UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

To: Subcommittee on the United Nations Model Tax Convention between Developed and Developing Countries

From: USCIB Tax Committee

Re: Comments on discussion draft Capital Gains on OITs

Date: August 20, 2020

USCIB[1] appreciates the opportunity to comment on the proposals concerning modifications to Article 13 and its commentary, including the proposals on Offshore Indirect Transfers (OIT). We recognize the concern of some countries that OITs may be used to avoid local country tax on the effective disposition of local assets. We believe, however, that an overbroad rule on OITs may discourage foreign direct investment because broad OIT rules can result in taxation in inappropriate circumstances and unrelieved double taxation. We have discussed these issues in more detail in our comment letters to the Platform for Collaboration on Tax.[2]

USCIB also recognizes the confusion created by paragraph 18 of the current Commentary. We find the clarifications suggested by the draft are also unclear and should be revised.

These topics are discussed in more detail below.

Offshore Indirect Transfers

Paragraph 21 of the draft Commentary (which we believe should be moved to earlier in the discussion) urges countries to consider a number of factors when considering whether to include the paragraph covering OIT transfer in their treaties. Unfortunately, only two factors are mentioned: 1) whether and to what extent domestic law permits taxation of OITs and 2) the administrative and collection challenges raised by OITs. USCIB believes that other factors should be considered including the impact on foreign direct investment and the difficulty of eliminating double taxation. Countries should also consider how business routinely structures foreign operating investments. While cases that have raised concerns in developing countries could be captured by a more limited scope rule , an overbroad rule might distort business investment in order to avoid the onerous administrative rules or double taxation risks. We believe the final rule should balance these objectives to provide reasonable protection for the tax base of developing countries while not discouraging foreign investment in those same countries.

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[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide and works to facilitate international trade and investment.

[2] https://www.uscib.org/uscib-content/uploads/2017/10/USCIB_Comments_on_the_Taxation_of_Offshore_Indirect_Transfers_FINAL_10_19_2017.pdf https://www.uscib.org/uscib-content/uploads/2018/09/Toolkit_Comments-USCIB-September_11_2018-final.pdf

The UN proposal does not address the potential domestic law consequences for a country adopting the provisions concerning OIT. In one sense this is appropriate, since the UN is not the forum for determining domestic tax policy. However, failure to raise these issues (for example, the treatment of corporate reorganizations, minority interests, losses etc.) may result in a provision that discourages foreign investment because it increases the likelihood of double taxation with no appropriate means of eliminating double taxation. It is also important that any country that is considering adopting such rules provide an appropriate opportunity for stakeholder comment and should consider transition rules that exempt existing investments.

Application of the Ownership and Value Tests

The draft treaty and commentary language begin on page 6 with a new draft paragraph 6. The test for whether the source country is permitted to tax OITs is two part: a percentage of ownership threshold and a percentage of value threshold.

While the actual percentage of ownership is left for negotiation between treaty partners, an example uses a 20% threshold. The example thus implies that 20% is a reasonable threshold. This threshold seems far too low given the burdens potentially imposed on OITs, including the need for significant information about the nature and value of assets held at lower tiers of the ownership chain. The threshold is determined by aggregating direct and indirect ownership. There is no guidance, however, on how indirect ownership would be determined. Thus, a person with a very small direct ownership interest might be liable for tax on an OIT if stock was attributed through and across chains of entities. Small stock interests might be held in "street name" by a bank or brokerage firm, and looking through these interests is extremely difficult. The ownership test is satisfied if at any time during the 365-day period preceding the alienation of the shares, the alienator held directly or indirectly the relevant percentage of stock. This implies that the test would have to be performed on each of those 365 days to disprove ownership of stock. This requirement creates a significant burden which may decrease investment.

The percentage of value threshold is that more than 50 percent of the shares' value at any time during the 365 days preceding the alienation of the shares is attributable to property that would be taxable in the source State if gains from the alienation the property would have been taxable in the hands of the resident of the other State at the time of the alienation of the shares. There is no pro rata limitation, so 100% of any gain would be taxable even if only 50+% of the value is attributable to taxable property. There is also no requirement that the gain be attributable to the taxable property. That is, the underlying property that creates the tax liability might have little or no gain (or even a loss) and the gain might be attributable to other property held by the corporation. Nevertheless, 100% of the gain would be taxable in the "source" jurisdiction. Further, the issue of determining the value of the relevant properties is unaddressed. Using fair market value would be effectively impossible since it would require valuations and possibly appraisals of many assets, whether individually or in the aggregate. The only method that might be able to be applied would be cost for financial accounting purposes. Even then, in a large corporation there may be thousands of assets that would need to be valued and evaluated to determine the source of any gain from bulk disposition of those assets. This would need to be done to determine whether at any time during the 365-day period preceding alienation the value test was satisfied; this implies a test that is applied daily for that 365-day period. This information will not be available on a daily basis. These difficulties arise even before turning to the directly or indirectly part of the valuation test and to the potentially low ownership threshold referenced above. It is not clear how it is manageable to determine the test's required percentage results if assets and their values have to be attributed through relatively small minority interests. Minority shareholders may have no ability to compel a corporation to provide this information.

These difficulties argue for only applying these rules when dispositions are likely to be structured primarily to avoid underlying tax liabilities. If the UN decides to go forward with this proposal, there should be thresholds and carve-outs. Corporate reorganizations should be carved-out. Corporate reorganizations usually require a substantial continuity of interest and therefore are unlikely to raise the change of ownership/disposition concerns that rules addressing OIT are supposed to address. Thresholds should be high enough to make the rules administrable while addressing any concerns. USCIB does not have recommendations on thresholds, but 20% stock ownership is too low. One suggestion may be establishing cut offs based on percentages after multiplying ownership interests. For example, there is no further attribution of either stock or assets if the ownership percentages when multiplied together are under a certain percentage. Similarly, assets should not be attributed to another company if the value of the assets owned by one company attributable to the source jurisdiction is under a set percentage (say 25%).

Further work would also be needed to explain the interaction between this new paragraph 6 and existing paragraphs 4 and 5. While the proposal says new paragraph 6 is "subject to" paragraphs 4 and 5, it does not explain what this means. Are paragraphs 4 and 5, respectively, intended to limit a "source" State's taxation of offshore indirect transfers of immovable property situated in that State or of stock in corporations resident in that State to the circumstances described in those paragraphs (even though both provisions are drafted as confirming positive taxing rights rather than limiting such rights)? Is the proposed language intended simply to mean that new paragraph 6 will not limit the "source" State taxing rights already existing in paragraphs 4 and 5?

<u>Elimination of Double Taxation</u>

Paragraph 22 of the proposed Commentary describes a number of cases that could create the risk of unrelieved double taxation. Paragraph 23 suggests that one way to address such situations would be to resort to the mutual agreement procedure, in particular the discretionary ability of competent authorities under Article 25(3), second sentence, to address cases of double taxation not addressed in the treaty (e.g., so as to deal with triangular cases of the type referenced in the proposed Commentary). USCIB is skeptical that the mutual agreement procedure would result in any relief if the countries believe that the treaty has preserved their right to tax the OIT. We note, in particular, the limitations on the potential usefulness of Article 25(3) noted in paragraph 55.1 of the Commentary on Article 25, as a result of domestic law constraints. In order to prevent double (or multiple) taxation of the same gain, there need to be clear priority rules. There also need to be rules for stepping-up the basis of the underlying assets that generate the gain on the OIT (not just the stock that is disposed of). Basis step-ups may also be needed for the shares in intermediate corporations if multiple taxation is to be effectively avoided, further illustrating the complications that can result from efforts to tax indirect transfers.

Higher ownership percentage thresholds would eliminate some of these problems by reducing the number of transfers that would be subject to taxation.

Proposed revisions to paragraph 18 of the Commentary

The proposed amendments to paragraph 18 of the Commentary paragraph 18 are confusing. The revisions seem to be attempting to describe the residual source-based taxing right retained through the Commentary's alternative to Article 13(6) by reference to "property" that is not mentioned in the preceding paragraphs (rather than by reference to "gains" not mentioned in the preceding paragraphs). But in doing so they create confusion about what is the scope of the "property" mentioned in the preceding paragraphs. For example, Article 13(1) allows source State taxation of gains realized by a resident of a Contracting State "from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State". The proposed new Commentary says:

> ***The alternative, unlike the alternative previously suggested in this paragraph, refers to "property other than property mentioned" in the previous paragraphs of Article 13 rather than to "gains … other than those gains mentioned" in these paragraphs. This means that where property that is mentioned in paragraphs 1, 2, 4 or 5 is alienated but the provisions of these paragraphs restrict the right of the State of source to tax the gain from the alienation of that type of property to certain situations, gains from the alienation of such property in situations not covered by these paragraphs shall be taxable only in the Contracting State of which the alienator is a resident. One example would be a gain from the alienation of immovable property situated in the State of residence of the alienator: since immovable property is mentioned in paragraph 1 but that paragraph only indicates that the other State may tax gains from the alienation of immovable property situated in that other State, the gain from the alienation of immovable property situated in the State of residence of the alienator would only be taxable in that State.***

It is not clear what this language implies about, for example, a gain from the alienation of immovable property situated in a third State -- is that "immovable property" mentioned in paragraph 1 and therefore not taxable by the "source" State under the residual taxing right in the Article 13(6) alternative (as the proposed Commentary seems to suggest), or is it potentially taxable in the "source" State because it's other than immovable property situated in the "source" State? As another example, is the property mentioned in Article 13(2) "movable property", "movable property forming part of the business property of a permanent establishment", or "movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State"?

USCIB agrees that the existing language for the Article 13(6) alternative is in need of improvement, but we believe the proposed language needs to be clarified to ensure that it reflects the intentions of the Committee.

Direct Transfer of certain property

USCIB supports the decision (page 10, paragraph 12) of the Subcommittee not to recommend the inclusion of a provision covering the alienation of derivatives and securities issued by resident companies.