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Department of Economic and Social Affairs

International Cooperation in Tax Matters

Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on the work of its eighth meeting

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Note

Symbols of United Nations documents are composed of capital letters combined with figures.

The term "country" as used in the text of this report also refers, as appropriate, to territories or areas.

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Introduction

A. Terms of reference

1. In its resolutions 1980/13 of 28 April 1980 and 1982/45 of 27 July 1982, the Economic and Social Council stated the terms of reference of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, as follows:

(a) Formulation of guidelines for international cooperation to combat tax evasion and avoidance;

(b) Continuing the examination of the United Nations Model Double Taxation Convention between Developed and Developing Countries and consideration of the experience of countries in bilateral applications of the Model Convention;

(c) Study of possibilities of enhancing the efficiency of tax administrations and formulation of appropriate policy and methodology suggestions;

(d) Study of possibilities of reducing potential conflicts among the tax laws of various countries and formulation of appropriate policy and methodology suggestions.

B. Opening of the meeting

2. The eighth meeting of the Ad Hoc Group of Experts, which was held from 15 to 19 December 1997 at the Palais des Nations, Geneva, was opened on 15 December 1997 by Mr. Abdel Hamid Bouab of the Department of Economic and Social Affairs of the United Nations Secretariat. He noted that the agenda of the eighth meeting was drawn from both the recommendations made by the Group at its seventh meeting and from informal discussions held at Geneva on 11 and 12 December 1997.

3. Agenda item 4 concerned the tax havens and the exchange of information. Mr. Bouab observed that tax havens which connoted a tax jurisdiction that imposed little or no tax on taxable entities had been utilized in transfer-pricing mechanisms to share their profits in transactions between head office and branches in other countries. Since tax havens were being used increasingly by drug traffickers and smugglers for parking their ill-gotten gains from nefarious and socially undesirable activities, there was a need to arouse world conscience against their continuance. It was considered necessary to invoke the provisions relating to exchange of information in double taxation avoidance agreements to deal effectively with the phenomenon of tax havens.

4. Agenda item 2 concerned the tax treatment of new financial instruments and derivatives. That involved the question of whether the income from a considerable range of financial instruments, many of them hybrids with the characteristic of more than one type of instrument, should be treated for tax purposes as interest, capital gains, business profits or income from other sources. The tax treatment of financial instruments and derivatives was an issue that called for increased cooperation between the Organisation for Economic Cooperation and Development (OECD) and the United Nations with a view to working out a common approach.

5. Agenda item 3 concerned the tax treatment of transfer pricing, in particular as it related to the efforts made by Group companies to manipulate prices of goods, services and debt service charges between related entities so as to minimize their aggregate tax burden. Although OECD had made a significant contribution to that subject over the last two decades, it was necessary for both developed and developing countries to arrive at a consensus while dealing with the subject.

6. Agenda item 1 concerned the updating and revision of the Model Convention and the manual for the negotiation of bilateral tax treaties between developed and developing countries. The justification for the revision of the Model Convention and the manual included the developments in the world economy and the emergence of international trade as the primary factor in global development, and also the changes made in the OECD Model Convention over the last few years.

7. Under agenda item 5, "Other topics", Mr. Bouab mentioned that the Group might wish to expand its role to include the provision of technical assistance and training workshops for tax administrators in the field of international taxation, including the examination of OECD and United Nations Model Double Taxation Conventions, transfer-pricing mechanisms, innovative financial instruments and tax havens. Such technical assistance and training workshops for tax administrators would enable them to deal effectively with international tax evasion and avoidance, and would facilitate the resolution of treaty disputes and negotiation of tax treaties, thus contributing significantly to improving international income allocation and distributive justice.

C. Attendance

8. The following members of the Group attended the eighth meeting: Atef Alawneh (Palestinian Authority), William Alder (Jamaica), J. A. Arogundade (Nigeria), Abdel

Ali Benbrik (Morocco), Benoît Bohnert (France), Ernst Bunders (Netherlands), Abdoulaye Camara (Côte d'Ivoire), Mordecai Feinberg (United States of America), Antonio Figueroa (Argentina), Mayer Gabay (Israel), Hafeezullah Ishaq (Pakistan), Iraci Kahan (Brazil), Mona Kassem (Egypt), Helmut Krabbe (Germany), Daniel Luthi (Switzerland), Adélaïde Nare (Burkina Faso), Maria Pastor (Spain), John Shepherd (United Kingdom of Great Britain and Northern Ireland), Hillel Skurnik (Finland), Seth Terkper (Ghana) and Lianshun Zhang (China) (for details, see annex I below).

9. The meeting was attended by observers for the following States Members of the United Nations: Australia, Barbados, Belgium, Brazil, Chile, China, Denmark, Gabon, Guinea, Israel, Jamaica, Jordan, Mali, Malta, Niger, Spain, Senegal, Sri Lanka and Venezuela (for details, see annex I below).

10. Observers for Palestine also attended the meeting.

11. The meeting was attended by observers for the following international bodies and other institutions: Association des Administrateurs Africains des Impôts, Association de Planification Fiscale et Financière, Caribbean Community Secretariat, Commonwealth Association of Tax Administrators, Inter-American Center of Tax Administrators, International Association of University Presidents, International Bureau of Fiscal Documentation, International Chamber of Commerce, International Fiscal Association and OECD (for details, see annex I below).

12. The Secretariat gratefully acknowledged the contributions of Sheldon Cohen, Lawrence Lokken and Adolfo Atchabahian in preparing documents for submission to the meeting (for details, see annex I below).

D. Election of officers

13. The Group elected Antonio Figueroa (Argentina) as Chairman and Hillel Skurnik (Finland) as Rapporteur. Abdel Hamid Bouab served as Secretary, and was assisted by Suresh Shende (Assistant Secretary), Lawrence Lokken (Special Adviser), Sheldon S. Cohen (Special Adviser) and Adolfo Atchabahian (Consultant).

E. Adoption of the agenda

14. The Group adopted the following substantive agenda for the eighth meeting:

1. Update of the United Nations Model Convention and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries;
2. Financial instruments;
3. Transfer pricing;
4. Tax havens, including exchanges of information;
5. Other topics;
6. Arrangements for the ninth meeting.

F. Documentation

15. To facilitate its work, the Group had before it the following documents:

(a) Annotated provisional agenda (ST/SG/AC.8/1997/L.1);

(b) United Nations Model Double Taxation Convention between Developed and Developing Countries (ST/SG/AC.8/1997/L.2);

(c) The United Nations Model in practice (ST/SG/AC.8/1997/L.3);

(d) Issues raised by the use of tax havens, with particular reference to the obtaining of information concerning tax haven transactions by tax authorities of other countries (ST/SG/AC.8/1997/L.4);

(e) Taxation of derivatives and new financial instruments (ST/SG/AC.8/1997/L.5);

(f) The globalization of capital markets (ST/SG/AC.8/1997/L.6);

(g) The taxation of international income in developing countries (ST/SG/AC.8/1997/L.7);

(h) Review of tax treaties between developing countries: a comparison with the United Nations Model Double Taxation Convention between Developed and Developing Countries (ST/SG/AC.8/1997/L.8);

(i) Tax havens: the need to neutralize their distorting effects in the international tax context (ST/SG/AC.8/1997/L.11);

(j) Manual for the negotiation of bilateral tax treaties between developed and developing countries (ST/SG/AC.8/1997/L.12);

(k) Report of an informal consultation of members of the Steering Committee for the Eighth Meeting of the Group of Experts (ST/SG/AC.8/1997/L.13);

(l) Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on the work of its eighth meeting (ST/SG/AC.8/1997/L.14);

(m) Final Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on the work of its eighth meeting (ST/SG/AC.8/1997/L.15).

16. A list of working papers and conference room papers is contained in annex II below.

I. Tax havens, with special reference to exchanges of information

17. The subject of tax havens was introduced by the Secretariat, which noted that tax havens are threats to the tax systems of both developed and developing countries. Tax havens compromise the principle of tax neutrality because they cause tax considerations to inappropriately affect investment choices. Techniques were described that had been adopted by many countries as defences against tax haven activities, including controlled foreign corporation and foreign investment funds legislation. Bank secrecy and confidentiality rules in tax havens made it difficult for other countries to uncover tax fraud and other illicit activities, and some tax havens, not wishing to be viewed as having complicity in illicit activities, had agreed to exchange some tax information.

18. The Group of Experts generally agreed that the tax haven issue should not be viewed as a conflict between developed and developing countries because both groups of countries were injured by tax haven activity. An observer noted that the tax haven problem was worse than it had been five years previously, and would probably get worse because Internet commerce and electronic banking made it ever easier to move funds into tax havens, which, among other things, had made the use of tax havens feasible for people with only modest wealth.

19. The discussion of the topic began with an effort to define the concept of tax haven. One member suggested that very broadly, any aspect of a country's laws or practices that was subversive of other countries' tax regimes could be considered a tax haven characteristic. Several speakers pointed to two basic features of tax havens: minimal or no tax on at least some types of income and lack of effective access to and exchange of tax information. A member and an observer listed the following characteristics, the presence of more than one of which was a good indicator of a tax haven:

(a) Low or zero effective tax rate;

(b) An unwillingness to make information available;

(c) A lack of transparency;

(d) No requirement that real business activity be carried on;

(e) In the case of a haven regime within a country with an otherwise acceptable tax system, a separation of the special regime from the domestic economy – a "ring fence".

A. Low or no tax

20. Several members of the Group suggested that it was the effective rate of tax, not the nominal rate, that determined whether a country had the low-or-no-tax characteristic of a tax haven. A country with high nominal income tax rates might nevertheless be a tax haven with respect to some investments if it had special exemptions or allowances that reduced the effective rate of tax on income from particular types of investments, although some believed that it was not appropriate to label a country a tax haven merely because it had different tax regimes for different types of income. Moreover, the crucial factor was the practical application of the law, not the nominal terms of the law. In some countries, unpublished rulings were given that substantially eroded the tax base, tax rates were varied by private negotiation or the law might simply not be enforced as written. Such a lack of transparency – a policy of applying the law differently in practice from how it was stated in publicly available documents – was one of the most troublesome tax haven practices.

21. However, several members suggested that a country's failure to tax all income of all locally organized entities should not in all cases be considered a tax haven characteristic. For example, a country should not be considered a tax haven merely because it grants tax holidays or other concessions as means of attracting foreign investments to finance real economic activities within the country. Also, a country was not a tax haven merely because its overall policy on taxing business income was to impose tax at a low rate on a broad tax base. Moreover, exemptions and other reliefs given only as a means of avoiding double taxation should not mark a country as a tax haven.

22. In response, it was suggested that the distinguishing characteristic of a low-or-no-tax haven was that the tax haven facilitated the avoidance of taxation worldwide on income from sources in other countries. In that view, the characteristic of a tax haven was the ability to shift funds to that country's tax jurisdiction without shifting economic activity to the country.

23. Some members of the Group believed that even that conception of tax haven was too broad because it would classify as tax havens all countries with territorial tax systems, and some exemptions intended only as relief from double taxation might be considered tax haven provisions.

24. However, the Group reached a consensus that lack of transparency is an invidious tax haven characteristic.

25. Several members of the Group noted that although the use of tax incentives to attract investment into a country should not be considered a tax haven characteristic, tax competition among countries for investment was often unhealthy, and such competition might usefully be considered by the Group on another occasion.

B. Information exchange

26. The Group quickly reached consensus that lack of access to tax information was a tax haven characteristic. Such lack of access might derive, for example, from bank secrecy laws, other laws protecting the confidentiality of financial information, or laws facilitating the issuance of bearer shares and bonds.

27. It was also agreed that the best way to provide access to tax information was through tax treaties with provisions for information exchanges or separate international agreements on information exchanges. Those provisions should deal explicitly with any bank secrecy laws of either country. It was suggested that countries with extensive experience in information exchanges provide tools to help countries with less experience to initiate exchange programmes. An additional approach was to urge countries to abandon laws and practices that were harmful to the tax systems of other countries.

28. It was pointed out that some countries had had some success in obtaining information on transactions in tax havens by indirect means. For example, if a country's laws required resident individuals and corporations to disclose to the tax administration all records and documents in their possession, including material kept outside the country, those laws might sometimes be used to obtain records on tax haven transactions. Also, a tax administrator's power to compel the production of documents might be extended to a foreign parent corporation of a domestic subsidiary corporation. Moreover, a taxpayer, particularly if accused of a tax crime, could be ordered by a court to waive secrecy rights under the laws of a tax haven country. If the taxpayer dealt with banks having branches in the taxing country and in various other countries, the tax administrator might be able to compel the bank to produce records on transactions of branches in other countries, including tax havens. Finally, courts in non-haven countries might refuse to accept the defence that a disclosure of tax information would violate the criminal laws of a tax haven.

29. Some members of the Group from developing countries observed that although such techniques might be effective for large developed countries with great economic power and highly developed legal systems, they might be less practical for smaller countries, particularly developing countries.

II. Innovative financial instruments

30. The subject of derivatives and other financial instruments was introduced by the Secretariat. It was pointed out that all financial instruments consisted of or were constructed from three basic building blocks: financial assets (stocks and bonds); options; and forward contracts. Options came in two forms: options to buy (call options) and options to sell (puts). A person might be either the holder of an option (the person entitled to buy or sell) or the writer of the option (the person required to honour the holder's right to buy or sell). Because the obligation was not reciprocal, the holder usually paid a premium to the writer when the option was issued. A forward is an agreement whereby one person agreed to buy designated property at a specified future date for a specified price and the other person agreed to sell. Because the obligations under a forward contract were mutual, no money changed hands when a forward was made if the contract price was the market forward price at that time. A futures contract was a type of forward that was traded on an organized exchange and subject to the rules of the exchange, which usually required that the contract be marked to market by an interim settlement each day. Options and forwards were called derivatives because their values fluctuated with the values of the underlying property, but they did not directly represent an ownership in that property.

31. Most countries were in the process of developing their domestic rules for financial assets and derivatives. In so doing, it was important that the rules for various types of instruments be as consistent with each other as possible. Because an option or forward contract economically duplicated (or was the opposite of) all or a portion of the ownership of the underlying property, it was possible, by combining derivatives or financial assets and derivatives, to achieve the economic equivalent of ownership of the property or any desired portion of the ownership. Thus, if the rules for the three types of building blocks were not fully consistent, taxpayers using derivatives for legitimate

business reasons (principally, to manage risk) might find those uses upset by asymmetrical tax treatments, and other taxpayers would exploit those discontinuities to the detriment of tax revenues. Unfortunately, complete consistency was not practicably achievable because derivatives blurred the lines between capital gains and other income, realized and other gains, dividends and interest, and various other categories commonly used in tax laws. Thus, a tax law could completely eliminate the asymmetries and arbitrage opportunities that derivatives facilitated only by eliminating all of those categories and simply imposing tax on net accretions to wealth, an approach that was only theoretical and not practicable. The objective must thus be to achieve consistency to the extent practicably achievable, recognizing that derivatives threatened all categorizations in a tax law affecting financial transactions and holdings.

32. According to the Secretariat, those who have studied the matter have generally agreed that income from cross-border derivative transactions can feasibly be taxed only on a residence basis, and that withholding taxes at source on payments under such derivatives was not practical, if even theoretically appropriate. Derivatives transactions often exploited thin margins between prices available in different markets. For example, it might be possible for a person to borrow money at a variable rate, enter into an interest-rate swap to exchange the variable-rate obligation for a fixed-rate obligation, and wind up with an interest obligation at a rate marginally lower than could have been obtained by borrowing directly at a fixed rate. However, the difference is usually very small. Even a small withholding tax (e.g., 5 per cent of the taxpayer's payments under the swap agreement) is likely to be larger than the margin exploited by the transaction. If so, the result of the withholding tax is that the transaction will not occur, and no withholding tax will be collected.

33. A representative of OECD spoke of that organization's work on financial instruments. He noted that although the concept of derivatives was very old, the use of derivatives had grown greatly in recent years because of the globalization of financial markets and because of the financial risks (principally, currency and interest risks) that businesses increasingly encountered in international commerce. He further noted that a withholding tax on cross-border payments under derivatives simply caused derivatives transactions subject to the tax not to occur. Usually, the result was that the transactions moved offshore and residents devised ways of participating in the offshore markets without incurring the withholding tax (e.g., through the use of offshore subsidiaries). Other observers confirmed that the experience of several countries had been that withholding taxes generally cannot be imposed at source on derivatives transactions.

34. Several members of the Group agreed that payments under cross-border derivatives transactions should not, as a general rule, be subject to withholding taxes. However, some members from developing countries noted that income tax treaties made by developing countries, following the United Nations Model Convention, were generally based on the premise that the countries of source and residence should share tax jurisdiction over income from cross-border transactions; those members questioned whether that policy should not also be followed for derivatives transactions. In response, it was suggested that although such a sharing was appropriate where the income economically derived from the source country, the country from which a cross-border derivatives payment emanated was not usually the economic source of any income other than that reported on a residence basis by the payor. For example, if a business in country A entered into a swap with an investment bank in country B, the bank made no investment in country A but instead earned its income under the swap from activities and capital located in country B; payments by the country A business to the bank thus did not include any income of the bank from country A sources. If country A taxed all income of the country A business on a residence basis, it taxed all income from the transaction that originated in that country. One member of the Group made an analogy to cross-border sales of physical goods, where if the seller carried on no activities in the buyer's country, no portion of the seller's income on the sale was considered to be from sources in the buyer's country. It was also noted that 1995 additions to the commentaries to the OECD Model Double Taxation Convention had clarified that because an interest swap was not a debt claim, payments under the swap were not subject to the interest article of the Convention.

35. The OECD representative noted that source taxation of derivatives however, was appropriate in some circumstances. For example, if a derivatives transaction was made at arm's length but at a price differing from the market price, a payment was made from one party to the other to compensate for that divergence; that payment might have the economic effect of a loan, the implicit interest on which might appropriately be taxed as such. Also, when derivatives contracts were made between related persons, the pricing might not be at arm's length, and withholding taxes on the excess payments might be appropriate. United Kingdom legislation on derivatives contains three anti-abuse rules directed at those and other transactions, including a rule that a derivatives transaction with a tax haven country was presumed not to be at arm's length. The United States also

had rules to ensure that derivatives transactions did not inappropriately avoid withholding and other taxes. A 1995 addition to the commentaries to article 21 of the OECD Model Convention had suggested a provision that might be added to the article to ensure that it did not inappropriately exempt income from derivatives contracts not at arm's length.

36. An observer noted that double taxation could result if a financial instrument was classified differently by two countries (e.g., if one country treats a swap as including an embedded loan and another finds no embedded loan). It was noted that OECD had recognized the problems of inconsistent classification and was working on developing solutions to those problems.

37. Several members noted that the time was not ripe for the Group to be making recommendations on that subject, and that the purpose of its discussion at that meeting should be considered to be exchange of information. It was suggested that all countries still had much to learn in that area.

III. Transfer pricing

38. The subject of transfer pricing was introduced by the Secretariat. It was noted that at the international level, transfer pricing had become a matter of concern to all countries, but efforts by tax administrations in that area had steadily evolved over the decades. The United States, which had subsequently taken a leading role in the development of transfer-pricing rules, had not often questioned reported transfer prices in international transactions until the 1960s. After four years of deliberation, extensive transfer-pricing regulations had been issued by the United States in 1968, which had confirmed the arm's length principle as the basic guide and had elaborated on the application of that principle. In 1979, OECD had issued transfer-pricing guidelines, which were generally consistent with United States regulations but put forward additional considerations. During the late 1980s and early 1990s, the United States Treasury had undertaken an extensive revision of its transfer-pricing regulations, which had culminated in the issuance of new regulations in 1993 and 1994. The latter stages of the development of the new regulations had coincided with the OECD revision of its transfer-pricing guidelines, which had led to the issuance of new guidelines in 1995 and the supplementation of the guidelines in 1996.

39. Transfer-pricing distortions often arose from the desire to minimize taxes, but other factors could also be the source of distortions. For example, political factors within a large corporation might cause income to be shifted artificially to favoured divisions, and some multinational corporations had shifted income away from foreign subsidiaries to the parent corporation, principally to enhance the ability of the parent's management to control the funds.

40. The Group recognized that transfer pricing was a multilateral problem and that an international consensus was needed in dealing with it. The Group acknowledged that the arm's length standard was the base on which that consensus must rest. However, it noted that the arm's length principle was not easy to apply, and that nearly all of the detailed elaboration in the United States regulations and the OECD guidelines were an effort to meet the difficulties of applying that standard. One member of the Group suggested that those difficulties were especially great for developing countries, because given the limited markets in many types of goods and services, comparable prices were often not available. For example, in dealing with oil companies, world prices for oil could be used for transfers of oil, but comparables could generally not be found to test payments for services made by local corporations to their foreign parents and other affiliates. Members from developing countries suggested that all countries encountered those problems. However, an Observer from a developing country noted that developing countries had special difficulties in gathering the administrative resources necessary to audit transfer prices.

41. It was suggested that because cross-border payments always involved at least two countries, cooperation and exchanges of information among countries was a key to managing transfer-pricing problems.

42. Some developing countries had experimented with alternatives to the arm's length principle. A few countries had rules presuming a certain level of net income from particular activities. Other countries had enacted assets taxes, which were premised on the idea that net income could reasonably be expected to be at least a certain percentage of the taxpayer's investment and that a tax imposed on net asset values could reasonably approximate the effects of the income tax (e.g., one third of the expected return on net assets if the income tax rate was 33 per cent). The income tax might be allowed as a credit against assets tax, in which case the assets tax effectively functioned as an alternative minimum tax. A member of the Group suggested that in some situations, especially those of companies with losses, those substitute mechanisms could result in excessive taxation, and that it was better that countries, rather than resort to those substitutes, develop their ability to apply the arm's length principle.

43. Over the last five years, several countries, beginning with the United States, had developed procedures for

advance pricing agreements (APAs). Those procedures had been received by the business community with some hesitation. An observer noted that in his country, businesses had been afraid that information disclosed in the course of obtaining APAs would be used by the tax administration in auditing the businesses for prior years. That fear had been somewhat alleviated by assurances that the information would be so used only in cases of blatant abuse. It was observed that the APA procedure was time-consuming, and the costs of formulating APAs were substantial for both the tax administration and taxpayers. Moreover, an effective APA programme can only be administered by a trained and specialized staff. However, those costs and staffing requirements were usually substantially less than the costs of an audit after the fact, particularly if the audit led to litigation.

44. The members of the Group generally agreed that lack of expertise and resources was a major problem in the transfer-pricing area for developing countries and some smaller developed countries. One possible solution to that dilemma was the creation of one or more multilateral organizations that would assist in auditing companies jointly on behalf of the member countries. That proposal was not considered by the Group.

45. One member of the Group suggested that a multinational arbitration framework was needed to aid developing countries in resolving transfer-pricing issues, and that the United Nations should assist developing countries in organizing such a framework. It was noted, however, that an arbitration forum would not solve what might be the major problem for developing countries – garnering the resources needed to develop transfer-pricing cases – and that without a solution to that threshold problem, developing countries that brought arbitration cases would be overwhelmed by the preparation of the companies and would lose the cases. It was also noted that over the last decade, arbitration clauses had been included in some income tax treaties, which generally applied only if the competent authorities did not agree within a reasonable period of time, and only if arbitration was consented to by both tax administrations and the taxpayer. Moreover, the member States of the European Union had concluded among themselves a multilateral arbitration convention, which became effective at the beginning of 1996. However, no arbitration proceedings had yet been brought under those procedures. In the view of several members of the Group, further ventures into arbitration should probably await the results of experience with existing arbitration procedures.

46. Several members of the Group expressed a need for training and other assistance to aid developing countries in gaining practical expertise in transfer-pricing issues. Several speakers described efforts of the United Nations, OECD, the International Monetary Fund, the United States Internal Revenue Service and other organizations to meet that need. A desire was expressed for the Group to extend its efforts in this area. The Secretariat had prepared a report on technical assistance that would be considered by the Group later in the meeting.

IV. Updating of the United Nations Model Double Taxation Convention Between Developed and Developing Countries

47. Discussion of the subject of the updating of the United Nations Model Double Taxation Convention was begun by a representative of the International Bureau of Fiscal Documentation, who introduced a study of the Model Convention in practice. There were 27 provisions of the United Nations Model Convention that were either not found in the OECD Model Convention or differed from its corresponding provisions. The study covered 26 of them, examining whether each of the provisions was included in each of the 811 income tax treaties concluded since the United Nations Model Convention had been published in 1980, of which 697 had been concluded between developing countries and developed countries or other developing countries and 114 between OECD countries.

48. The study found that six of the 26 United Nations provisions were included in more than 40 per cent of the treaties made by developing countries, as follows:

Article	*Description*	*Percentage of inclusion*
5 (3) (a)	Construction supervisory activities may be PE	59
5 (3) (a)	Construction site less than 12 months	69
12 (3)	Tapes for radio or television broadcasting	88
13 (4)	Gains on shares of real property holding companies	44
13 (5)	Major shareholdings in other companies	46
21 (3)	Source taxation of other income	44

49. Several of the provisions were included in less than 10 percent of these treaties:

Article	Description	Percentage of inclusion
7 (5)	Omission of rule that no profits attributable to purchase	6
14 (1) (c)	Source tax on services income exceeding specified amount	6
16 (2)	Source tax on salaries of top-level managerial officials	9
20 (2)	Equal treatment of students	8
25 (4)	Implementation of mutual agreement	6
26 (1)	Disclosure of secret information	7
26 (1)	Implementation of information exchanges	9

50. Some of the United Nations provisions were found as often or more often in treaties between OECD countries than in treaties involving developing countries:

		Percentage of inclusion	
Article	Description	OECD	Developing countries
12 (3)	Tapes for radio or television broadcasting	89	88
13 (4)	Gains on shares of real property holding companies	58	44
13 (5)	Major shareholdings in other companies	54	46
18	Social security payments taxable only in payer State	42	30

51. Only the following United Nations provisions were included significantly more often in treaties involving developing countries:

		Percentage of inclusion	
Article	Description	OECD	Developing countries
5 (3) (a)	Construction supervisory activities may be PE	34	59
5 (3) (a)	Construction site less than 12 months	25	69
5 (3) (b)	Services as PE	2	31
5 (4) (a), (b)	Delivery not excluded as PE	0	26
5 (5) (b)	Dependent agents with stock of goods	8	34
7 (1)	Limited force of attraction	8	22
7 (3)	Elaboration on deductions of PE	5	28
14 (1) (b)	Independent services/183-day rule	18	38

52. The members of the Group generally agreed that a revision of the United Nations Model Convention was needed. Because the OECD Model Convention and commentaries had been revised in many particulars since the issuance of the United Nations Model Convention in 1980, it was necessary that the United Nations Model Convention be revised, as mandated by the General Assembly (see A/52/6/Rev.1, sect. 10, para. 10.24 (a) (ii)). It was also suggested that the process of updating the United Nations Model Convention be ongoing because revision tended to become more and more difficult as time passed since the last updating. A representative of OECD explained that the changes to the OECD Model Convention and commentaries since 1980 had been technical in nature, involving issues of application and interpretation rather than matters of fundamental substance, and that because few of those technical changes involved questions peculiar to developed or developing countries, most of them should be equally useful in the developing country context. He also noted that the OECD had invited non-member countries to comment on the OECD Model Convention and that the comments received from 17 non-member countries had been reported in volume II of the 1997 updating of the OECD Model Convention and commentaries. The members agreed that the Group should consider the OECD changes for inclusion in the revised United Nations Model Convention.

53. Some members cautioned that a revised United Nations Model Convention should be issued only if the Group was able to reach consensus on substantially all issues of concern to developing countries that affected the Model Convention, and that if the Group only reached consensus on the inclusion of various of the OECD changes, publication of a new document as a United Nations Model Convention would give the false impression that the Group had agreed to a comprehensive revision. Those members suggested that the Group only issue a report to supplement the 1980 Model Convention if it was not able to reach consensus on substantially all of the relevant issues.

54. An observer suggested that revisions of the United Nations Model Convention take into account how technological innovation could have the effect of eroding source taxation by, for example, making it possible to do extensive business with residents of a country without establishing a permanent establishment in the country.

55. Based upon informal consultations with members of the Steering Committee, the Chairman and the Secretary recommended that the Group proceed with the updating of the Model Convention, as follows: during the current meeting, the Group would identify which OECD updates were generally acceptable to the Group and which required further discussion. The latter, as well as any other issues that should be considered in a revision of the Model Convention, would be referred by the Secretariat to a focus group

consisting of the following five members of the Group: Mr. Benbrik, Mr. Gabay, Mr. Feinberg, Mr. Figueroa and Mr. Shepherd. Alternate members, to serve if any of the principal members were unable to serve, were Mr. Alder, Mr. Bunders, Mr. Ishaq and Mr. Skurnik. The focus group would work on the updating project throughout 1998 by correspondence, at least two on-line conferences, and one meeting to be held in person. The results of that effort would be referred to the Group at least two months before the ninth meeting of the Group of Experts, to be held sometime between June and October 1999. After discussion, that proposal was accepted by consensus.

56. Proceeding article by article, the Group discussed the changes made to the text of the articles of the OECD Model Convention and other matters that should be considered in updating the United Nations Model Convention. Some of the OECD article changes were found suitable for inclusion as such in the United Nations Model Convention articles. The Group did not discuss the commentaries, and referred all potential changes to the Commentaries to the focus group, together with all other unresolved issues.

57. Article 9, paragraph 2, required a country to make an "appropriate adjustment" (a correlative adjustment) to reflect a change in a transfer price made by the other country under article 9, paragraph 1. It was suggested that if the transfer price corrected by the primary adjustment under paragraph 1 was fraudulent, no adjustment should be made. Another observer noted that a correlative adjustment under paragraph 2 could be very costly to a small country, and suggested that a small country might consider not including paragraph 2 in its treaties. Several members of the Group responded that they believed that paragraph 2 was an essential aspect of article 9. However, a country could closely examine the primary adjustment under paragraph 1 before deciding what correlative adjustment was appropriate to reflect the primary adjustment. Moreover, it might be possible in some instances to spread the correlative adjustment over a period of years. It was further observed that any fraud in connection with the transfer price was against the interests of the country making the primary adjustment, which might assess a penalty on the fraud.

58. In 1995, OECD amended article 10, paragraph 2, and article 11, paragraph 2, to change "if the recipient is the beneficial owner of the dividends (interest)" to "if the beneficial owner of the dividends (interest) is a resident of the other Contracting State". The same substitution was made in article 12, paragraph 2 of the draft revised United Nations Model Convention presented for the Group's consideration. The purpose of those changes was to allow the benefits of those articles to a beneficial owner residing in a treaty country, regardless of the residence of any broker or other intermediary collecting the income on behalf of the beneficial owner, and correspondingly to deny treaty benefits when the beneficial owner was not a resident of the treaty country, even if the intermediary collecting the income was a resident. Several members of the Group expressed support for that change, but some members had doubts about its effects on developing countries and countries that taxed on a remittance basis, and recommended that it be examined by the focus group.

59. The draft revised United Nations Model Convention proposed adding a new paragraph 6 to article 10, dealing with branch taxes. The Group agreed that because that paragraph and the accompanying commentaries had not previously been considered by the Group, it should first be studied by the focus group. However, it was suggested that because not all countries had branch taxes, that paragraph might be better placed in the commentaries. Also, the focus group should consider whether the draft paragraph, which referred to "profits attributable to the permanent establishment," was broad enough, given that article 7, paragraph 1 of the United Nations Model Convention allowed the source country to tax more than the profits attributable to the permanent establishment.

60. As to article 12, paragraph 1 of the OECD Model Convention, because of fundamental differences between that paragraph and paragraphs 1 and 2 of article 12 of the United Nations Model Convention, the change made to the OECD Model Convention in 1997 should not be included in the United Nations Model Convention.

61. In 1992, OECD deleted the words "for the use of, or the right to use, industrial, commercial, or scientific equipment" from article 12, paragraph 3 of its Model Convention. The Group agreed that because of the broad substantive effect of that deletion, the issue of whether the same deletion should be made in the United Nations Model Convention should be referred to the focus group for study. It was also suggested that the focus group consider providing additional guidance in the commentaries on the indistinct dividing line between payments for know-how, which were royalties under article 12, paragraph 3, and payments for technical assistance services, which were not royalties.

62. It was noted that article 13, paragraph 4 – allowing taxation at source of gains on sales of shares of companies whose assets consist principally of immovable property – had commonly been included in treaties, even treaties among OECD countries, although the paragraph was not found in the OECD Model Convention. However, it was suggested that the focus group consider strengthening the provision by making it applicable to interests in partnerships and trusts

holding immovable property. On the other hand, the focus group might consider whether it should apply when the company was in an active business other than managing property (e.g., a hotel company). It was also suggested that paragraph 5 of article 13 – which allowed source taxation of gains on dispositions of substantial participations in a company – might be modified to limit source country tax to a rate less than that generally applied in that country.

63. It was suggested that in article 14, paragraph 1(b) – which allowed income from independent personal services to be taxed by the source country if the services performer was present in that country for at least 183 days – the 183-day threshold was too long. Although the 183-day rule might be seen as only a back-up of the fixed base rule in paragraph 1 (a), a member of the Group noted that it was often possible for substantial services to be rendered in a country without either a fixed base or 183 days of presence in the country. It was agreed that the issue should be studied by the focus group.

64. A member of the Group suggested that paragraph 2 of article 16 – allowing salaries of top-level managers to be taxed in the country of which the company was resident – should be examined by the focus group.

65. Several speakers suggested that the focus group consider whether article 18, relating to pensions and social security benefits, should be modified to reflect the privatized social security systems adopted by several countries.

66. In paragraph 3 of article 19, OECD had added a reference to article 17. The effect of that change was that remuneration of sportsmen and entertainers performing services for a contracting State in the other State were taxable at source under article 17, rather than being taxable only in the employer State under article 19, paragraph 1(a). It was agreed that the focus group should consider whether that change should be made in the United Nations Model Convention.

67. The OECD commentaries on article 21 (Other income) had been amended to suggest an additional provision to limit the application of the article to derivative transactions not at arm's length. The Group agreed that the focus group should consider that amendment, taking due note of the differences between the OECD and United Nations Model Conventions in the basic provisions of article 21.

68. In the 1980 United Nations Model Convention, the final sentence of article 24, paragraph 4 was in brackets, indicating that the sentence should be omitted in a treaty that did not contain an article on capital taxes (article 22). It was agreed that the brackets had been included in error because article 24 applied to all taxes, including capital taxes, even if capital taxes were not otherwise covered by the treaty.

69. Several members of the Group noted that some treaties contained provisions for collection assistance in article 26, even though neither the United Nations nor the OECD Model Convention contained such a provision. The Group agreed that the focus group, in its consideration of article 26, should examine whether the United Nations Model Convention or the commentaries should include provisions for collection assistance.

V. Technical training

70. The Secretariat presented a proposal for a series of training seminars in international taxation for tax administrators in developing and transitional economy countries. It was noted that with the growth of international commerce and investment, the tax administrations of all countries were faced with increasing challenges in assessing and collecting the taxes due to them from international transactions. For developing and transitional economy countries, that challenge was further complicated by limitations on their resources for developing practical expertise in international taxation, particularly such complex and quickly developing areas as transfer pricing and financial innovation. The Secretariat therefore proposed that the United Nations arrange a series of interregional workshops to improve the practical technical skills of tax administrators of developing and transitional economy countries in international taxation, including practical methods and strategies for combating tax evasion. The workshops would be based on case studies and lectures presented by experts in international taxation and finance, including eminent tax administrators and university professors. The workshops would also provide an opportunity for participating tax administrators to share their experience and point of view on matters having a vital bearing on the tax systems of their countries. The Secretariat proposed a series of five workshops to be held in five locations dispersed among the regions of the world. Each workshop would last 10 working days, and each would be attended by about 50 representatives of 15 to 20 developing countries in the region. It was proposed that although funding for the workshops had not yet been obtained, the costs be shared by the United Nations, the United Nations Development Programme, and the host countries.

71. The Group received the proposal with enthusiastic approval. Several members indicated that they would urge their countries to serve as hosts for one of the workshops or

to provide assistance in other ways. The members also suggested that financial support be sought from other organizations.

72. Members of the Group and observers made several suggestions for maximizing the effectiveness of the workshops. It was suggested that because all tax administrations lost personnel to the private sector, the workshops be structured to train workshop participants to train other members of their tax administrations in the matters covered in the workshops. Several members suggested that the workshops be planned in careful coordination with the training efforts of other organizations in order to focus the limited resources available for the workshops on subjects and countries that were not covered by other training programmes. Also, it was suggested that the workshops would be more successful if each workshop were focused on one or a small number of topics, and that it might not be desirable to mix in a single workshop participants from countries with tax administrations in widely differing stages of development. Also, those attending a workshop could only be expected to participate actively in the discussion, rather than merely listen to lectures, if the number of participants in each workshop was not greater than 25.

73. The Secretary thanked the members and observers for their suggestions, and noted that the United Nations welcomed participation and assistance from other organizations.

VI. Opening statement*

74. On behalf of the Secretary-General, I would like to extend my warm welcome to all the participants attending the eighth meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters. We are extremely grateful to all the members and observers of the Group of Experts for having found the time, despite their very busy schedules and preoccupations in their own countries, to continue the important work specifically assigned to the Group by the Economic and Social Council. I am also overwhelmed by the presence of so many representatives of various international, regional and interregional organizations. It is indeed gratifying to note their active support and participation in the Group's deliberation.

75. In its resolution 1273 (XLIII) of 4 August 1967, the Economic and Social Council requested the Secretary-General to set up an ad hoc working group consisting of experts and tax administrators nominated by Governments, but acting in their personal capacity, both from developed and developing countries and adequately representing different regions and tax systems, with the task of exploring, in consultation with interested international agencies, ways and means for facilitating the conclusion of tax treaties between developed and developing countries, including the formulation, as appropriate, of possible guidelines and techniques for use in such tax treaties that would be acceptable to both groups of countries and would fully safeguard their respective revenue interests. Pursuant to that resolution, in 1968 the Secretary-General set up the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries, composed of tax officials and experts from the specified countries. In its programme budget for the 1998–1999 biennium (A/52/303), the General Assembly requested that the United Nations Model Convention Double Taxation Convention and the manual for the negotiation of tax treaties between developed and developing countries be updated and constitute major outputs in 1999.

76. The agenda provides for review by the Group of substantive issues related to tax treatment of tax havens, new financial instruments, transfer pricing and the revision of the United Nations Model Double Taxation Convention and manual. Your deliberations on those issues may provide for suggestions, recommendations and guidelines.

77. One of the substantive agenda items that was discussed and will be reviewed by the Group concerns the revision and update of the United Nations Draft Model Double Taxation Convention between Developed and Developing Countries and the manual for the negotiation of bilateral tax treaties between developed and developing countries. After the publication of the Model Convention in 1980, the Council decided that the Group should continue and extend the scope of its work. The process of revising and updating the Model Convention has continued since then, and the draft version prepared by the Group has been considered by the Steering Committee and will now be discussed by the Group of Experts. The primary goals of the revised version of the Model Convention is to establish fiscal guidelines for trade liberalization and expansion with a view to releasing additional resources for sustainable growth and promoting tax harmonization. The deliberations of the Group at this meeting will reflect whether those goals are likely to be realized.

78. A second substantive agenda item deals with financial instruments. The role of new financial instruments, in particular derivatives, in promoting international commerce is very significant. Derivatives are basically financial

* Delivered by Mr. Abdel Hamid Bouab of the United Nations Secretariat, on behalf of the Secretary-General.

agreements whose returns are linked to or derived from the performance of an underlying asset, such as bonds, currencies and commodities. The innovative financial instruments present challenges to the four main issues with which tax legislation is basically concerned, namely, quantification of income, character of income, timing of realization and source of income or gain. Taxation of new financial instruments and derivatives is a new area, particularly for developing countries. The absence of consensus on the treatment of financial instruments may seriously hamper free flow of capital, and may quite possibly lead to tax evasion and even double taxation. It is hoped that the deliberations of the Group may lead to harmonization of tax treatment of new financial instruments.

79. A third substantive agenda item relates to the tax treatment of transfer pricing. In 1974, the Group observed that transfer pricing was an issue of primary importance, both for developed and developing countries, in connection with the proper international treatment of multinational corporations and their complex network of subsidiaries and branches. Even after 23 years, the question of transfer pricing has still continued to engage the attention of tax administrators the world over. The widely differing tax rates and practices in different countries in which multinational corporations and their associated enterprises operate has prompted them to adopt transfer-pricing strategies to minimize the aggregate tax burden. The arm's length principle which is universally considered to be adequate to deal with the transfer-pricing phenomenon is also beset with innumerable difficulties. It is considered that the active role played by OECD and the Group of Experts in dealing with the transfer-pricing mechanisms will lead to obtaining a consensus in the matter.

80. A fourth substantive agenda item deals with tax havens, including exchanges of information. Tax havens which connote a tax jurisdiction that imposes little or no tax on taxable entities have been increasingly utilized in transfer-pricing mechanisms to shelter profits in transactions between head office and branches in other countries. Since tax havens are being used increasingly by drug traffickers and smugglers for parking their ill-gotten gains from nefarious and socially undesirable activities, there is a need to arouse world conscience against their continuance.

81. As regards other topics that the Group may consider, one of the proposals made at the seventh meeting was the provision of technical assistance to developing countries by upgrading the skills in negotiating capabilities of tax treaties. The United Nations proposes to arrange workshops in major developing countries to impart training in international taxation to tax administrators in the region. Subject to satisfactory financial arrangements, five or six workshops may be held in 1998 at Accra, Abidjan, Buenos Aires, Kuala Lumpur, Moscow and New Delhi. A paper on this subject prepared by the United Nations Secretariat is before the meeting. All delegates attending the meeting are requested to give their views on this proposal with a view to improving its functional utility.

82. The agenda is both challenging and stimulating. I am sure that your deliberations and constructive suggestions will be of immense benefit to the international community. I and my colleagues in the Secretariat stand ready to facilitate your work by assisting you in every way we can.

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Annex II

List of documents

ST/SG/AC.8/1997/L.1	Annotated provisional agenda
ST/SG/AC.8/1997/L.2	United Nations Model Double Taxation Convention between Developed and Developing Countries
ST/SG/AC.8/1997/L.3	The United Nations Model in practice
ST/SG/AC.8/1997/L.4	Issues raised by the use of tax havens, with particular reference to the obtaining of information concerning tax haven transactions by tax authorities of other countries
ST/SG/AC.8/1997/L.5	Taxation of derivatives and new financial instruments
ST/SG/AC.8/1997/L.6	The globalization of capital markets
ST/SG/AC.8/1997/L.7	The taxation of international income in developing countries
ST/SG/AC.8/1997/L.8	Review of tax treaties between developing countries: a comparison with the United Nations Model Double Taxation Convention between Developed and Developing Countries
ST/SG/AC.8/1997/L.9 and 10	Not issued
ST/SG/AC.8/1997/L.11	Tax havens: the need to neutralize their distorting effects in the international tax context
ST/SG/AC.8/1997/L.12	Manual for the negotiation of bilateral tax treaties between developed and developing countries
ST/SG/AC.8/1997/L.13	Report of informal consultation of members of the Steering Committee for the Eighth Meeting of the Group of Experts
ST/SG/AC.8/1997/L.14	Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on the work of its eighth meeting
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ST/SG/AC.8/1997/CRP.1	1996 Update to the OECD Report Multinational Enterprises and Tax Administrations
ST/SG/AC.8/1997/CRP.2	Transfer pricing and arm's length principle: Nigeria's Experience
ST/SG/AC.8/1997/CRP.3	Comments on the revision of the United Nations Model Tax Convention and its commentaries

ST/SG/AC.8/1997/CRP.4	Proposals about amendments to be introduced into the United Nations Model Double Taxation Convention between Developed and Developing Countries
ST/SG/AC.8/1997/CRP.7	Descriptions of the 1994, 1995 and 1997 updates to the Model Tax Convention
ST/SG/AC.8/1997/CRP.8	The 1996 and 1997 updates to the transfer pricing guidelines for multinational enterprises and tax administrations
ST/SG/AC.8/1997/CRP.9	Innovative financial transactions: tax policy implications (A report by the special sessions on innovative financial transactions)
ST/SG/AC.8/1997/CRP.10	Update of the United Nations Model and the manual for the negotiation of bilateral tax treaties between developed and developing countries. The United Nations Model Convention: revision or reform?
ST/SG/AC.8/1997/CRP.11	Proposal for training of tax administrators in developing and transitional economy countries in international taxation
ST/SG/AC.8/1997/CRP.12	Prevention of use and abuse of tax havens: exchange of information
ST/SG/AC.8/1997/CRP.13	Summary of changes in OECD Model Convention and commentaries
ST/SG/AC.8/1997/CRP.14	Update of the United Nations Model Convention
ST/SG/AC.8/1997/CRP.15	APFF comments with respect to tax havens
ST/SG/AC.8/1997/CRP.16	Brazilian legislation related to transfer pricing

Part two

Selected papers presented at the meeting

The United Nations Model Double Taxation Convention Between Developed and Developing Countries in practice*

I. Introduction

1. The aim of the present paper is to assess the impact of the United Nations Model Double Taxation Convention Between Developed and Developing Countries on current tax treaty practice. It is based on an extensive research project, in which 811 concluded treaties were scrutinized in order to ascertain whether they had adopted the distinctive provisions of the United Nations Model Convention. The provisions considered were determined by comparing the United Nations Model Convention with the OECD Model Tax Convention on Income and Capital of 1977. The changes made to the OECD Model Convention in 1992 and subsequently were not taken into account.

2. The research project was carried out using the International Bureau of Fiscal Documentation Tax Treaty Database. It covered all comprehensive tax treaties concluded from 1 January 1980, the year in which the United Nations Model Convention was published, to 1 April 1997, the date of the most recent version of the Tax Treaty Database. The treaties concluded by the former USSR and former Yugoslavia that continue to be applied by a number of new States in that region of the world were counted only once.

3. For the purposes of the present research project, a distinction had to be drawn between developed and developing countries. Such a distinction inevitably carries an element of subjectivity, and so that invidious task was considerably simplified by reference to membership of the Organisation for Economic Cooperation and Development (OECD) at the time of publication of the United Nations Model Convention. The 24 countries that were members of OECD in 1980 were regarded as developed countries, and all other countries were regarded as developing countries, regardless of their actual stage of development. That meant, for example, that Mexico and Hungary, which joined OECD only recently, were counted as developing countries.

4. In the first instance, research focused on the tax treaties concluded by developing countries with either a developed or another developing country; that group, referred to as group A in the present paper, comprised 697 treaties. The project also looked at the tax treaties concluded between OECD countries; that group, referred to as group B, comprised 114 treaties.

5. The provisions that are specific to the United Nations Model Convention are scrutinized below, as follows:

No.	*Article*	*Paragraphs*
5(3)(a)	Construction activities	8–15
5(3)(b)	Furnishing of services	16–21
5(4)(a) and (b)	Delivery of goods	22–24
5(4)(f) OECD	Combination of activities	25–26
5(5)(b)	Stock agents	27–33
5(6)	Insurance activities	34–39

* Prepared by W. F. G. Wijnen and Marco Magenta, Consultants to the Department of Economic and Social Affairs of the United Nations Secretariat.

No.	*Article*	*Paragraphs*
5(7)	Agents with one principal	40–44
7(1)	Limited force of attraction	45–52
7(3)	Management fees, interest and royalty payments	53–55
7(5) OECD	Purchase of goods	56–57
8B	Shipping profits	58–63
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–	Summary of groups A and B coverage of articles scrutinized	132

6. Provisions relating to the withholding taxes on dividends, interest and royalties were not examined since the United Nations Model Convention, unlike the OECD Model Convention, does not recommend a particular percentage for those categories of income. In that respect, any withholding rate, including the rates recommended by the OECD Model Convention, is consistent with the United Nations Model Convention. A more fundamental question that was not examined is the omission from the United Nations Model Convention of the second sentence of Article 4(1) of the OECD Model Convention, which limits the treaty concept of residence. The inclusion or omission of that provision is so intertwined with the rest of the treaty and the domestic law of the treaty partners that it would have been impossible to consider it without extending the project to unmanageable proportions.

7. Even the most cursory glance at a number of concluded treaties is sufficient to reveal the tremendous variety that can be achieved within the confines of a seemingly simple and rigid framework. The authors of the present paper had no choice but to select the most important and commonly occurring variations for comment. Nevertheless, where appropriate, some provisions of particular interest are mentioned even though they are found in only a very limited number of treaties.

II. Article 5 (3) (a): Construction activities

A. The United Nations Model Convention

8. Article 5 (3) (a) of the United Nations Model Convention reads as follows:

"(3) *The term 'permanent establishment' likewise encompasses:*

(a) A building site, a construction, *assembly* or installation project *or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;*

(b) *(...)*"

9. The relevant differences between the construction clause of the OECD and the United Nations Model Conventions refer to:

(a) The inclusion of supervisory activities;

(b) The minimum period of six months.

B. Tax treaties

1. Supervisory activities

10. According to the OECD commentary, supervisory activities are explicitly subsumed under the construction clause provided that the work is performed by the main contractor himself. However, supervisory activities performed by a subcontractor who is not engaged in the physical work do not constitute a permanent establishment. In that respect, the United Nations Model Convention departs from the OECD Model Convention. According to the United Nations Model Convention, supervisory activities may constitute a permanent establishment irrespective of whether they are performed by the main or subcontractor and irrespective of whether the contractor is physically involved in the work.

11. There are 449 treaties in which supervisory activities are included as one of the elements that may constitute a permanent establishment. Of those, 410 were concluded by developing countries, with either a developed or another developing country (group A), and 39 were concluded between developed countries (group B).

2. Minimum period

12. There are 513 treaties that prescribe a minimum period shorter than the 12 months recommended by the OECD Model Convention. Of those, 484 were concluded by developing countries with either a developed or another developing country (group A), and 29 were concluded between developed countries (group B). Of the 29 treaties in group B, five prescribe a 9-month period and 24 prescribe a 6-month period. The following periods shorter than 12 months are found in the treaties:

	Period	
Number of treaties	*Days*	*Months*
50	—	9
2	275	—
2	—	8
1	—	7
355	—	6
58	183	—
1	—	5
5	120	—
29	—	3
3	90	—
7	0*	0*

* No minimum period is included.

13. There are 298 treaties that prescribe a minimum period of 12 months or longer. Of those, 215 were concluded by developing countries with either a developed or another developing country (group A), and 83 were concluded between developed countries (group B). All treaties in group B prescribe a 12-month period.

14. The following periods of 12 months or longer are found in the treaties:

	Period	
Number of treaties	*Days*	*Months*
2	—	36
4	—	24
3	—	18
289	—	12

15. For the sake of completeness, it should be mentioned that a few treaties contain different limits for the various types of construction activity.

III. Article 5 (3) (b): Furnishing of services

A. The United Nations Model Convention

16. Article 5 (3) (b) of the United Nations Model Convention reads as follows:

"*(3) The term 'permanent establishment' likewise encompasses:*

(a) (...);

(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period."

17. This provision is not specifically included in the OECD Model Convention.

B. Tax treaties

18. There are 221 tax treaties with a specific provision for the furnishing of services. Of those, 219 were concluded by developing countries with either a developed or another developing country (group A), and two were concluded between developed countries (group B).

19. The following periods are found in the treaties:

	Period	
Number of treaties	*Days*	*Months*
1	—	18
19	—	12
9	—	9
2	275	—
1	—	8
111	—	6
34	183	—
3	—	4
6	120	—
23	—	—
2	91	—
5	90	—
5	0*	0*

* No minimum period is adopted.

20. In 10 treaties concluded by developing countries (group A), a distinction is made between services performed for unrelated enterprises and services performed for related enterprises. In those treaties, a minimum period applies to services performed for unrelated enterprises and no minimum period or a shorter minimum period applies to services performed for related enterprises. Seven treaties prescribe no minimum period in situations involving related parties, and three treaties prescribe a shorter period than for situations involving unrelated parties (i.e., 30 days instead of 90 days).

21. The two treaties between developed countries (group B) prescribe the 6-month period recommended by the United Nations Model Convention.

IV. Article 5 (4) (a) and (b): Delivery of goods

A. The United Nations Model Convention

22. Article 5 (4) (a) and (b) read as follows:

"(4) Notwithstanding the preceding provisions of this article, the term 'permanent establishment' shall be deemed not to include:

(a) The use of facilities solely for the purpose of storage *or* display *[]* of goods or merchandise belonging to the enterprise;

(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage *or* display *[]*; (...)."

23. In this paragraph, the term "delivery" as provided in the corresponding provisions of the OECD Model Convention is omitted.

B. Tax treaties

24. There are 167 tax treaties that do not list "delivery" as one of the activities that do not constitute a permanent establishment. All are concluded by developing countries with either a developed or another developing country (group A).

V. Article 5 (4) (f) OECD: Combination of activities

A. The United Nations Model Convention

25. The United Nations Model Convention does not include the provision contained in Article 5 (4) (f) of the OECD Model Convention, which is formulated as follows:

"... the maintenance of a fixed place of business solely for any combination of activities, mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character."

B. Tax treaties

26. In line with the United Nations Model Convention, no provision for the combination of activities is adopted in 264 treaties. Of those, 233 were concluded by developing countries with either a developed or another developing country (group A), and 31 were concluded between developed countries (group B).

VI. Article 5 (5) (b): Stock agents

A. The United Nations Model Convention

27. Article 5 (5) (b) of the United Nations Model Convention reads as follows:

"(5) Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 7 applies – is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such person:

(a) Has and habitually exercises in that State an authority to conclude contracts ...; *or*

(b) *Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.*"

28. This subparagraph (b) extends the concept of an "agent".

B. Tax treaties

29. There are 243 treaties with a specific provision for stock agents. Of those, 234 were concluded by developing countries with either a developed or another developing country (group A), and nine were concluded between developed countries (group B).

30. The provisions differ in wording albeit not in content. Thus, in 62 of the treaties, reference is made to the fulfilment of orders or to the supply of goods rather than to the delivery of goods.

31. In addition to the provision for stock agents, 56 of the treaties include a specific provision for agents who habitually secure orders for the sale of goods or merchandise. Further, 30 of those treaties include a specific provision for agents who manufacture or process goods. An example of the first type of provision is:

"*(c) he habitually secures orders for the sale of goods or merchandise in the first mentioned State, wholly or almost wholly on behalf of the enterprise itself, or on behalf of the enterprise and other enterprises controlled by it or which have a controlling interest in it.*"

32. An example of a provision for agents who manufacture goods is:

> "*(c) he manufactures, assembles, processes, packs or distributes in the first-mentioned State for the enterprise goods or merchandise belonging to the enterprise.*"

33. Finally, in two treaties the specific provision for stock agents applies only in the case of abuse. This provision reads as follows:

> "*(b) (stock agent) ... The foregoing provision of this subparagraph shall apply only if it is proved that in order to avoid taxation in the first-mentioned State, such person undertakes not only the regular delivery of the goods or merchandise, but also undertakes virtually all the activities connected with the sale of goods or merchandise except for the actual conclusion of the sales contract itself.*"

VII. Article 5 (6): Insurance activities

A. The United Nations Model Convention

34. Article 5 (6) of the United Nations Model Convention reads as follows:

> "*(6) Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.*"

35. This provision is not included in the OECD Model Convention. The provision broadens the definition of permanent establishment by including the following activities carried on by insurance enterprises:

(a) The collection of premiums;

(b) The insurance of risks.

36. These activities qualify as a permanent establishment only if they are not performed through an agent of an independent status.

B. Tax treaties

37. There are 210 tax treaties with a specific provision for insurance activities. Of those, 184 were concluded by developing countries with either a developed or another developing country (group A), and 26 were concluded between developed countries (group B).

38. It should be noted, however, that only in 137 treaties (5 of which belong to group B) are insurance activities deemed to constitute a permanent establishment as provided by the United Nations Model Convention. In the remaining 73 treaties (21 of which belong to group B), the same result is achieved by adopting in article 7 or in the protocol to article 7 a provision stating that the provisions of article 7 do not affect the application of domestic law regarding the taxation of profits from insurance business.

39. In seven treaties in group A, the right of the source State to tax profits from insurance activities is limited to 2.5 per cent of the gross amount of the premiums. In one of those treaties, that limitation applies only to profits from reinsurance activities, while the right to tax profits from insurance activities remains unlimited.

VIII. Article 5 (7): Agents with one principal

A. The United Nations Model Convention

40. Article 5 (7) of the United Nations Model Convention reads as follows:

> "(7) An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. *However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph.*"

41. The second sentence of this provision extends the scope of the permanent establishment concept by treating an agent who acts wholly or almost wholly for one principal as a dependent agent.

2. Tax treaties

42. There are 243 tax treaties with a specific provision for agents with only one principal. All have been concluded by

developing countries with either a developed or another developing country (group A).

43. In 54 of those treaties, the scope of this provision is limited to cases in which the transactions between the agent and the enterprise are not on an arm's length basis. An example of such an additional clause is: "*(...) if the transactions between the agent and the enterprise were made under conditions which differ from those which would be made between independent enterprises.*" In five of those treaties, the taxpayer is given the possibility of demonstrating that the transactions were concluded in arm's length conditions.

44. In 22 of those treaties, this specific provision covers not only activities performed by the agent on behalf of the enterprise itself but also activities on behalf of associated enterprises. In that case, the provision may be formulated as follows: "However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise *itself or on behalf of that enterprise and other enterprises controlling, controlled by, or subject to the same common control, as that enterprise,* he will not be considered an agent of an independent status within the meaning of this paragraph."

IX. Article 7 (1): Limited force of attraction

A. The United Nations Model Convention

45. Article 7 (1) contains a force of attraction, which is limited as follows:

> "(1) The 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 through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; *(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.*"

46. Clauses (b) and (c) strengthen the position of the source State by extending its right to tax to profits from business activities that are not carried out by an enterprise through its permanent establishment. The source State may attribute such non-p.e. profits to a permanent establishment of the enterprise it they are derived from the sale of goods or merchandise or any other business activity in the source State, provided that these transactions are similar to those concluded through the permanent establishment.

B. Tax treaties

47. There are 162 treaties with a limited force of attraction rule. Of those, 153 were concluded by developing countries with either a developed or another developing country (group A), and nine were concluded between developed countries (group B).

48. In 38 of those treaties (one of which belongs to group B), the enterprise may prove that the transactions or activities were genuinely carried out other wise than through the permanent establishment. The wording of this provision differs in the various treaties. Two frequently recurring examples are:

> "*However, the profits derived from the sales described in subparagraph (b) or other business activities described in subparagraph (c) shall not be taxable in the other State if the enterprise demonstrates that such sales or business activities have been carried out for reasons other than obtaining a benefit under this convention.*"

> "*The provisions of subparagraph (b) and (c) shall not apply if the enterprise shows that such sales or activities could not reasonably have been undertaken by that permanent establishment.*"

49. In 19 of those treaties (five of which belong to group B), the limited force of attraction rule applies only in cases of tax avoidance or abuse, in which case the burden of proof is on the tax authorities. An example of such a provision is:

> "*The provisions of subparagraph (b) and (c) shall only apply provided that it is proved that the transaction concerned has been resorted to in order to avoid taxation in the Contracting State where the permanent establishment is situated.*"

50. In 12 treaties (three of which belong to group B), the limited force of attraction rule applies only if there is some connection with the permanent establishment. An example of such a provision is:

> "*The provisions of subparagraph (b) and (c) shall only apply provided that the permanent establishment has*

contributed in any manner in those sales or activities."

51. In six treaties in group A, the scope of the limited force of attraction rule is restricted; the rule applies only to sales of goods or merchandise and business activities of the *same* kind as those sold or effected through the permanent establishment, not to *similar* sales and activities.

52. One treaty in group A refers only to sales, not to other business activities.

X. Article 7 (3): Management fees, interest and royalty payments

A. The United Nations Model Convention

53. Article 7 (3) of the United Nations Model Convention reads as follows:

> "(3) In *the determination* of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes *of the business* of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. *However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise by way of interest on moneys lent to the head office of the enterprise or any of its other offices."*

54. In the above paragraph, the principles laid down in the first sentence are defined and clarified in the second and third sentences.

B. Tax treaties

55. There are 201 treaties that include a clarification with respect to the determination of the profits of a permanent establishment. Of those, 195 were concluded by developing countries with either a developed or another developing country (group A), and six were concluded between developed countries (group B).

XI. Article 7 (5): OECD: Purchase of goods

A. The United Nations Model Convention

56. The United Nations Model Convention does not include the provision contained in article 7 (5) of the OECD Model Convention, which is formulated as follows:

> "No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise."

B. Tax treaties

57. In line with the United Nations Model Convention, the above-mentioned provision is omitted from 45 treaties. All were concluded by developing countries with either a developed or another developing country (group A).

XII. Article 8 B: Shipping profits

A. The United Nations Model Convention

58. Article 8 B (2) of the United Nations Model Convention reads as follows:

> *"Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other*

State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ... per cent. (The percentage is to be established through bilateral negotiations.) (...)"

59. This provision attributes to the source State a limited right to tax shipping profits, if the shipping activities in the source State are more than casual.

B. Tax treaties

60. There are 108 treaties providing for source State taxation with respect to shipping profits. Of those, 105 were concluded by developing countries with either a developed or another developing country group (group A), and three were concluded between developed countries (group B).

C. Deviations from the United Nations Model Convention

61. A number of treaties contain provisions similar to but deviating from the United Nations Model Convention. The most relevant deviating provisions can be summarized as follows:

(a) In four treaties in group A, the taxing right of the source State is unlimited;

(b) In 101 treaties in group A and three in group B, the right of the source State to tax is not dependent on the activities being "more than casual". Consequently, under those treaties it is irrelevant whether there is a scheduled or planned visit of a ship to a particular country to pick up freight or passengers;

(c) In 14 treaties in group A, the scope of the provision is extended to air transport profits;

(d) Five treaties in group A provide for a limited taxing right during the first 10 fiscal years after the entry into force of the treaty. After that period, the source State loses its right to tax profits of shipping enterprises of its treaty partner.

62. In three treaties in group A, the taxing right of the source State is limited to profits from the operation of ships between ports of the source State and ports of third States. Profits from operations between ports of the source State and ports of the treaty partner State are therefore not subject to tax in the source State.

D. Limitations to the taxing right of the source State

63. There are various types of limitation in the 104 treaties that provide for a limited right to tax in the source State. Those limitations can be summarized as follows:

(a) Fifty-nine treaties in group A and three in group B provide for a reduction of the tax imposed by the source State by 50 per cent;

(b) One treaty in group A provides for a reduction of the tax imposed by the source State by two thirds;

(c) Five treaties in group A provide for a reduction of the tax imposed by the source State of 50 per cent during the first five years after the entry into force of the treaty and of 25 per cent during the subsequent five years;

(d) Eight treaties in group A allow a withholding tax to be levied on the gross amount of the receipts derived in the source State; the withholding percentages vary from 1 to 3 per cent;

(e) Five treaties in group A provide for a maximum taxation in the source State equal to the lesser of 50 per cent of the tax imposed by domestic law and a certain percentage of the gross receipts derived in that State; the percentage varies from 2 to 4 per cent;

(f) Thirteen treaties provide that the tax charged by the source State "*shall not exceed the lesser of: (a) 1.5 per cent of the gross revenue derived from sources in that State; and (b) the lowest rate of (name of one Contracting State) tax that may be imposed on profits of the same kind derived under similar circumstances by a resident of a third State.*" In one of those treaties, the percentage in (a) is 1 per cent rather than 1.5 per cent;

(g) Ten treaties provide that (a) the tax imposed by the source State is to be reduced by 50 per cent and (b) the taxable profits are to be deemed not to exceed a certain percentage of the gross receipts; the percentage varies from 5 to 7.5 per cent.

XIII. Article 12 (3): Radio or television broadcasting

A. The United Nations Model Convention

64. The royalty definition of article 12 (3) of the United Nations Model Convention reads as follows:

"(3) The term 'royalties' as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, *or films or tapes used for radio or television broadcasting*, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience."

65. The OECD Model Convention does not include in the definition of the term "royalties" payments made as a consideration for the use of or the right to use films or tapes used for radio or television broadcasting.

B. Tax treaties

66. There are 712 treaties that mention films or tapes used for radio or television broadcasting in the royalty definition. Of those, 610 were concluded by developing countries with either a developed or another developing country (group A), and 102 were concluded between developed countries (group B).

67. It should be mentioned, however, that radio broadcasting is not mentioned in 39 treaties in group A and six treaties in group B. Further, six treaties in group A and five in group B include a generic reference to sound and video recording or to all means of reproduction of sound and image, while television and radio broadcasting are not expressly mentioned.

XIV. Article 13 (4):Real property shares

A. The United Nations Model Convention

68. Article 13 (4) of the United Nations Model Convention reads as follows:

"*(4) Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State.*"

69. This provision is not specifically included in the OECD Model Convention.

B. Tax treaties

70. There are 374 treaties with a specific provision for real property shares. Of those, 308 were concluded by developing countries with either a developed or another developing country (group A), and 66 were concluded between developed countries (group B). In a number of those treaties, real property shares are dealt with not in a separate paragraph but together with gains on the alienation of real property in the first paragraph of the capital gains article.

71. In many treaties, real property shares quoted on an approved stock exchange are excluded from this special regime. On the other hand, quite a number of treaties specifically include interests in real property partnerships and/or trusts.

72. In nine treaties, the special regime for real property shares applies only if the participation exceeds a certain limit.

XV. Article 13 (5): Other shares

A. The United Nations Model Convention

73. Article 13 (5) of the United Nations Model Convention reads as follows:

"*(5) Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of ... per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.*"

74. Under the OECD Model Convention the right to tax capital gains on the alienation of shares is attributed to the State of which the alienator is resident, whereas under the United Nations Model Convention, that right is attributed to the State of which the company is resident (the source State).

B. Tax treaties

75. There are 384 treaties which more or less follow the recommendation of the United Nations Model Convention. Of those, 322 were concluded by developing countries with either a developed or another developing country (group A), and 62 were concluded between developed countries (group B).

76. In all, the taxing right on capital gains on shares is explicitly attributed to the source State. It should be mentioned, however, that the same result may be achieved without such an explicit attribution. This is the case if, for example, the capital gains article does not contain a sweeping clause and there is no other income article, or there is another income article that is in conformity with article 21 (3) of the United Nations Model Convention. Such situations, in which the source State can apply its domestic legislation, are not included in the above-mentioned figures.

77. Further, it should be mentioned that the structure and wording of the regime for capital gains on shares in many treaties deviate considerably from the recommendation of the United Nations Model Convention set out above. The complexity of this regime in many treaties makes it difficult to consider its elements in isolation rather than in their entire context. Nevertheless, a few general remarks can be made.

78. In many treaties, the taxation right attributed to the source State is limited:

(a) In 82 treaties in group A and 25 treaties in group B, the source State has only the right to tax capital gains on shares derived by individuals who emigrated to the treaty partner State. In most of those treaties, this taxation right is limited to a certain period after emigration;

(b) In 13 treaties in group A, the tax that the source State may levy on capital gains on shares is explicitly limited to a certain percentage, varying from 10 to 25 per cent;

(c) In seven treaties in group A and one in group B, the taxation right of the source State is limited by the exclusion of capital gains realized in the course of a corporate organization, reorganization, amalgamation, division or similar transaction;

(d) In two treaties in group A and three in group B, the taxation right of the source State is limited to cases in which the shares are sold to a resident of the source State.

79. In 228 treaties in group A and 50 treaties in group B, no minimum participation requirement is adopted. Of the remaining 106 treaties, 44 have a participation requirement based on the shares sold, and 62 have one based on the shares owned by the seller.

XVI. Article 14 (1): Additional criteria

A. The United Nations Model Convention

80. Article 14 (1) of the United Nations Model Convention reads as follows:

"(1) Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State *except in the following circumstances, when such income may also be taxed in the other Contracting State:*

(a) If he has [] a fixed base *regularly available to him in the other Contracting State for the purpose of performing his activities; in that case*, only so much of *the income* as is attributable to that fixed base *may be taxed in that other Contracting State; or*

(b) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State; or

(c) If the remuneration for his activities in the other Contracting State is paid by a resident of that Contracting State or is borne by a permanent establishment or a fixed base situated in that Contracting State and exceeds in the fiscal year ... (the amount is to be established through bilateral negotiations)."

81. The principal differences between the independent personal services provisions of the OECD and United Nations Model Conventions are to be found in the criteria based on:

(a) A length of stay of 183 days;

(b) An amount of remuneration.

B. Tax treaties

1. The length of stay

82. In comparison with the OECD Model Convention, the source State's right to tax is extended by a provision that it may tax if a professional is present in that State for at least 183 days in a fiscal year, even if there is no fixed base.

83. There are 284 tax treaties with a length of stay criterion. Of those, 264 were concluded by developing countries with either a developed or another developing country (group A), and 20 were concluded between developed countries (group B).

84. The following periods are found in the treaties:

	Length of stay in	
Number of treaties	*Days*	*Months*
225	183	
1	182	
2	180	
1		6
17	120	
2	91	
36	90	

85. There are no treaties between developed countries that prescribe a period shorter than 183 days.

86. The length of stay must be computed over the fiscal year, a period of 12 months or the calendar year. One treaty, however, provides for a length of stay (183 days) to be computed over two consecutive years.

87. No fixed base criterion has been adopted in 46 of those treaties, two of which have been concluded between developed countries. In one treaty in group A, neither a fixed base nor a 183 days' presence in the source State is per se sufficient to attribute a taxing right to the source State, but both criteria must be met at the same time.

88. In two treaties in group A, the right to tax is attributed to the source State if a fixed base is maintained in that State for at least 183 days. In that case, the existence of the fixed base is irrelevant if it is not maintained for a period of at least 183 days. On the other hand, the fact that a professional stays in the source State for more than 183 days is also not relevant in the absence of a fixed base maintained for the said period.

2. The amount of remuneration

89. In the United Nations Model Convention, the source State's right to tax is extended by a provision that the source State may tax any remuneration for independent personal services that exceeds a certain amount.

90. There are 45 tax treaties that include a criterion based on the amount of remuneration; all have been concluded by developing countries with either a developed or another developing country (group A).

91. No fixed base criterion has been adopted in 14 of those treaties; two of them also include no length of stay criterion.

XVII. Article 16 (2): Top-level managerial officials

A. The United Nations Model Convention

92. Article 16 (2) of the United Nations Model Convention reads as follows:

> "*(2) Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.*"

93. In this provision, the principle applicable to the taxation of directors' fees is extended to the taxation of the remuneration paid to top-level managerial officials.

B. Tax treaties

94. There are 68 treaties dealing with remuneration paid to top-level managerial officials. Of those, 62 were concluded by developing countries with either a developed or another developing country (group A), and 6 were concluded between developed countries (group B).

95. In 11 treaties (five of which belong to group B), a definition is adopted of the term "top-level managerial function". According to that definition, the term applies only to functions similar to those carried out by the members of the board of directors referred to in article 16 (1) of the OECD and United Nations Model Conventions.

96. In seven treaties (three of which belong to group B), remuneration for the discharge of day-to-day functions is excluded from the scope of article 16. In those treaties, such remuneration is covered by article 15 (Dependent personal services).

XVIII. Article 18 A (2) and 18 B (3): Social security payments

A. The United Nations Model Convention

97. The provision recommended by the United Nations Model Convention in article 18 A (2) and 18 B (3) on social security payments reads as follows:

> "*Notwithstanding the provisions of paragraph 1, pension paid and other payments made under a public scheme which is part of the social security system of*

a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State."

98. This provision is not specifically included in the OECD Model Convention. It attributes an exclusive taxation right to the source State.

B. Tax treaties

99. There are 254 treaties with a separate provision for social security payments attributing the right to tax to the source State. Of those, 206 were concluded by developing countries with either a developed or another developing country (group A), and 48 were concluded between developed countries (group B).

100. Most of those treaties prescribe an exclusive taxation right. Only in 31 treaties in group A and 20 treaties in group B is a non-exclusive taxation right attributed to the source State.

101. In 15 treaties in group A and five in group B, the taxation right attributed to the source State is limited by the exclusion of social security payments made to an individual who is both a resident and a national of the treaty partner State. In one treaty in group A and one treaty in group B, the taxation right of the source State is limited to social security payments made to nationals of the source State. Finally, in one treaty in group B, the taxation of the source State is limited by a maximum rate of 17.5 per cent.

XIX. Article 18 B (1) and (2): Pensions

A. The United Nations Model Convention

102. The provisions recommended by the United Nations Model Convention in article 18 B (1) and (2) on pensions read as follows:

"(1) Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration to past employment *may be taxed* in that State.

"(2) *However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.*"

103. The OECD Model Convention does not attribute any right to tax to the source State. The United Nations Model Convention attributes a non-exclusive taxation right to the source State.

B. Tax treaties

104. There are 295 treaties attributing to the source State a right to tax pensions. Of those, 259 were concluded by developing countries with either a developed or another developing country (group A), and 36 were concluded between developed countries (group B).

105. Most of those treaties prescribe a non-exclusive taxation right. Only in 41 treaties in group A and four treaties in group B is an exclusive taxation right attributed to the source State. In one treaty in group B, the exclusive taxation right of the source State applies only to the State's own nationals.

106. In 149 treaties in group A and 28 in group B, the taxation right of the source State applies to annuities. It should be noted, however, that in six of those treaties in group A, the source State taxation applies only to annuities and not to pension payments, which are taxable exclusively in the residence State.

107. In 16 treaties in group A and eight treaties in group B, the taxation right of the source State is limited to lump sum payments, while all other pension payments are taxable only in the residence State of the recipient.

108. In a number of treaties, the right of the source State to tax pensions is not specifically dealt with by a separate treaty provision. In 14 treaties in group A and three treaties in group B, that taxation right is based on an "other income" article that is in line with the United Nations Model Convention. In six treaties, there is no "other income" article, which means that the source State can apply its domestic law.

109. In 34 treaties in group A and six in group B, the taxation right of the source State is limited to a percentage that varies from 5 to 20 per cent. Furthermore, two treaties in group B provide for a reduction of 50 per cent of the ordinary tax rate in the source State. In most of those treaties, the limited flat rate does not apply in all cases. In some treaties, the limited taxation right applies only to periodic payments, while lump sum payments are subject to ordinary taxation. In other treaties, pensions are subject to a limited taxation right, or if lower, the tax which would be due by a resident of the source State on the pension payment

and/or annuity. Further, there are treaties providing for different percentages for pension payments and annuities.

110. In six treaties in group A and one in group B, the taxation right of the source State is limited to payments that exceed a certain amount per year. In six other treaties in group A, the allocation of the taxation right to the source State is subject to the condition that the pension and/or annuity be borne, paid or deducted by an enterprise or a permanent establishment situated in that State.

111. In nine treaties in group A and two in group B the taxation right of the source State is limited to pensions and/or annuities that are paid to a former resident of the source State.

112. In a number of treaties, the taxation right of the source State depends in various configurations on the nationality of the receiver of the pension payment or annuity. A few other treaties contain a number of other additional conditions.

XX. Article 20 (2): Equal treatment of students

A. The United Nations Model Convention

113. Article 20 (2) of the United Nations Model Convention reads as follows:

> "*(2) In respect of grants, scholarships and remuneration from employment not covered by paragraph 1, a student or business apprentice described in paragraph 1 shall, in addition, be entitled during such education or training to the same exemptions, reliefs or reductions in respect of taxes available to residents of the State which he is visiting.*"

114. This provision is not specifically included in the OECD Model Convention.

B. Tax treaties

115. There are 53 treaties with a specific equal treatment provision for students. All were concluded by developing countries with either a developed or another developing country (group A).

116. It should be mentioned, however, that there are many treaties prescribing a greater exemption, relief or reduction than that recommended by the United Nations Model Convention.

XXI. Article 21 (3): Source State taxation of other income

A. The United Nations Model Convention

117. Article 21 (3) of the United Nations Model Convention reads as follows:

> "*(3) Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may also be taxed in that other State.*"

118. This provision deviates from the OECD Model Convention in that the source State may tax "other income" that arises in the source State.

B. Tax treaties

119. There are 343 treaties providing for source State taxation on "other income" arising in the source State. Of those, 308 were concluded by developing countries with either a developed or another developing country (group A), and 36 were concluded between developed countries (group B).

120. It should be mentioned that there is no "other income" article in 38 treaties. Such situations, in which the source State can apply its domestic legislation, are not included in the above-mentioned figures.

121. Three of those treaties in group A provide for a withholding tax to be applied on the gross amount of "other income". The withholding rates are 10, 15 and 17.5 per cent. Three other treaties in group A attribute an excessive taxing right to the source State rather than the non-exclusive taxing right prescribed by the United Nations Model Convention.

XXII. Article 25 (4): Implementation clauses

A. The United Nations Model Convention

122. Article 25 (4) of the United Nations Model Convention contains the following bilateral (second sentence) and unilateral (third sentence) implementation clauses:

> "*(4) (...). The competent authorities through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the*

implementation of the mutual agreement procedure provided for in this article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure."

123. This provision is not specifically included in the OECD Model Convention.

B. Tax treaties

124. There are 39 treaties that cover the implementation of the mutual agreement procedure. In 27 treaties, only the bilateral implementation clause of the second sentence is adopted and in one treaty only the unilateral implementation clause of the third sentence is adopted. The remaining 11 treaties include both implementation clauses.

125. All the treaties were concluded by developing countries with either a developed or another developing country (group A); none were concluded between developed countries.

XXIII. Article 26 (1): Prevention of tax fraud/evasion, secret information and implementation

A. The United Nations Model Convention

126. Article 26 (1) of the United Nations Model Convention reads as follows:

"(1) The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention, insofar as the taxation thereunder is not contrary to the Convention, *in particular for the prevention of fraud or evasion of such taxes.* The exchange of information is not restricted by article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. *However, if the information is originally regarded as secret in the transmitting State* it shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes *which are the subject of* the Convention. Such persons or authorities shall use the information only for such purposes *but* may disclose the information in public court proceedings or in judicial decisions. *The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning matters in respect of which such exchanges of information shall be made, including, where appropriate, exchanges of information regarding tax avoidance.*"

B. Tax treaties

1. Prevention of tax fraud/evasion (first sentence)

127. There are 154 treaties that explicitly refer to the prevention of tax fraud or evasion. Of those, 146 were concluded by developing countries with either a developed or another developing country (group A), and eight were concluded between developed countries (group B).

128. There are only a few treaties whose wording deviates from the recommendations of the United Nations Model Convention.

2. Secret information (fourth sentence)

129. There are 50 treaties explicitly dealing with information that is secret in the transmitting State. All were concluded by developing countries with either a developed or another developing country (group A).

3. Implementation clause (last sentence)

130. There are 65 treaties that cover the implementation of the exchange of information. All were concluded by developing countries with either a developed or another developing country (group A).

131. A few of the treaties do not contain any reference to tax avoidance.

132. By way of a summary, the following table lists the number of treaties in groups A and B that contain the provisions scrutinized above:

	Tax treaties	
United Nations Model Convention articles	Group A	Group B
5 (3) (a)	410	39
	484	29
5 (3) (b)	219	2
5 (4) (a) and (b)	167	—
5 (4) (f) OECD	233	31
5 (5)	234	9
5 (6)	184	26
5 (7)	243	—
7 (1)	153	9
7 (3)	195	6
7 (5) OECD	45	—
8 B	105	3
12 (3)	610	102
13 (4)	308	66
13 (5)	322	62
14 (1) (b)	264	20
14 (1) (c)	45	—
16 (2)	62	6
18 A (2) and B (3)	206	48
18 B (1) (2)	259	36
20 (2)	53	—
21 (3)	308	36
25 (4)	39	—
26 (1)	146	8
	50	—
	65	—
Tax treaties 1980/1997	697	114

Issues raised by the use of tax havens, with particular reference to the obtaining of information concerning tax haven transactions by tax authorities of other countries*

Contents

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I. Introduction

1. In some cases, multinational enterprises have little choice concerning the country or countries in which they will carry on business activities and thus become subject to tax. The exploitation of natural resources, for example, can take place only where those resources are located. In most cases, however, enterprises have a very wide range of locational choice. With the dramatically increasing liberalization and integration of the world economy, enterprises can establish operations practically anywhere in the world. In addition, there has been an enormous increase in the share of total economic activity represented by the provision of services and intangibles, as opposed to "hard goods," and an enterprise engaged in this type of business has even greater latitude to "source" its income where it chooses.[1] To take a simple example, a server (computer) facility used by an enterprise to offer goods or services over the Internet can be located anywhere in the world that has telecommunication links (which means anywhere).[2]

2. Moreover, even if an enterprise establishes a business operation in a specific country, the enterprise may earn some of the resulting profits outside that country – for example, by selling goods produced in the country through a subsidiary located in another country and financing the operations through a finance subsidiary also located elsewhere. Banks, insurance companies and other financial institutions also have very broad discretion in choosing where to earn income, given the globalization of financial markets and the almost complete absence of restrictions such as exchange controls. Moreover, by choosing favourable terms for transactions between various entities in the multinational group ("transfer prices"), the enterprise can determine the amount of income attributed to each jurisdiction involved. Even individual investors can benefit from the freedom to choose where income will be earned.[3]

3. It is this freedom to make locational decisions that has fuelled the rapid growth in the utilization of tax havens. Since enterprises and investors seek to minimize their tax burdens, they tend to "place" income in jurisdictions where taxes are not imposed or imposed only at low rates.

II. What is a tax haven?

4. In the most general terms, a tax haven can be defined as a jurisdiction which imposes little or no tax on companies, trusts or other entities organized there.[4] By forming a company in such a jurisdiction and arranging for that company to derive income from third countries, a multinational enterprise may be able to shelter income from taxation both at the source and in its residence country. By forming a holding company or a trust in a tax haven, an individual or institution may similarly be able to shelter investment income from taxation.

5. Some countries are tax havens because they simply do not impose any income or profits taxes.[5] Others have historically taxed only income derived from activities carried on within the country.[6] In many instances, however, a country has established itself as a tax haven by enacting specific legislation which extends tax benefits selectively. For example, a country may extend tax exemption only to specially designated companies or other entities (often called something like "exempted companies" or "international business companies") which are owned by non-residents and derive income from outside the jurisdiction.[7] In other cases, favourable tax provisions apply to all taxpayers but only with respect to particular kinds of income – for example, dividends received by a holding company from subsidiaries.[8] Countries falling in this category often resent being considered a tax haven; but the effect of their legislation is the same with respect to the covered items of income as that of a country which imposes little or no tax on broader categories of income.

6. A country may benefit from being a tax haven in three ways. First, although it may impose little or no income or profits tax, it normally collects licence and other fees, which produce some revenue, particularly if the country succeeds in attracting large numbers of enterprises or investors.[9] Secondly, the creation of tax-haven companies, trusts or other entities in the country produces a certain level of employment for local lawyers, accountants and administrative personnel. (Some countries, such as Ireland, expressly condition tax benefits on the guarantee by the investor of some level of local employment.[10]) Thirdly, the establishment of a large number of trading or financing companies in a country often leads to the establishment of the country as a banking centre. Many tax havens are island countries with relatively poor economic prospects other than promoting activities of the kind described above.

Types of tax haven jurisdictions

7. It is impossible in a paper of this kind to describe all of the tax havens of the world and the tax advantages that each one offers. One treatise on the subject lists 66 jurisdictions as offering tax haven benefits of one kind or another.[11] It may be useful, however, to distinguish among

three types of jurisdictions which may be thought of as tax havens.

"Pure" tax havens

8. The first are countries which offer exemption or near exemption from tax for all kinds of income derived from sources outside the country by non-resident-owned entities. Some of the most popular countries falling in this category are Bermuda, the Bahamas, Barbados, the British Virgin Islands, the Cayman Islands, Costa Rica, Cyprus, Gibraltar, Guernsey, Jersey, Liechtenstein, the Netherlands Antilles and Panama.[12]

"Pure" tax havens with favourable income tax treaties

9. The second category consists of countries that, besides imposing little or no tax, have an unusually favourable income tax treaty relationship with another country or countries. A currently important example is Mauritius. Many private investments in India are made through Mauritius holding companies. This happens because Mauritius, in addition to imposing only modest taxes, has an income tax treaty with India that reduces withholding taxes on dividends to 5 per cent (if the holding company owns at least 10 per cent of the voting shares of the payor) and provides exemption from Indian capital gains tax on the disposition of shares of an Indian company – provisions that are not included in India's income tax treaties with most other countries.[13]

10. Another important example is Malaysia,[14] which has established the Island of Labuan as an international offshore financial centre, offering virtual exemption from taxation. Companies established in Labuan may benefit from Malaysia's relatively large number of income tax treaties. (Recently, however, some of Malaysia's treaty partners have indicated that they are considering denying treaty benefits to Labuan companies.[15])

Selective tax havens

11. The third category of countries that can be considered tax havens (although such countries may not regard themselves as tax havens) consists of countries which provide favourable tax treatment for particular kinds of activities.[16] An example is the Netherlands. It generally imposes substantial rates of tax on companies.[17] However, pursuant to the so-called "participation privilege", a Dutch company is not subject to tax on dividends received from companies in which it holds a substantial interest, even if they are located in foreign countries. Gains from disposition of shares of such companies are also exempt.[18] Therefore, a Dutch company holding the shares of subsidiaries will pay no Dutch income tax with respect to such holdings. In addition, the Netherlands has recently established a very favourable tax regime applicable to group finance companies (companies that borrow from other group companies and/or third parties and relend to group operating companies).[19] In addition, the Netherlands does not impose tax on income derived by a foreign branch of a Dutch company if it is subject to any tax abroad;[20] the result is that many enterprises establish Dutch companies with branches located in other countries.

12. Other examples of selective tax havens include Ireland, which extends favourable tax treatment to various kinds of financing, insurance and services activities under its "Dublin Docks" scheme and also to certain manufacturing operations,[21] and Belgium, which extends extremely favourable tax treatment to "coordination centres", "distribution centres" and "service centres" carrying out administrative, financial and sales support activities for multinational enterprises.[22]

Tax havens offering secrecy

13. Many tax havens seek to enhance their attractiveness to international companies and investors by offering confidentiality with respect to the company's or investor's affairs. Thus, for example, in Vanuatu, the affairs of "exempt" companies (non-resident-owned companies that earn income from outside the country) are entirely secret, and violation of the secrecy law is subject to criminal punishment.[23] A larger number of tax-haven countries enforce bank secrecy laws, which (at least in the absence of criminal activity) prohibit local banks and governmental officials from disclosing any information concerning financial transactions carried out in the country.[24]

III. Concerns raised by tax havens

14. The existence of tax havens presents serious concerns for authorities in non-tax-haven countries.

Erosion of the tax base

15. In the normal range of trade and investment transactions, the first concern of the tax authorities is that, even if the operating subsidiaries of multinational enterprises deal with their tax-haven affiliates on "arm's length" terms, transactions between them involve an erosion of the tax base

of the country in which the operating company is located. If a manufacturing company, for example, sells its output to a tax-haven sales company, which resells the products to customers (rather than the manufacturing company selling to customers directly), a portion of the profit will escape tax in the country in which the manufacturing company is located. If tax-haven affiliates make charges to the manufacturing company and such charges are allowable expenses in computing the manufacturing company's taxable profits, the effect will be similar. Such charges may include such items as:

(a) Interest charged by a group finance company on debt financing provided;

(b) Royalties charged by a group licensing company for the licensing of patents, know-how or other intangibles;

(c) Premiums charged by a captive insurance subsidiary;

(d) Fees charged for management, administrative, technical, financial or other kinds of services provided.

As indicated above, since an increasingly large segment of international trade is conducted in cyberspace (the Internet and related means of communication), the potential for the erosion of the tax bases of non-tax-haven countries by routing transactions through tax havens will markedly increase. For example, it is now feasible for the entire process by which a customer negotiates for orders and pays for goods or services to be handled through a server (computer) located in a tax haven.[25] Moreover, the feasibility of having personnel perform services in a tax haven is markedly increased by the ease with which their efforts can be made available anywhere else in the world.[26]

"Transfer pricing" abuse

16. A related concern which the utilization of tax havens raises for tax authorities is the fact that the terms on which the types of transactions referred to above take place may not, in fact, be at arm's length. This is the well-known "transfer pricing" problem.[27] In their desire to maximize the amount of income attributed to group companies located in tax havens, enterprises may set the terms of intra-group transactions in a way that unduly favours the tax-haven participants. Here again, since the communications revolution makes it more and more likely that services may be performed in a great number of countries, including tax havens, the challenges created for tax authorities by "transfer pricing" practices will increase.[28]

Inability to obtain information

17. The third major concern is the frequent inability of tax authorities to obtain information from the authorities in the tax-haven countries. This gap presents problems in two generally unrelated areas.

Promotion of criminal activity

18. Those tax havens with strict secrecy laws are thought to be widely used to carry out criminal transactions, including "money laundering".[29] The secrecy shield may effectively prevent law enforcement authorities (the tax authorities and others) from reconstructing the financial dealings that form part of a course of criminal conduct.

Information relating to commercial transactions

19. The inability to obtain information from tax-haven countries may also impede the efforts of tax authorities to examine and, if necessary, adjust intra-group commercial transactions – that is, assure themselves first that the transactions had economic reality and, secondly, that they were carried out on an arm's length basis. If the tax haven enforces secrecy laws, they may act as a bar to the provision of information.[30] Even in the absence of such laws, many tax-haven countries are not parties to any income tax treaties (since they have no reciprocal relief to offer to a potential treaty partner) and, in the absence of such treaties, they may have neither a legal basis nor the inclination to provide information to other countries.

IV. Responses to tax haven concerns

20. Developed countries (and to an increasing extent, developing countries) have responded to these problems in several ways.

Tax haven legislation

21. An increasingly popular response to the first of the three problems described above (erosion of the tax base) is the adoption of legislation under which a parent corporation or substantial shareholder resident in a country is subject to its share of the income of a tax-haven company. Two basic patterns of tax rules can be identified. The first – and more widely adopted – type of regime relates to "controlled foreign corporations". While the specific rules vary from country to country, the general thrust of such legislation is to make a parent corporation of (or a substantial shareholder

in) a tax-haven corporation include in taxable income its pro rata share of specified kinds of "tax-haven income" earned by the tax-haven corporation, whether or not it receives a distribution of that income.[31] The types of income subject to this treatment may include such things as dividends, interest and royalties received from related persons and income derived from selling goods or performing services for related entities located in other jurisdictions. Some laws establish a "black list" of tax-haven countries, any operations in which will give rise to taxable income.[32] Some other laws exempt operations in countries which impose tax at a substantial rate (e.g., at least 25 per cent).[33]

22. In addition, a few countries have adopted rules under which resident shareholders in offshore investment companies (i.e., companies principally deriving passive portfolio income) must pay tax on their shares of such income, either on a current basis or on a deferred basis but with an interest charge to compensate for the delay in the payment of the tax.[34]

23. If a special regime of the type described above applies, the tax saving which would otherwise be achieved by "placing" income in a tax haven is negated by the fact that tax is imposed by the country in which the parent company or shareholder is resident. This may still, however, result in a shift of revenues between countries; payments made to the tax-haven entities may reduce the profit taxed by the country from which the payments are made (the source country), even while the same amounts are increasing the tax paid in the country of residence.

Policing "transfer pricing"

24. The second type of response by tax authorities to the problems raised by tax havens is to monitor transactions between related entities and, where necessary, to adjust the terms of such transactions to arm's length terms. This process of policing "transfer pricing" has become a major concern of tax authorities in almost every country. While the problem is not limited to transactions involving tax havens (since enterprises may enter into non-arm's length transactions for a number of reasons other than simply "placing" income in tax havens), tax haven transactions are generally monitored with particular care.

25. The Organisation for Economic Cooperation and Development (OECD) has published an extensive set of transfer pricing guidelines,[35] which are followed more or less closely by most OECD member countries. In addition, some countries, most notably the United States, have published their own transfer pricing guidelines.[36]

26. Transfer pricing issues are among the most difficult and important issues in the field of international taxation today, and the number and complexity of those issues range far beyond the scope of this paper.

27. As indicated above, however, the fact that rapidly growing shares of the transactions carried out internationally involve services or the provision of intangibles has undoubtedly not only complicated the process of determining arm's length prices but also increased the role that tax haven entities will play in international trade and investment.[37]

28. Reference was made above to the fact that an enterprise that, let us say, supplies information to its customers worldwide can locate the server(s) (computer(s)) which supply such information essentially anywhere, and many of them are consequently located in tax havens. A similar trend can be seen in the area of financial transactions. More and more, companies and investors are entering into highly sophisticated transactions, such as those involving derivative financial instruments,[38] which do not easily fit into traditional tax pigeonholes. Many of these transactions involve at least one party located in a tax haven. As indicated above, banks and financial institutions – no longer being restricted by exchange controls and similar restraints – can undertake transactions anywhere. It is now considered standard procedure to locate any internationally oriented investment fund in a tax haven.

29. The result of these developments is that the policing of potential "transfer pricing" abuses has become an area of increasing concern to tax administrators throughout the world.

Procuring information concerning tax haven transactions

Use of tax treaties

30. In cases involving what have been described above as "selective" tax havens, tax authorities should be able in many cases to obtain information under the exchange-of-information provisions of income tax treaties. Belgium, Ireland and the Netherlands, for example, are parties to a large number of bilateral income tax treaties based on the OECD Model Convention, which includes a provision obligating the tax authorities of each of the two treaty countries (subject to certain conditions) to exchange with the tax authorities of the other such information as may be

necessary to permit the latter to apply their country's tax law.[39]

31. A special comment may be appropriate concerning the position of Switzerland. That country has a long history of preserving commercial and financial confidentiality, and applies a bank secrecy law. It has therefore been unwilling to include in its income tax treaties the standard exchange of information provisions of the OECD Model Convention;[40] it has typically agreed to supply only such information as may be needed to implement the tax treaty itself – as opposed to the revenue laws of the treaty partner in general. This raised a major obstacle in the recently concluded negotiations of a new income tax treaty between Switzerland and the United States. The United States is firmly committed to a full exchange of information between treaty partners; it deferred the conclusion of its proposed treaty with Kazakhstan, for example, until it was satisfied that that country's bank secrecy law would not impede its ability to procure information.[41]

32. In the case of Switzerland, however, it did not succeed in obtaining a provision as broad as the one in the OECD Model Convention. The new treaty (which has not yet been ratified) requires the exchange of information only in cases of "tax fraud";[42] and in many cases it may be difficult for a tax administrator to satisfy the Swiss authorities that tax fraud was involved in transactions which the tax administrator wishes to examine. For example, the Swiss may take the position – and arguably, with merit that an inquiry into a "transfer pricing" transaction does not involve fraud, at least unless there are special circumstances suggesting improper conduct.

Securing the agreement of the tax haven to supply information

33. Although it may be impracticable for a country to enter into a full-scale tax treaty with a tax haven, it may prove possible to enter into a reciprocal agreement relating only to the exchange of information. The United States has entered into a number of such agreements.[43] It may be necessary, however, to offer the tax haven some incentive to sign such an agreement, since it may feel that the reciprocal right that it acquires to obtain information from the country seeking the agreement is not of particular importance. In the case of the United States, the incentive was provided by a provision in United States law that prohibits United States taxpayers from deducting the expenses of attending any convention or meeting in a country located in the Caribbean area unless that country has entered into an exchange of information agreement.[44] Since tourism is very important to the countries in that area, several of the countries entered into the necessary agreements. That approach may not be practical for many countries, however.

34. Even if a tax haven is not prepared to enter into a general exchange-of-information agreement, it might be prepared to enter into a more limited agreement specifically relating to the provision of information in cases involving possible criminal conduct. The United States, for example, has entered into a series of agreements under which the tax authorities of the Cayman Islands (which have not entered into a general exchange-of-information agreement) have agreed to supply information in respect of criminal prosecutions, including tax prosecutions, being conducted by the United States.[45] Vanuatu has agreed, under pressure from Australia, to similar measures.[46] Presumably, however, the number of cases in which tax havens will be willing to enter into such agreements is limited.

Cooperation with other non-tax-haven countries

35. In a number of situations, the tax authorities of two (or more) non-tax-haven countries have cooperated to gather information concerning tax haven transactions. Suppose, for example, that subsidiary F, located in country X, sells goods which it produces to subsidiary G, located in a tax haven, which in turn re-sells the products to the parent company, located in country Y. By combining the information available to both of them, the tax authorities of countries X and Y should be able to reconstruct the terms of both sets of transactions with subsidiary G and thereby determine the amount of profit which was lodged in the tax haven. This process may be facilitated if country X and country Y, like several of the OECD countries, have entered into agreements (or working arrangements) under which the two countries conduct simultaneous examinations of the same or related taxpayers and/or exchange industry-wide information.[47]

36. This technique, in principle, could be applied not only in the case of sales of goods but also in cases involving "pass-through" royalty or insurance arrangements or the provision to third parties of services involving several members of an affiliated group.

Self-help

37. Apart from international agreements and bilateral cooperation, there are many steps that a country can take to require persons subject to its jurisdiction to produce information concerning transactions entered into by resident entities or individuals with tax-haven entities. Whether such measures are appropriate and politically feasible in a particular country will, of course, depend upon its individual

situation, including the nature of the taxes it imposes, its tax administrative capacity and its legal system in general. As a way of suggesting the available possibilities, however, we can look to the measures that have been adopted in the United States, since they have been rather extensive.

38. In general, a United States corporation can be compelled to produce to the Internal Revenue Service (IRS) any documents or other information in its possession.[48] This includes records kept outside the United States.[49] It also includes records kept by others over which the corporation has control; this has been interpreted to require a parent corporation to produce records maintained by its foreign subsidiaries.[50]

39. A second source of information are banks of which a taxpayer is a customer. Many banks, at least, operate throughout the world in branch form. In one famous case the IRS compelled a Canadian bank which had a branch in the United States to produce records relating to an account which a customer maintained at branches which the bank maintained in the Bahamas, Antigua and the Cayman Islands.[51]

40. The third principal source of information is the foreign parent company of a subsidiary operating in the United States. In a landmark case, the IRS succeeded in requiring Toyota, a Japanese company not itself engaged in business in the United States, to produce information concerning its profits on automobiles transferred to its United States subsidiary in "transfer pricing" transactions.[52] The rationale was that, even though acting through a subsidiary, the parent company had sufficiently entered into business activities in the United States (a "purposeful exploitation of the United States market") to justify imposing United States legal procedures upon it.[53] Once again, in a case involving the fugitive financier Marc Rich, a court upheld the IRS in requiring the production of documents in the possession of the Swiss parent of a United States subsidiary, reasoning that actions taken outside the United States can give rise to legal liability in the United States if those actions have an effect within the territory of the country.[54]

41. In many instances, taxpayers and other persons who are requested by the IRS to produce information located in a tax-haven country defend against the request by pleading that it would be a violation of the bank secrecy laws of the tax haven to divulge the information. This is often in fact the case. United States courts have held that this does not automatically prohibit the IRS from demanding the information; rather, the United States' interest in securing the information in order to enforce its tax laws must be weighed against the possible detriment to the person asked to produce the information.[50] The result has been, in some instances, that the person has been ordered to produce the requested information; in others, where serious criminal liability would result and/or the IRS's need for the information seemed less than compelling, the information was not required to be divulged.[55]

42. The IRS has overcome foreign bank secrecy laws in one other ingenious way. Under many of such laws, the person owning the bank account can waive the secrecy requirement. In several cases, the court has ordered a United States taxpayer involved in a criminal case to waive the secrecy law applicable to his tax haven account.[56] This was possible, of course, only because the taxpayer was personally subject to the jurisdiction of the court and was the owner of the account.

43. All of the above measures have been taken under the general legal principles and procedures governing the right of the IRS to compel the production of information in tax cases. Two statutory provisions directed specifically at international information-gathering have also been adopted, however.

44. Under generally applicable United States tax principles, a determination by the IRS of a taxpayer's liability is presumptively correct, and a taxpayer bears the burden of showing that it is incorrect.[57] Under the first of the above-mentioned legislative initiatives, if a taxpayer is requested by the IRS to produce records located abroad but fails to do so (for example, pleading a violation of a foreign country's secrecy laws), the court in a United States subsequent proceeding may prohibit the taxpayer from using any documentation covered by the request to carry its burden of proving an IRS determination incorrect.[58] In effect, this law simply says that a taxpayer cannot withhold documentation from the IRS but later attempt to use that documentation to its advantage in a court proceeding.

45. A provision having considerably broader significance was adopted in 1989 to strengthen the IRS's ability to police "transfer pricing" transactions.[59] This provision applies to any United States corporation which is at least 25 per cent foreign-owned. It requires the United States corporation to report in detail all transactions which it entered into with its foreign owner(s) or any related persons. It also requires the United States corporation to maintain books and records fully documenting both the relationship between the United States corporation and the foreign owner or owners (and related entities) and the nature and terms of all transactions entered into between them. These documents must disclose information about the financial results of the transactions not only for the United States corporation but also for the foreign participant(s). Such records must be kept in the United States or produced in the United States within 60

days of a request by the IRS for them. There are potentially substantial monetary penalties for a failure to comply.

46. Beyond this, the statute requires the foreign owner(s) to appoint the United States corporation as agent for the service of process, so that the IRS can legally issue subpoenas, demanding the production of documents, to the foreign owner(s) by delivering them to the United States corporation.[60] If the United States corporation fails to secure appointment as agent for service of process or if, when the subpoena is served on it, the documents demanded are not produced, the statute gives the IRS wide discretion to treat transactions between the United States corporation and its foreign owner(s) or related persons as occurring on such terms as it may determine based upon whatever information it may have – however inadequate or incomplete that may be.[61] The threat of arbitrary exercise of this broad discretion has caused most foreign-owned United States corporations to obtain the necessary appointment as agent for service of process for its foreign owner(s) and to produce documents requested.

V. Conclusion

47. It seems clear, although reliable statistics are not readily available, that the recourse by enterprises throughout the world to tax havens has dramatically increased as the world economy has grown and international trade and investment have been liberalized. Developments such as the mushrooming use of the Internet and similar communications channels and the proliferation of sophisticated financial instruments will only accelerate this trend. In order to protect their revenue bases from serious erosion, countries that are not tax havens will be required to become far more sophisticated and effective in policing transactions between enterprises resident or operating in their territory and related tax haven entities. A major problem in policing tax haven transactions is the difficulty of obtaining accurate information concerning the transactions involved. Certain measures can be taken unilaterally to assure greater access to information; exchange-of-information agreements may be secured in some circumstances, and cooperation between the tax authorities of two or more countries with compatible interests in monitoring tax haven transactions can be of assistance.

48. Nevertheless, the use of tax havens will continue to present fundamental problems for tax administrators, and those problems – and the cooperative measures that might be taken to deal with them – will continue to form appropriate subjects for consideration by international bodies concerned with tax policy and administration.

Notes

[1] See David R. Tillinghast, "The impact of the Internet on the taxation of international transactions", *Bulletin for International Fiscal Documentation*, vol. 50 (1996), pp. 524–527.

[2] See Owens, "The tax man cometh to cyberspace", *Tax Notes International*, vol. 14 (2 June 1997), p. 1,833.

[3] See the discussion of the use of holding companies in Richard A. Gordon, *Tax Havens and Their Use by United States Taxpayers: An Overview* (Washington, D.C., United States Treasury Department, Internal Revenue Service, 1981), p. 59.

[4] Ibid., p. 14; B. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* (Toronto, Canadian Tax Foundation, 1989), p. 113.

[5] Ibid., p. 15.

[6] See Walter H. Diamond and B. H. Diamond, *Tax Havens of the World* (Albany, Matthew Bender, continuously updated), vol. III, for a discussion of Panama.

[7] Ibid., vol. I, on Barbados.

[8] See para. 11 below.

[9] Gordon, op. cit., p. 15.

[10] Diamond and Diamond, op. cit., vol. II, on Ireland, p. 2.

[11] Ibid., vol. I, pp. 1–3.

[12] Ibid., vols. I and II.

[13] See Mahatme and Memoni, "Indian budget introduces tax reform", *Tax Notes International*, vol. 14 (17 March 1997), pp. 891–892. Under the 1997 Indian budget, the withholding tax on dividends was abolished, but the Mauritius treaty remains valuable in barring Indian tax on gains realized on disposition of shares in Indian companies.

[14] Diamond and Diamond, op. cit., vol. II, on Malaysia.

[15] Ibid., vol. I, p. 53.

[16] Arnold, op. cit., pp. 113–114.

[17] See *The Taxation of Companies in Europe* (Amsterdam, International Bureau of Fiscal Documentation, continuously updated), vol. 3.

[18] Ibid., pp. 112, 127.

[19] Van Castern and Hofland, "Dutch rules on group finance companies and base erosion measures analyzed", *Tax Notes International*, vol. 14 (3 March 1997), p. 743.

[20] *The Taxation of Companies in Europe* ..., vol. 3, p. 42.

[21] Diamond and Diamond, op. cit., vol. II, on Ireland; The Taxation of Companies in Europe ..., vol. 2, pp. 98–99.

[22] *The Taxation of Companies in Europe* ..., vol. 1, pp. 142–146.

[23] Diamond and Diamond, op. cit., vol. III, on Vanuatu, p. 3.

[24] Gordon, op. cit., pp. 15–17.

[25] See Abrams and Doernberg, "How electric commerce works", *Tax Notes International*, vol. 14 (12 May 1997), pp. 1,573–1,581.

[26] Frances M. Horner and Jeffrey Owens, "Tax and the Web: new technology, old problems", *Bulletin for International Fiscal Documentation*, vol. 50 (1996), pp. 516–524.

[27] See, e.g., Horner, "International cooperation and understanding: what's new about the OECD transfer pricing guidelines", *Tax Notes International*, vol. 13 (1996), p. 1,065.

[28] See Owens, loc. cit., p. 1,837.

[29] *The Economist* (26 July-1 August 1997), pp. 13, 19; Gordon, op. cit., p. 111.

[30] See paras. 38–46 below.

[31] For a comparison of the controlled foreign corporation regimes of several countries, see Arnold, op. cit., p. 127; for a comment on recent changes in the Australian provisions, see Lewis, "Australia proposes changes to taxation of foreign-source income", *Tax Notes International*, vol. 14 (27 January 1997), p. 267.

[32] See *Taxes and Investment in Asia and the Pacific*, (Amsterdam, International Bureau of Fiscal Documentation; 1996), vol. 1, giving a listing of countries under Australia's controlled foreign corporation legislation.

[33] See, e.g., J. Huston, T. Miyatake and G. Way, Japanese International Taxation (Yonkers, N.Y., Juris Publications, 1997), para. 5.04[2].

[34] For examples of such regimes existing in the United States and New Zealand and Australia, see United States Internal Revenue Code sections 1,291–1,297, relating to "passive foreign investment companies"; *Taxes and Investment in Asia and the Pacific*..., vol. 2, on New Zealand's "foreign investment fund" regime and the similar Australian regime.

[35] Organisation for Economic Cooperation and Development, Committee on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris, 1995).

[36] See, e.g., United States Treasury regulations, paras. 1.482–1 – 1.482–8.

[37] See Horner and Owens, loc. cit., p. 519.

[38] See Neighbour, "Innovative financial instruments challenge the global tax systems", *Tax Notes International*, vol. 14 (24 March 1997), p. 979.

[39] See Organisation for Economic Cooperation and Development, Committee on Fiscal Affairs, *Model Double Taxation Convention on Income and on Capital*, art. 26 (Paris, 1992). Hereinafter cited as the "OECD Model Convention".

[40] See the *Commentary* on the OECD Model Convention, art. 26, para. 24, noting Switzerland's reservation.

[41] See "U.S. access to bank account info. Stalls approval of Kazakh treaty", *Tax Notes International*, vol. 11 (31 July 1995), p. 262.

[42] See *Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Income*, art. 26, para. 1, reproduced in Tax Treaties (Chicago, Chicago Clearinghouse, 1996), vol. 3, para. 9101.26.

[43] See Zagaris, "Dollar diplomacy: international enforcement of money movement and related matters", *George Washington Journal of Law and Economics*, vol. 22 (1989), pp. 465, 505.

[44] United States Internal Revenue Code, section 274 (h).

[45] See Zagaris, loc. cit., p. 496.

[46] See Diamond and Diamond, op. cit., vol. II, on Vanuatu.

[47] The United States, for example, has entered into simultaneous examination agreements with nine countries. See *Internal Revenue Manual* (Audit), para. 42(10) (10).7. It also shares industry-wide information with treaty partners. See *idem*, para. 42(10) (10).10.

[48] First National City Bank of New York v. Internal Revenue Service, 271 F.2d 616 (2d Cir. 1959), cert. denied 361 U.S. 948 (1960).

[49] In re Grand Jury Subpoenas Duces Tecum Addressed to Canadian International Paper Co., 72 F. Supp. 1013, 1020 (S.D.N.Y. 1947).

[50] United States v.Vetco, Inc. 644 F.2d 1324 (9th Cir. 1981), appealed orders affirmed, 691 F.2d 1281 (9th Cir. 1981), cert. denied 454 U.S. 1098 (1981).

[51] See In re Grand Jury Proceedings: United States v. Bank of Nova Scotia, 691 F.2d 1384 (11th Cir. 1984), cert. denied, 462 U.S. 1119 (1983) and 722 F.2d 657 (11th Cir. 1983), cert. denied 469 U.S. 1106 (1985); In re Grand Jury Proceedings, 740 F.2d 817 (11th Cir. 1984), cert. denied 469 U.S. 1106 (1985).

[52] U.S. v. Toyota Motor Corp., 561 F. Supp. 354 and 569 F. Supp. 1158 (C.D. Cal. 1983).

[53] The court relied on World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 297–8 (1980) (a non-tax case).

[54] Marc Rich & Co., A. G. v. United States, 707 F.2d 663 (2d Cir. 1983), cert. denied 463 U.S. 1215 (1983).

[55] See, e.g., Société internationale pour participations industrielles et commerciales, S.A. v. Rogers, 357 U.S. 197 (1958); United States v. First National Bank of Chicago, 699 F.2d 341 (7th Cir. 1983); Gerling International Insurance Co.

v. Commissioner, 86 T.C. 468 (1986); United States v. Vetco. Inc. .

[56] United States v. Chidoni, 732 F.2d 814 (11th Cir. 1984); U.S. v. Cid, unreported, No. 85–4271 (5th Cir. July 30, 1985); United States v. Davis, 767 F.2d 1025 (2d Cir. 1985). But an order to consent to inspection of foreign bank accounts generally (as opposed to a specific, known bank account) may violate a United States person's constitutional privilege against self-incrimination. See United States v. Pedro, 662 F. Supp. 47 (W.D. Ky. 1987); Senate Select Committee v. Secord, 664 F. Supp. 562 (D.D.C. 1987).

[57] See United States Tax Court, rule 142.

[58] United States Internal Revenue Code, section 982.

[59] Ibid., section 6038A.

[60] Ibid., subsection (e).

[61] Ibid., subsection (e) (3).

Taxation of derivatives and new financial instruments*

Contents

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I. Introduction

1. Derivatives and other innovative financial products pose immense challenges to tax systems.[1] On the one hand, tax policy makers and administrators must be adroit in spotting and responding to uses of those instruments that would otherwise avoid or inappropriately reduce taxes. On the other hand, if a country's tax laws respond to financial innovation in a heavy-handed way, the result may only be to deny to the country's residents the overall benefit of obtaining cheaper and more plentiful capital.[2] Generally, an excessive tax on a financial transaction raises little revenue because it simply kills off transactions of that type. Even uncertainty about the tax treatment of a particular instrument can effectively block the instrument from the market.

2. The present paper examines alternatives for taxing income from derivatives and other newer financial products. Section I discusses the treatment of bonds issued at discount. Sections II, III, and IV discuss income taxation of parties to the three basic types of financial derivatives – options, futures and forward contracts, and swaps. Section V examines the issue of straddles – whether special rules should be provided to curb tax avoidance strategies using offsetting positions. Section VI discusses income tax problems arising from the use of derivatives and other financial instruments to produce synthetic instruments – combinations of instruments that yield financial results substantially identical to those of a type of instrument different from the constituent elements of the synthetic instrument. Section VII discusses the taxation of financial instruments used to hedge business and investment risks. Section VIII examines contingent payment instruments – sometimes called hybrids – that mix together characteristics of debt instruments and equity-flavoured derivatives. Sections I through VIII focus primarily on issues that a Government faces in developing its domestic tax laws on financial products. Section IX examines issues of international taxation affecting derivatives – the issues peculiarly arising when the parties to a financial instrument are residents of different countries.

3. Frequent reference is made to the laws of the United States of America, which has the most highly developed system of tax rules on financial instruments, including derivatives. The extensive United States response to financial innovation has at least two causes. First, highly developed markets for financial instruments of all sorts have a longer history in the United States than in most other countries; thus, taxpayer demand for guidance on the taxation of new financial instruments arose earlier and with greater intensity in the United States than in many other countries. Second, in the United States, political attitudes about taxation generally favour the taxation of all economic income from capital and vigorous responses to tax-avoidance strategies. In many respects, United States law represents the outer limits of what a country might do to attack the tax problems presented by financial innovation.

II. Discount bonds

4. When a debt instrument is issued at a discount from its face value, the return to the instrument's holder and the issuer's borrowing cost include the amount of the discount, as well as any periodic payments designated as interest in the instrument. Annual investment returns and borrowing costs are realistically reflected only if the discount accrues for tax purposes more or less as it accrues economically. Interest is compensation for the use of money and accrues solely by the passage of time. All compensation for the use of money – that is, all amounts that predictably accrue to the holder of a debt obligation solely by the passage of time – should be accrued for tax purposes in an economically realistic manner, whether those amounts are stated as interest in the instrument or take some other form, such as discount on the obligation's issuance.

5. In the United States, original issue discount is accrued for tax purposes by a constant interest method, which is described immediately below. Two alternatives to that method – ratable accrual and delaying the recognition of discount income and expenses until maturity or until the holder sells the instrument – are discussed thereafter.

A. Constant interest method

6. Under the constant interest method, the issuer and holder of a discount obligation annually accrue a portion of the discount as interest expense and income. That portion is computed by applying a constant interest rate against the sum of the issue price and all prior accruals of discount. If periodic interest payments are made on the obligation, each accrual of discount is reduced by the amount of interest payable for that period.

7. To illustrate the application of the constant interest method to a zero coupon bond, assume that a corporation organized, managed and operating in country *X* issues a bond providing for a single payment of 10,000 units (u) of country *X* currency five years after the issue date; the bond is purchased by a country *X* investor at the issue price of 6,139u. The yield to maturity is 10 per cent compounded

semi-annually.[3] If the discount of 3,861u is accrued on a constant interest basis, the accrual for the first six months in the bond's term is 307u (one half of 10 per cent of 6,139u), for the second six months is 322u (one half of 10 per cent of the sum of 6,139u and the first interest accrual of 307u), and so forth throughout the bond's term. If a six-month accrual period begins in one taxable year and ends in the next, the discount accrued for the period is prorated on a daily basis.

8. To illustrate the application of the constant interest method to an interest-bearing bond, assume interest of 300u is payable each six months under a five-year 10,000u bond. If the market rate of interest is 10 per cent when the bond is issued, the issue price is 8,456u (the present value at 10 per cent of semi-annual payments of 300u each for five years and 10,000u at the end of those five years). The discount accrual for the first six months is 123u (one half of 10 per cent of the issue price of 8,456u less the interest of 300u); for the second six months, the accrual is 129u (one half of 10 per cent of the sum of 8,456u and 123u, less 300u).

9. An advantage of the constant interest method is that it conforms reasonably well to market forces. In the examples above, if the prevailing interest rate remains at 10 per cent, the sum of the issue price and all interest accruals will always equal the bond's fair market value. In the first example, the fair market value of the bond at the end of the first year will be 6,768u (the present value at 10 per cent compounded semi-annually of 10,000u payable in four years), and the sum of the issue price and the interest accruals for the first year will also be 6,768u (the sum of 6,139u, 307u and 322u). Thus, any gain or loss realized by a holder on a sale of the bond before maturity is largely true capital gain or loss – gain or loss resulting from a shift in market values, not from the mere passage of time.

10. A disadvantage of the constant interest method is that its administration is complex. Issuers and holders of discount obligations must annually recognize interest expense and income computed by a methodology that is unfamiliar to many investors. However, for most corporate debt, the complexity is not especially burdensome if issuers are required to report interest income to their bond holders and to the tax administration. Corporations typically have accounting staff who can do constant interest calculations with little effort. Bondholders need only report on their tax returns the amounts reported by the issuer.

11. A criticism sometimes made of the constant interest method is that, notwithstanding its relative complexity, it is not exact because the assumption of a constant yield to maturity does not fully conform to market behaviour.[4] Typically, the market rate of interest is lower for a shorter-term obligation than for an otherwise identical longer-term instrument (although the opposite is occasionally true, usually for only brief periods of time). For example, the market rate of interest might be 10 per cent for five-year instruments and 9.8 per cent for four-year instruments. The bond in the first example is a five-year instrument when issued but a four-year instrument one year later. Thus, if market rates remain unchanged, the instrument's fair market value after one year is 6,820u (the present value at 9.8 per cent compounded semi-annually of 10,000u payable in four years). If the holder sells the bond after one year, gain is recognized of 52u (selling price of 6,820u, less the 6,768u sum of the holder's cost and income accruals).

12. That gain results solely from the passage of time, and in theory should be accrued as interest rather than being deferred until the instrument is sold. However, whereas the constant interest method can be applied solely from basic facts of the instrument (the issue price and the amount and time of each payment), a more precise calculation of the accrual could be made only with market data about the term structure of interest, which often is not available. Thus, the constant interest assumption, although inexact, is probably the only practical means of approximating economic reality.

13. Another disadvantage of the constant interest method is that it often taxes bondholders on interest income long before they receive any cash under the bond. However, since interest-bearing bonds are widely available, investors who lack the means to pay tax on accrued but unpaid discount can simply not invest in discount bonds, and the tax on accrued discount probably has little distortive effect on the market.

B. Alternatives to constant interest method

14. There are two obvious alternatives to the constant interest method – accruing discount on a straight line basis and recognizing discount only as it is paid. Recall the first example used above, where a 10,000u five-year zero coupon bond is issued for 6,139u, producing a yield to maturity of 10 per cent compounded semi-annually. The discount of 3,861u might be allocated ratably among the 10 six-month accrual periods, 368u to each period. For most instruments, ratable accrual recognizes discount more rapidly than the constant interest method. In the example, the discount accrual for the first six months is 368u by ratable accrual and 307u by the constant interest method. Alternatively, the entire discount might be recognized either when the bond is paid at maturity or, for holders who sell their bonds before maturity, when the bond is sold.

15. The advantages of ratable accrual are few. In terms of computation, it is simpler than accrual by the constant interest method, but the computations under the constant interest method are not especially difficult, particularly if issuers are required to inform bondholders annually of the amounts of accrued discount. Although the constant interest method is not exact, ratable accrual usually diverges even more from economic reality. Objections deriving from the fact that holders are taxed on amounts not received in cash apply equally to ratable accrual and the constant interest method.

16. Tax compliance and administration may be simplified by recognizing discount only at maturity or on the sale of a discount bond. However, if capital gains are taxed differently from other income, that solution may not be as simple as first appears. Since discount income is a substitute for interest income, it should be taxed as ordinary income, not as capital gain. Thus, if gains on redemptions and sales of bonds are generally treated as capital gain, the portion of a gain on sale that represents accrued discount must be separated from the remainder of the gain, and that can be done only by the discount accrual mechanisms described earlier. Also, enforcement of a tax imposed on sale may be more difficult if information reporting requirements apply to interest income but not capital gains.

17. If bondholders and issuers treat discount consistently and are taxed at the same rates, tax revenues are not affected by a Government's choice between the various alternative treatments of bond discount. However, tax revenues can be severely depleted by rules on discount bonds that treat holders and issuers differently. For example, a tempting solution to the discount problem is to allow issuers to accrue discount as interest expense, while permitting holders to defer recognition of discount income until maturity, on the theory that large businesses are well equipped to do the computations but investors often are not. In the first example, that solution allows the issuer of the zero coupon bond a deduction for discount expense of 307u for the first six months of the bond's term, and taxes that amount to the holder several years later when the bond matures. If issuer and holder are both taxed at 30 per cent, the Government is out 92u (30 per cent of 307u) for four and a half years. If the Government borrows at 10 per cent, the cost of the holder's deferral of the discount income for that six-month period alone is 51u (measured as of the instrument's maturity).[5] Smaller but significant losses accrue to the Government for each of the remaining accrual periods in the bond's life.

III. Options

18. Options come in two common varieties – options to buy (calls) and options to sell (puts).[6] Since an option gives the holder a right to purchase or sell at a specified price, the "strike price", but imposes no obligation on the holder, the holder usually pays a premium to the issuer (writer) of the option when the option is issued. The amount of the premium is a function of the option price, the period for which the option will remain open and the volatility of market prices for the underlying property, rate or index. Since the issuer holds the premium during the option's term, the time value of money also affects the market pricing of an option. An option is said to be "in the money" whenever the market value of the underlying exceeds the strike price; to be "deep in the money" when that excess is substantial; and to be "out of the money" when the current market value equals or is less than the strike price. An option may have a cash settlement feature, under which the option obligation is settled by a cash payment on the option's expiration date, rather than by an actual purchase or sale of the underlying property. Even in the absence of a cash settlement feature in the option, options are commonly settled by offsetting trades or other cash transactions.

19. In many countries, standardized options are issued and traded on established options markets. Traded options are commonly issued on stock, stock indexes, interest rate futures and currencies. Other options are individually designed in negotiations between the holder and issuer.

20. Three courses of action are open to holders of options: (a) exercising the option by buying or selling the optioned property; (b) letting the option expire unexercised; and (c) disposing of the option before it expires, either by selling it or by entering into a closing transaction with the issuer that effectively cancels the option. Tax rules on options must provide for all three possibilities.

21. Countries vary in their tax treatments of options. Under one approach, which is generally followed in the United States, an option has no tax consequence to the holder or issuer until it is exercised, closed out or lapses, when the results are as follows:

(a) *Exercise*: if a call option is exercised, the option premium is included in the holder's cost for the property acquired and the issuer's amount realized in the sale. For example, if a premium of 100u is paid for an option to purchase 1,000 shares of *X* Corporation stock for 5u per share and the option is subsequently exercised, the holder's cost for the stock is 5,100u (sum of the option premium of 100u and the exercise price of 5,000u), and the issuer of the option is treated as selling the stock for that amount. If a put option is exercised, the premium reduces both the holder's selling price for the underlying and the issuer's cost of the property;

(b) *Lapse or sale*: if an option expires unexercised, the premium is then included in the issuer's taxable income and allowed as a deduction to the holder. If the holder sells the option before its expiration, gain or loss is recognized equal to the difference between the sales proceeds and the premium paid. If the holder and issuer close out the option, each party recognizes gain or loss equal to the net amount paid or received, including both the option premium and any payment made in the closing transaction. In the United States, gain or loss on the expiration or disposition of an option is usually capital gain unless the option is held or issued in the ordinary course of the taxpayer's trade or business.[7]

22. In other countries, the issuer is taxed on the option premium when it is received, and the exercise of the option, if it occurs, is treated as an independent transaction in which the issuer's selling or purchase price is the amount received or paid on exercise, exclusive of the option premium.[8] If the issuer enters into a closing transaction with the holder, any amount paid or received by the issuer in that transaction is gain or loss, recognized at the time of the closing.

23. Under the latter system, the holder is not typically allowed a deduction for the premium when it is paid but recognizes gain or loss when the option is exercised.[9] Under a call option (option to buy), the holder has gain or loss on exercise equal to the difference between the value of the property at that time and the total of the holder's cost, including both the option premium and the amount paid on exercise of the option. Under a put option (option to sell), the holder's gain or loss on exercise is the net amount received for the underlying (the amount received on exercise less the option premium) less the property's value. If the option expires unexercised, the holder is then allowed a deduction for the premium. If the holder disposes of the option, gain or loss is recognized equal to the difference between the amount received in the sale or closing transaction and the premium paid.

24. Neither of those approaches is without problems. The first approach, which links the option with the transaction occurring if and when the option is exercised, ignores the time-value-of-money advantage that the issuer enjoys by holding the premium during the option's term. As a result, options can be used to avoid rules requiring the accrual of interest income, including bond discount. If, when issued, an option is so deep in the money as to be almost certain to be exercised, the option premium functions economically as a loan because, at market, the strike price approximates the forward price for the underlying, less the sum of the premium and interest thereon from the issue date to the exercise date. If the option has no tax consequence to the holder until it is exercised, sold or terminated, an investor seeking only an interest return may therefore hold such an option as a device to avoid tax rules requiring the accrual of interest. That device can be frustrated by a tax rule requiring the option premium to be treated as a loan.[10] However, it is not easy to identify options that are so certain of exercise as to ensure that such treatment is fair, and that difficulty would make any such rule hard to enforce. The problem could also be solved by a more radical but arguably simpler solution – to recognize that option prices always reflect the time value of the option premium and to require interest accruals on the premium in all cases where it is paid when the option is written.

25. The first approach is also vulnerable to the use of straddles for avoiding tax. Assume *A* buys a call option on shares of the stock of *X* Corporation, and simultaneously writes a call option on the same number of shares at the same option (strike) price but with a slightly different maturity date. Apart from transaction costs, the premium paid on the first option approximately equals the premium received on the second, and any gain or loss on either option will be offset by a virtually identical loss or gain on the other. However, if the values of the options change at all, *A* might sell or close out the losing option near the end of the tax year and replace it with a third option differing only slightly in maturity date from the option retained from the original two. That year-end manoeuvre has little effect on *A*'s economic position, but in the absence of anti-avoidance rules it produces a deductible loss that will not be offset by taxable income until the options mature or are closed out during a subsequent year. The result is a deferral of tax. The straddle problem is discussed further in section V below.

26. Under the second approach, in which the option is considered independent of the underlying property, the issuer is usually taxed on the option premium when it is received, while the holder is not permitted any allowance for the premium before the option is exercised, is disposed of or lapses. The result is favourable for the Government, and that approach effectively discourages at least some uses of option straddle transactions. However, it discourages option transactions generally, and contradicts economic reality. An option premium resembles an insurance premium, and a tax on an option premium when received is like a tax on gross insurance premiums, making no allowance for the possibility of losses.

27. The United States uses a third approach for holders of non-equity options (exchange-traded options on property other than individual stocks).[11] Unless the option is identified as part of a hedging transaction, the holder of such an option is subject to a mark-to-market regime, under which gain or loss is recognized annually equal to the difference between the premium paid and the option's value at the end of the year (adjusted for gain or loss recognized under that rule in preceding years). That approach avoids the deferral opportunities of the first approach, and also avoids taxing issuers of options on receipts that have not fully accrued as income. However, the approach works well only for options traded on an active market providing realistic daily price quotes.

28. A fourth approach applies in the United States to options that have been identified as hedges. The treatment of hedging transactions is discussed more fully in section VII below.

IV. Futures and forwards

29. A futures or forward contract is a contract to buy and sell something for a stipulated price at a designated future date. The subject of the contract (the underlying) may be a physical commodity (e.g., wheat or pork bellies), a currency or a financial instrument. The underlying can also be a market index or floating interest rate. By the contract, the seller takes a "short" position in the underlying and the buyer takes a "long" position.

30. The term "futures" generally refers to standardized contracts traded on organized markets, subject to extensive regulation. Futures contracts include commodity futures, interest rate futures (contracts on fixed rate debt instruments, including United States Treasury obligations and United Kingdom gilts), currency futures and stock index futures. A "forward" is a contract made outside an organized market. Forward contracts commonly cover all of the subjects of futures contracts (commodities, interest rates, currencies and stocks), but the contract terms can be tailored more precisely to the parties' needs.

31. Under futures contracts (also called exchange-traded contracts), the exchange clearing house is effectively the counterparty to all contracts. Under forward contracts (also called over-the-counter contracts), the counterparty is usually a bank or other financial institution.

32. Because the rights and obligations under a futures or forward contract are mutual, it is not common for either party to pay a premium to the other when the contract is made.[12] However, exchange-traded contracts typically require each party to a contract to make a margin deposit with the exchange. The margin is initially 1 per cent to 5 per cent of the amount of the contract, but it is adjusted daily under a mark-to-market procedure, by which each party's margin account is increased or decreased by the amount by which the contract's value changed from the preceding day.

33. Futures and forward contracts normally provide for physical delivery of the underlying, but they are usually closed out before the delivery date or settled for cash on the delivery date.[13] Some contracts provide exclusively for cash settlement rather than physical delivery. A closing transaction or cash settlement consists of a cash payment by the losing party to the gaining party equal (in the case of a cash settlement) to the difference between the spot market price for the underlying item on the delivery or settlement date and the contract price.

34. The relationship between the spot and forward prices of an item is a function of the time value of money (including both interest and storage costs for physical commodities). For example, the futures price of wheat approximates the sum of the spot price and the cost of carrying the wheat to the settlement date. If the futures price exceeds that sum, arbitragers can profit by making futures contracts to sell and covering their obligations under the contracts by buying wheat at the spot price and holding it for delivery under the contracts. Other arbitrage strategies can exploit an opposite difference. Arbitrage transactions thus keep the spot and forward prices near time-value equilibrium. The forward rate under a currency contract is a function of the spot exchange rate and the prevailing interest rates on obligations issued in the two currencies.

35. Futures and forwards can be used as highly leveraged vehicles for speculation. For example, if the initial margin is 1 per cent of the contract amount, a futures contract is a means for reaping the entire benefit of a rise in the market price of an item with an investment of 1 per cent of the item's value. The risk of loss is equally great.

36. More often, futures and forwards are used for hedging. For example, if an owner of property intends to sell it at a particular time in the future, the person can protect against declines in the property's market value by making a futures or forward contract to sell. Similarly, a farmer might lock in a price for a portion of his crop by making a futures contract, maturing around harvest time, to sell a quantity of the crop to be grown. Conversely, if a person anticipates a need to purchase property at a particular future time, a futures or forward contract to buy protects the person against the risk of rises in the market price.

37. Countries vary widely in their treatment of futures and forwards, but three basic approaches predominate – a realization approach, a mark-to-market approach and a matching approach for hedging transactions.

38. Under a realization approach, neither party to a contract recognizes gain or loss until the contract is concluded or disposed of by a sale, closing transaction, cash settlement or delivery at maturity.[14] On a sale, closing transaction, or cash settlement, each party recognizes gain or loss equal to the amount received or paid. On a physical delivery, the selling party has gain or loss equal to the difference between the amount received and the seller's cost or other tax basis for the property sold, and the buying party's cost for the property is the contract price. Alternatively, the buying property can also be required to recognize gain or loss on a physical delivery equal to the difference between the underlying's value at that time and the contract price.

39. Under the mark-to-market approach, gain or loss on a contract outstanding at the end of a taxable year is recognized in an amount equal to the contract's fair market value on the last day of the year, appropriately adjusted for any gain or loss recognized on the contract for earlier years. For contracts sold or closed out during the year, the gain or loss is the amount paid or received, adjusted for gain or loss recognized for earlier years. For exchange-traded contracts, the mark-to-market approach is facilitated by the fact that the contracts are marked-to-market daily by the exchange.[15]

40. Under the matching approach, which is described more fully in section VII below, the tax treatment of a contract held as a hedge is coordinated with the taxation of the position being hedged.

V. Swaps

41. A swap (also known as a notional principal contract) is an instrument requiring one party to make payments to the other, and perhaps vice versa, in amounts calculated by applying a specified rate or index to a "notional" principal amount. An example is an interest rate swap under which for a particular period (say, five years), *A* agrees to make quarterly payments on 1,000u to *B* at the 90-day London interbank offered rate (LIBOR) as of the date of payment, and *B* agrees to make simultaneous payments to *A* of 25u each (one fourth of 10 per cent of 1,000u). Because the payments in this case are simultaneous, they are offset, and only one payment of the net amount is made each quarter. For example, if the LIBOR for a particular quarter is 8 per cent, *B* must make a net payment to *A* for the quarter of 5u (25u, less one fourth of 8 per cent of 1,000u). However, the payments need not be simultaneous. For example, *A* might be required to make quarterly payments, while *B*'s obligation might be annual, in which case netting is possible only for one set of payments each year.

42. Swaps can be made as speculations on market changes but they are more often used to hedge market risks. *B* might make the contract in the example because it has borrowed 1,000u at a variable interest rate tied to the LIBOR and wants to eliminate the risk of interest rate fluctuation. *B*'s variable interest payments under the loan will be offset by the variable payments it receives from *A* under the swap, and *B*'s ultimate obligation thus consists of the payments at 10 per cent fixed interest to *A* under the contract. *A* might be an investment bank that will lay off the risk in another transaction. Alternatively, *B* might be an investment bank and *A* might be an investor that holds a 1,000u bond paying interest at the LIBOR but wants instead to receive interest at a fixed rate. Typically, a swap is made by a company or investor with a financial institution. The financial institution usually attempts to hold a balanced portfolio of contracts in which offsetting positions effectively eliminate all market risk. Occasionally, a financial institution acts as broker in making a swap between two customers.

43. Other swaps include the following:

(a) *Equity swap* (*A* pays amounts equal to the dividends on 100 shares of *X* stock, *B* pays amounts equal to the dividends on 100 *Y* shares, and the parties exchange payments at maturity equal to the values at that time of the notional amounts of stock). The payments under an equity swap may also be based on one or more stock indexes;

(b) *Commodity swap* (for five years, *A* annually pays 100u to *B*, and *B* pays to *A* 40 times the price of a bushel of corn on the payment date);

(c) *Currency swap* (for five years, *A* annually pays $100 to *B*, and *B* simultaneously pays 1,000u to *A*);

(d) *Basis swap* (an interest rate swap where one party's payments are based on one floating interest rate (e.g., the United States prime rate) and the other's on another such rate (e.g., the LIBOR));

(e) *Forward rate agreement* (an interest rate swap for only one period);

(f) *Cap* – one party makes periodic payments equal to a notional principal amount times the excess (if any) of a particular varying rate or index over a stipulated fixed rate, and the counterparty makes a single payment when the contract is made or a series of fixed payments. For example, suppose *A*, who has borrowed 1,000u at the 90-day LIBOR, is willing to absorb the risk of limited increases of the LIBOR but wants to be protected in the event the LIBOR rises above 10 per cent. To do so, *A* buys a cap from *B* under which *B* agrees to make a payment to *A* each quarter equal to one fourth of the product of 1,000u and any excess of the LIBOR for the quarter over 10 per cent;

(g) *Floor* – same as a cap, except that the periodic payment is the notional principal amount times the excess of the fixed rate over the variable rate (e.g., 1,000u times the number of percentage points by which the LIBOR on the payment date is less than 5 per cent). A floor might be purchased by an investor who, for example, holds a 1,000u bond paying interest at the 90-day LIBOR and who is generally willing to bear the risk of interest rate fluctuation but wants to be protected against the possibility of the LIBOR falling below 5 per cent;

(h) *Collar* – each party is simultaneously the recipient of the periodic payments under a cap and the payor of the periodic payments under a floor, or vice versa.

44. Most swaps can be analysed as a series of forward contracts. For example, if a currency swap obligates *A* to pay $100 annually to *B* for five years and *B* to pay 1,000u to *A* on the same dates, the contract is essentially a series of five currency forwards maturing one, two, three, four, and five years after the contract date. However, caps, floors and collars are in effect series of options. Those equivalencies have two related tax-policy implications. First, the problems and solutions discussed above in connection with options and forwards apply as well in this context. Second, if tax rules for options, forwards and swaps are not consistent, taxpayers, with the assistance of investment bankers, will exploit those inconsistencies.

45. The basic payments under a swap are periodic, but one of the parties may make a lump sum payment when the contract is made, at the end of the contract period or at some other time. For example, under a cap or a floor, one party usually makes a single fixed payment (equivalent to an option premium), and the other party agrees to make periodic payments. Also, a swap under which both parties make periodic payments may be off-market, in which case the party benefiting from the market deviation makes a compensating payment to the other in addition to that party's periodic payments under the agreement. Assume the market equates variable rate interest at the 90-day LIBOR with a five-year fixed rate of 11 per cent, but *A* and *B* make a five-year agreement to swap the 90-day LIBOR for fixed interest at 10 per cent. *A* and *B* will agree that the party making the fixed payments must also make a lump sum payment, probably when the contract is made, to compensate for the below-market rate of the fixed payments. If the fixed interest payments are at, say, 12 per cent, the compensating lump sum payment would be made by the payor of the variable payments.

46. In most countries, periodic payments under a swap are recognized as made (as income by the recipient and deductions by the payor). Countries vary in their treatment of non-periodic payments. In some countries, non-periodic payments – like periodic payments – are treated as income to the recipient and deductions for the payors when made. In other countries, non-periodic payments are amortized over the instrument's term.

47. The treatment of periodic payments has not been considered problematical, but non-periodic payments have proven to be more difficult to classify. If non-periodic payments are treated as income and expense as they are made and received, the parties to the contract are treated symmetrically, but taxpayers might nevertheless utilize that treatment as a means of reducing tax. For example, if a company has a loss carry-over deduction that is about to expire, it might make an off-market interest rate swap under which it receives a lump sum payment when the contract is made. The inclusion of the payment in income when received does not increase the company's tax because the income is absorbed by the loss. The company will make larger periodic payments than it would have under a market-rate swap, but the deductions for those payments can be deducted against income for the years in which they are made. As a result, the life of the loss carry-over is effectively extended.

48. Also, the recognition of lump sum payments as made and received might disrupt the markets for swaps. If an investment bank holds a balanced portfolio and amortizes lump sum receipts on a realistic basis, it essentially has no net income or loss from the contracts (apart from the margin it extracts as its profit) because deductions for payments will roughly equal income from receipts. On the other hand, if lump sum receipts are income as received, the bank may have artificial net income when its portfolio is expanding in size and artificial net losses when the portfolio is contracting. That artificial income and loss may make dealing in swaps less profitable than it would be under tax rules treating receipts more realistically, or it might cause investment banks to charge customers more than they otherwise would.

49. Those problems can be addressed by requiring taxpayers to amortize lump sum payments under swaps, but reasonably realistic amortization schemes are complex. For example, in the United States, lump sum payments are usually amortized by reference to market prices for forward contracts and options equivalent to the taxpayer's rights

under the swap.[16] For that purpose, a swap is considered analogous to a series of cash-settled forward contracts, and a lump sum payment under a swap is allocated over the contract's life according to the market prices for the analogous forward contracts. That method may be illustrated by the following example:[17]

Example 1

A swap contract requires *A* to make three annual payments to *B* of $2,350 each (the notional principal amount 1,000 bushels of corn times $2.35, the current price for corn) and *B* to make simultaneous payments to *A* equal to 1,000 times the spot price for corn on the payment dates.[17] When the contract is made, the forward prices for corn are $2.40 for a one-year forward, $2.55 for a two-year forward and $2.75 for a three-year forward. Because *A*'s fixed payments are below market, *A* pays *B* $535 when the contract is made. That non-periodic payment is amortized by treating it as a loan from *A* to *B* that *B* will repay, with interest, in three payments of $50 in one year (1,000 times the excess of the one-year forward price of $2.40 over the $2.35 price at which *A*'s fixed payment is pegged), $200 in two years (1,000 times excess of $2.55 over $2.35), and $400 in three years (1,000 times excess of $2.75 over $2.35). The non-periodic payment of $535 equals the present value of those three payments at a discount rate of 8 per cent compounded annually. Each assumed payment is divided between a time-value component (determined at 8 per cent) and a principal component, as follows:

Year	Assumed Payment	Time-value component	Principal component
	(United States dollars)		
1	50	43	7
2	200	42	158
3	400	30	370
	650	115	535

The principal component is treated as a periodic payment under the swap, and the time-value component is disregarded. *A*'s periodic payment to *B* for the first year is thus deemed to be $2,357 (sum of $2,350 actually paid at the end of the first year and $7 amortization of the up-front payment); the deemed periodic payments for the second and third years are $2,508 (sum of $2,350 and $158) and $2,720 (sum of $2,350 and $370). The periodic payments, enhanced by amortization of the non-periodic payment, are treated as income of the recipient (*B*) and deductible expense of the payor (*A*).

50. The procedure followed in the above example is complex because it requires both extensive information about market transactions and considerable computational sophistication. Since most swaps are large transactions constructed by major financial institutions, that complexity is not often troublesome for taxpayers. Moreover, the forward rates used by the parties in determining the amount of the lump sum payment can be the basis of the allocation if they are "reasonable".

51. However, in some situations, the parties' pricing of the contract is not based on forward rates, and comparable forward rates may not be available. The United States Treasury therefore provides for an alternative "level payment method", under which the lump sum payment is amortized as though it were the present value of a series of equal payments falling due simultaneously with the periodic payments under the contract. That method may be illustrated by the following example:

Example 2

An interest rate swap requires *A* to make five annual payments to *B* of $11,000 each (11 per cent of the notional principal amount of $100,000) and *B* to make simultaneous payments to *A* equal to the product of $100,000 and the one-year LIBOR on the date of payment.[18] When the contract is made, the LIBOR swaps even on the market for fixed interest of 10 per cent. *B*, who gets 11 per cent in that off-market swap, therefore pays a "yield adjustment fee" to *A* when the contract is made of $3,791, which the parties computed as the present value at 10 per cent of five annual payments of $1,000 each (11 per cent of $100,000, less 10 per cent of $100,000). Under the level payment method, the allocation to the first year is $621 – the assumed payment of $1,000, reduced by the time-value component (10 per cent of the yield adjustment fee of $3,791). That amount is recognized as a receipt by *A* and a payment by *B* in addition to the periodic payments for the year. Similarly, the allocation to the second year is $683 ($1,000, less the time-value component computed as 10 per cent of the excess of $3,791 over the principal component of $621 for the first year), to the third year is $751, and so forth.

52. If the lump sum payment is made other than when the contract is made (e.g., at the end of the contract term), the level payment method is applied as though the contract provided for a lump sum payment at the outset equal to the

present value of the payment actually required. Normally, the amortizations of a non-periodic payment are treated as income to the recipient and expense to the payor, and the time value of money amounts are ignored. However, if the non-periodic payment is made at the outset and is "significant" in amount, the payment is treated as an embedded loan and the interest element of the embedded loan is recognized as income and expense. For the recipient, the income has its source at the residence of the payor under the source rule for interest.[19]

VI. Straddles

53. The United States has found it necessary to provide special loss deferral and capitalization rules for "straddles".[20] Assume *A* buys a call option on shares of the stock of *X* Corporation and simultaneously sells a call option on the same number of shares at the same option (strike) price but with a slightly different maturity date. Apart from transaction costs, the premium paid on the first option very nearly equals the premium received on the second, and any gain or loss on either option will be offset by a virtually identical loss or gain on the other. However, if the values of the options change at all, *A* might sell or close out the losing option near the end of a tax year and replace it with a third option differing only slightly in maturity date from that of the original two. That year-end manoeuvre also has little effect on *A*'s economic position but it produces a loss that, if allowed as a tax deduction, will not be offset by taxable income from the options transactions until the remaining options mature or are closed out during the following year. The loss can therefore be deducted against other income, effectively producing a deferral of tax. The United States Congress found that result unacceptable.

54. Since 1981, United States law has generally disallowed any deduction for loss on the sale, exchange, or closing of a "position" in actively traded property to the extent that the loss is offset at year-end by an unrealized gain in an "offsetting position".[21] The disallowed loss is carried forward and is allowed in a succeeding year when it is no longer offset by unrealized gain in an offsetting position. In the example, the loss realized by selling or closing out one of the options in the first year is deferred until the offsetting option is exercised, sold or closed out.

55. The actively traded property comprising a straddle may, for example, be a commodity, a debt instrument, an option, a futures or forward contract or a swap.[22] Stock may also be part of a straddle but only if the offsetting position is an option.

56. Offsetting positions exist if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind).[23] For example, if *A* holds 100 shares of the stock of *X* Corporation and also has a put option on 100 shares of *X* stock, the positions are offsetting because the put option, which can be exercised to sell the stock for the strike price if the stock's value falls below that amount, substantially diminishes *A*'s risk of loss on the stock. Thus, if the stock's value increases above the strike price of the put and *A* allows the put to expire unexercised while retaining the stock, the loss sustained on lapse (the amount of the option premium) is not deductible to the extent of the unrealized gain in the stock. The put does not eliminate all risk of loss; for example, if the value of *X* stock remains constant, A will lose the option premium without reaping any offsetting benefit. However, the straddle rule applies if an offsetting position produces a "substantial diminution" of the risk of loss; an elimination of risk is not necessary. Moreover, the positions may be considered offsetting even if the strike price under the put is less than the stock's value when the put is acquired and the put therefore does not protect *A* from all risk of loss on the stock.

57. The straddle rules are complex and difficult to enforce. The taxpayer's purpose in acquiring the offsetting positions is not relevant. Assume *B*, a United States resident, purchases a bond denominated in Japanese yen, and to protect against currency risk simultaneously enters into a forward contract to sell yen; the term of the forward contract is shorter than the bond's term, and *B* realizes loss on the forward when it matures. Because the loss on the forward is offset by currency gain in the yen position represented by the bond it is non-deductible, at least in part, even if *B* promptly enters into another forward contract to continue the protection against currency risk. The ultimate result – deferral of the loss deduction until the offsetting gain is realized – is not unreasonable, but the accompanying record-keeping burden may be more than *B* bargained for in acquiring the investment.[24]

58. Conversely, even if a taxpayer's purpose in acquiring offsetting positions is to defer tax by a straddle strategy, the taxpayer is likely to keep records that do not call attention to the connection between the two positions, thus leaving for the tax auditor a difficult job in making the connection required for the application of the straddle rules. The auditor's task is even more difficult if the property underlying the two positions is not identical (e.g., stock in a mutual fund invested in all stocks in a particular index and a cash settled put option on the index).

59. The straddle rules also defer deductions for interest and other costs incurred in financing or carrying any position (leg) of a straddle.[25] Assume *A* purchases silver and simultaneously enters into a futures contract to sell an identical amount of silver in 18 months; the purchase is financed with borrowed money, and *A*'s costs in carrying the silver include interest on the borrowing and storage and insurance costs.[26] The futures price for the silver approximates the sum of *A*'s purchase price and the interest, storage and insurance costs for 18 months. The futures contract thus guarantees *A* reimbursement of the carrying costs as well as offsetting the risk of loss from a drop in silver prices. The United States Congress concluded that the carrying costs, as well as any loss on a closing out of either the silver position or the futures contract, should be deferred until income from the straddle transaction is recognized. However, a consequence of the capitalization of carrying costs is greater complexity for taxpayers and tax auditors, who must identify both the positions comprising a straddle and the interest and other costs "properly allocable" to property included in the straddle.

60. The United States straddle rules only apply to United States citizens and residents and to non-residents engaged in business in the United States. They do not affect United States withholding taxes, and thus have no application to non-residents who invest in the United States but are not engaged in business in that country.

61. Much of the complexity of the straddle rules derives from the efforts of the United States Congress to frustrate avoidance strategies. For individual investors, those efforts seem to have largely succeeded. However, United States-based multinational corporations may have less difficulty in avoiding the straddle rules. For example, if a domestic affiliate holds one leg of the straddle and a foreign affiliate holds the other leg, the straddle rules apparently do not apply because domestic and foreign affiliates cannot join in a consolidated return.

62. The United States experience probably proves that compliance and enforcement complexity is an unavoidable consequence of any effective effort to deal with straddles. That experience may also establish that straddle strategies, if not limited by anti-avoidance rules, can impair a country's ability to tax income from capital.

63. In the United States, gains and losses on most instruments used in straddles are capital gains and losses,[27] and capital losses are generally deductible only against capital gains. Thus, straddles, if not curbed by the straddle rules, would usually be effective only to defer tax on capital gains. A country that does not tax capital gains may encounter fewer difficulties with straddle transactions if it categorizes straddle losses as capital.

64. However, countries that want to have effective taxes on capital gains are likely to find those taxes increasingly compromised by straddles. Straddle strategies are abetted by the relatively low margin requirements and transaction costs for many derivatives. In the absence of straddle rules, a taxpayer wanting to shelter a large gain from tax can often defer the capital gains tax indefinitely by engaging in a series of straddle transactions involving huge nominal amounts but having a cost to the taxpayer that is not large in relation to the deferred tax.

VII. Synthetics

65. In many contexts, derivatives can be used to convert an investment in one type of property into an investment with characteristics indistinguishable from property of another type.[28] For example, by the use of a forward contract, an equity holding can effectively be converted into debt or vice versa, as follows:

$$\text{Equity} = \text{Principal} + \text{Dividend}$$

where "dividend" refers to the entire return on equity, including capital appreciation.

$$\text{Debt} = \text{Principal} + \text{Interest}$$

A forward contract to purchase an equity interest can be represented as follows:

$$\text{Forward contract} = \text{Dividend} - \text{Interest}$$

That equivalence holds because although the buyer under a forward contract generally benefits from a rise in the value of the underlying, the forward price is the sum of the underlying's value when the contract is made and the cost of carrying the underlying to the maturity date. Combining those three equations:

$$\text{Debt (consisting of Principal + Interest)}$$
$$+ \text{ Forward contract (consisting of Dividend} - \text{Interest)}$$
$$= \text{Equity (consisting of Principal + Dividend)}$$

66. Thus, if *T* owns a 10 per cent, $1,000 bond and makes a forward contract to purchase *X* Corporation stock in one year for $1,100, her economic position is the same as if she owned $1,000 worth of *X* stock. Conversely, if *T* owns $1,000 of *X* stock but prefers the position of a bondholder, she could satisfy that wish by making a contract to sell the

stock for $1,100 in one year because, by rearranging the terms of the last equation above:

Equity – Forward contract = Debt

67. Additional synthetics can be constructed from a relationship known as put-call parity:

Call option – Put option = Forward contract

For example, if *T* holds an option to purchase *X* stock for $1,100 in one year and is issuer of a put option requiring her to purchase *X* stock for $1,100 in one year, she is certain to obtain the stock for $1,100 in one year (under the call if the stock goes up or under the put if the stock goes down), and her economic position is thus the same as if she had a forward contract to purchase *X* stock for $1,100 in one year.

68. Combining the phenomenon of put-call parity with the relationships noted above yields still more equivalencies:

Debt + Forward contract = Equity

Debt + Call option – Put option = Equity

Debt – Equity + Call option = Put option

Equity – Forward contract = Debt

Equity – Call option + Put option = Debt

Equity – Debt + Put option = Call option

69. Because of those equivalencies, derivatives can be used to exploit inconsistencies in the tax treatments of debt, equity and various types of derivatives. For example, if the tax rules for two types of property (e.g., debt and equity) are different, a taxpayer can often use derivatives to combine the economic consequences of one type of property (e.g., equity) with the tax consequences of the other type (e.g., debt), thus creating at least two problems – mischaracterization of income and avoidance of realization rules.

A. Mischaracterization

70. Distinctions between ordinary income and losses (revenue account) and capital gains and losses (capital account) are difficult to maintain in a world in which derivatives are freely available to taxpayers. For example, if capital gains are not taxed or are taxed at rates less than those applied to ordinary income, taxpayers may use derivatives to make investments yielding income that has all of the economic hallmarks of ordinary income but also satisfies the legal definition of capital gains.

71. Assume *T* purchases silver and simultaneously enters into a futures contract to sell an identical amount of silver. The forward price of silver equals or closely approximates the sum of the spot price for silver and the costs (interest, storage and other expenses) of holding silver until the delivery date; whenever the prices in the spot and forward markets depart from that relationship, arbitragers enter the market to restore the relationship. Since *T* holds both silver and a contract to sell silver, *T* will not be affected by changes in the price for silver, but the spread between the price paid in the spot market and the price to be received under the futures contract guarantees a profit compensating *T* for the time value of the investment in silver. *T*'s ownership of the silver and the contract put *T* in the economic position of a lender because he has an expectation of a return from the transaction that in substance is in the nature of interest and he undertakes no significant risks other than those typical of a lender.[29] A lender's return (interest income) is usually taxed as ordinary income. However, *T*'s profit will be in the form of gain on the sale of the silver, and gains on sales of investments are usually capital gain. If *T*'s profit qualifies for a preferential capital gains tax rate, that backhanded way of investing in a debt instrument allows ordinary interest income to be converted into capital gains.

72. The simplest solution to that problem is to tax capital gains at the same rates as ordinary income. That solution might be seen as allowing the tail to wag the dog since the taxation of capital gains has traditionally been seen as a much larger issue than the taxation of derivatives. However, as taxpayers become more sophisticated in investment strategies, the use of derivatives to avoid unwanted tax characterizations will become more common, and the capital-gains/ordinary-income distinction might become a dividing line between well advised and poorly advised taxpayers, rather than a line separating different types of income.

73. The United States has tried more limited responses to the problem. In 1993, the United States Congress adopted a provision taxing as ordinary income all or part of the gain on a "conversion transaction".[30] The hallmark of a conversion transaction is that substantially all of the taxpayer's expected return from the transaction is attributable to the time value of the taxpayer's net investment in such transaction.[31] An example is an acquisition of property and the making of a contemporaneous contract to sell the property. A straddle (two or more offsetting positions in exchange-traded property) is also a conversion transaction if the expected return is attributable to the time value of money. The silver

transaction described in paragraph 71 above was cited by Congress as an example of a conversion transaction.

74. Gain on a disposition or termination of any position included in a conversion transaction (the silver or the futures contract in the example) is ordinary income, except to the extent that it exceeds the "applicable imputed income amount". The latter amount is interest on the taxpayer's investment in the transaction (the purchase price of the silver), computed at 120 per cent of the prevailing yield on United States Treasury securities of like term.[32] In the example, if the futures contract is made through a clearing house of a major board of trade, the interest rate implicit in the contract is likely to be no higher than the rate imputed by the statute, and the investor's gain – whether it occurs on a sale of the silver, a sale or closing of the futures contract or both – will usually be largely if not entirely ordinary income.

75. A more mechanical system applies in the United States to synthetic instruments constructed with currency contracts. Assume *B*, a United States citizen, has \$1,000 to invest in a one-year debt instrument; the prevailing interest rates are 8 per cent in the United States and 2 per cent in Japan, and the spot exchange rate is \$1 equals 100 yen. If *B* invested in a United States instrument, the investment would accumulate to \$1,080 after one year (\$1,000 plus 8 per cent thereof). However, *B* (a) converts the \$1,000 to 100,000 yen, (b) purchases a one-year 100,000 yen debt instrument at 2 per cent interest, and (c) makes a forward contract to sell 100,200 yen in one year. The forward rate is \$1 equals 94.44 yen,[33] and *B* will thus have \$1,080 after one year (102,000 yen at 94.44 yen per dollar). The \$80 profit consists of interest of \$21.18 (2,000 yen at 94.44 yen per dollar), and currency gain of \$58.82. Under United States law, currency gain is ordinary income unless it arises from a forward or futures contract or option that is held for investment and is not part of a straddle.[34] Since the forward contract in the example protects *B* against the risk of currency loss on the yen note, the note and the forward contract are offsetting positions – a straddle. *B*'s income from the transaction is thus ordinary income, just as it would have been if *B* had invested in a United States instrument.

76. The United States solutions to those problems are complex and incomplete. The practical alternatives to those solutions are either to eliminate from the income tax laws any distinction between ordinary income and capital gains, or to allow taxpayers a free hand to alter tax characterizations at will through the use of derivatives. As derivatives become more widely available and understood, the latter alternative will probably become increasingly unpalatable to countries that either exempt capital gains from tax or tax capital gains at rates much lower than ordinary income.

B. Avoidance of realization rules

77. Under most income tax laws, gains and losses on investments in property are recognized only when realized by a sale, exchange or other disposition of the property. Thus, a holder of appreciated property is not taxed on the appreciation so long as the property is held, but a capital gains tax may be incurred if the holder sells the property and reinvests the sales proceeds in other property. By the use of derivatives, it is often possible to obtain the economic equivalent of a roll-over of investments without making a sale or exchange that triggers a capital gains tax.

78. Assume individual *E*, an employee of *X* Corporation, owns substantial amounts of *X* stock, which was acquired by the exercise of employee stock options and comprises the majority of *E*'s wealth. *E* wants to have a more diversified investment portfolio but would incur substantial capital gains taxes on selling *X* stock and reinvesting in securities of other firms. *E* enters into a swap agreement with an investment bank under which, for a period of five years, *E* will pay the bank amounts equal to the dividends on 1,000 *X* shares and the bank will pay to *E* amounts equal to the dividends on a specified basket of stocks of other companies (when the agreement is made, the basket of stocks has the same value as 1,000 *X* shares); at the end of those five years, *E* will pay the bank an amount equal to the value of 1,000 *X* shares at that time, and the bank will pay *E* an amount equal to the value of the basket of shares. The economic result is the same as though *E* had sold 1,000 *X* shares and reinvested the proceeds in the basket of shares. However, *E* has made no sale or exchange of *X* shares, and thus incurs no capital gains tax.

79. Few countries, if any, have addressed the realization-avoidance potential of derivatives.[35] Any effort to address the problem would quickly encounter a frustrating reality: given the great variety and flexibility of derivatives, rules prescribing particular results for particular investment techniques could easily be avoided. For example, suppose a rule were adopted declaring that the making of an equity swap of the sort illustrated in the preceding paragraph should be treated as a sale or exchange of the stock that is the basis for the taxpayer's payments under the swap (1,000 *X* shares in the example), to the extent that the taxpayer owns such stock when the swap agreement is made. That rule would curb equity swaps, but it would not solve the problem because numerous other techniques can be used to obtain the

same results. For example, a short sale of *X* stock, combined with an investment in the basket of stocks, has the same effect as the equity swap, and at least in the United States, the making of a short sale against the box is not a realization event. A sale of a call option on *X* stock, combined with a purchase of a put on *X* stock and a futures contract on the basket of stocks, also has the same effect.

80. The realization avoidance problem could be attacked effectively only by a rule that treats a taxpayer as having sold property whenever the taxpayer enters into one or more transactions that have the effect of offsetting the benefits and burdens of the taxpayer's ownership of the property. However, such an approach is also beset by numerous problems. *E*'s five-year equity swap looks a lot like a sale of *X* stock combined with an investment in the basket of stocks, but would such a characterization be fair if the term of the equity swap was six months? If a six-month swap is not a realization event, what should be done about a taxpayer who enters into a series of six-month swaps extending over, say, five years and thereby accomplishes the same results as *E*? Would the proposed rule apply only when the offsetting positions eliminated all risks and benefits of ownership or when those risks and benefits are substantially diminished? If the latter, how is the line to be drawn between substantial and insubstantial? Whatever rules were settled on, would tax auditors have the sophistication and time to sort through taxpayers' records to determine whether and how the rules applied?

81. A more comprehensive and perhaps simpler approach to the problem would be to require all substantial investors to use a mark-to-market system for exchange-traded securities, requiring unrealized gains and losses to be recognized annually and thereby eliminating the realization rule. That is a radical solution because it would change the entire system of dealing with gains and losses on property in order to frustrate a particular avoidance technique. However, as the availability and understanding of derivatives expands, the application of the realization rule may become increasingly arbitrary, and Governments may be pushed to consider radical alternatives to the rule.

82. Another comprehensive, radical and perhaps simpler approach is to repeal all taxes on capital gains. However, that solution does not address the problem discussed earlier: strategies to convert taxable ordinary income into exempt capital gains.

VIII. Hedging

83. Derivatives are remarkably effective as instruments for gambling. Using derivatives, investors can take large positions with cash investments as small as one per cent of those positions; their investments can double, triple or more, or be wiped out by relatively small changes in the value of the positions.

84. However, a much more common use of derivatives is for hedging risks arising from business activities or investments. A manufacturer of products from corn might make futures contracts to buy corn to ensure that its manufacturing profits will not be impaired by rises in the price of its basic input.[36] An export seller of goods might make a forward contract to sell foreign currency to be received in a sale in order to protect its profit on the sale from erosion by currency fluctuation. A company that has borrowed in the currency of country *X* but reports its profits in the currency of country *Y* might make a series of forward contracts to purchase *X* currency with *Y* currency to cover its payments under the loan, thereby eliminating the possibility that borrowing costs might be increased by an unfavourable change in the exchange rate. A bank that makes long-term loans from funds received as short-term deposits might acquire a variety of derivatives positions to mitigate the resulting interest-rate risk.

85. One of the more important steps a Government can take to facilitate productive uses of derivatives is to formulate tax rules allowing gains and losses from derivatives held as hedges to be coordinated, both in character and in time, with income and loss from the transactions being hedged. Where hedge accounting is not accepted, asymmetric taxation of the hedge and the underlying can lead to distortions.[37] As a result, a perfect hedge before taxes can be quite imperfect after taxes.

86. The United States Treasury adopted hedging rules in 1994. They are briefly described below as a means of highlighting the crucial issues and outlining one set of responses to those issues.[38]

87. The United States rules apply only to transactions made in the "normal course" of the taxpayer's business, "primarily to reduce" either or both of two types of risk: (a) the risk of price changes or currency fluctuations with respect to property held or to be held by the taxpayer, provided that gain or loss on a disposition of the property cannot be capital gain or loss; and (b) risks of interest rate or price changes or currency fluctuations with respect to obligations of the taxpayer, both current and anticipated, whether arising from borrowings or business operations.[39]

The rules do not apply to a hedge of a dividend stream, the overall profitability of a business unit, or other business risks that do not relate directly to interest rate or price changes or currency fluctuations.[40]

88. The risks of a taxpayer's business are judged by looking at the business as a whole. For example, if the prices of products the taxpayer manufactures from corn vary directly with the price of corn, the business probably is not subject to a price risk, and if so, purchases of corn futures cannot be justified as a hedge. However, the taxpayer's judgement on those matters is usually respected. A hedge of a particular asset or liability or pool of assets or liabilities is generally considered to reduce overall risk if it reduces risk with respect to those assets or liabilities, and is "reasonably expected to reduce the overall risk of the taxpayer's operations."[41] Similarly, if the taxpayer has a programme that, as a whole, is reasonably expected to reduce overall risk, the risk-reducing effect of each instrument acquired as part of the programme need not be demonstrated.

89. The character rules for hedges apply to an eligible transaction only if it is identified as a hedge in the taxpayer's records before the end of the day on which the transaction is entered into.[42] Also, substantially contemporaneously with entering into the hedging transaction, the taxpayer must identify the item, items or aggregate risk being hedged, usually by identifying the transaction creating the risk and the type of risk that the transaction creates.[43]

90. The policy underlying the identification requirement is twofold. First, it is probably not feasible to apply the hedging rules mandatorily to all transactions serving hedging functions because, given the quantity of derivatives transactions made by many taxpayers, it is not possible for tax auditors to police a mandatory requirement. Second, although the identification requirement effectively makes the character rules elective,[44] the requirement that the identification be made on the day the transaction is entered into precludes taxpayers from using the rules selectively – applying them when they turn out to be advantageous and otherwise disregarding them.

91. Under the United States rules, the hedge and the hedged risk must be held by the same entity. That requirement is imposed to simplify administration of the hedging rules but it creates a dilemma for complex enterprises that want to centralize the hedging of the business risks of all of their affiliates for reasons of financial efficiency. The rules also require that the hedging transaction be made with an unrelated person. For example, hedge accounting is not allowed where an operating company hedges a business risk with a derivative purchased from an affiliated financing entity. The purpose of that requirement is probably to minimize disputes over whether prices are at arm's length, but it can also interfere with efforts to centralize hedging functions.

92. Gains from transactions identified as hedges are generally ordinary income, even if the transactions do not qualify as hedges or the identification is defective.[45] Loss from a hedging transaction is ordinary loss if the transaction fully qualifies and the identification is made in accordance with the rules, but loss is characterized without regard to the hedging function if the rules are not fully complied with. Since the hedging rules apply only to hedges of risks arising in the ordinary course of business, the ordinary characterization of gains and losses from hedging transactions usually matches with the characterization of income from the property and activities being hedged.

93. The United States hedging rules also deal with the timing of the recognition of income or loss from hedging transactions, but without prescribing detailed timing rules. Generally, taxpayers' accounting methods for hedging transactions must clearly reflect income, and that standard requires that taxpayers reasonably match the timing of income, deduction, gain or loss from the hedging transaction with the timing of income, deduction, gain or loss from the item or items being hedged.[46] The matching requirement, which applies whether or not a hedging transaction is identified as such, often is not satisfied by accounting methods that recognize hedging gains and losses as realized.

94. For example, if a taxpayer hedges an aggregate risk, rather than matching particular hedges with the risks from particular transactions the taxpayer might use a "mark-and-spread method", under which hedges are marked-to-market at least quarterly and gain or loss from hedges is allocated over the period for which the hedging transactions are intended to reduce risk.[47] Gains and losses on hedges of inventory must generally be taken into account at the times that they would affect income if treated as parts of the costs of the goods being hedged.[48] Although the rules require coordination of the treatment of gains and losses from hedging transactions with the treatment of income or loss from hedged activities and property, it is not permissible to merge hedges into the accounts for hedged items. For example, gain or loss on an inventory hedge cannot be included in the inventory accounts.

95. The hedging rules supersede several inconsistent rules that might otherwise apply to transactions used as hedges. For example, futures contracts and currency forward contracts are generally subject to a mark-to-market requirement, and gains and losses from those contracts are arbitrarily classified as 40 per cent short-term capital gain or loss and 60 per cent long- term capital gain or loss,[49] but

neither the mark-to-market rule nor the characterization rule applies to contracts properly identified as hedges.[50]

IX. Hybrids

96. Companies sometimes issue instruments – termed hybrids – that combine features of debt and derivatives. A common example is a bond convertible into stock of the issuer, which is in substance a package consisting of a debt instrument and an option on the issuer's stock. In recent years, investment bankers have developed increasingly sophisticated hybrid instruments. For example, *X* Corporation might issue a two-year instrument under which it will make a single payment at maturity equal to the sum of $1,000 and the product of $1,000 and the percentage increase, if any, in a stock index from the issue date to the maturity date. If the stock index rises over the two-year term by, say, 25 per cent, the payment at maturity is $1,250 (sum of $1,000 and 25 per cent of $1,000).

97. Such instruments raise several difficult tax issues. First, should they be characterized as debt or equity? They are commonly treated as debt, particularly if the contingency has no relationship to the issuer's profits (e.g., the stock index example) and often when they have a more direct connection with the issuer's equity (e.g., convertible bonds).

98. Second, if the instrument is treated as debt, how should the embedded derivative be reflected in the tax treatment of the instrument? One approach is to separate (bifurcate) the instrument into its constituent parts and subject each part to the tax treatment it would enjoy as a separate instrument. For example, the instrument tied to the stock index could be analysed as a $1,000 zero coupon bond and an option on the stock index. If the instrument is issued for $1,000 and the premium on such an option is $145, the issue price of the zero coupon bond would be $855, and the issuer and holder would have discount (interest) expense and income of $145 over the two years of the bond's term. If the holder received $1,250 at maturity, $1,000 would be treated as a payment on the bond, and the remaining $250 would be attributed to the option, producing gain (for the holder) and loss (for the issuer) on the option of $105 ($250, less $145).

99. One difficulty with the bifurcation approach is that given the chameleon quality of derivatives, instruments can often be deconstructed in a variety of ways; and because the tax treatments of various types of financial instruments are often not consistent with each other, one bifurcation of a particular instrument can yield different results from another bifurcation of the same instrument. That problem can be overcome in part by tax regulations prescribing how instruments are to be bifurcated, but continuing innovation may put such regulations to difficult tests.

100. Another difficulty with bifurcation is that the market information needed to bifurcate is not always available. For instance, although options on stock indexes are widely traded, the terms of the embedded option in the example may differ significantly from those of traded options (e.g., they may cover a much longer period of time).

101. If the taxpayer hedges out its risk on the embedded derivative, hedge accounting (combining the hedge with the instrument) is a helpful alternative to bifurcation. However, where the taxpayer bears that risk, practical alternatives to bifurcation can open many avenues for manipulation and abuse.

X. International issues

102. Derivatives and other unusual financial instruments pose several challenges for most countries' systems for taxing cross-border investments.

A. Withholding taxes

1. Discount bonds

103. Taxing discount income is particularly difficult when the holder of the bond is not a resident of the issuer's home country. Investment income is often subject to withholding taxes in the country of source (typically, in the case of debt instruments, the issuer's country of residence). Among 22 Organisation for Economic Cooperation and Development (OECD) countries responding to a recent survey, only five attempt to impose withholding taxes on discount income of non-resident holders of discount bonds.[51] All but one of those five countries consider discount income to be subject to the interest articles of their income tax treaties.[52]

104. The practicality of withholding taxes on discount income is doubtful. Tax can only be withheld from payments, not from accruals. Moreover, withholding taxes are typically not imposed on gains on sales of investments, largely because it is usually not feasible for the buyer or a broker to measure the seller's gain and because a withholding tax on gross sales proceeds would impede investment flows. A requirement that tax on discount income be withheld by residents purchasing discount bonds from non-residents would be especially problematical because purchasers usually lack knowledge of several facts needed to compute the non-resident's discount income. Among OECD countries, only two require resident buyers of

discount bonds to withhold tax from the purchase price when the seller is a non-resident.

105. If an interest-bearing bond is issued at a discount, tax on discount income can be withheld from the interest so long as the withholding tax on the interest and discount income does not exceed the interest.[53] However, there is no feasible means of withholding tax from discount accruals on zero coupon bonds.

106. The issuer can be required to withhold tax on the discount income at maturity.[54] However, if resident investors are taxed on discount income on an accrual basis rather than at maturity, requiring withholding from non-resident holders at maturity is futile unless a mechanism is developed for withholding tax on discount income when a non-resident sells a discount bond. If a non-resident holding a discount bond to maturity is taxed on discount income but a non-resident selling a discount bond before maturity is not taxed, non-residents have a strong incentive to sell their discount bonds rather than hold them to maturity. Economically, there is little difference to an investor between a sale shortly before maturity and a payment from the issuer at maturity. The result is that foreign investors are subject to tax only if poorly advised.

2. Derivatives: country practices

107. Under the practices of most countries, payments to non-residents under derivatives are generally not subjected to withholding taxes.[55]

108. Payments under option contracts are usually not subject to withholding taxes when made to residents of other countries. None of the 22 countries responding to a survey of OECD countries reported imposing withholding taxes on option payments, although some reserve the right to reclassify the payments as interest in appropriate cases and to subject the reclassified payments to withholding taxes.[56]

109. Similarly, payments and other transfers under futures and forward contracts are usually exempt from withholding taxes when made to residents of other countries. None of the respondents to the OECD survey reported imposing withholding taxes on payments under futures and forward contracts.[57]

110. Payments under swaps are generally not subject to withholding taxes when made to residents of other countries, but some countries apply withholding taxes to such payments in at least some circumstances. Among the 22 respondents to a survey of OECD countries, only Greece taxes all payments to non-residents under swaps. In Ireland, such payments are nominally subject to withholding tax, but payments by banks doing business in Ireland are usually exempted. Australia and Canada sometimes tax swap payments as interest. Such payments are taxable in the United Kingdom of Great Britain and Northern Ireland when made to any foreign person other than a bank carrying on business through a permanent establishment in that country, but if the recipient is a resident of a country having an income tax treaty with the United Kingdom, the payments are exempted under the "other income" article of the treaty unless the income is attributable to a permanent establishment of the recipient in the United Kingdom.[58] In the United States, payments under swaps are treated as income from sources in the country of the recipient's residence.[59] Since United States withholding taxes only apply to income from United States sources, that rule has the effect of exempting payments to non-residents.

111. However, in several countries, if a loan is embedded in a derivative, implicit interest on that loan may be subject to withholding tax.[60] For example, if an interest rate swap is on terms differing from those prevailing in the market and one of the parties makes a payment at the outset to compensate for the market deviation, the transaction is, in substance, a swap at market and a loan, wrapped together in one instrument, and the return on that embedded loan may be taxed as interest (see para. 123 below).

3. Withholding taxes on derivatives payments substituting for taxable payments

112. If derivative payments are not subject to withholding taxes, derivative transactions may be used to avoid withholding taxes on dividends and interest. For example, if a country *X* resident owns stock of a country *Y* corporation, dividends on the stock are likely subject to a country *Y* withholding tax. However, the country *X* resident can achieve the same economic result without the withholding tax by purchasing stock of a country *X* corporation and making an equity swap agreement with a country *Y* bank to swap cash flows from the *X* corporation stock for the cash flows under the *Y* corporation stock.[61]

113. As another example, assume the prevailing interest rates are 2 per cent in country *X* and 8 per cent in country *Y*, the spot currency exchange rate is 100x (the country *X* currency) for 1y (the country *Y* currency), and the one-year forward rate is 94.44x for 1y; *A*, a resident of country *X*, wants to invest 1,000y at the 8 per cent rate. If *A* acquires a one-year, 8 per cent, 1,000y bond issued by a country *Y* person, the interest of 80y will likely be subject to withholding in country *Y*. However, *A* might achieve the same result by purchasing a one-year, 2 per cent, 100,000x bond issued by a country *X* person, and simultaneously entering into a one-year forward contract with a country *Y*

bank to exchange 102,000x for 1,080y (102,000/1,080 is 94.44). After one year, *A* will have 1,080y, just as if *A* had acquired a one-year, 1,000y, 8 per cent bond, but *A* has no interest income from country *Y* sources and thus is not subject to any country *Y* withholding tax on interest.

114. However, it is not likely that country *Y* could, in either of the foregoing examples, block evasion of its withholding tax by imposing withholding tax on the swap or forward payments. If country *Y* taxes the payments on the theory that they substitute for dividends from a country *Y* corporation or interest income from country *Y* sources, the withholding tax can probably be avoided by making the swap or forward contract with a country *Z* bank. Even if many countries follow country *Y*'s lead in taxing swap payments, there will always be a country *Z* willing to be a tax haven in such transactions.

115. Moreover, that foreign investors obtain the economic equivalent of dividends or interest from country *Y* sources through the use of derivatives probably would not justify taxing derivative payments, even if it were feasible to tax them. Country *Y* retains the ability to tax all dividends paid by country *Y* corporations and all interest paid by country *Y* issuers, and the object of its withholding taxes is presumably to reach income produced by economic activities in country *Y*. That objective does not require that country *Y* tax a shadow created by financial wizardry, even though that shadow has all the appearances of dividends or interest from country *Y* sources.

4. Withholding taxes on all derivatives payments

116. A country might impose withholding tax on derivatives payments made by residents to non-residents on the theory that the payments represent income outflows from the taxing country – the traditional subject of withholding taxes. Whether or not the payments substitute for dividends, interest or other types of income caught by withholding taxes is not relevant under that theory. However, that is a very problematical approach, for at least two reasons.

117. First, it requires taxing all derivatives payments to non-residents. The practice of a few countries imposing withholding taxes on swap payments but not on payments under options and futures and forward contracts is likely to be self-defeating. Swaps are not a unique breed. Virtually anything that can be done by a swap can also be done by one or more options, futures or forwards. The likely effect of withholding taxes on swap payments, but not other derivatives payments, is a skewing of international transactions in derivatives without any material amounts of tax being collected.

118. Second, in many and probably most instances, a withholding tax on derivatives payments would make the derivatives transaction unprofitable, causing it not to occur and therefore eliminating any possibility of a tax collection. That may be illustrated by the following example:[62]

(a) *A*, a resident of country *X*, borrows at 8.5 per cent and enters into an interest rate swap with a country *Z* bank under which *A* makes an annual payment to *Z* at the LIBOR on a notional principal amount equal to the amount borrowed, and *Z* pays *A* 8.5 per cent fixed on the same amount;

(b) *B*, a resident of country *Y*, borrows at a floating rate of 75 basis points (0.75 per cent) above the LIBOR, and enters into a swap with the same country *Z* bank to pay fixed interest at 9.5 per cent and receive variable interest at 75 basis points above the LIBOR.

119. Those transactions occur because:

(a) If *A* borrowed directly at a variable rate, the rate would exceed the LIBOR (would be, for example, the LIBOR plus 25 basis points). Thus, the combination of the fixed rate borrowing and the swap at the LIBOR gives *A* the effect of the borrowing at the LIBOR, which is 25 basis points less than *A* could obtain in a direct borrowing at a variable rate;

(b) Similarly, *B*'s ultimate obligation under its borrowing and swap (fixed interest at 9.5 per cent) is more favorable than the rate *B* could obtain by borrowing directly at a fixed rate. Assume *B* could borrow at a fixed rate only at 9.75 per cent;

(c) The bank has an annual profit of 0.25 per cent of the notional principal amount. On the fixed payments, it annually gains 1 per cent of that amount (9.5 per cent received from *B* and 8.5 per cent paid to *A*), and on the variable payments it loses 0.75 per cent (LIBOR received from *A* and LIBOR plus 75 basis points paid to *B*).

The transactions will not occur if any of those conditions disappears.

120. Assume country *Y* imposes a 10 per cent withholding tax on residents' payments to non-residents under swap contracts. The annual tax on *B*'s payments to the country *Z* bank – 0.95 per cent of the notional principal amount (10 per cent of 9.5 per cent) – converts the bank's profit of 0.25 per cent into a loss of 0.7 per cent (pre-tax profit of 0.25 per cent, less tax of 0.95 per cent). The bank's response to the tax will be to agree to pay the LIBOR plus 75 basis points to *B* only if *B*'s fixed payments are at 10.56 per cent (10.56 per cent, less 10 per cent thereof, is 9.5 per cent, the amount the bank must clear to preserve its profit). However,

B can borrow directly at 9.75 per cent and will thus do so rather than making the variable rate borrowing and swapping with the bank.

121. In sum, the effect of country *Y*'s withholding tax is effectively to preclude *B* from entering into the swap with a non-resident. If country *Y* has a well developed banking system, *B* might make the swap with a country *Y* bank. If no country *Y* institution offers swaps on advantageous terms, the result is likely to be a loss of economic advantage to *B* and a diminution of country *Y* tax revenues. Without the withholding tax, *B* enters into the swap to reduce interest costs; if the withholding tax makes the swap unprofitable, *B*'s borrowing costs are higher than they would be with the swap, and after deduction of interest, *B*'s taxable income – and hence its tax obligation to country *Y* – are reduced. The net result of country *Y*'s imposition of the withholding tax is thus less tax revenue, not more.

122. Under most income tax treaties, derivatives payments are exempted from withholding taxes under the capital gains or other income articles.[63] In the example, country *Y* might impose a withholding tax on derivatives payments as a means of pressuring country *Z* and other countries with financial centres to make income tax treaties with country *Y*. However, that strategy is not likely to be a wise one because a withholding tax would probably be seen by country *Z* banks as no more than a minor irritation, whereas, as shown in the analysis of the example, the tax might be quite damaging to both country *Y* residents and the country *Y* fisc.

5. Substance versus form

123. The clothing of derivatives can be used to cloak transactions that should be subject to withholding taxes. Assume *A*, a country *X* resident, enters into a swap agreement with *B*, a country *Y* resident, under which *A* transfers to *B* 1,000u when the contract is made and *B* promises to transfer 80u to *A* on each of the first, second, third and fourth annual anniversaries of the date of the agreement and 1,080u on the fifth anniversary. That transaction is simply a five-year, 8 per cent loan of 1,000u by *A* to *B*, and the 80u payments by *B* should be taxed as interest. If country *Y*'s tax laws include a substance-over-form doctrine, its withholding tax on interest should apply to those payments. If country *Y* does not have a substance-over-form doctrine and does not impose withholding taxes on swap payments, it is vulnerable to that charade. However, the extension of withholding taxes to all swap payments, including the vast majority that are not artificially constructed to avoid tax, seems to be a poor solution to the problem.

6. Derivatives transactions among related persons

124. Concern has also been expressed about the tax avoidance potential of derivatives transactions between related persons. For example, if a country *X* corporation engages in a derivatives transaction with an affiliate in country *Y*, the parties might, as a tax avoidance ploy, agree to terms that deviate from those prevailing in the market. The solution to that problem lies in an arm's length requirement, either in the internal laws of countries *X* and *Y* or in an income tax treaty between them. But suppose the *X* corporation and the *Y* corporation each enter into derivatives transactions with an unrelated bank in country *Z*, a tax haven. Both of those transactions might be off-market on terms that make the *Z* bank whole (what it loses on one contract, it gains on the other) but have the net result of reducing the aggregate tax burden of the *X* and *Y* corporations. The solution to that problem is probably a more sophisticated use of an arm's length rule, although enforcement of the rule would be complicated by the difficulty tax auditors would inevitably encounter in identifying abusive transactions.

7. Net income taxation of branch operations

125. If a resident of one country carries on business through a branch in another country, the branch's net income is typically taxed in the latter country. In that context, the principal issue raised by derivatives is the task of identifying particular derivatives of the taxpayer with operations of the branch. That issue is particularly difficult for financial intermediaries that manage a global portfolio through operations in several countries.

B. Distortions resulting from country-to-country variations in internal laws

126. Distortions might arise when the residence countries of the parties to a derivatives transaction follow different rules in taxing the transaction. Assume *A*, a resident of country *X*, purchases a cap from Bank *B*, a resident of country *Y*; under the agreement, *A* pays 600u to *B* when the contract is made, and *B* agrees to make 12 quarterly payments to *A* equal to the product of 25,000u and any excess of the 90-day LIBOR on the date of payment over 9 per cent.[64] Under the laws of country *X*, all payments under a swap, including lump sum payments, are taxable income to the recipient and deductible expense to the payor when made. Under the laws of country *Y*, periodic payments are recognized as made and received, as under the laws of country *X*, but a lump sum payment is amortized over the

contract's term. Specifically, *B* recognizes the 600u as taxable income in three installments – 55u for the first year, 225u for the second year and 320u for the third year. Neither country imposes a withholding tax on any payment under the contract.

127. The lack of symmetry in the treatments of the lump sum payment in countries *X* and *Y* may not be a problem. Each party to the contract is taxed in the same way as it would have been taxed if that party had made the contract with a resident of its home country. The lack of symmetry thus may neither encourage nor discourage either party from dealing internationally, rather than locally.

128. However, it is possible that the tax rules may be reflected in the pricing of the contract. That is, in domestic transactions where the lump sum payment is made at the outset of the contract, the cap price may be higher in country *X* than in country *Y* to reflect the larger present value of the tax on the recipient of the lump sum payment; the opposite may be true when the lump sum is payable at the conclusion of the contract term. If so, the discrepancy between the tax rules in countries *X* and *Y* provides an incentive for a country *X* resident to purchase the cap from a country *Y* resident when the lump sum is up front and from a country *X* resident when it is payable in arrears.

129. It seems unlikely that tax rules (other than those imposing withholding taxes) are reflected in the pricing of derivatives. In the absence of withholding taxes, each party to the contract is taxed in its home country on a net basis, and the amount of tax thus depends on the amounts of associated expenses. When investment banks maintain balanced portfolios and bank customers use derivatives as hedges, net income or expense from derivative payments are probably a small percentage of the payments. In any event, that percentage varies from bank to bank and customer to customer. In the United States, many users of derivatives (e.g., pension funds) are tax exempt. The lack of a uniform relationship between the gross amounts of derivatives payments and the taxes on those payments makes it unlikely that tax consequences are passed from party to party in the pricing of derivatives.

130. A potentially more serious arbitrage opportunity arises if a hybrid instrument issued by a country *X* resident to a country *Y* holder is characterized by country *X* as debt and by country *Y* as equity. Returns on the instrument may be deductible by the issuer for country *X* purposes as they accrue, not subject to country *X* withholding taxes until paid and not taxed to the holder by country *Y* until paid. The results may be more favorable than those obtainable for instruments of country *X* issuers held by country *X* residents or instruments of country *Y* issuers held by country *Y* residents. If so, cross-border transactions may arise having little purpose other than to exploit the differing classifications of the instrument, potentially causing serious revenue losses for country *X*.

XI. Conclusion

131. Derivatives pose a basic dilemma for tax policy makers. Because derivatives are sophisticated financial instruments, unsophisticated tax rules can simultaneously facilitate the use of derivatives in tax avoidance strategies and hinder useful market activities in derivatives. On the other hand, greater sophistication in tax rules carries the price of greater complexity for both taxpayers and the tax administration. Tax rules that perfectly mirror the market are probably not practically possible. Governments must try to achieve a balance where the tax rules do not impose a crushing burden in the form of either unrealistic tax results or unrealistic compliance burdens.

132. In the international sphere, derivatives, discount bonds and other financial innovations put withholding taxes at risk. A country probably cannot impose withholding taxes on payments under any of the common types of derivatives without effectively excluding its residents from international derivatives markets. Discount income on domestic bonds held by non-residents can in theory be subject to withholding taxes as interest, but there probably is no practical means for collecting any material amounts of withholding tax on such income. Through the use of discount bonds and derivatives, non-resident investors can obtain virtually any desired financial result without incurring withholding taxes. Revenues from withholding taxes can therefore be expected to decline as investors become more knowledgeable about those financial instruments.

Notes

[1] The term "derivative financial instrument" has been defined as a risk-shifting financial contract whose payment terms are determined by or derive from the value of an underlying transaction, including forwards, futures, options, swaps, caps, floors, collars and other similar financial instruments. See Charles T. Plambeck, H. David Rosenbloom and Diane M. Ring, "General report", *Cahiers de Droit Fiscal International*, vol. LXXXb (1995) pp. 658 and 660.

[2] See John Neighbour, "Innovative financial instruments challenge the global tax system", *Tax Notes International*, 17 March 1997, pp. 931 and 934. Neighbour identifies four goals for an ideal system for taxing innovative financial instruments: neutrality (economically equivalent instruments should be taxed in the same way, whatever their legal form), equity, certainty and administrability.

[3] That is, if 6,139u were deposited in an account bearing interest at the rate of 10 per cent compounded semi-annually, the account would grow to 10,000u in five years.

[4] See Bankman and Klein, "Accurate taxation of long-term debt: taking into account the term structure of interest", *Tax Law Review*, vol. 44 (1989), p. 335; Sims, "Long-term debt, the term structure of interest and the case for accrual taxation", *Tax Law Review*, vol. 47 (1992), p. 313; and Strand, "The taxation of bonds: the tax-trading dimension", *Virginia Law Review*, vol. 81 (1995), p. 47.

[5] The sum of 92u and interest thereon at 10 per cent compounded semi-annually for four and one half years is 143u. Another way of expressing the comparison is that the deferral diminishes the present value of the tax on the holder from 92u to 59u (the present value at 10 per cent of 92u payable in four and a half years), thereby reducing the effective tax rate on the accrual from 30 per cent (92u/307u) to 19 per cent (59u/307u).

[6] An option is the right but not the obligation to buy (a call option) or sell (a put option) a specific quantity of an underlying, at a specific price (the strike price) on a specified future date (or over a specified period) (see Plambeck et al., op. cit., p. 663).

[7] More completely, the option holder's gain or loss on the sale, closing transaction or lapse of the option is capital gain if the underlying is or would have been a capital asset, and for non-corporate taxpayers, the preferential rate for long-term capital gains (currently 28 per cent) applies to a capital gain only if the option was held for more than one year (see United States Internal Revenue Code (IRC) §§1234(a) and 1234A). For the issuer of an option on stocks, bonds, commodities or commodities futures, gain or loss on a closing transaction or on the option's lapse is treated as short-term capital gain or loss unless the option was issued in the ordinary course of the issuer's business (see IRC §1234(b)).

[8] See OECD Committee on Fiscal Affairs, *Taxation of New Financial Instruments* (1994), pp. 20 and 21.

[9] Under one variation of this approach, the holder amortizes the option premium as a series of deductions over the instrument's life.

[10] That approach is used by the United States for an interest rate cap (essentially, a series of options on an interest rate) if the cap premium is significant.

[11] See United States Internal Revenue Code §§1256(a), 1256(b)(3) and 1256(g)(3).

[12] Occasionally, over-the-counter contracts are made "off market" – at prices different from the prevailing forward price for the underlying. When that is done, the party advantaged by the market deviation makes one or more compensating payments to the other party to the contract. In most countries, the tax rules for futures and forwards make no provision for those payments, and taxpayers often treat them in whatever way they find advantageous.

[13] An exchange-traded contract can be closed out by the contract holder purchasing an opposite contract (e.g., a contract to purchase if the original contract was a contract to sell) covering the same quantity at the same price and with the same delivery date. An over-the-counter contract can be closed out by negotiation with the counterparty.

[14] In several countries, an extension of the maturity date is treated as a taxable closing of the original contract and the making of a new one. Also, in several countries, if a forward contract is offset by an opposite position, the contract is deemed closed when the taxpayer acquires the offsetting position (see Plambeck et al., op. cit., p. 679).

[15] The mark-to-market approach is used for exchange traded contracts in Belgium, Switzerland and the United States (see Plambeck et al., op. cit., p. 679).

[16] See United States Treasury Department Income Tax Regulation §1.446-3(f).

[17] Taken from ibid., §1.446-3(f)(4) Ex. 7.

[18] Taken from ibid., §1.446-3(f)(4) Ex. 5.

[19] See ibid., §§1.446-3(g)(4) and 1.446-3(g)(5).

[20] France also has such rules; in other countries, straddle transactions are limited only by general rules on tax avoidance transactions (see Plambeck et al., op. cit., pp. 681 and 682).

[21] See United States Internal Revenue Code §1092(a)(1); for a more complete description of the straddle rules, see also Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, second edition (1990).

[22] See United States Internal Revenue Code §1092(d).

[23] See ibid., §1092(c)(2).

[24] The record-keeping burden is increased by rules requiring that a "successor position": to a closed-out loss position be taken into account in determining when the loss is deductible (see United States Treasury Regulation §1.1092-1T(a)). Assume the yen moves in the opposite direction after the first forward matures and is replaced by the second forward, with the result that the unrealized currency gain in the yen position represented by the bond disappears. However, the value of the second forward simultaneously rises, and *B*'s loss on the first contract continues to be non-deductible for the following year to the extent of unrealized currency gain in the second forward.

[25] See United States Internal Revenue Code §263(g).

[26] Taken from United States Government document S. Rep. No. 144, 97th Cong., 1st Sess., reprinted in 1981-1 CB 412, 473.

[27] However, currency gains and losses are ordinary income or loss, except when they accrue on a forward contract, futures contract, or option that the taxpayer holds for investment and elects to treat as a capital asset and that is not part of a straddle (see United States Internal Revenue Code IRC §988(a)(1)).

[28] In the analysis that follows, transaction costs, credit risks and several other factors are ignored, and various other factors are greatly simplified; the relationships described thus tend to be somewhat more complex than the discussion indicates.

[29] See United States Government document H.R. Rep. No. 111, 103d Cong., 1st Sess. 636-37 (1993).

[30] See United States Internal Revenue Code §1258(a).

[31] See ibid., §1258(c).

[32] See ibid., §1258(b).

[33] The market sets forward rates in currencies so that an amount invested at the prevailing interest rate will accumulate to the same value at the forward date, regardless of the currency in which it is invested. If spot and forward rates diverge from that equivalence, arbitrage transactions quickly bring the market back to that balance. In the example, the forward rate must be such that a dollar investment ($1,000 plus $80) will have the same value as a yen investment (100,000 yen plus 2,000 yen). That condition is satisfied by a one-year forward rate of $1 equals 94.44 yen (102,000/1,080 = 94.44).

[34] See United States Internal Revenue Code IRC §988(a)(1).

[35] The Clinton Administration has made proposals to curb some such devices, but the United States Congress has shown little inclination to enact the proposals into law.

[36] See *Corn Products Ref. Co. v. Commissioner of Internal Revenue*, United States Government document 350 US 46 (U.S. Sup. Ct. 1955).

[37] See Plambeck et al., op. cit., p. 675.

[38] Several other countries have adopted hedging rules that resemble the United States rules in broad outlines and in many details (see Plambeck et al., op. cit., pp. 675-676; for a fuller description of the United States hedging rules, see also Bittker and Lokken, op. cit., 1997 supplement).

[39] See United States Treasury Regulation §1.1221-2(b).

[40] See ibid., 8555, 1994-2 CB 180, 182.

[41] See ibid., §1.1221-2(c)(1).

[42] See Treasury Regulation §1.1221-2(e)(1).

[43] See ibid., §1.1221-2(e)(2).

[44] The United States Internal Revenue Service may, at its discretion, impose hedge accounting for transactions not identified by the taxpayer, but that discretion is probably exercised only in extraordinary circumstances.

[45] See United States Treasury Regulation §1.1221-2(f)(1).

[46] See ibid., §1.446-4(a).

[47] See ibid., §1.446-4(e)(1).

[48] See ibid., §1.446-4(e)(3).

[49] See United States Internal Revenue Code §1256(a); a preferential rate of 28 per cent is provided for net long-term capital gain of non-corporate taxpayers.

[50] See ibid., §1256(e).

[51] See OECD Committee on Fiscal Affairs, op. cit., p. 58.

[52] The United Nations, OECD, and United States model treaties all define interest as income from debt-claims of every kind, including premiums or prizes attaching to such securities, bonds or debentures; however, none of the models refers specifically to discount income. Some treaties include other language that might encompass discount income. For example, under the Germany-United States treaty, the term "interest" includes all other income that is treated as income from money lent by the taxation law of the contracting State in which the income arises.

[53] Among OECD countries, the United States is apparently the only one that does this (see United States Internal Revenue Code §§871(a)(l)(C)(ii), 881(a)(3)(B)); however, discount income, like explicit interest, is exempt from United States withholding taxes if the bond is held as a portfolio investment (see ibid., §871(h)).

[54] Among the five OECD countries that impose withholding taxes on discount income, all require withholding when a discount bond is redeemed from a non-resident holder.

[55] See Plambeck et al., op. cit., pp. 684-686.

[56] See OECD Committee on Fiscal Affairs, op. cit., p. 53.

[57] See ibid., p. 48.

[58] See ibid., p. 53.

[59] See United States Treasury Regulation §1.863-7(b)(l).

[60] See Plambeck et al., op. cit., p. 686.

[61] A similar issue arises in securities lending transactions. Assume *A*, a country *X* resident, purchases stock of the country *Y* corporation and lends it to a country *Y* resident under an agreement requiring the latter to make substitute payments to *A* to compensate for dividends on the stock during the period of the loan. The securities loan thus does not alter *A*'s economic position as a shareholder of the *Y* corporation, but if country *Y* does not tax the substitute payments as dividends, the withholding tax is avoided. Few countries, if any have clearly established the tax treatment of those payments. A memorandum of understanding accompanying a 1992 income tax treaty between the United States and the Netherlands provides that dividend equivalent payments by a borrower of securities to a securities lender are, for withholding tax purposes, treated as dividends paid by the company to the lender (see Reuven S. Avi-Yonah and Linda Z. Swartz, "United States international tax treatment of financial derivatives", *Tax Notes International*, No. 787.

[62] Taken from OECD Committee on Fiscal Affairs, op. cit., pp. 105 and 106.

[63] In the United Nations Model Double Taxation Convention Between Developed and Developing Countries, the capital gains exemption is in article 13 (3) and the other income exemption is article 21 (1). A 1995 addition to the commentary on article 11 of the OECD Model Income Tax Convention (para. 21.1) provides that, for treaty purposes, the term interest does not include payments made under certain kinds of non-traditional financial instruments where there is no underlying debt (for example, interest rate swaps). However, the term may include imputed interest on loans embedded in such instruments, as determined under a substance over form rule, and abuse of rights principle or any similar doctrine. The OECD commentary also suggests an addition to the other income article that would, in the case of transactions among related persons, restrict that article's application to the consideration that would have changed hands if the transaction were at arm's length (see art. 12, commentaries 7-12). The addition is suggested as a means of addressing difficulties in dealing with income arising from certain non-traditional financial instruments, but it is not, by its terms, limited to that context.

[64] Taken from United States Treasury Regulation §1.44b-3(f)(4)Ex.1.

The globalization of capital markets*

Contents

* Prepared by the United Nations Secretariat.

I. Introduction

1. Capital markets are in the process of rapid evolution. Capital flows – which were formerly directed towards banks and controlled by Governments – are now held by individuals, institutions or private mutual funds, and can circulate freely and instantaneously to projects that will yield the maximum profit. Electronic computerized data transmission now gives capital flows an unprecedented mobility on all the financial markets on the planet. Moreover, the volume of such flows has grown – tripling or increasing tenfold in the past few years – mainly as a result of the success of mutual funds whose assets often exceed those of many Governments.

2. We will examine, in turn, the current evolution of capital markets and the attempts made by Governments and international organizations to regulate them, as well as the political and economic consequences of the globalization of capital movements. Lastly, we will consider future prospects in an attempt to find an answer to a fundamental question: will the globalization of capital flows be mobilized to promote economic growth, social progress and development?

II. Current evolution of capital markets

A. Previous situation

3. In the past, rivalries between nations were resolved by means of armed conflicts in which empires or ideologies clashed. Today, the wars being waged seem increasingly to be removed from the principal events taking place on the economic and financial front.

4. During the cold war, the super-Powers provided assistance in the form of official financial flows or subsidies to centralized economic systems and developing countries whose survival they ensured. Today, those flows and subsidies have been considerably reduced or have even disappeared in some cases, giving way to the laws of the market place, which govern growth, development, employment or decline.

B. Current situation

5. Today, the main problem facing Governments is how to attract new investment with a view to creating jobs and promoting sustained economic growth. Governments compete for capital. To that end, nations vie with each other through variations in their interest rates or their rates of exchange, and through the competitiveness of their markets. The world has become capitalist, and ever-increasing financial movements can reward savings and productivity and thus strengthen a country's economy. Conversely, foreign capital can also abandon an economy or withdraw abruptly if an unfavourable fiscal policy drives it away. Speculators may attack a weak currency to weaken it still further. Capital movements may penalize unproductive expenditure and thus help to destroy a country's economy. Governments and heads of enterprises, therefore, strive to attract that capital by offering it favourable conditions and strive to utilize it more productively than their rivals.

6. With the end of the cold war, official subsidies and other financial flows dried up in such countries as the Democratic People's Republic of Korea, Myanmar and Cuba, while investors preferred to steer their capital to countries or areas where the climate was more favourable to them, such as the Republic of Korea and Taiwan Province of China. Capital has thus become more mobile and more difficult to stabilize and control.

C. Demand for capital

7. During the 1990s, more than 50 developing countries have created capital markets, and some 3 billion people have freed themselves from Marxist or government controlled economies. Those countries need capital to get their new market economies to take off. In Asia and Latin America, economies are in a state of full expansion; they must establish infrastructures and find capital to sustain their economic growth. After a period of recession, the United States of America, Europe and Japan also need capital to finance their expansion, create jobs, make good their budget deficits and privatize their State enterprises.

8. In the face of the increased demand for capital, competition has become increasingly fierce. In order to attract those financial flows and pay a return on them without overburdening the costs of production, some countries have had to resort to lowering wages or extending working hours. Moreover, the increasing budget deficits of the United States, Europe and Japan have triggered an additional demand for capital. The financing of those deficits has reduced the amount available to sustain economies at the very time when they are emerging from the recession of the late 1980s. The indices already show the importance of those demands for capital: interest rates in Europe are rising, while inflation is declining. Loans are becoming increasingly expensive, and risk breaking the recent cycle of recovery.

9. The countries with economies in transition are also seeking capital. The dearth of capital has already led to the demise of the former USSR, which was unable to create sufficient capital or utilize it effectively. China and India have appealed to the capital markets in order to avoid a recession.

10. In South Africa, reforms became essential when the international embargo, including the embargo on capital, led to the country's paralysis. Lastly, Argentina, abandoning its government-controlled policy, has opened its frontiers to capital imports, and has privatized its national companies (railways, highways, ports and so on), thus bringing about the economic expansion of the country, following the investment of $10 billion raised on the international capital market.

11. All the above-mentioned countries are engaged in rapidly establishing a complete capital market infrastructure. The first countries to achieve such an infrastructure will have the benefit of direct and preferential access to international investors. Many countries are planning to establish derivative markets, including futures markets and options, which will allow improved coverage of risks related to stocks and shares, bonds and exchange rates. Thailand, for example, will shortly establish a currency and interest-rate futures market.

D. Supply of capital

12. Private capital is offered on the world investment market for the purchase of bonds and shares in companies, and is outside government control. Where does it come from? Who owns or manages it? The capital comes mainly from mutual funds, pension funds or insurance funds, and thanks to a worldwide network of computerized communications, it circulates freely in search of the maximum profit. In some cases, the managers come from Wall Street and have become international celebrities. In others, they are less well known managers of such institutions as the New York State Teachers' Pension Fund or the Robeco group in the Netherlands. More often, they are the managers of investment funds, such as the Pacific Investment Management Company in California, which controls assets amounting to over $55 billion.

13. The assets of institutional investors amount to approximately $8,000 billion in the United States and $6,000 billion in Europe. To date, those funds have invested less than 1 per cent in emerging markets. All projections indicate that investment in those markets will increase to 5 to 10 per cent of total assets in the next 10 years. Investors are now convinced that the emerging markets offer higher returns than those of the industrialized countries, and that the risk can be controlled by a policy of diversification. There is, therefore, a unique opportunity, during which countries seeking capital will have access to the resources of the industrialized countries.

14. On the other hand, it will be noted that some traditional capital-exporting countries have become debtors. For instance, Saudi Arabia's petrodollars have dried up. Germany, which in 1989 exported capital amounting to $80 billion, has been importing it in the amount of $20 billion a year since its reunification with the German Democratic Republic.

E. Volume of capital movements

15. According to estimates, the volume of mobile international capital now amounts to $3,000 billion. That volume has tripled in three years. It currently represents three quarters of the total national budgets of the seven major industrial countries in the world (G-7). Moreover, capital flows to the emerging countries exceeded $200 billion in 1994, whereas they amounted to only $80 billion in 1989; private capital accounts for the whole of that increase.

16. Although bank loans are regulated and require guarantees from Governments, the International Monetary Fund or the World Bank, private capital circulates and can be invested almost freely.

17. The composition of capital has also evolved in recent years. Capital is composed of direct investments, in which the purchaser retains control of the investment, loans – either bank loans or secured loans – and stocks and shares. Capital movements on the stock market have increased very rapidly, and now amount to approximately $50 billion a year.

18. The free circulation of capital outside government control has led to the transfer of the concept of power, traditionally invested in Governments, to private holders of capital. That development explains the inability of central banks to curb the speculations that have recently attacked the value of the yen, the dollar and the European currencies. Governments have thus seen their ability to control their budgets and their capital reduced. Their fiscal resources appear to be reduced in relation to private capital, and no longer allow them to make the necessary investments. The same applies to the international financial institutions, the World Bank and the International Monetary Fund, which are financed by Governments.

19. In contrast, multinational financiers, managers of private funds and directors of companies or banks tend to become increasingly powerful. Governments urge them to steer their clients' investments towards their countries: the emergence of private capital as a leading actor on the international scene marks a great turning point in the evolution of world financial management. After the Second World War, it was generally believed that Governments were responsible for the allocation of resources. Today, the markets have taken over that role, thus confirming the decline in state control or "New Deal" trends.

20. Moreover, until the early 1980s, Governments endeavoured to regulate the international monetary system and capital movements for fear of losing their natural capital and control over domestic economic policy.

21. Attempts at authoritarian regulation, however, have failed, as is evidenced by the collapse of the economies of totalitarian regimes and the difficulties encountered by welfare States since the late 1980s. In different ways, they are the root cause of the disasters experienced by the former USSR and the budgetary collapse of the West.

22. Countries that have attempted to impose severe restrictions on capital movements have generally had to recognize the fluidity of the financial markets, which have moved towards more welcoming political centres, thus creating an offshore industry that still exists. Governments have been compelled to reduce the barriers to capital movements, in particular to reduce the amount of tax deducted at source on foreign investments.

23. The liberalization of trade has been accompanied by a liberalization of capital exchanges. According to some financial circles, world capital markets have become, as it were, "the international monetary fund of the 1990s".

24. From the standpoint of Governments responsible for controlling emerging markets, the question of the taxation of capital flows is extremely important. Such taxes can be useful if they are used to build a market infrastructure. Too high a rate of taxation, however, would drive investors away. The key is to find a proper balance that takes account of the experience of other countries. Brazil, for example, has just imposed a tax of 1 per cent on foreign investments, which has apparently not reduced the flow of capital.

III. Consequences of the globalization of capital markets

A. Beneficial economic consequences

25. The globalization of capital has beneficial characteristics in many respects. In order to attract the capital necessary for their development, national economies must become or remain open to foreign investment, and must adopt responsible fiscal and monetary policies.

26. A fully developed financial market also makes it possible to steer investments towards the most useful projects, and thus to acquire the indicators essential to a market economy. That development will be achieved more rapidly if foreign investors have access to the domestic market: since Brazil opened the BOVESPA stock exchange to foreign investors, the volume of transactions has increased tenfold. Besides contributing capital, world capital also permits the transfer of essential technology which makes it possible to develop a financial market architecture.

27. The majority of Governments have made economic stability one of their highest priorities. Thus, the lowering of customs barriers has introduced competition into previously protected markets. If Governments impose excessive regulations or too high a rate of taxation, if public expenditure is too high in relation to revenue, and if the central banks destroy too many liquid assets, foreign capital will not be attracted or it will be withdrawn if it is already there. International mutual funds have become a strategic weapon in the arsenal of democracies.

B. Adverse consequences

28. However, the play of market forces may also have adverse consequences. The decision makers and controllers of capital, indeed, turn away from States that are experiencing serious budget deficits or whose budgets are burdened by considerable social expenditure. Deficits and the absence of economic and financial reforms may dissuade capital from investing in the countries in question. The gap between rich and poor may, therefore, widen in the face of the exigencies of this social Darwinism and the rigid rules of capitalist disciplines.

29. The threats confronting the welfare States do not, however, come only from abroad. Sweden, for example, owing to its generous social expenditure, currently has such a large deficit that some of its major industrial enterprises are considering moving their business abroad. The same

applies to the United States, where the return to economic growth has given rise to fears of too rapid expansion and renewed inflation. The bond market has reacted, interest rates have risen and the currency has depreciated. In Mexico, following the assassination of the presidential candidate, capital has fled for fear of an unfavourable political climate. In China and Viet Nam, on the other hand, capital has flooded in too rapidly, bringing in its train a rise in inflation and the overvaluation of the currency.

30. Lastly, it is believed that if Governments reduce taxes on capital movements, create offshore markets and establish a stable and convertible currency, private capital will flow in.

C. Domestic savings

31. Domestic savings are clearly the alternative solution to the call for foreign capital. Savings have, however, decreased in recent years since prosperity has placed more consumer goods on the market. Traditionally, it was national savings that supplied the economy with investments that ensured growth and employment.

32. Today, however, Governments have difficulty in keeping those reduced savings within the country. For example, the United States is the largest exporter of capital in the world, despite a considerable budget deficit that the use of domestic savings would help to clear or reduce; the United States deficit, however, is financed mainly by foreign capital. In Chile, Australia and Mexico, Governments have established mandatory savings plans. Since the restructuring of the pension system, the State has encouraged the development of private pensions, which have increased the rate of savings and are invested mainly in the stock market.

IV. Conclusions

33. The globalization of capital markets and the growth of trade will help to create new surpluses that could meet the world demand for capital. However, those financial resources, in search of an attractive rate of remuneration, will be invested in countries that achieve a fundamental balance in their public finances and that introduce economic and financial measures for reducing budget deficits and current payments, rationalizing and privatizing public enterprises, developing private savings and the capital market, and liberalizing trade.

34. During the past decade, a growing number of developing countries, emerging countries and economies in transition have introduced the reforms necessary for the restoration of financial equilibrium. However, the need to attract external financial flows that could contribute to the creation of jobs and the growth of their economy required, in particular in the context of the globalization of capital markets, a greater effort in favour of national capital markets. The development of such markets, combined with national capacity-building and the establishment of institutions connected to the international financial centres, would help to enhance the effectiveness of financial mediation in the allocation of resources, channel external flows, and increase and diversify the volume of medium and long-term financial resources necessary for the economic development of those countries. Lastly, those flows, both internal and external, cannot fail to constitute a source for the mobilization of additional financial resources through appropriate taxation.

The taxation of international income in developing countries*

Contents

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Introduction

1. The issue of greatest concern in international tax today – and indeed for the past 15 years or so – is transfer pricing. Because of the large amounts of tax revenue at stake, difficulties in complying with the pertinent tax rules, the potential for abuse and the risk of double taxation of income, it is an important issue for tax administrators and multinational business enterprises alike. Although several other issues that affect the taxation of international income by developing countries today will be discussed, much of the present commentary will centre on transfer pricing due to its current importance in the international tax area.

2. Inter-company transfer prices are prices charged among members of a multinational group of affiliated companies for goods, services, property and loans transferred on an inter-company basis from one country of operation to another. The prices charged for goods, services and loans by one group member to another affect how much tax will be received by each country in which the group operates. If the prices charged for transactions between group members operating in different countries are set too high or too low, then income is effectively shifted from one country to another. Not surprisingly, tax authorities around the world want to ensure that income is not understated because a distributor overpays its foreign manufacturing affiliate or a manufacturer undercharges its foreign distributor.

3. If a United States parent company charges its foreign subsidiary $1,000 for goods to be resold in the foreign country, the foreign subsidiary's profit in the foreign country, absent a transfer pricing adjustment, will be the subsidiary's resale price over its $1,000 cost. If the United States Internal Revenue Service (IRS) determines that the appropriate transfer price is $1,200, the United States parent will have an additional $200 of income in the United States. Does that mean that the foreign subsidiary then adjusts its cost to $1,200 and reports $200 less income in the foreign country? Not necessarily. It depends on whether the foreign country has rules similar to the IRS for determining appropriate transfer prices. It then further depends on whether the foreign country's tax authorities agree with the IRS as a factual matter on how much income the parent earned based on all the relevant data.

4. If the foreign country's tax authority agrees that the appropriate transfer price is $1,200, then tax revenues are moved from the foreign country to the United States. In many cases, however, the multinational in that example would be indifferent whether the transfer price is $1,200 or, for example, $800. If it pays more taxes in the foreign country because the transfer price on goods sold to its foreign subsidiary is lower, the taxes in its home country will be correspondingly lower, and therefore its overall tax liability may be substantially the same. The main reason is that tax rates in many major trading countries are similar and have tended to converge in the past 12 years. From a tax point of view, the multinational is often merely a stakeholder between the tax authorities of the two countries. Obviously, however, in which country the tax is paid matters very much.

5. The situation for the multinational is quite different if one country has a lower effective tax rate than the other country. In that case, the multinational might have an incentive to shift income from the high-tax jurisdiction to the low-tax jurisdiction, particularly if the high-tax jurisdiction is unlikely to examine the multinational's transfer prices.

6. The situation for the multinational is also quite different if the multinational is being challenged in both countries on its transfer prices and the multinational is unable to persuade the tax authorities to adopt the same price. If the IRS says that the appropriate price is $1,200 but the foreign country tax authority says the appropriate price is only $800, the multinational group will pay tax twice on the same $400 of income. Whether the rates are the same is beside the point. Double taxation may be avoided if the IRS and the other country are able to resolve their dispute through the competent authority provisions of the applicable tax treaty.

I. How industrial countries have addressed transfer pricing issues

7. There have always been significant administrative difficulties in making sure that taxpayers set appropriate transfer prices for tax purposes in international transactions with related parties. As international commerce grows, that becomes a more and more important question. With the encouragement of the United States of America, the world community has largely adopted the so-called arm's length standard, which sets transfer prices based on prices charged in transactions between unrelated parties. That standard has been widely accepted as the theoretically correct pricing rule. The problem is that it is usually difficult to find a transaction from which to derive an arm's length price. As a result, the United States and other countries have tried to find alternative rules, involving functional analysis, comparative rates of return and profit splitting. Those approaches, while theoretically flawed, may be practical supplements to the arm's length standard.

A. The arm's length standard

1. Arguments in favour of the arm's length standard

(a) International norm

8. The arm's length standard has been adopted by nearly every country as the guiding principle for determining transfer prices between members of a group. Its use has been recommended by both the United Nations and the Organization for Economic Cooperation and Development (OECD).

9. In the United States, the Revenue Act of 1921 contained the first articulation of the arm's length standard in the income tax area. The 1935 regulations interpreting a predecessor to section 482 provided that the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. They did not, however, require the use of any particular method. The courts applied a number of different standards for determining when transactions were conducted at arm's length, such as whether the related party received a "fair and reasonable price" or a "fair price including a reasonable profit".

10. By the early 1960s, the international and business climate had changed considerably. Congress became increasingly concerned that United States companies were shifting income to their foreign subsidiaries. The United States House of Representatives proposed legislation that required the United States taxpayer to demonstrate that its transfer prices with its foreign affiliates were supported by comparable prices with unrelated third parties; if not, the group's income was to be apportioned between the related members under a formula based on their relative economic activities. The United States Senate rejected the proposal, concluding that it was better to address improper multinational allocations through guidelines and regulations.

11. The IRS issued regulations under section 482 in 1968 that governed transfer pricing practices for United States taxpayers until July 1994, when a new set of section 482 regulations was issued. The 1968 regulations reaffirmed the arm's length standard, and provided the first detailed articulation of the arm's length approach by establishing rules for specific kinds of inter-company transactions, including the performance of services, the licensing or sale of intangible property and the sale of tangible property. The United States approach influenced other countries to adopt the same arm's length approach. Under most of its bilateral tax treaties, the United States is obligated to apply the arm's length standard to transactions by persons subject to its tax jurisdiction.

(b) Less arbitrary than formulary approach

12. The arm's length standard uses real transactions that occur in the market place as the standard for allocating income between countries. That market-based approach is believed by its supporters to be more acceptable to taxpayers and tax administrators than arbitrary formulas that depend on relative assets and employees, for example, without regard to how the market place really operates.

(c) Double taxation risk is lower

13. Because the arm's length standard is so widespread, its consistent use throughout the world minimizes the problem of double taxation. Any industrialized country that were to depart from its use without coordinating the departure with other countries would increase the double taxation risk. The use of different methods places more pressure on competent authorities under the international treaty system to work out the differences, and the competent authority process is known for taking a long time to resolve cases.

2. Problems with the arm's length standard

(a) Complexity

14. Determining an appropriate transfer price can be very complex, particularly because the taxpayer rarely has available information on comparable third party prices. In many cases, comparable third party prices simply do not exist. The work necessary to compile data and properly analyse the related and unrelated transactions can be extremely burdensome and costly.

(b) Uncertainty

15. The determination of an appropriate transfer price is often very subjective. Taxpayers complain that the tax authorities use the benefit of hindsight to adjust prices, providing much uncertainty in the business environment. If a multinational taxpayer has a significant amount of inter-company cross-border transactions, even small changes in transfer prices can result in huge increases in tax liability.

16. Uncertainty also provides room for abuse by taxpayers. Transfers within multinational corporations often involve enigmatic subjects, such as intangible property and non-standardized products. In such cases, there are usually no comparable transactions involving third parties to judge the reasonableness of the multinational's transfer price.

(c) Failure to reflect economic reality

17. Many economists believe that the arm's length standard does not reflect economic reality because related group members do not behave the same way as unrelated parties. When companies are integrated into a multinational corporation, there are usually greater cost savings and efficiencies than if the companies were unrelated, and the arm's length standard's focus on unrelated parties fails to take those economies of scale into account.

18. Moreover, contrary to what the IRS and other tax authorities may believe, transfer prices are often set with little regard for tax consequences. In the real world, corporate executives frequently set prices based on such non-income tax considerations as costs, competition, supply and demand, import duties, anti-dumping rules and local regulatory requirements. In addition, there are often internal political considerations within the organization, such as the relative power of executives in charge of the manufacturing and distribution functions within the group, and the need for management to justify the success of its strategic decisions regarding the location of a plant or the selection of a market. Imposing the arm's length standard may interfere with the way that business would otherwise operate.

B. United States experience in enforcing the arm's length standard

1. United States Internal Revenue Service attempts to move away from the arm's length standard

19. The 1968 regulations stood the test of time quite well but by the 1980s were showing signs of strain caused by several factors. In the 1986 tax legislation, United States Congress made one significant but narrow change to the basic transfer pricing law by requiring income of the transferor from sales, licenses and transfers of intangible assets to be commensurate with income generated by the related transferee. Congress also directed the IRS to study whether legislative or regulatory change to the scheme of the existing transfer pricing regulations was needed. It was recognized that change was needed because the 1968 regulations reflected the United States' status as a major capital exporter.

20. In response to the Congress directive, the IRS issued its 1988 White Paper on transfer pricing. The White Paper was received with hostility from some commentators because they believed it represented a retreat from the arm's length standard. Instead, in their view, the Treasury Department proposed applying arm's length rates of return in circumstances where inadequate comparable pricing data was available.

21. After much reflection, in January 1992 the IRS proposed new transfer pricing regulations to provide more detailed guidance on transfers of tangible property and to implement the 1986 legislation that requires royalties on intangible property to be commensurate with the income derived by the transferee from such property. Those regulations also added a requirement that the taxpayer's transfer prices be justified by comparing the taxpayer's profits to the profits of its competitors. That requirement evoked significant protest from multinational business and foreign Governments. Businesses claimed that sufficient information about their competitors was not available. Foreign Governments claimed that the "comparable profits" requirement undermined the arm's length standard's focus on comparable transactions rather than comparable profits.

22. After taking into consideration comments received from the 1992 regulations and temporary and proposed regulations issued in 1993, the IRS issued final transfer pricing regulations in July 1994. Those regulations reaffirm the use of the arm's length standard, and require the taxpayer to determine arm's length pricing using the best method available, i.e., the method that yields the most reliable measure of arm's length results. The comparable profits test is no longer required as a confirming methodology but may be used as a method for determining transfer prices if there are no closely comparable transactions for which reliable information is available. Those regulations represent an extraordinary good faith effort by the United States to make the arm's length standard work in a complex world, in 40,000 words to be exact.

23. The issue still with us, however, is how much importance should be placed on comparable profits of competitors. Several non-United States tax authorities have asserted that any method keyed to comparable profits is impossible to reconcile with the arm's length standard. But if comparable transactions simply do not exist or are too difficult to find, then some form of comparable profits approach or perhaps even a formulary apportionment approach may be the only way to determine an appropriate allocation of international income.

2. Possible United States legislation

24. The United States Congress has introduced several bills in recent years that would require a minimum amount of taxable income to be reported by certain foreign-owned

United States corporations or United States branches of foreign corporations that engage in more than a threshold level of transactions with foreign-related parties. Under such a proposal, the taxpayer's taxable income from any category of business would be no less than 75 per cent of the amount determined by applying an applicable profit percentage to the taxpayer's gross receipts from that business category.

25. Despite the defeat of the Democrats in the 1994 elections in the United States, Senator Dorgan, a Democrat who has been a strong advocate of formulary apportionment, has continued to push for adoption of that method. That formulary apportionment is similar to the manner in which income among states is allocated and apportioned, as if the multinational were a unitary worldwide business. Most states use a three-factor apportionment formula of sales, property and payroll, with each factor equally weighted. A "unitary" formulary apportionment formula used by a few states (e.g., California) combines the income of the entire affiliated group and then applies the three-factor formula to that larger income base. Although Senator Dorgan has found some sympathetic ears among the Republican majority, the prevailing view among legislators is to maintain the arm's length standard. However, although Republicans are opposed to new taxes they are least likely to resist more efficient taxation of foreign multinationals as a means of keeping with the principles of the Contract with America. Renewed interest in formulary apportionment is therefore likely.

26. The IRS will continue to object to formulary apportionment, citing the need for the harmonization of international standards, the uncertainties created by the differences in accounting methods and record keeping, the administrative burdens imposed by formulary apportionment on United States and foreign multinationals alike, the potential for double taxation of income, and the intense international resistance to moving away from the arm's length standard. In that respect, the United States Treasury Department last year sponsored a formulary apportionment conference, at which Deputy Secretary Lawrence Summers reaffirmed the United States Government's full, unqualified support of the international consensus for the arm's length standard. He emphasized that a move to a formulary approach would require the international community to agree upon a definition of total income and a formula to apportion that income, problems similar to those now being addressed under the rubric of the arm's length standard.

27. It is likely that Congress will grant the IRS the time to allow the final regulations and the rapidly developing advance pricing agreement procedure – in which multinationals and tax authorities negotiate unilateral, bilateral or multilateral agreements with respect to transfer prices – to be implemented and evaluated without further substantial change. Also, pleas will continue to be made about the need for United States competitiveness as an argument against formulary apportionment for United States multinationals, and the need not to discourage needed foreign investment of capital as an argument against formulary apportionment for foreign multinationals.

3. United States problems in enforcing arm's length standard

(a) United States Internal Revenue Service problems in litigating section 482 cases

28. The 1986 tax legislation permitted the IRS to shift its attention away from tax shelters, which had comprised as many as 50,000 of the 82,000 cases docketed in the Tax Court. In the mid-1980s, the IRS began to step up its international audit focus by forming litigation teams of economists, engineers, accountants and attorneys; devoting more resources to section 482 cases through the Coordinated Examination Program; and identifying key international tax issues for litigation. At the end of 1994, there were 105 section 482 cases pending in the Tax Court and the United States Court of Federal Claims, with at least $3.7 billion of section 482 deficiencies at issue (a total of $33 billion in deficiencies was pending in federal courts). Audits of foreign corporations increased more than 350 per cent from 1990 to 1993. Despite the IRS emphasis on auditing and litigating section 482 cases, its victories in the area have been few and far between. Some of the reasons for that lack of success are set out below.

(b) Inability to access foreign-based documents

29. Before it was equipped with some of the weapons discussed below, the IRS experienced difficulty in gaining access to information used by related parties in making pricing decisions, particularly where foreign-based documents were in the custody of foreign parents of United States subsidiaries. Summons were often unenforceable because courts lacked jurisdiction over the foreign parent. In other cases, foreign-based documents did not exist due to lax record-keeping standards in foreign jurisdictions. Information exchange provisions in treaties have been ineffective in providing the IRS with the requested information because of exceptions for measures that would violate the other country's laws or require the disclosure of trade secrets, as well as long delays in negotiating with the foreign Government concerned over what information is accessible.

(c) Inability to impose regular tax penalties

30. The IRS had authority to impose the general 20 per cent accuracy-related penalty in transfer pricing cases before the 1990 legislation discussed below, and periodically did so. However, the authors have been unable to find any cases in which the taxpayer actually paid that penalty. In 1990, former IRS Commissioner Fred Goldberg explained in Congressional hearings that a 20 per cent penalty based on negligence or a substantial understatement is a possibility only in a flagrant case because there are usually reasonable points of view on both sides. There are cases where IRS pricing turns out to be as wrong as the taxpayer's pricing. If the IRS says it is $10 and the taxpayer says $20 and the court comes in at $15, both are half wrong. Application of the 20 per cent penalty based on grounds other than negligence, such as a substantial understatement of tax, is also difficult.

(d) Limited reach of general record-keeping requirements

31. United States tax law requires all persons liable for United States tax to keep records sufficient to establish their correct federal income tax liability, for inspection by the IRS. There is little guidance on the scope of that requirement. Courts have held that the IRS may not use that requirement to compel a taxpayer to create new records during the audit process if its existing records otherwise meet the minimum record-keeping requirements. Moreover, that requirement does not apply to foreign parents that are not themselves liable for United States tax.

(e) First legislative reaction: section 982 (1982)

32. Section 982 of the Internal Revenue Code provides that the IRS may issue a "formal document request" for foreign-based documentation after an "informal" document request has been issued and rejected. If the taxpayer does not "substantially comply" with the formal request, the taxpayer will be precluded from later introducing in court any foreign-based documentation covered by the request. The exclusionary rule does not apply if the taxpayer shows "reasonable cause" (e.g., difficulty of producing documents). The potential violation of foreign law is not an excuse. Section 982 precludes only the introduction of documents, not testimony.

(f) 1989 expansion of section 6038A and 1991 final regulations

33. Based on concerns that foreign multinationals were not paying their fair share of United States tax by artificially reducing the United States tax liability of their United States subsidiaries, the United States Congress completely reworked section 6038A (enacted in 1982). That reworked version has eliminated many difficulties the IRS had experienced in obtaining foreign-based documents in the custody of foreign multinationals.

34. First, because of expanded reporting requirements many new foreign parties and transactions are now brought under IRS scrutiny. Second, United States taxpayers must maintain records that are sufficient to establish the correctness of their United States tax returns with respect to transactions with foreign-related parties. Third, every foreign-related party is required to designate the reporting corporation in the United States as its agent for service of process in the United States. Fourth, a $10,000 civil penalty may be imposed on reporting corporations for non-compliance with the annual information reporting and record-keeping requirements, with an additional penalty of $10,000 for each 30-day period of continuing non-compliance after the taxpayer has been notified by the IRS.

35. Fifth and most important, the IRS has been granted sweeping new powers by Congress to impose the "non-compliance penalty" if (a) a foreign-related party fails to designate the reporting corporation in the United States as its agent for service of process, or (b) a reporting corporation refuses to comply with a summons issued to such corporation directly or as agent for the foreign party, even if there is reasonable cause for such failure. When the non-compliance penalty applies, the IRS has the sole discretion to determine transfer prices between the reporting corporation and the foreign-related party with respect to the transaction for which documents or testimony are requested. The IRS may apply the non-compliance penalty to any year not closed by the statute of limitations.

36. Those strong United States enforcement measures are not without their critics, however. Some commentators have noted that the existence of penalty documentation provisions, combined with aggressive transfer pricing audit procedures, may prompt multinationals to overpay taxes in a country to avoid penalties and minimize controversy costs. Thus, such penalties and audits may pose a threat to the tax bases of the other countries in which such multinationals operate, particularly countries in which enforcement is lax.

(g) President Clinton's plan to target foreign multinationals

37. During his 1992 presidential campaign, former Arkansas Governor Clinton pledged to collect $45 billion in tax revenues by cracking down on foreign companies that

prosper in the United States and manipulate tax laws to their advantage. Once in office, President Clinton pledged to increase transfer pricing enforcement and to require multinationals – both United States and foreign – to support their transfer pricing calculations with more thorough and contemporaneous documentation. The revenue estimate, however, was reduced to $3.8 billion (from $45 billion) over five years. Clinton's proposal was enacted by the United States Congress in 1993. Clinton's 1994 budget also proposed additional funding to double the audit rates on foreign multinationals' United States subsidiaries.

38. More recently, the Clinton administration has emphasized the continuing global consensus for the arm's length pricing principle and the development and successes of the advanced pricing agreement programme, which appears to be well received by taxpayers and tax administrators alike.

(h) 1993 transfer pricing penalties

39. In 1993, the United States Congress enacted new penalties equal to 20 per cent, or as high as 40 per cent for more aggressive cases, of the tax underpayment attributable to a transfer pricing adjustment. To avoid those penalties, a taxpayer must maintain sufficient documentation to establish that given the available data and the applicable section 482 pricing methods, the chosen method for determining transfer prices provides the most reliable measure of an arm's length result. The documentation must exist when the tax return is filed, and must be provided to the IRS within 30 days of request.

40. Those penalty rules and the final transfer pricing regulations are inextricably linked. The extent to which taxpayers wish to adopt aggressive positions under the transfer pricing rules is controlled by the requirements in the penalty rules to act reasonably. The penalty rules are intended to change taxpayers' behaviour by forcing them to justify their transfer pricing prior to filing tax returns, rather than many years afterward in response to an IRS examination. Taxpayers must now prepare contemporaneous documentation of their transfer pricing methods and provide such documentation to the IRS upon request. Those penalty rules are the culmination of years of IRS complaints that taxpayers wait until the audit stage to justify their related party transactions. That tactic resulted in delays in (or denial of) IRS access to taxpayer's transfer pricing information, and therefore caused more controversy between the IRS and the taxpayer. Contemporaneous documents are more probative since they do not allow a taxpayer to delay stating its reasoning. Thus, the taxpayer is denied the advantage of post-return rationalizations.

C. Transfer pricing practice of other industrial countries

41. A task force of nine OECD member countries prepared part I of a discussion draft of guidelines regarding transfer pricing on 8 July 1994, under a mandate from the OECD Committee of Fiscal Affairs, and released part II of the discussion draft on 8 March 1995. On 27 June 1995, the Committee on Fiscal Affairs approved the final version of the transfer pricing guidelines. In March 1996, supplemental chapters to the final guidelines were approved. Those OECD transfer pricing guidelines, which are a revision of an OECD report from 1979, were prepared to reflect and update OECD members' views on transfer pricing issues in light of the increased globalization of national economies and the change in legislation and practices of a number of countries since 1979. OECD plans to periodically review and revise the guidelines on an ongoing basis.

1. Commitment to arm's length standard and transaction-based methods

42. OECD believes that each enterprise within a multinationals' worldwide group should be treated as a separate entity. The arm's length standard for establishing transfer prices on cross-border transactions is believed to be the best method of taxing those separate entities, avoiding double taxation, minimizing conflict between tax administrations and promoting international trade. The arm's length principle is believed to place multinational enterprises and independent enterprises on a more equal footing for tax purposes, thereby avoiding the creation of any tax advantages or disadvantages attributable to operating as either a multinational or an independent.

43. OECD recognizes the difficulty of applying the arm's length method and the administrative burdens it causes for both taxpayers and tax administrators, but it nonetheless believes that the costs are worth the benefits. To depart from the arm's length principle would threaten the international consensus and increase the risk of double taxation. The degree of experience and common knowledge among taxpayers and tax administrators has established a sufficient body of common understanding. That understanding should continue to be streamlined in order to improve the administration of the arm's length principle. Those concepts derive from the 1968 studies by Assistant Secretary of the United States Treasury Department, Stanley Surrey, and the IRS.

44. The OECD guidelines are premised on the assumption that the most direct and reliable way to determine arm's length prices is by use of either the comparable uncontrolled

price method, resale price method or cost plus method. After considerable criticism of the comparable profits method originally provided in the draft guidelines, the final guidelines replaced that method with the "transactional net margin method," a similar profits-based method that emphasizes the comparability of the transactions upon which the profit comparisons are made. The primary criticism of the comparable profits method included in the draft guidelines was that it tended to diverge from the arm's length pricing principle, instead substituting a so-called arm's length profits or rate-of-return principle. Critics contended that when applied to complex, diversified multinational enterprises, misapplication of the comparable profits method was likely because, as described in the draft guidelines, it did not expressly prohibit the aggregation of operating profits over broad product lines. There was also concern that even when functional similarity exists between two enterprises, those enterprises may be fundamentally non-comparable because factors other than products and functions – such as valuable intangibles, like a brand name, or simply greater management efficiency – can influence profitability. Concern was also expressed that the dependence on comparable "profits" would lead to undertaxation of unusually profitable firms and overtaxation of firms with abnormally low profits. In the light of those concerns, the OECD drafters eventually replaced the comparable profits method with the transactional net margin method, which attempts to address all those concerns.

45. Notwithstanding differing nomenclature and emphases, most commentators expect that there will be a fundamental accord in the practical application of the comparable profits method in the United States regulations and the transaction net margin method as it is adopted in other OECD countries. In both instances, the so-called profits-based methods are methods of last resort, to be used only when there is insufficient data to use the methods more closely linked to specific transactions, namely, the comparable uncontrolled price, resale price and cost plus methods.

2. Rejection of global formulary apportionment

46. OECD rejects global formulary apportionment as an alternative to the arm's length principle for determining the proper level of profits across national taxing jurisdictions. A global formulary apportionment formula would presumably allocate global profits of a multinational group on the basis of some combination of relative cost, assets, payroll and sales. To effectively avoid double taxation, a world consensus would be needed on the measurement of global income and the associated accounting system, the factors to be used for apportionment and the relative weight of each factor. Each country would want to emphasize factors that maximized its revenue. There also is concern that any formula would be arbitrary, and would disregard market conditions and relative functions and risks. In addition, differences in treatment of exchange-rate movements would skew the formula's application.

3. Monitoring OECD member nation compliance with the 1995 guidelines

47. Jeffrey Owens, head of fiscal affairs for the OECD, has indicated that the Committee on Fiscal Affairs will monitor the implementation of the 1995 transfer pricing guidelines by member nations. Monitoring will entail peer reviews of each country by two or three other countries. The peer review teams will examine legislation, regulations and practice, and will identify any issues that should be discussed with the reviewed country. Such peer reviews should assist in refining legislation, regulations and practices and should encourage consistent application of the guidelines.

4. Advanced pricing agreements

48. As mentioned above, when a multinational is attempting to set appropriate transfer prices between two tax jurisdictions with comparable tax rates, in many instances it is more like a stakeholder between the two jurisdictions and is mainly concerned with avoiding double taxation. Realizing that fact and the desire of multinationals to avoid compliance problems in the factually complex transfer pricing area in general, in 1991 the IRS formalized a procedure for obtaining advance pricing agreements. The procedure allows multinationals to enter into an agreement with the IRS covering the prospective determination and application of transfer pricing methods for certain international transactions. Under that procedure, the multinational proposes a transfer pricing method and provides data showing that it produces arm's length results between the taxpayer and the specified affiliates with respect to specified inter-company transactions. The IRS then analyses the proposal and discusses it with the taxpayer. If the proposal – which may be modified to address IRS concerns – is acceptable to the IRS, the parties execute an advance pricing agreement.

49. Tax authorities in a number of countries have adopted, formally and informally, programmes similar to the IRS advance pricing agreement programme. In appropriate cases, a multinational may obtain an advance pricing agreement that is either unilateral, bilateral or multilateral. Of course, multinationals prefer the latter two arrangements in that they

are the only way of ensuring the elimination of double taxation.

50. Initially, many multinationals received the advance pricing agreement programmes with scepticism. Now, however, many multinationals have come to view advance pricing agreements favourably, citing certainty regarding the tax consequences of inter-company transactions, the elimination of exposure to transfer pricing penalties and limiting record-keeping responsibilities to specified items. Consequently, multinationals indicate that they believe that the use of advanced pricing agreements will continue to grow, although enthusiasm is less strong in such countries as Germany and France, partially due to the reluctance of their taxing authorities to enter into such agreements. From the viewpoint of tax authorities, advance pricing agreements appear to be a more efficient use of resources. The IRS estimates that the budget for its entire advance pricing agreement programme is about the same as the cost of bringing one transfer pricing case to trial. Notably, the OECD transfer pricing guidelines endorse the use of advance pricing agreements, and the Committee on Fiscal Affairs is expected to issue guidelines on carrying out such agreements.

II. Constraints on developing countries' ability to effectively tax multinationals

A. Dependence on the corporate income tax

51. Developing countries have long relied on the corporate income tax as a principal means of revenue. Those taxes account for up to one third of revenue in some developing countries.

52. It may seem at first unusual that a levy as complex as the corporate income tax would be so prominent in developing countries, in which the number of tax experts is relatively low. One reason is that many of the tax systems of developing countries that are former colonies can be traced to the tax systems of their colonizing countries, and the corporate income tax is a principal means of taxation in industrial countries. Another reason is the foreign tax credit granted to taxpayers in industrial countries. The foreign tax credit gives credit only for income taxes paid abroad. However, no credit is given to the multinational in its home country for sales taxes or gross receipts taxes paid abroad. Obviously, as an aid to attracting foreign investors, developing countries need to preserve as much as possible the investors' foreign tax credit.

53. Corporate income taxes are important for another reason: they are relatively easier to collect than other types of taxes. Personal income taxes, for example, are difficult to collect when an economy is mostly agricultural and a population is geographically dispersed. Moreover, much of the population may fall below the low personal exemption levels. In practice the individual income tax typically becomes a tax on employees who work in large firms that withhold taxes from wages.

54. Property taxes are only a minor revenue source in most developing countries, for several reasons. Many properties are too small to be readily assessed. Self-valuation does not work well. Assessors are often subject to political influence.

55. The majority of tax revenues in developing countries comes from taxes, on commodities, which include value added taxes, sales taxes and excise taxes on imports and exports. Sales taxes come in various forms, but the least desirable form is the turnover tax, which has been quite common in developing countries. The turnover tax is imposed at every stage of the production-distribution chain. Those taxes distort decisions at the production level, and cause a cascading of tax liabilities as each transaction accumulates more tax. The pure form of value added tax (VAT) – that is, one that allows the tax paid by a firm on its purchases or inputs to be credited against or subtracted from the tax that the firm charges on its output or sales – generally has less distortive effects. Many developing countries have difficulty administering a pure form of VAT. However, in recent years several developing countries have implemented a pure VAT with success. India is a good example. Uganda adopted a new VAT that began in 1996. The bottom line, though, is that each country needs to do what is administrable – there is no single type of VAT or sales tax that is most appropriate in all cases.

B. Administrative constraints

56. The most important additional constraints that developing countries face are the relative lack of sophisticated record-keeping in many of the local business enterprises and the limited resources available to tax authorities for tax enforcement. Those are barriers to implementing broad-based taxes, such as income taxes and VAT. The key to overcoming those barriers is to modify those taxes and the rules applied in collecting them so that the taxes are enforceable using the available business records and the limited resources available to the tax authorities.

57. There are also differences among developing countries. It may be that some of those differences arise more or less

by accident, or from the peculiarities of the taxes that those countries have imposed. Or they may in part reflect cultural and historical differences in the willingness of some peoples to voluntarily submit to the income tax.

58. One could also point to numerous similar examples in which developing countries have responded to administrative realities in choosing their tax policies. In many respects, those developments have parallelled the trends noted in the United States and other developed countries.

59. In recent years, countries in Latin America and elsewhere have abandoned their highly progressive income tax rate structures. That shift in tax policy has in large part resulted from the conclusion in those countries that tax authorities cannot effectively administer such highly progressive taxes. At the same time that developing countries have been reducing the progressivity of their income taxes, they have been adopting VAT as a central part of their tax systems. Once again, a relatively simple broad-based tax has proved the most effective. Difficulties have arisen when they have employed a variety of rates or a complicated scheme of exemptions from the tax.

60. Another common strand in most of the recent reforms of income tax or VAT is the enactment of relatively broad exclusions for low-income taxpayers (in the case of income tax) or broad groups of small merchants (in the case of VAT). In several countries, the movement away from highly progressive income taxes and towards broad-based consumption taxes has been accompanied by the elimination of a variety of less productive taxes that they had previously imposed. In other developing countries, reforms have been unsuccessful when they have been too complex or have otherwise failed to take sufficient account of the realistic limits of the country's tax authority.

61. That experience suggests that in developing a more productive tax system, developing countries should realistically assess their ability to administer particular taxes and tax rules, as well as their ability to improve those administrative capacities. Most developing countries will probably conclude that they cannot count on making dramatic improvements in their tax administration in the short run. Most developing countries will also be able to identify numerous administrative constraints that they must take into account in developing tax policy.

62. If a developing country keeps those considerations in mind, its emphasis in developing a tax system will probably be on keeping it as simple and as stable as possible. That focus on simplicity and stability should lead developing countries to consider ways of simplifying their current tax systems. Most likely, it will also lead them to adopt rules or taxes that may be only rough approximations of preferred taxes or preferred rules, but that are more effective because they are more administrable.

63. The transfer pricing arena, perhaps better than any other area of international tax law, illustrates how taxpayers can often gain the upper hand through their access to highly qualified tax professionals. Even the IRS, with all its resources, has a fairly dismal record of successfully challenging taxpayers in that area. The sustention rate with regard to the IRS examiner's proposed transfer pricing adjustments has generally been less than 30 per cent in the past five years. That problem, however, is worldwide, and steps are being taken to correct it. The United Kingdom's Department of Inland Revenue, which has only litigated one transfer pricing case to date, recently announced that it plans to increase enforcement of laws intended to prohibit transfer pricing abuse. Among developing countries, Brazil's tax authority recently announced that it is creating a special unit, consisting of senior audit personnel, accountants, economists and lawyers, to handle transfer pricing cases exclusively.

III. Recent attempts by developing countries to combat transfer pricing abuse

64. To understand how multinationals should be taxed by the various countries in which they operate is a daunting task for even the most experienced tax practitioner, much less the staff of a developing country's tax administration. They must see the above-mentioned 40,000 words of regulations under section 482 and shake their heads, possibly with awe but more likely with disgust and frustration. In the United States, the rules for taxing foreign operations have reached a level of complexity that threatens to result in a breakdown of the system for taxing and auditing multinational taxpayers. In many instances, even the most sophisticated taxpayers find it difficult to determine their tax liability. IRS officials freely admit that they are unable to enforce the rules effectively. It is no wonder that developing countries conclude that their tax administrations are incapable of administering such a complex system of taxation, and resort to simpler but nonetheless cruder ways of taxing multinationals.

65. Many developing countries, such as the Philippines and Thailand, have no laws on their books regarding inter-company pricing. Some of those countries implement controls through their Customs divisions for import and export transactions. Declared prices are compared with standard prices compiled by Customs, and the duty base can be increased for any difference. However, there is rarely

coordination between Customs and the tax administration with respect to income taxes.

66. Other developing countries have general statements in their law regarding transfer pricing, often providing broad authority to their tax administrators to determine transfer prices but without any specific rules regarding how they will be determined. Chile, for example, empowers its tax authority to question the prices or values in which inter-company transactions are carried out when those prices differ from those ordinarily obtained in the domestic or foreign market. In Malaysia, when a Malaysian company derives less profit than would normally arise from a trading transaction with a commonly controlled non-resident, the Director General can tax the non-resident on a fair percentage of the profits from trading in Malaysia. A similar rule exists in Singapore. In Papua New Guinea, the Commissioner General of Internal Revenue is authorized to ascertain the arm's length value of inter-company transactions by reference to contemporary market value, and where no such reference is available to determine the arm's length value using his own discretion.

67. Some developing countries are slightly more specific in their provisions designed to counter tax avoidance through transfer pricing. In Argentina, for example, when exports from Argentina are priced below the wholesale market price of the goods in the importing country, the Tax Board is authorized to assess the exporter's profits on the basis of the wholesale market price in the importing country. Conversely, when the price of imports into Argentina is above the wholesale market price in the exporting country, plus shipping and insurance expenses, the Tax Board may adjust the importer's costs of goods downwards and treat the difference as Argentine source income of the importer.

A. Mexico

68. Mexico, in particular, has made great strides in recent years in its regulation of transfer pricing. Mexico's admission to the OECD and its signing of the North American Free Trade Agreement and tax treaties with the United States and Canada have no doubt accelerated Mexico's increased interest in transfer pricing. Mexico has been assisted by the IRS in training international examiners.

69. Effective 1 January 1997, Mexico amended its transfer pricing provisions to recognize six transfer pricing methods of determining arm's length prices: comparable uncontrolled price, resale price, cost plus, contribution profit split, residual profit split and transaction operating margin method. Those methods are intended to be in harmony with the OECD guidelines. Mexico's new transfer pricing provisions also include extensive documentation requirements and special penalties for underpayments of tax due to transfer pricing. Like those in other North American countries, Mexico's tax authority continues to actively pursue resolution of transfer pricing compliance issues through advance pricing agreements.

70. Interestingly, the new Mexican transfer pricing laws specially discourage transactions with low-tax jurisdictions, or tax havens, by establishing a presumption that such transactions are not at arm's length prices and granting the tax authority broad authority to determine the proper price unless the taxpayer can prove through properly prepared documentation that the prices are arm's length.

71. Since 1 January 1995, the Mexican tax authorities have expressly required that *maquiladora* companies comply with the arm's length principle, though a special safe harbour provision for those corporations is available. *Maquiladoras* are Mexican corporations that operate assembly plants, generally along the United States-Mexico border, to assemble or further manufacture component parts to take advantage of lower labour costs and then resell the finished goods outside Mexico. Those corporations typically are wholly owned by a United States parent corporation that repurchases the goods. While those corporations were technically subject to arm's length principles under prior law, there was no enforcement. Thus, most *maquiladoras* did not report significant income taxes, and paid the minimum Mexican assets tax instead. With those new requirements to report profits on an arm's length basis, there is evidence that the *maquiladoras* are paying more attention to Mexican income taxes.

B. Republic of Korea

72. In accordance with its recent initiation into OECD membership, the Republic of Korea passed legislation in 1995 that marked an unequivocal departure from the former formulary apportionment transfer pricing regime to a regime with the arm's length principle as its foundation. The new legislation adopts the OECD pricing methods as acceptable methods, and provides for advance pricing agreements between multinationals and the Republic of Korea's National Tax Administration.

73. A recent National Tax Administration notice, effective 1 January 1997, requires particularly extensive contemporaneous documentation. In addition to specifying a supporting transfer pricing methodology, the notice requires that the taxpayer provide "segmented" income

statements showing the gross profit from numerous types of transactions. Although the documentation rules do not set forth specific transfer pricing penalties, failure to file the documentation can subject the taxpayer to fines and increase the likelihood that it will be selected for audit.

C. Brazil

74. In the past, Brazil's tax authority attempted to enforce arm's length pricing under a law that provided for adjustments to taxable income in cases in which the transfer price charged was "notoriously" higher or lower than the fair market value. Obviously, the term "notoriously" gave taxpayers a considerable degree of latitude.

75. Effective 1 January 1997, new legislation in Brazil provides for more sophisticated transfer pricing rules. In May 1997, Brazil's tax authority issued transfer pricing regulations providing for use of the comparable uncontrolled price, resale price and cost plus methods. Commentators generally agree that Brazil's move towards those types of rules and more vigorous enforcement is reflective of its desire to become a member of OECD.

IV. Other approaches that developing countries take to effectively enforce taxes on income

76. One approach for developing countries to overcome administrative constraints is to adopt taxes or tax rules that are simpler to administer, even if they are only approximations of the taxes or rules that the countries would ideally like to impose. Several presumptive approaches that have been used in countries where the tax administration is not equipped to properly enforce an income tax are considered below. Over time, certain countries have replaced those approaches with taxes based on actual income tax as their collection and enforcement capabilities have developed. Accordingly, the discussion proceeds to focus on the use of a minimum tax on imputed income from business assets as a means to overcome the difficulties that developing countries face in administering their income tax systems.

A. Taxes on "presumptive" net income

77. The idea of taxing imputed income is not new. Several of the countries of sub-Saharan Africa have long imposed such a presumptive tax as a percentage of a taxpayer's gross revenue. Colonial America once had a presumptive tax based on the number of windows in a taxpayer's house.

78. Presumptive taxes have more recently been used by developing countries to overcome the difficulties of administering an income tax. Of course, such presumptions are often very imperfect measures of net income. Nevertheless, those taxes have the advantage of simplicity in sectors of a developing economy where it may be unrealistic to try to enforce a tax on net income in a purer form.

79. The use of such presumptive taxes can lead to distortions and tax evasion, especially if different presumptive taxes are applied in different sectors of the economy. If one sector is more favourable, then taxpayers will attempt to shift income artificially to that sector.

80. In Argentina, there is a presumed net taxable income for certain types of activities of non-residents, including international transportation, international news agencies, insurance and reinsurance operations, and distributors of foreign films. For example, a non-Argentine company that ships goods in containers within Argentina or from Argentina abroad is deemed, as an irrebuttable presumption, to have net income from Argentine sources equal to 20 per cent of the gross amount collected from those activities.

81. In Colombia, on the other hand, there is a broad-based presumptive income tax applicable to all corporations. The taxpayer's net income is presumed to be at least equal to 4 per cent of its total net assets as of the last day of the preceding fiscal period. The 30 per cent corporate income tax is paid on the basis of the higher of presumptive income or ordinary taxable income. The taxpayer may rebut the presumptive income amount only in very limited circumstances. Since 1990, taxpayers who pay corporate taxes on the basis of presumptive income may deduct in the following two years the excess of taxes paid on presumptive income over taxes that would have been paid on an ordinary taxable income.

B. Rebuttable presumptions under the income tax

82. Many countries also employ rebuttable presumptions in enforcing their income taxes. Those are basically collection devices, which impose tax based on indicators of income rather than true income. They can be either withholding taxes based on gross wages, or presumptions of net income based on a taxpayer's professional experience

or lifestyle. The French *forfait* system, which is widely employed in West Africa, uses a practice of determining income tax assessments through a process of negotiation with the individual taxpayer, starting with rebuttable presumptions developed for classes of taxpayers based on indicators other than conventional records of income and deductions. Such systems are subject to corruption because the tax collectors typically do not have the information needed to negotiate an objective assessment.

83. Other countries, such as the Republic of Korea, have attempted to apply a variant of the *tahshiv* system first developed in Israel. Under that system, the tax administration attempts to estimate taxpayers' incomes based on more objective factors, including detailed studies of samples of businesses in various sectors.

84. Even in some relatively developed countries, the majority of taxpayers are taxed on the basis of such rebuttable presumptions. Such systems may result in improved enforcement for some countries. It seems likely, however, that a country that has sufficient resources and sophistication to develop the information needed for such a system to work well should also have sufficient resources to enforce some variant of a more conventional income tax.

85. It is necessary to distinguish collection devices from taxes on presumptive net income. First of all, the taxpayer can overcome a rebuttable presumption by showing his true net income, though as a practical matter rebuttable presumptions often result in a final determination of tax for many taxpayers. Second, use of such rebuttable presumptions generally should not prevent a foreign taxpayer doing business in the developing country from receiving a foreign tax credit for the developing country's income tax against the taxpayer's income tax liability in his home country. By contrast, the United States and other countries generally do not allow such a foreign tax credit for a foreign presumptive tax on a tax base other than net income.

C. Minimum taxes on assets

86. In recent years, several countries have supplemented their conventional income tax on business activities with a minimum business assets tax of general application that is based on an assumption that taxpayers realize a minimum net return from assets that they employ in such activities. Those new business assets taxes are more sophisticated than a tax on gross revenue or on the number of windows in a taxpayer's house. They are also more limited than some other presumptive taxes in that they only apply to assets employed in business activities.

87. A business tax is based on the value of the assets employed in a taxpayer's business, at a rate intended to be the equivalent of such an imputed income tax. The assets can be valued on either a gross or net basis. Mexico's assets tax, adopted in 1989, has contributed to its progress in achieving voluntary compliance. Other Latin American countries, including Venezuela, have since adopted various forms of a business assets tax.

88. The imposition of taxes on imputed business income results from the difficulties that those countries have faced in enforcing their income taxes in both the domestic and international sectors of their economies. Because an income tax is based on accounting for a taxpayer's costs and deductions it is difficult to enforce an income tax against domestic taxpayers whose accounting systems are not well developed. Furthermore, because developing countries have limited resources for enforcing their income taxes they are vulnerable to taxpayer efforts to conceal their gross income. Obviously, it is more difficult to conceal physical assets. Also, because each year's calculation is based on the prior year's calculation the tax authorities are in a better position to detect fraud by comparing different years. In the international sector, multinational companies have the necessary accounting systems but they are often able to avoid a developing country's income tax through manipulation of transfer prices in transactions with related foreign parties. An imputed income tax or assets tax eliminates both those problems because it is not based on a direct measurement of a taxpayer's net income.

89. Of course, such a tax is not a panacea because it requires continuous revaluation of the taxpayer's business assets. If the tax is imposed on net assets, it is also open to abuse by taxpayers who fraudulently reduce their net assets with fraudulent debt. Mexico's assets tax eliminates the potential of abuse from artificial debt by imposing its assets tax on a taxpayer's gross assets. Thus, a country considering such a tax must weigh those difficulties against the extra revenue that they can obtain from the tax.

90. The minimum assets tax is based on the theory that no one would invest capital unless it can produce a minimum return. Presumably, the taxpayer would put the capital to a more productive use if a minimum return were not being met. The rate used is generally 1 per cent to 2 per cent on gross assets, and as high as 3 per cent on the basis of net assets.

1. Preserving the United States foreign tax credit

91. If a developing country were to structure such a tax as a minimum tax within its income tax system, it should be careful not to do so in a way that discourages investment by foreign companies. The United States and other developed countries generally avoid double taxation on foreign income by allowing their taxpayers a credit for foreign income taxes paid on foreign source income. An investment in a developing country will typically not be economically attractive for such a company if such foreign tax credit is not available for taxes paid to the country. Such a foreign tax credit is generally available only for foreign income tax liability.

92. Peculiarities of the rules governing the United States foreign tax credit cause the credit to be based on the amount of foreign income tax that is actually paid under the law of the foreign country. A business assets tax is not creditable in the United States. Further, a taxpayer's tentative liability for a country's income tax will not be eligible for a United States foreign tax credit to the extent that it is offset by a credit for an assets tax or other presumptive tax that is enacted as an alternative minimum tax. That is because of the so-called multiple levies rule under IRS regulations, which provides that if two taxes overlap, the tax imposed first is the tax that must qualify for the foreign tax credit. It is important that in structuring an assets tax as an alternative minimum tax, a developing country allow a credit for a taxpayer's income tax liability against the assets tax that it would otherwise owe, rather than structuring the offset as a credit of assets tax against tentative income tax liability. That was the technique employed in assisting the Government of Mexico with the design of its assets tax. Thus, if the income tax liability is 30 units and the assets tax liability is 20 units, the 30 units of income tax should be paid first, with 20 units of that amount acting as a credit against the assets tax; if the 20 units of assets tax is paid first as a credit towards the 30 units of income tax, only the excess 10 units of income tax will be creditable.

2. Assets tax in selected Latin American countries

(a) Mexico

93. Mexico imposes a 1.8 per cent tax on the average value of gross assets owned by all companies and individuals engaged in business in Mexico, including permanent establishments of non-residents. The assets tax operates as a minimum tax, and is payable only to the extent that it exceeds the taxpayer's income tax liability. A taxpayer may credit any income tax liability for a tax year against its tentative assets tax liability. That helps to mitigate the inflation problem, which is the biggest systematic threat to the integrity of an assets tax. Mexico does employ a system of indexing values for inflation throughout its tax system. Such indexing is important because of inflation. But even if the valuation of a taxpayer's assets is imperfect, the assets tax still serves a useful function of backstopping the income tax for taxpayers who would otherwise evade it.

94. The Mexican law has a number of features designed to cause the assets tax to be a reasonable estimate of the taxpayer's net income. Assets so employed are not included in the assets tax base until two years after they are first placed in use in the business. That takes into account the possibility that a taxpayer will realize a below-market rate of return on his assets during the start-up phase.

95. The Mexico assets tax is also structured to take into account the fact that a taxpayer's actual return on business assets will fluctuate over time. As mentioned above, the assets tax is imposed only to the extent that a taxpayer's tentative liability for such tax exceeds his current income tax liability. If the taxpayer pays assets tax in one year because it exceeds the income tax but pays income tax in a subsequent year, the taxpayer is entitled to a refund of the "excess" assets tax in the prior year up to the amount by which the income tax in the subsequent year exceeds the assets tax. The taxpayer may recover "excess" assets taxes for up to 10 previous years. It should be noted that income tax in the subsequent year must be paid even though a refund of the prior year's excess assets tax is due; that is, the tax and the refund are not netted. That ensures that the income tax paid in the subsequent year is fully creditable for foreign tax credit purposes.

(b) Venezuela

96. Venezuela's assets tax is 1 per cent of gross assets. It differs from the assets tax in Mexico, however, in that the excess assets tax is not separately refunded but rather is offset against the following three years of income tax liability, if any. Thus, it is uncertain whether the portion of income tax liability that is offset by prior payments of excess assets tax will be creditable in the United States – it is possible that only the net payment of income tax will be creditable.

(c) Peru

97. Peru's assets tax is now 1.5 per cent of gross assets, recently reduced from 2 per cent. It differs from the assets tax in Mexico and Venezuela, however, in that there is no ability to reduce payments of income tax for payments of

excess tax in prior years. It is now established that the income tax is creditable in the United States.

3. Use of assets tax to combat transfer pricing abuse

98. The assets tax will not only ease the problems that developing countries experience in their attempts to assess tax on multinationals but also reduce the incentives of multinationals to manipulate transfer prices when the multinationals know that they must pay at least some tax in the local jurisdiction. Indeed, the multinational will want to ensure that its income tax liability is higher than the assets tax so that the taxes paid are creditable in its home country. Tax administration would be simplified by substituting a simple tax calculation for the complexity involved in auditing transfer prices.

V. Improving the collection and enforcement of taxes on the income of multinationals

A. Effective administration

99. Effective administration is the key to creating a productive tax system. The best designed tax system will not work if it is poorly administered. Even a poorly designed tax system, on the other hand, can work reasonably well if it is well administered.

100. It is also important for a developing country to work smarter, as well as harder. Any country's efforts to establish a productive tax system will be more likely to succeed if its taxes and major tax rules are appropriate for its own needs and circumstances.

101. The problem is that it is difficult to get Governments to focus on those priorities of good tax administration and to choose appropriate tax rules. Questions of administration are seldom glamorous. It is always easier to assume that enacting a law or issuing a regulation solves the problem. Obtaining the resources needed to administer the law and regulations properly is a struggle. And in choosing taxes and major tax rules, it is often easy to resort to gimmicks, to argue about what is the ideal tax regime or to borrow rules directly from another country. It is always harder to calculate what taxes and what rules will really work well under a country's own unique circumstances.

102. Whatever the other goals for a country's tax system, however, that system will not be productive unless it is well administered and is designed to take a country's economic and social circumstances into account. Because those are basically pragmatic considerations, they are equally important whether the prevailing philosophy is market-oriented, State-run or anything in between.

B. Penalty structures

103. To the extent that a developing country cannot collect its taxes through withholding and other automatic collection mechanisms, it must rely on enforcement activities directed at individual taxpayers. The goal of such individual enforcement activities must be to promote what is generally known as "voluntary" compliance, which is compliance that does not require direct enforcement activity against the taxpayer in question. The key to such quasi-voluntary compliance is to increase the probability that a taxpayer who evades the law will pay significant penalties. That requires the imposition of appropriate penalties, the allocation of sufficient resources to enforcement activities and the efficient use of those resources.

104. A penalty structure need not be elaborate. In fact, as with so many other issues there is a great advantage in having a system of penalties that is simple enough that it can be easily understood. It is important, however, that the penalties for willful non-compliance be severe enough to be effective but not so severe that they are unlikely to be imposed at all in practice. An effective penalty structure also requires an effective administrative structure for adjudicating tax disputes and imposing appropriate penalties fairly and predictably. No penalty structure will be useful if the probability of detection and likelihood of being penalized if detected remain low.

C. Targeting enforcement activities

105. No matter how successful a developing country is in expanding its enforcement budget, however, it will undoubtedly be operating with limited resources. Therefore, it will also be essential that it effectively target its enforcement activities. That means identifying groups of taxpayers whose compliance is low and then allocating resources effectively among the enforcement efforts directed at those groups.

106. There are obvious political limitations on such a targeting process. Often, it will mean directing increased enforcement activity against politically important groups, particularly true in countries in which elite groups have not paid their fair share of tax in the past. Thus, the targeting

process requires a great deal of political sophistication and restraint. It is doubtful, however, that a developing country can develop a productive tax system unless it gives the tax authorities a great deal of latitude in targeting the domestic taxpayers with the greatest potential for increased collections.

107. Apart from such political considerations, the main tension in the targeting process will arise from balancing the conflicting needs to focus both on the largest taxpayers and on the groups with the largest collective tax avoidance. In most countries, the most obvious targets for enforcement activity are the largest firms operating in the country. The IRS, for example, has in recent years made a point of shifting its ablest people and its primary resources towards the tax controversies with the greatest tax dollars at stake.

108. It is equally important, however, to achieve at least a minimum level of enforcement in the broader sectors of the economy, in which the total amount of tax avoidance may be greatest – usually the agricultural and small business sectors. Assuming that the taxes imposed on such taxpayers are reasonably enforceable, it is probably wise to target those groups with enough enforcement to move them to a higher level of voluntary compliance.

D. Obtaining qualified personnel

109. It is well known that the key to sound tax administration is people – finding good people and then training them, keeping them and protecting their integrity. That is just as true in the United States as it is anywhere else. Concerning the recent budgetary problems in the United States, it has been revealed that the IRS finds it very difficult to attract and keep the best people because its pay scales have declined relative to those in the private sector. Of course, the budgetary crisis in the United States is partly real and partly manufactured. Nevertheless, its situation illustrates just how universal is the problem of finding and keeping good people in the tax administration.

110. It is important that tax authorities in developing countries make hard choices on how best to utilize their best people. Some of them clearly must be assigned to the critical tasks of drafting regulations, devising forms and internal manuals, and organizing enforcement activities. However, tax authorities also assign some of their best people to tax analysis units to identify problems in administration and enforcement, analyse the causes of those problems and identify solutions. Clearly, it will also be useful for those people to be in touch with their counterparts in other countries and to make use of the resources available from regional and international organizations.

E. Incentives for tax personnel

111. In many countries, the question of targeting particular groups for enforcement activities will be related to the question of motivating the country's tax collectors. Many tax reforms have floundered and the enforcement of many existing taxes has lagged because countries have been unable to mobilize their tax collectors to enforce the law. Sometimes, the problem has resulted from the way that tax officials are compensated.

112. Many developing countries employ financial incentives based on revenue "targets" or quotas in financing their tax administration. Apparently, those countries believe that their resources are insufficient to pay their tax officials an adequate salary, and they must use incentive compensation as an alternative. Like the United States, however, any developing country must consider whether it is more economical in the long run to pay salaries that will attract competent and well-motivated employees than to economize and substitute incentive compensation schemes that undermine the integrity of the tax collection system. Agents will always respond to incentives but sometimes in perverse ways. Although incentive compensation plans are not recommended, if a developing country must rely on incentive compensation it is important that it adjust those incentives to ensure that they encourage administrative effort and permit the central authorities to exercise the necessary oversight.

VI. Considerations when making changes to a country's tax laws

113. The recent tax reform efforts in developing countries reflect a new pragmatism in their approaches to taxation. In a wide variety of countries, there has been movement towards tax systems that are more effective in raising revenue, and away from tax systems designed primarily to promote narrow economic or social objectives. That has parallel similar pragmatic trends in the more developed countries. Many new techniques are being tried, and it remains to be seen which will work.

114. Among the most important considerations that any country must take into account in designing its tax system are the administrative requirements for enforcing particular taxes, and the limitations on the ability of its tax

administration to implement certain taxes or tax rules. A developing country, like any other country, must be realistic and creative in choosing taxes and tax rules that will take such administrative realities into account, with minimum sacrifice of tax equity or economic efficiency. If it will not be possible to administer a particular tax or tax rule effectively for the foreseeable future, it must consider whether there is a substitute or a back-up tax or rule that will work better, even if that means a fundamental change in the tax system.

115. A developing country should also continually re-examine whether it has overcome administrative constraints that it has tried to accommodate in the past. For example, trade taxes have been widely accepted as a necessary evil for many low-income countries that have not developed the capacity to impose more broadly based consumption or income taxes. Most commentators would agree, however, that a developing country should work to shift its reliance away from trade taxes as soon as possible.

116. There are more than merely practical reasons both to favour taxes that work and to adopt the best rules that will work well. If a developing country cannot administer a tax effectively, it will not be applied evenly to all taxpayers; that is the most fundamental kind of inequity in a tax system. Moreover, if a tax is widely evaded, that will tend to destroy taxpayers' sense of the equity of the tax system and ultimately their willingness to cooperate with the system. Conversely, rules designed solely to accommodate administrative constraints almost always do so at the cost of equity or economic efficiency in the tax system. Thus, developing countries should move towards more equitable or efficient rules as soon as it is administratively feasible.

117. Any country must also evaluate its tax system in the light of its particular social environment. There are many social, political and economic factors that are cited as limitations on the ability of developing countries to employ certain taxes or to develop a productive tax system. One of a developing country's main tasks must be to evaluate the many potential barriers and to distinguish the real constraints from the problems that it can overcome.

118. It is important in that regard to beware of fads and to avoid adopting particular taxes or rules because everyone else is doing so. In developing a tax system that is appropriate for a country, it is important to keep in mind that the idea of the best possible tax system is the enemy of actually developing a better tax system. Small improvements should not be delayed because the "best" system cannot be obtained. More modest reforms introduced earlier may give the best results in the long run.

VII. International cooperation

119. In conclusion, the authors wish to commend the United Nations for convening the current meeting. They also wish to suggest that the meeting be followed up with further cooperation in the field of tax administration.

A. Bilateral cooperation in taxing international transactions and capital flows

120. The most direct kind of cooperation, of course, is in the area of tax enforcement itself. Informal cooperation in tax administration between developing and developed countries has become much more common over the past 30 years. It is important, however, to go beyond informal cooperation. Only formal public agreements can provide both the framework needed for systematic cooperation and a clear incentive to taxpayers to comply with the law.

121. In the past, some developing countries have hesitated before formalizing such cooperation. They may have thought that in that way they could attract investment from those foreigners seeking to avoid taxes in their home countries. It is increasingly clear, however, that attracting such "hot" money is far less important to most developing countries in the long run than creating the kind of environment that will enable them to attract stable investment from legitimate multinational enterprises. That requires bilateral cooperation with the countries in which those enterprises are based, and an important part of such cooperation is cooperation in tax enforcement.

B. Multilateral cooperation in analysing administrative problems and developing administrative capacity

122. Just as important as bilateral cooperation in tax enforcement is increased cooperation among developing countries in addressing their common problems of tax administration. Over 30 years ago, one of the first regional organizations dedicated to such cooperation was formed: the Inter-American Center of Tax Administrators (CIAT).

123. CIAT has developed into a useful forum for the exchange of ideas. Its annual conferences have produced a wealth of informal contacts and useful technical papers. Through its own publications and its central library, it has increased its members' access to useful materials on tax administration. Its professional staff has coordinated

technical assistance projects in the hemisphere, and has published a handbook on tax administration that has had a major impact on improving tax administration in its member countries.

124. CIAT has also served as a model for similar organizations that have sprung up since that time, including the African Association of Tax Administrators, the Commonwealth Association of Tax Administrators, the Study Group on Asian Tax Administration and Research, and the Caribbean Organization of Tax Administrators. Since 1985, the Council of Executive Secretaries of Tax Organizations has held an annual meeting. Those meetings have provided a useful forum for worldwide exchange of information and for expanding cooperation in addressing basic questions of tax administration. Developing countries may wish to consider expanding their cooperation with each other, on their own, through their regional organizations, and through such international bodies as the United Nations Secretariat, the International Monetary Fund and the World Bank.

125. There are many areas in which developing countries could benefit from the pooling of resources to study common problems and to develop practical programmes for increasing the productivity of their tax systems. One particularly promising possibility is in the joint development of appropriate computer software. Another is the joint study of methods for estimating the public and private compliance costs of existing taxes and tax reform proposals, including the transitional costs of changes in the law. A third area where joint efforts might be useful is in the study of methods for training and compensating tax administration employees.

126. Such cooperation would not eliminate the need mentioned above to base reforms squarely on each country's individual situation. Nevertheless, there would be several clear benefits from closer cooperation on those and other issues. Perhaps the most obvious benefit would be the savings that could result from avoiding unnecessary duplication of effort in studying problems and developing solutions. Through such a pooling of resources, developing countries should be able to accelerate their progress towards improving their tax administration and developing simpler and more stable tax systems.

127. A less obvious but equally important benefit from such cooperation would be the encouragement that it could provide to increased foreign investment in developing countries. One of the big costs for a multinational company investing in the developing world is the need to cope with the ambiguities and peculiarities of the developing countries' tax systems: the proliferation of approaches to tax administration in the developing countries increases those costs and discourages such investment.

128. Cooperation in developing common approaches to common problems can provide a big boost to developing countries' efforts to achieve full participation in the world economy if it helps to reduce the uncertainties facing multinational companies doing business in the developing world.

VIII. Recommendation for new international tax initiative

129. The authors wish to suggest a new initiative in the international tax field that they believe would enhance cooperation in and just enforcement of international tax laws. Some of the nations represented at the meeting may not have the capacity to ensure that sophisticated international corporations pay their fair share of taxes for their business activities within that nation's territory. After all, even the very large and developed countries are having a difficult time ensuring that those large diversified corporations pay their fair share of taxes. The arm's-length standard that seems now to be the norm in the developed countries is not easily administered. It requires a staff of well-trained lawyers, accountants, economists, business planners etc. to insure the capacity to follow the profits from the ultimate sale back along the chain of commerce. There is some desire on the part of several legislators in the United States to go to some formulary system; not that such a system would be easily applied but it gives the appearance of simplicity.

130. The authors' suggestion would require a good deal of international cooperation but would not require large staffs nor would it increase complexity: their goal is to put tax and administrative staffs worldwide on an equal playing field with the corporate world.

131. In the United States, many states realized a number of years ago that they had a similar problem to that under discussion. The smaller states lacked the capacity to audit large national corporations, which operated across many states' boundaries. They organized the Multi-State Tax Commission, a group to which each state pays dues in accordance to its size and use of the Commission's services – a fee-for-service system. The Multi-State Commission then audits the large corporations' activities in various states, and makes a fair and uniform allocation of the corporation's income among the states in which it operates.

132. The authors suggest that either the United Nations, a regional body or an organization such as CIAT take over a similar function to that provided by the Multi-State Commission. That body would develop a set of uniform principles or a model statute – along the lines of section 482 of the United States Internal Revenue Code – that would be adopted by all the countries participating. Thus, they would all agree to use the same principles in allocating income in multinational transactions. That might sound like a large step, but it is really rather minor; most of those rules are rather similar now. In addition, many countries have strict and arbitrary rules that are not enforced in practice.

133. Thus, a group of international experts would draft a code, like those now devised in the treaty area. They would also draft implementing regulations or forms. Thus, a corporation doing business in four or five countries that are members of such a new alliance would prepare one form for that allocation.

134. The next step is to have a group of experts at the disposal of that international group. The retired professionals of many countries could be used as a corps of experts in law, accounting, auditing, economics etc., to be on call for their advice, to check results with and to assist in resolving disputes.

135. The idea is to achieve a level playing field on which all parties come well prepared. That would lead to an *in terrorem* effect: tax returns would be better prepared and more forthrightly stated if the corporate world knew that countries had the capacity to meet them with equal intellectual force. A fairer system would yield better international commerce, and fairer allocation of prices.

136. Such suggestions may sound revolutionary, but when CIAT was first suggested in 1996 many people thought it was unrealistic. Now, more than 30 years later, CIAT is a real force in the tax world and has produced a number of offspring in other parts of the world. The authors hope the United Nations can act as a catalyst in working on that and other ideas to help all developing countries do their jobs better; and most importantly, to help such countries to receive their fair share of the income produced by international activities.

137. The authors are hopeful that a working group will be appointed by the United Nations or some similar organization to work out the details of their proposal. From their experience, they have learned that the tax systems of the world have more similarities than differences. They believe that it is possible to find a mutually acceptable method of fair taxation for both the countries involved and the international business community.

Review of tax treaties between developing countries: a comparison with the United Nations Model Double Taxation Convention Between Developed and Developing Countries*

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* Prepared by Professor Stephen Crow, consultant to the United Nations Secretariat.

I. Introduction

1. The present paper provides a comparison of the "associated enterprises" or transfer pricing articles of a sample of 46 bilateral and two multilateral income tax treaties between developing countries.[1] This represents approximately 25 per cent of the treaties between developing countries in force as of December 1996. The comparison examines the correlation between the terms of the associated enterprise articles (the articles) in the sample treaties and the articles in the United Nations Model Double Taxation Convention Between Developed and Developing Countries.[2] The purpose is to assess the extent to which the articles of the sample treaties are at variance with the articles of the Model Convention; look for the presence of any patterns or trends where variances are observed; propose certain relationships between the treaty parties that may explain any trends or patterns observed; and discuss possible implications of such variances. The work initiated in the present paper will be extended to test the strength of those relationships between contracting States and any correlation between them and treaty variation.

2. Section I contains an analysis of the Model Convention "associated enterprises" provisions, as included in the May 1995 draft version of the Model Convention that was prepared for the June 1995 meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters. That document contains the articles as they appear in the Model Convention, as well as proposed changes. In this case, the proposed changes include additional provisions for the "associated enterprise" articles. Section I also contains a summary of the results of the comparison, identifying, in general terms, the distinguishing characteristics of observed variations from the articles of the Model Convention and any trends or patterns in the variations. To enhance the analysis and offer a cross-sectional perspective, the comparison looks separately at 18 bilateral treaties in which the one contracting State is held constant and the treaty partners represent a cross-section of developed and developing countries. For the purposes of structural validity, the two constant treaty partners represent both developed (France) and developing (Argentina) countries. The sample of French and Argentine treaties were drawn from the 1996 tax treaty file of the International Bureau of Fiscal Documentation (IBFD). Where appropriate, the Argentine treaties are included in the developing country sample.

3. Section II presents the treaty-by-treaty comparison, and identifies the specific variations from Model Convention provisions for each comparison. This analysis shows which countries are the contracting States to each treaty and how each of the treaties compare with the Model Convention provisions, and summarizes the variations observed, taking special note of those that occur with sufficient frequency to indicate possible patterns or systematic behaviour. Section III discusses a set of possible relationships between contracting States that may offer some explanation for the presence of the observed variations, and suggests how this could impact the treaty process.

4. Section IV discusses the implications of the results, possibilities for future inquiry and the localized conclusions that can be drawn from the observations made.

II. Summary of results

5. As of 6 December 1996, there were approximately 214 income tax treaties in force between developing countries, as listed in the IBFD tax treaty file on the Lexis/Nexis databases. A sample of 52 treaties was selected, generally at random. The final sample of 46 was obtained after the elimination of duplications in multilateral treaties. The only criteria imposed on the selection process was that it cover the major economic and geographic areas of the global business community, and that it provide for some observations to reflect treaties between developing countries both within and across those geographic and economic areas. The 18 treaties that include Argentina or France as a constant contracting State were selected from the same IBFD file. There was no distinguishing feature that dictated the selection of the two anchoring countries or the specific treaties other than to make sure that one of the anchoring countries was a developed country and the other was a developing country.

6. The "associated enterprise" articles of the sample treaties were compared against the provisions, both existing and proposed, of the United Nations Model Double Taxation Convention Between Developed and Developing Countries, as presented to the Ad Hoc Group of Experts on International Cooperation in Tax Matters at its meeting of 5–7 June 1995 in New York (see ST/SG/AC.8/1995/WP.9).

7. The analysis of those provisions is presented in table 1. The provisions present in the Model Convention, article 9 (1) (a) and 9 (1) (b), describe related enterprises in terms of common control, management, or capital investment either between two entities or through a third party. The operative language of article 9 (1) provides that where the allocation of profits between related enterprises located in different contracting States is distorted as the result of the related party status of the enterprises, the contracting State to which the related enterprise therein has under-reported

profits may impose an adjustment on that enterprise to accrue the amount under-reported.

8. The language of article 9 (2) provides the protection against double taxation. It states that in the event one contracting State to the treaty has imposed an adjustment under 9 (1), the other contracting State shall make an appropriate adjustment accordingly. This adjustment would be expected to be compensatory and to restore the aggregate profits of the enterprise group to its original level.

9. The above-mentioned document offers two provisions, in draft form, for consideration as additions to the existing article 9 model. Those two are proposed as draft articles 9 (3) and 9 (4).

10. Draft article 9 (3) provides that article 9 (1) shall not preclude a contracting State from making an adjustment to accrue profits to secure the clear reflection of income or to preclude tax evasion. The essence of the provision can be interpreted to give the contracting State the opportunity to impose an adjustment where the treaty, for whatever reason, produces an anomalous result or has not effectively precluded tax evasion.

11. Draft article 9 (4) provides that in making the adjustment for the attribution of misreported profits, the contracting State may use its customary allocation or apportionment method. It makes no specific reference to the article 9 (1) adjustment, but that should be specified. The provision, as it now reads, seems to allow for the possibility that article 9 (1) and 9 (2) adjustments could each be made under different methods, thereby providing the opportunity for double taxation.

12. A substantial number of departures from the Model Convention were observed in the comparison of the developing country treaties reviewed. Only about 32 per cent of the treaties reviewed in the sample include all of the Model Convention provisions. Most of that 32 per cent use the same literal language as the model articles, but a few provide their own wording. It is not possible to determine whether these variations are significant without looking at underlying economic and trade, cultural and historical relationships between the contracting States (see section III below).

13. In contrast, 54 per cent of the treaties reviewed (26 out of 48) include only the provisions of article 9 (1) of the Model Convention, with one of the 26 treaties including only the provisions of article 9 (1) (a) in its definition of related enterprises. In so doing, although those treaties provide for adjustment in the contracting State to which profits are under-reported, they do not provide for protection against double taxation. Given the frequency of the occurrence of double taxation, it must be asked why such a basic protection – one of the two key focuses of the Model Convention – should be excluded. Section II below will discuss possible explanations for this and other observed variant behaviour.

14. Two other variations were observed that are worthy of note. First, four of the treaties reviewed were observed to have no "associated enterprise" articles. It is difficult to imagine what factors could be so extreme as to precipitate the complete absence of such articles. Second, several treaties include statute of limitation provisions in the articles; this is mainly the case for developed country treaties, but does occur in one of the developing country treaties.

15. Of the nine French treaties reviewed in table 3, six are with developing countries and three are with developed countries. The six treaties with developed countries are uniformly consistent in that they include article 9 (1) (a) and (b), precisely as contained in the Model Convention. However, none of them incorporate the double taxation protection of article 9 (2).

16. Of the three French treaties with developed countries, all are consistent with the content and language of the Model Convention articles 9 (1) and 9 (2). Some include variations of the proposed provisions as well, and one includes a statute of limitations provision.

17. Of the nine Argentine treaties reviewed in table 4, seven are with developed countries and two with developing countries. Of the seven treaties with developed countries, five contain all the articles of the Model Convention and the tax evasion provisions of its proposed article 9 (3); of those five, three include statute of limitation provisions. The apparent anomaly is the treaty with France (not considered in the review under table 3). Only article 9 (1) (a) is included in this treaty: the third party definition of related enterprises, the double tax protection of article 9 (2) and the tax evasion provisions are omitted.

18. Of the two Argentine treaties with developing countries, at least one includes all the provisions of article 9 (1) but omits article 9 (2). The treaty with Bolivia contains no specific "associated enterprise" article.

19. Thus, variation between Model Convention articles and sample articles does occur, but the final assessment of the significance of that variation for the treaty process and the contracting States using the Model Convention will depend on the next phase of the present inquiry, i.e., the consideration of factors that contribute to the explanation of that variation.

Table 1
Analysis of "associated enterprises" provisions of the United Nations Model Double Taxation Convention Between Developed and Developing Countries

Article	*Provision*	*Explanation*
9 (1) (a)	Where an enterprise of a contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other contracting State, or	Describes related enterprises in terms of common control, management or capital investment between entities
9 (1) (b)	Where the same persons participate directly or indirectly in the management, control or capital of an enterprise of a contracting State and an enterprise of the other contracting State	Describes related enterprises in terms of common control, management or capital investment through a third party
9 (1)	And in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly	Provides that where the allocation of profits is distorted as a result of the related party status of the enterprises, the contracting State to which a related enterprise has under-reported profits may impose an adjustment on the enterprise in that contracting State to accrue the profits deemed under-reported as a result of the related status
9 (2)	Where a contracting State includes in the profits of an enterprise of that State – and taxes accordingly— profits on which an enterprise of the other contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the contracting States shall, if necessary, consult each other	This provision is the double taxation protection. In the event that one contracting State to the treaty has imposed an adjustment under 9 (1) (a), the other contracting State shall make an appropriate adjustment
9 (3)[a]	The provisions of paragraph 1 shall not limit any provisions of the law of either contracting State which permit the distribution, apportionment, or allocation of income, deductions, credits or allowances between persons, whether or not residents of a contracting State, owned or controlled directly or indirectly by the same interests, when necessary in order to prevent evasion of taxes or clearly to reflect the income of any such persons	The language of this draft provision provides that article 9 (1) shall not preclude a contracting State from making an adjustment to accrue profits where either the treaty produces an anomalous result, or despite the treaty there is the very real possibility that the enterprise is evading taxes
9 (4)[a]	Insofar as it has been customary in a contracting State to determine the profits to be attributed to an enterprise of that State on the basis of an apportionment of the total profits of the enterprise and any associated enterprises among them, nothing in paragraph 1 shall preclude that contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted however, shall be such that the result shall be in accordance with the principles contained in this article	Provides that in making a 9 (1) (a) adjustment, the contracting State may use its customary or conventional method to determine the magnitude of the adjustment

[a] Draft article; not yet a part of the Model Convention.

III. Sample analysis

20. In tables 2, 3 and 4, the results of the review of the individual treaties are presented. Table 2 compares "associated enterprises" Model Convention provisions with those of 46 tax treaties between developing countries.

21. Tables 3 and 4 compare "associated enterprises" Model Convention provisions with those of tax treaties between France and other countries and Argentina and other countries, respectively.

22. A summary discussion of the results of the comparison was presented in Section I above. The following section discusses the specific details of the analysis.

Table 2
Comparison between "associated enterprises" provisions of the Model Convention and developing country tax treaties

				Treaty articles				
IBFD	*Order*	*Treaty parties*		*9(1)(a)*	*9(1)(b)*	*9(2)*	*Other*	*Comments*
1996	1	Thailand	Viet Nam	Y	Y	N	N	
1996	2	Sri Lanka	Yugoslavia	Y	Y	N	N	
1996	3	Thailand	Philippines	Y	Y	Y	Y	§1: adjustment subject to statute of limitations: <5 years after year of accrual, for CS
1996	4	Singapore	Philippines	Y	Y	N	N	
1996	5	Morocco	Tunisia	Y	Y	N	N	
1996	6	Morocco	Romania	Y	Y	N	N	
1996	7	South Africa	Israel	Y	Y	N	N	
1996	8	Singapore	Israel	Y	Y	N	N	
1996	9	Estonia	Lithuania	Y	Y	Y	N	
1996	10	United Arab Republic	Iraq	Y	Y	Y	N	
1996	11	Romania	Ecuador	Y	Y	M	N	§2: where profits of DE taxed by FCS includes profits which would accrue to a DCS but for an RP status between DE and FE, FCS shall make an appropriate adjustment
1996	12	Cyprus	Syrian Arab Republic	Y	Y	Y	N	
1996	13	Cyprus	Czechoslovakia	Y	Y	N	N	
1996	14	The former Yugoslav Republic of Macedonia	Croatia	Y	Y	Y	N	
1996	15	United Arab Emirates	China	Y	Y	Y	N	
1996	16	Thailand	China	Y	N	N	N	
1996	17	Singapore	China	Y	Y	N	N	
1996	18	Romania	China	Y	Y	N	Y	
1996	19	Poland	China	Y	Y	N	N	

IBFD	Order	Treaty parties		Treaty articles 9(1)(a)	9(1)(b)	9(2)	Other	Comments
1996	20	Papua New Guinea	China	Y	Y	Y	N	§3: approximates the language of the suggested §3, which says that nothing in §§1 or 2 precludes DCS law from dictating determination of profits attributable to DE
1996	21	Kuwait	China	Y	Y	Y	N	
1996	22	Cyprus	China	Y	Y	Y	N	
1996	23	Republic of Korea	Bulgaria	Y	Y	N	N	
1996	24	Indonesia	Bulgaria	Y	Y	N	N	
1996	25	Hungary	Bulgaria	Y	Y	Y	N	
1996	26	China	Bulgaria	N	N	N	N	Treaty has no "associated enterprise" article, nor does treaty mention transfer pricing as such
1996	27	Republic of Korea	Brazil	Y	Y	N	N	
1996	28	India	Brazil	Y	Y	N	N	
1996	29	Czech Republic	Brazil	Y	Y	N	N	
1996	30	China	Brazil	Y	Y	N	N	
1996	31	Botswana	Mauritius	Y	Y	Y	N	
1996	32	Latvia	Belarus	Y	Y	Y	N	
1996	33	Pakistan	Bangladesh	Y	Y	N	N	
1996	34	Republic of Korea	Bangladesh	Y	Y	N	N	
1996	35	India	Bangladesh	Y	Y	N	N	
1996	36	Albania	Hungary	Y	Y	Y	N	
1996	37	Albania	Malaysia	Y	Y	N	N	
1996	38	Albania	Poland	Y	Y	Y	N	
1996	39	Albania	Romania	Y	Y	Y	N	
1996	40	Algeria	Tunisia	Y	Y	Y	N	
1996	41	Andean Group	Bolivia	N	N	N	N	No "associated enterprise" or transfer pricing provisions
1996	42	Andean Group	Colombia	N	N	N	N	No "associated enterprise" or transfer pricing provisions
1996	43	Andean Group	Ecuador-Peru	N	N	N	N	No "associated enterprise" or transfer pricing provisions
1996	44	Andean Group	Venezuela	N	N	N	N	No "associated enterprise" or transfer pricing provisions
1996	45	Arab Economic Union Council	Egypt, Iraq, Jordan, Kuwait, Sudan, Syrian Arab Republic, Yemen	M	M	N	N	Art. 8: CS may disregard commercial and financial relations between enterprises if such conditions would *decrease* profits in that State; art. 8(a) and (b): parent subsidiary/affiliate and brother/sister provisions

IBFD	Order	Treaty parties		Treaty articles 9(1)(a)	9(1)(b)	9(2)	Other	Comments
1996	46	Argentina	Bolivia	N	N	N	N	No "associated enterprise" or transfer pricing provisions

Key: Y = yes
N = no
M = different wording but consistent with Model Convention

Table 3
Comparison between "associated enterprises" provisions of the Model Convention and tax treaties between France[a] and other countries

IBFD	Order	Treaty parties		Treaty articles 9(1)(a)	9(1)(b)	9(2)	Other	Comments
1996	1	France	Algeria	Y	Y	N	N	
1996	2	France	Bangladesh	Y	Y	N	N	
1996	3	France	Benin	Y	Y	N	N	
1996	4	France	Brazil	Y	Y	N	N	
1996	5	France	Central African Republic	Y	Y	N	N	
1996	6	France	Cyprus	Y	Y	Y	Y	
1996	7	France	Australia	Y	Y	N	N	Some modification of language, but essence consistent with Model articles
1996	8	France	Austria	Y	Y	Y	Y	
1996	9	France	Canada	Y	Y	Y	Y	Statute of limitations provision included

Key: Y = yes
N = no

[a] For treaty with Argentina, see table 4 below.

Table 4
Comparison between "associated enterprises" provisions of the Model Convention and tax treaties between Argentina and other countries

				Treaty articles				
IBFD	Order	Treaty parties		9(1)(a)	9(1)(b)	9(2)	Other	Comments
1996	1	Argentina	Austria	Y	Y	N	N	
1996	2	Argentina	Canada	Y	Y	Y	Y	Statute of limitations and fraud provisions
1996	3	Argentina	Denmark	Y	Y	Y	Y	Statute of limitations and fraud provisions
1996	4	Argentina	Finland	Y	Y	Y	Y	Statute of limitations and fraud provisions
1996	5	Argentina	France	Y	Y	N	N	
1996	6	Argentina	United States	Y	Y	Y	Y	
1996	7	Argentina	Netherlands	Y	Y	N	N	Statute of limitations and fraud provisions
1996	8	Argentina	Bolivia	N	N	N	N	
1996	9	Argentina	Brazil	Y	Y	N	N	

Key: Y = yes
N = no

IV. Discussion of results

23. The results of the review of the 46 developing country income tax treaties reveal substantial variation from the articles of the Model Convention. However, it is not clear what impact that variation may have on the treaty process. Two constraints operate here to limit the conclusions or inferences that can be drawn. First, the present study has been limited to the "associated enterprise" articles of the treaties. It is at best unclear whether similar levels of variation will appear, under similar conditions, in the articles of the treaties that were not reviewed; that question can only be answered with a comprehensive review of the sample treaties. Second, a review of the treaties does not by itself reveal the factors that were considered by the contracting States during the negotiations when the treaty was developed. The present inquiry is currently being expanded to look at those considerations, on the hypothesis that such relationships between the contracting States can be identified and specified. It is not likely that a prediction model of any great degree of accuracy could be constructed, but such analysis would be of substantial value for the study of tax policy, economics and multinational business.

24. Rather, what is presented below are two items for the consideration of the meeting. First, a number of relationships between contracting States are proposed in connection with the above-mentioned hypothesis. Second, section IV considers, to the extent that evidence permits, the implications that the variations observed in the sample treaties reviewed may have for the treaty process and the "associated enterprises" provisions of the Model Convention.

25. There are several factors that could influence the treaty development process. Some help to explain the developed countries' tendency towards a well-defined set of rules that reduce ambiguity but also flexibility. Others help to explain the developing countries' tendency towards flexibility and a set of general rules that may, in the process, allow individuality and customization of business arrangements but also tend to obfuscate clarity. Most of the examples below have been derived from anecdotal evidence, from sources with varying degrees of experience in treaty development and negotiations.

26. Developed countries generally represent complex and sophisticated societies and commercial environments, with equally complex and sophisticated regulatory systems. They are "rules-oriented" countries. This is a natural consequence of the evolution of society and commerce, and of all the complexities that integrating a myriad of independent parts into a working unit generally brings with it. In these rules-

oriented environments, the emphasis is placed on a well-defined set of rules to provide for governance and direction. By definition, there is less room for spontaneous flexibility: any flexibility in the system must be designed into the rules. One would expect to find developed countries devoting substantial resources to drafting their rules and then to monitoring compliance. This is what we see when we look at the resources that developed countries or countries with complex commercial dealings, as well as agencies that monitor compliance, expend on writing and enforcing those rules, such as taxation laws and regulations.

27. Another factor affecting developed countries' treaty considerations is the growing competition for tax dollars in the global business market. Among the developed countries, there is a pattern of movement towards tax conformity.[3] Conformity brings with it, among other things, a parity in tax rates.[4] That parity has the effect of placing a soft upper bound on the tax burden of a multinational enterprise. There are global conditions that bring this about. Developed countries are in competition for trade markets and capital. Although they want to protect against depleting their treasuries, they do not want tax costs to create a comparative disadvantage for business in their jurisdiction. As a result of such pressures, the business tax rate becomes, in the economically competitive sense, inflexible. Since countries cannot protect their treasuries by simply raising tax rates, the tax issue that they are very much concerned about is the allocation of those limited international tax dollars.[5] As the allocation issue develops, each country responds with more sophisticated rules and regulations, and intensified efforts in the area of enforcement.

28. The character of the product also impacts treaty and trade considerations. Those countries that trade in manufactured and technology-based products or intellectual properties tend to adhere more closely to the Model Convention articles and incorporate the proposed additions. These are sophisticated products and the trade arrangements are complex. This complexity, as well as the number of permutations possible in the population of multinational commercial arrangements, make it more difficult and more costly to apply an "arm's length" or "independent" pricing standard since that requires that each transaction be considered individually. In the interest of clarity, consistency and compliance, these countries prefer a well-defined environment. This preference is also consistent with the rules-oriented nature of the country or business. Although the developed countries tend to fall into that category, it is a product-based factor and can play a role in the treaty process for developing countries as well.

29. Such factors are equally important to the treaty considerations of developing countries, but their concerns are the antithesis of those discussed above. In contrast, the developing countries tend to emphasize flexibility in their regulations[6] and in their treaty considerations. Their incentive structure is different. They are expanding into new markets, importing capital investment, and building their product and technology base. Whereas rules and structure are consistent for a developed economy, those same elements constrain the capabilities of the developing economy to tailor commercial arrangements to meet specialized business needs as a means of optimizing their development and growth goals. That is the objective of tax holidays or tax havens: they emphasize capital formation and business growth over tax revenues in an effort to encourage trade, either in a general area or in specific products or technologies.

30. Regulation of transfer pricing can also reflect a country's economic incentives in the same ways as tax holidays do. The developing countries tend to employ a general "arm's length" profits test and deal with cases on an individual basis, rather than design specific but sometimes puzzling definitions of acceptable transfer pricing[7] methods and strictly administering their enforcement procedures. Except for the egregious case, during the time developing countries are building their technologies, product bases and markets, they are more interested in business and capital growth than in the flight of tax dollars. The purpose of the general standard is to permit the country to deal with such problems as fraud but allow them the flexibility to accommodate a wide range of customized arrangements. This leaves the flexibility in the hands of the individual country that needs it.

31. There are transaction cost considerations associated with the various treaty strategies. Many developing countries look to developed countries for education and training in specialized areas. The developing country can support a visiting scholar, or send its own nationals to a foreign country. Many developing countries express their preference to send their individuals to the developed country rather than encourage visiting scholars, because this allows their students to have access to more facilities and to develop the country's resident knowledge base rather than subsidize exposure to a single source for a limited time. Such a strategy provides a much more attractive cost-benefit picture for the developing country. In such cases, the treaty provisions of the developing country would be expected to emphasize those articles that focus on the tax treatment of their teachers and students in foreign countries.

32. Historical trade and cultural factors may also impact treaty considerations of contracting States. For example,

colonial or cultural ties may precipitate special investment arrangements between States, or may result in more liberal economic subsidies on non-income tax levels. The inducements between these countries in structuring income tax treaties are significantly different than those where the relationships have been built on a primarily commercial basis. For example, concerns about tax revenue flight or tax allocation are substantially mitigated by these overriding considerations; under those conditions, one would expect that treaty provisions would reflect less rigour in construction and would have a less constraining character.

V. Implications

33. In conclusion, the results of the comparison indicate that treaties between developing countries – and in some cases between developing and developed countries – do exhibit a departure from the standard provisions of the Model Convention. But how is that departure to be interpreted?

34. The discussion in section III above shows that there are many factors that, *ex ante,* could logically be expected to affect treaty considerations. Section III does not contain an all-inclusive list, but much of what is posited in that discussion is consistent with what we see, for example, in treaty terms and the regulatory schemes of developed and developing countries with regard to transfer pricing.

35. The results must be viewed in the context of the issue that has been addressed, i.e., a review of treaty articles concerning "associated enterprises" or transfer pricing. It is not clear that the results of the present review can help to predict what could be expected of a more comprehensive review – such as that undertaken by Lawrence Lokken in 1995 (see ST/SG/AC.8/1995/L.9) – dealing solely with developing countries.

36. The results do show the presence of variation from the Model Convention articles in the reviewed treaties between developing countries. It is reasonable to posit that such variation is not by accident, that such variations have a purpose; in any case, whether intentional or not, the effect of such variation is that the contracting States have placed themselves in a position that seems to allow more flexibility in dealing with individual business transactions.

37. Although demonstrating that such variation exists is of some information value, the next step is to try to explain what factors were at work during the construction of the articles. Section III above proposed several possible considerations, but no single factor will explain all the individual departures in each case. Accordingly, there is a need to test whether any of the hypothesized factors do actually affect the treaty process.

38. The value of such information lies in its ability to assist contracting States in dealing with the process. It is important to try and determine what is included – i.e., why certain departures are incorporated – before any contracting State can determine what should be included.

39. In short, the results can be said to demonstrate that the "associated enterprises" provisions of tax treaties between developing countries do vary from the standard Model Convention articles. Although that variation may exhibit trends, it is not clear what the implication of those trends or patterns are because it is not clear that there is any distinct pattern of factors causing the variation. It would be detrimental to eliminate such variation until its causes are known and can be specifically addressed in treaty provisions.

40. The results also provide material that would support the efficacy of information and education programmes on double taxation treaties, the treaty process and treaty negotiations. As understanding grows of the instances of variation, the amount of information available for such programme services will grow as well.

Notes

[1] Developing countries are defined, for the purposes of the present paper, as any country that is not a member of the Organisation for Economic Cooperation and Development. This appears to be consistent with earlier papers in this area.

[2] United Nations publication, Sales No. E.80.XVI.3.

[3] See Wunder, H. F., and S. R. Crow, "International tax reform since 1986: an update", *Tax Notes International,* 7 April 1997.

[4] See ibid., footnote 3.

[5] See Crow, S. R., and E. H. Sauls, "Tax and management implications for transfer pricing for international business", in *Proceedings: Academy of International Business, West and Southeast Asia Regional Conference* (Hong Kong, June 1993).

[6] See Crow, Stephen R., "The new mandate for international transfer pricing: a new paradigm for multinationals", in *Proceedings: 1996 Western Decision Sciences Institute Conference,* April 1996.

[7] See ibid., footnote 6.

Tax havens: the need to neutralize their distorting effects in the international tax context*

Contents

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I. Introduction

1. The mere existence of tax havens, let alone their satisfactory definition, gives rise to varied reactions among tax experts. We should, however, confess that, for our purposes, we do not consider experts those who merely describe them and explain, with an obvious vested interest, how the tax regimes of these havens work, and how foreign individuals and foreign legal entities can take advantage of such regimes or of other forms of treatment such as those of a corporate or banking nature.

2. In any event, tax havens exist. It is therefore necessary to define their main features, and rather than criticizing or justifying their presence, we should look into the reason for their current existence.[1] It is also very important to minimize, and if possible, eliminate tax havens as tax-evasion mechanisms on an international level or as shelters for hiding gains from illicit activities.

II. Definition of a tax haven

3. Predictably, authors have varied opinions on how a tax haven is set up and what it is.

4. Alain Vernay[2] began his interesting book with a harsh look at tax havens. Accepting them as part of reality, he said they were where "timid as well as bold capital dreams of escaping to sooner or later. There, secrecy is secure, taxes are light and freedom absolute". The author uses an anecdotal style, full of colourful and readable touches, to tell abundant inside stories taken from current political and economic realities, which are directly or indirectly related to the tax havens examined in the book. That style, however, does not seem very useful in defining the basic features of tax havens. This is evident in the book where he says "a tax haven is always a fair ground, a free-trade zone and a currency-exchange office all lumped together; it is populated by a foreign legion of wealthy people and united essentially by customs conventions, and by a common use of financial regulations, a common parity rate and a common concept of profit".[3]

5. Richard Gordon's statement,[4] however, is somewhat more substantial. For him a tax haven is "any country that has a low tax rate or no taxes at all" either for all income or a given category of income, and one that also offers a certain degree of banking or trade secrecy.

6. Milka Casanegra de Jantscher's[5] brief and substantial analysis is more useful for our purposes. The term *refugio tributario* (tax shelter) used here is interchangeable with tax haven. In the author's opinion, it is a place where foreigners can receive income or acquire assets without having to pay high taxes on them.

7. The Executive Secretariat of the Inter-American Centre of Tax Administration (CIAT) also elaborated a definition of a tax haven, saying that it was not only a place where tax benefits were awarded or where one could take advantage of legal provisions to obtain certain tax benefits, but was also a place that possessed other, non-tax features which made the country or place a suitable centre for carrying on a diversity of businesses. The CIAT concludes this definition, however, by emphasizing the subjective aspect, saying that it referred mainly to persons or entities not resident in these places or countries.[6]

8. Casanegra de Jantscher says that this last circumstance is the distinctive quality of a tax haven. Obviously, it is therefore of decisive importance in terms of taxation for those countries whose residents, citizens or companies are attracted by the pull of the tax havens.

9. As a consequence, while there is an element of legitimacy in foreigners availing themselves of the diverse comparative advantage offered by tax havens, it is equally legitimate for these countries to be concerned about losing the income and wealth of its residents, citizens or companies to these havens; their concern stems from the desire to check this tendency, which obviously causes a loss of tax revenue and restricts the volume of funds available for development of their national economies.

III. Reasons for the existence of tax havens

10. We are inclined to say that perhaps the main cause of the boom in tax havens in recent times – especially since the Second World War – has been, on the one hand, the highly unstable, disorderly, if not chaotic, development in both the political and the economic spheres, often accompanied by frenetic devaluation of their currencies by many countries, particularly developing countries, along with the steady growth, on the other hand, of informal, clandestine, hidden or underground economies in almost all countries, without any distinction as to their degree of economic development.[7]

11. The first category of reasons, engendered by situations of legal insecurity, sharp restrictions or even absence of guarantees in the exercise of the right of ownership, or discretionary measures of confiscation or appropriation of property, understandably leads to a search for locales which offer adequate levels of security and in which these sources

of uncertainty do not exist. In these circumstances, the factors mentioned take absolute priority, and it is only after they have been provided for that, when conditions are similar in different tax havens, the decision may be influenced by tax considerations, with the aim of reducing the tax burden or of avoiding tax altogether.

12. As to the second category of reasons, which may originate in either licit or illicit activities, they may be motivated to some extent by tax considerations. Thus Tanzi notes in respect of the United States of America that, in comparison with the relatively small increase in the underground economy during the period 1970–1978, there is some indirect evidence indicating that after 1978 the underground economy grew more rapidly because of the sharp increase in marginal income-tax rates.[8]

13. In the above-mentioned observation, which clearly refers to income tax rates, there is a reason which is normally regarded in itself as a factor giving rise to the existence of tax havens, namely a level of taxation imposed by a country which its taxpayers consider high and which they therefore find it justified to reduce by diverting part of their income to countries with lower taxation.

14. It should be recognized that, as far as individuals are concerned, their decision to move into a tax haven may also be influenced in the event that the latter imposes no tax at all on inheritance.

15. In sum, any one of the reasons mentioned, or all of them together, which may take an infinite variety of forms, give rise to an inclination to abandon a certain type of politico-economic environment and look into places whose legal systems foster confidence among individuals, either at the present time or in the future, or where the tax burden is lighter.

16. In other words, whatever the purpose associated with them – tax, financial, corporate, etc. – tax havens do not necessarily arise spontaneously, but are more often the result of causes outside them; in reality, however, in the more orderly and stable political-economic climate which the entire world is experiencing in the current decade, and also because of the widespread trend to reduce income-tax rates, either for individuals or for companies, we believe that tax havens are gradually losing the understandable and limited degree of justification they might have had because of various reasons explained earlier.

IV. Characteristics and scope of tax havens

17. On the basis of what we have explained, it is not really acceptable to consider tax havens in terms of a single, general and exhaustive definition that would cover all the places which might, in some degree, be regarded as such. In each case, the actual and effective circumstances of their operation need to be examined.

18. There are tax havens where the operations carried out "have a bona fide commercial purpose", as Casanegra de Jantscher explains,[9] and after clarifying that such operations are generally not considered inherent in a tax haven, although they take place in it, the author explains the concept as follows:

> "Some industries located in tax shelters are engaged in the production of goods for the domestic or foreign market. There are royalties which the tax shelters pay for patents which are actually used in the country. There are foreign citizens or companies which work in tax-shelter countries and although they benefit from the low tax rates in the country, they do 'real' business within its borders."

Casanegra de Jantscher continues:

> "On the other hand, many of the businesses in tax shelters are fictitious, in that little or no business is carried on in the tax shelter itself. The merchandise bought and sold by subsidiaries in the tax shelters does not usually pass through the territory of the country but goes directly from the country of origin to the country of destination. The property of the consortia established in tax shelters is generally located thousands of kilometres away; and neither the concessionaire nor the beneficiary normally resides in the tax-shelter country."

19. It may be said that the hypothesis described in the paragraph we have just cited – generally made possible through the operation of subsidiary or holding companies formed ad hoc with their headquarters in the tax havens – is a typical feature of international economic life. While it is true that this modus operandi may arise from other causes – either purely commercial, or involving business strategy at the global level, or even political – it is equally true that what tends to predominate in them is the objective of reducing, or avoiding, the payment of taxes, either in the country of origin of the goods which are being marketed or of the services which are being provided, or in the country of destination of such goods or services, or perhaps in both.

20. To the extent that the latter is the objective sought, it "is generally achieved", Casanegra de Jantscher notes,[10] "either (1) by accumulating income in the tax-shelter country at low tax rates, and later withdrawing it and investing it elsewhere in accordance with the wishes of the investors; or (2) by artificially moving economic gains from high-tax countries to a tax-shelter country".

21. In this respect, we feel that it is relevant to note that the transnational corporations (as Hubert Hamaekers[11] notes, on the basis of data extracted from documentation produced by the Organisation for Economic Cooperation and Development, over 60 per cent of world trade is carried out within the network covered by these corporations) are the bodies which are most likely to operate in this manner, through utilization of the well-known mechanism of transfer pricing of the goods and services exchanged within the same economic group between the parent corporation and its subsidiaries or branches established in different countries.[12] The vulnerability of this mechanism is all the greater when the transfer prices do not correspond to the "arm's length" principle, i.e., those which, in respect of each transaction, could result from the operation of the market in relation to the goods or services being traded.

22. At all events, it should be made clear that it cannot possibly be maintained that tax havens are characterized only by the dichotomy described. A definition of tax havens, covering the characteristics they may have and the varying forms these characteristics may take, would be very broad. As evidence of this it may be mentioned that, in his book on this subject, one author lists 13 indicators which, according to him, are usually taken into consideration when identifying tax havens.[13]

23. A brief classification of tax havens, largely in terms of taxation, might be based on the following categories:[14]

(a) There is no tax on the income of companies or on dividends transferred abroad;

(b) The income-tax rates are reduced;

(c) Resident companies are exempt from the tax on income obtained abroad, so that it is especially important to distinguish it from income produced within the tax haven; this group could be subdivided into (i) countries which withhold tax at source on dividends that companies transfer abroad to persons who are not resident in the tax haven, and (ii) those which do not withhold tax on such dividends;

(d) Income tax is not applied to the profits of holding companies; in this case too a subdivision should be made into (i) countries which withhold tax at source on dividends paid by holding companies to their shareholders, and (ii) those which exempt from tax the dividends paid by holding companies to their shareholders and the interest paid out to creditors.

24. In our opinion, this type of classification of tax havens – drawn up solely from the standpoint of income tax, since this is the largest part of the tax burden as a whole – should not be viewed merely as an exercise in classification; rather, it should be seen as a guide for developing taxation policies which could be adopted by countries whose tax revenues are diminished by the abuse of such havens by their taxpayers, whatever their legal nature or tax status.

25. A comparison of legislation enacted over the last few decades has shown that many countries have sought to develop such legislation with a view to preventing the abuse of certain provisions of their tax legislation or to preventing fraud or tax evasion, in both cases by utilizing some sort of operational mechanism which takes into account the use of tax havens.[15] This situation, on the one hand, and, on the other, the new opportunities created by the current tendency towards economic integration among regional groups of countries – with the predictable result of harmonization in the various fields of taxation – raise questions about the fate in coming years of the different measures which might be taken to neutralize the distorting effects on taxation caused by tax havens.

V. Towards the neutralization of tax havens

26. It must be clearly understood that this goal of neutralization is based essentially on unavoidable taxation principles that must be respected at both the national and international levels. One of those principles, tax equity, is related to fairness; while another is efficiency – based mainly on economic considerations – which, if not taken into account, could compromise the obligation to achieve the best allocation of resources.[16]

27. Tax havens, as we have very briefly defined them, have inherent characteristics which in most cases tend to nullify application of the taxation principles mentioned above, thereby undermining the tax revenues of the countries which are the source of the capital whose yield escapes fair taxation.

28. The goal of universality in taxation of income is therefore seriously eroded by the utilization of tax havens to escape taxation; as a result the principle of equality is not fulfilled. It is fairly simple to achieve – as pointed out by Tanzi[17] – by using a tax haven which "may provide a

convenient tax address, and thus a convenient tax residence, for taxpayers who wished to reduce their tax liabilities".

29. Tanzi goes on to say that "this possibility will be particularly attractive for individual taxpayers from high-tax countries who would be subject to high marginal tax rates on reported incomes in their countries". This taxation manoeuvre of using the principle of an address or residence for taxation purposes – which may also be used by corporate entities – has as many possibilities as one might imagine, to such a degree that, as Tanzi concludes, "If the residence principle is fully applied, these earnings might end up escaping taxation almost completely".

30. In the final analysis, according to Tanzi,[18] "it is *not* the existence of the tax havens that tends to lower the world tax rate on capital income, but the tax treatment of incomes earned elsewhere and channelled to the tax havens". He goes on to say: "If source base taxation were widely used, tax havens would not have much of an effect on the tax rates unless the tax haven countries developed large production bases themselves. It is the combination of tax havens with the application of the residence principle to some incomes that has this depressing effect on the world rate of taxation on capital income."

31. Keeping in mind this phenomenon of the transfer of tax bases to the tax havens, Pagan and Wilkie[19] explain that the developed countries – which (as the authors themselves state) inevitably had high tax rates – when faced with the problem of preserving their tax base, have since the mid-1970s envisaged, amongst other measures, "ways to attack the growing use of tax havens", such as the provisions for counteracting both tax avoidance and tax evasion adopted in the United States, Canada, Germany, the United Kingdom, Belgium and France. Some of those provisions single out for special treatment any operations carried out via tax havens or by enterprises established in tax havens, which are sometimes named in the relevant legislation.

VI. Exchange of information between taxation authorities

32. The effort to maintain the levels of tax revenue necessary for the provision of public services – which the abuse of tax havens, as we have shown, often tends to defeat – combined with the thorny problem of combating tax evasion at the international level – frequently encouraged by tax havens – have led the affected countries to make use of a special tool: the exchange of information between national taxation authorities with a view to uncovering evidence of tax evasion by taxpayers resident in one country who failed to declare in that country income or assets originating in the other country.

33. Virtually all examples of existing bilateral conventions for avoiding or reducing international double taxation, including that of the Andean Pact, despite having been clearly inspired by the principle of the source – and, by extension, agreements based on those conventions – contain clauses concerning the exchange of information between taxation authorities. There are also agreements in force whose sole aim is to ensure that that exchange takes place.

34. The European Union, for its part, as early as 1977 – when it was known as the European Economic Community – adopted a directive providing for mutual assistance by the competent authorities of the member States in the area of direct taxation,[20] the provisions of which deal with so-called indirect as well as direct taxes, which are listed by the directive, for each signatory country. The multilateral treaty aimed at avoiding double taxation on income ratified by the five Scandinavian countries (Denmark, Finland, Iceland, Norway and Sweden), in force since 1 January 1990, also contains provisions in this area.

35. In any case, it must be recognized that the exchange of information between the taxation authorities of countries has been fraught with obstacles; in summing up the current situation in the area, Alberto Giovannini states that there has been a "remarkable absence of cooperation among tax authorities in industrialized countries, mirrored by strategic use of bank secrecy laws to attract foreig.. tax evaders".[21]

36. A rigorously objective analysis of the exchange of information which we are discussing leads to the conclusion that it is a suitable mechanism for achieving its intended objectives. The difficulties which may arise in that context are not inherent and are not in themselves barriers to exchange. On the contrary, those difficulties are unrelated, exogenous, mostly political in nature; however, we do not support using sovereignty as an argument for opposing progress in the use of such exchanges.

37. We do feel, on the other hand, that it is quite legitimate to be concerned about the need to ensure confidentiality, discretion or secrecy when processing information in the exchange mentioned above. All possible safeguards must be put into place to avoid betraying that trust during exchanges of information. It is not, however, acceptable to refuse any exchange of tax information whatsoever, on the grounds that confidentiality could be violated.

38. In short: what is basically required to guarantee the successful exchange of information between taxation authorities is for the countries themselves to clearly show the political will to do so. Once that has been achieved, such

exchanges must be coupled – as they are to a large extent in the European Union directive mentioned above – with all the guarantees necessary to make them a careful, responsible, serious task shared by the taxation authorities of the various countries. Thus, it is necessary to ensure that such exchanges are in fact linked to the investigation of manoeuvres or behaviours which are presumed and indeed proven to be attempts to avoid taxation. The existence of such a link will be reason enough for justifying such exchanges. Were that not the case, there would be no purpose in or justification for exchanging information.

Notes

[1] Thus, we wish to dissociate ourselves from past descriptions of tax havens. A brief reference to them appears in the introduction to L. W. Watson's dissertation of 20 November 1985 presented at the seminar on international trade held in Sao Paulo, Brazil, with references to the works of R. A. Gordon, *Tax havens and their use by United States taxpayers*, published in 1981, and C. Doggart, *Tax havens and their use*, published in 1979.

[2] Alain Vernay, *Los paraísos fiscales* (Barcelona, Plaza y Janés, S. A., 1970), p. 13.

[3] Op. cit., p. 253.

[4] Gordon, op. cit., in footnote 1.

[5] Milka Casanegra de Jantscher,"¿Qué son los refugios tributarios?" originally published as "Finanzas y desarrollo", vol. 13, No. 1, and reproduced in the *Boletín de la DGI*, Buenos Aires, December 1976, p. 676.

[6] Executive Secretariat of CIAT, "Problemática general de los paraísos tributarios", a paper presented during the course on tax administration and international taxation, given in Ajijic, Mexico, 17–28 March 1980.

[7] *The Underground Economy in the United States and Abroad* (Lexington, Massachusetts, Lexington Books, D. C. Heath and Company, 1982), by Vito Tanzi, is a good reference source on the subject.

[8] Vito Tanzi, op. cit. in footnote 7, p. 90.

In the conclusions of a later work ("The underground economy in the United States: annual estimates for 1930-1980", International Monetary Fund, Staff Papers, June 1983), the same author puts forward the view, on the basis of applying a methodology explained in the book that in 1980 the informal economy in the United States accounted for a share of between 4.5 per cent and 6.1 per cent of the gross domestic product.

[9] Op. cit. in footnote 5, p. 676.

[10] Op. cit. in footnote 5, p. 677.

[11] Hubert Hamaekers, "Transfer pricing: history; state of the art; perspectives" (Amsterdam, International Bureau of Fiscal Documentation, mimeo, May 1997).

[12] In various parts of their paper "Transfer pricing strategy in a global economy" (Amsterdam, International Bureau of Fiscal Documentation, 1993), Jill C. Pagan and J. Scott Wilkie link the subject of transfer prices with the existence of tax havens and explain the legislative measures adopted by various countries to prevent manoeuvres which they believe may jeopardize their tax revenue.

Vito Tanzi also makes a perceptive analysis of the interrelationship between transnational corporations and transfer prices – a subject which has been given extensive and in-depth treatment in recent years – in "Globalization, tax competition and the future of tax systems", Washington, D.C., IMF Working Paper, December 1996, under the sub-heading "Taxes on enterprise income".

[13] The book by Hoyt L. Barber (*Tax Havens: How to Bank, Invest and Do Business – Offshore and Tax Free* (McGraw-Hill, 1993)) is a typical example of our comment in the first paragraph of this paper regarding persons who confine themselves to describing tax havens (the author identifies 45 places as tax havens) and using this information to engage in a kind of marketing.

Of the 13 indicators mentioned above (listed on p. 8 of the book) 12 are as follows: tax structure; political and economic stability; exchange control; treaties signed in tax matters; government attitude; modern laws on commercial companies; facility of procedures for the formation of companies and competitive tariffs in that respect; facility of communications and transport; professional and banking services; secrecy and confidentiality; incentives and opportunities for investment; and location of the tax haven. Barber also mentions the application of English common law and, explaining the reason for this reference on p. 12 of his book, makes his mercenary intention even clearer in saying: "English common law has a long tradition and case law history to draw upon. It is definitely the preferred choice of legal systems. Confidentiality in financial transactions is customary practice and required under common law. Americans will find this attitude refreshing."

[14] See "*Paraísos fiscales: Su origin. Su justificación. ¿Su próximo exterminio?*"by Teresa Gómez and Daniel Malvestiti, in *Periódico Económico Tributario* (Buenos Aires, La Ley, year II, No. 46, 29 September 1993), p. 2.

We feel that it is beyond the scope of this paper to consider, and therefore will not take up, the "legal modalities of operation in tax havens" described in paragraph 6 of op. cit. in footnote 6.

[15] That tendency has been observed not only at the national level, but also, as pointed out by Ben Terra and Peter Wattel (*European Tax Law*, Deventer, the Netherlands, Kluwer Law and Taxation Publishers, 1993, pp. 83, 186 and 231), at the supranational level within the current European Union, where various measures and draft directives in the taxation field have been aimed at facilitating member States' efforts to counteract the negative effects on their taxation revenues that might result when their taxpayers try to avail themselves of the tax advantages offered by tax havens.

[16] Ben Terra and Peter Wattel (op. cit. in footnote 15, p. 243) maintain that: "International tax avoidance and evasion lead to losses for national budgets, violate the principle of fair taxation (honest taxpayers will have to pay more) and therefore cause distortions in the conditions of competition and prevent optimal allocation of capital."

[17] Vito Tanzi, (*Taxation in an Integrating World*, Washington, D.C., The Brookings Institution, 1995), p. 78.

[18] Op. cit. in footnote 17, pp. 80/81.

[19] Op. cit. in footnote 12, pp. 17/18.

The authors' explanation, on pp. 233/234, of the various factors which are sources of concern when studying in depth the transfer prices adopted by transnational corporations obviously includes, among those factors, the different ways tax havens are used.

[20] The relevant text is reproduced in its entirety beginning on p. 279 of the op. cit. in footnote 15.

This question of the exchange of information – as Tanzi says on p. 82 of the op. cit. in footnote 17 – "has acquired, and will continue to acquire, fundamental and growing importance in an integrating world".

[21] Vito Tanzi, op. cit. in footnote 17, p. 82.

Tanzi himself, in the same work, when making his final observations (p. 136), extends this lack of cooperation to the tax havens: these, he says, have no interest in sharing information with the countries from which they attract capital.

Furthermore, according to Tanzi, the various limitations surrounding the exchange of information, including between countries which are not tax havens, suggest that it would be unrealistic to suppose that exchange of information could be the one, simple solution to the problem created by lack of cooperation and by the attitude of the tax havens.

Report on informal consultations of members of the Steering Committee for the Eighth Meeting of the Group of Experts

A meeting of members of the Steering Committee for the Eighth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters was held at Geneva on 11 and 12 December 1997. In attendance were four members of the Committee, Mr. William W. Alder, Mr. Mordecai Feinberg, Mr. Antonio Figueroa and Mr. Daniel Lüthi (11 December only), and one observer, Mr. Ken Allen of Australia. Also in attendance were Mr. Abdel Hamid Bouab and Mr. Suresh Shende of the United Nations Secretariat, and three consultants, Mr. Alfredo Atchabahian, Mr. Sheldon Cohen and Mr. Lawrence Lokken.

Because the members of the Steering Committee in attendance did not comprise a quorum, those present decided to proceed with an informal discussion. They designated Mr. Figueroa to serve as moderator of the informal meeting. He noted that each of the principal subjects on the agenda for the meeting – tax havens and related issues of information exchange, innovative financial instruments, transfer pricing, and revisions of the United Nations Model Double Taxation Convention and the manual for negotiation of bilateral tax treaties between developed and developing countries – was of great importance in the real world of treaty negotiations. However, he noted that each of these topics could occupy a full week of discussion, and the Steering Committee thus had to organize the meeting carefully in order to guide the discussion most fruitfully.

Those participating in the informal consultations generally agreed that tax havens and related issues of information exchange constituted a subject that could be productively discussed at the meeting of the Group of Experts. It was observed that the substantial benefits that developing and transitional economy countries could realize from information exchanges were not universally appreciated. It was also suggested that the topic should include the matter of harmful tax competition between countries, which had been the subject of an OECD study. One member urged that the Group express support for the policies of OECD and the European Union discouraging countries from operating as tax havens. It was also suggested that although the Group's discussion of that issue would probably raise many ideas of individual members on the topic, the Group was not likely to reach any consensus on the matter.

It was agreed that because the subject of innovative financial instruments was highly specialized and in the process of rapid development, the Group's consideration of that subject should continue the introduction of the topic, begun at the seventh meeting of the Group, and should lay the ground for future efforts of the Group. No conclusions on the subject should be expected from the discussion at that meeting. Also, the Group's consideration should take into account the work of OECD on financial instruments.

The members of the informal meeting also agreed that in the discussion of transfer pricing, members of the Group of Experts from developing and transitional economy countries should be encouraged to identify problems that they had with the OECD guidelines. For example, countries with limited markets might have special problems with the arm's length method because of the scarcity of comparative price data. Those problems might be exacerbated in countries whose informal sectors accounted for substantial portions of economic output. Also, tax administrators in smaller countries might find it difficult to muster the resources needed to do the complex economic analyses often required to apply the guidelines. For those reasons, developing and transitional economy countries might have to resort to more rough-and-ready methods of transfer pricing, realizing that the results of those methods might sometimes conflict with those obtained by the tax administrations of countries employing more sophisticated analyses. Technical assistance might be needed to meet that challenge, and the United Nations should be requested to provide the necessary training and technical support.

The Group's discussion of the issue might also include transfer pricing for raw materials, a topic that might not be developed as completely in the OECD guidelines as many countries might wish. Cost sharing, advance pricing agreements and arbitration were also mentioned as possible topics of discussion. It was noted that arbitration procedures under the European Union arbitration agreement and the United States-Germany Income Tax Treaty had not yet been utilized, and that a member of the Group from an EU country might be encouraged to discuss the prospects for future utilization of the procedures.

It was observed that the job of revising the United Nations Model Double Taxation Convention Between Developed and Developing Countries was a very large undertaking, raising many difficult issues. It was agreed that that effort could best be begun by considering the appropriateness for the United Nations Model Convention of the updates to the OECD Model Convention adopted since

1980. The Group of Experts might also consider a list of reservations to the OECD Model Convention that had been developed through meetings held by OECD with several non-member countries, as well as the treaty practices of various countries that deviated from both the United Nations and the OECD Model Conventions.

After extensive discussion of how the Group of Experts might best approach the job of updating the United Nations Model Convention, it was agreed that the following should be recommended to the Group: in the eighth meeting, the Group would identify the OECD updates that were generally acceptable to the Group and those that were not. The latter would be referred to a focus group consisting of five Group members. The focus group would work on the updating project throughout 1998 by correspondence, holding at least two on-line conferences and one meeting in person. The results of that effort would be taken up at the ninth meeting of the Group of Experts, to be held in mid-1999.

The updating of the manual for negotiation of bilateral tax treaties between developed and developing countries would await completion of the revision of the United Nations Model Convention and consultations with those who had found the old manual to be useful.

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