CAPITAL GAINS TAXES
AND OFFSHORE
INDIRECT TRANSFERS

Finance: Uncovered
BACKGROUND

Fair taxation is necessary to overcome global poverty and extreme inequality. But corporations in many cases avoid paying their fair share of taxes in countries where their substantial profits are generated. It means developing countries in particular miss out on huge sums, which could be spent on healthcare and education.

In 2017, Finance Uncovered, a UK-based journalism training and reporting organisation, produced a story on how a UK private equity company avoided paying tens of millions of dollars in Capital Gains Tax (CGT) in Uganda after it sold a profitable business there. While researching this story, Finance Uncovered suspected capital gains tax avoidance could be a systemic issue—a new dimension in the tax justice debate. The following year, Finance Uncovered published three more stories involving oil, mining and telecom companies avoiding billions of dollars in CGT in countries where the profitable businesses were located. It seemed CGT avoidance was an important, yet relatively unexplored area.

In 2019, Oxfam started analysing further cases and potential policy responses. The result is this report. Its purpose is to generate appreciation for and understanding of CGT avoidance in the global tax justice policy debate. We also hope this report provides a tool for civil society activists and investigative journalists to analyze and expose this form of tax avoidance.

ACKNOWLEDGEMENTS

The report was written by Henrique Alencar and Judith van Neck from Oxfam in collaboration with Nick Mathiason from Finance Uncovered. The paper was coordinated by Paul Groenewegen and supported by a number of (former) colleagues. Special mention should be made to Susana Ruiz Rodriguez, Oli Pearce, Daniel Mulé, Francis Weyzig, Ted Jeory, George Turner, Stefan Verwer, Maarten de Vuyst, Nguyen Thu Huong, Joseph Olwenyi, Namit Agarwal, Frank Boeren and Inèz Meerema.

The report is part of the Money Trail project supported by the Dutch Postcode Lottery. For more information please contact the lead author: Henrique.Alencar@oxfamnovib.nl

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LIST OF ACRONYMS

ATAF  African Tax Administration Forum
BIT  Bilateral Investment Treaty
CGT  Capital Gains Tax
COMESA  Common Market for Eastern and Southern Africa
DTA  Double Tax Agreement
EAC  East African Community
GAAR  General Anti-Avoidance Rule
MAP  Mutual Agreement Procedure
OECD  Organisation for Economic Co-operation and Development
OIT  Offshore Indirect Transfer
SAAR  Specific Anti-Avoidance Rule
SADC  Southern African Development Community
TJN-A  Tax Justice Network Africa
UN  United Nations
UNCITRAL  United Nations Commission on International Trade Law
UNCTAD  United Nations Conference on Trade and Development
URA  Uganda Revenue Authority
All countries are heavily dependent on taxation as the primary revenue source for the provision of essential public services to its citizens, such as health, education and social security. While most countries have experienced budgetary tensions in recent years, the COVID-19 crisis is dramatically aggravating the situation. With national budgets stricken by the exceptional expenditures on health, social protection and efforts to protect employment, a sustained and fair economic recovery will surely require additional revenues.

As many countries also face precarious debt situations, increased tax revenues are needed to overcome the crisis and lessen the impending increase of inequality and poverty. But developing countries often have difficulties reaching their potential in domestic revenue collection. A major reason for this is that developing countries miss out on at least USD100 billion every year due to tax avoidance by multinationals.

When governments lose tax revenues on such an enormous scale, it is ordinary people who pay the price. This is because the essential public services they rely on are denied adequate funding. A stark effect of underfunded public services is that too many girls and women in developing countries suffer from poor access to health and education. Tax avoidance is therefore a key factor in the rapid rise in extreme inequality.

To meet the Sustainable Development Goals set out by the 2030 Agenda and adopted by 193 countries, governments and tax revenue authorities must hold multinational corporations accountable to pay their fair share of taxes in the places where they operate and have an economic presence.

While Corporate Income Tax remains the most significant source of revenue that governments collect from companies – and the focus of considerable research in recent years – the taxation of capital gains is often overlooked as an important source of government revenue.

Normally triggered by the transfer of assets between different entities (such as the sale of oil extraction rights or telecom licenses from one company to another), the effective enforcement of Capital Gains Tax (CGT) ought to be raising significant revenue for developing countries. Over the past three decades, developing countries have witnessed a large volume of investment activity – particularly focused on extractive industry assets and telecom businesses – regularly bought and sold at often vast profits.

These transactions of local assets should have seen significant amounts of Capital Gains Tax revenue flowing to developing country governments. CGT, in fact, has the potential to make a big difference to the provision of essential services that could in turn help improve the life chances of citizens.

However, there are strong indications that developing countries have not been able to tax capital gains made by multinationals inside their borders. It seems a tax avoidance technique has been developed that is widely used by multinationals to avoid the payment of Capital Gains Tax in countries where their valuable assets are located. Known as Offshore Indirect Transfer (OIT), this technique involves relatively complex corporate structures and the establishment of intermediary entities in tax havens.

Our report analyses seven Capital Gains Tax cases in developing countries. Some of these cases are still under legal dispute. The total amount of tax developing countries could be missing out on from this tiny sample is over $2.2 billion. Such a huge amount of potential tax from such a small sample size indicates that when it comes to CGT avoidance, there could be a huge amount at stake.

Although many multinational companies arrange their corporate structure and transactions to avoid Capital Gains Tax through Offshore Indirect Transfers, countries today do have concrete options to effectively ensure the taxation of capital gains.

Through the enactment of domestic legislation and the inclusion of specific clauses in Double Tax Agreements, developing nations can strengthen their tax regimes and prevent the avoidance of significant revenue. This report will outline possible options in this respect.
Tax revenues are essential for countries so they can provide essential public services for citizens, as well as performing other basic government functions. The quality of public healthcare or education provision has a crucial impact on the lives and opportunities of all people, especially women, girls and the most vulnerable in society. If a country wants to effectively tackle poverty and economic inequality, and so facilitate economic and social advancement for all its citizens, the collection of taxes in a progressive and fair way is essential.

Looking closely at the fiscal situation of developing nations, it is clear that public budgets are more dependent on the taxation of domestic and multinational corporations than in rich countries. To ensure sufficient revenue is available for fundamental public investment, governments and tax revenue authorities must be able to hold accountable multinational corporations so that they pay their fair share of taxes.

However, the current rules of international taxation establish that corporate taxation takes place overwhelmingly in the countries where multinationals are headquartered. This is generally in developed nations and it is an unsatisfactory outcome when part of the wealth and value, sometimes the overwhelming part, has been created in other countries.

At the same time, developing countries must be able to raise domestic resources in a sustainable way. The importance of revenue mobilization by developing countries has been widely recognized as a path towards sustainable development. Increasing domestic tax revenues has been acknowledged as a priority for many years. The current COVID-19 crisis further increases its importance.

With the exceptional social expenditure and unprecedented economic deterioration precipitated by the COVID-19 crisis, developing countries urgently need to raise more revenue. As many developing countries also risk facing unsustainable debt situations, a new round of external borrowing would help governments to address emergencies in the short term but also certainly increase the difficulties faced over the near future. Governments therefore need to consider an expansion of national tax bases as the way towards increased tax revenues. With the dramatic adverse effects caused by COVID-19, governments cannot leave pending reforms unaddressed.

A broader tax base incorporating the taxation of wealth and capital (both for individuals and corporations) presents itself as a progressive and technically sound direction to increase domestic revenues and finance the
The good news is that countries have at their disposal the power to establish legal rules to prevent this form of avoidance. To achieve this, important roles are played by:

a) Domestic tax legislation – i.e. formal rules and procedures to be followed by national tax administrations to enforce and collect taxes effectively; and

b) Double Tax Agreements, due to their significant function allocating taxation rights from cross-border transactions between the involved countries.

This report will focus on the legal analysis and the impact of Capital Gains Tax avoidance. It will also present recommendations to civil society organizations and policymakers interested in protecting their tax base and successfully enforcing taxation on multinational corporations.

The report will initially analyze what constitutes a Capital Gain, how countries choose to tax them; and the development of Offshore Indirect Transfers, the international tax avoidance technique utilized by multinational corporations in this specific area.

In order to clearly illustrate this initial analysis, the report will use an example focused on a fictional oil multinational corporation operating in developing countries.

Following this initial explanation of the subject, the report will focus on seven concrete cases of Capital Gains Tax avoidance through Offshore Indirect Transfers, which have resulted in a total loss in tax revenue over over $2.2 billion to developing countries such as India, Uganda or Vietnam.

The report will then focus on the legal and technical aspects of Capital Gains Taxation and Offshore Indirect Transfers – from the perspective of domestic tax legislation as well as Double Tax Agreements signed between countries. This section will look in detail at the policy options countries can utilize to prevent tax avoidance through OITs.

The final chapter will summarize the main findings of the report and synthesize the main policy recommendations for developing countries interested in curtailing the leakage of public revenue through this specific tax avoidance technique. At the same time, it provides some policy guidance for civil society organizations and tax justice activists to lobby their governments to adopt policies to prevent this form of tax avoidance.
CAPITAL GAINS TAXES (CGT) AND OFFSHORE INDIRECT TRANSFERS (OIT)

Capital Gains and Capital Gains Taxation

A capital gain is the rise in value of an asset – for example, shares of companies, real estate property or valuable art items. When there is a change in ownership of an asset (normally through a sale), the capital gain is realized. Some of the most valuable transactions often involve licenses for extractive industries or telecommunications.

Domestic legislation varies on the fine print and specific details, but it is widely accepted that capital gains occur when an asset changes hands. For example, at the moment shares in a company are sold. The amount considered to be a capital gain will be the value received by the final transfer of the asset minus the value initially paid. A simple example can illustrate this:

OilCorp is a multinational group involved in the extractive industry. A local subsidiary of OilCorp has purchased the license to extract oil in Resourceland, a developing country, for $100 million. After a number of years operating under that license, OilCorp decides to finish its operations in Resourceland and sells its extractive license to EnergyCorp for $450 million. EnergyCorp now has full control over the oil extraction license and will from now on be liable for taxes on any income generated by its activities. However, as OilCorp earned a substantial profit from this transaction, it is now liable to Capital Gains Tax (CGT). As OilCorp had an initial expense of $100m, it has generated a total capital gain of $350 million (that is $450m minus the initial $100m cost).

As countries need revenue for financing public services, governments are normally interested in levying taxes over meaningful economic activities. This includes capital gains. In most domestic tax regimes, the right of a jurisdiction to tax capital gains is either included in the main tax legislation (such as an Income Tax Act) or established in a specific legislation (a Capital Gains Act). While some countries design a specific rate for the taxation of capital gains, other countries will simply use the rate already in place for Corporate Income Taxation. Following on the previous example:

Resourceland recently passed an Income Tax Act which establishes a 35% rate for the taxation of corporate income. However, Resourceland also has in place a Capital Gains Act. This specific legislation establishes a 20% tax over any profits generated on the transfer of assets. Since the country has CGT legislation and a rate specifically developed for this type of transaction, the 35% corporate income rate is not applied. As a result, Resourceland will collect tax worth $70 million (Total profit of $350m x 20% Capital Gains Tax).

The structure of multinational corporations also affects the ability of countries to tax its operations. Most people think of a multinational corporation as one entity that has direct control over its assets spread around the globe. However, it is not that simple. The ownership structure of multinational corporations is often complex – motivated by management structures, international operations, corporate legislations and of course, tax minimization. For instance, multinational corporations often establish a complex network of holding companies and subsidiaries to control assets that generate revenue (like oil extraction licenses). This can be illustrated by examining two opposing scenarios:

Simple scenario of direct control:
- OilCorp is a multinational corporation with its headquarters in the United States;
- OilCorp has direct ownership of OilCorp Resourceland, a subsidiary registered in the oil-rich country of Resourceland;
- OilCorp Resourceland has direct ownership of extraction licenses of oil fields located in Resourceland.

Complex scenario of indirect control:
- OilCorp is a multinational corporation with its headquarters in the United States;
- For tax purposes, OilCorp has created a holding company in the Netherlands. The corporate structure of OilCorp involves subsidiaries located in many jurisdictions, including locations that have no oil reserves or relevant staff and that are described by some as competitive and business friendly, or as tax havens by others. These jurisdictions tend to have a broad network of Double Tax Agreements, generous corporate tax incentives, secrecy around transactions and ownership structure, reduced tax rates and non-intrusive tax administrations;
- OilCorp’s Resourceland subsidiary is not directly owned by the main entity of OilCorp but is routed through a number of related entities located in various jurisdictions.
As a result of these relatively complex structures and networks of entities spread across many countries, multinational corporations have at their disposal a number of techniques and strategies they can use to reduce their tax payments. Among these is the shifting of profits out of resource-rich countries to low tax jurisdictions. This often results in the avoidance of taxes in developing countries. This paper looks into a specific technique for the avoidance of Capital Gains Tax, which is the focus of the following pages.

**EXAMPLE OF ABUSE OF CGT THROUGH OFFSHORE INDIRECT TRANSFER (OIT)**

OilCorp wants to purchase a license to extract oil in Resourceland. To manage the oil extraction, the multinational company establishes a local subsidiary named OilCorp Resourceland. OilCorp’s directors know that one day in the future it could potentially sell its oil license to another company, if an interesting offer is presented and a good profit is achievable.

OilCorp’s directors at its US headquarters are advised that a future direct sale of the license from OilCorp Resourceland to another company would result in the Resourceland government charging CGT from OilCorp Resourceland.

To avoid this, OilCorp headquarters develops a strategy to avoid paying CGT in any future transaction. The directors realize that this can be achieved by selling shares in its Resourceland subsidiary instead of directly transferring the oil license.

With this scenario in mind, OilCorp headquarters creates an intermediate company based in the business friendly jurisdiction of Havenland. OilCorp headquarters adjusts its structure so that OilCorp Havenland has full ownership and control of OilCorp Resourceland.

With this structure in place, when EnergyCorp approaches OilCorp to purchase the oil license, OilCorp headquarters has the opportunity to fully avoid paying CGT on the transaction. Instead of selling the oil license directly to EnergyCorp and triggering CGT charges in Resourceland, the deal is structured so that OilCorp Havenland actually sells to EnergyCorp the direct control of OilCorp Resourceland.

When OilCorp Havenland transfers full control of OilCorp Resourceland to EnergyCorp, the following is achieved:

(i) The license remains under direct control of OilCorp Resourceland;
(ii) EnergyCorp acquires full control of OilCorp Resourceland, which owns the oil license; and
(iii) As the license doesn’t change hands – it remains directly owned by OilCorp Resourceland – no capital gains is realized and no CGT is levied where the asset is located.

This technique is known as Offshore Indirect Transfer (OIT). In simple terms, it is the transfer of an entity that has control over an important asset, instead of a direct transfer of the asset itself.

As observed in the example above, the objective of OITs is the transfer of the effective control and ownership of an asset without actually changing its legal direct owner. While there is an actual transfer in the control of legal entities, the relevant asset (which holds value) is only being indirectly transferred. OilCorp Resourceland continues to control the oil license, but now EnergyCorp controls OilCorp Resourceland. As the license remains directly controlled by OilCorp Resourceland, no CGT is levied in the jurisdiction where the asset is located.

Oil is a clear example of a technique used to avoid taxes which would normally have been charged after the direct transfer of an asset. As direct and indirect transfers both result in the actual control of the asset changing hands, tax systems should guarantee that both forms of transfers are treated identically for tax purposes. With the system as it is, there is a clear incentive for multinational companies to distort transactions and deny developing countries of much needed public revenue.

Abuse of CGT through Offshore Indirect Transfer (OIT)

Due to the wide variety of laws and regulations across different jurisdictions, corporations are able to structure their organization and cross-border transactions for their own benefit. This will be again examined through our previous example:
As countries have the power to tax the direct transfer of a local asset, the taxation of capital gains from OITs is a logical extension of that power. If OITs are not taxed and there is no anti-avoidance legislation in place, CGT arising from the transfer of an asset can be easily avoided by interposing an intermediary entity.

As demonstrated in the OilCorp example, OITs necessarily require two or more jurisdictions – Resourceland and Havenland. While Resourceland is unable to collect CGT as there was no direct transfer in the ownership of the oil license, Havenland (the country where the intermediary entity is located) could opt to charge CGT from the gains generated by the transfer of OilCorp Resourceland to EnergyCorp. Let us go back to our fictional case study:

When OilCorp Havenland sold its control over OilCorp Resourceland to EnergyCorp, it made a $300m gain. If Havenland chose to, it could levy CGT over the profit of OilCorp Havenland.

However, most intermediary entities are placed in business friendly jurisdictions like Havenland, which have a policy of either applying a very low CGT rate or no CGT at all.

When two countries have competing claims to tax a transaction because of its international dimensions (as Resourceland and Havenland), Double Tax Agreements – also called bilateral tax treaties – determine which country can tax it. This determination is crucial to prevent CGT avoidance and will be dealt with later in this report.

While our example paints a basic picture of how multinational companies can avoid the payment of Capital Gains Taxes through OITs, practical cases can be more complex and come with specificities. While this is an under-reported area in the tax justice debate, there are a number of well-known cases of multinational companies structuring transactions through OITs and avoiding the payment of taxes in jurisdictions where they operate and hold valuable assets.

Seven cases are discussed ahead. They show that the practice of tax avoidance through OITs occurs across countries and continents. In most of the cases reviewed below, the use of OITs led to court cases – some still ongoing – and to changes in national legislation. The resulting loss of Capital Gains Tax from these seven cases alone is over $2.2 billion, which illustrates the importance of this area for multinationals and individual countries – particularly developing countries.
CASES OF CGT AVOIDANCE THROUGH OITS

India: Vodafone and Hutchison

Hong-Kong based Hutchison Telecommunications International Ltd (HTIL) owned a Cayman Islands subsidiary named CGP Investments Holdings Ltd (CGP). CGP in turn controlled 67% of Indian-based Hutchison Essar (HEL).

In 2007, HTIL sold its CGP subsidiary – which held significant assets in the telecom sector in India – for approximately $11.1 billion to Vodafone. The sale generated a potential CGT liability of $1.7 billion. After the transaction, the Indian tax authorities claimed Capital Gains Tax under its Income-Tax Act.

While traditionally tax administrations will consider the seller of the asset (HTIL) the party responsible for the payment of the Capital Gains Tax, Indian legal convention has long established that the actual buyer (Vodafone) is required to withhold the amount owed as CGT at the moment of transaction and effectively pay the taxes on behalf of the seller. As a consequence, the Indian government has pursued Vodafone for the payment of any taxes.

The Indian government argued that Vodafone was "liable to pay the taxes since the intention of Vodafone was to purchase the 67% shareholding of HEL, which was a company based in India and that the gains were liable to be taxed since the transfer of controlling stake had taken place in India." Vodafone challenged this interpretation, arguing that the capital gains accrued from the sale of shares did not satisfy any of the taxability conditions in India, as the transfer of shares took place between a Dutch and a Hong-Kong-based companies, both outside the jurisdiction of India.

In 2012, the Indian Supreme Court ruled in favor of Vodafone, stating that the Indian tax administration did not have the jurisdiction to levy tax on overseas transaction between non-resident companies.

Shortly after this decision, the Indian Finance Act 2012 was enacted. It included a controversial amendment with retrospective powers (applying to transactions since 1962) that specified that income arising from the sale of shares can be taxed in India if: (i) the transfer of shares takes place outside India; and (ii) the value of the shares depends primarily on assets in India. This bill effectively established that this model of OIT was taxable in India and renewed the tax demand against Vodafone, also taking a step to prevent any other similar case of avoidance through OIT.
Figure 2: Vodafone and Hutchinson

After receiving a renewed tax demand in 2013, Vodafone initiated arbitration proceedings against the retrospective tax legislation on April 2014 based on the India-Netherlands Bilateral Investment Treaty (BIT). The arbitration case, held at the Permanent Court of Arbitration in The Hague, had its first hearing in February of 2019 and is currently awaiting further developments.

In 2017, Vodafone initiated a second arbitration proceeding, this time based on the India-UK BIT. The Indian government has engaged with the national courts in different ways to prevent the establishment of this arbitration case. This has initiated further legal disputes – which are still ongoing – and prolonged the questions around this case.

In 2018, an official from the Indian tax administration said that India may not accept potential arbitration orders benefiting Vodafone, adding that the tax department will continue with its CGT charges. According to this position, India believes that taxation is not covered under Bilateral Investment Treaties and cannot be arbitrated: “We believe that the arbitration panel cannot decide on the tax demand. If they overrule the tax demand, then India will not accept the arbitration order. We will continue with tax recovery proceedings. If the panel rules that tax demand is not proper, then it is questioning the sovereign, which we will not accept.”

The present tax dispute between Vodafone and India is a high-profile example of the structural legal uncertainty brought forward by a dispute between a multinational company and a national government, with conflicting decisions taken by national legislators, court systems and multiple arbitrations panels. The utilization of retrospective legislation by India has also greatly added to the legal uncertainty of this case. The dispute involves a number of jurisdictions and investment treaties, and will most likely remain contentious over the following years.

Namibia: Paladin Energy and CNNC

Paladin Energy is an Australian-based multinational mining company.

In 2012, Paladin purchased from Aztec Resources Ltd the Langer Heinrich uranium mine, located in Namibia, for N$86,000 ($10,132).

The license for the Langer Heinrich mine is held by the Namibian subsidiary of Paladin Energy (Langer Heinrich Uranium (Pty) Ltd), which is controlled through a Mauritian-based entity named Langer Heinrich Mauritius Holding Limited (LHMHL).

In 2014, Paladin sold a 25% stake of Mauritian-based LHMHL to CNNC (China National Nuclear Corporation), for a total amount of N$2bn ($173m), delivering a profit of N$665m ($58m) to Paladin – after taking into account Paladin’s original acquisition cost as well as exploration, development and capital expenditure costs.

Since the amendment of Namibia’s tax legislation in 2011 (through the Income Tax Act of 2011), the country has a specific CGT applicable to the sale of shares of companies holding Namibian mining licenses. As the amended provision does not make any reference to the place of transaction, Namibia seeks to enforce CGT on transactions that take place in any jurisdiction. Besides the CGT measure, Namibia also has in place a General Anti-Avoidance Rule (GAAR) intended to prevent transactions construed to avoid the payment of taxes.

The CGT rate was first set at 34%, and then slightly reduced in 2014 to 33%. As a result, a successful application of the CGT on Paladin’s transaction would result in a total of N$219m ($19m) in taxes to the Namibian tax administration.

As the sale of the shares was transacted through an Offshore Indirect Transfer, Paladin Energy argued that the sale of shares in a Mauritian-based subsidiary does not constitute a taxable transaction in Namibia. According to the company, there was no direct sale of the mining license and the transaction took place outside of the country. As the Namibia-Mauritius DTA does not allocate Capital Gains Taxation rights to Namibia in these
Instead of directly holding ULTD shares, Actis managed its control through a Bermuda-based subsidiary named Globeleq, which was later renamed Umeme Holdings (UHOL) and relocated to Mauritius. In November of 2012, UHOL floated 39% of its shares in ULTD on the Uganda Securities Exchange, raising around $65m which was used for debt pay-off and reinvestments in its business operations.

In 2014, an additional 45.7% of ULTD shares were sold and the remaining 14.3% stake was floated in 2016. These share sales generated an estimated capital gain of

**FIGURE 3: ACTIS AND UMENE**
As Actis held its ULTD shares indirectly through Mauritius-based UHOL, the capital gain of $129m was considered by Actis to have taken place in Mauritius.

In line with the DTA between Mauritius and Uganda, “gains from the alienation of such property shall be taxable only in the Contracting State of which the alienator is a resident”, in this case Mauritius.28 As the CGT rate in Mauritius is 0%, Actis shifted the entire $129m profit to other parts of its corporate structure and seemingly avoided paying any CGT on this transaction.

However, if the capital gains of this Ugandan enterprise had been taxed in Uganda, based on its 30% CGT rate, an amount close to $38m in taxes would have been generated. This is equal to 6% of Uganda’s annual health budget.29 According to Everline Aketch from Uganda Christian University, this figure could have paid the annual salaries of more than 12,000 doctors in Uganda.30

These findings were unearthed by a four-month joint investigation by Uganda’s Observer and the London-based Finance Uncovered, which was supported by the global trade union federation Public Services International (PSI) Union.

Rosa Pavanelli, the general secretary at PSI, said: “To see a UK-owned, World-Bank-supported, privatized electricity corporation shuffling funds out of a developing country and into an offshore tax haven is appalling but unfortunately not surprising.”

Actis did not dispute it made a $129m profit from selling its shares in ULTD, and stated to Finance Uncovered that Umeme and Actis paid 100% of taxes due. The fund said that during its 11 years involvement with Umeme the number of Ugandans connected to the grid had risen from 5% to 16% of its 37 million population. Energy losses through theft and power outages both fell, while bill collection rate had risen to 98.4% Actis affirms that it sees no compromise between their responsibility towards investors and creating a positive impact for countries where they operate. When asked why it structured its shareholding in ULTD through Mauritius (benefitting of a 0% CGT rate), the company declined to comment.

After being presented with the report’s conclusions, the Uganda Revenue Authority (URA) stated that it is now assessing the situation.

Uganda: Heritage and Tullow

Tullow Uganda Limited (a subsidiary of multinational Tullow Oil) and Heritage Oil and Gas Limited Company (HOGL) operated in Uganda as explorers and developers of oil fields, based on Production Sharing Agreements with the Ugandan government. In 2010, Tullow purchased Heritage’s share in a number of co-owned assets for $1.45bn. Following the transaction, the Uganda Revenue Authority (URA) charged Heritage for $434m, based on the rate of 30% CGT.
From the onset of the dispute, Heritage argued that the transaction was not taxable in Uganda as it took place through the sale of a subsidiary based in the Channel Islands and because Heritage itself is not incorporated in Uganda. Due to the high potential value of tax revenue from the sale of Heritage’s licenses (Ush 1.13 trillion) – which would be sufficient to pay the annual salaries of over 209,000 primary school teachers in the country – the URA opted to pursue the payment through the national courts. The URA argued that the underlying assets were located in Uganda and that the sale required the consent of the Ugandan government, making the transaction taxable under Ugandan law.

Besides litigating against the tax charge in courts, HOGL also opted to change its residence from the Bahamas to Mauritius to benefit from the favourable DTA between Mauritius and Uganda and avoid CGT charges.

According to Panama Papers leaked documents, the residence change to Mauritius was made to defeat the tax charges in Uganda, being undertaken “primarily due to the Double Tax Agreement between Uganda and Mauritius”.31

A February 2010 e-mail from a Heritage accountant states the following: “Heritage is due to complete the sale of an asset in Uganda. Due to tax reasons emanating from Uganda, the directors have been advised to re-domicile Heritage to Mauritius before the sale. The group is working hard to eliminate potential tax charges by

Uganda without Heritage having to move, but as a second line of defense the directors have been advised to move to Mauritius so that the process can be completed if it becomes necessary.”

John Christensen, co-founder of the Tax Justice Network, argued that “the proposal to re-domicile its operations is clearly an attempt at aggressive tax avoidance since the only motive is to dodge a potential tax liability”.

Due to Heritage’s initial refusal to pay CGT, the Uganda government delayed its approval of the transaction. As Tullow had yet to pay Heritage, the Ugandan government threatened not to renew Tullow’s exploration licenses unless it received the demanded CGT.

Fearing that this dispute would affect its business in Uganda, in 2011 Tullow proposed a temporary solution for the $434m payment - pending litigation - which was accepted by all parties:

(i) Heritage paid $121m as a “refundable deposit” to the Ugandan government, representing the mandatory 30% that must be paid before a tax dispute can be brought to court in Uganda;32 and

(ii) Tullow withheld $283m of its total $1.45bn payment to Heritage, depositing the money (along with an additional $30m from Tullow) in a London bank account.33

This resulted in URA receiving the full amount in 2011, even though the relevant legal proceedings were not resolved until 2013.
In April 2013, the arbitration court ruled in favour of Uganda and permanently confirmed its right to levy Capital Gains Taxation of $434m over the transaction between Tullow and Heritage. Also in 2013, a London-based court ordered the refund by Heritage of the $313m initially advanced by Tullow in 2011, clearly establishing Heritage as the CGT taxpayer.34

In 2012, Tullow had further CGT disputes with the Uganda government. When selling exploration rights to CNOC (China National Offshore Oil Corporation) and Total for $3bn, the URA charged Tullow for $473m in CGT. This was challenged by Tullow for a long period (both in Ugandan courts and in arbitration courts in Washington DC) until a settlement was reached between both parties in June 2015 for a total of $250m.35 The settlement was met with dismay by legal experts and civil society actors in Uganda, as a previous positive decision from the Tax Appeals Tribunal in Uganda appeared to secure $404m for the URA. However, due to additional pending contractual issues and the possibility of further years awaiting arbitration court rulings, both parties opted for the settlement.

Uganda: Zain International and Bharti Airtel

Zain International BV (ZI) is a Dutch company that, among other investments in African telecommunication services, owned the Kampala-registered mobile phone operator Celtel Uganda (Celtel). The ownership of Celtel was not held directly by ZI, as the shares were controlled by Dutch-based Zain Africa BV (ZA). In 2010, ZI sold for $10.7bn its control over ZA – and as a result the ownership of Celtel – to a Dutch subsidiary of Bharti Airtel (BA), an Indian-based communications multinational.36

Shortly after, the Uganda Revenue Authority (URA) initiated CGT collection proceedings against ZI for $85m. At first, URA attempted to tax the sale of shares. However Uganda’s domestic legislation did not capture this form of DIT taxation (movable property). Still pursuing the taxation, the URA reassessed the transaction as primarily based on the telecom license, as the domestic legislation did grant the right to tax immovable property. ZI denied the taxation claims by Uganda, stating that both Zain Africa and Bharti Airtel are incorporated in the Netherlands and that the transaction was in no way connected to Ugandan assets.

In December of 2011, Kampala’s High Court ruled in favour of Zain International and dismissed the CGT claim raised by URA, stating that URA did not have jurisdiction to impose CGT on the transaction.37 However, after an appeal was submitted by the government, the Uganda Revenue Authority received a favourable sentence from the Court of Appeal in 2014 which recognized the right for URA to assess and tax offshore companies trading on Uganda-based immovable assets, however it did not decide on the specific ZI case.38 39

After the Court of Appeal decision, ZI argued that the Netherlands-Uganda DTA ensured the exclusive right of the Netherlands to tax the transaction. Tax researcher Martin Hearson has observed that as the Netherlands-Uganda DTA has distanced itself from the UN model treaty, the DTA does not include a provision allowing Uganda to tax capital gains on the transfer of shares by Dutch residents related to Uganda-based assets.40

As a response, Uganda has argued that despite the allocation of the taxation rights to the Netherlands in the Netherlands-Uganda DTA, a provision in its Income Tax Act designed to avoid treaty shopping - Section 88I(5) - denies the benefits of treaties to companies whose underlying ownership is mostly based in a third country.41 Based on this section of its domestic legislation, Uganda argues that the Netherlands-Uganda DTA does not apply to this case and therefore it has a clear legal right to tax the transaction.

The question now remains whether Uganda’s domestic law can override its obligations under international treaties. The Netherlands has requested the opening of a Mutual Agreement Procedure (MAP)42 – established by the Netherlands-Uganda DTA. However until now, this procedure has not been formally opened. The URA is currently unable to collect the taxes as Zain no longer has assets in Uganda. This has led the URA to request assistance from the Netherlands for the collection of the taxes. However, the Netherlands is adamant a MAP needs to be established before any taxes are collected.

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**FIGURE 4: ZAIN INTERNATIONAL AND BHARTI AIRTEL**

- **Zain International BV (ZI)** (Netherlands incorporated)
- **Zain Africa BV (ZA)** (Netherlands incorporated)
- **Celtel Uganda (HEL)** (Uganda incorporated)

- **Subsidiary** (Netherlands incorporated)
- **Bharti (India incorporated)**

- $10.7 b
Vietnam: ConocoPhillips and Perenco

ConocoPhillips (CP) is a multinational oil company based in the United States, with a number of subsidiaries throughout the world. In 2012, ConocoPhillips UK Ltd (a UK subsidiary of CP) sold two of its entities (ConocoPhillips Gama Limited and ConocoPhillips Cuu Long) to UK-based Perenco Overseas Holding Ltd, part of the Anglo-French oil firm Perenco.43

The two UK-based entities transferred to Perenco exclusively contained ownership of CP’s substantial oil interests in Vietnam. The total price paid by Perenco for both entities was $1.3bn. This resulted in a considerable profit of $896m for CP UK.

While Vietnamese assets changed hands from CP to Perenco, the transaction took place through an Offshore Indirect Transfer, and as a consequence no CGT was to be paid in Vietnam. Due to a specific feature in UK’s fiscal legislation that prevents the taxation of profits from the sale of shares in subsidiaries – the substantial shareholder exemption – no CGT was paid in the UK either.

CP and Perenco argued that no taxes were due in Vietnam as their transaction centered on a deal between two UK-based companies. According to a CP spokesperson, “the sale was between two UK incorporated and resident entities with no taxable presence in Vietnam. The target companies are also UK companies. As a result, no taxes were owed on the sale in Vietnam”.44

However, the UK-Vietnam DTA declares that capital gains generated from transactions involving shares deriving their value from immovable property situated in one of the contracting states may be taxed in the jurisdiction where the property is located45.

In this specific case, the Vietnamese tax administration interpreted this rule as granting to Vietnam the right to levy CGT on this transaction – as the shares sold for $1.3bn derive their value exclusively from oil rights exclusively located in Vietnam.

Based on this understanding, the Vietnamese government initiated the internal proceedings to levy CGT on the CP-Perenco transaction. Based on Vietnam’s current tax rules, this would have generated an estimated amount of $179m.

While the Vietnamese government had a strong case for taxing the amount under the UK-Vietnam DTA, questions remained regarding the existence of domestic legislation which was in force at the time of the transaction (2012) authorizing the taxation. In 2015, Vietnamese legislation clearly established the right to tax profits of foreign companies on capital assignment deriving their underlying value from Vietnamese assets, regardless of where the transaction took place. However, the legislation – Decree 12/2015/ND-CP – only entered into effect in 2015 and has no retroactive powers46.

Since 2015, the right of Vietnam to levy CGT on the profit of foreign companies over direct or indirect assignment of shares in Vietnam – regardless of the place where the transaction takes place – is distinctly established47. However, the lack of a specific rule dealing with OITs at the moment of the transaction between CP and Perenco (2012) enabled the oil corporations to argue against the payment of CGT in this specific case.

In November 2017, CP and Perenco launched a preventive arbitration case against the Vietnamese government under the UK-Vietnam Bilateral Investment Treaty and United Nations Commission on International Trade Law (UNCITRAL) rules, seeking to prevent the collection of CGT. According to recently published information, the dispute was scheduled to take place in a UN arbitration court with initial hearings expected in late 2019.48
Peru: The Acquisition of Petrotech

Savia Peru (SP), formerly Petrotech Peruana, is an extractive company which began operations in Peru in 1994. The company is incorporated and resident in Peru. It is currently the second largest oil producer in the country at 9,700 barrels per day, with two oil fields (Z-2B and Z-6) under production.51 SP is ultimately owned by Petrotech International (PI), with the shares of the Peruvian entity being held by an intermediary corporation named Offshore International Group Inc (OIG). 52 Both PI and OIG are based in the United States – respectively Delaware and Texas.

In February 2009, Colombian government-owned Ecopetrol and KNOC (Korea National Oil Corporation) jointly purchased OIG from Petrotech International in a transaction conducted in the United States. OIG – whose main asset was the Peruvian entity PP – was sold for approximately $900 million, evenly split between Ecopetrol and KNOC.53

At the time of the transaction, the tax legislation of Peru did not have any specific provisions detailing how Offshore Indirect Transfers should be taxed. As a result of
the lack of legislation dealing with OITs, the acquisition of OIG went untaxed in Peru. A legislative commission of the Peruvian Congress has estimated that, if a suitable legislation was in place, Peru could have charged Petrotech International over $270 million in Capital Gains Tax from this transaction.54

Due to the high amount of revenue lost55 and the use of an OIT by Petrotech International to avoid taxes in Peru, this episode raised a lot of controversy and led to Congressional investigations in Peru.56 Shortly after a parliamentary special commission determined that the transaction was structured mainly to avoid the payment of taxes, Peru’s income tax legislation was amended in 2011 to ensure that capital gains from Offshore Indirect Transfers can be regularly taxed in the country from now on.57

Peru has recently taken further steps to prevent tax leakages in the country. In May 2019, it enacted a GAAR – which can be used to tackle a broad number of tax avoidance techniques.58 The important role of GAARs for countries fighting to effectively tax multinational companies will be further analysed in this report.
LEGAL AND TECHNICAL CONSIDERATIONS

As outlined in the cases featured in our report, a clear understanding of taxation rights related to OITs requires a comprehensive analysis of the domestic legislation of the countries involved as well as their Double Tax Agreements (DTAs). The final section of this report will analyse both topics.

DTAs are tax treaties between two countries that determine which country has the right to tax specific international (or cross-border) transactions. While DTAs do not create new taxes, they are employed to avoid double taxation (or double non-taxation) when more than one country has the opportunity to tax the same income. This includes the taxation of capital gains that involve more than one country.

Following our example:

Resourceland and Havenland have a DTA that regulates the taxation rights of capital gains from international transactions. The DTA affects the OilCorp – EnergyCorp transaction, as it involves the transfer of a property that is located in one country (Resourceland) but controlled by a resident of the other country (Havenland). According to the DTA, a gain from the transfer of property is taxable only in the country where the seller is resident.

This clause of the DTA results in Havenland (where the seller OilCorp Havenland is resident) being the only country that can tax this transfer of property located in Resourceland.

As Havenland opts not to tax capital gains, OilCorp is able to avoid the payment of any CGT in this transaction. It must be highlighted that as Havenland opts not to impose CGT, the DTA is not actually preventing double taxation – but restricting taxation by Resourceland.

If the clause of the DTA did not curtail Resourceland’s right to tax this transaction, the outcome would be very different. With that in mind, DTAs are crucial to proper understand OITs and the avoidance of Capital Gains Tax.

However, as important as tax treaties are, a favorable DTA is only half the solution for countries to tax OITs. This is because DTAs do not actually create taxes, but merely regulate taxation rights.

When a DTA grants to a country the taxation right over capital gains, that country still needs a domestic legislation that establishes the taxation of capital gains.

To further ensure its right to tax such offshore transactions, the domestic law on CGT should firmly establish the taxation of OITs. In fact, a favorable DTA may prove to be insufficient if the proper domestic legislation fails to clearly assert the country’s right to impose CGT in these cases.

Following our scenario:

Resourceland and Havenland renegotiated their DTA and now Resourceland has the right to tax capital gains from the OilCorp – EnergyCorp oil license transaction. However, Resourceland’s domestic legislation – the Capital Gains Act – is an outdated legislation that makes no reference to OITs. Resourceland’s tax administration tries to tax the transaction, but the national courts rule against the taxation of OITs as the law does not establish it.

The taxation right of Resourceland cannot be enforced without an appropriate domestic law establishing the taxation of capital gains from OITs. As such, it is essential that countries have clear and precise legislation that establish the taxation of OITs in domestic law, otherwise countries will fail to collect CGT from OITs, whatever the content of their DTAs. A further examination of domestic legislations and Double Tax Agreements will demonstrate the specific topics that countries should consider to effectively tax OITs.

Domestic legislation: policy options to curtail CGT avoidance

Capital Gains Taxation is normally established either through a general tax legislation (Income Tax Act) or a specific law for this purpose (Capital Gains Act). For a government to be able to effectively tax Offshore Indirect Transfers, the CGT legislation should contain a clear provision regarding OITs, describing with clarity which are the taxable assets as well as other important details.

Additional issues that policy designers should take into consideration when developing their domestic legislation include how will the national tax administrations actually find out that an offshore transfer has taken place and the difficulty in collecting taxes from a company located abroad.

Policy design models

There are two standard models which are used to ensure taxation of OITs and the effective enforcement of CGT. This is particularly relevant as the collection of taxes related to transactions concluded outside the enforcing country is often complex.

FINANCE UNCOVERED
(ii) Deemed disposal of asset by resident entity

The domestic legislation will recognize a deemed disposal of assets by the local entity that directly owns the assets. It will consider that a change of control of the asset occurred, triggering CGT charges directed at the local entity.

According to the International Senior Lawyers Project, “once the source country learns of the transfer of a controlling interest in a company within its jurisdiction by an offshore investor, the source country would treat the transfer as though the source country company had sold its assets to a new deemed source country company. Thus, it would tax the Indirect Transfer as though a direct sale of assets had occurred”60.

A deemed disposal legislation directs the national tax administration to consider that the following fictitious events have occurred and implement the correspondent tax measures:

a) The local entity sold the asset for its market value (the amount involved in the OIT);

b) As the local entity sold the asset for a profit (market value minus the original price), the profit must be normally subject to Capital Gains Tax; and

c) The local entity purchases the asset back for the same market value price – this ensures the correct ownership of the asset, as in fact it has not been transferred from the local entity. If in the future the asset is again transferred, the market value price will be considered the new original price for purposes of evaluation and taxation.

The method of deemed disposal is considered to facilitate the enforcement and collection of the taxes, as taxation will be levied over a resident taxpayer. It avoids the complexities that arise when a country attempts to tax a non-resident entity – including DTA-related constrains that might restrict the taxation of foreign entities.

A disadvantage of this method is that the local entity may have difficulties paying the taxes, as it has not necessarily received money from the offshore transaction – as it was carried out by another member of the multinational group. As a result, the local entity would have received no profit from the transaction but at the same time will be considered responsible for the Capital Gains Tax. If the local entity is not able to pay the total amount of taxes being levied, possible solutions include a deferral or spread of capital gains – resulting in the spread of tax payments over the durable life of the asset.61

This model is utilized by a minority of countries that attempt to tax OITs, due to the disadvantages mentioned above. Examples of countries currently using this model include Uganda and Ghana.

(iii) Offshore transaction, local taxation

The second model establishes the direct taxation of a non-resident entity. Following this model, the government will recognize the OIT as a transaction made offshore by a non-resident, but at the same time the national tax administration will source and tax the operation in its country. Due to this cross-border element, this model involves the assessment and collection of taxes from a non-resident entity.

This model levies taxation over the non-resident entity that actually disposed of assets and received compensation for it, so it does not involve deemed disposals or taxation of entities that were not directly involved in the offshore transaction. Enforcement is a clear challenge as the taxable entity is a non-resident and DTA-related constrains might be in place. However, agency collection mechanisms, withholding taxes and international enforcement agreements can be implemented for that objective.

As non-resident entities are ordinarily only taxed by a government regarding the income derived from sources in that country, this model requires the establishment of source of value rules and is better structured with clear rules around taxable assets – both examined ahead.

This model is broadly considered to be easier to apply and has a higher success rate of tax collection, being utilized by most countries that established legislation for taxing OITs – including India and Kenya.

SAAR and GAAR

A distinct option from the two models presented is for a country to establish a Specific Anti-Avoidance Rule (SAAR) or use a General Anti-Avoidance Rule (GAAR) to tackle tax avoidance through Offshore Indirect Transfers. SAARs and GAARs can play an important complementary role to the models described above.

SAARs have the aim of tackling a specific form of tax avoidance – such as CGT avoidance through OITs. For example, China will evaluate the purpose of a transaction and if it is determined that there was no “bona fide commercial purpose” in the offshore transaction, CGT will be imposed.62 SAARs are discretionary legislations, clearly providing flexibility to a tax administration as it can use a broad concept of bona fide (good faith) to tax different transactions.

GAARs are even broader legislations that can cover any form of transaction or structure considered not to have commercial substance or with a principal purpose of achieving a tax benefit – which can include OITs. GAARs have the advantage of addressing developing tax avoidance techniques that are unpredictable or currently unknown by legislators and government officials. Due to its design as an expansive rule not objectively directed at
specific situations, a GAAR can be used to prevent multiple forms of tax avoidance. As examined in the previous section on concrete cases, Peru’s recent adoption of a GAAR serves as a clear example of a developing nation adopting this form of legislation to prevent broader tax avoidance.

When properly designed and administered, SAARs and GAARs play an important role to reduce tax leakages and should be considered as important legal options by most countries. While both SAARs and GAARs can be properly designed to successfully tackle CGT avoidance through Offshore Indirect Transfers, the inclusion of clear rules-based provisions regarding OITs in the Capital Gains Tax legislation should be considered a preferred option. The policy models examined previously objectively address OITs and create clear standards in the legislation, while SAARs and GAARs will in most cases require litigation for its application and involve a degree of subjectivity and uncertainty.

Therefore, while SAARs and GAARs should be seen as important pieces of legislation to tackle tax avoidance and have their implementation promoted by civil society actors across all jurisdictions, they do not constitute permanent substitutes of specific legislations designed to ensure the taxation of OITs.

**Taxable assets and transactions**

When determining which assets are liable to tax from OITs, most countries tend to focus on **immovable property**. Due to its fixed location and clear connection with local natural resources or domestic economic activities (i.e. licenses for extractive industries, energy provision, water distribution, telecommunication licenses), an immovable property is generally seen as a verifiable and settle asset that derives a significant portion of its value from domestic attributes.

Due to this clear connection between domestic economic attributes and the economic value of the immovable property, the right of countries where the property is based to tax these assets is generally recognized. As will be analyzed in the next section, the policy models examined previously objectively address OITs and create clear standards in the legislation, while SAARs and GAARs will in most cases require litigation for its application and involve a degree of subjectivity and uncertainty.

While the concept of immovable property might seem straightforward, there is a clear need for domestic legislations to develop a precise definition of what constitutes an immovable property. As DTAs and domestic tax legislation make reference to which category of assets is subject to taxation, tax administrations and national courts require a definite and unequivocal explanation of which assets should be considered as immovable. If no such domestic legislation is in place, there is a risk of long-standing litigation and legal uncertainty for taxpayers and national tax administrations.

A number of jurisdictions – i.e. China, India and Kenya – go further and also impose taxation over OITs of specific **moveable property**, such as shares of companies that are established in their country. Countries that have a clear policy of levying CGT over the direct transfer of company shares consider the taxation of OITs involving shares a logical extension of their tax policy – as recognized by the model for Double Tax Agreements designed by the United Nations.

For the effective enforcement of taxation over OITs of moveable property, additional considerations must be reflected in the domestic legislation, including: the evaluation and effective location of the property; and the ability of countries to identify and effectively tax transactions of non-residents.

National tax systems should guarantee that both direct and indirect transfers of shares (and other forms of moveable property) are treated the same way for tax purposes. Following this logic, transactions that are normally exempted of CGT based on domestic legislation – i.e. mergers and acquisitions – should remain exempted when done through indirect transactions. If CGT is not levied over such direct transactions, this approach should be maintained when the same transactions are done through indirect transfers.

**Ownership requirements, assets transferred and source of value**

A minimum requirement on the ownership of entities and the assets transferred is often utilized by legislations to establish the taxation of capital gains generated by OITs.

A minimum ownership requirement will establish how much of the ownership must change hands for the taxation of OITs to be triggered. If an OIT only results in a small percentage of the ownership of the local entity being transferred (i.e. 5% or 10%), most countries will choose not to tax the transaction. The rationale of this policy decision is to avoid the taxation (and complex enforcement measures) of operations made by small portfolio shareholders – as done in many countries also on the direct disposal of small shareholder interests.

Minimum requirements are also established regarding the transfer of assets. This rule will establish a minimum percentage (i.e. 10% or 20%) of the local assets owned by the foreign entity that must be transferred for OITs to be taxed. If the assets transferred do not reach the minimum percentage established, the transaction will not be considered a taxable event.

Finally, rules regarding the source of value of the shares are also used. Such rules establish that the value of the
entity being directly transferred must derive a percentage of its value (50% in DTA models, 80% in South Africa legislation) from assets that are located in the country. Following this reasoning, OITs can only be taxed by a government if the value of the entity being transferred in another jurisdiction is based on assets located in its country.

To illustrate the multiple policy designs made possible due to these elements, a brief analysis into three countries that recently established OIT taxation follows:

• In the wake of legal disputes around the taxation of OITs in Peru (mainly due to doubts by national courts regarding the effective application of its ambiguous anti-avoidance legislation), an amendment to the Income Tax Act was introduced in July of 2018 to clarify the taxation of these transactions. As clearly established in the new legislation, the taxation of Offshore Indirect Transfers only takes place if there is a change by 50% or more of the ownership of the Peruvian entity.65

• In Peru, the 2011 amendment to the Income Tax Law establishes requirements regarding both asset transfers and source of value for OITs to be subject to Peruvian tax. On transfer of assets, a dual requirement establishes that (i) at least 10% of the total assets and (ii) at least 20% of the Peruvian assets from the foreign-entity must be transferred for OIT taxation to take place. Additionally, at least 50% of the value of the shares transferred must relate to assets based in Peru.66

• In 2012, following a ruling in favor of Vodafone in a still ongoing OIT dispute, an amendment was made to the Income Tax Act of India regarding OITs. The legislation establishes no minimum ownership requirements by referring to “any share or interest” that derives substantial value (50%) from India-based assets.67

Period of application
Another common issue is the period of the application of a legislation. While the large majority of laws have exclusively a prospective effect – only having effect on actions and operations that take place after the law takes effect – there are specific cases where laws are established with a retrospective effect – retroactively changing the legal consequences of actions and operations that were committed before the law took effect.

It is fundamental that national legislators take all possible repercussions into consideration and effectively clarify the application period of new legislations. Retrospective laws are generally considered detrimental to legal certainty as they can impose penalties on acts that were considered legitimate when performed. However, when faced with substantial losses due to OITs, some countries have opted for retrospective laws to collect CGT. For example, India (2012) and Chile (2002) established the taxation of OITs in a retrospective manner in response to well known cases of tax avoidance. As analysed in the previous chapter, India’s retrospective legislation led to numerous legal challenges that remain under dispute.

Reporting requirement
For a domestic tax administration to impose taxation over capital gains generated by a transaction that takes place at another jurisdiction – as is the case with OITs – it is fundamental that it is informed of the transfer. Often tax administrations have no knowledge of transactions undertaken in other jurisdictions that change the effective ownership of assets based in their country. In order to avoid that, countries should implement in their domestic legislation reporting requirements. These requirements ensure that corporations are required to inform of any change in the beneficial ownership of companies and assets, therefore guaranteeing that any changes in the direct control of assets is informed to national tax administrations.

How to strengthen Double Tax Agreements against CGT avoidance?
Double Tax Agreements (DTAs) utilized by all countries are mainly based on models developed by the OECD, the United Nations and regional organizations (ATAF, COMESA, EAC, SADC and others). The DTA models are designed to be used by countries negotiating bilateral treaties, often serving as the basis for negotiation and policy decisions. While these models have similar structures and legal concepts, it is widely recognized that DTAs based on the UN and regional models are overall more favourable to developing countries, as these models curtail fewer of their taxing rights.68

In their latest version, both UN and OECD models establish as a general rule that residency countries (Havenland) have the right to tax capital gains. However, both models also present some exceptions to this general rule, which result in the source country (Resourceland) holding the taxation rights over capital gains. Article 13(4) presents in both models – is one of these exceptions. This article ensures that jurisdictions where an immovable property is located (such as licenses for extractive or telecom industries) are entitled to tax capital gains generated by its indirect transfer.

The rule for indirect transfers of immovable property in article 13(4) in the allocation of taxation rights to the jurisdiction where the asset is physically located or legally registered. Based on this rule, Resourceland would be entitled to levy CGT on the profits earned by OilCorp Havenland as the oil license (immovable property) is based in Resourceland.
The wording of article 13(4) highlights that the asset must be considered an immovable property. As discussed in the previous section, a clear definition of the term *immovable property* is required. While this definition is addressed in article 6 of both DTA models, there is a strong need for the term to be defined in more details in the domestic legislation of the involved countries. The DTA clause directly refers to the meaning that *immovable property* has under the domestic law – which reinforces the need for countries to have a clear concept in their legislations.

While article 13(4) is a positive development, it does not translate into a direct impact on most DTAs. This is the result of a number of factors, such as: (i) individual DTAs are the result of rigorous negotiations between countries, not necessarily following the recommendations from the UN or OECD models; and (ii) DTAs that were signed previously are not automatically updated to reflect new models and require (often lengthy) renegotiations.

This is illustrated by the fact that out of the more than 3,000 DTAs currently in effect, only around 35% include article 13(4) with a direct reference to OITs on immovable property. When considering only DTAs involving a low or lower-middle income country, the percentage drops to 31%. These numbers reflect that while advances have been made in the OECD and UN models, the overwhelming majority of DTAs involving developing countries do not include clauses against tax avoidance through OITs – leaving these countries vulnerable to tax leakages.

The Platform for Collaboration on Tax – a joint IMF, World Bank and OECD organisation – also noted that the probability that article 13(4) is included in a DTA: (i) drops by about 6% if one of the countries is a resource-rich low-income country; (ii) drops by about 13% if one of the countries is a low tax jurisdiction; and (iii) increases if there are significant differences in CGT rates between the countries. Another significant figure demonstrates that the number of DTAs with clauses related to CGT and immovable property – not necessarily in line with article 13(4) – reaches 60% of all DTAs in effect.

Finally, statistics also demonstrate that countries with multiple DTAs will in most cases have article 13(4) included in only a portion of their treaties, while another part of their DTAs have no clause regarding OITs – as they involve negotiations with different countries and subject to distinct tax policies. This inconsistency is exploited by multinational corporations and advisers, with corporate structures and transactions being design to exploit DTAs that do not contain such protective clauses.

While both the OECD and UN models favour CGT related to OITs of immovable property, the two models differ regarding OITs of specific moveable property. While the OECD model does not recognize the right of source countries to tax capital gains derived from OITs of moveable property, the UN model establishes that possibility through article 13(5).
The possibility of countries using article 13(5) in their DTAs will increase the opportunities for developing countries to pursue the taxation of OITs, as it establishes the taxation from capital gains generated from the alienation of company shares or comparable interests (i.e. interests in partnerships or trusts). This is made clear by the following comments from the United Nations:

Paragraph 5 of the UN Model, which has no equivalent in the OECD Model, allows a state to tax gains on the alienation of shares in a company, or comparable interests such as interests in a partnership or trust, where the company or relevant entity is a resident of that state in which the alienator (seller) holds directly or indirectly (or has held at any time during the preceding 365 days) a substantial participation. The minimum participation is not specified in paragraph 5 but it is often 25 per cent. The 365-day rule is an anti-avoidance provision designed to ensure that a taxpayer cannot escape source taxation by selling off multiple small parcels of shares that together form a substantial holding.74

As examined in the previous section on domestic legislation requirements, in order to effectively pursue this policy choice, further regulations related to enforcement and evaluation must also be taken into consideration.

After examining the crucial role played by Double Tax Agreements, it is clear that such treaties are fundamental in determining the level of success that countries can have when fighting against tax avoidance. Due to their importance, governments and civil society organizations must give special attention to the negotiation procedures and implementation of DTAs.

As a positive example, in March 2019 the Kenyan High Court declared the DTA between Kenya and Mauritius unconstitutional due to procedural issues, following a challenge presented by the Tax Justice Network – Africa (TJN-A).75 As a result, Kenya and Mauritius were required to renegotiate their DTA.

In July 2019, further attention was brought to the role played by Mauritius’ network of Double Tax Agreements through the Mauritius Leaks reporting by ICIJ.76 The different reports demonstrate how disadvantageous DTAs have resulted in multinational companies avoiding taxes in multiple African countries through corporate structures based in Mauritius – a country broadly recognized as a tax haven.77 The findings by the ICIJ and the heavy impact caused by Mauritius DTAs on domestic revenue led to both Senegal and Zambia recently terminating their tax treaties with Mauritius.78
CONCLUSION

Capital gains are made regularly as the value of assets rise due to positive economic activities or broader circumstances. As countries make a policy decision to tax these gains by individuals and corporate taxpayers, specific legislation and incidental regulations must be enacted to ensure effective collection of Capital Gains Tax. Due to ongoing attempts by corporate taxpayers to reduce their overall tax payments through various techniques (both domestic as well as cross-border), measures to prevent tax avoidance must also be carefully structured.

The avoidance of CGT by multinational corporations through Offshore Indirect Transfers deprives developing nations of much needed public revenue. It is clear that in some cases this amounts to billions of dollars, as witnessed in the still ongoing litigation between India and Vodafone. The utilization of OITs by multinational corporations results in developing nations missing an opportunity to collect taxes from transactions involving assets with a clear connection to local natural resources or domestic economic activities.

However, while multinational companies have a legitimate right to arrange their corporate structure and transactions through Offshore Indirect Transfers, countries interested in collecting CGT should take concrete measures to effectively tax capital gains realized by OITs. The taxation of OITs is already recognized as the established international norm and included in both OECD and UN models. To effectively implement this international agreement, effective domestic legislation is required. Through the enactment of specific domestic legislation and the inclusion of express clauses in Double Tax Agreements, developing countries can strengthen their tax regimes and prevent avoidance.

In order to achieve that, the following policy options are presented as recommendations for the establishment of domestic legislation and Double Tax Agreements that ensure effective taxation of capital gains derived from OITs in developing countries:

- Establish and reinforce capital gains domestic legislation
  In order to successfully tax capital gains generated by OITs, it is fundamental that countries have in place a domestic legislation that clearly authorizes national tax administrations to tax such transactions. Tax legislation should recognize and single out the right of the national tax administration to enforce CGT over Offshore Indirect Transfers. Based on the national tax policies applied to regular direct transactions, governments should establish similar rules for indirect transactions focused on immovable and moveable properties done through offshore corporate structures.

  Governments may opt between two distinct models (described previously in the report), based on policy decisions and domestic context. It must be highlighted that further regulations and auxiliary policies that allow governments to effectively enforce CGT taxes over OITs must be put in place. Finally, unless required otherwise by impending factors and domestic context, countries should promote legal certainty and favor legislations with prospective effects – instead of retroactive laws.

- Establish SAAR or GAAR as complementary legislation
  Specific Anti-Avoidance Rules (SAARs) or General Anti-Avoidance Rules (GAARs) can be used by governments to tackle multiple forms of tax avoidance – including OITs. Governments intent on preventing tax leakages should be encouraged to develop anti-avoidance rules, as examples in different countries demonstrate the positive impact of such rules. However, they should be considered as complements – and not as alternatives – to a comprehensive capital gains legislation that clearly addresses the taxation of OITs.

- Negotiate (and renegotiate) Double Tax Agreements in line with clauses establishing the taxation of OITs
  Double Tax Agreements play a crucial role in the taxation of capital gains generated by OITs, as they clearly involve more than a single jurisdiction and are cross-border transactions. The presence of specific clauses in DTAs can ensure that developing countries are in a position to tax capital gains from OITs. In that sense, the taxation of Offshore Indirect Transfers involving immovable property can be established by article 13.4 of the OECD and UN models, while article 13.5 of the UN model does the same for specific moveable property. Developing countries must ensure that ongoing negotiations for new DTAs will focus on the insertion of such clauses, while renegotiations should take place to insert the clauses in DTAs that are already in effect.
To recap, below please find the main policy options to prevent Capital Gains Tax avoidance:

1. Developing country governments should have precise legislation in place that authorizes national revenue authorities to successfully tax capital gains generated by OITs for immovable and moveable properties involving offshore corporate structures.

2. Developing country governments should have specific national tax policies in place to effectively enforce CGT taxes over OITs, either through using the ‘deemed disposal of asset by resident entity’ model or the ‘offshore transaction, local taxation’ model. Reporting requirements should also be established to ensure that governments become aware of offshore transactions that alter the beneficial owner of national companies and assets.

3. Developing country governments should prioritize developing and establishing a comprehensive national capital gains legislation. While SAARs and GAARs also play significant roles in tackling tax leakages, a properly designed CGT legislation is the preferred method to address OITs.

4. Developing country governments should have the right to tax capital gains in their own country, therefore they should (re)negotiate their DTAs to ensure articles 13.4 and 13.5 of the UN model are included.

5. Multinational companies must pay their fair share of taxes, including on capital gains, in the countries where these (im)moveable assets are located and economic gain is derived from.
The following incomes shall be deemed to have been derived by a non-resident through a connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through or from any property held in India, or through or from any property in India, or through or from any asset or source of income in India, or through or from any property held in India, and shall be included in the income chargeable to tax in India.

Other estimates point to higher figures. Achim Steiner, the administrator of the United Nations Development Programme, points to hundreds of billions of dollars each year. https://www.un.org.cn/info/6/620.html


Double Tax Agreements are also frequently described as Bilateral Tax Treaties. As this report also analyses the impact of Bilateral Investment Treaties, it will utilize the Double Tax Agreement nomenclature to avoid possible misunderstandings.

The $2.2 billion value is a sum of the amount of taxes effective avoided in the seven concrete cases analysed in this report: Vodafone in India ($1.7 billion), Paladin in Namibia ($19 million), Actis in Uganda ($38 million), Zain in Uganda ($85 million), ConocoPhillips in Vietnam (originally at $179 million, ConocoPhillips and Vietnam settled out of court for an undisclosed value — considered 50% of original amount at $89.5 million), Petrotech in Peru ($270 million).


The Vodafone – Hutchinson case and its Implications. https://www.vccircle.com/industry/8xsZbdPh1p5yK9l1mRg0M/Trial-in-Rs22100-crore-Vodafone-India-tax-dispute-to-begin.html

Endnotes


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10 The Vodafone – Hutchinson case and its Implications. VCCircle. October 6th, 2008. https://www.vccircle.com/industry/8xsZbdPh1p5yK9l1mRg0M/Trial-in-Rs22100-crore-Vodafone-India-tax-dispute-to-begin.html


12 Section 9(1)(i) — The following incomes shall be deemed to have been derived by a non-resident through a connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India.


15 Trial in Rs22,100 crore Vodafone India tax dispute to begin in February 2019. Live Mint. November 14th, 2017. https://www.livemint.com/Industry/8xsZbdPh1p5yK9l1mRg0M/Trial-in-Rs22100-crore-Vodafone-India-tax-dispute-to-begin.html


22 Namibia-Mauritius DTA: https://mr.mu/download/Mtius_Namibia.pdf


25 Actis was created by the Commonwealth Development Corporation in 2004. At that time, 60% of the company was sold to individual and corporate partners of CDC. In May 2012, the remaining 40% was sold, whereby Actis became an independent entity.

26 Actis states its mission is to facilitate the growth of companies in the developing world, however the company has received previous criticism from the UK’s Public Accounts Committee in 2007 due to excessive executive payments, with Actis presenting “extraordinary levels of pay in a small publicly owned organisation charged with fighting poverty, with the Chief Executive receiving £970,000 in 2007”.


28 Mauritius-Uganda DTA. Article 14, paragraph 4.


35 Tullow pays $250 mn to settle Uganda tax dispute out of court. Reuters - https://af.reuters.com/article/ugandaNews/idUSL5N0EQ2Q0202130614


41 Uganda Income Tax Act, Section 88 (5): Where an international agreement provides that income derived from sources in Uganda is exempt from Ugandan tax or is subject to a reduction in the rate of Ugandan tax, the benefit of that exemption or reduction is not available to any person who, for the purposes of the agreement, is a resident of the other contracting state where 50 percent or more of the underlying ownership of that person is held by an individual or individuals who are not residents of that other Contracting State for the purposes of the agreement.https://www.finance.go.ug/sites/default/files/Publications/Income%20Tax%20Act.pdf

42 Mutual Agreement Procedure (MAP) clauses are present in a large number of DTAs. MAP is a dispute resolution method between the two countries that are part of a DTA. Through MAP, the tax authorities of both countries are able to consult and resolve disputes regarding the application of the clauses in the DTA, similar to an arbitration ruling. Based on the specific clause of the contract, a MAP resolution can be considered binding for both countries. In the specific context of the Netherlands-Uganda dispute over the Zain case, The Netherlands is seeking a MAP resolution on the right of the Uganda Revenue Authority to tax the transaction. Uganda has so far opposed the establishment of a MAP to address this case.


45 United Kingdom-Vietnam DTA. Article 13, paragraph 2(a).


51 Savia Peru. Quiénes somos http://www.saviaperu.com/nosotros/sobre-savia/quiennes-somos/


55 The Commission from the Peruvian Congress estimated total economic losses from Petrotech activities in the country at $482 million, with $270 million related to the Offshore Indirect Transfer and the avoidance of Capital Gains Tax. The remaining $212 million are related to other items, including incorrect use of tax credits and unpaid fees and fines.


68 Double taxation agreements and developing countries. Institute of Development Studies, K40 (Knowledge, Evidence and Learning for Development) https://assets.publishing.service.gov.uk/media/5b3b610040f0b645fd592202/Double-Taxation-Treaties_and_Developing_Countries.pdf

69 Article 13(4): Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 percent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

70 Article 6: The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources, ...

71 With the recent event of the Multilateral Convention related to the implementation of BEPS-related measures, the impact of the current version of article 13(4) should increase.


73 Article 13(5): Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least ___ per cent [the percentage is to be established through bilateral negotiations] of the capital of that company or entity


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