Transfer Pricing Economists for Development
Paris
France
www.tped.eu

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The Platform For Collaboration on Tax

Discussion Draft

The Taxation of Offshore Indirect Transfers – A Toolkit

Subject: Comments on the Discussion Draft on The Taxation of Offshore Indirect Transfers ("OITs")

Dear Sir or Madam,

The purpose of this letter is to present TPED's comments after the release by The Platform For Collaboration on Tax of the Draft on the Taxation of Offshore Indirect Transfers ("the Draft" or "the Draft Report").

Transfer Pricing Economists for Development ("TPED") is a recently-launched Paris-based Think-Tank aiming to promote the development and sharing of business economics knowledge in transfer pricing as an enabler of development of emerging economies and developing countries.

In line with the Association's focus, TPED's comments focus on the economic aspects of the Draft distinguished from, but in support of, the tax and legal considerations, which have been duly taken into account.

Our comments will focus on:

- the proposed **extended definition of immovable property in article 13(4) MTC**, including reference to government rights under which companies may operate;
- the valuation of such rights **for the assessment of the 50% criterion in said article 13(4) MTC**; and
- **the taxation of the *whole* transaction** in the State issuing the rights, and related "basis step-up" for the enterprise as a whole, once that the 50% threshold is satisfied, as opposed to pro-rated taxable asset rule.

We use this opportunity to compliment the authors for using real cases examples in the Draft as opposed to hypothetical, simplified examples.

1. The Extended Definition of Immovable Property

The discussion draft suggests the following terms:

> "*Box 10: Extended definition of immovable property*
>
> > *"Immovable property" includes…*
> >
> > *(e) A right granted by or on behalf of the government (whether or not embodied in a license) to be a supplier or provider of:*
> >
> > *(i) goods (such as radioactive materials)*
> >
> > *(ii) utilities (such as electricity or gas); or*
> >
> > *(iii) other services (such as telecommunications and broadcast spectrum and networks)*
> >
> > *country wide or within a geographical area of Country L*"

The Draft defines "*in economic terms, the concept of 'immovability' might be most meaningfully thought of as proxying for the possibility of location specific rents*". […] *This view suggests an expansive definition of 'immovability' capable of capturing at least the most likely sources of significant LSR.*" Still, the Draft acknowledges "*the concept of LSR has not been fully developed to be readily captured in legislative language*" and that "*LSRs can be difficult to identify in general" with the exception of "government-created rights, notably in the extractive industries and telecoms*."

Our comments here focus exclusively on economic concepts and will not delve into legal analysis; we must note, however, that extending the definition of "immovable property" in the language of international tax treaties in order to allocate taxing rights may face legal challenges in numerous jurisdictions throughout the world. The physical or corporeal nature of "immovable property" and its inherent or construed connection with "land" can trigger challenges of interpretation which perhaps could be avoided if an entirely new "qualification" (other than "immovable property") were created. Perhaps "government rights" would deserve a separate article in the Model Convention. Again, and although any legal analysis is outside the scope of this commentary we would like to point out that a different – and greater – definition of immovable property would have to be reconciled with the guidance developed under the G-20/OECD BEPS Project, whereby in the new Chapter VI of the OECD Transfer Pricing Guidelines governmental rights are treated as intangible property, as discussed in the next section.

The Draft, nonetheless, calls for the following comments from an economic and transfer pricing perspective:

- **(a) Government rights within the proposed extended definition of immovable property are *intangible assets***

The *"right[s] granted by or on behalf of the government (whether or not embodied in a license)"* targeted by the Draft seem to correspond in part or in full with the OECD Transfer Pricing Guidelines' "*rights under […] government licenses*":

"Government licenses and concessions may be important to a particular business and can cover a wide range of business relationships. They may include, among others, a government grant of rights to exploit specific natural resources or public goods (e.g. a licence of bandwidth spectrum), or to carry on a specific business activity. Government licences and concessions are intangibles within the meaning of Section A.1" (para. 6.6)

They fulfill the criterion set by the OECD and the UN with respect to an intangible:

- *"In these Guidelines, therefore, the word "intangible" is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances."* (para 6.24 of the OECD Transfer Pricing Guidelines)

- "*For the purposes of this chapter the term "intangible" encompasses something which is neither a physical nor a financial asset, which is capable of being owned or controlled for commercial purposes, whose use or transfer would be compensated had it occurred between independent enterprises in comparable circumstances*." (para. B.5.2.3 of the UN TP Manual)

The current Draft Report is, in our opinion, not explicit enough with respect to the exact nature of the assets included in the extended definition, and whether these assets are to be deemed intangibles or not.

On the contrary, the Draft Report provides a relatively elliptic definition of intangibles, which does not include the government rights in scope of the extended definition: "*Intangible Property. For purposes of this report, this term is defined herein as property which has no physical presence, for example, a financial asset such as corporate stock; intellectual property; business goodwill*" (page 7), which is not necessarily aligned with either the definition by the OECD or the one by the UN.

Instead of qualifying the rights in scope of the extended definition as intangible assets, the Draft Report links them to Location Specific Rents “(LSRs”), while acknowledging the inherent challenges of the concept (an economic concept rather than a legal one).

Based on the above, it would be useful to leverage the developments made in the transfer pricing area about the concept of LSRs:

The concept of LSR has been elaborated in the context of transfer pricing[1].

The concept of Location Specific Advantages (LSAs), which captures the same phenomenon, is widely used in international economics literature[2], and is now better defined in the transfer pricing context. Various authors have contributed to the definition of LSAs[3], the definition of Location Rents resulting from the exploitation of the sources of LSAs and the allocation of LSAs among various members of a Multinational Enterprise[4][5].

LSAs may involve the supply side, notably “factors of production and distribution that can be exploited to produce a particular product or service cheaper, better and/or with less risk, or to increase the ability of a company to sell more products, at a higher price and/or achieve a larger market share”.[6]

On the other hand, they may also relate to the wider market structure and demand side, for instance legal, regulatory or administrative restrictions, as well as physical or other constraints, limiting the number of competitors and inducing an artificial scarcity in the relevant market. These location specific advantages may then lead to excess demand and the capability for the incumbents to sell more products at a higher price[7].

Both the OECD and the UN have commented that LSAs, at the origin of the LSRs, do not constitute intangibles per se, are not capable of being owned or controlled, but still should be taken into account in a transfer pricing analysis. The exclusive reliance in the wording of the

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1 See glossary to the 2017 update of the United Nations Transfer Pricing Practical Manual for developing countries.

2 The concept of location specific advantages is one widely used in international economics literature, see for example Dunning, J.H. (1977), "Trade, Location of Economic Activity and the Multinational Enterprise; a Search for an Eclectic Approach", in Ohlin, B., Hesselborn, P.O., and Wijkman, PJ. (éd.), The International Allocation of Economic Activity, London, MacMillan.

3 Patton M.F., Quick P.D., “Location Savings after Sundstrand v Commissioner: out of the BALRM and into the Game Room?”, Tax Management International Journal, July 1991, 20-7

4 McKee M. and M. McDonald, “Location Savings in competitive markets”, Tax Management Transfer Pricing Report, Vol. 9, No. 19, Feb 2001.

5 Gonnet, Fris and Coriano, “Location Specific Advantages-Principles”, Transfer Pricing International Journal (June 2011).

6 Patton and Quick, (1991)

7 Gonnet, Fris and Coriano, “Location Specific Advantages-Principles”, Transfer Pricing International Journal (June 2011).

Draft Report on LSRs to justify the taxation in the local country of certain rights may create confusion.

In TPED's view, governments rights within the extended definition are indeed "market specific characteristics" but fall under the "intangible" category, as they are owned and controlled by the local entity. Still, they are indeed or may be at the origin of LSRs in the local country.

As a matter of economic policy, it should be noted that the attribution of "immovable property" treatment to such government-created "intangibles" extends the "force of attraction" feature of immovable property to governmental licenses. This could represent an incentive for the "over-regulation" of domestic markets, which would be distortionary and particularly detrimental to developing economies. Immovable property exerts such "force of attraction" in respect to taxing rights because of its inherent connection with a nation's territory irrespective of its regulatory or institutional environment; governmental licenses and other such "intangibles", instead, are not inherent to land but "created" as a consequence of economic policy choices, governmental activity, domestic laws, and regulations within each country's institutional framework. Therefore, by granting such extended taxing rights or "force of attraction" to "government-created assets", by equating such "assets" to "immovable property", states that are in fact "consumer markets" or "labor markets" would have a "tax incentive" for increased regulation and increased governmental interference in domestic markets. Over-extended regulatory activities triggered by such "tax incentive" could have detrimental welfare effects to the countries that take this approach: over-extended regulations could distort the allocation of factors of production and of capital, distort competition and reduce investment within such countries, and most critically reduce consumer surplus and labor welfare in developing economies.

In light of the above, we recommend;

- **To confirm the intangible nature of the "government rights" within the extended definition of the Draft Report, and to align it with that of the OECD Guidelines / UN Manual,**

- **To retain the reference to LSRs but, as a consequence of the exploitation of an intangible owned by a company (the government rights), while acknowledging that such an intangible/government rights may not be the only source of the LSRs that the company benefits from (see Section 2),**

- **To further refine the nature of governmental rights and regulations (e.g. in extractive industries and utilities) that conform to the object and purpose of the rule, thereby discouraging an "over-regulation" of markets.**

The next section discusses the valuation of such rights, now properly defined, for the assessment of the 50% criterion in said article 13(4) MTC.

2. The valuation of such rights for the assessment of the 50% criterion in said article 13(4) MTC and proposed "inside basis step-up"

Article 13(4) MTC states that "Gains derived … from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property in (a) … State may be taxed in that …. State." Where usually the value of an underlying real estate can be assessed in a relatively straightforward manner, this is very different in assets that are brought under article 13(4) by an extension of the definition of immovable property. The value is in many cases derived from exploitation activities in-country that involve more activities abroad, investment and knowledge than the mere holding of a governmental license as described in the extension of the article 13(4) definition. Such broader activities, investments and knowledge are often owned or performed by more than one party in multiple countries, and therefore critically linked to analyses that are ruled by the Transfer Pricing Guidelines.

The Draft Report seems to make a clear and direct link between LSRs (or residual/excess value) and the government rights in scope of the extended definition, but acknowledges only in a few instances that other value creating activities could be involved in the value creation process:

- while discussing taxation in the country where an asset is located (in the inter-nation equity section) , the Draft suggests cases where "*perhaps, a substantial part of those [capital] gains are attributable to value-enhancement provided from abroad […] Establishing the extent of any such contribution, however, could of course be problematic*" (page 18)
- "*The increase value of the entity sold may reflect in part managerial and other expertise contributed by the seller. […] It may indeed be that there are company-specific as well as location-specific rents at work*" (page 21)

In TPED's view, the understanding of the origin of LSRs, and more generally of value and profit creation by the local company (owning the rights) is crucial as it forms the basis for the subsequent financial evaluation of the 50% threshold. It cannot be presumed that only the "government right" explains the local company's flow of profits, and therewith its value.

We suggest using economic theory concepts, already leveraged by the OECD and the UN in their definition and assessment of LSAs, to confirm the origin of value and profit in such situations.

In transfer pricing, the treatment of LSRs demands

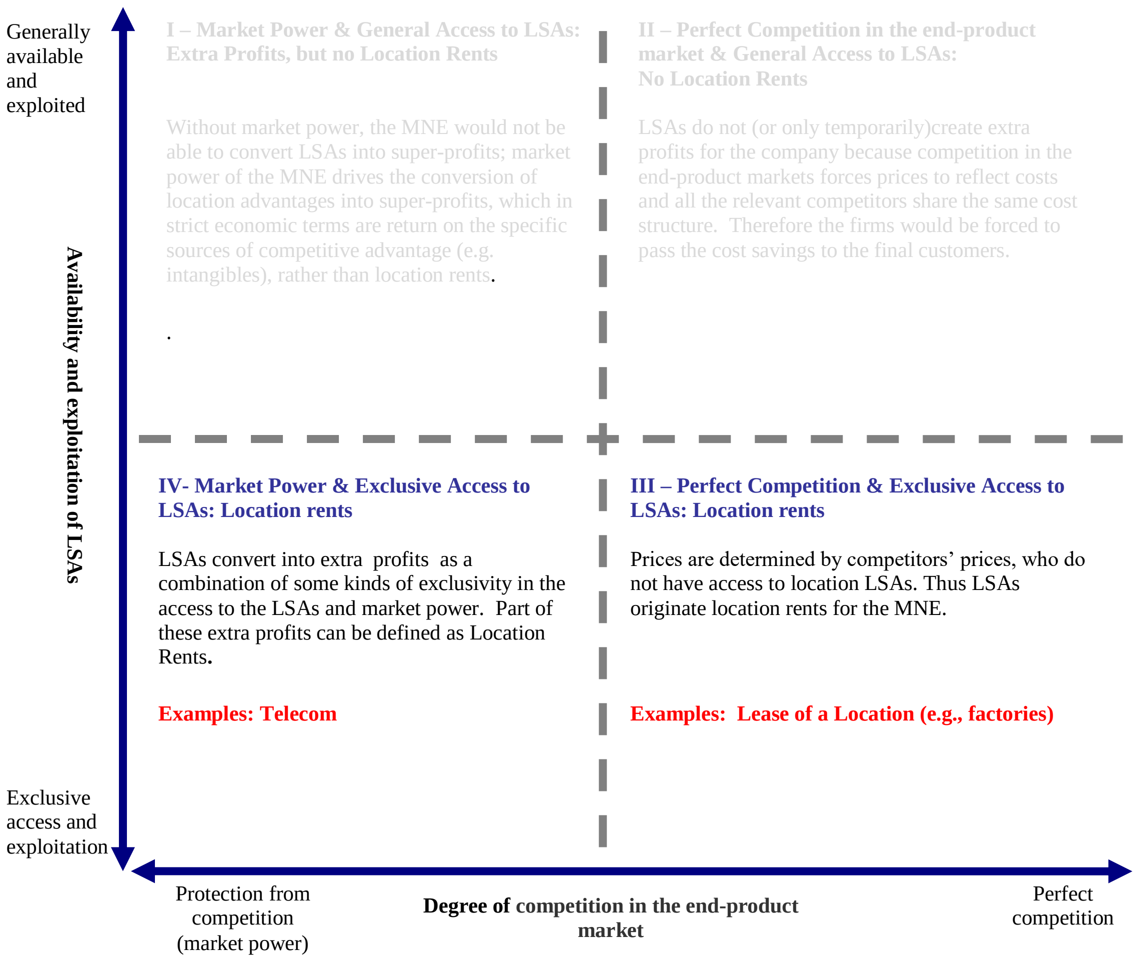
1. an understanding of LSRs in the broader context of how the MNE operates, and
2. an apportionment of such LSRs between entities (or even parts thereof) of the MNE involved in the exploitation of such LSRs.

As LSRs result in some forms of super profits (or residual profits in transfer pricing terms), it is generally the case that the generation of such LSRs does not involve a passive behavior from the beneficiary of such rights. There will likely be counter examples to this active behavior, notably found in what the Draft calls the "minimal definition of immovable property": a lease of land for instance may generate LSR and sees its value increasing by factors not related to any active management of the right, (for instance investments in the neighboring surroundings by the State; etc.).

In general though, LSRs are the fruit of an active management, notably through people, investments, expertise, etc. Looking at the "extended definition of immovable property", the government rights in the telecom industry (category (iii)) clearly fall in the category of active management. The government indeed allows to an operator to operate under certain spectrum usage rights, within the context of a specific national regulatory framework. Still, such an operator needs to make large investments in networks, needs to deploy relevant technologies, and needs to structure a suitable commercial offering, to attract and retain customers, often in a highly competitive market. In case such operator generates LSRs, it is generally a combination of all its assets (including the government rights) which are at the origin of such value.

The LSA matrix provides an illustration that LSRs do not originate by the mere market feature or grant of a right but in some cases, also involve other intangibles:

LSA Matrix



Under such a matrix, we focus on quadrants III and IV where there is exclusivity in the access to, and availability and exploitation of, the sources of LSAs.

In the context of a perfect competition, any LSR resulting from a specific right or a specific restriction is indeed explained fully or quasi-exclusively by the right or the restriction. A lease of land might be within this category.

On the contrary, other rights (or restrictions) do not generate LSR (and then gain value) in the absence of an active management through people, investments, expertise, etc.

This suggests that:

- In the first case, the full value should be recognized locally, in the place where the LSR is realized where the right/the restriction (or even the -exclusive - market feature) is awarded.

- In the second case, the LSRs result from exclusivity in the access to the LSAs (for instance a government right) and market power, generally related to the Company's competitive advantage. Such competitive advantage cannot be obtained from a passive behavior by the Company or by the "group" or wider "enterprise" to which it belongs. Active management, notably through people, investments, belonging to a wider multinational firm, and non-local knowledge and expertise is common to multinationals in multiple sectors, which want to ensure their profitability and continuity not only in each local country but worldwide. Companies operating under certain government rights do have specificities in the sense that

  - they are (to a varying extent) regulated meaning that their tariffs, investments, returns are (more or less) regulated (controlled);

  - they operate under the strict supervision of the Government or a regulator; and

  - they may have special obligations or treatment, for instance of their employees.

  But there is a myriad of situations. The extent to which such regulated companies need to develop and maintain value-added intangibles varies depending on the markets they are in. Utilities such as gas and electricity do not face the same challenges as the telecom industry, and government concessions and licenses for manufacturing, production, oil refineries, or container terminal locations, to name a few, have their returns and value intertwined and inextricably linked with a broader business venture. All the other (non-governmental) assets and intangibles may have been developed locally and/or may have been contributed by other non-local entities of a multinational group.

In the transfer pricing world, which entities are entitled to the LSRs‘ underlying profits depends on which entities contribute to 1. securing the exclusivity and 2. developing the competitive advantage.

The above analysis should be straight-forward only in the case of a local company owning a lease of land, owned by an entity without any staff or substance. But for companies with more complex operations, such as the ones targeted by the extended definition, the above will form the basis of a broad understanding of the contribution of the various companies involved (including the local company, owning the government rights and possibly other intangible assets, its parent, and possibly other group companies).

The subsequent step is the financial valuation of the asset in scope of the immovable property definition. We understand that the 50% threshold should be evaluated by comparing the fair market value of the ("extended") immovable property with the total value of the assets, for which the transaction provides an arm's length price. Within this financial valuation exercise, not only the immovable property should be revalued, but all the assets of the company, including intangible assets, some of them not appearing on the balance sheet of the company. This asset reevaluation is well-known to accountants who routinely perform Purchase Price Allocations post-transactions.

In the context of the current Draft Report, a number of questions arise:

- What is the value of the government rights in isolation from the rest of the assets of the Company?

- What is the value of the other intangibles (such as customer relationships/clientele or the brand) in isolation from the government rights?

- How to treat goodwill that accountants typically recognize in their PPAs?

    - In this respect, we note that the Draft Report includes business goodwill in the scope of intangibles. The OECD does not. Under the OECD Guidelines, goodwill, while not an intangible, should be taken into account in a transfer pricing analysis. Isn't goodwill exactly what the Draft Report intends to relate to the government rights and tax in the context of the realization of a capital gain?

The above has large implications in terms of the evaluation of the 50% share:

Assume an individual "location specific asset" akin to an immovable property (as proposed in the Draft) has a historical value of $100, and that a transaction involving the sale of the shares of the parent of the local company, owning such asset (OIT) suggests an arm's length price for the local company and its parent of $500. Assume further that revalued tangible assets are worth $150. Remains $250 of value, which should be split among the various intangibles of the firms (both the local company and the parent), including a revaluation of the immovable property. Depending the results of this analysis, the 50% threshold may or may not be reached.

Furthermore, the Draft notes that in taxing the entire value of the transaction, even if source countries allow and recognize a full "step-up" in the depreciable or amortizable basis of "all assets", a substantial "time-value of money" benefit would accrue to local tax treasuries. Given the multitude of intangible assets (separate from the government right itself) that could be "stepped-up" as a result, it is theoretically possible that a substantial "write-off" could be triggered on the same year when the "gain" is captured by the local country. This would reduce the present value of the tax revenue of the first year, while other "stepped-up assets" would provide further amortizations and depreciation in future years. Therefore, the net revenue effect to local treasuries arising from such broad, enterprise-wide "step-up" is hard to anticipate but may well be far less substantial than suggested in the Draft. If, instead, the taxing right and the "step-up" in question were limited to the "government right" itself (as opposed to the entire enterprise value), then a time-value "benefit" would always accrue to local revenue authorities (a lesser gain, and a write-off spread over-time). In this case, perhaps a recommendable policy would be to abandon the 50% threshold and tax all indirect transfers of government rights, with a corresponding step-up.

In light of the above, we recommend:

- **To confirm that the evaluation of the 50% threshold should be based on the comparison of the immovable property fair market value with that of all the assets within the transaction scope (including assets and functions of the local Company and its foreign affiliates which, in conjunction, support the enterprise value in question)**

- **To confirm that an economic and financial evaluation should be performed on a case-by-case basis, involving the evaluation of all individual assets in scope (including intangibles, also those that are not within the balance sheet of the companies in scope – both local and parent company involved);**

- **To indicate that PPAs, as performed by accountants, should not exclusively be relied upon but like the OECD has suggested that PPAs of the transaction provide some insights which are not necessarily binding the transfer pricing analysis. In this respect the treatment of goodwill is crucial.**

- **To provide guidance with respect to the suggested techniques to apportion the various blocks of value for the purpose of the 50% evaluation.**

3. The taxation of the whole transaction in the state that issues the right, once that the 50% threshold is satisfied, as opposed to pro-rated taxable asset rule.

Under current OECD and UN Model MTCs, the full amount of the capital gain is taxed when the 50% is met.

The "force of attraction" approach seems to trump the assertion of whether the gain in question is reasonably attributable to the location-specific "asset", which seems a relatively fair assumption in the context of the existing definition of immovable property. But as the intent is to broaden the definition to a larger scope of industries, firms and activities, we wonder whether applying a "force of attraction" approach for the gain which is not attributable to the immovable property or to the governmental right itself is coherent with the underlying economics that justifies the proposed allocation of taxable rights.

The Draft Report presents the taxable asset rule that Kenya has adopted for the extractive sectors, where the source country imposes tax only on a proportionate basis, equal to the share of the revalued immovable property over total value of the assets, when the immovable property accounts for between 20% and 50% of the transaction value.

In light of a broader definition of immovable property, this approach could be in our view be a promising approach, as

- It focuses only on the asset of the Company that is tight to the country, i.e.; the government rights,

- It avoids a taxation of the other company's intangibles (not government rights), which all other companies (not operating under government rights) have to similarly use for their business,

- It may allow to broaden the scope of the definition of immovable property to all types of government rights (to the extent they fall under the OECD/UN definition of intangibles)

- It raises the question of the benefits of maintaining a 50% threshold, which may create adverse effects.

In light of the above, we recommend considering the taxable asset rule as an alternative to the source rule, involving the full taxation above a threshold and zero taxation below.

Conclusion

The Draft Report aims to expand the taxation rights of countries where certain assets are located by an extension of the reach of article 13(4) MTC. This seems to be the intended and economically justifiable extension of the taxing rights of countries where value is created based, for more than 50%, on locally issued government rights. However, it incites certain legal challenges (given varying local-country definitions of "immovable property" in spite of the treaty), and perhaps an entirely new article ought to be created.

Government rights within the proposed extended definition of immovable property are "intangible assets"; as such, we recommend an alignment with the OECD and UN intangibles definition. From an economic policy perspective, such category of assets should be further defined so as to avoid creating a "tax incentive for over-regulation" of local markets which could be particularly damaging to workers and consumers in developing economies.

As the test for purposes of article 13(4) MTC is whether these rights have a value of more than 50% of the total transaction price, in the first place the identification of the (type of) assets concerned is critical. Secondly, the valuation needs to be done for the right, distinguished from possible other contributing elements to the value creation as a whole. Economic theory on LSRs can provide the foundation for an understanding of the interplay between the various activities, assets and contributing entities. An explicit alignment with the OECD / UN LSA concept is welcomed, as well as guidance with respect to the financial and economic valuations recommended for the purpose of the 50% assessment.

Taxation as suggested under method 1 is based on a deemed disposal of the asset(s) concerned. Taxation under method 2 needs the same analysis of the relations between the different entities concerned. Under both methods however, the source rule applies where the full value is taxed when the 50% threshold is met (and no taxation below). The Kenyan example (on the extractive sector) provides an illustration of an alternative taxable asset rule.

Under this method, a pro-rata application of values should be used in certain instances. A taxable asset rule, together with extended immovable property clearly defined as local "government related" intangibles (separate and different from other intangibles) could accompany an even larger definition of immovable property (such as the one proposed by the Draft Report in page 57). This would also prevent the unintended inflation of the "asset step-up" described in the Draft.

The choice between methods suggested may well be left to the discretion of the country of location of the asset. It is critical however that this choice is respected and followed by the country of residence of the entity transferred.

We finally also mention that the value of the OIT itself may be influenced by the applicability of one method rather than the other.

We thank you again for the opportunity of providing comments and remain at your disposal for further comments.

Best regards

On behalf of TPED[8]

Sébastien Gonnet, TPED President, NERA Economic Consulting Paris

Romero J.S. Tavares, TPED Vice President, WU Vienna University of Economics and Business, Vienna

Pim Fris, NERA Economic Consulting, Paris

Giammarco Cottani, Ludovici & Partners, Milan

[8] The views expressed are those of the authors, not necessarily those of TPED or its other members.