. 84.  
94. Id. , at p. 100.  
95. J. Braithwaite & P. Drahos Global Business Regulation p. 25 (Cambridge University Press 2000); Stewart, supra n. 6, at p. 158.  
96. Keen & Ligthart, supra n. 60, at p. 94.  
97. Stewart, supra n. 6, at p. 172.  
98. Meintz, supra n. 57, at p. 5.  
99. Id. , at p. 10.  
100. Id.  
102. Meintz, supra n. 57, at p. 20.  
103. Id.  
105. By April 2010, such agreements were in force with: Algeria, China, France, India, Mozambique, Netherlands, the United Kingdom and the United States. Similar agreements were ratified with: Brazil, Czech Republic, Democratic Republic of Congo, Iran, Norway, Sudan, Turkey and Zambia. An agreement was signed with Canada, but it is not yet ratified. See www.sars.gov.za/Legal/International-Treaties-Agreements/Pages/MAAs-on-Customs.aspx.  
110. Id.  

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tions, as long as information about those investments is exchanged between South Africa and those tax havens. These agreements also impose an obligation on South Africa to provide information to the relevant countries about their residents that may have investments in South Africa.111

It is important to note that South Africa is a member of the OECD’s Global Forum.112 In 2011, South Africa went through the peer review process and its combined phase-one and phase-two report was published by the OECD in October 2012.113


Multilateral conventions are another form of legal instruments that can be used to exchange information in tax matters. Indeed, the OECD has noted that over the last few years exchange of information using bilateral tax treaties is gradually being overtaken by the multilateral Convention on Mutual Assistance in Tax Matters (the "Convention") (1988).115 This is because the costs of engaging in a multilateral convention are lower than those incurred in engaging in many bilateral tax treaties.

The multilateral Convention on Mutual Assistance in Tax Matters (1988) was developed by the Council of Europe and the OECD, and opened for signature by the member states of both organizations on 25 January 1988.116 Although the Convention was initially open only to members of the OECD and of the Council of Europe, gradually some EU and OECD member states signed it.117 Nevertheless, the Convention did not achieve widespread implementation and a number of states did not sign or ratify it. For example, the United Kingdom did not sign this Convention until 2007.118 With the international focus on exchange of information over the last few years, a large number of developing countries became eager to quickly achieve a high level of compliance with international exchange of information standards. The OECD began to explore the possibility of extending the Convention to developing countries that were eager to take advantage of increased transparency and exchange of information but lacked the resources to negotiate a series of bilateral agreements. In 2008, the OECD, the G20 and the Global Forum embarked on measures to ensure that the Convention becomes a global legal instrument for transnational tax administrative cooperation. In April 2009, the G20 called for action "to make it easier for developing countries to secure the benefits of the new co-operative tax environment that entailed a multilateral approach for the exchange of information".119 Consequently, in 2010, the original Convention was amended by a Protocol to align it to the international standards on information exchange for tax purposes and to open it to all countries outside the Council of Europe or OECD. The amended Convention entered into force on 1 June 2011. By March 2013, more than 50 countries (mainly developed countries) had either become signatories to the Convention or had stated their intention to do so. On 3 November 2011, South Africa signed, but has not yet ratified, the Convention.120 Although there has been an increase in the number of countries that have signed the Convention, significant work in administrative capacity building is still required for many developing countries, before they can be admitted as parties to the Convention.

In general, the provisions on exchange of information in the Convention overlap with those of article 26 of the OECD Model (2010) and with the OECD TIEA Model. This section will not cover a detailed discussion of the sections of the Convention but only point out a few pertinent features. Just like the OECD TIEA Model, article 4(1) of the Convention provides for the exchange of information that is foreseeably relevant for the administration or enforcement of the parties’ domestic laws concerning the taxes covered by the Convention. Article 4(3) deals with notification procedures and provides that a party may, according to its internal legislation, inform its residents or nationals before transmitting information concerning him. Just like article 26 of the OECD Model (2010), the Convention provides for different forms of exchanging of information: exchange of information on request (article 5), automatic exchange of information (article 6), spontaneous exchange of information (article 7), simultaneous tax examinations (article 8) and tax examinations abroad (article 9).

Since the provisions of the Convention are generally similar to those in article 26 of the OECD Model (2010) and the OECD TIEA Model, the challenges that arise from applying these provisions will not be repeated here.

7. Regional Instruments To Permit Information Exchange

7.1. Introductory remarks

Different regions (comprising a number of countries) have also come up with instruments to permit information exchange. The examples covered briefly in this work are the rules enacted by the European Union and initiatives by the Southern African Development Community (SADC), to which South Africa belongs, and the African Tax Administration Forum (ATAF).

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112. Id.
114. Convention between the Member States of the Council of Europe and the Member Countries of the OECD on Mutual Administrative Assistance in Tax Matters (25 Jan 1988) (as amended through 2010), Treaties IBFD.
115. Stewart, supra n. 6, at p. 161.
116. Id.
117. Id.
118. Id.
119. Id.
120. Croome, supra n. 111, at p. 1.
7.2. The European Union

The European Union has had directives and regulations on mutual exchange of information for decades. Legal obligations for information exchange within the European Union date back to 1970s, when the European Council adopted Directive 77/799 concerning mutual assistance and information exchange and Directive 76/308 on mutual assistance in recovery of tax claims. Those directives were replaced by Directive 2010/24 and Directive 2011/16 to reflect the currently applicable internationally agreed standards.

Unlike the instruments for exchange of information discussed in the previous sections, the EU Directives have certain pertinent features that are worth pointing out. Directive 2011/16 sets time limits for exchange of information, which may be quite short. For example, article 7(1) of this Directive provides that information must be exchanged, upon request, within two months of receiving the request if that information is already available to a Member State. Where the tax authorities must obtain the information from the relevant taxpayer or organizations, the information must be exchanged within six months of receiving the request. Article 20 of the Directive 2010/84 provides that the costs of recovery and enforcement of tax debts are, as far as possible, to be recovered from the taxpayer concerned. Otherwise, the collecting country shall bear the cost and not seek to recover it from the requesting country, unless there is a specific or extraordinary problem.

Another directive that ensures exchange of information in the European Union is the Savings Directive (2003/48), which came into effect on 1 July 2005. The Savings Directive (2003/48) requires automatic exchange of information relating to interest income to ensure the effective taxation of interest in the beneficial owner’s state of residence. It also provides that the administrative costs for the exchange of information are generally to be borne by taxpayers as part of their ordinary business administration. It is, however, worth noting that, initially, Austria, Belgium and Luxembourg were allowed to apply a withholding tax instead of the automatic exchange of information because of their bank secrecy laws. Belgium discontinued the transitional withholding tax as of 1 January 2010 and it agreed to automatic exchange of information. Luxembourg and Austria still do not exchange information automatically. From 1 July 2011, these countries levy a withholding tax at a rate of 35% (increased from 15%) and transfer 75% of the revenue to the investor’s state of residence. The European Union signed an agreement with Liechtenstein, allowing exchange of information on request in the event of tax fraud.

7.3. The Southern African Development Community (SADC)

Within the SADC, mechanisms are in place to ensure effective exchange of information. In terms of the SADC Memorandum of Understanding on Cooperation in Taxation and Related Matters entered into in 2002, member states were mandated to come up with a model tax treaty for the SADC and to draw up guidelines for the effective exchange of information and the implementation of mutual assistance and cooperation procedures. In 2012, the SADC Model was finalized and is now used by all SADC countries in negotiating tax treaties amongst themselves and with other countries outside of the region. Article 26 of the SADC Model (which deals with exchange of information) largely follows article 26 of the OECD Model (2010), so a detailed discussion of its provisions is not necessary. The SADC countries also signed the SADC Agreement on Assistance in Tax Matters (AATM) in 2012, which deals exclusively with tax administration matters, as opposed to tax policy issues relating to tax treaties. In terms of the AATM, the contracting states undertake to assist each other in respect of tax matters, such as the exchange of information. The exchange of information provisions in the AATM complement those in article 26 of the SADC Model. Article 4 of the AATM provides for the following types of exchange of information: spontaneously, automatically, or upon request. Article 5 of the AATM provides for the setting up of tax examinations abroad to strengthen effective exchange of information. The article also provides that, upon the request of one contracting state, simultaneous examinations can be conducted by two or more states having a common interest in the affairs of a particular taxpayer. Article 9 of the AATM provides that the costs of assistance in collection of taxes shall be borne by the requested state. An exception is, however, made in the case of substantial or extraordinary costs, which the requested state anticipates to arise. In such a case, the requested state is expected to notify the requesting state, whereupon the competent authorities of concerned states ‘shall decide the manner in which the costs shall be borne’.


125. The SADC consists of 15 member states: Angola, Botswana, Democratic Republic of Congo (DRC), Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, United Republic of Tanzania, Zambia and Zimbabwe. The SADC’s mission is to promote sustainable and equitable growth and to be a competitive and effective player in the world economy. For details on SADC member states, see www.sadc.int/member-states/.


127. SADC Model Tax Agreement on Income (Sep. 2011), Models IBFD.
Since the provisions of the SADC Model and the AATM have similarities with those of article 26 of the OECD Model (2010) and the OECD TIEA Model, they face similar challenges in application.

### 7.4. The African Tax Administration Forum (ATAF)

On the African continent, the ATAF, which promotes and facilitates mutual cooperation among African tax administrators, has come up with an African Agreement on Mutual Assistance in Tax Matters. This agreement will allow African tax administrations to assist each other in exchanging information through simultaneous tax examinations between themselves and abroad.ATAF’s Acting Executive Secretary Logan Wort stated that “although there was growth on the continent, the challenge was to stem the tide of tax and capital outflow out of the African economies”. He pointed out that “illicit capital flight from developing countries is anything between USD 500 billion and USD 800 billion per annum” and that “in some cases revenue lost exceeded the level of aid received by developing countries”. Thus, exchange of information was crucial in the development of African economies, as it allowed the continent’s tax authorities to gather information that may be relevant to the legal processes of taxpayers in different countries. Many African countries still need to ratify the African Agreement on Mutual Assistance in Tax Matters.

### 8. Domestic Legislation That Allows for Exchange of Information

#### 8.1. Introductory remarks

In addition to bilateral, multilateral and regional exchange of information instruments, some countries have also enacted domestic legislation that allows for exchange of information on a unilateral basis.

#### 8.2. US FATCA

The United States enacted the Foreign Account Tax Compliance Act (FATCA), which became operational on 1 January 2013 and deals with the tax reporting of assets held in foreign bank accounts. FATCA generally requires foreign financial institutions to report directly to the US Internal Revenue Service (IRS) information about financial accounts held by US taxpayers or foreign entities in which US taxpayers hold a substantial ownership interest. To comply with this legislation, foreign financial institutions are expected to report their findings to the IRS, thereby preventing US persons from hiding income and assets overseas. US persons with accounts in foreign financial institutions are expected to provide the foreign financial institutions with FATCA-required documentation; otherwise, they will be deemed non-compliant and the foreign financial institutions will be obligated to deduct a 30% withholding tax on any “withholdable payment” credited to a US person’s account. If a foreign financial institution fails to comply with FATCA, it will be subject to a 30% withholding tax on any “withholdable payment” made to its proprietary account. In terms of the FATCA provisions, the costs of administering tax information exchange under these provisions are to be borne by the persons/entities being investigated.

The US Treasury issued FATCA Regulations, which deal with reporting and withholding obligations regarding US taxpayers with financial accounts held abroad. The IRS noted that the motivation behind the regulations is to prevent the “abuse of the US voluntary tax compliance system and address the use of offshore accounts to facilitate tax evasion.” To ensure cooperation with other governments in this matter, the US Treasury has forged coalitions with foreign governments to efficiently and effectively implement FATCA. In this regard, the US Treasury has come up with a Model Intergovernmental Agreement for implementing FATCA, which serves as the basis for concluding bilateral agreements with interested jurisdictions.

FATCA has, however, drawn criticism from US-born expatriates and individuals with dual citizenship who say that it violates national sovereignty and bank secrecy laws. FATCA has also been criticized for placing administrative burdens on foreign financial institutions, which will need to make significant process and technology changes to comply with FATCA or they could face significant consequences for failure to enter into a FATCA agreement with the IRS.

### 8.3. Swiss Rubik Agreements

Switzerland developed the concept of Rubik agreements as a result of the US investigations into the operations of the Swiss bank UBS and the Liechtenstein bank LGT. In 2008, the US released a report stating that UBS had opened Swiss accounts for an estimated 19,000 US clients with nearly USD 18 billion in assets and none of those accounts were reported to the IRS. Rubik agreements were concluded with the United Kingdom, Switzerland, Ireland, and other countries. The US Treasury issued FATCA Regulations, available at http://www.accountingweb.com/article/treasury-and-irs-issue-final-fatca-regulations/220882.

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133. Id.
A Critique on the Effectiveness of “Exchange of Information on Tax Matters” in Preventing Tax Avoidance and Evasion: A South African Perspective

Germany, and Austria. For example, the Switzerland-United Kingdom Rubik Agreement (2011) states that the objective is to provide for reciprocal co-operation between the UK and Switzerland to ensure effective taxation in the UK of individuals with financial assets in Switzerland. The agreement implements a final withholding tax on UK taxpayers’ future investment income, gains on assets, and their previously untaxed assets in Switzerland. The agreement also provides for automatic exchange of information regarding UK taxpayers’ income from Switzerland.

The Swiss Rubik agreements take a different approach to international cooperation in tax matters, since they allow for the use of other alternative measures to international cooperation rather than prioritizing exchange of information.

9. General Challenges Posed by the Different Instruments for Exchange of Information

9.1. Introductory remarks

Because of capital flight, many developing and transition countries regard exchange of information as important in preserving their tax bases. Information exchange provisions help countries monitor the foreign investments of their residents in offshore jurisdictions, so that they can effectively enforce their tax laws. Although various exchange of information instruments discussed in this article have given countries tools for finding out whether their residents are involved in offshore tax avoidance or evasion, in practice, there are a number of issues that could hamper their effectiveness. As the challenges that relate to specific instruments have been discussed in the previous sections, the discussion in this section covers concerns that relate to the exchange of information instruments in general.

9.2. Legitimacy

Stewart (2012) notes that some of the instruments for exchange of information have created “transnational tax information exchange networks” whose legitimacy is questionable. She explains that the use of these tax information exchange instruments has created networks that are becoming institutionalized and have developed into “soft” law in the sense that they are driven by organizations, systems, data storage and transmission systems as well as legal and financial expertise to identify and utilize relevant data. This is often not the case for tax administrations of developing countries. National tax authorities will be required to have significant expertise in the administration and collection of data. They must be able to manage high-level computing systems, data storage and transmission systems as well as legal and financial expertise to identify and utilize relevant data.

9.3. Sustainability

The sustainability and effectiveness of the various international tax measures for exchange of information is questionable in the long run. Vording and Caminada (2001) note that meaningful international exchange of information procedures will require that a substantial part of national tax administrations’ efforts has to be devoted to providing services to other national tax administrations. For many tax administrations of many developing countries which lack the necessary resources, this is a daunting task as professional expertise in tax information exchange is necessary for effective exchange of information among countries. National tax authorities will be required to have significant expertise in the administration and collection of data. The OECD does not have the power to impose sanctions on those countries. Similarly, if any legal issue arises out of the exchange of information process, there is no capacity in these “soft” law mechanisms to resolve the matter. Individual countries have to decide for themselves what actions they consider necessary to ensure the effective enforcement of their tax laws.

In addition to the challenges posed by the “soft” law on exchange of information that has been developed by the OECD Global Forum, individual countries, such as the United States and Switzerland, have come up with their own national investigations into the offshore investments and activities of individuals and companies. The legitimacy of these national measures that seem to coerce other countries to comply with foreign laws has been criticized for infringing on the sovereignty of nations. Weiss (2005) notes that measures for exchange of information that extend across borders can be viewed as a threat to national sovereignty, since they may have the ultimate effect of extending “the state’s capacity to govern.”

9.4. Accountability

The effectiveness of these international tax information exchange measures has been questioned due to the lack of effective accountability as regards the data exchanged. Accountability regarding exchange of information in tax matters will require a level of transparency from organizations, such as the OECD Global Forum.

137 Abkommen zwischen der Schweizerischen Eidgenossenschaft und der Bundesrepublik Deutschland über Zusammenarbeit in den Bereichen Steuern und Finanzmarkt (21 Sept. 2011), Treaties IBFD, which was supplemented by the Protokoll zur Änderung des Abkommens zwischen der Bundesrepublik Deutschland und der Schweizerischen Eidgenossenschaft über Zusammenarbeit in den Bereichen Steuern und Finanzmarkt (5 Apr. 2012), Treaties IBFD. Despite the approval by the German Lower House (Bundestag), the ratification of the agreement was rejected by the German Upper House (Bundesrat) on 23 Nov. 2012, thereby preventing this agreement from entering into force.

138 Abkommen zwischen der Schweizerischen Eidgenossenschaft und der Republik Österreich über Zusammenarbeit in den Bereichen Steuern und Finanzmarkt (13 Apr. 2012).

139 Stewart, supra n. 6, at p. 152.
Challenges in international accountability regarding exchange of information in tax matters are going to become more pronounced in the future, as exchange of information involving bilateral, multilateral and unilateral measures becomes increasingly integrated and bureaucratized.  

9.5. Efficiency

The effectiveness of preventing illicit cross-border capital flows by using various instruments for exchange of information is questionable. Some provisions in these instruments are a duplication of provisions in other instruments, which creates a web of similar instruments with little impact. A study by Huizinga and Nicodeme (2004) shows that, although international patterns of bank deposits across many developed countries were significantly affected by tax rates, exchange of information on tax matters had no significant effect on taxpayer’s decisions.

9.6. Impeding on global capital flows

A further concern is that various instruments for exchange of information may impede global capital flows and efficient operation of the global market. This is especially so if the tax information obligation becomes so significant that it hinders international trade and investment. There is, however, no evidence that tax information exchange has had this effect as yet.

9.7. Impeding on taxpayer privacy

In the enforcement of exchange of information measures, there are concerns as to whether taxpayer rights and privacy will be protected when information about their affairs is provided to other countries. In a tax treaty context, taxpayer rights can be protected by national laws, since, in most countries, tax treaties become part of the law of the countries concerned. This is, however, not the case with other information exchange instruments, such as the TIEAs, where taxpayers are not guaranteed the protection accorded by national laws in the case of a breach of their rights when their information is exchanged. Even though an instrument such as the TIEA is an agreement between the relevant states, in the process of exchanging information, if data is illegally obtained and used for criminal and civil proceedings against taxpayers, such taxpayers may not have legal protection under their domestic law. There is also the risk that data can become available for purchase from paying agents, such as banks, tax administration officials, or that it can be illegally accessed through search and seizure actions.

These privacy concerns are further compounded by the lack of a harmonized approach across all bilateral and multilateral exchange of tax information instruments. This is of particular concern since the agreements entered into using these instruments are now connected by a complex web of jurisdictions which apply differing standards of exchange of information to taxpayers. For instance, although there is an OECD TIEA Model, the provisions in the TIEAs, as signed by various countries, are often worded in a variety of ways. This is the case especially with regard to banking secrecy provisions. Critics of this trend, such as Schenk-Geers (2009), have recommended that pertinent provisions, such as those relating to banking secrecy should be standardized.

The other privacy concern is that tax information exchange under tax treaties or TIEAs is not categorically subject to taxpayer notification that a foreign government is seeking information about them. Article 26 of the OECD Model and article 1 of the OECD TIEA Model merely provide that where countries have notification procedures, these should not be unduly used to delay exchange of information. The 2010 Protocol to the multilateral Convention empowers, but does not require, the contracting states to inform nationals before transmitting information about them to another country.

These concerns for taxpayer privacy will increase especially if automatic information exchange is established and if central repositories of information are set up. Cockfield (2010) has recommended that it is time for a global taxpayer bill of rights to be drafted as a means of increasing trust and confidence in the tax administration. It is worth noting that, in 2003, the OECD produced a Practice Note on Taxpayers’ Rights and Obligations, which provides that taxpayers have a right to expect that the tax authorities will not intrude unnecessarily upon their privacy.

10. Conclusions

In view of the scale of global financial transactions, it is doubtful that tax administrations will see raises in revenue collected as a result of tax information measures. This could be explained by the fact that tax evaders are constantly “one step ahead” of tax administrations. The successful implementation of measures for exchange of tax information requires a significant improvement in the operations and processes of national tax administrations, as well as much closer cross-border cooperation between tax administrations.

146. Stewart, supra n. 6, at p. 172.
147. Huizinga & Nicodeme, supra n. 73, at p. 1093.
148. For instance, sec.108(1) ITA 1962, read with sec. 231 of the Constitution, provides that the national executive of South Africa may enter into an agreement with the government of any other country to regulate the taxation of income, profits, gains and donations which may be taxable in both countries. As soon as a tax treaty is ratified and has been published in the Government Gazette, its provisions are effective as if they had been incorporated into the ITA.
149. Stewart, supra n. 6, at p. 176.
150. Stewart, supra n. 6, at p. 176.
151. Id.
152. Schenk-Geers, supra n. 30, at pp. 188 and 193.
The notion that the current OECD standard of exchanging information upon request is an effective deterrent to illicit financial flows and widespread tax evasion is not entirely true. An effective deterrent standard for information exchange would need to have a significant impact on the pattern of portfolio investment, which is largely determined by their after-tax returns. Tax evaders do not seem to be deterred by the OECD’s standard. This would explain why some countries have come up with additional unilateral exchange of information measures, such as the FATCA in the United States and the Rubik agreements in Switzerland. These countries hope that their initiatives are likely to be far more effective in curtailing illicit financial flows.

Automatic exchange of information is internationally recognized as a more effective tool for tackling tax evasion. At the L20 Labour Summit held in Los Cabos, Mexico, in June 2012, the L20 called on the G20 to “upgrade the standards of the OECD-led Global Forum on Tax Transparency to include automatic exchange of information between tax authorities and the application of sanctions on jurisdictions that fail the minimum requirements.”

Johannesen and Zucman (2012) state that treaties are not fundamentally ineffective in preventing tax evasion but their content matters critically. According to these authors, a way to resolve the shifting of profits to tax havens that do not sign treaties is for the OECD to urge those tax havens to sign treaties with all other countries through a comprehensive multilateral agreement that would prevent tax evaders from transferring funds from haven to haven. This is supported by the OECD Action Plan on Base Erosion and Profit Shifting, which states that “progress on transparency has been made by the Global Forum on Transparency and Exchange of Information for Tax Purposes, but the need for a more holistic approach has been revealed when it comes to preventing BEPS, which implies more transparency on different fronts.”

159. Id., at p. 21.
Tax Treaty Case Law Monitor
Prof. Wim Wijnen and Prof. Jan de Goede

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Tax Treaty Interpretation after Ben Nevis (Holdings) Ltd v. Her Majesty’s Revenue and Customs (2013)

In this article, the author examines the principles of tax treaty interpretation as set out by the UK Court of Appeal in Ben Nevis (Holdings) Ltd v. Her Majesty’s Revenue and Customs (2013).

1. Introduction

The decision of the UK Court of Appeal in Ben Nevis (Holdings) Ltd v. Her Majesty’s Revenue and Customs (2013) is a landmark in tax treaty jurisprudence. It is the first reported case concerning the application of article 27 of the OECD Model (2010) on mutual assistance in collection of taxes. The decision is also an important statement on the principles of tax treaty interpretation. UK law on treaty interpretation and application is largely developed by the Court of Appeal. In modern times, it is extremely rare for the Supreme Court to hear cases involving tax treaties. Only one tax treaty case has been decided by the House of Lords (the predecessor to the Supreme Court) in the 21st century. That case did not canvas principles of treaty interpretation.

The basic facts of the case are relatively simple. The South African Revenue Service (SARS) sought both interim and permanent relief and collection of taxes owed to it for the 1998, 1999 and 2000 years of assessment, following the final determination of a tax appeal in October 2010. On 4 March 2011, a judgement was entered against Ben Nevis for the tax assessed in proceedings in South Africa.

Two questions of international tax law arose in this case:
- the interpretation and application of the Protocol (2010) to the United Kingdom-South Africa Income and Capital Tax Treaty (2002); and
- the abrogation of the “Revenue Rule”, i.e. the principle that the courts of one country will not enforce the revenue laws of another country.

Prior to the Protocol (2010), no provision had been made in any tax treaty between the two countries for mutual assistance in the collection of taxes.

2. Revenue Rule Not Abrogated

In the High Court, Her Majesty’s Revenue and Customs (HMRC) and SARS argued that the Revenue Rule had been abrogated by the treaty provisions. In consequence, it could no longer be said that there is a public policy that prevents SARS, as the South Africa competent authority, from collecting tax debts due to it and from taking enforcement action directly in the United Kingdom. This argument was rejected by the High Court. The public policy objection to a foreign tax authority enforcing tax debts remains contrary to all concepts of independent sovereignties. This question was not pursued on appeal. As a result, any enforcement action can only be undertaken within the confines of treaty provisions agreeing mutual assistance.

3. Treaty Interpretation

The difficult question the Court of Appeal had to address was the temporal application of article 25A inserted into the United Kingdom-South Africa Income and Capital Tax Treaty (2002) by the Protocol (2010). The tax treaty was signed on 4 July 2002 and entered into force on 17 December 2002. In its original form, it did not provide


8. Id., at para. 51.

for mutual assistance in the collection of taxes. The Protocol (2010) was signed on 8 November 2010 and came into force on 13 October 2011. The Appellants’ case was that the protocol did not authorize the collection of South African taxes due for the years 1998, 1999 and 2000 in the United Kingdom.

The article on entry into force of both the treaty and the Protocol (2010) followed article 30 of the OECD Model (2010). Article 27 of the tax treaty reads in part:

This Convention shall enter into force on the date of receipt of the later of these notifications and shall thereupon have effect:

(a) in South Africa:

(i) with regard to taxes withheld at source, in respect of amounts paid or credited on or after 1st January next following the date upon which this Convention enters into force;

(ii) with regard to other taxes, in respect of taxable years beginning on or after 1st January next following the date upon which this Convention enters into force;

(b) in the United Kingdom:

(i) in respect of income tax and capital gains tax, for any year of assessment beginning on or after 6th April in the calendar year next following that in which this Convention enters into force;

(ii) in respect of corporation tax, for any financial year beginning on or after 1st April in the calendar year next following that in which this Convention enters into force.

In a similar vein, article VI of the Protocol (2010) specifies:

This Protocol shall enter into force on the date of the later of these notifications and shall thereupon have effect in both Contracting States:

(c) in relation to revenue claims referred to in Article IV of this Protocol, in respect of requests for assistance made on or after the date of entry into force of this Protocol.

While the tax treaty generally applied to the taxes specified in article 2, article 25A, as inserted by the Protocol (2010), required assistance in collection of an amount owed in respect of taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, as well as interest, administrative penalties and costs of collection or conserved related to such amount.

Two critical questions of interpretation arose:

– the temporal interaction between the new article 25A, inserted by the Protocol (2010), and article 27 (Entry into force) of the tax treaty;

– the effect of article 27 on the new article 25A in light of the fact that the new article 25A applied to taxes not expressly referred to in article 27.

At the heart of the problem was an anomaly between the scope of the United Kingdom-South Africa Income and Capital Tax Treaty (2002) generally and the new articles relating to international administrative cooperation inserted by the Protocol (2010). In common with the OECD Model (2010), the tax treaty is generally limited to the taxes identified in article 2. The provisions in article 27 of the tax treaty (patterned on article 30 of the OECD Model (2010)) addressing entry into force and the time when the treaty has effect are written by reference to the taxes identified in article 2. The later addition of the new article 25A requiring assistance in collection of taxes and its companion, the substitute article 25 setting out the newly adopted standard for exchange of information, are not restricted to the taxes identified in article 2. This anomaly is not unique to the United Kingdom-South Africa Income and Capital Tax Treaty (2002), but is found in the OECD Model (2010) itself. The same mismatch is found in article 24 (Non-discrimination) of the OECD Model (2010), which is likewise not limited to the taxes identified in article 2.

4. Principles of Treaty Interpretation

Somewhat surprisingly, HMRC and SARS contended that the rules of interpretation of treaties set out in articles 31 and 32 of the Vienna Convention on the Law of Treaties (the “Vienna Convention”) (1969) did not apply to either the United Kingdom-South Africa Income and Capital Tax Treaty (2002) or the Protocol (2010) because South Africa is not a party to that Convention. Even more surprising was that the judge at first instance agreed. The Court of Appeal emphatically rejected this contention, holding that the rules of interpretation set out in articles 31 and 32 of the Vienna Convention (1969) are rules of customary international law and, therefore, binding on all states regardless of whether or not they are parties to that Convention. The trial judge preferred to rely on the “Commerzbank principles” set out by Mummery J in IRC v. Commerzbank AG (1990) (a summary of the principles of treaty interpretation in the context of bilateral tax treaties). That summary has been adopted by the Court of Appeal in successive decisions on tax treaties and reads as follows:

"It is necessary to look first for a clear meaning of the words used in the relevant article of the convention, bearing in mind that consideration of the purpose of an enactment is always a legitimate part of the process of interpretation": per Lord Wilberforce (at p. 272) and Lord Scarman (at p. 294). A strictly literal approach to interpretation is not appropriate in construing legislation which gives effect to or incorporates an international treaty: per Lord Fraser (at p. 285) and Lord Scarman (at p. 290). A literal interpretation may be obviously inconsistent with the purposes of the particular article or of the treaty as a whole. If the provisions of a particular article are ambiguous, it may be possible to resolve that ambiguity by giving a purposive construction to the convention looking at it as a whole by reference to its language as set out in the relevant United Kingdom legislative instrument: per Lord Diplock (at p. 279).

The process of interpretation should take account of the fact that:

The language of an international convention has not been chosen by an English parliamentary draftsman. It is neither couched in the conventional English legislative idiom nor designed to be construed exclusively by English judges. It is addressed to a much wider and more varied judicial audience than is an Act of Parliament which deals with purely domestic law. It should be interpreted, as Lord Wilberforce put it

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12. Ben Nevis (Holdings) Ltd v. Her Majesty's Revenue and Customs (2013), at para. 24. Despite this, the approach adopted by the judge was not entirely inconsistent with the principles in the Vienna Convention (1969). See id., at paras. 25 to 42.

(3) Among those principles is the general principle of international law, now embodied in article 31(1) of the Vienna Convention on the Law of Treaties, that ‘a treaty should be interpreted in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose’. A similar principle is expressed in slightly different terms in McNair’s The Law of Treaties (1961) p 365, where it is stated that the task of applying or construing or interpreting a treaty is ‘the duty of giving effect to the expressed intention of the parties, that is, their intention as expressed in the words used by them in the light of the surrounding circumstances’. It is also stated in that work (p. 366) that references to the primary necessity of giving effect to the ‘plain terms’ of a treaty or construing words according to their ‘general and ordinary meaning’ or their ‘natural signification’ are to be a starting point or prima facie guide and ‘cannot be allowed to obstruct the essential quest in the application of treaties, namely the search for the real intention of the contracting parties in using the language employed by them’.

(4) If the adoption of this approach to the article leaves the meaning of the relevant provision unclear or ambiguous or leads to a result which is manifestly absurd or unreasonable, recourse may be had to ‘supplementary means of interpretation’ including travaux préparatoires. per Lord Diplock (at p. 282) referring to article 32 of the Vienna Convention, which came into force after the conclusion of this double taxation convention, but codified an already existing principle of public international law. See also Lord Fraser (at p. 287) and Lord Scarman (at p. 294).

(5) Subsequent commentaries on a convention or treaty have persuasive value only, depending on the cogency of their reasoning. Similarly, decisions of foreign courts on the interpretation of a convention or treaty text depend for their authority on the reputation and status of the court in question: per Lord Diplock (at pp. 283–284) and per Lord Scarman (at p. 295).

(6) Aids to the interpretation of a treaty such as travaux préparatoires, international case law and the writings of jurists are not a substitute for study of the terms of the convention. Their use is discretionary, not mandatory, depending, for example, on the relevance of such material and the weight to be attached to it: per Lord Scarman (at p. 294). 14

In Ben Nevis, Lord Justice Lloyd Jones, giving the judgment of the Court of Appeal, observed that the summary was ‘particularly helpful’ as it derived in part from the earlier decision of the House of Lords in Fothergill v. Monarch Airlines Limited, 15 which dealt with a multilateral treaty. He further noted that the Commerzbank principles are largely derived from the Vienna Convention (1969). While there is no conflict between the two, the Commerzbank principles, being in the nature of a summary, does not deal with certain aspects addressed in articles 31 and 32 of the Vienna Convention (1969). Thus, although the Commerzbank principles remain the central statement on tax treaty interpretation in UK law, the Court of Appeal has mandated a more systematic analysis by reference to articles 31 and 32 of the Vienna Convention (1969) in Ben Nevis. Both the High Court and the Court of Appeal started their analysis by examining the ordinary meaning of the Protocol (2010) in context in the light of its object and purpose as required by article 31(1) of the Vienna Convention (1969). The High Court judge noted that there was nothing in the Protocol (2010) itself that addressed its purpose expressly beyond the implication to be derived from the terms of article 25A itself. However, he adopted the purpose expressed in the implementing instrument, namely, to assist in international tax enforcement. 16 The Court of Appeal agreed, adding that the clear purpose of the Protocol (2010) is to amend the effect of the tax treaty as originally concluded. Thus, in interpreting the Protocol (2010) and the provisions it inserts into the tax treaty, it is necessary to consider them within the context of the tax treaty (as amended), which they form part of. No temporal limitation was expressed in the article and the purpose did not suggest any legal or policy reason for imposing, or an intention to impose, such a limitation. 18

While it is correct that there is no temporal limitation expressed and the purpose did not suggest a reason for imposing such a limitation, in the author’s view, the converse is also true. The fact that the purpose of the Protocol (2010) was to assist in international tax enforcement does not itself suggest a reason why its effect should extend beyond the period during which the protocol itself or, possibly, the tax treaty it amends, is in force.

5. Interpretative Material

5.1. Introductory remarks

The High Court and Court of Appeal were invited by the parties to consider several sources of support for their contentions on the interpretation and application of the United Kingdom-South Africa Income and Capital Tax Treaty (2002) and the Protocol (2010). The status and manner of use of the material was not comprehensively examined by reference to the rules in articles 31 and 32 of the Vienna Convention (1969). Nonetheless, helpful observations were made by the High Court and the role of these sources was carefully examined by the Court of Appeal.

5.2. Commentary on the OECD Model (2010)

Temporal issues relating to assistance in the collection of taxes are addressed in the Commentary on Article 27 of the OECD Model (2010), on which article 25A of the United Kingdom-South Africa Income and Capital Tax Treaty (2002) is based, including. 19 Nothing in the Convention prevents the application of the provisions of the Article to revenue claims that arise before the Convention enters into force, as long as assistance with respect to these claims is provided after the treaty has entered into force and the provisions of the Article have become effective. Contracting States may find it useful, however, to clarify the extent to which the provisions of the Article are applicable to such revenue claims.

in particular when the provisions concerning the entry into force of their Convention provide that the provisions of that Convention will have effect with respect to taxes arising or levied from a certain time. States wishing to restrict the application of the Article to claims arising after the Convention enters into force are also free to do so in the course of bilateral negotiations.

The High Court judge identified the Commentary as supplementary. He considered that the first sentence of this paragraph supported the conclusion that the article applied to tax claims arising prior to the entry into force of the United Kingdom–South Africa Income and Capital Tax Treaty (2002). He also considered that the recommendation in the Commentary that the matter may be clarified by the parties did not arise in this case. The Court of Appeal, on the other hand, considered that the Commentary gave no indication either way. It simply recognized that the parties could agree to enforcement of claims arising prior to the entry into force of the tax treaty and that although a provision addressing this issue is helpful, it is not essential.

5.3. Expert evidence

The Appellants sought to introduce expert evidence in relation to the interpretation of the provisions of the United Kingdom–South Africa Income and Capital Tax Treaty (2002) and the Protocol (2010) in the form of expert witness reports of Prof. Maria Grau Ruiz and Dr Avery Jones. This evidence was rejected as inadmissible by both the High Court and the Court of Appeal. The meaning of a tax treaty is a matter of international law and, as such, the meaning of a tax treaty is a legal question for argument by the parties and one of construction for the court. It is not a matter of evidence.

5.4. Legal writing

Prof. Grau Ruiz’s book “Mutual Assistance for the Recovery of Tax Claims” was presented by the Appellants and accepted by the Court of Appeal as admissible, but the Court did not consider it assisted, particularly in light of the Court’s conclusions on the Commentary on the OECD Model. An article by Jacques Sasseville, Head of the OECD Tax Treaty Unit, was also accepted by the Court of Appeal.

5.5. Parallel treaty

By way of comparison, the Appellants pointed to temporal issues in the Convention on Mutual Administrative Assistance in Tax Matters (the “Mutual Assistance Convention”) (1988), which deals, inter alia, with cross-border collection of tax. Article 28(6) of the Mutual Assistance Convention (1988) specifies that its provisions, as amended by a protocol in 2010, shall have effect for administrative assistance with prospective effect, i.e. in relation to taxable periods or tax liabilities after its entry into force. The Mutual Assistance Convention (1988) did not originally include such a rule. Article 30 of the Mutual Assistance Convention (1988) permits contracting states to reserve the right not to provide assistance for tax claims in existence on its date of entry into force. The Court of Appeal considered that this indicates that the Mutual Assistance Convention (1988) originally applied to pre-existing tax liabilities unless there was an applicable reservation. Article 28(6), introduced by the protocol in 2010, expressly allows any two or more parties to agree that the Convention shall apply to assistance relating to earlier taxable periods or charges to tax. The Court of Appeal considered that this comparison did not help the Appellants.

5.6. Foreign judicial decisions


27. Convention between the Member States of the Council of Europe and the Member Countries of the OECD on Mutual Administrative Assistance in Tax Matters (25 Jan. 1988) (as amended through 2010), Treaties IBFD.
30. U.S. CA 9th cir., Stuart v. United States 813 F.2d 243 (9th Cir. 1987), Tax Treaty Case Law IBFD.
5.7. Memorandum of understanding between the United Kingdom and South Africa

Article 25A(1) of the Protocol (2010) provides that the United Kingdom and South African competent authorities may enter into memoranda of understanding to settle the mode of application of the United Kingdom-South Africa Income and Capital Tax Treaty (2002). The tax administrations introduced a memorandum of understanding concerning assistance in the collection of taxes under article 25A of the United Kingdom-South Africa Income and Capital Tax Treaty (2002), which was concluded between the representatives of the two competent authorities on 24 February 2011.33 Witness evidence was introduced to the effect that it was negotiated and agreed during the course of negotiating the Protocol (2010).

The Appellants argued for exclusion of the memorandum of understanding as an aid to the interpretation of the Protocol (2010) or the tax treaty, in particular because it is not an agreement between the states but between their competent authorities (i.e. their tax authorities). The Court of Appeal ruled that it was admissible pursuant to article 31(2) and/or 31(3) of the Vienna Convention (1969), as an agreement relating to the tax treaty, which was made between all the parties in connection with the conclusion of the treaty (article 31(2)(a)) or a subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions (article 31(3)(a)) or subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation (article 31(3)(b)).34

The Appellants also referred to the fact that in Commerzbank a joint statement of the UK and US tax authorities was not regarded as admissible. The Court of Appeal in Ben Nevis noted that the judge in Commerzbank was not addressing the status of the joint statement in the context of the Vienna Convention (1969).

In the memorandum of understanding the parties agreed that requests for assistance are not restricted to claims that were finally determined after the entry into force of article 25A of the tax treaty. It also records a qualification on the assistance to be provided in relation to revenue claims that are more than five years old on the date of the request for assistance. Since the Appellants agreed that an enforcement procedure can apply to tax liabilities which arose before the Protocol (2010) came into force, a measure of retrospectivity was accepted. However, the Court found that the memorandum of understanding did not assist on whether article 25A applied before the effective dates set out in article 27.

Both Lords Justices Lloyd Jones35 and Jackson36 expressed criticism (with which Lord Justice Floyd agreed) of the fact that the memorandum of understanding was unpublished and that the only way in which taxpayers could obtain a copy is by making a Freedom of Information Act request. In the interests of fairness to taxpayers, such memoranda of understanding may have an important bearing on the position of taxpayers and should be readily available to the public.

5.8. Other relevant rules of international law

Although the decision in Ben Nevis reasserts the primacy of the Vienna Convention (1969) in interpreting tax treaties and provides a systematic application of those rules, this issue received less explicit attention. Article 31(3)(c) of the Vienna Convention (1969) requires any relevant rules of international law applicable in the relations between the parties to be taken into account. Three rules were relevant in this case.

Firstly, the revenue rule provided the context for the case. The Appellants argued in the High Court that article 25A of the Protocol (2010) should be construed narrowly as it involved a departure from the Revenue Rule.37 The purpose of the protocol was to overcome the effect of the revenue rule.

Secondly, the Defendants sought to rely on the principle of non-retroactivity in article 28 of the Vienna Convention (1969):

Unless a different intention appears from the treaty or is otherwise established, its provisions do not bind a party in relation to any act or fact which took place or any situation which ceased to exist before the date of the entry into force of the treaty with respect to that party.

Somewhat surprisingly, the Appellants accepted that article 25A could apply to requests relating to tax liabilities arising before the entry into force of the Protocol (2010) and restricted only by article 27 of the United Kingdom-South Africa Income and Capital Tax Treaty (2002).38 In the author’s view, this made the principled argument on non-retroactivity more difficult. The Court of Appeal ruled that the principle of non-retroactivity is not a peremptory norm of international law and article 28 of the Vienna Convention (1969) makes clear that the parties may agree to the contrary. In that respect, the parties expressed their intention in article VI of the Protocol (2010) that article 25A should apply to all requests made on or after the date of entry into force of the Protocol (2010). Thus, the Court of Appeal considered that this was not a true case of retrospective application. By reference to the principles of domestic law, the Court of Appeal considered that there was no unfairness or objectionable retrospection in enforcing the claims and no legitimate expectation that the Revenue Rule would not be overcome by a tax treaty.39

In the author’s view, the Court of Appeal glossed over the application of the principle of non-retroactivity in article 28 of the Vienna Convention (1969). While it is clearly open to contracting states to agree retroactive application of a treaty, this is only one part of the analysis. Indeed, the difficulty in this case was the lack of express intention.

33. Id., at para. 39.
34. Id.
35. Id., at para. 41.
36. Id., at paras. 57 to 61.
39. Id., at paras. 43(1), (2) and (3).
leaving the matter as one of interpretation. The main principle expressed in article 28 is that treaties do not normally bind a party in relation to any act or fact which took place prior to their entry into force. The expression "unless a different intention appears" suggests that a compelling case is needed to establish that the presumed norm has been displaced. The observation that the principle of non-retroactivity is not a peremptory norm of international law misses the point. All that it indicates is that the parties may agree the contrary. It does not negate the presumption of non-retroactivity. A treaty reasonably susceptible of two constructions should be construed in favour of non-retroactivity.

This line of reasoning also suggests that the Court of Appeal focused on the wrong part of article 27 of the United Kingdom-South Africa Income and Capital Tax Treaty (2002) and article VI of the Protocol (2010). Article 28 of the Vienna Convention (1969) also affirms that the temporal division is at entry into force. The relevant wording in the Protocol (2010) is:

Each of the Contracting States shall notify to the other, through the diplomatic channel, the completion of the procedures required by its law for the bringing into force of this Protocol. This Protocol shall enter into force on the date of the later of these notifications.

The language in article 27 of the tax treaty is similar in effect. Unlike the later parts of those articles, which direct the effect of the tax treaty on the taxes specified in article 2, this language is general and applies to the whole tax treaty. The real focus of the Court’s attention should have been on what was the relevant “act or fact which took place or any situation which ceased to exist before the date of the entry into force”. If these are the transactions that gave rise to the tax liabilities in question, they would have clearly arisen before entry into force of either the tax treaty or the Protocol (2010).

This addresses the anomaly identified by the Court of Appeal, namely, that if the assistance in tax collection applied to the operative dates for the various taxes mentioned in article 27 of the tax treaty, different temporal limitations would apply to the taxes mentioned in article 2. The anomaly only exists by misapplication of article 28 of the Vienna Convention (1969) and reference to the wrong part of the provisions on entry into force of the tax treaty and Protocol (2010).

The third rule was found in the European Convention on Human Rights. In the High Court, the Appellants argued, as a separate ground, that retroactivity in this case infringed article 1 of the First Protocol to the Human Rights Convention. The High Court rejected this argument and the point was not appealed.41 Retroactivity, whether as a matter of domestic or international law, always gives rise to concerns about both legal certainty and prescriptive norms not being in existence at the time conduct is undertaken. These three rules taken together suggest that, as a matter of construction, retroactivity should only be found where it is express or by necessary implication. Although the contracting states did not take heed of the advice of paragraph 14 of the Commentary on Article 27 of the OECD Model (2010) to clarify the issue, such advice was apparently followed in concluding a protocol amending the United Kingdom-India Income and Capital Tax Treaty (1993) on 30 October 2012 (some four months after the High Court decision in Ben Nevis).42 Article 10(2) of that protocol makes the administrative assistance provisions expressly retroactive.

6. Conclusions

In placing the Vienna Convention (1969) at the centre of tax treaty interpretation, the Court of Appeal has firmly brought the interpretation of tax treaties more fully in line with treaty interpretation generally. International consistency will follow from the use of the Vienna Convention (1969) as the framework for interpretation, rather than national courts each offering their own formulations of the applicable principles. This emphasizes the need for a careful study of the Vienna Convention (1969) and the customary international law it reflects.

40. Id., at paras. 25 to 29.

41. Ben Nevis (Holdings) (2012), at paras. 46 and 47.


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IBFD, Your Portal to Cross-Border Tax Expertise
In this article, the author provides his opinion on the current debate on tax avoidance by multinational enterprises.

1. Introduction

Even in the face of opposition to tax evasion and tax avoidance from a rising number of states, more and more other states are trying to create all kinds of agreeable tax incentives to attract more companies. The result is a deadlock. The President of the European Council, Van Rompuy, talks about a trillion euro in revenue losses. More and more citizens are turning against companies and governments that permit or take advantage of massive tax reductions. This article takes a closer look at all these developments.

2. Who Are the Key Players in this Discourse?

At the time of the writing of this article, the newspapers were full of stories about companies trying to reduce their effective tax burdens through all kinds of structures. This is not a new phenomenon. In the last few years, angry citizens have been the driving force behind movements that express their vehement discontent with companies paying as little tax as possible. Non-governmental organizations (NGOs), such as SOMO, Tax Justice Network, Action-Aid, Christian Aid, Robinhoodtaxes.org, are waging war against the behaviour of these companies. Some NGOs have published articles and reports on their fight against tax systems like the one in place in the Netherlands – with incentives like the participation exemption being branded “antisocial”.

Other organizations, on the other hand, have opted for a sort of “preventive approach”: “We are not saying your company is doing something wrong, but just tell us what you are paying.” They simply protest against the company until it answers the question on what it effectively pays in taxes and in which country. Vodafone was faced with various groups occupying its shops in protest against tax avoidance amounting to GBP 6 billion. Robinhoodtaxes.org even uses professional actors to make impressive short movies to influence public opinion. The Dutch beer brand Grolsch was beset by a professionally set up action to influence public opinion. As these structures are considered to be artificial, many tax consultants consider these NGO-induced agitations to be a rearguard action on a road to nowhere. But, are they really? Is this a movement fed by public outcry befitting the spirit of the crisis when some companies still generate quite magnificent profits that are totally out of proportion to the tax they pay every year? A movement that implodes once the crisis has ended? This author does not think so.

The world is going through a lot more. People in the western world have become accustomed to solving international tax law issues using the OECD Model. And when any western company invests in non-western economies, it is immediately assumed that those countries will follow the OECD interpretations. By including mutual agreement procedures in tax treaties, any risk of double taxation should be avoided.

The economy’s globalization has not been beneficial in all respects. New countries have risen, with far more financial and economic power than many of those in the West. The most important countries are grouped under the umbrella title “BRIC countries”: Brazil, Russia, India and China. While Russia’s real economy may not exactly count as huge, the opposite is true of the other three countries. Their size means that a globally operating company must be present: either for business-to-business operations or simply because they are home to a vast number of consumers whose income is growing strongly – income they are eager to spend.

These are exactly the countries that the western countries should be concluding tax treaties with. However, this is difficult as BRIC countries are not likely to accept the OECD Model. The following example illustrates this:

Example

Company A establishes a sales company in India. The sales company is converted into a stripped distributor to avoid the margin being allocated to India based on the OECD Models and the OECD Transfer Pricing Guidelines. Most recently, “BRICS” is the more common term since South Africa’s tremendous growth. A second layer of growing economies is on the rise (e.g. Indonesia). Most of these countries rely heavily on the UN Model. Most recently, the UN Model Tax Convention on Income and on Capital (1 Jan. 2011), Models IBFD.

As these structures are considered to be artificial, many countries no longer accept them. They think that the pres-
ence of a distributor in their country is the reason why the company generates profit there. They simply want to tax this profit, irrespective of any tax treaties. Companies facing this issue are frequently forced to take their case to national courts where the outcome is uncertain, to say the least.

Brazil and India are countries with their own distinct tax interpretations. They are the foremost examples of countries that refuse to accept the tax standards that the western countries find acceptable. Even if all the transfer pricing models show that eliminating functions and risks means that no more than 10% profit needs to be generated over the costs, these countries’ tax authorities regard such a distributor as an ordinary sales company and they feel that 30% is a more reasonable percentage. Many legal proceedings involving India relate to this issue. Brazil follows a different approach. It was the first country in the world to require an electronic corporate income tax return. However, it started to amend the forms very often, so that few companies could be compliant, which resulted in heavy penalties. Brazil also has its own view on what constitutes a reasonable profit allocation. If any model treaty provides guidance for such interpretation, it is the model treaty drafted by the United Nations. However, even this will not stop countries like Brazil from applying a much broader source state approach than the United Nations has ever intended.

What is the response of the Western world? As early as 2007, the OECD set up a Steering Group to tackle aggressive tax planning. Part of the strategy is creating a database solely accessible to tax authorities. The idea is to record as many examples of aggressive tax planning as possible, so that the participating states can share a great deal of knowledge. In addition, the OECD has published several reports. The western world has awakened to the growing pressure from the rest of the world on tax structures solely designed to minimize tax liabilities. In particular, the BEPS Report (OECD 2013) stirred up a hornet’s nest. Although an OECD report is not binding, this report is likely to influence multinationals’ tax structures. Their corporate social responsibility makes companies anxious about newspaper reports on investments in poorer countries because the wages there are still conveniently low, about tax avoidance through debt financing and about all kinds of transfer pricing structures. Companies are increasingly aware of what it means to be living in an information society in the year 2013. The internet is a sure-fire way to have any happening on the other side of the world revealed immediately.

And the European Union? Of course, the European Union had to act. In December 2012, the European Commission issued an Action Plan to reinforce the fight against tax fraud and tax evasion. One of the tax planning instruments subject to scrutiny is the hybrid loan.

EU legislation would have to be enacted to make it impossible for the income from a hybrid loan to be tax free in one country and for interest on such a loan to be deductible in another one, but is this a realistic solution? In other words: what are the chances of the European Union being able to change the Member States’ tax laws, knowing the strong focus on taxation of some of these countries and knowing that some of them will unequivocally reject any interference in their tax systems.

Ultimately though, these questions need not be answered. In a world where NGOs force companies to act responsibly vis-à-vis the global society, major investment countries no longer stomach the erosion of their taxable bases, and, as the political call to arrive at a more equitable taxation grows ever louder (in Western countries too), it seems impossible to reverse these processes. The European Union has one additional instrument available to challenge the tax systems of the Member States which are “too competitive”; namely the State aid provisions. It is expected that we will see more cases investigating the question of State aid in the future.

Section 3. describes an example of a company with what is called a fully tax efficient structure. It discusses whether such a company engages in culpable behaviour and the role of governments in this respect. How much blame should companies shoulder for paying no tax on very high profits? As long as states continue to create legislation while proclaiming the adage “every man for himself and the devil take the hindmost”, the culpability, at the very least, is shared.

3. How Google Optimizes Its Tax Position

3.1. Introductory remarks

The choice of Google is a random one. Being able to find a wealth of information about the structure’s elements by simply googling around a bit helps. However, instead of Google, the author could equally have picked Starbucks, Vodafone or Amazon, which are merely a limited sub-collection of a mammoth group of companies that know how to find extremely innovative ways of reducing their tax burdens.

Over the years, Google has carried out a solid expansion of its operations. It has evolved from merely administrating the largest internet search engine in the world to being the owner of YouTube. In some parts of the world, Google is now also known as the organization where you can book the cheapest plane tickets and holidays.

Google was incorporated in California in 1998. In 2011, its revenue reached nearly USD 38 billion and its profit USD...
10 billion. The effective tax rate was 2.4% in that year, while the statutory tax rate in the United States was 35%. The big question is how Google, rooted in the American business community, managed to realize this fantastic result: normally the part of the profit paid out as a dividend should effectively have been taxed at 35%.

3.2. Building blocks

3.2.1. Initial comments

Section 3.2. provides an outline of some of the features of the US tax system corresponding to the four principles that Google’s tax structure is based on. The US tax system has always predominantly followed the maxim that with respect to large countries it should make no difference to companies whether they invest in the United States or elsewhere (capital export neutrality). The tax burden will always relate to the rate levied on domestic profits. Nevertheless, this maxim exists only in theory.

3.2.2. Principle 1

The United States taxes US companies on their worldwide income. The US tax rate of 35% is quite high compared to the applicable rates in other Western countries. Profits of non-resident companies are taxed only if they are repatriated to the United States.

3.2.3. Principle 2

The United States, like any country, has rules for the avoidance of double taxation. The first option is a system of deducting foreign taxes from the US taxable base, which does not eliminate double taxation in full. The second option (the credit system) is more effective in avoiding double taxation. Under this system, foreign profits are included in the US taxable base on which the related US tax is calculated. The foreign tax charged is deducted from the US tax liability. The deduction cannot exceed the US tax due on those profits (ordinary tax credit). This is why most companies opt for the tax credit method instead of the deduction system.

Companies have an obligation to reduce their foreign tax burden as much as possible. Companies should seize any opportunity to go to court if valid reasons exist to dispute the application of a tax rule in the foreign country. Failure to do so will result in the losses involved being qualified as voluntary taxes, which are unavailable for a set-off.

3.2.4. Principle 3

Like many credit systems, the US set-off system is fairly easy to get around. To counter this, the United States has implemented tax legislation to prevent tax avoidance: Subpart F rules target foreign passive income and income generated through inter-company transactions. This legislation seeks to safeguard the US taxable base from taxable revenues being artificially transferred to third countries at the cost of the US taxable base. Since the introduction of the check-the-box-regulations in 1997, the application of the US CFC legislation can easily be avoided.

3.2.5. Principle 4

The fourth basic assumption is the application of the OECD Transfer Pricing Guidelines. This means the remuneration in inter-company transactions should be at arm’s length.

3.3. Google’s tax planning toolkit

3.3.1. Shifting of intellectual property rights

Some years ago, Google directors anticipated that the value of their intellectual property (IP) rights would rise in the period ahead of them. As exploiting these rights in the United States would result in a high tax burden, transferring IP rights to another country through a sharing agreement seemed to be perfectly reasonable. Ireland became the country of choice, inspired by an agreeable tax rate of 12.5% and the availability of appropriate personnel.

The cost sharing agreement involved two elements. The first was to have the parties bear the costs for the IP development in proportion to the opportunity to develop this right. In other words: from that time on, the IP right was enhanced with value from locations all across the globe. Since the value was no longer created solely in the United States, this left the US Internal Revenue Service (IRS) largely empty-handed.

The new group companies outside the United States could acquire the entitlement to the existing IP rights at an arm’s length price. After some negotiation, the IRS agreed to the proposed transfer prices.

The next question was how all of this should be structured effectively. Google set up a subsidiary in Ireland (Ireland Holdings Limited, IHL). This new subsidiary acquired the rights to exploit Google’s IP rights for Europe, Middle East and Africa (EMEA) through the cost sharing agreement. In 2006, Google concluded an advance pricing agreement, obtaining certainty on the price for the relevant transfer prices. All profits generated within the EMEA were to be taxed in Ireland and no longer in the United States, except if repatriated.

3.3.2. The Double Irish

The Double Irish involved the incorporation of a second Irish company (Google Ireland Limited, GIL) which was responsible for managing royalties earned in EMEA countries and coordinating activities for the EMEA region. The company was to be incorporated by a Dutch intermediate holding company. Ireland Holdings Limited, which holds the intellectual property right, granted the Dutch intermediate holding company a licence and, in turn, this company granted Google Ireland Limited a sub-licence.

As a result of this structure, Google enterprises within the EMEA pay Google Ireland Limited for the right to use the IP rights. In Ireland, those payments are taxed at 12.5%.
whereas in other EMEA countries they are deductible at the local regular rate. Newspapers report that 88% of the non-US royalties are directed through this Irish sub-subsidiary.13

3.3.3. **Checking the box**

The US tax system allows foreign companies to choose their status (check-the-box rules): they can be treated either as transparent entities or as corporations.14 Some companies are not allowed to choose a transparent status (per se corporations). The IHL is not a per se corporation and may opt for being treated as a transparent entity.

The activities of the Dutch intermediate holding company and GIL are attributed to IHL. This holding company is a passive subject to US Subpart-F legislation, since its activities do not go beyond receiving royalty payments. It is basically subject to US legislation on controlled foreign companies (CFC) and the profits are deemed to have been distributed to the US based holding company, where they are taxed at 35%.

By choosing the transparent status, GIL’s activities can be attributed to IHL. Since GIL effectively coordinates the activities within the EMEA region, this company is active. This attribution means the core activities of IHL become “active operations.” Hence, the profits can continue to be amassed in Ireland, making the holding company lose its passive character.

3.3.4. **The hybridization of IHL**

The next step was to prevent income from being taxed within IHL at the rate of 12.5%. For this purpose, IHL’s place of effective management was moved to Bermuda, where the rate is 0%. This decreases further, the tax difference between the tax savings due to deducted royalties (in countries where the rate is usually higher than 12.5%) and the amount of tax that is finally paid on the right to use IP.

3.3.5. **The fiscal relationship between the Netherlands and Ireland**

Transferring the effective management of IHL to Bermuda does not lead to any tax consequences in the United States. The United States still deems IHL to be an Irish company, while Ireland considers that company to be a Bermudian company. And then the interposition of a Dutch company suddenly makes sense: Ireland has not concluded a tax treaty with Bermuda, so the royalties can be subject to 20% withholding tax. If this occurs, agreements with companies are concluded on a case-by-case basis.18 With revenue exceeding EUR 40 billion, 88% of which flows through GIL, an agreement with Google would appear to be a very interesting opportunity for the Netherlands.

The question is often raised as to whether the Netherlands can be held liable for the culpable behaviour of companies. The Dutch substance requirements have been amended in 2001 to be in line with the international standards. While the Dutch tax regime offers many attractive features (tax treaty network), lack of withholding tax on interest and royalties, those features also benefit “legitimate” companies.

The following diagram illustrates the Google structure. The table shows how this structure caused the effective tax burden to drop to 21.96/1,000 = 2.2%. For simplification purposes, it assumes hypothetical revenue of EUR 1,000.

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13. See www.businessweek.com/magazine/content/10_44/b4201043146825.htm.
17. NL: Corporate Income Tax Act (Wet op de vennootschapsbelasting, Vb) 1969, sec. 8c. National Legislation IBFD.
3.3.6. And Bermuda?

Two directors have been appointed for INL in Bermuda to effectively manage this company. Although both of them are also lawyers at a trust office in Hamilton, they have already showed that they can act in Google’s best interest. One of the first actions these gentlemen took was to convert the legal form of limited liability company into unlimited liability company, which means that the financial statements no longer need to be published.

3.4. “All’s well that ends well” for Google’s shareholders?

Once the money has reached Bermuda’s shores, the shareholders will still not be able to get their hands on it. If they wish to have their dividend and enjoy it, profit should first be repatriated from Bermuda to the United States. However, this comes at a cost of 35%. Thus, their profits have turned into what is referred to as “locked-out profits”. A fantastic tax structure has been implemented, but nobody can get to the money. This outcome is definitely not one that the shareholders had in mind. It may seem that as a consequence of the chosen structure, a deferred tax liability could be recognized in the amount of the overseas tax profits. However, according to the US rules, an exception is made for income which will be reinvested overseas (permanently reinvested earnings). It is clear that this exception is being used by the companies.

How could shareholders obtain their dividends? The simple way is to sell shares, realize a capital gain and then buy back the shares. However, these shares are expensive (the value of one share exceeds USD 1,000). Companies would need money to implement this solution (e.g. loans from overseas banks).

Google is not the only company to have this problem. Together, US multinationals apparently have accumulated between USD 1.3 and USD 1.6 trillion in tax havens. If repatriated to the United States, this money would alleviate the high national debt by at least 33%. Regrettably, the shareholders do not want to accept this consequence. Having gone through much effort to concoct a wonderful tax structure, one does not want to find out that it is useless if one wishes to obtain dividends. Companies like Google are doing well in the eyes of stock exchange analysts because of their tax optimization. But what is the point in performing well if the gains cannot be realized?

It would be strange if the United States had not tried to solve this issue. Over the last couple of years, multinationals with a Google-like structure spent more than USD 1 billion on lobby organizations to push for a repatriation tax holiday (a one-off voluntary disclosure scheme to be able to distribute dividends stashed away in Bermuda or elsewhere without having to pay the US tax). The first time a repatriation tax holiday was allowed was in 2004:


companies had to pay only 5.25% in taxes, provided the amounts repatriated to the United States would be used for creating new jobs, research and development activities, and other socially desirable expenditures. The 2004 American Jobs Creation Act was one of the results of this deal. The idea behind the repatriation tax holiday was to bring USD 312 billion to the United States. However, the deal between the government and businesses could hardly be regarded as a success. Companies took advantage of this one-off tax reduction, but failed to uphold their part of the bargain. Despite being highly successful in providing reasons as to why they were unable to do so, they managed to antagonize President Obama: a strong advocate of a fair tax system. In March 2011, the Obama administration announced that it would refrain from introducing another repatriation tax holiday. Later on, Obama changed his mind and is now considering this.

Low-taxed profits belonging to US multinationals are in limbo in the tax havens. Companies failed to capitalize on the chance they had in 2004 of repatriating them at a favourable tax rate in exchange for proper investments. It remains to be seen which way the wind blows under the next government.

4. Companies versus Governments

Companies like Google, which employ sophisticated tax planning structures, have evidently crossed the lines of what is acceptable. Once they have committed themselves to using such structures, they should accept the consequences. If the shareholders want their dividends, they should have them distributed and pay the US tax due. In view of these events, it is, nevertheless, annoying to see that some elements of the tax system (like the participation exemption in the Netherlands), which were designed to promote economic development of businesses, are now allegedly used for avoiding income tax. Since corporate income tax has usually already been paid in the country where the subsidiary is established, there is no need to do so in the Netherlands. Recently, a Dutch newspaper reported that this participation exemption is disadvantageous for developing countries. In the author’s view, this is incorrect. If a developing country is trying to create employment, the common practice would be to reduce its corporate income tax rate. If the Netherlands did not have the participation exemption, the benefits granted in
the developing country would be cancelled out by the application of the Dutch tax rate to profits repatriated from the developing country.

How can bilateral tax treaties play a pivotal role in the tax avoidance system? This does not seem possible even if a company performing some administrative tasks wants to access them. The existing Dutch treaty network may be used to reduce the withholding taxes on interest and royalties, but only if certain (substance) requirements are met. For financing activities, the requirements of article 8c of the CIT A 1969 must be satisfied. International tax law is built on the concept of the “ultimate beneficiary”, whereas journalists usually search for the “ultimate ultimate beneficiary”, which is usually the top holding company.26

In the author’s opinion, NGOs target the wrong international tax law elements: Google has argued its case with a clean conscience, albeit not accepting the consequences of the game, i.e. taxation upon repatriation. This is what should warrant the attention of the NGOs.

The tax position of companies is one of the issues their stakeholders hold them accountable for. Can those companies be blamed for taking advantage of the differences in rules between the various states to reduce their tax burden? In general, all companies take the opportunities international law offers them. But there is nothing wrong with that. Global organizations would not be efficient if they failed to have a structure under which as little tax as possible is paid. Revenue and cost optimization involves not only tax considerations: many companies relocate to or create subsidiaries in countries where the cost of labour is low. The shareholders have a role to play in testing a company’s corporate social responsibility policy.

It seems that it is only a matter of time before some of the traditional tax planning building blocks will be abolished. One of them is the hybrid loan. The problem is not so much the company employing this type of financing arrangement but rather countries not charging tax on the revenue from hybrid loans, even if interest has been deducted in the country where the company paying the interest is established.27 Both the European Union and the OECD would like to discourage companies from using such structures. It seems that other traditional tax planning options will increasingly be targeted in the coming years.

In the author’s view, companies should stick to all the rules of the game. If a company is deemed to be active, then it should actually be active. A letterbox company with few management meetings a year may be perfectly suited to managing IP rights. Management of IP rights can be undertaken in a relatively simple manner, but establishing an intra-group finance company is considerably more complicated. Even if a finance company based in Switzerland employed 50 people, it is still doubtful whether the effective management of that entity is not located somewhere else. Should the group feel the need to set up a new factory in India and should this partly be achieved through “borrowed” capital from the Swiss financing company, the decision about how much will be funded and at what price is unlikely to be taken in Switzerland, more likely by the CFO in consultation with the Executive Board.28

If a company is set to perform activities, those activities should actually take place (which is, however, not always the case).29 Situations where companies claim to perform activities in certain countries/islands but where those activities are actually non-existent, constitute tax evasion and not tax avoidance. The same can be said of situations where a trust office exercises the control over a company in circumstances in which no reasonable shareholder would leave the company management to such a trust office. What exactly is the role of states in all of this? They determine both the tax burden they impose on companies and the parties to and conditions of the bilateral tax treaties they conclude. However, their willingness to cooperate is still limited. Where a company has the world as its playing field, countries are only concerned with one thing: having as much of that “world” flowing through their territory as possible, as this generates funds. This outlook has sometimes led to quite extraordinary situations. The British minister, George Osborne has appeared in the headlines for proposing tax changes to make the United Kingdom the most favourable place to do business in the world, with the lowest corporate income tax rate. What is more, an innovation box has been introduced in the United Kingdom and certain withholding taxes have been abolished. Additionally, Osborne has appointed 2,000 new tax inspectors to tackle companies that are utilizing the more favourable tax laws of countries other than the United Kingdom. Thus, the entire world should operate through London; a failure to do so (opting for another favourable country) will, at the very least, create major difficulties with Her Majesty’s Revenue and Customs. This reveals a huge imbalance: enterprises cannot simply change the rules, whereas the states can. Thus, companies should not be blamed for going to other more favourable countries. Even a lot of state-controlled companies optimize their tax positions in this way: Energie de France has a Dutch holding company and the Dutch national railway company which leases train carriages through Ireland.

Who engages in culpable behaviour? The companies, which exercise the rights created by the states? Or the states with their two-pronged policies of attracting companies, while at the same time coming down on companies trying to explore better alternatives? In any case, the catch-all term “tax avoidance” for companies opting for the most beneficial route to reducing their tax burdens has a strong contender in the term “tax competition”: states trying their best to coax companies into establishing themselves on their respective territories.

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26. Companies, such as Philips or HP, are organized in sectors involving a lot of subsidiaries. An “ultimate beneficial owner” approach would lead to major tax disadvantages as far as withholding taxes are concerned.
27. Sec. 13(4) Vpb 1969.
28. This will only be different if it has been established that the CFO and the CEO physically attended the important meetings in Switzerland.
29. See www.youtube.com/watch?v=XcmjLYs7A4
Both camps should take their fair share of the blame. Companies can be accused of culpable behaviour if their tax structure is perfect to the point that they can no longer distribute dividends at which they want the state – the one party to suffer most from these actions – to help them out, of if their structures for routing of cash flows are not supported by the facts. The latter situation is simply called tax evasion and deserves a tough approach. At the same time, states display similar behaviour. The United Kingdom policy towards tax competition is an example.

5. The Changing World

Companies go for the lowest possible tax burden. States have their own reasons for facilitating this. However, these days, people (who are also the customers of those companies) no longer accept that no tax is paid in the countries where the profit is made.30 The actions of the NGOs have become more forceful and more professional. NGOs increasingly use the possibilities that modern times have to offer. The internet has made the world smaller, so nothing can be kept secret any more. The NGOs’ campaigns will not be ignored, as corporate social responsibility is a prominent topic in the boardrooms of many multinationals. No one wants coverage in the press, the risk of being damaged is just too big.

Likewise, there are rising economies to contend with: China, Brazil and India. Not long ago, the BRIC countries were countries whose economies were still burgeoning – which is the reason why many tax treaties with Brazil contain a tax sparing credit. But the world has changed rapidly. Nowadays, the BRIC countries are listed among the more important countries in the world.31 The BRIC countries and South Africa will join efforts to incorporate their own World Bank because of their discontent with the one in place.32 The BRIC countries have become major investors in the Western world. They also attract investment, because their economic growth has increased the spending power of their people. These countries start to recognize the superb structures Western countries can create, but fail to accept them, as can be witnessed in the numerous tax proceedings pending in India.33

As regards tax matters, the BRIC countries have largely gone their own way. The source state principle seems to be of major influence in this respect.34 Why should they accept their countries being used for cheap labour without a fair share of corporate income tax? Globally operating companies cannot afford to disregard Brazil or India.

However, other developing countries do not have such a strong position. Companies have high requirements before they establish factories there: the land should be given away preferably for free, the infrastructure needs to be good and the corporate income tax rate should be low. Once again, the NGOs lend a helping hand here.

Recently, the United Nations issued its Practical Manual on Transfer Pricing for developing Countries (the “UN Manual”).35 In this Manual, the UN aims to take a leadership role in an attempt to draft global transfer pricing guidance that can be used by countries all over the world in developing and implementing transfer pricing regulations. Does it make any sense that the UN takes the lead? It would if it meant that almost all countries around the world will apply the same principles. This would reduce double or non-taxation. Yet in practice, the outcome is not that positive. The principal merit of the UN Manual is that it shows how four of the main UN states (Brazil, China, India, and South Africa) view inter-company pricing. Surprisingly, these four states have four different views, which obviously further complicates the matter, as shown in the examples below.

Brazil argues that the “arm’s length” principle produces immoral results, for instance, where a cost plus arrangement is set up, simply because it does not accept the “plus” that can be determined using the regular comparisons. The country introduced fixed margins for gross profits and markups. Brazil effectively applies a system that has elements of formulary apportionment. The Brazilian perspective is that the conventional use of the resale price and cost plus method implies uncertainty and legal instability, since these are implemented by the taxpayer without previous consent by the tax authorities.

China, on the other hand, has quite different problems, facing certain challenges that are not addressed by the OECD Transfer Pricing Guidelines. The situation in China is believed to be so unique that there is a lack of appropriate comparables coupled with difficulties in quantification and allocation of location-specific advantages, as well as issues relating to the identification and valuation of intangibles. In practice, this means that the Chinese tax authorities will always try to adjust the comparables to create a more reasonable arm’s length price. An example is a Chinese manufacturing plant paying royalties to a Western affiliate since 2003. In ten years’ time, the innovative character of the Chinese company could demand the Western affiliate to pay royalties in China instead.

India’s approach differs from that of China. Profit allocation is normally based on three factors: functions, assets and risks. India believes that the allocation of risks can be artificial. Contractual risk allocation would imply that an R&D plant in India is operating risk free; consequently, this subsidiary would only be entitled to a lower cost plus remuneration. The Indian tax authorities do not accept this approach. India believes that if the core function or

30. At least, this is how the NGOs portray it. However, if an individual opens a coffee bar next to Starbucks, he will never generate the same revenue as Starbucks does, because the popularity of that brand is the consequence of worldwide investments. Therefore, it is understandable that its profit is not fully taxable in the source country.
31. Similar countries are: Ghana, Indonesia, Korea (Rep.), South Africa, and Taiwan.
33. Companies like Vodafone, Galileo International and Rolls Royce have major legal proceedings pending in India.
R&D services are located there, important strategic decisions by management and employees of the subsidiary are required. The Indian subsidiary is deemed to control its operational and other risks, resulting in a higher remuneration.

South Africa has difficulties in determining the proper arm’s length prices, for the same reasons as China. It is clear that hardly any comparables are available from South Africa, while Western comparables cannot be applied. Therefore, South Africa uses a more holistic approach with respect to, for instance, service fees. The current two-step OECD approach (has a service been rendered? Is the charge at arm’s length?) is applied in an alternative way. The tax authorities investigate whether the recipient has an economic and commercial benefit, whether the services are performed by the recipient and whether the service fees include shareholder services. Hence, they go beyond the paperwork supporting the system and look at what actually happens from their perspective. In many situations, this approach will obviously shift the income and the tax burden to South Africa.

Although the UN Manual aims to take the lead in the transfer pricing world, the whole world does not pursue the same line of argument. Not even all UN countries apply the same approach. Several relatively small upcoming economies have their own perceptions. They have learned to understand the way companies approach pricing and try to prevent their tax bases from eroding.

The application of the OECD Guidelines and commonly used databases will not always help determine an acceptable profit allocation. Most databases do not provide information on developing countries. In particular, inter-company pricing between OECD states and non-OECD states should be tailor-made. The UN Manual provides some guidance but nothing more than that.

Will all these developments result in the end of tax planning? In the author’s opinion, some of the structures are based on economic principles and should not be challenged, even if this means that the source state can levy less tax. For example, the right to use a famous brand can be sold at arm’s length to a group entity in a tax-friendly country. It can be sufficient to have lawyers who manage the IP rights in that country and to send an invoice for their use once a year (whether this structure is acceptable depends on the circumstances of an individual case). However, once companies have opted for a structure, they should accept the consequences and not ask the state to help them repatriate profits.

In the Tax Annex to the St. Petersburg G20 Leaders’ Declaration, it reads that actions are identified in the area of transfer pricing to put an end to the disparity between the location of profits and the location of real activities. It is not impossible that there will be a move from applying the arm’s length principle to a system which will ultimately be close to formulary apportionment. The path would probably go via country-by-country reporting in combination with a full exchange of information to a system where profits are taxed where they are actually generated.

6. Conclusions

The author is astonished at the extremely dogmatic nature of the discussion on tax avoidance – the difference between tax avoidance and tax evasion seems to have vanished completely.

This debate on tax avoidance evokes a lot of emotion. Tax law will almost certainly change. But the changes should not mean multinationals will be allowed to perform passive activities in the head office country only – this would really be a step too far. The NGOs have become part of the world of taxation; and there is little wrong in that. Tax evasion should be tackled vigorously, but tax avoidance is a different story. While some things are no longer appropriate, some of the tax structures are perfectly reasonable. And if there is a desire to change this, new laws have to be created, preferably initiated by the OECD and the UN. That which has yet to be changed cannot be used against a company.

37. Id., at p. 3 (an analysis of how G20 looks at the automatic exchange of information).
What Is Needed To Perfect the Chinese GAARs?

This article considers certain issues that should be addressed in the pursuit of the perfection of the Chinese general anti-avoidance rules (GAARs).

1. Background
Since the introduction of the general anti-avoidance rules (GAARs) in the Chinese Enterprise Income Tax Law (EITL) in 2008, plenty of ambiguities have arisen with regard to their interpretation and application. To address the problems identified during the implementation of the GAAR provisions in the past five years and to improve the rules, constant efforts have been made by the State Administration for Taxation (SAT), including the issuance of a series of guidelines on the application of the GAARs in different cases. Undoubtedly, this will help to make the rules more enforceable. This article does not discuss the efforts by the tax authorities to improve the existing rules, but, instead, shows that certain fundamental principles which should be taken into account in the course of perfecting the Chinese GAARs have failed to be adequately evaluated by the Chinese legislators.

Prior to 2008, few public debates were conducted with regard to the feasibility of introducing GAARs in China. Based on the experiences of other jurisdictions, such as Canada, the United Kingdom and the United States, Chinese legislators should have conducted a thorough and comprehensive evaluation of the context in which GAARs operate to justify their adoption. As a transplanted tool, a GAAR may have difficulty in fitting well into the particular circumstances in China. Now that the GAAR has been in operation for quite a long time, it makes no sense to take action with the wisdom of hindsight. However, a retrospective review can still improve the understanding and exploration of the context in which GAARs operate and make them more effective.

2. Is There a Coherent Definition of a GAAR?
The Chinese GAARs have three legislative sources: the EITL, the Implementation Regulations of the EITL and the Special Measures for Tax Adjustment. A comparison of the relevant articles in these three sources reveals some contradictions and ambiguities which must be eliminated for the effective functioning of the GAARs.

Article 47 of the EITL provides a basis for the GAARs by stating that the tax authorities are entitled to apply reasonable methods to make adjustments if an enterprise conducts an arrangement without a reasonable business purpose which results in a reduction of the taxable income or the tax due. The EITL Implementation Regulations define “arrangement without a reasonable business purpose” as a transaction mainly intended to reduce, eliminate or defer the tax due. To render these two articles enforceable, the Special Measures contain a chapter entitled “General Anti-avoidance Management,” under which the tax authorities may launch a GAAR investigation when any one of the following arrangements is identified: abuse of tax preference, abuse of tax treaties, abuse of entity form, tax evasion by means of tax haven or other arrangements without reasonable business purpose. The tax authorities examine whether the form and the substance of an arrangement, the time and the effective period of an arrangement and the implementation method of an arrangement are in line with the principle of substance over form. They re-characterize tax avoidance arrangements in accordance with their economic substance and cancel any tax benefits obtained by the enterprise from such tax avoidance arrangements.

In the author’s view, the current legal sources for the Chinese GAAR leave much room for logical and technical improvement.

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1. For example, on 10 December 2009, the SAT issued a Notice Regarding the Administration of Taxation of the Gains from Share Transfers by Non-resident Enterprises (Guo Shui Han [2009] No. 698; Notice 698), which concerns the levying of enterprise income tax (EIT) on non-resident enterprises transferring their shares in Chinese enterprises. Based on the general anti-avoidance provision in the EITL and its implementing regulations, Notice 698 expressly authorizes the re-characterization of equity transfers which may give rise to tax avoidance. Another example may be the SAT Notice Regarding Interpretation and Recognition of Beneficial Ownershipships under Tax Agreements (Guo Shui Han [2009] No. 601; Circular 601), which provides criteria for the status of “beneficial owners” under tax treaty articles on dividends, interest, and royalties.

2. CN: Special Measures for Tax Adjustment, ch. 10.
3. Art. 92 Special Measures for Tax Adjustment
4. Art. 93 Special Measures for Tax Adjustment
5. Art. 94 Special Measures for Tax Adjustment
First, article 47 of the EITL provides nothing more than a general basis for a GAAR. The fact that detailed explanations are provided by lower-level legislative bodies may be problematic. Some commentators have observed that it is the Chinese tradition that the level of detail increases when the lawmaking body’s rank decreases and the higher-level legislation is generally broadly formulated. The National People’s Congress, which is the supreme legislator, enacted the EITL, the State Council enacted the Implementation Regulations, and the Special Measures were issued by the SAT. According to the Legislation Law, which is the governing law for all law-making activities in China, basic fiscal and tax systems can only be regulated by national law. Thus, the GAARs, as an important component of the tax system, should have been enacted by the National People’s Congress as a national law (just like the EITL). Although the wording of national law can be broad, the EITL should provide a general concept which incorporates the basic elements of a GAAR, such as tax avoidance, tax benefit, and powers of reconstruction. Unfortunately, the present version of article 47 of the EITL fails to provide such a framework. The lack of a reasonable business purpose is only one element of tax avoidance and the reduction of taxable income or tax due is merely an example of tax benefit. The absence of the basic definitions in the EITL renders the provisions of the Implementation Regulations and Special Measures legally without foundation and contrary to the Legislation Law.

Second, in enacting the expanded definition of the GAARs in the Implementation Measures, the State Council has gone beyond the scope of its authority. Article 47 of the EITL refers to the concept of “arrangement without reasonable business purpose.” This concept has been explained by article 120 of the Implementation Measures as an arrangement which is primarily intended to reduce, eliminate or defer the tax due. According to article 47 of the EITL, the GAARs should target only arrangements aiming to reduce taxable income or tax due. A question arises in the case of an arrangement, the main purpose of which involves tax deferral instead of a tax reduction. There is no clear answer to the question of whether the GAARs can be applied in this case. It may be argued that the explanation in the Implementation Measures has broadened the scope of the GAAR to include tax deferral. However, this broadening does not have a legal basis because of the principle contained in the Legislation Law that a lower-level law cannot contravene a higher-level law.

Third, the Special Measures have the least legal authority of all three legal sources for the GAARs. Due to the simplicity and contradictions in the EITL and its Implementation Regulations, the Special Measures have become the major legal source for the application of the GAARs. They provide much more detailed guidelines than the other two sources do. However, according to the Legislation Law, national law and administrative regulations have higher legal authority than administrative rules. As an administrative rule with insufficient legal force, the GAARs are subject to higher-level laws and administrative regulations, which may make their application ineffective in certain cases.

To remedy the aforementioned shortcomings, amendments should be made to the EITL and the Implementation Regulations: Special Measures should be incorporated in the EITL as basic elements of the GAARs. Tax avoidance should be mentioned as the main element, and tax benefits should replace the “reduction of taxable income or tax due.” The criteria of tax avoidance and tax benefit may be provided by the Implementation Measures, Special Measures or other similar rules. If the GAAR provision in the EITL remains general, it will be sufficient to cover any expansions or clarifications by the lower-level legislative bodies and will be compliant with the Legislation Law. The upgrading of an administrative rule to the status of national law would make its application free from obstacles caused by other higher-level laws and administrative regulations.

This is, however, truly easier said than done in the present circumstances. To amend the EITL is not straightforward, as national law involves a complicated procedure which is usually difficult to initiate and time-consuming to complete. For this reason, the present design has been chosen as an interim solution. To solve the problems which have been encountered during the period of application of the GAARs, the SAT has prepared detailed guidance which is expected to be released soon. It is too early to make any comments on the contents of this guidance; however, the fact that it will be issued by the SAT leaves the problems explained above unsolved.

3. The Principle of Certainty in the Application of the Chinese GAARs

The importance of legal certainty has been repeatedly stressed by academics and echoed by national legislators. Much discussion about the GAARs has focused on negative aspects arising from their vagueness. Freedman (2004) noted that certainty is more important in a tax evasion case than in an avoidance case because sanctions for evasion may include imprisonment. Therefore, a high degree of legal certainty is required for taxpayers to assess and avoid the severe consequences. In contrast, in most jurisdictions, tax avoidance will not result in any punishment even if it has been detected; the only consequence being the annulment of the tax benefit. Nevertheless, this difference may not be convincing enough to justify a lower degree of certainty in avoidance cases. After all, from an economic point of view, the annulment of a tax benefit is not much different from other economic sanctions, so

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7. CN: Legislation Law, art. 8.
that the categorization of cases does not make much sense. Certainty should be a common requirement for tax rules in all cases.

A desirable law should be certain enough to ensure its predictability, which is central to the rule of law. The rule of law means that every aspect of a tax, either substantial or procedural, should be regulated by law, so that taxpayers can assess the tax consequence of their transactions. A differentiation should be made between justified certainty and absolute certainty: absolute certainty should never be expected to be a feature of a GAAR. As a tool for tackling unpredictable forms of tax avoidance, a GAAR must have general and broad terms to cover different scenarios. Just as Chris Atkinson (2011) suggested, the GAAR is desirable if it can provide guidance based on which:

- taxpayers are able to foresee, with a reasonable degree of accuracy, the tax consequences of their actions prior to undertaking a course of action;
- the revenue authority has clear and coherent standards to apply to determine whether particular actions are acceptable or not; and
- the courts have clear and coherent standards to give effect to the GAAR and to test the appropriateness of the exercise of any discretion by the tax authorities. 11

The main obstacle to certainty is the retrospective use of tax rules. Retrospective laws can hardly be certain because it is impossible to know what the law is prior to undertaking the conduct. Retrospectivity can only be accepted in a limited number of cases or in the interests of parties. 12 Unfortunately, tax rules issued by the SAT frequently have retrospective effect. One unofficial study conducted by Jiguang Zai (2012) found that retrospective effect took three different forms, one of which was that tax rules become effective before they are issued. 13 There are more than 200 SAT rules falling within this category, and an extreme example is the Notice on the Enterprise Income Tax Issues of Funding and Project Management of Clean Development Mechanisms (Caishui [2009] 30) jointly issued by the SAT and the Ministry of Finance on 23 March 2009 with retrospective effect from 1 January 2007 (more than two years prior to its enactment). Jiguang Zai (2012) justified this phenomenon on the following three grounds:

- Business transactions are so complicated that it is necessary for the rule to be retrospective to tackle sophisticatedly designed tax evasion cases.
- Current tax laws are too general to be applied, so that the SAT’s explanatory rules are necessary for their application. In some cases, the explanation cannot be accomplished without assistance from external parties, so that the whole process takes a long time.

- As income tax is calculated on an annual basis, the rules should be effective from the first day of the fiscal year even though they are enacted in the middle of the year. This is necessary for the application of uniform rules in the same year.

It must be conceded that all these three points expose some objective facts but they fail to explain the rationality of these facts. A good tax law should maintain a balance between the fiscal needs and the interests of taxpayers, and retrospective effect should not just be applied as a tool to raise revenue at the expense of taxpayers’ justified expectations based on the laws applicable to them.

In contrast to the rationality proposed by Jiguang Zai (2012), some points relating to the inevitability of retrospective tax rules should not be neglected. The Chinese tax rules are mostly issued by the SAT. The SAT pays much attention to the effect of its rules on tax collection and the raising of revenue, which may undermine certainty or other elements of the quality of the rules. In addition, unlike higher-level legislation which is subject to strict procedural requirements that secure its predictability, certainty and stability, rules are enacted by the SAT through a much looser procedure. 14 It is much easier for the SAT to enact or amend a rule than for the Congress or the State Council to pass or amend a law. However, the vast discretion and flexibility enjoyed by the SAT may erode the quality of its rules.

The GAAR, a tax rule with general and vague terms as its striking feature, should address the above-mentioned issues to secure legal certainty. Retrospective force should be restrained, if not eliminated, to the uttermost. The status of the legislative body enacting it should be higher so as to increase the authority, stability and certainty of the rule. However, absolute certainty should not be the aim of tax law. Taxpayers should never expect a GAAR to be certain enough to predict the exact amount of their tax liability.

4. Is There an Effective Dispute Settlement System for the GAAR?

As the application of the vaguely worded GAARs will surely create disputes, an effective dispute settlement mechanism will be of significance to the success of the GAARs. Currently, there are two settlement procedures available to taxpayers: administrative review and litigation. A careful review will indicate that neither system is working as effectively as intended.

The Administrative Review Law provides that any person who considers that his lawful rights and interests have been infringed upon by a specific administrative act may seek administrative review. 15 The SAT issued its Interim Rules on Administrative Tax Review on 17 January 2004. After

12. Art. 84 Legislation Law: national law, administrative regulations, local decrees, autonomous decrees, special decrees, administrative and local rules do not have retrospective force, except where a special provision is made in order to better protect the rights and interests of citizens, legal persons and other organizations.
14. The legislative process of the National People’s Congress includes: the introduction of a draft, the discussion and deliberation of a draft by different groups, amendment of the draft, voting on the draft and signing by the state president. The process for enacting administrative regulations and rules includes: drafting, reviewing, amendment, signing by the premier. See chs. 2 and 3 Legislation Law.
15. CN. Administrative Review Law, arts. 2 and 6.
six years of experimental application, the interim rules were finalized on 15 December 2009. A striking feature of these rules is that external experts will be allowed to be members of the administrative review committee. On 26 October 2012, the SAT established its Administrative Review Committee (ARC), which consists of 16 SAT officials and eight external experts, including professors, certified tax agents and tax lawyers. The ARC is responsible for reviewing complex key cases and setting administrative review policies for the local tax administrations.

The SAT has been making efforts to promote the administrative review as an important channel for settling tax disputes. However, the following issues have made these efforts ineffective. First, the reviewing body lacks the necessary independence. According to the Administrative Review Law, the application for review shall be referred to the tax authorities at the next highest level, which means that the disputed action will be reviewed within the same system, although by a higher-ranking authority. Having the same objectives and similar comprehension of tax rules, the authorities at the higher level can hardly be expected to produce an opinion which is much different from the original one. To render the reviewing authority independent and authoritative, the SAT has made it clear in its Rules on Taxation Administrative Review that external experts may be included in the review committee and this has been put into practice by inviting eight experts to the ARC. Nonetheless, the introduction of a limited number of external experts can hardly be enough to secure the independence of the reviewing authority. Second, the prerequisite for the application of the review is both theoretically and practically defective. When applicants apply for administrative review they should first pay taxes and overdue fines or provide the relevant guarantees as set by the tax authorities. Otherwise, they will not be entitled to seek an administrative review. This has been designed to prevent the deferral of tax by initiating review proceedings. However, the interests of the taxpayers have failed to be properly respected, and sometimes this prerequisite may constitute an obstacle to the review as an effective method of remedy. It is unfair to require the taxpayer to pay the tax in advance if the final decision is in his favour (even if the tax may be refunded later on). Third, the review makes the whole system complicated and inefficient. The SAT Rules on Taxation Administrative Review provide different treatments for different cases. If the disputes are related to tax collection, administrative review is a precondition for litigation. For other disputes, taxpayers have a choice between review and litigation. The problem is that it is sometimes unclear as to whether the dispute is related to the collection of tax or not, and the dual process of review and litigation diminishes the efficiency of the dispute settlement procedure, making the whole system unnecessarily complicated.

The second legal method for dispute settlement is litigation. International experience has shown that different approaches taken by courts to interpret and apply a GAAR have considerably influenced the GAAR’s success in identifying tax abuse and countering its detrimental effects. GAAR cases already decided by judges are taken as an indication of the judicial attitude and have a profound influence on the rules themselves. In addition, the need for a judicial interpretation is rooted in the nature of the GAAR: the GAAR is too general, so an independent and fair judgement is necessary to allow it to be properly applied. Thus, the judiciary plays a pivotal role in the origin and development of the GAAR.

Unlike the practice in other countries, the Chinese courts’ position in taxation cases is negligibly weak and the Chinese GAAR cases are almost exclusively dealt with by the SAT. Chinese taxpayers have rarely sought recourse to litigation. Since the adoption of the Law on Tax Collection and Management, tax cases have accounted for less than 1% of the total number of administrative cases (despite the prevalence of tax disputes). The lack of judicial influence in taxation cases may be attributed to the following factors. First, the precondition of paying tax has substantially impeded the exercise of the right of action. This means that the right is not available to taxpayers if they cannot afford to pay the taxes and overdue fines. A motion to remove this precondition was put forward during the discussion on a draft amendment to the Law on Tax Collection and Management in early 2013. Unfortunately, the motion was rejected by the tax administration. Second, unfair advantages gained by the tax authorities make litigation a daunting prospect for the taxpayers. Due to the insufficient and vague provisions of tax law, rules and regulations enacted by the tax administration have become the major source of law. As the “maker of the rules”, the tax administration can easily produce a binding interpretation in its own favour. In addition, there are few tax experts in Chinese courts and the lack of tax knowledge makes the judges reliant on assistance from the tax administration. It is quite common in practice that the judges seek opinions from tax authorities on tax cases. This makes taxpayers reluctant to start legal proceedings against tax authorities. Third, fears of revenge also discourage the taxpayers from going to court. Taxpayers are afraid that their future actions will be subject to closer scrutiny by the tax authorities if they bring a case against them. To maintain a good relationship with the tax authorities, taxpayers usually choose not to litigate, even if they feel that they are being treated contrary to the law.

It can be concluded that both administrative review and litigation face challenges in China and can hardly be regarded as effective methods of remedy for taxpayers. This explains why negotiation and compromise are widely applied as a way of dispute settlement. The failures of the system, especially the lack of judicial influence, should be adequately remedied, not only for the settlement of disputes but also for the operation of the GAARs. The GAAR is usually a generally worded guideline with discretion as its inherent feature. Administrative discretion must be applied to cope with various tax evasion schemes and to

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16. CN: Rules on Taxation Administrative Review, art. 23; and CN: Law on Tax Collection and Management, art. 88.
secure the effectiveness of the system. Judicial discretion is a safeguard for the fair application of the GAARs. To function as intended, judicial discretion must be exercised in an independent way, so that it is able to rectify administrative decisions. It is beyond the scope of this article to advocate any structural changes in China. The inclusion of external experts is a positive step taken by the SAT to improve the system of dispute resolution. However, the system can never be perfect without the active involvement of the judiciary, which will take a long time and much effort to become reality in China.

5. Remaining Policy Issues

This section outlines some policy issues which should be addressed for the perfection of the GAARs. The first issue is whether there is a practical distinction between tax evasion and avoidance? This is a question almost as old as tax itself, and an answer to it can be found in every tax textbook. However, it is not easy to answer it in Chinese practice. Decades ago, a general perception was held that tax evasion is characterized by a wilful misconduct and blatant violation of the tax liability and, therefore, illegal, whereas tax avoidance is legal because it is only the exploration of loopholes in national and international tax rules. This perception was popular among the tax authorities for some time. As a result, various tax avoidance schemes were created which attracted the attention of the government. The recent legislation uses the expression "taobi", which means both evasion and avoidance. The similar treatment of evasion and avoidance makes both of them illegal and any differentiation between them redundant. If no differentiation is made between acceptable and unacceptable tax avoidance, there will be no room for tax mitigation or planning. Should that be the case, the GAARs can only be a tool to strengthen the collection of tax, instead of a rule to strike a balance between revenue collection and the legitimate interests of taxpayers.

Second, the burden of proof in the application of the GAARs contributes to their effectiveness and should be designed with prudence. Many countries require taxpayers to prove that a transaction constitutes legitimate tax planning. For example, in the United States, the taxpayer has the burden of proving that a transaction has meaningful economic effect and a substantial non-tax purpose. This approach certainly facilitates the tax administrations’ ability to use a GAAR to counter tax avoidance arrangements. On the other hand, some countries have adopted a different more taxpayer-friendly attitude. For instance, in Canada, the burden of proving the abusive nature of a transaction is imposed on the tax authorities. The Canadian experience illustrates that the imposition of an unreasonable burden of proof on the government may effectively limit the potential application of a GAAR.

The burden of proof in China is imposed on taxpayers. As illustrated by international experience, the allocation of the burden of proof is just a policy issue and cannot be said to be right or wrong, good or bad. In view of the fact that the Chinese taxpayers are in a comparatively weak position and there are no effective remedies available, the burden of proof undoubtedly aggravates the position of Chinese taxpayers.

Third, the interaction between GAARs and special anti-avoidance rules (SAARs) should be clarified, i.e. whether the application of the SAARs will preclude the operation of the GAARs. The SAARs are rules designed to target particular types of transactions. In comparison with the general and vague language of the GAARs, the SAARs provide more certainty. The issue is whether the general and broad GAARs can apply to a transaction which is the subject matter of a SAAR. In other words, should the GAARs be used as a second step in the assessment of whether a taxpayer’s conduct is abusive? There are various responses to this question. Generally, if the GAARs are considered to be in a similar position to a SAAR, it can be concluded that they are targeting different groups of transactions and there should be no overlap. If the GAARs are designed as a catch-all provision to counter all kinds of unexpected or unspecified situations, they may still apply even though the taxpayer complies with the SAAR. The relationship between the GAARs and the SAARs remains unclear in China.

According to article 47 of the EITL, the GAARs should not apply to arrangements, such as thin capitalization, controlled foreign companies and transfer pricing (which are the targets of the SAARs). Article 47 of the EITL states explicitly that it only addresses arrangements other than specific transactions regulated by the preceding articles. As pointed out by the Canadian government, the SAARs “close the barn door only after the horse has bolted” and generally do not apply to transactions carried out before the rules are announced. This may make it possible for some types of abusive conduct to fall outside the SAARs’ scope. Considering the purpose of the GAARs and the SAT’s position, it may be assumed that the Chinese tax authorities will employ the GAARs as a second step to crack down on arrangements designed to circumvent the SAARs. This may contradict the spirit of article 47 of the EITL. Amendments should be made to the present law to establish a clear basis for the interaction between the GAARs and SAARs, which the tax authorities should follow.

19. Art. 103 Draft Amendment to the Law on Tax Collection and Management. Previously, the concept of “toushui” (tax theft) was used. To be in line with the international norms, this term has been replaced by “taobi”, which means both evasion and avoidance.
22. Sulami, supra n. 17.
23. According to article 96 of the Special Adjustment, tax authorities conducting a general anti-avoidance investigation may request the designers of the scheme to provide all the relevant materials and supporting evidence.
6. Conclusions

Having been in operation for over six years in China, the GAARs have played a significant role in countering various abusive schemes. Nevertheless, both the tax administration and taxpayers still face many challenges regarding their application. To make the Chinese GAARs function more effectively, a holistic approach is necessary to properly address issues discussed in this article. These are: certainty as to the scope of application of the GAARs, the elimination of, or the limitation on, their retrospective effect, an improvement of the efficiency of the dispute settlement mechanisms, a more active role taken by the judiciary in dispute settlement, the relationship between the GAARs and the SAARs and the burden of proof as regards tax avoidance. A good tax law should work as a tool, not only to raise revenue but also to maintain a balance between revenue collection and the protection of taxpayers’ legitimate rights.
Base Erosion and Profit Shifting – An Action Plan for Developing Countries

In this article, the author discusses the importance of the Base Erosion and Profit Shifting (BEPS) Action Plan for developing countries and the benefits that those countries may realize by participating in the BEPS discussions.

1. Introduction

Governments in the G20 and OECD have launched an international action plan to combat international tax planning structures used by multinationals to pay very little tax globally. This action plan is a response to public demands that politicians do something about the perceived inequity between multinationals that are able to pay very little tax and domestic enterprises that pay their taxes, as well as the disconnection between where multinationals do their business and where they pay their taxes.

The action plan released by the OECD in July 2013 (the “BEPS Action Plan”) contained 15 action points aimed at addressing base erosion and profit shifting (BEPS) concerns by:

- establishing international coherence of corporate income tax systems;
- restoring the full effects and benefits of international standards;
- ensuring transparency while promoting increased certainty and predictability; and
- establishing a multilateral instrument to implement the responses to BEPS swiftly.

The BEPS Action Plan noted the importance of developing countries, as they may face BEPS issues differently. Various mechanisms are being put in place to consider the specific BEPS concerns of developing countries and to explore possible solutions with all stakeholders. Although these efforts will no doubt become clearer in the coming months, so that developing countries may be integrated into the BEPS discussion, it is obvious that the current BEPS Action Plan does not reflect properly the interests of developing countries. It is in this context that this paper examines the BEPS Action Plan from the developing countries’ perspective.

2. Action 1 – Modifying the Residence-Based International Taxation System

The BEPS Action Plan contains an implicit admission that the residence-based international tax model has not been working properly in a number of areas. In particular, Action 1 identifies the difficulties of applying current international tax rules to digital economy, and Action 7 calls for an update of the definition of permanent establishment to prevent abuses. These actions stem from the ability of multinationals to carry out substantial activities in one country and legally pay no tax in that country, or anywhere.

Current international tax standards facilitate non-taxation of multinationals because they are largely residence-based – i.e. profits of multinationals are taxable exclusively in the residence state, unless there is a substantial presence (based on the notion of permanent establishment) in the states in which the multinationals operate. The source states’ ability to impose withholding taxes on interest and royalties paid to the foreign owners of capital and intangibles is often limited or prohibited by tax treaties based on the residence model. In addition, the presumption of national sovereignty in the design of tax systems means that many countries are able to lower their taxes, in particular on corporate headquarters activities, to attract multinationals to locate their “residence” there. The public breakdown of this system is clearly illustrated by discussions around US-based multinationals, such as Amazon, Starbucks, Google, Apple and Microsoft, where these companies are paying very little taxes in the countries where they conduct their businesses, as well as in the United States. Some of these multinationals are able to manage their businesses in such a way that avoids the

3. This principle is based on OECD Model Tax Convention on Income and on Capital art. 7 (22 July 2010), Models IBFD, which provides that “profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State.


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2. Id., at pp. 25-26.
definition of permanent establishments, so that very little

taxes are paid in the countries where they conduct their

business. Others are able to extract profits out of these
countries through royalties and interest payments and
be subject to low or zero withholding taxes. Since many
of these modern business activities are highly mobile, as
evident in the context of digital economy, multinationals
are able to locate their “residence” in low-tax jurisdictions
and thus pay little to no tax in their home countries as well.

To address these concerns, OECD/G20 countries intend to
rethink the residence-based model, which presumes exclu-
sive taxation in the residence state, at least in the context
of digital economy. In addition, the definitions of permanent
establishment are being re-examined to prevent abuses.
Developing countries ought to participate in the discus-
sions in both of these areas to influence international stan-
dards away from the residence-based model and, prefer-
ably, to move them towards a consumption/source-based
model. The opportunity is there now for the developing
countries, as the public opinions in major OECD/G20
countries also demand a closer connection between where
multinationals conduct their business and where they pay
their taxes.

3. Action 2 – Updating the Arm’s Length

Principle

The BEPS Action Plan contains three actions on the recon-
siderations of the arm’s length principle as a method for
allocating income earned by multinationals among coun-
tries in which the multinationals do business.7 In broad
terms, these actions recognize that the arm’s length prin-
ciple can be misapplied to separate income from the eco-
nomic activities that produce it and to shift the income
into low-tax environments. The focus of this work is on
the transfers of intangibles and other mobile assets for less
than full value, the over-capitalization of lowly taxed group
companies and contractual allocations of risk to low-tax
environments in transactions that would be unlikely to
occur between independent parties.

The substantive work on intangibles has largely been
carried out and released for public consultation in July
2013.8 The main idea behind this work is that important
functions leading to value creation should be rewarded
under the arm’s length principle. The important func-
tions include, among others, design and control of research
and marketing programmes, management and control of
budgets, control over strategic decisions regarding intan-
gible development programmes, important decisions
regarding defence and protection of intangibles, and
ongoing quality control over functions performed by inde-
pendent or associated enterprises that may have a material
effect on the value of the intangibles.

Further work in the BEPS Action Plan is likely to elab-
orate on this basic principle that transfer pricing out-
comes should be in line with value creation. The align-
ment of the arm’s length principle to reflect value creation
has important implications for the tax base of developing
countries. It is crucial for developing countries, through
the participation in OECD/G20 work, to ensure that the
value creation functions include the market facing factors.
Efforts to recognize and incorporate market facing factors
in the allocation of income of multinationals have, to a

certain extent, been led by countries such as India and
China. To date, such discussions often appear in the guise
of “marketing intangibles” or “location savings” and are
likely to continue until OECD/G20 countries recognize
the link between market facing factors and value creation,
and reward these factors appropriately under the arm’s
length principle.9

The work to date on the application of the arm’s length
principle to intangibles has stressed that a legal owner of
intangibles not performing important functions associated
with the intangibles does not need to be compensated for
intangible-related returns. Furthermore, the BEPS Action
Plan recognizes that relying on the arm’s length principle
alone may not be sufficient to address all the BEPS con-
cerns. Special measures may be proposed:

- for transfers of hard to value intangibles;
- to ensure that inappropriate returns will not accrue to
  an entity solely because it has contractually assumed
  risks or provided capital;
- to clarify the circumstances in which transactions can
  be re-characterized;
- to provide protection against common types of base
  eroding payments, such as management fees and head
  office expenses.

The OECD/G20 work in this area should also benefit
developing countries, as they may use the special mea-
sures to prevent BEPS involving low-tax environments.
However, the appropriateness of such special measures for
developing countries ought to be considered in the context
of other domestic anti-avoidance measures that develop-
ing countries have adopted.

4. Action 3 – Improving Domestic

Anti-Avoidance Rules

4.1. Introductory remarks

The BEPS Action Plan contains a number of actions to
establish international coherence of corporate income
taxation systems. These actions focus on the develop-
ment and refinement of four potential domestic anti-
avoidance rules; namely, the controlled foreign companies
(CFC) regimes, limitation rules for interest deductions and
other financial payments, anti-tax haven regimes and anti-
hybrid mismatch rules. The development of these anti-
avoidance rules is clearly relevant for both developed
countries and developing countries. However, developing
countries may need to consider these anti-avoidance rules

7. BEPS Action Plan, supra n. 1, Actions 8, 9 and 10.
8. See OECD, Revised Discussion Draft on Transfer Pricing Aspects of
Intangibles (OECD 2013), available at http://www.oecd.org/ctp/transfer-
pricing/revised-discussion-draft-intangibles.pdf.
Pricing for Developing Countries, 19 Asia-Pac. Tax Bull. 1 (2013), Journals
IBFD.
from a different perspective, based on the unique features of their economic environment and existing tax systems.

4.2. CFC rules

CFC rules are used by developed countries to tax multinationals based in their countries on income accrued in foreign subsidiaries. These rules are intended as anti-deferral or anti-abuse in nature, as they are designed to tax income of foreign subsidiaries prior to distributions to parent companies located in developed countries. Even though many developing countries do have CFC rules under their domestic tax law, the role of CFC rules is not the same for these countries, as they often do not have many home-grown multinationals. In addition, to the extent that deferral or base erosion is a concern for developing countries, the application of withholding taxes on payments to non-residents or non-deductibility of certain payments (e.g. those made to entities in low-tax environments) often offers a simpler and more effective anti-abuse mechanism.

OECD/G20 countries are re-examining CFC rules because they often fail to tax income of foreign subsidiaries when, arguably, they should. These shortcomings are caused by special exceptions adopted by OECD/G20 countries to improve competitiveness of their multinationals. As part of the review of CFC rules, OECD/G20 countries will have to remove the special exceptions that allow their multinationals to route home country income to foreign subsidiaries, while, at the same time, maintain the competitiveness of their multinationals.

The BEPS Action Plan states explicitly that:

While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have positive spillover effects in the source countries because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction.

Such improvements of CFC rules in developed countries would obviously be important for developing countries, as they help reduce the incentive for BEPS in the source countries. Nevertheless, there is no obvious impetus for the OECD/G20 countries to amend their CFC rules in such a way.

Many countries, such as the United States, have adopted CFC rules that are designed to protect their own tax base. To the extent that their CFC rules have been circumvented at the expense of the US tax base, the United States is likely to try to close the loopholes. It is less clear whether the United States (and other OECD/G20 countries) will amend their CFC rules to prevent BEPS in developing countries. An example where such a debate may occur is the “look-through” exception used in US and many countries’ CFC rules for royalty and interest paid from a CFC to another CFC, provided that the payments come from an underlying active business. Such payments clearly have the ability to erode the tax base of many developing countries, but they are currently carved out of CFC rules in many developed countries, such as the United States, due to competitiveness considerations for their multinationals.

OECD/G20 countries have to appreciate that the spill-over effects claimed in the BEPS Action Plan would be realized only when CFC rules in their countries are amended to remove the existing incentive for multinationals to shift profits from the source/developing countries. At the same time, developing countries have to influence this policy discussion by asserting international pressures on OECD/G20 countries. One possible approach is to link such efforts with international cooperation, where currently the scale of cost-benefit is typically tipped in favour of developed countries.

4.3. Limitation rules for interest and related financial payments

In Action 4 of the BEPS Action Plan, OECD/G20 countries will develop recommendations concerning the design of rules to prevent base erosion through the use of interest expense and other financial payments, such as financial and performance guarantees, derivatives, and captive and other insurance arrangements. This work is likely to involve developing special measures to deal with thin capitalization (i.e. where excessive debt is used to finance subsidiaries in high-tax environment), as well as “fat capitalization” problems (i.e. where interest is deductible against domestic profits in the high-tax environment, while equity is used to finance tax-exempt foreign operations). In addition, it is envisaged that the OECD Transfer Pricing Guidelines will be updated to clarify how the arm’s length principle may be used to support these special measures.

While OECD/G20 recommendations on the design of limitation rules for interest and financial payments are potentially useful for developing countries, such rules are already relatively well-known in practice. From the developing countries’ perspective, it is important to recognize that such limitation rules often set the limit for “acceptable” base erosion. For example, if an interest limitation rule uses a threshold of 3 to 1 based on debt to equity ratio, then it is signalling to multinationals that base erosion up to that limit is considered acceptable. In contrast, some developing countries already rely on withholding taxes to limit the extent of base erosion through interest and related financial payments. This mechanism is clearly a simpler and more effective countermeasure for BEPS in developing countries, although the adverse impact of such withholding taxes on cost of capital also has to be consid-

13. BEPS Action Plan, supra n. 1, at p. 16 (Action 3).
15. See A Comparative Study of the Thin Capitalization Rules in the Member States of the European Union and Certain Other States, 45 Eur. Taxn. 9 (2005), Journals IBFD.
ered. For developing countries, an approach could be to reduce these withholding taxes progressively through tax treaties that are carefully negotiated. As such, developing countries need to assess the appropriateness of any limitation rules on interest and related financial payments in the context of their withholding tax and tax treaty policies.

4.4. Anti-tax haven regimes

The role that preferential tax regimes and tax havens play in BEPS has been relatively well documented since the OECD launched its attack on harmful tax practices in 1998. The BEPS Action Plan shifts the debate on preferential tax regimes by recognizing that, increasingly, preferential tax regimes have taken on the form of low corporate tax rates on particular types of income, such as income from financial activities and intangibles. Thus, in contrast with the harmful tax project in 1998, this action is unlikely to target low taxation and ring-fencing per se. Instead, the focus is expected to be on spontaneous exchange of information of rulings related to preferential regimes and the substance requirements of such regimes.

The starting point of the OECD/G20 countries in the BEPS Action Plan appears to be that low or even zero taxation regimes could be acceptable if the regimes are available only to companies that meet certain substance requirements and countries offering these regimes are prepared to exchange rulings issued under their regimes. Developing countries (including traditional tax haven jurisdictions) wishing to compete for business activities of multinationals would be wise to take note of, if not actively participate in, influencing these discussions.

For the moment, it is not clear what kind of preferential regimes will be targeted although the BEPS Action Plan signals that “it will take a holistic approach to evaluate preferential tax regimes in the BEPS context”. It is also not clear what will be considered substantial activities for different types of preferential regimes. As many developing countries do promote investments in their countries by offering special tax incentives and preferential tax regimes, this is an area where their interest needs to be represented. At the very least, from the developing countries’ perspective, it would be necessary to exclude from the BEPS Action Plan preferential tax regimes offered through special economic zones, where such regimes are typically conditional on substantial economic activities.

Many OECD/G20 countries have argued that spontaneous exchanges of rulings related to preferential regimes that have BEPS implications for their countries is a compulsory obligation under bilateral tax treaties. When this approach becomes the generally accepted international practice, developing countries could benefit equally from the sharing of rulings issued by their treaty partners. On another level, however, it is questionable whether developing countries have the ability and resources to handle and pursue potential BEPS caused by such preferential regimes. As such, developing countries cannot rely solely on spontaneous exchange of information to address BEPS concerns related to harmful preferential regimes. Other domestic anti-avoidance measures, such as the application of withholding taxes on, or non-deductibility of, payments to entities in jurisdictions on a “blacklist” could be simpler and more effective.

4.5. Anti-hybrid mismatch rules

Action 2 of the OECD/G20 Action Plan calls on countries to develop recommendations on domestic and treaty rules to neutralize the effects of hybrid mismatch arrangements involving hybrid instruments and hybrid entities. These arrangements exist primarily because of inconsistencies in the way domestic law of different countries classify financial instruments and entities. It is unlikely that OECD/G20 countries will be able to coordinate domestic law definitions under this action. Instead, the action may include domestic law changes that neutralize the tax benefits of hybrid mismatch arrangements, as well as changes to the OECD Model (2010) to ensure that hybrid instruments and entities (and dual resident entities) are not used to obtain treaty benefits unduly.

Hybrid mismatch arrangements have the same BEPS consequences for developing countries, as they do for developed countries. Nevertheless, the commercial benefits of some hybrid financial instruments and entities and the flexibility that they offer as investment vehicles into developing countries have not been explored sufficiently. The OECD/G20 work to date has targeted hybrid arrangements that are inherently fictitious with no commercial substance. While such hybrid arrangements may not be too complicated to identify in developed markets represented by the OECD/G20 countries, a similar exercise may be more complicated for relatively under-developed markets in developing countries. To the extent that hybrids have been used to lower cost of capital for risky investments into developing countries, the policy decision to neutralize the benefits of such hybrids could have adverse consequences for investments into developing countries.

Anti-hybrid mismatch rules in the OECD/G20 countries also could have the effects of neutralizing some specific tax incentives that developing countries may provide under their domestic law. For example, Brazil offers investors a deduction on their net equity under its domestic tax law. This specific rule allows companies to invest into Brazil using equity, and, at the same time, to obtain tax deductions in Brazil for certain payments that the investors will receive. Anti-hybrid mismatch rules which tax such payments in the hands of the investors would negate any intended tax benefits offered by Brazil.

5. Action 4 – Establishing a Coherent Tax Treaty Policy

Action 6 of the OECD/G20 Action Plan aims to assist countries to develop domestic and tax treaty rules to prevent the granting of treaty benefits in inappropriate circumstances. This work is not new. The Commentary on Article 1 of the OECD Model (2010)\(^\text{19}\) already includes a number of examples of anti-abuse provisions that could be used to address treaty shopping and treaty abuse situations. These options are, however, rarely used in practice and more efforts are needed to promote their use in tax treaties.\(^\text{20}\)

The BEPS risk of tax treaties has come to the fore lately with Mongolia cancelling four of its high-profile treaties following the IMF recommendations to renegotiate these treaties.\(^\text{21}\) While tax treaties promote investments, they also come at a cost as they typically limit source state withholding taxes or prohibit source state taxation of certain types of income. These costs are not often highlighted by developed countries when they negotiate tax treaties with developing countries, assuming that the developing countries are able to take into account such costs. Until OECD/G20 countries are more transparent about the costs of tax treaties, inserting more treaty anti-abuse rules will not solve the inherent mistrust in tax treaties that is becoming more and more apparent.\(^\text{22}\)

Once developing countries understand better both the benefits and the costs of tax treaties, and are able to negotiate their treaties taking into account the full picture, including making use of treaty anti-abuse rules where appropriate, then tax treaties have a chance to function properly. It is only then that cancellation of tax treaties as a reaction to their real costs might become a thing of the past. If treaties have not been negotiated in good faith, there is little chance that they can be interpreted and applied in good faith. Thus, to be successful in achieving Action 14 of the BEPS Action Plan to make the treaty dispute resolution mechanism more effective, OECD/G20 countries need to provide more assistance to developing countries when negotiating tax treaties. Until developing countries fully understand the treaties they enter into, it is difficult to persuade them to resolve treaty disputes speedily and have them commit to arbitration as a dispute resolution process. Developing countries will simply continue to use a dispute resolution process as a tool to frustrate what they perceive as unintended treaty outcomes.

Action 15 of the BEPS Action Plan calls for a multilateral instrument to enable jurisdictions to implement the BEPS measures swiftly, without having to renegotiate their bilateral treaties. OECD/G20 countries need to do more to reflect the interests of developing countries in this multilateral instrument. Even if this can be done, since the multilateral instrument is likely to require trade-offs between costs and benefits, developing countries would be well advised to be wary of such an instrument. It is difficult enough for developing countries to assess the costs and benefits of a tax treaty on a bilateral basis, let alone in the context of a multilateral instrument that is open for every country wishing and willing to sign.

6. Action 5 – Embracing International Cooperation

Progress on transparency and exchange of information has been made by the Global Forum on Transparency and Exchange of Information for Tax Purposes. OECD has also announced separately that automatic exchange of information will replace exchange of information on request as the international standards going forward.\(^\text{23}\) The importance of transparency and exchange of information in preventing BEPS has been reinforced again in the BEPS Action Plan. Although developing countries may be the beneficiaries of this initiative, in practice, they are more likely to be called upon to use their scarce resources to assist tax collection in developed countries.

As discussed previously, developing countries ought to examine a number of the actions in BEPS Action Plan in the context of international cooperation. Developed countries need to be reminded of the inherent imbalance in efforts to establish transparency and exchange of information and be encouraged, for example, to adopt CFC rules that, at the very least, do not facilitate BEPS in developing countries and to spontaneously exchange rulings that concern BEPS in developing countries. In addition, two specific actions in the BEPS Action Plan have the potential to further redress this imbalance.

In Action 12, the OECD/G20 countries propose to develop recommendations regarding the design of mandatory disclosure rules that require taxpayers to disclose their aggressive tax planning schemes. Such mandatory disclosure rules have been used in many developed countries to assist tax administrations to obtain timely, targeted and comprehensive information for the early detection of aggressive tax planning techniques.\(^\text{24}\) Action 13 of the BEPS Action Plan contains a similar call to re-examine transfer pricing documentation prepared by multinationals, with a view to enhancing transparency for tax administrations in all the countries in which they operate. The OECD has issued a White Paper on Transfer Pricing Documentation\(^\text{25}\) following the BEPS Action Plan. The White Paper makes suggestions as to how transfer pricing documentation rules

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19. OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 (22 July 2010), Models IBFD.
22. The Netherlands appears to be taking the first step towards this approach, see (in Dutch) www.rijksoverheid.nl/ministeries/ln/nieuws/2013/08/30/kabinet-pakt-internationale-belastingontwijking-aan.html.
might be modified to make transfer pricing compliance simpler and more straightforward, while, at the same time, providing tax authorities with more focused and useful information for consideration in connection with transfer pricing risk assessment and transfer pricing audits. In particular, the White Paper suggests a two-tiered approach through which both the “big picture” information is made available for risk assessment purposes and detailed information on the related party transactions can be required when the arm’s length character of specific transactions needs to be assessed.

From the developing countries’ perspective, it is important to recognize that disclosure and transfer pricing documentation rules can be compliance-cost-intensive for their taxpayers and resource intensive for tax administrations. Developing countries would need to weigh these factors carefully when considering whether to adopt any of the recommendations proposed by OECD/G20 under these actions. Even when developing countries do not consider it appropriate to have such disclosure and documentation rules in their domestic law, aggressive tax structures as well as big-picture information uncovered by OECD/G20 countries under disclosure and documentation rules they impose on their taxpayers may be relevant for developing countries. Such information ought to be made available to treaty partners through spontaneous exchange of information.

7. Conclusions
OECD/G20 countries need the cooperation of developing countries to establish new international standards in areas covered by the BEPS Action Plan. Developing countries also have much to gain from active participation in this action plan, as many of the actions in the BEPS Action Plan will also help developing countries secure their tax base.

In summary, the BEPS Action Plan offers developing countries an opportunity to:
– influence the development of source-based international standards for digital economy and permanent establishments;
– argue that the arm’s length principle ought to recognize the values created by market-based factors and remunerate them adequately;
– participate in the design of CFC rules in developed countries to ensure that they do not encourage BEPS in source countries;
– develop their own anti-avoidance rules such as limitation rules for interest and related financial payments, anti-tax haven rules and anti-hybrid mismatch rules, taking into account international developments and their own economic environment;
– encourage developed countries to take into account the full costs and benefits of tax treaties in their negotiations with developing countries and to address explicitly the role of tax treaties in facilitating BEPS in developing countries; and
– embrace international cooperation while adding to this agenda their own requirements, such as spontaneous exchanges of rulings, information on aggressive tax schemes and transfer pricing documentation that may help prevent BEPS in developing countries.

These actions for developing countries recognize that developing countries’ interest may diverge from that of the G20/OECD economies. In such areas, for example, in addressing taxation of digital economy, the definition of permanent establishment and arm’s length standards, developing countries need a coordinated voice to promote source-based international standards. There are also areas of the BEPS Action Plan, for example, in the design of domestic anti-avoidance rules, where developing countries may not wish to follow G20/OECD countries because of the unique features of their economic environment. Finally, it is also time for developing countries to balance the scale of international cooperation agenda by putting in requests of their own. OECD/G20 countries need to be prepared to provide support and information that will help developing countries collect taxes if they want exchange of information and assistance in return.

26. For further information, see http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-documentation.htm.
India Aims To Reduce Transfer Pricing Disputes through Safe Harbour Rules

In this article, the author describes and evaluates the Indian safe harbour rules, which were introduced with the aim of reducing transfer pricing disputes.

1. Introduction
Alarmed at the trend in increasing transfer pricing litigation since the introduction of transfer pricing provisions in the Income Tax Act (ITA) 1961, which both impacts the collection of tax revenue and creates a negative impression in the minds of taxpayers and foreign investors, the Indian government has recently notified safe harbour rules, as a speedy, simple and less adversarial alternative route for concluding transfer pricing assessments. This article aims to describe the features of the Indian safe harbour provisions, their lacunae (which could also be regarded as suggestions for improvement) and the options available for taxpayers involved in transfer pricing transactions.

2. Legislative Background
The Indian safe harbour rules were enacted by the Central Board of Direct Taxes (CBDT), the top tier agency for administration of direct tax law, pursuant to section 92CB of the ITA 1961. Section 92CB provides that the safe harbour rules should prevail over the normal transfer pricing assessment based on the arm’s length principle (ALP), referred to in sections 92, 92C and 92CA. It is noteworthy that, while the transfer pricing provisions were inserted in the ITA 1961 by the Finance Act 2001 as sections 92 to 92F (Chapter X) with effect from 1 April 2002, section 92CB was inserted by the Finance Act 2009 with effect from 1 April 2009, and the safe harbour rules were notified four years later.

Safe harbour rules were based on six reports submitted by a four-member committee headed by Mr N. Rangachary (a former chairman of the CBDT) between September 2012 and April 2013. Those reports recommended safe harbour criteria for six specified sectors (due to a paucity of data for other sectors):
- information technology (IT);
- IT-enabled services (ITES);
- contract research and development (R&D) in the IT and pharmaceutical sectors;
- financial transactions (outbound loans and corporate guarantees);
- automotive ancillaries (original equipment manufacturers).

On 14 August 2013, the government announced draft safe harbour rules and invited comments from all stakeholders by 26 August 2013. On 18 September 2013, after considering the received comments, the government notified the Income Tax (16th Amendment) Rules 2013, which insert Rules 10TA to 10TG dealing with safe harbour provisions in the Income Tax Rules (ITR) 1962.

Table 1: Number of cases involving transfer pricing adjustments

<table>
<thead>
<tr>
<th>Financial year</th>
<th>Number of transfer pricing audits completed</th>
<th>Number of adjustment cases</th>
<th>Percentage of adjustment cases</th>
<th>Amount of adjustment (in INR Cr) (1 Cr = 10 million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004-05</td>
<td>1,061</td>
<td>239</td>
<td>23%</td>
<td>1,220</td>
</tr>
<tr>
<td>2005-05</td>
<td>1,501</td>
<td>337</td>
<td>22%</td>
<td>2,287</td>
</tr>
<tr>
<td>2006-07</td>
<td>1,768</td>
<td>471</td>
<td>27%</td>
<td>3,432</td>
</tr>
<tr>
<td>2007-08</td>
<td>218</td>
<td>84</td>
<td>39%</td>
<td>1,614</td>
</tr>
<tr>
<td>2008-09</td>
<td>1,726</td>
<td>670</td>
<td>39%</td>
<td>6,140</td>
</tr>
<tr>
<td>2009-10</td>
<td>1,830</td>
<td>813</td>
<td>44%</td>
<td>10,908</td>
</tr>
<tr>
<td>2010-11</td>
<td>2,301</td>
<td>1,138</td>
<td>49%</td>
<td>23,237</td>
</tr>
<tr>
<td>2011-12</td>
<td>2,638</td>
<td>1,343</td>
<td>51%</td>
<td>44,531</td>
</tr>
<tr>
<td>2012-13</td>
<td>3,200</td>
<td>1,600</td>
<td>50%</td>
<td>70,016</td>
</tr>
<tr>
<td>Total</td>
<td>16,243</td>
<td>6,695</td>
<td>41%</td>
<td>163,385</td>
</tr>
</tbody>
</table>

USD (INR 60 = USD 1) USD 27.23 billion

Source: Ministry of Finance, Department of Revenue

* FCA, FCS, BGL, B.Com. and CFO, Company Secretary and Legal Head of Smariplay Technologies (India) Pvt. Ltd, Bangalore, India. The author can be contacted at krishnamurthyvijay@hotmail.com.

3. Features of the Indian Safe Harbours

Under the safe harbour rules, if the taxpayer’s international transactions with its associated enterprises comply with specified predetermined criteria, the actual transfer prices used in those transactions will be accepted by the tax authorities without determining the ALP of those transactions, which is usually tedious, complex, skewed and adversarial. The safe harbour methodology prescribed under section 92CB of the I.T.A. 1961 is a deviation from the ALP principle and has statutory authorization to prevail over the ALP-based assessment methodology contained in sections 92C and 92CA. However, if the taxpayer does not qualify or decides to opt out of the safe harbour option under section 92CB, the transfer pricing assessment is completed under sections 92C and 92CA.

The safe harbour rules are available for a period of five years starting from the assessment year 2013-2014. The taxpayer has the choice of applying for the safe harbour for all five years or one year at a time. The taxpayer has to make this election by filing Form 3CEFA before filing the income tax return for a particular assessment year. A taxpayer can also opt out of the safe harbour for any assessment year by filing a statement (no format prescribed) to that effect.

The taxpayer can avail himself of the safe harbour only if he is an eligible assessee and can only do so in respect of eligible transactions. The terms ‘eligible assessee’ and ‘eligible transactions’ are elaborately defined in the ITR 1962 (Rule 10TA, 10TB and 10TC). To exercise the safe harbour option, there has to be an eligible transaction between the eligible assessee in India and its associated enterprise (also referred to as foreign principal), either or both of whom are non-residents. There is an overlap between the definitions of eligible assessee and eligible transactions, but, effectively, the following categories of taxpayers and transactions are eligible to apply for application of the safe harbour rules:

- a taxpayer who is engaged in providing software development services, IT-enabled services or knowledge processing outsourcing services, with insignificant risk, to a non-resident associated enterprise;
- a taxpayer who is engaged in providing contract research and development services with insignificant risk to its foreign principal, wholly or partly relating to:
  - software development; or
  - generic pharmaceutical drugs.
- a taxpayer who has given an intra-group loan to a wholly owned subsidiary which is a non-resident if:
  - the loan is sourced in Indian rupees; and
  - the taxpayer is not engaged in any financial services business involving lending or borrowing; and
  - the loan has a fixed repayment period;
- a taxpayer who has extended an explicit corporate guarantee (excluding letters of comfort and other similar guarantees) to its wholly owned subsidiary which is a non-resident in respect of any short or long-term borrowing;
- a taxpayer who is engaged in the manufacture and export of core or non-core automotive components, provided more than 90% of the total annual turnover is derived from original equipment manufacturer sales;

<table>
<thead>
<tr>
<th>Number</th>
<th>Eligible international transaction</th>
<th>Safe harbour</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Provision of software development services with insignificant risk up to INR 5 billion (USD 82 million) in the previous year</td>
<td>Operating profit = no less than 20% of operating expenses</td>
</tr>
<tr>
<td>2</td>
<td>Provision of software development services with insignificant risk exceeding INR 5 billion (USD 82 million) in the previous year</td>
<td>Operating profit = no less than 22% of operating expenses</td>
</tr>
<tr>
<td>3</td>
<td>Provision of IT-enabled services with insignificant risk up to INR 5 billion (USD 82 million) in the previous year</td>
<td>Operating profit = no less than 20% of operating expenses</td>
</tr>
<tr>
<td>4</td>
<td>Provision of information technology enabled services with insignificant risk exceeding INR 5 billion (USD 82 million) in the previous year</td>
<td>Operating profit = no less than 22% of operating expenses</td>
</tr>
<tr>
<td>5</td>
<td>Provision of knowledge processing outsourcing services</td>
<td>Operating profit = no less than 25% of operating expenses</td>
</tr>
<tr>
<td>6</td>
<td>Intra-group loans not exceeding INR 500 million (USD 8.2 million)</td>
<td>State Bank of India (SBI) base rate on 30 June of the applicable year plus 150 basis points</td>
</tr>
<tr>
<td>7</td>
<td>Intra-group loans exceeding INR 500 million (USD 8.2 million)</td>
<td>SBI base rate on 30 June of the applicable year plus 300 basis points</td>
</tr>
<tr>
<td>8</td>
<td>Provision of corporate guarantee not exceeding INR 1 billion (USD 16.4 million)</td>
<td>The commission fee may not be lower than 2% of the guarantee amount</td>
</tr>
<tr>
<td>9</td>
<td>Provision of corporate guarantee exceeding INR 1 billion (USD 16.4 million) and the credit rating of the associated enterprise by a registered credit rating agency is between adequate and the highest safety</td>
<td>The commission fee may not be lower than 1.75% of the guarantee amount</td>
</tr>
<tr>
<td>10</td>
<td>Provision of contract R&amp;D services wholly or partly relating to software development with insignificant risk</td>
<td>Operating profit = no less than 30% of operating expenses</td>
</tr>
<tr>
<td>11</td>
<td>Provision of contract research and development services wholly or partly relating to generic pharmaceutical drugs with insignificant risk</td>
<td>Operating profit = no less than 29% of operating expenses</td>
</tr>
<tr>
<td>12</td>
<td>Manufacture and export of core automotive components</td>
<td>Operating profit = no less than 27% of operating expenses</td>
</tr>
<tr>
<td>13</td>
<td>Manufacture and export of non-core automotive components</td>
<td>Operating profit = no less than 8.5% of operating expenses</td>
</tr>
</tbody>
</table>
The safe harbour rules require the taxpayer to determine transfer prices in such a manner that these generate the specified minimum income required to be taxed. In that situation, the tax authorities will accept the actual transfer prices so established and will not attempt to determine the ALP. However, if the determined transfer prices result in the actual margins being lower than the safe harbour margins, the taxpayer cannot claim the protection of safe harbour rules and must undergo the traditional ALP-based assessment.

The safe harbour margins/interest/commission fee prescribed in Rule 10TD for the specified eligible international transactions are presented in Table 2.

The safe harbours have been defined on the basis of the cost plus method, which is the operating profit (i.e. operating revenues minus operating costs) divided by operating costs. Operating revenues, costs and profits have been defined in the ITR 1962 (Rule 10TA) and essentially refer to the normal operating costs and revenues in respect of the specified international transactions of the eligible taxpayers. It is important to note that under the traditional ALP-based assessment, other methods, for example, comparable uncontrolled price or profit split, may be more appropriate.

Taxpayers assessed under safe harbour rules for any year have to maintain the same level of documentation for that year as that required under the traditional ALP-based assessment (Rule 10TD(5)). Despite the fact that several objections to this requirement were made when the draft rules were circulated for comment, the government has chosen to retain it, possibly to ensure continuity in the documentation over years, since the taxpayer is given the option of using the safe harbour for any year and opting out of the safe harbour for the subsequent year. It may also happen that the taxpayer loses its eligibility to use the safe harbours.

The procedural requirements for safe harbour provisions are laid down in Rule 10TE. The taxpayer can opt for the application of safe harbour rules by filing Form 3CEFA with the Assessing Officer (AO). In such event, the AO is required to either permit the use of the safe harbour or, in the case of doubt, refer the matter to the Transfer Pricing Officer (TPO) within two months from the end of the month in which the Form is received. The TPO may require the taxpayer to submit any information/evidence in order to decide whether the taxpayer is eligible for the safe harbour. His decision must be communicated to the taxpayer, with a copy to the AO, within two months from the end of the month in which the reference is received from the AO. The TPO may not deny the taxpayer’s eligibility for using the safe harbour without giving him an opportunity to be heard in person. If the taxpayer is aggrieved by the order of the TPO refusing the application for safe harbour, the taxpayer can object to the Commissioner (to whom the TPO is subordinate) within 15 days of receipt of the TPO’s order. The Commissioner is required to decide the case within two months from the end of the month in which the objection is received. If the AO does not make the reference, the TPO does not decide on the reference or the Commissioner does not decide on the objection within the prescribed time limit (i.e. within two months from the end of the month in which the form/reference/objection is received), the safe harbour will be deemed to be granted.

With regard to subsequent assessment years, if the AO thinks that there has been a change in the facts or circumstances relating to the eligibility of the taxpayer or the international transaction (for example, functional profile, contractual obligations, risks undertaken by the taxpayer in respect of the international transaction), he can make another reference to the TPO to decide on the eligibility of the taxpayer for the safe harbour and the above-mentioned time frames and consequences will apply in the same way.

If the taxpayer does not file Form 3CEFA for the safe harbour or if he is held to be ineligible (whether for the initial or any subsequent assessment year), the AO will complete the transfer pricing assessment under the provisions of sections 92C and 92CA of the IGA 1961 on the basis of the ALP without regard to the safe harbour provisions.

The safe harbour framework is not available in the case of an associated enterprise which is located in a no- or low-tax country (i.e. where the maximum tax rate is less than 15%) or with whom India does not have an information exchange agreement (Rule 10TF).

An important condition stipulated in Rule 10TG is that if the safe harbour option is used for any year, the taxpayer is not entitled to invoke the mutual agreement procedure under any tax treaty for double taxation that occurs for that year. The Indian government’s position seems to be that high location savings accrue to units operating in India which is consequently reflected in the high safe harbour margins. If double taxation arises due to the application of another country’s tax rates, India should not give credit to alleviate such double taxation.

4. Evaluation of the Safe Harbour Option

Before deciding whether to avail himself of any of the safe harbours, the taxpayer should evaluate:

- how his actual margins compare to the prescribed safe harbour margins;
- whether the documentation maintained by the taxpayer is detailed and extensive enough to justify the actual transfer prices if the actual margins are substantially lower than the safe harbour margins; and
- whether, notwithstanding that the actual margins are substantially lower than the safe harbour margins, his transfer prices should be aligned to safe harbour margins in order to take advantage of the simpler, quicker, more predictable and less adversarial safe harbour assessment (section 92CB) as opposed to the complex and uncertain traditional assessment (sections 92, 92C and 92CA).
Table 3: Characteristics of transfer pricing assessment under different methods

<table>
<thead>
<tr>
<th>Features</th>
<th>Safe harbour-based assessment (section 92CB)</th>
<th>Advance pricing agreement (APA)-based assessment (sections 92CC and 92 CD)</th>
<th>ALP-based assessment (sections 92, 92C and 92CA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Timeframe</td>
<td>Financial year or longer</td>
<td>Five prospective financial years</td>
<td>Financial year</td>
</tr>
<tr>
<td>2 Applicability</td>
<td>Certain categories of taxpayers and transactions</td>
<td>Taxpayers that have concluded the APA</td>
<td>All taxpayers who have not opted for safe harbour or APA-based assessment</td>
</tr>
<tr>
<td>3 Transfer prices</td>
<td>Higher than normal in order to achieve threshold margins</td>
<td>Lower than under safe harbours, based on the taxpayer’s documentation</td>
<td>Higher than under APAs or safe harbours, largely depending on the tax authorities, who usually decide in a pro-revenue manner</td>
</tr>
<tr>
<td>4 Complexity</td>
<td>Least complex since the tax authorities accept transfer prices set by the taxpayer if the safe harbour margins are achieved</td>
<td>Complex during the APA negotiation and simple thereafter</td>
<td>Maximum complexity since the tax authorities determine the ALP for each year (high litigation risk)</td>
</tr>
<tr>
<td>5 Certainty</td>
<td>Very high since any transfer price that achieves the safe harbour will be accepted by the tax authorities</td>
<td>Very high once the APA is negotiated and executed</td>
<td>Very low since transfer prices will be scrutinized each year</td>
</tr>
<tr>
<td>6 Costs</td>
<td>Lowest administrative cost. Higher tax payments due to high safe harbour parameters. Double taxation is likely to arise due to the unilateral nature of India’s safe harbours.</td>
<td>High administrative costs of concluding the APA, which can be spread over the term of the APA. Lower tax payments can be negotiated based on supporting documentation. Double taxation can be avoided if bilateral APAs are negotiated between the competent authorities of two countries.</td>
<td>Administrative and tax costs are uncertain, depending on whether a tax assessment is disputed and on the outcome of the litigation. Theoretically, MAP proceedings are available to deal with any double taxation that arises but, in practice, this can be a very lengthy procedure.</td>
</tr>
</tbody>
</table>

5. Alternative Methods for Determination and Verification of Transfer Prices

Apart from evaluating safe harbour rules, taxpayers should also evaluate other methods for the determination and verification of transfer prices. Table 3 summarizes the features of each of these different methods.

6. Opportunity for Tax Planning Using Safe Harbours

If the taxpayer’s operating margin is above the prescribed safe harbour rules, the taxpayer can increase payments to overseas associated enterprises by way of royalties, technical know-how fees and contributions under cost sharing agreements, and these payments will not be questioned by the tax authorities, as long as the safe harbour margins are achieved.

7. Suggestions for Improvement

If the taxpayer’s margins are below the safe harbour thresholds, the taxpayer should be given the option of utilizing the safe harbours and remitting the difference in the tax payable. For example, if the safe harbour is 25% and the taxpayer’s actual margins are 22%, the taxpayer should be given the option of paying tax on an additional 3% margin and using the safe harbour instead of being disqualified for safe harbour and subjected to the complex and traditional ALP-based assessment. A compensatory adjustment mechanism, at the option of the taxpayer, should be a part of the safe harbour rules.

The safe harbour framework should have been made applicable from the introduction of the transfer pricing provisions (i.e. assessment year 2002-2003) rather than for an initial five-year period commencing from assessment year 2013-2014. This would have provided the taxpayers with an option of settling outstanding tax disputes for prior years by means of paying the tax based on the safe harbour margins. Since the government is willing to accept the tax payment based on safe harbour rules from assessment year 2013-2014 onwards, there should be no reason why it should not extend this facility to earlier years. Not only would this be regarded as a taxpayer-friendly measure but it would also reduce the number of litigated cases and increase the tax revenue. For this purpose, section 92CB of the ITA 1962, which authorizes the safe harbour rules and which came into effect on 1 April 2009, would need to be amended accordingly.

The ITR 1962 deny access to mutual agreement procedures (MAP) for taxpayers who avail themselves of the safe harbour rules. However, due to the unilateral nature of the Indian safe harbour rules, which have been framed without consultation or coordination with any of its major trading partners, double taxation can occur in several situations, for example:

- For knowledge process outsourcing (KPO) services, the taxpayer is required to use a minimum 25% margin for the safe harbour. If the overall margin between India and the overseas country where the associated enterprise resides is 30%, any difference in the determination of taxable margin in the overseas country by more than 5% will lead to double taxation.
- The minimum interest acceptable in order to access the safe harbour on loans exceeding INR 500 million...
to a wholly owned overseas subsidiary amounts to 12.7% (i.e. State Bank of India’s base rate of 9.7% on 30 June 2013 plus 300 basis points). If the overseas country allows interest deduction at any lower rate, double taxation arises to the extent of the disallowance.

Denial of access to MAP reduces the attractiveness of the safe harbour framework. By permitting MAP access, tax authorities may negotiate with a view to arriving at taxable margins that are mutually acceptable to both countries. India is not sending the right signals by disallowing MAP access to a taxpayer who avails himself of the safe harbour rules, which could motivate overseas jurisdictions to treat Indian subsidiaries resident in those countries in a similar way.

It is questionable whether the ITR 1962 (subordinate legislation) can deny access to the MAP when section 90(2) of the ITA 1961 (primary legislation) allows the taxpayer to access treaty benefits (which include the MAP) if these are more beneficial to the taxpayer. A judicial ruling on this point will have to be awaited.

The safe harbour framework requires the taxpayer to maintain the same level of documentation as that required under the traditional ALP-based assessment, thereby substantially diluting its avowed aim of making tax compliance easier for the taxpayer. This leads to a situation where the assessment is finalized on the basis of safe harbour margins, but the taxpayer has to maintain extensive transfer pricing documentation, in the absence of which penalties will apply.

To realize the benefits of a safe harbour, taxpayers who opt to pay taxes on the basis of the safe harbours for a continuous period of five years (without the current possibility of opting out for any year) should not be obliged to maintain documentation during this period.

The ITR 1962 prescribe a lower safe harbour for Information Technology Enabled Services (ITES) (i.e. 20% or 22% depending on whether the unit’s turnover is below or above INR 5 billion) and a higher safe harbour for Knowledge Process Outsourcing (KPO) (i.e. 25% irrespective of the unit’s turnover). They have listed several activities under each of these two categories and define them as:

- ITES = BPO (business process outsourcing) + IT;
- KPO = BPO + IT + knowledge/advance analytical or technical skills.

However, considerable overlaps can occur when it comes to classifying services under these two categories. By definition, ITES include data processing, data mining, support centres, data search integration and analysis services, whereas KPO includes business analytics, finance analytics and market research services. It is not so clear how to classify, for example, an Indian captive unit which is engaged in analysing credit card spending details or data on sales that take place in a chain of department stores or on insurance claims made globally. The taxpayer will prefer to classify this unit under ITES, but the tax authorities will prefer the KPO classification due to the different safe harbour margins. There might be disputes and litigation on this point and as the services offered by each business unit are distinct, the ruling in one case cannot be used as a precedent in other cases. It would be desirable to eliminate this distinction between ITES and KPO and prescribe a uniform margin for both.

The safe harbours for certain categories of taxpayers are defined based on operating margins and operating costs. However, the ITR 1962 are silent on the following issues:

- whether any operating cost that is wholly or partially disallowed under any statutory provision (for example, on the ground that it is paid to a related party or due to a failure to deduct tax at source before payment) should be considered in computing the operating costs. Taxpayers would prefer to exclude costs to the maximum extent possible in order to reduce the base on which margins are computed, while the tax authorities would like to inflate the base;
- whether costs incurred under cost contribution agreement with an associated enterprise will have to be considered; and
- whether overhead costs (rent, electricity, management salaries) can be included in the operating costs (how much costs will be allocated will depend on the method of allocation).

It is likely that even under the safe harbour rules, disputes will arise on the treatment of operating margins and costs.

Another aspect on which the ITR 1962 are silent is whether the safe harbour has to be complied with at the unit level or at the service level if an Indian unit renders multiple services with different margins to its overseas associated enterprise; for example, an Indian ITES unit with a turnover exceeding INR 5 billion (applicable safe harbour is 22%) renders both accounting and payroll services. Their individual margins (i.e. operating margin/operating costs) are 18% and 25% and the combined margin is 23%. If the tax authorities apply the safe harbour at the unit level, accounting services will also qualify for safe harbour, but if the tax authorities apply the safe harbour at the service level, only payroll services will qualify for safe harbour and accounting services will be subject to the traditional and complex ALP-based assessment.

Safe harbours are available only in the case of loans and guarantees by an Indian company to its wholly owned overseas subsidiary. The following are not covered:

- loans and guarantees by an Indian unit to its overseas subsidiaries which are not wholly owned by it (majority-owned overseas joint-venture);
- inward loans and guarantees by an overseas foreign principal to its wholly owned Indian unit.

In the case of Indian units engaged in the manufacture and export of core and non-core automotive components, the ITR 1962 only mention that at least 90% of the total annual turnover of the exporter should be comprised of original equipment manufacturer sales. As the rules are silent on the identity of the buyer, it has to be assumed that the buyer must be a non-resident associated enterprise since only then transfer pricing provisions apply. This aspect should have been explicitly clarified and not left for inference.
8. The OECD Position on Safe Harbours

The initial OECD view on safe harbours was generally negative. The use of safe harbours by tax administrations was not recommended since it was not in line with the arm’s length principle and could adversely impact on the national revenue of both the country implementing the safe harbour and the country where the associated enterprise was situated, notwithstanding the fact that it could simplify transfer pricing compliance and administration.\(^2\)

However, considering the prevalent trend of several member countries implementing safe harbour provisions in their transfer pricing legislation (claiming that the benefits to all stakeholders would outweigh the concerns, especially where the safe harbour framework was carefully crafted) and the need for a multilateral approach (i.e. cooperation between countries to ensure that the combined application of safe harbour provisions in both the countries does not result in double taxation or non-taxation), the OECD recently approved the use of safe harbours in specified circumstances by revising section E of chapter IV of its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the “OECD Guidelines”).\(^3\)


Paragraph 4.105 of the OECD Guidelines recommends that the exhaustive documentation necessary for the determination of the ALP be dispensed with when the taxpayer opts for safe harbour. In contrast, the Indian framework requires this documentation to be maintained even if the taxpayer opts for safe harbour (Rule 10TD (5)).

Paragraph 4.115 of the OECD Guidelines recommends MAP proceedings in order to avoid or mitigate any double taxation that is likely to occur as a result of a safe harbour. The Indian legislation disallows recourse to MAP proceedings in the case of an assessee who has opted for safe harbour (Rule 10TG).

Paragraph 4.117 of the OECD Guidelines recommends that the safe harbours be adopted on a bilateral or multilateral basis by means of competent authority agreements between countries, which would eliminate the possibility of double taxation or non-taxation. The Indian legislation is unilateral and framed without coordination with the safe harbour framework of any other country.

10. Conclusions

Recently, India has significantly expanded its transfer pricing legislation by introducing APAs and safe harbour rules, both of which provide taxpayers with an alternative framework to determine their transfer prices without having to undergo the traditional and adversarial ALP-based assessment. Notwithstanding these useful provisions, there are still concerns about their implementation by revenue-oriented tax authorities. Taxpayers will have to examine safe harbours, APAs and the traditional ALP-based assessment to choose the best option for their particular circumstances. Considering the various drawbacks of the Indian safe harbour framework, only time will tell whether it has proved to be beneficial.
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