The government collects VAT of $30 over the course of the supply chain which is borne by the end consumer.

Example 2-2

Company C established in the PRC is a Small Scale VAT taxpayer, whose outputs are subject to 3% VAT. it sells machine components to Company D for $100 plus VAT of 3%, total $103. Company D is a General VAT taxpayer subject to 17% VAT. Company D sells finished goods at $200 plus VAT of 17%, total $234. Company D will remit VAT of $34 to the government as it is unable to claim a credit for the $3 charged by the Small Scale VAT taxpayer, thus creating VAT leakage in the supply chain. The leaked VAT becomes a cost to Company D.

Although a VAT system allows a government a constant source of revenue which is easier for it to police and ensure compliance, there have been concerns voiced about the administrative and compliance costs of operating a VAT system. Administrative costs refer to the costs incurred by a government to employ people and infrastructure, including hardware and software to administer a VAT system. Compliance costs refer to the cost a business must incur to be in VAT compliance. This may be the cost of employing additional staff or professional advisors or the time spent by the proprietors of smaller enterprises to maintain their VAT books and records, which may impact on the time they can commit to doing actual business.

Accordingly, some jurisdictions prefer to impose a single stage levy at the point of final sale, often referred to as Sales Tax, as discussed below.

In the international business environment, there are supplies of goods and services across borders, where different tax regimes in each jurisdiction would prohibit a credit for VAT imposed in another jurisdiction. This would be a hindrance to international trade.

The question is "who has the right to tax, the jurisdiction of origin or the jurisdiction of arrival?". The general theory is that as VAT is a tax on final consumption, the jurisdiction of destination should have the VAT taxing rights.

Accordingly, most VAT regimes zero rate the export of goods and services, which means that there is no VAT on the export of goods and services. In addition, the taxpayer is still able to

claim a credit for input VAT incurred on its purchases as tax refund on export.

VAT is generally collected in the jurisdiction of destination according to the prevailing rate in that jurisdiction. For example, the PRC imposes VAT on imports and Australia imposes GST on imports. If the goods or services, once imported, are used for production whereby value is added, a credit for the VAT charged on import will be available.

The destination principle provides a level playing field for all businesses competing in a particular jurisdiction as they are not hampered by a home country VAT which could price them out of a particular market where the VAT in the destination jurisdiction is lower. In some instances, there would even be double taxation.

(b) Sales Tax

As opposed to being collected at the various stages of value added, Sales Tax is a final tax collected at the final point of sale and collected from the businesses that make the final sale. Thus, the sellers act as the collection agent on behalf of the government.

Although Sales Tax is generally easier to administer, it is open to non-compliance. For example, sales tax is a final tax on the sale of goods, with no credit system in place. Purchasers are thus not incentivized to obtain valid invoices to obtain a credit for input taxes and thus prices are potentially subject to manipulation such that revenues raised from sales tax may be lowered.

Furthermore, the tax base may be reduced, resulting in lower tax collections, as sales tax is generally imposed on the sales of goods rather than the supply of services. In some jurisdictions, a separate indirect tax may be imposed on the supply of services, thus increasing administration and compliance costs for the government and businesses.

For example, in the PRC, prior to the imposition of VAT on the supply of intangible assets, real estate and services, which commenced as a pilot program in Shanghai in 2012 and was fully implemented in May 2016, a non-creditable Business Tax ("**BT**") was applied to these supplies. As a consequence, many enterprises were filing both VAT and BT returns, which has added to their compliance burden, and consumers of these supplies were subject to the cascading effect of BT, thus

increasing the cost of these supplies, as the BT passed down the supply chain with no credits available.

The introduction of an overriding VAT system consequently brought the PRC further into line with internationally accepted principles.

(c) Capital Duty

Capital Duty is a tax charged on the share capital of a company. It was abolished in Hong Kong with effect from 1 June 2012 but continues to be levied in other jurisdictions such that it is still a consideration in international tax planning.

(d) Stamp Duty

Stamp Duty is generally a tax imposed on documents for the sale, lease or transfer of immovable property or the sale of shares. It is, in fact, a tax on certain transactions. As the financial impact of stamp duty can be considerable, it is an important aspect of international tax planning.

(e) Customs and Excise Duties

Customs Duties are taxes imposed on the import of goods into a jurisdiction, being payable at the point of entry on the assessed value of the goods being imported. Hong Kong, being a free port, does not impose customs duty on the importation of goods.

Excise Duty is an inland tax imposed on the production or sale of specified goods regardless of whether they are imported or produced locally. Excise Duties are generally imposed on alcohol, tobacco and fuels so they could be considered as a duty intended to influence behavior. Hong Kong imposes Excise Duty on alcohol, tobacco, methyl alcohol and hydrocarbon oil.

(f) Withholding Tax

Withholding Tax, in the context of international taxation, is a tax deducted at source by the jurisdiction wherein the income arises. The recipient of the income is the taxpayer with the payor being the agent to collect and pay the tax to the local tax authorities. The incidence of Withholding Tax and the reduction of the amount of Withholding Tax payable is one of the most important considerations in international tax planning.

Typically, the types of income subject to Withholding Tax are dividends, interest and royalties.

Withholding Tax also refers to the deduction of income tax by an employer from the remuneration of employees, often referred to as Pay As You Earn or Pay as You Go. For example, jurisdictions such as the PRC, the UK and Australia adopt a withholding tax system for the collection of individual income tax.

¶2-3000 Tax Policy Formulation

Tax policy formulation is an extremely complicated process as consideration has to be given to the impact, costs and benefits of a tax policy proposal to the society as a whole and to specific sectors, such as industries, businesses and individuals.

Depending on the goals and ideals of each government, different governments will formulate different tax policies to address both long term and short term social and economic issues facing each country. One of the Hong Kong's long term priorities is to encourage investments and to remain internationally competitive and thus, the Hong Kong government has always adopted a simple tax system. However, with an aging population which would inevitably produce an increased financial burden for the government, the need to broaden the city's tax base has been on the government's agenda for many years. An example of how the government utilizes tax policy to address short term issues is the recently proposed vacancy tax targeted at property developers to cool the ever-rising property prices in Hong Kong.

In the PRC, there was considerable policy debate on revising the Individual Income Tax Law to reduce taxes on the lower wage earning population and to change the tax residency rules to bring the PRC in line with international practices. The reforms were adopted by the Standing Committee of the National People's Congress ("**NPCSC**") on 31 August 2018 and promulgated through Presidential Decree No. 9, fully taking effect from 1 January 2019.

It is necessary to ensure that proposed changes to tax legislation do not produce anomalies when applied alongside existing tax legislation resulting in unanticipated loopholes or contradictions. For example, the proposal for the introduction of a GST in Hong Kong in order to broaden the tax base has been widely discussed and debated over the years. It has been argued that because a GST would likely decrease sales and adversely affect many businesses in the city, the proposal contradicts Hong Kong's goal to remain competitive in the international arena. If a GST were to be introduced, the government

must also consider formulating an exemption policy for the underprivileged population and a GST refund mechanism for tourists that would not create loopholes or add excessive administrative costs and burden on the government.

Accordingly, the drafting of tax legislation is very important in ensuring that the law achieves its defined effect and governments employ specialist law draftsmen to undertake this work.

Tax policy, in most developed jurisdictions, is formulated during the Budget process, whereby proposals for new or revised tax legislation are presented to the senior government officials with responsibility for fiscal affairs.

In Hong Kong, the Executive Council, the Legislative Council and the Tax Policy Unit are responsible for formulating and reviewing tax policies with input from the Inland Revenue Department ("**IRD**") and the Financial Services and Treasury Bureau. In the PRC, the National People's Congress ("**NPC**"), the State Council, the Ministry of Finance ("**MOF**") and the State Taxation Administration ("**STA**") all have the authority to formulate tax policy.

International organizations also assume an active role in advising countries on their tax policies. The OECD provides tax policy frameworks to countries for legislation designed to achieve specific goals, for example, investment in a jurisdiction. In December 2017, the International Monetary Fund ("**IMF**") provided the PRC with a technical assistance report which discusses the impact of tax policy on employment in the PRC, specifically covering the taxation of employed labor and small and medium-sized enterprises.[11]

¶2-4000 Consultation

Consultation is considered to be an important element of tax policy formulation. Consultation can be public, that is, releasing a draft of the proposed legislation to the public to elicit responses to the proposal, or targeted.

Participants in targeted consultation are generally selected because they have expertise in a particular area, for example, taxation, law and accounting. For instance, in Hong Kong, the Joint Liaison

11 International Monetary Fund. Fiscal Affairs Dept. (28 Mar 2018), *The People's Republic China: Tax Policy and Employment Creation*, International Monetary Fund, Washington, DC https://www.imf.org/en/Publications/CR/Issues/2018/03/28/Peoples-Republic-of-China-Tax-Policy-and-Employment-Creation-45765 Accessed 30 June 2018.

Committee on Taxation ("**JLCT**"), whose membership is made up of professional bodies, including the Taxation Institute of Hong Kong, the Law Society of Hong Kong, and the Hong Kong Institute of Certified Public Accountants, together with Chambers of Commerce, is regularly consulted with regard to changes in tax legislation. In particular, the Hong Kong government has continuously sought these organizations' views on how Hong Kong's tax base can and should be broadened.

Other participants in targeted consultation may be certain industry groups that will be specifically affected by the proposed legislation. For example, if proposed legislation is specifically targeted at the asset management business in Hong Kong, input will be sought from industry groups, such as the Association of Independent Asset Managers, Hong Kong.

Occasionally, consultation may be confidential, in that participants are required to sign a confidentiality agreement. Such consultation usually takes place when proposed tax legislation is controversial.

Overall, the purpose of consultation is to clarify the policy intent of the proposed / revised legislation, to provide input into the implementation of the policy with a view to minimizing the administrative and compliance burden on the taxpayer and to ensure that the proposed legislation does not produce unintended results.

¶2-5000 Gazetting

The Government of the Hong Kong Special Administrative Region Gazette ("**the Gazette**") is an official channel for promulgating information (e.g. legislation, public notices and appointments) which is required for statutory or other reasons to be made public.

Proposed changes in tax legislation are presented to the government in the form of a bill. In Hong Kong, the bill is presented to the Executive Council for approval. Once approved, the bill will be published in the Gazette and presented to the Legislative Council for reading. Each bill must have three readings and once the bill has been passed, it will be handed to the Chief Executive of Hong Kong to promulgate the law, at which point the law will be published in the Gazette.

¶2-6000 Implementation by Legislation

In Hong Kong, once the legislation has been enacted by the Legislative Council through publication in the Gazette, the Ordinance commences with immediate effect, or, if provision is made for it to commence on

countries will consider numerous factors, such as the place where work is performed, the location of the entity bearing the costs of employment, the location of the entity that has authority to instruct the individual or that bears the risk and responsibility for the work of the individual, the location where the contract of employment is negotiated, concluded and enforceable, and the place in which the individual's remuneration is paid. Normally, the location where work is performed is the same as the residence of one's employer, and thus the source of employment income would coincide with the employer's country of residence. However, given the mobility of individuals coupled with the international presence of many businesses today, there may be multiple locations from which individuals source their employment income. For instance, if an individual is sent abroad by his/her employer to work for a certain period of time, the source of his/her employment income would be both his/her home country where he/she ordinarily works as well as the country in which he/she has spent time such that he/she may be taxable in both countries. However, if the individual's duration of employment in the foreign country is short, most countries do not exercise their taxing right under their domestic laws or DTAs.

As paragraph 2 of Article 15 of the OECD Model Convention provides for an exemption from tax of employment income in the source country if certain conditions are met, to prevent abuse of this exemption, the OECD has outlined the factors below which are relevant to determining the true employer, and thus the locality of the employment income:

(a) who has the authority to instruct the individual regarding the manner in which the work has to be performed;

(b) who controls and has responsibility for the place at which the work is performed;

(c) is the remuneration of the individual directly charged by the formal employer to the enterprise to which the services are provided;

(d) who puts the tools and materials necessary for the work at the individual's disposal;

(e) who determines the number and qualifications of the individuals performing the work;

(f) who has the right to select the individual who will perform the work and to terminate the contractual arrangements entered into with that individual for that purpose;

(g) who has the right to impose disciplinary sanctions related to the work of that individual;

(h) who determines the holidays and work schedule of that individual.[10]

In Hong Kong, under Section 8(1) of the IRO, income from any office, employment of profit or pension is subject to Salaries Tax if it arises in or is derived from Hong Kong, i.e. if it is sourced in Hong Kong. The IRD has set out its views on how the source of employment income is determined in DIPN 10 (Revised). Although the IRD recognises in the DIPN that the source of employment income should be determined using a "totality of facts" approach as outlined in the decision *Commissioner of Inland Revenue v George Andrew Goepfert* (1989) 1 HKRC ¶90-003[11], it has maintained its position that it will place emphasis on three specific factors:

(a) the place where the contract of employment was negotiated and entered into, and is enforceable;

(b) the residence of the employer; and

(c) the place where remuneration is paid.

In addition, the IRD is of the view that if the employer is resident in Hong Kong, it is highly likely that the employment has a source in Hong Kong, even though the contract may have been negotiated and concluded outside Hong Kong. In contrast, the fact that remuneration is paid outside Hong Kong where the employer is resident in Hong Kong would also not likely cause the employment's locality to be offshore in the absence of other relevant factors. Once the source of an employment is determined to be in Hong Kong, all income from that employment would be caught by Section 8(1) of the IRO and subject to Hong Kong Salaries Tax. If, on the other hand, the source of an employment is determined to be offshore, then only income arising from services rendered in Hong Kong, calculated on a time apportionment basis, would be subject to Salaries Tax. However, Section 8(1B) of the IRO exempts employment income sourced in Hong Kong from Salaries Tax where services rendered in Hong Kong during visits do not exceed a total of 60 days in a year of assessment[12].

10 OECD (2017), *Model Tax Convention on Income and Capital: Condensed Version 2017*, OECD Publishing, Paris, http://dx.doi.org/10.1787/mtc_cond-2017-en, para 8.14 Commentary on Article 15.

11 [1987] HKLR 888.

12 A DTA to which Hong Kong is party normally extends the period of stay during which services are rendered tax free.

Economically the result is as follows:

Income:	$100
Hong Kong Salaries Tax (assume standard rate):	(15)
UK Income Tax (assume effective rate 32%):	(32)
Net After Tax Income:	$53
Effective Tax Rate:	47%

Example 6-3

Company C, incorporated in the UK, whose business is the design and fitting-out of shopping malls, is contracted by a company in the PRC to design and fit out a shopping mall in Shanghai. The contract provides for a fixed fee to be paid to Company C for the services and specifies that the duration of the project is 12 months.

Company C sends a team of 20 of its staff to the PRC to provide the design and fit out of the mall and, apart from staff making occasional visits back to the UK to take instruction, the team are present in the PRC for the whole 12-month period.

As the PRC imposes the charge to taxation on non-residents with a source of income in the PRC, that is the fee paid for performing services in the PRC, the fee paid to Company C will be subject to CIT in the PRC. Conversely, as the UK imposes taxation by reference to residence, the same fee will also be subject to corporate tax in the UK.

Economically the result is as follows:

Income:	$100
PRC Corporate Income Tax:	(25)
UK Corporate Tax:	(20)
Net After Tax Income:	$55
Effective Tax Rate:	45%

From the above examples, it should be clear that the incidence of economic or international juridical double taxation is a huge disincentive to conduct international business, thus hindering the flow of people, goods, capital and services across jurisdictional borders.

Indeed, in the words of the OECD with regard to international juridical double taxation:

> "Its harmful effects on the exchange of goods and services and the movement of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries"[3]

Accordingly, the following sections in this Chapter will examine in detail the remedies available to taxpayers to eliminate or minimize economic and international juridical double taxation.

¶6-2000 Methods of Double Taxation Relief

There are generally three methods by which countries provide taxpayers with relief from juridical double taxation: (i) the deduction method; (ii) the exemption method; and (iii) the credit method. Domestic tax legislation of home countries (i.e. countries which impose taxes based on residence) may provide for one or more of these methods, whereas the latter two methods are generally the agreed ways of elimination of double taxation between two jurisdictions that have concluded a DTA. Each of these methods are explained below, followed by computational examples illustrating how each method works quantitatively. Special issues arising from methods of double taxation relief are then discussed.

¶6-2100 Deduction of Overseas Taxes Paid as an Expense

Domestic tax law typically allows business expenses to be deducted from revenues in calculating an entity's taxable income. Therefore, where a home country taxes its residents on offshore sourced income that has already been taxed in the source country, the home country would allow its resident taxpayer to deduct the overseas taxes paid in the source country as a business expense in its home country's tax return. However, this can only provide a partial relief of double taxation as the overseas tax paid cannot be fully set off against the tax imposed by the home country, but rather can only be used to reduce taxable income in the home country such that the relief is limited to the domestic tax rate of the home country multiplied by the amount of the overseas tax.

3 Ibid.

As can be seen in the computational examples in section ¶6-2400 below, the deduction method provides a lower effective tax rate for a company than if no relief was allowed, but it is the least beneficial method for the taxpayer among the three methods commonly found in various countries' tax systems. The only situation in which the deduction method would provide the taxpayer with a higher benefit than the other methods is when the taxpayer has accumulated losses, especially if the foreign tax credits cannot be carried back or carried forward to offset taxes payable in previous or future years. For example, under the deduction method, the home country tax loss for the taxpayer would be increased from the availability of the tax deduction of the overseas tax paid. However, the overseas tax paid would not be included in the taxpayer's home country tax computation under the exemption method nor would it be available for offset against any taxes payable in the home country as the taxpayer does not have any taxes payable on tax losses.

¶6-2200 Exemption or Exclusion of Income Taxed in Other Jurisdictions

Where home countries allow taxpayers to exclude income already taxed in the foreign source country in their home country's tax return, this is called the exemption method. Because foreign income is only taxed once in the source country and not again in the home country, the exemption method provides full relief from double taxation for the taxpayer. Countries which adopt the territorial system of taxation typically use the exemption method. No taxes are collected on the foreign income by the home country and thus it falls outside of the home country's tax base, that is, the total amount of assets or income over which a country has taxing rights.

Although beneficial to the taxpayer, the exemption method encourages taxpayers to move capital to jurisdictions with low tax rates and therefore, home countries are unable to effectively protect their tax base. To counteract this effect, countries may impose restrictions on the use of the exemption method, such as only allowing it on foreign dividend income where the taxpayer actively participates in the management of the foreign company. Another variation of the exemption method is exemption with progression, which is further discussed in subsection ¶6-5300 below.

In terms of complexity, the exemption method is easier to administer than the credit method because it is not necessary to determine the nature and amount of foreign taxes paid – foreign income is simply excluded and not accounted for in the home country. The

administrative burden increases as home countries impose more restrictions on its use since additional steps are needed to determine whether taxpayers are eligible to apply the exemption method.

¶6-2300 Foreign Tax Credit

Countries which adopt a residence based worldwide system of taxation typically allow their taxpayers to credit foreign taxes paid against taxes payable in their home country. Therefore, this credit method also provides taxpayers with full relief from double taxation. However, the amount of credit available is generally limited by the amount of tax levied by the home country. For example, if the foreign country's tax rate is higher than that of the home country, the maximum foreign tax credit taxpayers can claim in their home country would be the home country's tax rate multiplied by the foreign income. Taxpayers would thus suffer the excess tax paid in the foreign country. Such limitation is imposed so that the home country would not have to subsidize the taxpayers' investment in the foreign country.

Because foreign income is included in the home country's tax return and remains in the home country's tax net, the home country's tax base is protected. However, the credit method increases the administrative burden for the home country as it must determine which types of taxes are creditable and implement a process to verify the amount of foreign tax paid. The types of foreign taxes that are creditable are usually in the same nature as the taxes levied on the same type of income in the home country. Creditable taxes are further discussed in subsection ¶6-5200 below.

Another problem with the credit method is that taxpayers tend not to repatriate foreign profits back to the home country if the home country's tax rate is comparatively high. This is because additional tax equal to the difference between the domestic tax rate and the foreign tax rate would have to be paid on such profits. If the home country does not impose taxes on deemed repatriations, such as Controlled Foreign Company ("CFC") rules (which will be discussed in Chapter 14), indefinite deferrals of foreign profits would have the same effect on its tax base as if the home country allows its taxpayers to use the exemption method.

¶6-2400 Typical Calculation of Each Method

Typical calculations of the deduction, exemption and credit methods are illustrated in the following example. A calculation which does

not provide for any double tax relief is also included such that the effects of each method on a taxpayer's position can be analysed and compared.

Example 6-4

Company X is a tax resident in Country A, where the corporate income tax rate is 20%. It operates a branch in Country B, where the branch income is subject to corporate income tax rate at 30%. Company X derives $1,000 of profits in Country A and its branch derives $500 of profits in Country B.

Deduction Method

Country A Profits [A]	$1,000
Country B Branch Profits [B]	500
Country B Tax on Branch Profits [B] x 30% = [C]	150
Profits before Country A Tax [A] + [B] – [C] = [D]	1,350
Country A Tax [D] x 20% = [E]	270
Total Tax Paid [C] + [E] = [F]	$420
Effective Tax Rate [F] / ([A] + [B])	28%

Exemption Method

Country A Profits [A]	$1,000
Country B Branch Profits [B]	500
Country B Tax on Branch Profits [B] x 30% = [C]	150
Country A Tax [A] x 20% = [D]	200
Total Tax Paid [C] + [D] = [E]	$350
Effective Tax Rate [E] / ([A] + [B])	23.3%

Credit Method

Country A Profits [A]	$1,000
Country B Branch Profits [B]	500
Country B Tax on Branch Profits [B] x 30% = [C]	150
Country A Tax ([A] + [B]) x 20% = [D]	300
Credit for Country B Tax [B] x 20% = [E] (credit capped at Country A's corporate income tax rate)	(100)
Total Tax Paid [C] + [D] + [E] = [F]	$350
Effective Tax Rate [F] / ([A] + [B])	23.3%

No Relief

Country A Profits [A]	$1,000
Country B Branch Profits [B]	500
Country B Tax on Branch Profits [B] x 30% = [C]	150
Country A Tax on Total Profits ([A] + [B]) x 20% = [D]	300
Total Tax Paid [C] + [D] = [F]	$450
Effective Tax Rate [F] / ([A] + [B])	30%

As shown in the above calculations, all three methods produce a lower effective tax rate than if no relief was available, but the exemption and credit methods produce the lowest effective tax rates because full/partial relief is given for foreign taxes paid. In fact, the OECD recommends that countries adopt the exemption and credit methods for providing relief of double taxation. But because the deduction method can be beneficial for taxpayers who have accumulated losses, countries may allow taxpayers to elect whether to use the deduction method or the exemption/credit method, either on a one-time basis at incorporation or in the year during which a change of tax law becomes effective or on an annual basis.

In practice, however, calculations are not as simple as the above example, mainly because countries use a combination of credit and exemption methods for different types of income and impose various restrictions on the use of each method. Specific rules for the use of the different tax relief methods are often in place to combat abuse of the methods for tax avoidance purposes and to preserve a country's tax base. Issues that arise in computations of tax relief from variations, restrictions and/or combinations of the different methods are discussed in the next section.

¶6-3000 Double Taxation Relief Computational Issues

¶6-3100 Variations of Double Taxation Relief Methods

The variations and limitations that countries place on double tax relief methods can be broadly categorized as follows:

(a) Hybrid systems – This is where the exemption method is used for particular types of income (e.g. active income from foreign

branches or dividends from operating foreign subsidiaries) while the credit method is used for the remaining types of income (e.g. passive income such as royalties, interest on foreign loans or dividends from foreign investment holding companies), and hence issues regarding characterization of income arise.

(b) Limits placed on the amount of foreign tax credits that can be claimed – These limits may be in relation to one or more of the following factors:

(i) The home country's tax rate in relation to the source country's tax rate – As discussed in subsection ¶6-2300 above, countries typically cap the foreign tax credit at the domestic tax rate at which the foreign income would have been taxed in the home country.

(ii) Nature of foreign taxes paid – Some countries may only allow foreign tax credits against withholding taxes paid but not against foreign corporate income taxes paid on underlying profits used to pay dividends. In other instances, capital taxes may not be creditable because the home country does not levy similar taxes.

(iii) Limits on each category of income or on the proportionate amount of foreign sourced income to total taxable income – Available foreign tax credits are often limited not only by the absolute amount of the taxpayer's tax liability of the home country, but also by the proportionate amount of income from each category or each foreign country. For example, a country may require taxpayers to separate foreign income into passive and active income and limit the foreign tax credit claimed in each category to the lesser of actual taxes paid or accrued for that category or the domestic tax liability on the foreign income in that category. In the PRC, the maximum creditable foreign tax for each foreign country is the lesser of the actual foreign tax paid or the domestic tax liability on total taxable income multiplied by the fraction of foreign income for each country over total taxable income.

(iv) Percentage of shareholding / Levels of lower tiered companies – Company A in Country X owns 75% of Company B in Country Y, which in turn owns 75% of Company C in Country Z. Whether Company A can claim foreign tax credits on dividends paid by Company B and Company C depends on Country X's tax rules. Countries

have different rules governing the minimum percentage Company A must hold in the lower tiered companies in order to be able to claim both the withholding tax on dividends paid as well as the foreign corporate income tax paid on the underlying profits out of which the dividends are being paid. There are also different rules that determine the number of tiers in the lower tiered companies for which Company A can claim foreign tax credits.

(c) Availability of carry forward or carry back of excess foreign tax credits – Because of the limits placed on the amount of foreign tax credits that can be claimed in a particular year, there may be excess credits that remain unclaimed. Countries may provide for such credits to be carried back to previous tax years or carried forward to future tax years.

(d) Group relief – Excess foreign tax credits may also be claimed by companies within the same corporate group. Countries would set out detailed rules to determine whether affiliated companies belong to the same corporate group.

(e) Limits placed on whether the exemption method may be used – Because foreign income falls out of a country's tax net under the exemption method, countries generally impose restrictions on its use using one or both of the following ways:

(i) Exemption with participation – This is where the exemption method may only apply to active income. However, to determine whether income is active or passive may not be as simple as it may first appear. For instance, interest income may have a passive nature, but if a company is in the business of deposit-taking and lending, such as a financial institution, interest would be classified as active income. Dividends received from a wholly owned foreign subsidiary could either be active or passive, depending on the business activities of the subsidiary. If the subsidiary is an investment holding company which receives dividends and interest from its investment portfolio, then the dividends it pays to its parent company would be passive income. On the other hand, if the subsidiary operates a factory in a foreign country and generates income from the sale of goods that it manufactures, then the dividends it pays to its parent company would be active income. Countries may also specify a minimum shareholding before dividends received from subsidiaries

can be classified as active income and hence exempt. This is typically 10% for most countries but the UK no longer requires a minimum shareholding for foreign dividends to be exempt from corporate income tax.

(ii) Exemption with progression – Many countries have progressive tax rates rather than a flat tax rate. In the system of exemption with progression, the exempt income is allocated the lowest tax brackets and the remaining taxable income is taxed at higher tax brackets such that double tax relief on foreign taxes paid on the exempt income is limited. Numerical examples are provided in subsection ¶6-5300 below.

Countries adopt different combinations of the above methods, which make computations of exempt foreign sourced income and foreign tax credits very complex. In fact, double tax relief calculations for countries which have an extensive double tax treaty network are even more complicated than those which have concluded few DTAs because different calculation methods would likely be agreed between different treaty partners. Although countries are likely to insist on adopting methods based on their own domestic tax laws during the DTA negotiation process, compromise on both sides may be required in order to successfully conclude a DTA. Therefore, the methods dictated by DTAs are often different from those specified by a country's domestic tax laws. Practitioners should thus be careful in determining the correct calculation methods in their clients' tax computations by referring to the appropriate DTA.

¶6-3200 Characterization of Foreign Sourced Income

One major issue with double tax relief computations that many taxpayers encounter is that of characterization of foreign sourced income. As emphasized above, different countries have different rules that govern the computation of double tax relief. The availability and extent of tax relief often depends on how foreign sourced income is characterized, as can be seen from the hybrid systems and exemption with participation method described above. A common dispute taxpayers have with tax authorities is whether income should be classified as active or passive. Because foreign active income is often exempt, taxpayers frequently assert income as active while tax authorities regard the same income as passive.

A typical example is rental income. Rental income is generally regarded as passive income because income is generated from the letting of assets which require little or no effort on the part of the income recipient. However, in some cases, property owners may spend significant amounts of time travelling overseas to actively manage their property by, for instance, screening new tenants, arranging for repairs and maintenance and attending meetings of owners' incorporation. In such cases, rental income from properties located in foreign countries may be classified as active income available for tax exemption in the home country.

Another example is the classification between interest income and dividends. Some countries exempt foreign dividends from tax if the taxpayer holds 10% or more of a foreign company's shareholding. Therefore, taxpayers may "dress up" loan relationships as equity investments in order to qualify for the home country's exemption on dividends received, while the same payment may be classified as interest in the source country to maximize tax deduction by payor. These examples demonstrate that it is imperative for practitioners to have a thorough understanding of the substance of their client's business transactions to ensure a correct classification of foreign income in double tax relief computations.

¶6-3300 Timing of Foreign Tax Payments

Another practical issue in the computations of double tax relief, particularly of foreign tax credits, is that the amount of foreign tax paid is not actually known until after the tax filing deadline of the home country. Most countries thus allow taxpayers to claim as credits foreign taxes accrued for the same tax year. Any difference between actual foreign taxes paid and accrued would then be adjusted in the following tax year.

¶6-4000 Computations of Foreign Sourced Income and Attributable Foreign Taxes

The following numerical example incorporates hypothetical facts and rules that illustrate how some of the variations and limitations described in section ¶6-3000 above work in practice.

¶12-2000 The "Arm's Length" Principle

¶12-2100 Definition of the "Arm's Length" Principle

"ARM'S LENGTH PRINCIPLE -- The international standard which states that, where conditions between related enterprises are different from those between independent enterprises, profits which have accrued by reason of those conditions may be included in the profits of that enterprise and taxed accordingly."[3]

The definitive guidance for determining "arm's length" pricing is the Guidelines. As stated in paragraph 16 of the Preface:

> "OECD member countries are encouraged to follow these Guidelines in their domestic transfer pricing practices, and taxpayers are encouraged to follow these Guidelines in evaluating for tax purposes whether their transfer pricing complies with the arm's length principle. Tax administrations are encouraged to take into account the taxpayer's commercial judgment about the application of the arm's length principle in their examination practices and to undertake their analyses of transfer pricing from that perspective."

Further, paragraph 1.8 of the Guidelines states:

> "There are several reasons why OECD member countries and other countries have adopted the arm's length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for members of MNE groups and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment."

Accordingly, the application of the arm's length policy not only permits tax jurisdictions to secure "a fair share" of taxation in international transactions, but it also encourages international trade.

The arm's length principle seeks to adjust the pricing of transactions between associated enterprises by referring to the conditions that

3 *OECD Glossary of Tax Terms* (n. 1).

would have applied between independent parties in comparable transactions in comparable circumstances. These are referred to as comparable uncontrolled transactions.

In order to achieve this, as discussed previously, each member of an MNE group is treated as if they are independent entities and the transactions between them are examined to identify if any of the conditions or circumstances differ from those which would have been present in comparable uncontrolled conditions.

This analysis of controlled and uncontrolled transactions which is the foundation of the arm's length pricing principle is referred to as a "comparability analysis".

In the case where enterprises are considered to be associated, Article 9, paragraph 1 of the OECD Model Convention continues:

> "... and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those that 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."

Article 9 is therefore considered as the authoritative statement of the "arm's length principle".

Article 41 of the EITL also provides for the application of the arm's length principle as follows:

> "If a business transaction between an enterprise and a related party does not comply with the arm's length principle, thus reducing the taxable income or revenue of the enterprise of the related party, the tax authorities shall be empowered to make adjustments using reasonable methods."

Article 110 of the EITIR elaborates that the "arm's length principle" as referred to in Article 41 of the EITL means "the principle of adopting fair market prices and business norms for transactions carried out between non-related parties." It is, therefore, necessary to examine in depth the "arm's length principle" as this is fundamental to the application of transfer pricing policies.

As previously discussed, Hong Kong has also recently enacted Section 50AAF of the IRO - Rule 1 - Arm's Length for Provision Between Associated Persons which requires income or loss between associated persons to be computed on an arm's length basis.

Step 1 - Identify the controlled transaction

In order to identify the controlled transaction, paragraph 1.36 of the Guidelines states:

> "The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated enterprises…can be broadly characterized as follows:
>
> - The contractual terms of the transaction.
> - The functions performed by each of the parties to the transactions, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices.
> - The characteristics of the property transferred or the services provided.
> - The economic circumstances of the parties and the market in which the parties operate.
> - The business strategies pursued by the parties."

Contractual terms of the transaction

To the extent that the associated enterprises have formalized their relationship by way of a written contract, these contracts must first be examined with a view to identifying the controlled transaction.

Most contractual relationships between independent enterprises are written to protect their individual interests and therefore, will be very specific in terms of pricing, roles, responsibilities, assumption of risk and permitted variances. Generally, once the terms are agreed, they will be strictly enforced and further variances will be accommodated only if it is in the interests of both parties to accept the variances.

In the case of contractual relationships between associated parties, the written contract may indicate how responsibilities, risks, and financial outcomes were intended to be divided at the time of execution but the actual performance of the associated parties under the contracts may be substantially different from that intended at the inception of the contract. These changes in performance are unlikely to be documented in a contractual form. They may just evolve over time or be implemented by the board of directors or through other internal policies.

Accordingly, a review of the contractual terms of the transaction alone is unlikely to provide sufficient information to identify the controlled transaction or transactions. It is also necessary to consider the other factors detailed above, that is, the functions performed, the assets used, risks assumed, the characteristics of the property transferred or services provided, and the market dynamics of the locations in which they operate.

Example 12-2

Company S, a member of an MNE group, is incorporated in Country P. It manufactures and sells precision tooling. A sister company of Company S, Company T, is incorporated in Country V. Company S has entered into a contract with Company T to provide marketing services in Country V in return for a fee. Relying on the contractual relationship alone, the controlled transaction would appear to be marketing services provided by Company T to Company S. However, a further analysis of the commercial and financial relationship between Company S and Company T, which involved examining financial records, audited financial statements, shipping documents and invoicing arrangements, indicates that Company S sells precision tooling to Company T, which takes the financial and inventory risk of the product, sells the product to third-party customers in Country V, and books the resultant profit. The controlled transaction should thus be recharacterized as a trading transaction.

The functions performed by each of the parties to the transactions

The pricing between two independent enterprises will typically reflect the functions performed, assets utilized and risks assumed. Accordingly, to be in a position to identify the controlled transaction and to compare the pricing of a controlled transaction with an uncontrolled transaction, it is necessary to perform a functional analysis.

A functional analysis requires the identification of economically significant activities, that is, functions performed, risks assumed and assets employed by the parties to the transaction. This analysis is crucial in determining the arm's length pricing of a transaction as typically, the functions undertaken by each related party correlate with the risks borne and the intangibles employed or developed, and hence the profitability of the enterprise undertaking the transactions.

The functions that are typically examined in the course of identifying the controlled transaction are as follows:

(a) General Management – includes activities such as development of corporate strategies, finance and administration, development of management information systems and other systems required to support the overall operation of the business.

(b) Product Research and Development – includes activities to create and develop new products or processes, new technology to enhance the business or to improve existing products or processes.

(c) Buy Function – includes activities relating to sourcing raw materials for the production process or finished goods for resale.

(d) Production – includes the manufacture of products, including production planning, product improvement, and quality control.

(e) Sales and Distribution – includes the pricing and sale of goods and services.

(f) Marketing – includes defining the company's goals with regard to a specific market or market segment, designing and launching sales campaigns to target the desired market and raising brand awareness.

(g) Pricing – involves strategic pricing, which is, assessing the trade-off between sales volume and product margins or tactical pricing designed to meet local or temporary market conditions.

The risks that are typically examined in performing the functional analysis include the following:

(a) Product Liability – the risk of the product failing, malfunctioning or not meeting the quality or performance expectations of the market.

(b) Market Risk – the risk of encountering adverse sales conditions due to increased competition in the market, decreased customer demand or the inability to develop markets, services or products to meet market demand.

(c) Inventory Risk – the risk of suffering financial losses through the ownership of inventory, for example, shrinkage, obsolescence, market collapse, natural disasters, or fire and water damage.

(d) Customer Credit Risk – the risk of supplying goods or services in advance of a customer's payment with subsequent default on payment by the customer.

(e) Foreign Exchange Risk – the risk that a fluctuation in foreign exchange rates may increase the costs of purchase or reduce the profits on sale or supply.

In considering the assets used in a transaction, both tangible and intangible assets are considered. As stated in paragraph 1.54 of the Guidelines:

> "The functional analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections available, etc."

Accordingly, it would not be appropriate to use a company that owns and employs highly guarded and unique intellectual property in its manufacturing process as a comparable with a company that employs generic techniques in its manufacturing process. The ownership and use of the intellectual property give the former company a product and market edge and therefore, its contribution to value creation should be compensated.

The characteristics of the property transferred or the services provided

The difference in the characteristics of property or services may, in some circumstances, account for the difference in their value in the open market. Accordingly, in identifying the controlled transaction and comparing the controlled transaction with an uncontrolled transaction, it is necessary to consider these characteristics and to assess their impact on the pricing of a transaction.

With respect to tangible property, it is necessary to consider the physical features of the property. For example, is it a luxury or unique commodity, commanding a higher price point, or a basic and readily available commodity with a lower price point? It is necessary to consider its quality and reliability, and the availability and volume of supply.

Where considering the provision of services, it is necessary to consider the nature of the services provided and the complexity of them. For example, a service provider, who is one of the few specialists in a given field, could reasonably expect to be remunerated at a higher

"The automotive industry is a good example where there are many LSAs that have led to extraordinarily high profits that are rightly earned by Chinese taxpayers. The LSAs include:

- the "market-for-technology" industry policy, which requires foreign automotive manufacturers to form JVs in order to assemble automobiles in China, requiring foreign automotive manufacturers to compete for limited market access opportunities by offering favourable terms including the provision of technologies at below market price;
- Chinese consumers' general preference for foreign brands and imported products – this general preference, as opposed to loyalty to a specific brand, creates opportunities for MNEs to charge higher prices and earn additional profits on automotive products sold in China;
- huge, inelastic demand for automotive vehicles in China due to the large population and growing wealth of the population;
- capacity constraints on the supply of domestically assembled automotive vehicles;
- duty savings from the lower duty rates on automotive parts (e.g. 10%) compared to imported vehicles (e.g. 25%) – when MNEs manufacture products in China as opposed to importing the products from outside of China, they are able to generate overall savings from the lower duty rates, even if the MNEs incur manufacturing costs and sell their domestically-manufactured products at a lower sales price compared to a foreign-manufactured vehicle; and
- a large supply of high quality, low-cost parts manufactured by suppliers in China."

If it has been determined that LSAs exist, it is necessary to ascertain the amount of LSAs, the extent to which LSAs are retained within the MNE group or are passed on to independent customers or suppliers and if not passed on, the manner in which independent companies transacting in similar conditions would allocate the net location savings.

In addition to considering the economic circumstances of the markets in which MNEs operate, it is also necessary to examine the economic circumstances of the MNE itself. For example, an MNE in the development phase of business may have lower margins as substantial expenditure and investment is required to be made on equipment, research and development, market research and product

or service launch. An MNE entering into new markets may have to lower its entry price point to obtain traction in the targeted market.

Conversely, an MNE with a well-developed business may find its margins dropping due to stagnation in product development, and the emergence of competitors in the market who are offering innovative products that are attracting its customer base.

Furthermore, its economic performance may be impacted by new data about the products or services it is offering. For example, the success of its product may have been based on the premise that it provided health benefits. If this claim was refuted by new studies, the demand for the product, together with its margins, would drop substantially. Hence, using an independent enterprise that provides a product that has proven health benefits would not be a reliable comparable.

In examining the economic circumstances of an MNE group, consideration should also be given to the impact of group synergies on pricing. For example, the combined purchasing power and the economies of scale may allow an MNE to raise its margins as a consequence of its ability to purchase in such large quantities that it is able to secure much lower prices for the goods it buys than its competitors. An MNE may be in a position to leverage off the consolidated balance sheet of the MNE group to secure preferential financing rates, thus allowing it to improve its margins.

These synergies may be beneficial to the MNE group, thus enabling it to increase its aggregate profits. Therefore, when examining potential comparables, consideration should be given to these factors and appropriate adjustments should be made to the pricing between group members to reflect the financial impact of these group synergies.

Business Strategies

Following on from the above, the business strategies of the MNE must be examined when considering the controlled transaction and seeking a comparable to determine an arm's length price.

As detailed in paragraph 1.114 of the Guidelines, the following areas should be considered in evaluating the business strategies of an MNE:

(a) Innovation and new product development;

(b) Degree of diversification;

(c) Risk aversion;

(d) Assessment of political changes; and

(e) The impact of existing labour law changes and the duration of such arrangements.

Step 2 - Compare the controlled transaction with comparable transactions

Once the five factors have been evaluated, the commercial and financial relations between the associated enterprises will be established and hence the controlled transaction should have been identified. It is then necessary to move onto step 2, that is, to compare the conditions and economic outcome of the identified controlled transaction with the conditions and economic outcome of comparable transactions concluded between independent parties.

In order to undertake the comparability analysis, it is necessary to choose the most appropriate transfer pricing methodology for the controlled transaction or transactions under review. The common methods of determining an arm's length price are discussed in detail at section ¶12-3000 below.

It will be necessary to choose the "tested party" if the cost plus, resale price or transactional net margin method is adopted. The tested party is the party to the transaction whose level of mark-up on its costs, gross margins or net profits will be measured against comparables to ascertain if it is transacting on an arm's length basis. Generally, the tested party will be the one that has the most simple functional analysis as it is usually easier to find comparables and apply a transfer pricing methodology that produces a reliable result.

The next step of the process is to identify comparables. These may be internal or external or uncontrolled comparables.

It may be assumed that an internal comparable, that is, a transaction of a similar nature conducted in a similar manner in relation to similar goods that an associated enterprise conducts with an independent third party, would be a reliable comparable for a similar transaction concluded between associated enterprises. In many cases, this is true, as the financial information is readily available internally and the transaction is easily identified.

However, it may be the case that the internal comparable is not reliable as there are inherent factors that differentiate the transactions between associates and third parties. For example, if a manufacturer sells goods to a third party in very limited volumes and sells the same product in vast quantities to associated enterprises, the pricing of

the sale of goods to the third party should not be taken as a reliable comparable as it will clearly not have bargaining power due to its low level of purchases. Accordingly, the price it pays will be higher than the price paid by associated companies who can rely on their buying power to reduce its purchase price.

External comparables are usually sourced from commercial databases or in the case of tax authorities, from information they have gathered from taxpayers in the course of tax examinations. There are a number of limitations on the information included in databases. For example, disclosure rules in one jurisdiction may provide that all financial information of companies is available to the public, whereas another jurisdiction may limit the publication of financial data. Accordingly, the information included in the database for one company may not be as comprehensive or reliable as for another company.

Often, commercial databases only include data concerning listed companies due to the constraints of obtaining information from private companies. Listed company data may not be useful as a comparable for determining the arm's length price for an unlisted group as different internal and external factors, such as public stakeholders interests influencing business strategies, will affect the economic performance of a listed company in a manner that may not be encountered by an unlisted group. However, in practice, listed companies are the mostly commonly used comparable companies.

Therefore, it is necessary to be objective and thorough in conducting a search for comparables in external databases, and where possible, manual searches should also be conducted to validate the appropriateness of the comparables chosen.

The process of selecting potential comparables can be either additive or deductive. In the additive approach, third parties are identified that may carry out comparable transactions. Information is gathered on the transactions conducted by these third parties to ascertain if they do indeed carry out comparable transactions. This approach is useful if the party conducting the search has knowledge of third parties undertaking comparable transactions, as they can be "added" to a list of companies in the search for a comparable.

The deductive approach involves taking a wide sample of companies that operate in similar industries, perform similar functions and that are not obviously different in terms of economic profile. The sample of companies will then be refined using various selection processes. For example, standard industry codes may be input initially to obtain the initial sample. Subsequently, other characteristics are input, such as turnover, headcount, product-specific information, such that the

and Mutual Agreement Procedures[5] ("**PN 6**"), issued on 17 March 2017 and effective 1 May 2017, reaffirms the reasonable transfer pricing as above. Articles 17 to 21 further elaborate on the application of the methodologies, which follow the general applications which are discussed in detail below.

Similarly, in the Appendix to DIPN 46, Transfer Pricing Guidelines – Methodologies and Related Issues, the IRD details that the same methodologies should be adopted in Hong Kong in determining the arm's length pricing.

The new DIPN 59 further reinforces the adoption by the IRD of the traditional transaction method and the transactional profits method in the determination of arm's length pricing. However, it does not preclude MNEs adopting alternative methodologies if the OECD recognized methodologies are not appropriate.

Typically, the traditional transaction methods are considered as the most direct methods of determining if associated enterprises are transacting with each other on an arm's length basis. The rationale being that the differences in pricing in controlled transactions and uncontrolled transactions can be linked to the commercial and financial relationships existing between enterprises. Assuming such conditions existing in the controlled and uncontrolled transactions are identical or similar, the price in the uncontrolled transaction can be substituted for the price in the controlled transaction resulting in an arm's length price. The same result can be achieved by making comparability adjustments, as necessary, to compensate for functional or market differences.

However, in cases where there is no publicly available information available on the gross margins of third parties to enable a reliable uncontrolled comparable to be obtained, or in circumstances where the nature and circumstances of the controlled transactions are so unique that there is no reliable uncontrolled transaction of an identical or similar nature, the transactional profit methodology may be more appropriate in establishing an arm's length price.

¶12-3100 Comparable Uncontrolled Price Method

"COMPARABLE UNCONTROLLED PRICE (CUP) METHOD -- A transfer pricing method that compares the price for property or

5 http://www.chinatax.gov.cn/download/pdf/20171122.pdf Accessed 26 February 2019.

services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances."[6]

At Chapter II, Part II, B.1, 2.15 of the Guidelines, it is stated:

> ".. an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for the purposes of the CUP method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking the transactions could materially affect the price in the open market; or, b) reasonably accurate adjustments can be made to eliminate the material effects of such differences. Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases, the CUP method is preferable over all the other methods."

Example 12-3

Company A is a toaster manufacturer. It sells the toasters it manufactures to its wholly owned distribution company, Company B, at USD20 per unit.

Company C also manufactures toasters and sells them to third parties at USD40 per unit.

Assuming that the commercial and financial risks assumed by Company A and Company C are such that there should be no material difference in pricing, adopting the CUP methodology, the arm's length price for the sale of the toasters from Company A to Company B should be USD40 per unit rather than USD20 per unit.

Practically, it is difficult to identify transactions between third parties, the circumstances of which are so similar to those conducted between associated entities, that there should be no material difference in pricing.

Take, for example, retailers who are "buying" products in the same market, selling identical products, for example, high street fashion, in the same markets and targeting customers with the same demographic profile. Prima facie, such transactions between third

6 *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, p.24 (n. 2).

supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector."[8]

A task force, the Task Force on the Digital Economy ("**TFDE**"), was created as a subsidiary of the Committee of Fiscal Affairs of the OECD in September 2013 with a mandate to deliver a report identifying issues raised by the digital economy and possible actions to address them by September 2014.

¶15-2220 Areas to be Addressed

The outcome of the deliberations of the TFDE was the publication of *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*[9] ("**BEPS Action 1 2015 Final Report**"), which was endorsed by G20 leaders with more than 110 countries/jurisdictions committing to its implementation at that time.

In the Executive Summary of BEPS Action 1 2015 Final Report, it was stated that:

> "Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring fence the digital economy from the rest of the economy for tax purposes."[10]

Accordingly, two specific areas were addressed which, whilst applicable to more traditional business models, were particularly exacerbated by the unique features of business models adopted in the digital economy. These two areas are discussed below.

BEPS issues in the digital economy

With regard to PEs, it was agreed that the list of exceptions was modified to ensure that only activities that are truly "preparatory or auxiliary" in nature fall within the exceptions provided by paragraph 4 of Article 5 of the OECD Model Convention.

In accordance with paragraph 4, inter alia, the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to an enterprise or the maintenance of a stock of goods

8 Ibid., p.14.

9 Available at https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#page1

10 OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p.11, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. https://doi.org/10.1787/9789264241046-en

or merchandise belonging to an enterprise solely for the purpose of storage, display or delivering are not treated as PEs. Likewise, buying offices are not considered as PEs.

However, as stated in the BEPS Action 1 2015 Final Report:

> "For example, the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a permanent establishment for that seller under the new standard."[11]

In the Commentary on Article 5 of the OECD Model Convention, this issue is further considered. Paragraph 128 identifies the issue relating to the fact that no PE may be considered to exist where the electronic commerce operations carried on through computer equipment in a jurisdiction are considered as preparatory or auxiliary activities covered by paragraph 4. Examples of what may be considered as preparatory or auxiliary include gathering market data, advertising, supplying information or providing communication links between the customers and suppliers.

However, at paragraph 129, the OECD elaborates that if such functions form a significant part of the business activity of the enterprise or, if the computer undertakes core functions of the enterprise, to the extent that the computer constituted a fixed place of business, a PE would be created.

BEPS Action 1 2015 Final Report also agreed to introduce new anti-fragmentation rules, thus ensuring that it is not possible to benefit from the exceptions included at paragraph 4 through the fragmentation or splitting up of business activities among closely related enterprises.

With regard to PEs, it was also agreed to modify the definition of a PE to handle artificial arrangements relating to the sale of goods or services within a group such that one group member undertakes the negotiation of contracts of goods or services for a group online seller in one jurisdiction but the corresponding income from the sale is booked in the accounts of the online seller.

As stated in the BEPS Action 1 2015 Final Report:

> "For example, where the sales force of a local subsidiary of an online seller of tangible products or an online provider of

11 Ibid., p.12.

advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modification by the parent company, this activity would result in a permanent establishment for the parent company."[12]

The BEPS report *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*[13] addresses the recommendations made in the BEPS Action 1 2015 Final Report.

With regard to transfer pricing, the BEPS Action 1 2015 Final Report concluded that the revised transfer pricing guidelines made it clear that legal ownership alone does not necessarily result in the entitlement to all or any of the income that is generated by the exploitation of intangible assets. Rather, group companies performing important functions, assuming significant risks and contributing significant assets are also entitled to appropriate returns.

The recommendations included in the BEPS report *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*[14] have subsequently been absorbed into the OECD TP Guidelines.

With regard to CFCs, BEPS Action 1 2015 Final Report concluded that the recommendations on the design of effective CFC rules would include definitions of CFC income that would be subject income that is typically earned in the digital economy to taxation in the jurisdiction of the parent company.

Broader tax challenges of the digital economy

The broader tax challenges of the digital economy for policy makers raised by the digital economy were discussed in the BEPS Action 1 2015 Final Report. These challenges relate to nexus, data and the characterization for direct tax purposes. They also include challenges for the collection of indirect taxes such as VAT and GST where goods and services are acquired by private consumers from overseas suppliers.

12 Ibid.

13 Available at https://read.oecd-ilibrary.org/taxation/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report_9789264241220-en#page1

14 Available at https://read.oecd-ilibrary.org/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en#page1

It is reported that the TFDE discussed and analyzed a number of options to address these challenges. It was concluded that:

(a) With regard to the collection of VAT/GST on cross border transactions, countries are recommended to adopt the principles outlined in the *International VAT/GST Guidelines*[15] published by the OECD in 2017 and introduce the collection methodologies included therein. The basic principles as outlined therein are the destination principle, the neutrality principle, meaning that taxation should not differentiate between electronic commerce and conventional forms of commerce, and the simplicity of compliance principle. In this regard, it was recommended that foreign suppliers be allowed to register for VAT in the market jurisdiction under a simplified registration and compliance regime, operating separately from the traditional scheme.

(b) None of the other options analyzed by the TFDE, being (i) a new nexus in the form of a significant economic presence, (ii) a withholding tax on certain types of digital transactions, and (iii) an equalization levy which is intended to address the disparity in the treatment of foreign and domestic businesses where the foreign business has sufficient economic presence in the jurisdiction, were recommended. The rationale being that measures developed through the BEPS Project would have a substantial impact on BEPS issues previously identified and that BEPS measures would mitigate the effects of the broader tax issues associated with the digital economy.

(c) Countries could, however, choose to introduce any of the three considered options into their domestic legislation to safeguard against BEPS, provided such introduction did not contravene their existing treaty obligations.

In summary, therefore, the OECD approach to addressing the tax challenges of the digital economy, in relation to direct taxation, following the publication of the BEPS Action 1 2015 Final Report, focuses on taxable presence (PE or nexus), transfer pricing regulation and CFC rules.

15 Available at https://read.oecd-ilibrary.org/taxation/international-vat-gst-guidelines_9789264271401-en#page1

¶15-2230 Latest Development

On 16 March 2018, the OECD issued an interim report, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*[16] (hereinafter referred to as the "**Interim Report 2018**").

The Interim Report 2018, in Chapter 3 concerning the implementation and impact of the BEPS package, indicates that, whilst the adoption rate of PE related actions (Action 7) at that time was low, some digitalized MNEs had started to change their business structures from remote sales models to local reseller models. Other such MNEs had taken proactive steps to realign their corporate structures with real economic activities by reconsidering their transfer pricing policies (Actions 8-10).

This clearly provides evidence that, whilst jurisdictions may be slow in entering into Multilateral Instruments to modify their DTAs to implement the BEPS measure, or if entering, are being selective in which BEPS Actions they adopt, the approach of the OECD in handling the tax issues associated with the digital economy by focusing on PEs and transfer pricing appears to be having a positive effect.

In the latest stage of development, at the time of writing, the OECD issued a Public Consultation Document, *Addressing the Tax Challenges of the Digitalisation of the Economy*[17] (hereafter referred to as the "**Public Consultation Document**") on 13 February 2019.

The issue of the Public Consultation Document and the proposals contained therein has been heralded as the commencement of BEPS 2.0 bringing with it possibilities of substantial changes to the framework for international taxation.

At paragraph 4 of the Public Consultation Document, the broader tax challenges relating to the allocation of taxing rights are discussed. It mentions that the Interim Report 2018 identified three characteristics that are present in highly digitalized business models as follows:

(a) Scale without mass which impacts the distribution of taxing rights as the number of jurisdictions which can impose taxing rights over time is reduced;

16 Available at https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-interim-report_9789264293083-en#page1

17 Available at http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf

(b) The heavy reliance on intangible assets straining the rules for the allocation of income from intangible assets; and

(c) Data and user participation presenting challenges to the existing nexus and profit allocation rules, in particular where a highly digitalized business that exploits the data and user generated content has little or no taxable presence in the jurisdictions where the users are located.

To address these issues, the Public Consultation Document contains four proposals, of which the first three focus on revising taxable presence rules. The aim is to recognize the value created by a business activity in user/market jurisdiction by expanding the taxing rights of those jurisdictions.

1. The "user participation" proposal

The underlying principle of this proposal is that securing and maintaining active participants is a critical component of value creation for highly digitalized business as the users help create brand presence, generate valuable data and create a critical mass enabling the business to establish market power. The proposition is that this potential methodology would be more appropriate for social media platforms, search engines and online marketplaces.

This proposal would modify existing profit allocation rules such that, for certain businesses, an amount of profit could be allocated to the jurisdiction where the business has active participants, irrespective of whether the business has a physical presence in that jurisdiction.

2. The "marketing intangibles" proposal"

Marketing intangibles are defined in the Glossary of the OECD TP Guidelines as:

> "An intangible…that relates to marketing activities, aid in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers."[18]

18 OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Glossary of Terms, p.27, OECD Publishing, Paris. http://dx.doi.org/10.1787/tpg-2017-en

The rationale behind this proposal is that an MNE can "reach into" a jurisdiction remotely to develop a user/customer base and other marketing intangibles. It is premised on the understanding that there is an intrinsic functional link between marketing intangibles and market jurisdictions. For example, a marketing intangible such as a brand may be perceived in a very favourable way in the minds of customers in a certain jurisdiction and as a consequence, it can be considered as being created in that jurisdiction.

Likewise, marketing intangibles such as customer data, customer lists and relationships are derived from activities targeted at the customers and users in the market jurisdiction, thus supporting the proposition that the intangibles as being created in that jurisdiction.

This proposal would modify existing transfer pricing and treaty rules and require marketing intangibles and the associated risks to be allocated to the market jurisdiction.

3. The "significant economic principle" proposal

This proposal is motivated by the view that the digitalisation of the economy has enabled businesses to be heavily involved in the economy of a jurisdiction without having any physical presence there, thus rendering the existing nexus and profit allocation rules ineffective.

Accordingly, it is proposed that a taxable presence would arise if a non-resident has a significant economic presence in a jurisdiction via digital technology, firstly evidenced by revenue generated on a sustained basis from the jurisdiction. However, sustained revenue alone would be insufficient to establish nexus (taxable presence).

Other factors would also require consideration such as the existence of a user base, the volume of digital content derived from the jurisdiction, billing and collection in local currency, the maintenance of a website in a local language, responsibility for the delivery of goods to the customer or the provision of after sales support and the existence of sustained marketing and sales activities to attract customers.

The proposal anticipates that the allocation of profits to a significant economic presence would use the fractional apportionment method whereby the tax base to be divided is defined, the allocation keys to divide that tax base are identified and the weighting of the allocation keys is determined.

4. The global anti-base erosion proposal

This proposal is intended to give jurisdictions the right to tax profits that have been subject to no or low taxation in other jurisdictions.

The proposal seeks to develop two inter-related rules:

(a) an income inclusion rule that would tax the income of a foreign branch or controlled entity if that income was subject to a low effective tax rate in the jurisdiction of establishment or residence; and

(b) a tax on base eroding payments that would deny a deduction or treaty relief for certain payments unless that payment was subject to an effective tax rate at or above a minimum rate.

It should be apparent from the discussions in this section that addressing the tax issues associated with the digital economy is high on the agenda of the OECD, but the practicalities of implementing proposals require consultation and the cooperation of parties participating in the BEPS initiative, which is a time consuming process.

¶15-3000 Harmful Tax Practices

¶15-3100 Background

The issue of harmful tax practices emerged as an increasing number of corporations began using tax havens to lower their global tax liability after the 1950s. With globalization and technological advances on the rise, many countries, especially smaller jurisdictions, tried to attract foreign businesses to set up companies in their jurisdictions by adopting a low or no tax regime. Because these countries typically do not require substantial activities to be carried on within their borders, many businesses have set up companies in these jurisdictions to engage in geographically mobile activities, such as provision of financial services or ownership and licensing of IP, to take advantage of the favourable tax regime as well as to access these jurisdictions' treaty network.

In response to increasing competition from these traditional tax havens and in order to protect their own tax bases, high tax jurisdictions subsequently started to introduce many special tax incentives to encourage businesses to set up various specific types of companies, for example, holding companies, service centres or fund management entities, in their own jurisdictions. The OECD has termed this phenomenon of low-tax competition as a "race to the

bottom." To address concerns arising from this race to the bottom, the OECD embarked on an initiative to develop measures to counter the effects of such harmful tax practices. In April 1998, it published its first report *Harmful Tax Competition: An Emerging Global Issue*[19] ("**1998 Report**"), which identifies two types of harmful tax practices, namely tax havens and harmful preferential tax regimes, and suggests countermeasures that countries can implement to combat such tax practices. (Note that this report and OECD's continuous work on countering harmful tax practices are restricted to addressing geographically mobile activities and do not include non-mobile activities, such as relocation of manufacturing activities.)

In 2000, the OECD's Global Forum on Taxation began to promote international cooperation by engaging both member and non-member countries to participate in and commit to exchange of tax information. It developed and released the *Agreement on Exchange of Information on Tax Matters*[20] ("**TIEA**") in 2002 and agreed on standards on transparency relating to availability and reliability of information in 2005. The purpose of the TIEAs is for competent authorities of jurisdictions around the world to bilaterally agree on the implementation of an exchange of information process. In June 2015, the OECD Committee on Fiscal Affairs approved a Model Protocol[21] to the TIEA which extends the scope of the original TIEAs to provide for automatic and/or spontaneous exchange of information in accordance with the common reporting standard developed by the OECD in 2013. Many countries have since entered into bilateral agreements to exchange tax information, adopting either the original TIEA or the Model Protocol. In addition, as of 29 October 2018, 104 jurisdictions[22] have signed the multilateral competent authority agreement[23], which provides for the automatic exchange of information pursuant to Article 6 of the Multilateral Convention. As a consequence, the harmful effects from the use of tax havens have now been substantially abated.

19 OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing, Paris, https://doi.org/10.1787/9789264162945-en

20 https://www.oecd.org/ctp/exchange-of-tax-information/2082215.pdf Accessed 3 Apr 2019.

21 https://www.oecd.org/ctp/exchange-of-tax-information/Model-Protocol-TIEA.pdf Accessed 3 Apr 2019.

22 http://www.oecd.org/tax/exchange-of-tax-information/MCAA-Signatories.pdf Accessed 3 Apr 2019.

23 http://www.oecd.org/ctp/exchange-of-tax-information/multilateral-competent-authority-agreement.pdf Accessed 3 Apr 2019.

However, preferential tax regimes remain prominent as countries continue to compete for foreign direct investment and to attract certain industries to set up businesses within their jurisdictions. Therefore, countering harmful tax practices is still relevant today and has hence been included as Action 5 in the OECD's BEPS Project.

¶15-3200 Definition of Harmful Tax Practices

In its 1998 Report, the OECD identified two types of harmful tax practices: (i) tax havens; and (ii) harmful preferential tax regimes. Although there is no formal definition as to what constitutes a harmful tax practice, the 1998 Report provided a list of factors to identify each of the two types.

¶15-3210 Tax Havens

The four key factors in identifying tax havens outlined in the 1998 Report are:

(a) No or nominal taxes;

(b) Lack of effective exchange of information;

(c) Lack of transparency; and

(d) No substantial activities

In order to be considered as a tax haven, it must fulfil the first condition (i.e. no or nominal taxes) and meet at least one of the remaining three conditions. Lack of effective exchange of information typically refers to the existence of legislation or administrative practices, such as bank secrecy rules, that protect the country's taxpayers from scrutiny by other jurisdictions' tax authorities. Lack of transparency refers to the fact that the application or operation of tax rules cannot be readily ascertained. For instance, even though a country's tax rules may be clearly stated, taxpayers may be able to obtain substantial tax benefits or deductions to reduce their tax liability through private negotiations with the country's tax administration. Conditions (ii) and (iii) are important features of tax havens because their existence prevents countries which impose tax on a residence basis from gaining information needed for tax revenue collection, thereby eroding their tax bases. Condition (iv) refers to the lack of a requirement for a country's taxpayers to carry on actual business activities within its borders to be considered a tax resident. This encourages businesses to simply book income in the tax haven without undertaking any income generating activities, thus facilitating the shifting of profits from high tax jurisdictions to no or low tax jurisdictions.

actual R&D activities and thus would not be considered as harmful. The BEPS Action 5 2015 Final Report explains that the proportion of expenditures directly related to R&D activities acts as a proxy for the extent of substantial activities undertaken by the taxpayer because it reflects the real value added by the taxpayer. It suggests that jurisdictions use the following formula to determine what income may be eligible to receive tax benefits under the nexus approach:

$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{Overall income from IP asset} = \text{Income receiving tax benefits}$$

Where:

(a) Qualifying expenditures = expenditures incurred directly in connection with the IP asset by a qualifying taxpayer (i.e. resident companies, domestic PEs of foreign companies and foreign PEs of resident companies of the jurisdiction providing the preferential tax regime)

(b) Overall expenditures = sum of all expenditures that would count as qualifying expenditures if they were undertaken by the taxpayer itself

(c) IP assets = patents, copyrighted software, or other IP assets that are non-obvious, useful and novel

The proportion of qualifying expenditures to overall expenditures incurred to develop the IP asset is referred to as the "nexus ratio". Jurisdictions may choose to treat this nexus ratio as a rebuttable presumption such that the onus is on the taxpayer to prove that they are entitled to more benefits from the IP regime than allowed by the formula if there are exceptional circumstances to justify such a treatment.

According to paragraph 4 of the Executive Summary of the 2018 Progress Report, all IP regimes, except for one, have either been abolished or amended to comply with the above nexus approach.

The DEMPE Concept

Interrelated to the nexus approach used for determining the substantial activity requirement of IP regimes is DEMPE, which is the acronym for the important functions which contribute to the value creation of intangibles - development, enhancement, maintenance,

protection and exploitation. DEMPE is a transfer pricing concept that was introduced by the OECD in its report *Aligning Transfer Pricing Outcomes with Value Creation* under BEPS Actions 8-10 ("**the BEPS Actions 8-10 2015 Final Report**"). Just as the nexus approach requires taxpayers benefiting from IP regimes to have actually incurred qualifying expenditures to the development of an IP rather than to simply be named as the developer of the IP, DEMPE requires the returns from intangibles, including IPs, be allocated to not merely the legal owner of the intangibles, but also to the parties which have performed important functions in the creation of the intangibles.

Prior to the introduction of the DEMPE concept, the legal owner of an intangible was entitled to all the returns generated by that intangible. As such, MNEs would often transfer the ownership of an intangible from a company in a high tax jurisdiction to a related company in a low tax jurisdiction such that the income generated by the intangible would be taxed at lower rates. The company in the low tax jurisdiction typically would not have contributed much economically to the value creation of the intangible. At the same time, related parties in high tax jurisdictions would pay royalties or licensing fees to this legal owner in the low tax jurisdiction for the use of the intangible to obtain a deduction at high tax rates. If MNEs also took advantage of tax incentives available from various IP regimes in the development of their intangibles prior to such transfer, the effective tax rate of the MNEs as a whole would be substantially reduced.

Realising that such tax structuring by MNEs has become a major concern of tax authorities around the world, the OECD developed the DEMPE concept to address this issue. The concept is consistent with the arm's length principle that the OECD has always advocated in the area of transfer pricing (see Chapter 12). Because the DEMPE concept requires all parties that have performed DEMPE functions in the value creation process of the intangible to be compensated proportionately to their contribution, there would now need to be a transfer pricing payment from the legal owner, to whom all returns on the intangible would initially be paid, to other related parties for their respective contribution. As mentioned in Chapter 12, to determine the appropriate amount of remuneration to which each party is entitled, a comparability analysis would need to be performed so that each function related to the DEMPE of the intangible can be identified as a controlled transaction and compared with other comparable transactions. Details of the transfer pricing guidelines relating to

intangibles can be found on pages 63 to 139 of the BEPS Actions 8-10 2015 Final Report.[28]

The impact of the introduction of the DEMPE concept is that MNEs should no longer be able to structure the ownership of their intangibles to produce an outcome that generates a high tax rate deduction and income that is either not taxed or taxed at nominal rates. However, there are many challenges with the practical implementation of the DEMPE concept that even the OECD acknowledges:

"i) A lack of comparability between the intangible related transactions undertaken between associated enterprises and those transactions that can be identified between independent enterprises;

ii) A lack of comparability between the intangibles in question;

iii) The ownership and/or use of different intangibles by different associated enterprises within the MNE group;

iv) The difficulty of isolating the impact of any particular intangible on the MNE group's income;

v) The fact that various members of an MNE group may perform activities relating to the development, enhancement, maintenance, protection and exploitation of an intangible, often in a way and with a level of integration that is not observed between independent enterprises;

vi) The fact that contributions of various members of an MNE group to intangible value may take place in years different than the years in which any associated returns are realised; and

vii) The fact that taxpayer structures may be based on contractual terms between associated enterprises that separate ownership, the assumption of risk, and/or funding of investments in intangibles from performance of important functions, control over risks, and decisions related to investment in ways that are not observed in transactions between independent enterprises and that may contribute to base erosion and profit shifting."[29]

28 Available at https://read.oecd-ilibrary.org/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en

29 OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - BEPS 2015 Final Reports*, para. 6.33, p.73, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. https://dx.doi.org/10.1787/9789264241244-en

Not only do the above issues present challenges for the taxpayer in preparing their intangibles related contemporaneous transfer pricing documentation, but tax authorities are also equally disconcerted by the lack of information available for use in their tax audits. Even though the BEPS Actions 8-10 2015 Final Report contains detailed specific guidance for both taxpayers and tax authorities on how to value intangible related transactions, disputes between these two sides are still likely to arise mainly because of different interpretations of what constitutes an important DEMPE function which entitles a party to a portion of the returns on the intangible. For hard-to-value intangibles, the onus falls on the taxpayer to rebut the tax authorities' presumption that the price for the transfer or use of the intangible is not at arm's length if there are material differences between the forecasts used to price the transaction and the actual financial results of the parties to which income from the intangible accrues, but the taxpayer may only rebut this presumption under one of four specified exemptions.[30] Because of the inherent uncertainties resulting from the application of the DEMPE concept by both the taxpayers and the tax authorities, taxpayers are advised to enter into advance pricing agreements with tax authorities if the value of the intangible involved is significant. Practitioners should also be apprised of the practical approach and interpretations local tax authorities of different jurisdictions adopt when they apply the DEMPE concept in their tax audits.

¶15-3320 Non-IP Regimes

Applying the nexus approach to non-IP regimes, the link that should be established is between the income qualifying for benefits under the preferential tax regime and the core activities necessary to earn that income. However, as different jurisdictions have introduced many different types of regimes, the definition of core activities would inherently vary depending on the specific regime that is being offered. For instance, countries which offer tax incentives for businesses setting up headquarters in their locations could look at the key activities giving rise to the income being earned by the headquarters, such as managerial decisions made by the taxpayer on behalf of other group companies and tasks undertaken to coordinate and implement regional projects for other group companies. Another example is where fund management regimes are offered, the core activities could be the investment and research services rendered by the fund manager.

30 See para 6.193 of section D.4 of Chapter VI of the BEPS Actions 8-10 2015 Final Report (n. 29).

With respect to regimes which provide tax incentives for offshore activities, such as India's availability of deductions for certain income of offshore banking units and international financial services centres, as long as such regimes do not contain harmful features or factors listed in subsection ¶15-3200 above, they would not be considered as harmful.

Paragraph 4 of the Executive Summary of the 2018 Progress Report states that almost all non-IP regimes that have been reviewed by the FHTP contain substantial activities requirements, which ensures that taxation is better aligned with the location where value is created.

With its goal of delivering a level playing field for all jurisdictions around the world, the FHTP will continue to review new preferential tax regimes and to monitor any changes made to existing regimes to ensure that substantial activities requirements are in place.

¶15-3400 Exchange of Information on Tax Rulings

The power of having access to financial information in the realm of combating tax evasion was demonstrated when the US unprecedentedly required UBS AG, a Swiss bank, to release the names of all their US clients in 2008 despite the existence of the Swiss banking secrecy rules. As the US uncovered more foreign banks that were offering various schemes to assist US taxpayers to evade US tax, along with the added pressure of the 2008 financial crisis to government revenues, the US was quick to enact the Foreign Account Tax Compliance Act in 2010, which required all foreign financial institutions to submit to the IRS the financial account information of all US taxpayers and foreign entities in which US taxpayers have a significant interest. Armed with additional information, the US was quick to recover lost tax dollars, but many countries were dissatisfied that the information flow went only one way. As a result, the G20 requested the OECD to develop a common reporting standard ("**CRS**") that would enable all countries to obtain financial information from their local financial institutions and automatically exchange such information with partner jurisdictions on an annual basis (the process of which is known as "the automatic exchange of information in tax matters" or "**AEOI**"). This intergovernmental approach would enhance transparency and level the playing field for tax administrations around the world in their tax enforcement work.

As of November 2018, 153 jurisdictions[31] have committed to such automatic exchange of financial information, with 90 jurisdictions[32] having successfully exchanged information in 2018. Both the PRC and Hong Kong are among the jurisdictions which have enacted legislation to allow for AEOI and which have successfully exchanged information with their partner jurisdictions in 2018.

Given the effectiveness and thus the importance of transparency of information, it is reasonable that the FHTP have chosen commitment to transparency of tax rulings as one of the two main areas of work in BEPS Action 5. Paragraph 95 of the BEPS Action 5 2015 Final Report defines rulings as "any advice, information or undertaking provided by a tax authority to a specific taxpayer or group of taxpayers concerning their tax situation and on which they are entitled to rely." Although tax rulings give both taxpayers and tax authorities certainty and predictability about the taxpayers' past and/or future tax positions, they are prone to create BEPS concerns because they are specific to a taxpayer or a group of taxpayers and thus are often confidential. The confidential nature of tax rulings necessarily leads to a lack of transparency, which is one of the key factors in identifying harmful preferential tax regimes. As a result, the OECD has developed a transparency framework where countries of the Inclusive Framework are obligated to exchange information on a spontaneous basis for the below six categories of tax rulings:

(a) Rulings relating to preferential regimes;

(b) Unilateral APAs or other cross border unilateral rulings in respect of transfer pricing;

(c) Cross border rulings providing for a downward adjustment of taxable profits;

(d) PE rulings;

(e) Related party conduit rulings; and

(f) Any other type of ruling agreed by the FHTP that in the absence of spontaneous information exchange gives rise to BEPS concerns.[33]

31 See *AEOI: Status of Commitments* at https://www.oecd.org/tax/transparency/AEOI-commitments.pdf

32 See *Exchanges that took place in 2018 under the AEOI Standard (As of 31 December 2018)* at https://www.oecd.org/tax/automatic-exchange/commitment-and-monitoring-process/AEOI-Exchanges-2018.pdf

33 *BEPS Action 5 2015 Final Report*, p.46 para. 91.