TAX TREATIES
BETWEEN DEVELOPED
AND DEVELOPING COUNTRIES

Sixth report

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INTRODUCTION

The Economic and Social Council, in resolution 1273 (XLIII) of 4 August 1967, requested the Secretary-General:

"To set up an ad hoc working group consisting of experts and tax administrators nominated by Governments, but acting in their personal capacity, both from developed and developing countries and adequately representing different regions and tax systems, with the task of exploring, in consultation with interested international agencies, ways and means for facilitating the conclusion of tax treaties between developed and developing countries, including the formulation, as appropriate, of possible guidelines and techniques for use in such tax treaties which would be acceptable to both groups of countries and would fully safeguard their respective revenue interests."

In resolutions 1430 (XLVI) of 6 June 1969, 1541 (XLIX) of 30 July 1970 and 1765 (LIV) of 18 May 1973, the Council authorized the Group of Experts on Tax Treaties between Developed and Developing Countries to continue its work. Council resolution 1765 (LIV) specifically requested the Group:

"To continue its work on guidelines for tax treaties between developed and developing countries and to study the implementation of tax agreements, in such areas as income allocation, international tax evasion and avoidance and tax incentives."

The Group has held six meetings since its inception. The present report covers the sixth meeting held at United Nations Headquarters from 8 to 19 December 1975.

Members of the Group, all of whom attended the sixth meeting, are as follows:
Carlos C. Martinez Molteni (Argentina); Francisco O. N. Dornelles (Brazil); Gilberto Urrutia Vistoso (Chile); Pierre Kerlan (France); Thomas Menck (Germany, Federal Republic of); A. N. E. Amissah (Ghana); S. R. Mehta (India); Simcha Gafny (Israel); Yuji Gomi (Japan); W. H. van den Berge (Netherlands); A. Scheel (Norway); Riaz Ahmad (Pakistan); Ambrosio M. Lina (Philippines); C. Sivaprakasam (Sri Lanka); Max Widmer (Switzerland); Adnan Baser Kafaoglu (Turkey); B. Pollard (United Kingdom of Great Britain and Northern Ireland); Nathan Gordon (United States of America).
For a complete list of persons who participated in the sixth meeting of the Group, see annex III of part one.

The Group elected the following officers: A. N. E. Amissah (Ghana), Chairman; W. H. van den Berge (Netherlands), Vice-Chairman; and A. Scheel (Norway), Rapporteur. Professor Stanley Surrey acted as Special Adviser to the Rapporteur.

The Group adopted the following agenda for its sixth meeting:

Guidelines for tax treaties between developed and developing countries:
(a) International income allocation
(i) Procedural problems

(ii) Substantive issues (interest, services, transfer prices)

(b) Exchange of information

(c) Non-permanent residents

(d) Capital gains

(e) Non-discrimination

(f) Income from immovable property

(g) Leasing

(h) General methods of relief from double taxation
Part One

REPORT OF THE GROUP OF EXPERTS ON TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES ON ITS SIXTH MEETING
Chapter I
GUIDELINES ADOPTED BY THE GROUP

A. Arrangements between treaty competent authorities regarding income and expense allocation between related entities

The following are guidelines for procedural arrangements regarding income and expense allocations, including transfer pricing, between related entities, and for the substantive implementation of such allocations. The guidelines are in the form of an inventory of possible arrangements from which the competent authorities under a tax treaty may select those to be utilized to implement the treaty provisions governing such allocations.

It is assumed in these guidelines that the treaty itself will contain articles relating to the following:

(a) Business profits. An article similar to article 7(2) of the Draft Convention of the Organisation for Economic Co-operation and Development (hereinafter referred to as the OECD Draft Convention) requiring that attribution of profits to a permanent establishment be made on an arm's length basis;

(b) Associated enterprises. An article similar in general to article 9(1) of the OECD Draft Convention requiring that transactions between associated enterprises (such as parent and subsidiary) be governed for tax purposes by an arm's length standard; an article similar in general to revised article 9(2) of the OECD Draft Convention requiring an appropriate correlative adjustment when article 9(1), or other allocation articles such as article 11(6) are applied;

(c) Mutual agreement procedure. An article similar in general to article 25 of the OECD Draft Convention establishing a mutual agreement procedure to be carried out by the competent authorities of the respective States. This procedure is designed to implement the treaty in matters of interpretation and application, to provide a forum for residents of the States involved to protest actions not in accordance with the treaty, and to eliminate double taxation in cases not provided for in the treaty. The wording of such an article 25 should make it clear that the mutual agreement procedure extends to articles 7 and 9 and also to allocations affecting other articles such as the article covering the method of relieving double taxation and articles providing for the treatment of certain expenses in the source country (e.g., articles 11 and 12);

(d) Delegation to competent authorities. In place of paragraph 4 of the OECD article 25 relating to some aspects of competent authority activity, there should be a statement along the following lines:

"The competent authorities of the Contracting States may communicate with each other directly for the purposes expressed in the preceding paragraphs."
"The competent authorities, through consultation shall develop appropriate bilateral procedures, conditions, methods and techniques concerning the implementation of the mutual agreement procedure authorized by this article. In addition, a competent authority may develop unilateral procedures, conditions, methods and techniques considered appropriate to facilitate the bilateral aspects above mentioned and the implementation of the mutual agreement procedure."

The above treaty provisions, in respect of income and expense allocations, including transfer pricing, embody these essential elements:

(a) Transactions between related entities are to be governed by the standard of "arm's length dealing". As a consequence, if an actual allocation is considered by the tax authorities of a treaty country to depart from that standard, the taxable profits may be redetermined;

(b) Taxpayers are entitled to invoke the mutual agreement procedure where they consider that such action by one or both of the tax authorities regarding such redetermination is contrary to the arm's length standard;

(c) The implementation of the mutual agreement procedure is delegated to the competent authorities of the treaty countries, with adequate powers to ensure full implementation and with the expectation that this implementation will enable the mutual agreement procedure to be an effective instrument for carrying out the purposes of the treaty. (While the delegation in the guideline article states that the competent authorities "shall develop" the appropriate procedures, some countries, not expecting a significant number of matters to arise, may prefer the phrase "may develop".)

As guidelines to facilitate the exercise by competent authorities of the implementation function thus provided, an inventory is presented of possible arrangements to be drawn upon by the competent authorities for this purpose, together with comments on some factors relevant to the use of possible arrangements. The inventory items and factors mentioned are not intended to be exhaustive of all the possibilities. Instead, the enumeration is intended to be open-ended, to be added to as experience dictates.

This inventory is divided into two main parts, "procedural aspects" and "substantive aspects". While the guidelines relate to implementation of treaty provisions on the income and expense allocation between related entities, portions of the procedural aspects may also be useful as guidelines to be utilized by the competent authorities to carry out their responsibilities in matters involving other provisions of the treaty presented to them by taxpayers. These include provisions involving excess payments of interest and royalties, the operation of the foreign tax credit article, fiscal domicile, the character of services rendered and so on.

1. Procedural aspects

The competent authorities should develop a procedural process for the handling of income allocation matters. The following are various aspects that the competent authorities should focus on in developing this bilateral procedural system.
(a) **Over-all aspect**

The procedural system should be suitable to the number and types of issues expected to be dealt with by the competent authorities and to the administrative capability and resources of those authorities. The process should not be rigidly structured but instead should embody the degree of flexibility required to facilitate consultation and agreement rather than hinder them by elaborate procedural requirements and mechanisms. But even a relatively simple procedural system must contain certain minimum rules that inform the taxpayers of their essential rights and obligations under the competent authority process. Such minimum rules would appear to involve such questions as:

At what stage in his tax matter can a taxpayer invoke competent authority activity?

Must any particular form be followed by a taxpayer in invoking competent authority activity?

Are there time-limits applicable to a taxpayer's invocation of competent authority activity?

If a taxpayer resorts to competent authority activity, is he bound by the decision of the competent authorities and must he waive resort to other administrative or judicial processes?

In what manner, if at all, can a taxpayer participate in the competent authority proceedings? What requirements regarding the furnishing of information by a taxpayer are involved?

(b) **Information on adjustments**

The competent authorities should decide on the extent and timing of information to be given by one competent authority to the other on adjustments involving income allocation. Thus, the information could cover adjustments proposed or concluded by the tax administration of one country, the related entities involved and the general nature of the adjustment.

Generally speaking, most competent authorities are likely to conclude that the automatic transmittal of such information is not needed or desirable. The competent authority of the country making an adjustment may find it difficult or time-consuming to gather the information and prepare it in a suitable form for transmission. In addition, the other competent authority may find it burdensome merely to process a volume of data routinely transmitted by the first competent authority. Moreover, the taxpayer can usually be counted upon to inform its related entity in the other country of the proceedings, and the latter is thus in a position to inform, in turn, its competent authority. For this reason, the functioning of a consultation system would be aided if a tax administration considering an adjustment possibly involving an international aspect would give the taxpayer warning as early as possible.

Some competent authorities, while not desiring to be informed routinely of all adjustments in the other country, may desire to receive, either from their own taxpayers or from the other competent authority, "early warning" of serious cases
or of the existence of a significant degree or pattern of activity respecting particular types of cases; similarly, they may want to transmit such information. In this event, a process should be worked out for obtaining this information. Some competent authorities may want to extend this early warning system to less serious cases, thus covering a larger number of cases.

(c) Invocation of competent authority consultation at point of proposed or concluded adjustments

The competent authorities must decide at what stage the competent authority consultation process may be invoked by a taxpayer and which competent authority a taxpayer should go to in order to commence that process. For example, suppose an adjustment is proposed by State A that would increase the income of a parent company in State A and the adjustment would have a correlative effect on a related entity in State B. May the company go to its competent authority in State A, asserting that the adjustment is contrary to the treaty, and ask that the bilateral competent authority process commence? (It is assumed, as stated earlier, that if the bilateral competent authority process is properly invoked, the two competent authorities must enter the process of consultation.) As another example, may the related entity in State B invoke its competent authority?

Probably most competent authorities, at least in the beginning stages of their experience, would prefer that the process not be invoked at the point of a proposed adjustment and probably not even at the point of a concluded adjustment. A proposed adjustment may never eventuate in final action and even a concluded adjustment may or may not trigger a claim for a correlative adjustment; even if it does, the latter adjustment may occur without problems. As a consequence, many competent authorities may decide that the process should not be invoked until the correlative adjustment (or other tax consequence in the second country) is involved at some point.

However, some competent authorities may prefer that the bilateral process be invoked earlier, perhaps at the proposed adjustment stage. Such involvement may make the process of consultation easier, in that the first country will not have an initial fixed position. In such a case the other competent authority should be prepared to discuss the case at this early stage with the first competent authority. Other competent authorities may be willing to let the taxpayer decide, and thus stand ready to have the process invoked at any point starting with the proposed adjustment.

In any event, at a minimum, the bilateral procedure must inform the taxpayer when it may invoke the process and which competent authority is to be addressed (presumably it would be the competent authority of the country where the invoking taxpayer resides). Also the form of the request should be specified, though here it is likely that a simple form would normally be suitable.

(d) Correlative adjustments

Governing rule. It is the general view that a tax treaty should provide that if one country makes an adjustment in the tax liabilities of an entity under the rules governing the allocation of income and expense, thereby increasing the tax liabilities of that entity, and if the effect of this adjustment, when reflected
in the tax status of a related entity in the other country, would require a change
in the tax liabilities of the related entity, then a correlative adjustment should
be made by the second country at the related entity's request if the initial
adjustment is in accord with the treaty standard governing allocation of income
and expense. (See, for example, revised article 9(2) of the OECD Draft Convention
which, it is here assumed, requires such correlative adjustment.)

The purpose of such a treaty provision is to avoid economic double taxation.
It is clear that the key aspect of such a treaty provision requiring a correlative
adjustment is that the initial adjustment itself must conform to the appropriate
arm's length standard. Such conformity thus becomes for this purpose an important
facet of competent authority consultation.

While many countries may be willing to agree that a correlative adjustment
should be made, some countries may believe it appropriate to reserve a degree of
discretion to the competent authorities, who could then decide that a correlative
adjustment need not be made where they conclude that the actual allocations of the
related entities which provoked the initial adjustment involved fraud, evasion,
intent to avoid taxes or gross abuse in the allocation method utilized. Such
countries may take the view that, if a correlative adjustment were required in such
situations and the taxpayer were thus given, in effect, an almost automatic
guarantee against the consequence of double taxation, the taxpayer would generally
have little to lose in initially utilizing clearly improper allocations. Hence, if
such discretion existed in the competent authorities and there were a risk to the
taxpayer of economic double taxation, he would be deterred from taking such action
and would be more careful in his allocations. Other countries may feel, however,
that the key objective of the treaty should be to avoid double taxation and, hence,
such aspects as fraud or the like should be left to other provisions of law,
though even here they might concede some modicum of discretion to be utilized in
outrageous cases.

Putting such situations to one side, some countries may not desire a provision
requiring correlative adjustments but would leave the entire matter to the
discretionary agreement of the competent authorities in the view that the
requirement of a correlative adjustment is too strong an invitation to a country
to make a large number of initial adjustments. Other countries, however, may
believe that the constraint that competent authorities must agree that the initial
adjustment conforms to an arm's length standard is itself a sufficient safeguard.

It is recognized that, to be effective, a treaty with a correlative
adjustment provision must also provide that any domestic law procedural or other
barriers to the making of the correlative adjustment are to be disregarded. Thus,
such provisions as statutes of limitations and finality of assessments would have
to be overridden to permit the correlative adjustment to be made. If a particular
country cannot, through a treaty, override such aspects of its domestic law, this
would have to be indicated as an exception to the correlative adjustment provision,
though it would be hoped that domestic law could be amended to permit the treaty
to operate.

The treaty need not prescribe the method of the correlative adjustment since
this depends on the nature of the initial adjustment and its effect on the tax
status of the related entity. The method of the correlative adjustment is thus an
aspect of the substantive issue underlying the initial adjustment.
Competent authority procedure. Given this correlative adjustment requirement, it is clear that the competent authority process must be available at this point. Thus, if the tax authorities of the second country do not themselves work out the correlative adjustment, the taxpayers should be entitled to invoke the competent authority process. Hence, as one of the minimum aspects of competent authority procedure, the competent authorities must establish rules as to which competent authority the taxpayers may go to, i.e., the competent authority of the country in which is located the related entity seeking the correlative adjustment or the competent authority of the country of the initial adjustment, or both. If a time-limit on the invocation is to be imposed (the OECD Draft Convention uses three years), then the limit must be stated and also the stage at which the time begins to run must be definitely described. In some countries when a taxpayer invokes the competent authority of its country, that competent authority may be in a position to dispose of the matter without having to consult the competent authority of the other country. For example, the first competent authority may be in a position to handle a matter having potential international consequences that arises from an adjustment proposed by a taxing unit in the country other than the central body. This is, of course, an aspect of domestic law as affected by the treaty.

As another minimum procedural aspect, the competent authorities must indicate the extent to which a taxpayer may be allowed to participate in the competent authority process and the manner of his participation. The general view appears to favour a reasonable degree of taxpayer participation. Some countries may wish to allow a taxpayer to present information and even to appear before them; others may restrict the taxpayer to presentation of data. Presumably, the competent authorities would make it a condition that a taxpayer invoking the process be required to submit to them relevant information needed to decide the matter. In addition, some competent authorities may, where appropriate, require that data furnished by a taxpayer be prepared as far as possible in accordance with internationally accepted accounting standards so the data provided will have some uniformity and objectivity. It is to be noted that rapid progress is being made in developing international accounting standards and the work of competent authorities should be aided by this development. As a further aspect concerning the taxpayer's participation, there should be a requirement that the taxpayer who invokes the competent authority process should be informed of the response of the competent authority.

The competent authorities will have to decide how their consultation should proceed once the process comes into operation. Presumably, the nature of the consultation will depend on the number and character of the cases involved. The competent authorities should keep the process of consultation flexible and leave every method of communication open, so that the method appropriate to the matter at hand can be used.

Various alternatives are available, such as informal consultation by communication or in person; meetings between technical personnel or auditors of each country, whose conclusions are to be accepted or ratified by the competent authorities; appointment of a joint commission for a complicated case or a series of cases; formal meetings of the competent authorities in person; etc. It does not seem desirable to place a time-limit on when the competent authorities must conclude a matter, since the complexities of particular cases may differ. Nevertheless, competent authorities should develop working habits that are conducive to prompt disposition of cases and should endeavour not to allow undue delay.
An important minimum procedural aspect of the competent authority process is the effect of a taxpayer's invocation of that process. Thus, must a taxpayer who invokes that process be bound by the decision of the competent authorities in the sense that he gives up rights to alternative procedures, such as resort to domestic administrative or judicial procedures? If the competent authorities do want their process to be exclusive and binding, it would be necessary that the treaty provisions be so drawn as to permit this result. Presumably, this result may be accomplished under the general delegation in the guideline article 25, paragraph 4 by requiring the taxpayer to waive resort to those alternative procedures. (However, even with this guideline paragraph, some countries may consider that their domestic law requires a more explicit statement to permit the competent authority process to be binding, especially in view of paragraph 1 of article 25 referring to remedies under national laws and of the present practice under treaties not to make the process a binding one.) Some competent authorities may desire that their actions be binding since they will not want to go through the effort of reaching agreements only to have the taxpayer reject the result if he feels he can do better in the courts or elsewhere. Other competent authorities may desire to follow the present practice and thus may not want to bind taxpayers or may not be in a position to do so under domestic law. This would appear to be a matter on which developing experience would be a useful guide.

A basic issue regarding the competent authority process is the extent to which the competent authorities should consider themselves under obligation to reach an agreement on a matter that comes before them. At a minimum, the treaty requires consultation and the obligation to endeavour to find a solution to economic double taxation. But must the consultation end in agreement? Presumably, disagreement would, in general, leave the related entities in a situation where double taxation may result contrary to the treaty, as, for example, when a country has opposed a correlative adjustment on the grounds that the initial adjustment was not in conformity with the arm's length standard. On the other hand, an agreement would mean a correlative adjustment made, or a change in the initial adjustment followed then by a correlative adjustment, or perhaps the withdrawal of the initial adjustment. In essence, the general question is whether the competent authority consultation is to be governed by the requirement that there be an "agreement to agree".

It should be observed that, in practice, this question is not as serious as it may seem. The experience of most competent authorities, at least as concerns disputes between developed countries, is that in the end an agreement or solution is almost always reached. Of course, the solution may often be a compromise, but compromise is an essential aspect of the process of consultation and negotiation. Hence, in reality, it would not be much of a further step for competent authorities to decide that their process should be governed by the standard of "agreement to agree". However, some countries would consider the formal adoption of such standard as a step possessing significant juridical consequences and hence would not be disposed to adopt such a requirement.

There was a recognition that, for some countries, the process of agreement might well be facilitated if competent authorities, when faced with an extremely difficult case or an impasse, could call, either informally or formally, upon outside experts to give an advisory opinion or otherwise assist in the resolution of the matter. Such experts could be persons presently or previously associated with other tax administrations and possessing the requisite experience in this field. In essence, it would largely be the personal operation of these experts.
that would be significant. If countries regard this step as helpful, it may become desirable for the United Nations or other appropriate organizations to draw up a list of names of experts available for this activity, and countries could resort to this panel of names. While there was considerable sentiment for experimenting with this approach, there was no present sentiment for a formal arbitration or a procedure before an international court or similar formal process, since rules in this matter of allocation have not developed to such a stage (though such a development on a regional level may be more likely). The general feeling was that the possible rigidity and procedural complexity of formal arbitration or an international court was not desirable at this stage, but that simple resort to outside assistance of the kind described above could be of use in certain situations. This resort to outside assistance could be useful even where the competent authorities are not operating under the standard of an "agreement to agree", since the outside assistance, through bringing in a fresh point of view, may help to resolve an impasse that would otherwise have ended in no resolution of the matter.

(e) Publication of competent authority procedures and determinations

The competent authorities should make public the procedures they have adopted with regard to their consultation process. The description of the procedures should be as complete as is feasible and at the least should contain the minimum procedural aspects discussed above.

Where the consultative process has produced a substantive determination in an important area that can reasonably be viewed as providing a guide to the viewpoints of the competent authorities, the competent authorities should develop a procedure for publication in their countries of that determination or decision.

The United Nations should consider the feasibility of compiling and making available both the procedural rules published by the various competent authorities and the published substantive determinations described above.

(f) Procedures to implement adjustments

The competent authorities should consider what procedures or rules may be required to implement the carrying out of the various adjustments involved. Some aspects to focus on are:

(a) The first country may consider deferring a tax payment under the adjustment or even waiving the payment if, for example, payment or reimbursement of an expense charge by the related entity is prohibited at the time because of currency or other restrictions imposed by the second country;

(b) The first country may consider steps to facilitate carrying out the adjustment and payment of a reallocated amount. Thus, if income is imputed and taxed to a parent corporation because of service to a related foreign subsidiary, the related subsidiary may be allowed as far as the parent country is concerned, to establish on its book an account payable in favour of the parent, and the parent will not be subject to a second tax in its country on the establishment or payment of the amount receivable. Such payment should not be considered a dividend by the country of the subsidiary;
(g) The second country may consider steps to facilitate carrying out the adjustment and payment of a reallocated amount. This may, for example, involve recognition of the payment made as a deductible item, even though prior to the adjustment there was no legal obligation to pay such amount. This is really an aspect of the correlative adjustment.

(g) Unilateral procedures

The above discussion has related almost entirely to bilateral procedures to be agreed upon by the competent authorities to implement the mutual agreement process. In addition, a competent authority may consider it useful to develop certain unilateral rules or procedures involving its relationship to its own taxpayers, so that these relationships may be better understood. (For example, the United States of America, in Rev. Proc. 70-18, has published rules respecting certain of its procedures in allocation cases.) These unilateral rules can cover such matters as the form to be followed in bringing matters to the attention of the competent authority; the permission to taxpayers to bring matters to the competent authority at an early stage even where the bilateral procedure does not require consultation at that stage; the question whether the competent authority will raise new domestic issues (so-called affirmative issues) between the tax authorities and the taxpayer if it goes to the competent authority; requests for information that will assist the competent authority in handling cases; etc.

Such unilateral rules regarding the operation of a competent authority would not require agreement to them by the other competent authority, since the rules are limited to the domestic relationship with its own taxpayers. However, it would seem appropriate to communicate such unilateral rules to the other treaty competent authorities, and to avoid wherever possible material differences, if any, in such rules in relation to the various treaties.
2. Substantive aspects

The following guidelines on the substantive aspect of international income and expense allocation, including transfer pricing, between related entities assumes that the treaty contains: (a) a provision establishing the arm's length standard to govern transactions between related entities and permitting a country to readjust an entity's profits to accord with that standard; (b) a provision requiring a correlative adjustment in the second country to reflect the effect of the initial adjustment as respects a related entity involved; (c) a provision establishing a mutual agreement procedure to be carried out by the respective competent authorities and extending to these adjustments; and (d) a provision requiring the competent authorities to implement this mutual agreement procedure and, for this purpose, requiring and authorizing the competent authorities to develop the necessary methods and techniques.

Since the competent authorities are required and authorized to implement the arm's length provisions, it is incumbent upon them to develop substantive principles that will enable them to handle matters involving that standard when their process is invoked by taxpayers. The development of such principles will also permit taxpayers to make their intercompany arrangements with knowledge of the standards involved and the ways in which the countries affected are applying those standards. Such knowledge in itself would tend to reduce the volume of matters coming before the competent authorities. Similarly, tax administrations in the countries affected can likewise be guided in their actions by such principles.

Most tax administrations under their national tax systems follow the arm's length standard (also adopted in the treaty provisions) as the standard for income allocation cases. However, tax administrations may differ in their application of that standard. One may have decided to follow an ad hoc approach, judging each case on its facts, and therefore will not have prescribed any substantive rules to be applied; another may have decided to develop fully articulated substantive rules for the various types of income allocation situations that arise. In between, there can be variations of either approach.

The initial task of the competent authorities is to harmonize the approaches already being applied in the two countries. Clearly, the difficulties in the task of harmonization will depend on the degree of variation between the approaches used by the two countries. The attitude taken toward the task of harmonization will also be affected by the number of cases requiring consideration by the competent authorities. If there are few such cases and, in addition, if each country utilizes a case-by-case approach, the competent authorities may themselves use that approach. But if the cases are likely to be frequent or if one country is already using an approach involving articulated rules (a situation likely and inevitably necessary when a country has a significant volume of income allocation cases), the competent authorities may have to utilize an approach that involves some rules rather than only case-by-case consideration. Moreover, since income allocation problems are increasingly becoming an important part of international tax relationships, it is desirable that competent authorities develop the appropriate rules to handle these problems.

In addition, it is likely that even a case-by-case approach must have its own internal rules. Administrators must base their judgements on something, and precedents, written or unwritten, would seem bound to develop. Perhaps a record of the experience of administrators using a case-by-case approach and of the expression
of the concepts and attitudes they bring to each decision would show that their approach does not differ markedly from that of countries using an articulated and prescribed set of rules.

An inventory of possible approaches to be drawn upon by the competent authorities follows, together with comments on some factors relevant to those approaches, as guidelines to facilitate the development of principles and rules relating to the substantive aspects of income and expense allocations.

**Loans**

As respects transactions involving loans, it is assumed that the treaty itself will contain articles relating to the following substantive aspects:

(a) **Excess interest.** An article similar to article 11 (6) of the OECD Draft Convention, in effect saying that interest paid on a loan between related entities in excess of the interest that would be paid in the absence of the special relationship between the payor and recipient shall not be governed by the other provisions of the article on "interest" and instead its treatment should be left to domestic law supplemented by other provisions of the treaty;

(b) **Business profits.** An article similar in general to article 9 (2) of the OECD Draft Convention requiring that transactions between associated enterprises (such as parent and subsidiary) be governed for tax purposes by an arm's length standard and a correlative adjustment, a complementary provision requiring that appropriate correlative adjustment is essential when either of the above provisions is applied. Hence, the profits of an enterprise may be adjusted upwards to reflect the profits that would have accrued to that enterprise as judged by relations between independent enterprises.

Against the background of these substantive provisions, two principal problems arise. Seen from the point of view of the country of the borrower, the interest stated in a loan contract or other debt arrangement between related entities, e.g., a parent and a subsidiary, may be excessive. As a consequence, the tax authorities of that country may seek to disallow the deduction for the excess interest in determining the tax liability of the debtor, perhaps treating the excess as a dividend where appropriate. Seen from the point of view of the country of the lender, the interest stated in the loan contract may be too low. Such a situation may in some cases be regarded as an effort to shift taxable profits away from the country of the lender. As a consequence, the tax authorities of that country may seek in those cases to impute an appropriate interest charge and thus increase the taxable profits of the lender to prevent such a shift in profits. This adjustment will presumably in turn cause the borrower to seek a deduction in its country, under the correlative adjustment clause, of the interest charge imputed to the creditor since, without such deduction, the related entities of creditor and borrower would together experience double taxation.

In each situation - that of excessive interest and that of none or insufficient interest - the criterion involved is the principal of the arm's length standard. Hence, each country is utilizing the same criterion. But the factor of which country initiates the use of the criterion will depend on whether the contract rate of interest is above or below the arm's length standard and, along the same lines, whether it is the country of the borrower or of the creditor that is as a consequence primarily affected.
Frequently, the creditor will be a parent corporation in a developed country and the borrower a subsidiary in a developing country. If this is so, the developing country in the typical adjustment case will be seeking to disallow a deduction for excess interest. The developed country, on the other hand, typically will be seeking, in a case involving a shifting of profits, to impute a higher rate of interest than that contained in the contract. Clearly these situations cannot coexist in the same loan. Hence, it must be that on some loans between related entities in developed and developing countries the lenders for certain reasons are charging too much interest and on some loans, probably far fewer in number, they are charging too little interest. However, it must be remembered that even between developed countries these problems exist, and the tax authorities of even a developed country may be seeking to disallow excess interest. But situations of too little interest being charged by a parent in a developing country (or a subsidiary in that country making a loan to a foreign parent) typically seem to arise rarely, largely because loans do not originate in these countries.

It should be recognized that, in one sense, the question of interest on intercompany loans may be seen by some as an artificial matter in that, from the point of view of the total profits of the group as a whole, the result is the same whether or not interest is charged. Hence companies not concerned with knowing the precise contribution of each component of the group to the total profit may not be concerned about making an interest charge on the company books on intercompany loans. However, since the use of money has a cost to a parent company, whether borrowed externally or generated internally, companies concerned with an accurate reflection of the contribution of component units to the total profit will make a charge on the company books for the use of money and hence will charge interest on intercompany loans. The principal observation here, however, is that company executives, from an internal company viewpoint, may or may not be concerned about how a total profit is divided among the component units. But from the standpoint of tax authorities this division is a crucial one, since the division of profits determines the allocation between countries of the revenues making up the total profit. Consequently, tax authorities cannot be content merely to follow the treatment of intercompany loans on a company's books, since this would mean that tax authorities would be delegating revenue decisions to book-keeping entries often made for particular purposes of the company and without regard to a fair division of the revenues between the countries involved.

Hence, tax authorities are often compelled to separate a total multicompany profit into segments that attempt to reflect accurately the earning power or profit contribution of the component within their own country. While this may seem to some an artificial or hypothetical task, it must be remembered that, as stated above, some companies are themselves interested in really knowing what each separate component is actually earning and therefore accountants have developed rules for so dividing a total profit. Essentially, these rules are also based on the arm's length standard and, in the case of loans, require that in a normal situation interest be chargeable to the borrower. In this sense, since loans between independent concerns do carry interest - lenders normally wanting a return on their loans - loans between related entities also should normally carry interest if the real profits being earned by the lender and borrower components of the related entities are a concern.

Thus, for tax purposes, it is proper to regard it as appropriate for parents to lend money to subsidiaries (and sometimes the other way around), and for such
loans in a normal case to carry an interest charge. Hence, the basic inquiry is the determination of the appropriate charge. Under the guiding treaty provisions, this becomes a search for criteria to apply the substantive rule of the arm's length standard.

As stated above, the concern of tax authorities in developing countries is to avoid a deduction for what they regard as excessive interest being charged to borrowers in their countries. Generally, the internal rate of interest in a developing country will be higher than the rate in the developed country or in the world market. The Group concluded that it would be appropriate to apply the arm's length standard by looking at the situation in the creditor country. In a sense, the image is that of an independent company in the developing country being able to borrow externally under conditions that would primarily focus on the creditor's lending capacity and not on the conditions facing companies in the developing country forced to borrow in their internal market. (It may be observed that, between OECD countries, there is no such presumption to focus on the situation in the creditor country. Rather, in discussing this part, the OECD Committee on Fiscal Affairs used a case-by-case determination as to whether to look at the rate in the creditor country, the rate in the borrower country or the international rate, let alone at other special factors.)

This being accepted, the question narrows to an appropriate rate viewed from conditions affecting the creditor. Such conditions may involve factors such as the following: Is the creditor obtaining its funds in its own market, and what is the general interest rate prevailing there, given the borrowing strength of the creditor itself? Or is the creditor able to utilize a world market rate and is that rate a lower one? Generally speaking, it is probably appropriate to use the general rate in the creditor country but to allow a higher rate if the creditor's actual cost for money can be shown to be higher (as where it paid a higher rate of interest to obtain the funds lent or there were currency devaluation losses) or a lower rate if the creditor's actual cost can be shown to be lower (as when the creditor is in a position to borrow internationally from its Government at a favourable rate and is in a sense an intermediary in transmitting funds through a loan to the developing country).

These may be useful criteria in fixing an arm's length standard and are susceptible of application on a case-by-case approach. Some competent authorities, however, may prefer to generalize these criteria and seek some rules of thumb in order to simplify administration. One possibility is to say that a developing country will not treat an interest charge as excessive if the rate does not deviate significantly from the market rate in the creditor country (except where the creditor can clearly prove a higher actual cost), and even then will not concern themselves unless the amounts are substantial. Since this requires a determination of interest rates in the creditor country, the competent authorities for a particular treaty could simplify administration by agreeing to a usual interest rate in the creditor country (this figure would have to be changed from time to time), and then agreeing to accept an interest charge, say, 20 per cent above or below that figure. They could add that, in exceptional circumstances where the amounts are significant, a higher figure could be accepted where a higher actual cost to the creditor can be proved or, on the other hand, a lower figure must be used where it is known the creditor received a preferential cost for money, for example, from a government agency for the purpose of relending to a developing country.
It should be recognized that in many developing countries the matter of excess interest is removed from the hands of the tax authorities because domestic law rules that exchange control authorities or investment authorities must approve the rate of interest to be charged by the creditor and the approved rate governs the contract for tax purposes as well.

Where a disallowance of excess interest is made by the borrower country, this step can require a correlative adjustment in the lender country. Thus, if the excess interest is to be regarded as a disguised dividend, then presumably the parent should receive a foreign tax credit in those cases in which such a credit is given for the corporate tax paid by the subsidiary. The point, in effect, is that the aspect of correlative adjustment may occur in a developed country when the initial adjustment arises in the developing country, the nature of the correlative adjustment depending upon the substantive issue involved.

The above relates to the competent authority administration of the excess interest aspect, as set forth in article 11 (6), which relates to the borrower. But essentially the same considerations apply to competent authority administration of the arm's length standard of article 9 (1) which relates to the creditor. Of course, the point of the inquiry is different, since the tax authorities of the creditor country may be seeking to impute an interest charge where no interest is stated in the loan contract between the related entities or where the stated interest is too low, so that a shifting of profits may be involved. But while the point of the inquiry is different, the standard to be followed, that of arm's length, is the same as in the excess interest situation, and hence the criteria developed above are likewise applicable. We are essentially dealing with two sides of the same loan coin, one labelled creditor and the other labelled borrower. In some countries, the imputed interest may be considered as a contribution or donation by the parent to the subsidiary, and the parent's income increased only to the extent that the amount of the interest exceeds a permissible limit on such a donation.

As a consequence, if the tax authorities in a creditor country for imputation purposes use a rate focused on the rate in the creditor country and for administrative convenience settle for a range on either side of that rate, as discussed above, such a practice should as a general rule of thumb seem acceptable to the competent authority and tax authorities in a developing country (or, in the process of correlative adjustment, perhaps even a developed country) where the borrower is located. Of course, as stated above, there may be exceptional cases and these can be dealt with as exceptions. Since the focus is on the rate in the creditor country, it would seem proper for the competent authority of a developing country to utilize one range as a rule of thumb in its consultative process with a competent authority of developed country A and another range for developed country B. This approach would not be inconsistent; rather, it would reflect an understanding that conditions are different in countries A and B.

It should be recognized that, as respects the discussion of the imputation of interest, we are dealing with both article 9 (1), which allows imputation of interest to the creditor, and a treaty provision requiring a correlative adjustment to reflect the imputed interest through a deduction in the tax liabilities of the borrower to avoid economic double taxation. But it should be evident that, as a general matter, the criteria governing the deduction of interest under a correlative adjustment reflecting the imputation in the creditor country are essentially the
same criteria that govern the disallowance of excess interest when it is the borrower country that has taken the initial step. In this light, it becomes understandable that the absence of a charge for interest in the original loan contract should not prevent a later deduction for imputed interest, as the correlative adjustment, when interest is properly imputed by the tax authorities of the developed country. (In reality, the portion of the correlative adjustment clause overriding domestic law barriers to the adjustment would override the barrier that interest was not originally stated in the contract.) This again is but the other side of the loan coin. Thus, the fact that an excessively high rate of interest is stated in the contract does not bar the tax authorities of the borrower country from disallowing part of that interest. Likewise, therefore, the fact that no interest or an excessively low rate of interest is stated should bar neither imputation of interest nor deductibility of the imputed interest under a correlative adjustment. Of course, a competent authority, in order to understand a case, may inquire as to why no interest was originally stated, just as he may ask why a high rate of interest was originally stated.

It should be observed in this regard that the initial adjustment to impute interest and the correlative adjustment to deduct that interest are tax computation matters and do not in themselves change the books of the related entities. The books may of course later be changed to reflect the situation. This aspect is one of the secondary factors growing out of the initial and correlative adjustments. See the earlier discussion under "Procedural aspects", item (f).

The domestic law of some countries does not allow a deduction for interest paid to a related foreign entity. Also, the domestic law of some countries may adhere to the rule that, if a loan contract between related entities does not call for interest, then where the tax authorities in the lender country impute interest to prevent a shifting of profits, the borrower cannot obtain a deduction under a correlative deduction since that would be contrary to the original contract. Countries that desire to maintain these domestic rules should therefore in their treaty negotiations indicate the existence of these rules and conform the correlative adjustment clause in accordance with them. This is thus a matter for negotiation in the treaty itself.

The initial adjustment imputing interest and a correlative adjustment allowing a deduction for interest may not complete the process of adjustment. The imputed interest may also give rise to a withholding tax on such interest if the country of the related entity has such a tax. The time of imposition of that tax and the amount of the tax will depend on the rules applicable to the withholding tax, including any treaty provisions relating to that tax. Of course, there may be a variety of instances in which loans or debt obligations are made without an interest charge and it is proper not to alter that arrangement to impute interest. Substantively these are situations in which it can be said that, because of the particular factors involved, even a creditor lending to an independent or unrelated entity would not require interest. Trade credits, including sales on a deferred payment basis, between parent and subsidiary may be carried without an interest charge if the parent would customarily do so with independent customers, or if the commercial practice in the creditor's country is not to charge interest on such credits depending on the time period involved. As another example, if a subsidiary is in financial difficulties and an interest-free loan is made by the parent, it would be appropriate not to charge interest if independent companies
in such a situation would forego interest in an effort to sustain the debtor company, as when a supplier may seek to aid a valued customer. Still another example would be the situation of start-up losses at the beginning of a subsidiary's existence. The point is not that such trade credits, financial difficulties or start-up losses are in themselves absolute factors that deny imputation of interest. Instead they are factors that clearly can occasion an inquiry as to whether in an independent setting these factors would be regarded as sufficient reason for not charging interest and therefore can support the explanation of a parent as to why its loan did not carry interest under such circumstances. Indeed, it is quite likely that these situations taken together may well represent a large number of the cases in which parent companies in developed countries do not charge interest on loans to subsidiaries in developing countries. Assuming that "no interest" cases exist between developed and developing countries to any appreciable extent, the occasion for imputation of interest may be considerably reduced between developed and developing countries.

As another aspect of the matter of a tax adjustment in the creditor country when a loan is interest-free, some countries under their domestic law do not impute interest, even though the absence of interest is recognized as improper under an arm's length standard, but instead disallow as a deduction the expense involved in obtaining the funds represented in the loan. However, the two approaches - imputation of interest or disallowance of expense - will not automatically reach the same final result. Thus, assume that the interest imputed to a parent would be 100 and the expense disallowed under the disallowance approach would also be 100. The net effect on the parent's taxable profit of either adjustment will here be the same - the taxable profit will increase by 100. (This assumes that it is always possible to ascertain the expenses involved in funding the loan, even where the loan is made from the internal funds of the parent. If this is not so, the disallowance of expense approach is likely to result in a lesser amount than would be the amount added under an imputation approach and hence the latter approach could result in a higher taxable profit on the parent's side.) But, under the expense disallowance approach, how is a correlative adjustment to be carried out? Unless it is considered appropriate for the subsidiary to reimburse the parent for the expense disallowance, there may be no way to alter the tax computation of the subsidiary. Yet if this is so, economic double taxation is the result, since the parent's taxable income will rise by 100 and the subsidiary's taxable income will remain the same, though it reflects the interest-free loan (and hence is 100 higher than would occur under an arm's length standard). It is thus seen that the expense disallowance method results in economic double taxation unless a correlative adjustment is made.

Further, if interest is not imputed, the opportunity to impose a withholding tax in the country of the subsidiary may not be so readily apparent. Indeed, the imposition of such a tax may depend on whether the country of the subsidiary regards the disallowed expense of the parent as in effect an "interest" cost of the subsidiary. Also, if the parent's country uses a foreign tax credit régime and if no correlative adjustment is made, the matter may end up with a higher foreign tax credit claimed by the parent, which is an improper result. The final determination of the credit amount will, however, depend on several factors, such as the application of the limitation on income from foreign sources and the method of its calculation. If such a correlative adjustment
is made and a withholding tax applied where appropriate, the consequences of the
two approaches would appear to be the same. Yet it should be clear that the
subsidiary country may conceptually find it more difficult to make the
correlative adjustment and apply a withholding tax in an expense disallowance
context.

All of the above discussion assumes that a real loan is involved. However,
an important area of difficulty exists in determining whether a transmission
of funds from a parent to a subsidiary is a loan transaction or an equity
transaction, that is, a contribution to the capital of the subsidiary. If it
is an equity transaction, then payments on the purported "loan" are really not
interest but dividends and hence are not deductible in computing the subsidiary's
tax (unless regular dividends are deductible under domestic law). Also, if the
"loan" is really an equity transaction and a contribution to capital, it is not
proper to impute interest. Hence, the classification of the transaction as
debt or equity is a crucial matter.

The problem of classification can be difficult to resolve. As a first step,
it can generally be said that, for a loan to exist, the related entities should
characterize the transaction as a loan and should give it the aspects of a loan,
such as an unconditional promise to pay a fixed amount of principal at a fixed
maturity date. But the fact that the related entities call the transaction a
loan and give it the aspects of a loan does not in itself answer the question
of classification. It is the reality of the situation and not just its
characterization as a loan that determines the final classification.

The mere fact that a parent-subsidiary relationship is involved does not
in itself bar a real loan from existing if the transaction may otherwise validly
be regarded as a loan. However, since a parent which is the sole owner of a
subsidiary is in a position either to make a contribution to capital or to make
a loan - a situation in which an independent creditor would not normally be
the very option possessed by the parent makes it all the more necessary that its
choice be carefully scrutinized on a case by case basis. When circumstances limit
such an option for the parent, as when it is only one participant in a joint
venture or there are significant minority shareholders, the presence of such
outside parties with financial positions that may differ from the parent can
affect the situation.

It appears to be generally accepted that no definite rules of thumb are
available to decide this matter of classification. Of course, in some countries
the classification as debt or equity may be made by the exchange authorities or
other authorities under domestic law when the investment is permitted to be
made, and this determination may under domestic law govern the tax situation or so
shape the investment that the issue will not arise. But where this is not so in
all likelihood the tax authorities and ultimately the competent authorities will
have to proceed case by case.

In so proceeding they can, of course, develop certain criteria or factors
that they will take into consideration. For example, the competent authorities
may wish to consider such questions as: Is the capitalization too "thin"? Does
the debt-equity ratio of the borrower company show a much higher amount of debt
than in the case of other companies engaged in similar businesses? Is the debt
convertible into stock of the borrower? Is the debt subordinated to the rights
of other creditors? Does the absence of interest over a period of time indicate a debt was really not intended? Was a failure of the borrower to pay interest or principal when due overlooked by the creditor, or did the creditor fail to press hard for payment? Answers to such questions may point to an equity contribution rather than to a loan or debt obligation. Also, it may be that what is really equity is disguised as a loan to manoeuvre around exchange or other restrictions.

When the competent authorities find that the transaction is really not a loan but an equity transaction, the country of the borrower may disallow a so-called interest payment as a deduction or, if no interest has been charged, it may decide it would not be appropriate to impute interest. It may be that many transactions involving related entities between developed and developing countries are situations in which an equity transaction or contribution to capital has been disguised as a loan. In such cases, the competent authorities should give the transaction the tax treatment it would receive if properly characterized as an equity transaction.

B. Arrangements between treaty competent authorities regarding exchanges of information

The following are suggested guidelines for arrangements regarding exchanges of information. The guidelines are in the form of an inventory of possible arrangements from which the competent authorities under a tax treaty may select the particular arrangements which they decide should be utilized to implement the treaty provision governing exchanges of information.

These guidelines are based on the following article, suggested as the guideline article on the subject of exchange of information to be included in a tax treaty (the relevant article in the OECD Draft Convention is article 26):

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

"2. In no case shall the provisions of paragraph 1 be construed so as to impose on one of the Contracting States the obligation:
"(a) To carry out administrative measures at variance with the laws or
the administrative practice of that or of the other Contracting State;

"(b) To supply particulars which are not obtainable under the laws or in
the normal course of the administration of that or of the other Contracting
State;

"(c) To supply information which would disclose any trade, business,
industrial, commercial or professional secret or trade process, or information,
the disclosure of which would be contrary to public policy (ordre public)."

Under this article, the implementation of the provision rests with the
competent authorities, who are, in effect, required to work out the arrangements
necessary for that implementation. An inventory of possible arrangements to be
drawn upon for this purpose is suggested herein, together with comments on some
factors relevant to the use of particular arrangements. The inventory items or
factors mentioned are not intended to be exhaustive of all the possibilities.
Indeed, the enumeration is intended to be open-ended, to be added to as experience
indicates. Nor is the inventory to be regarded as listing matters all of which are
to be drawn upon in every case. Instead, the inventory is a listing of suggestions
to be examined by competent authorities in deciding on the matters they wish to
cover.

1. Routine transmittal of information 2/

A method of exchange of information that is in use to a limited extent is that
of the routine or automatic flow of information from one treaty country to another.
The following are various aspects that the competent authorities should focus on in
developing a structure for such routine exchange. In considering routine exchanges
of information it should be recognized that some countries not desiring to receive
such information in a routine fashion (or unable to receive it routinely because
the transmitting countries do not routinely collect such information) may desire to
obtain information of this type under a specific request. Hence, in these
situations, items mentioned in the present section should be considered as
available for coverage under the next section, "Transmittal on specific request".

(a) Items covered

Regular sources of income. The items covered under a routine transmittal or
exchange of information may extend to regular sources of income flowing between
countries, such as dividends, interest, compensation (including wages, salaries,
fees and commissions), royalties, rents and other possible items whose regular flow

1/ This article is revised somewhat from that contained in Guidelines for Tax
Treaties between Developed and Developing Countries (United Nations publication,
Sales No. E.74.16.V). The changes reflect both subsequent suggested revisions by
the OECD Committee on Fiscal Affairs and discussions of the Group at its sixth
meeting. The revised OECD Commentary is applicable to the guideline article and
in this regard certain aspects of it are referred to in the present discussion of
the guidelines.

2/ In the following discussion, TC refers to the country transmitting
information, and RC refers to the country receiving information.
between the two countries is significant. It should be recognized, however, that at present most countries are not in a position to supply routine information of this character since their tax collection procedures do not operate to provide the needed data.

Transactions involving taxpayer activity. A routine exchange of information may cover certain significant transactions involving taxpayer activity.

(a) Transactions relevant to treaty itself:
- Claims to refund of TC tax made by residents of RC;
- Claims of exemption or particular relief from TC tax made by residents of RC.

(b) Transactions relevant to special aspects of TC law:
- Items of income derived by residents of RC that receive exemption or partial relief under special provisions of TC national law.

(c) Transactions relating to activities in TC of RC residents:
- Opening and closing by RC resident of branch, office etc. in TC;
- Creation or termination by RC resident of a corporation in TC;
- Creation or termination by RC resident of a trust in TC;
- Opening and closing by RC resident of bank accounts in TC;
- Property in TC acquired by RC resident by inheritance, bequest or gift;
- Ancillary probate proceedings in TC of RC residents.

(d) General information:
- Tax laws, administrative procedures etc. of TC;
- Changes in regular sources of income flowing between countries, especially as they affect treaty, including administrative interpretations and court decisions on treaty provisions and administrative practices or developments affecting treaty application;
- Activities that affect or distort treaty application, including new patterns or techniques of evasion or avoidance used by TC or RC residents;
- Activities that have repercussions regarding RC tax system, including new patterns or techniques of evasion or avoidance used by TC or RC residents that significantly affect RC tax system.

(b) General operational aspects to be considered

The competent authorities should consider various factors that can bear on the operational character of the routine exchange, including its effectiveness, such as:

(a) Countries that are more interested in receiving information on a specific request basis than on a routine basis, in their consideration of the specific request area, should keep in mind items mentioned in this inventory under the heading of routine information;
(b) A minimum floor amount may be fixed to limit minor data;

(c) The routine source of income items may be rotated from year to year, e.g., dividends only in one year, interest in another etc.;

(d) The information to be exchanged routinely need not be strictly reciprocal in all items. Country A may be interested in receiving information on some items but not others; the preferences of country B may extend to different items. It is not necessary for either country to receive items in which it is not interested. Nor should either country refuse to transmit information on certain items simply because the country is not interested in receiving information on those items;

(e) While the information to be exchanged on income items may not always be significant in itself as respects the income flows escaping tax, the routine exchange may provide indications respecting the degree to which the capital or other assets producing the income flows are escaping tax;

(f) Whether the information as to income items should cover only the payee or also the payor;

(g) Whether the information should cover only residents of RC or also those domiciled therein or citizens thereof, or be limited to any of these classifications;

(h) The degree of detail involved in the reporting, e.g., name of taxpayer or recipient, profession, address etc.;

(i) The form and the language in which the information should be provided.

(c) Factors to be considered by TC

The TC may desire to give consideration to factors affecting its ability to fulfil the requirements of a routine exchange of information. Such a consideration would presumably lead to a more careful selection of the information to be routinely exchanged rather than to a decision not to exchange information which will be of practical use.

Among the factors to be considered are the administrative ability of TC to obtain the information involved. This in turn is governed by the general effectiveness of its administrative procedures, its utilization of withholding taxes, its utilization of information returns from payors or others and the over-all costs of obtaining the information involved.

(d) Factors to be considered by RC

The RC may desire to give consideration to factors affecting its ability to utilize the information that could be received under a routine exchange of information, such as the administrative ability of RC to use the information on a reasonably current basis and to effectively associate such information with its own taxpayers either routinely or on a sufficient scale to justify the routine receipt of the information.
2. **Transmittal on specific request**

A method of exchange of information that is in current use is that of a request for specific information made by one treaty country to another. The specific information may relate to a particular taxpayer and certain facets of his situation or to particular types of transactions or activities or to information of a more general character. The following are various aspects that the competent authorities should focus on in developing a structure for such exchange of information pursuant to specific requests.

(a) **Items covered**

**Particular taxpayers.** The information that may be desired from a TC with respect to an RC taxpayer is essentially open-ended and depends on the factors involved in the situation of the taxpayer under the RC tax system and the relationship of the taxpayer and his activities to the TC country. A specific enumeration in advance of the nature or type of information that may be within the scope of an exchange pursuant to specific request does not seem to be a fruitful or necessary task. The agreement to provide information pursuant to specific request may thus be open-ended as to the range, scope and type of information, subject to the over-all constraints to be discussed herein.

The request for specific information may arise in a variety of ways. For example:

(a) Information needed to complete the determination of a taxpayer’s liability in the RC when that liability depends on: the taxpayer's world-wide income or assets; the nature of the stock ownership in the TC of an RC corporation; the amount or type of expense incurred in the TC country; the fiscal domicile of an individual or corporation;

(b) Information needed to determine the accuracy of a taxpayer's tax return to the RC tax administration or the accuracy of the claims or proof asserted by the taxpayer in defence of the tax return when the return is either regarded as suspect or under actual investigation;

(c) Information needed to determine the true liability of a taxpayer in the RC country when it is suspected that his reported liability is wrong.

**Particular types of transactions or activities.** The exchange on specific request need not be confined to requests regarding particular taxpayers but may extend to requests for information on particular types of transactions or activities. For example:

(a) Information on price, cost, commission or other such patterns in the TC country necessary to enable the RC tax administration either to determine tax liability in a particular situation or to develop standards for investigation of its taxpayers in situations involving possible under- or over-invoicing of exported or imported goods, the payment of commissions on international transactions and the like;

(b) Information on the typical methods by which particular transactions or activities are customarily conducted in the TC country;
(c) Information as to whether a particular type of activity is being carried on in the TC country that may have effects on taxpayers or tax liabilities in the RC.

Economic relationships between the countries. The specific request may extend to requests for information regarding certain economic relationships between the countries which may be useful to a country as a check on the effectiveness of its tax administration activities. For example:

(a) Volume of exports from TC to RC;
(b) Volume of imports into TC from RC;
(c) Names of banks dealing in TC with branches, subsidiaries, etc. of RC residents.

It should be noted that, since items in this category, such as the volume of exports from TC to RC, are presumably not regarded as secret to the tax authorities in TC, they may be disclosed generally in RC, as the guideline article 26 provides.

(b) Rules applicable to the specific request

The competent authorities should develop rules applicable to the transmission of specific requests by the RC and to the response by the TC. These rules should be designed to facilitate a systematic operational procedure regarding such exchange that is efficient and orderly. While the rules may be general in character in the sense that they set standards or guidelines governing the specific request procedures, the rules should also permit discussion between the competent authorities of special situations that either the RC or TC believes require special handling.

The rules should pertain to:

(a) The specificity of detail required to be stated in the request by the RC, the form of such request and the language of the request and reply;
(b) The extent to which the RC must pursue or exhaust its own administrative processes and possibilities before making a specific request; presumably the RC should make a bona fide effort to obtain the information for itself before resorting to the specific request procedure;
(c) The conditions affecting the nature and extent of the response by the TC. This aspect should cover the ability of the TC to provide documentary material when the RC needs material in that form for use in judicial or other proceedings, including the appropriate authentication of the documents.

3. Transmittal of information on discretionary initiative of transmitting country

The competent authorities should determine whether, in addition to the routine and specific request methods of exchange of information under which a TC country is automatically transmitting information or systematically responding to specific requests by the RC, they desire a transmittal of information on the discretionary initiative of the TC. Such a transmittal could occur when, in the course of its
own activities, the tax administration of the TC country obtains information that it considers would be of importance to the RC country. The information may relate to facets of a particular taxpayer's situation and the relationship of that situation to his liability in the RC country or to the liability of other taxpayers in the RC country. Or the information may relate to a pattern of transactions or conduct by various taxpayers or groups of taxpayers occurring in the TC or RC that is likely to affect the tax liabilities or tax administration of the RC country either in relation to its national laws or to the treaty provisions.

The competent authorities will have to determine, under the standards governing the exchange of information developed pursuant to the treaty, whether there is a duty on a TC affirmatively to develop a procedure and guidelines governing when such information is to be transmitted, or whether such transmittal is to be considered by the TC but is fully discretionary, or whether such transmittal need not even be considered by the TC. Even if it is agreed that there is a duty on the TC to develop a system for such transmittal, presumably the decision on when the conditions under that system have been met would rest on the discretionary judgement of the TC.

4. Use of information received

The competent authorities will have to decide on the permissible use of the information received by the RC. The decisions on this matter basically depend on the legal requirements set forth in article 26 itself. Under the guideline article the extent of the use of information depends primarily on the requirements of national law regarding the disclosure of tax information or on other "security requirements" regarding tax information. This being so, it is therefore possible that the extent of the disclosure or the restrictions on disclosure may vary between the two countries. However, such possible variance need not be regarded as inappropriate or as negating exchanges of information that would otherwise occur if the countries involved are satisfied with such a consequence under article 26 as adopted in their convention.

(a) Recipients of information received through exchange

The competent authorities will have to specify, either in detail or by reference to existing comparable rules in the RC, who are the qualifying recipients of information in the RC. Under the guideline article, the information can be disclosed, for example:

(a) To administrators of the taxes covered in the Convention;
(b) To enforcement officials and prosecutors for such taxes;
(c) To administrative tribunals for such taxes;
(d) To judicial tribunals for such taxes;
(e) In public court proceedings or in judicial decisions where it may become available to the public (it should be noted that paragraph 11 of the Commentary on the revised OECD Draft Convention states, and the Group agrees, that if a contracting State does not consider this consequence appropriate or if it is not
normal procedure under its national law, or if it is restricted to criminal courts, the treaty article would require modification).

(f) To the competent authority of another country (see 5 below).

If it is desired to include other disclosures of the information received, such as to administrators of other taxes, or to administrators of other revenue or control systems, e.g., customs officials, foreign exchange control authorities, "bribery commissions", comptrollers etc., then the guideline article must be altered. However, it should be observed that the concept of "tax secrecy" is generally regarded as a basic ingredient of effective tax administration so that departures in this regard from the guideline article are not likely to be made as a general matter.

(b) Form in which information is provided

The permissible extent of the disclosure may affect the form in which the information is to be provided if it is to be useful to the HC. Thus, if the information may be used in judicial tribunals and if, to be so used, it must be of a particular character or form, then the competent authorities will have to consider how to provide for a transmittal that meets this need. (See also the comment on documents under 2 (b) above.)

5. Consultation among several competent authorities

Countries may desire to give consideration to procedures developed by the competent authorities for consultations covering more than the two competent authorities under a particular treaty. Thus, if countries A, B and C are joined in a network of treaties, the competent authorities of A, B and C might desire to hold a joint consultation. This could be desired whether all three countries are directly intertwined, as where there are A-B, A-C and B-C treaties, or where one country is a link in a chain but not fully joined, as where there are A-B and B-C treaties but not an A-C treaty. Countries desiring to have their competent authorities engage in such consultations should provide the legal basis for the consultations by adding the necessary authority in the guideline article. Some countries may feel that the guideline article permits joint consultation where all three countries are directly linked by bilateral treaties. However, the guideline article does not cover joint consultation where a link in the chain is not fully joined, as in the second situation described above. In such a case, it would be necessary to add a treaty provision allowing the competent authority of country B to provide information received from country A to the competent authority of country C. Such a treaty provision could include a safeguard that the competent authority of country A must consent to the action of the competent authority of country B. Presumably, it would so consent only where it was satisfied as to the provisions regarding protection of secrecy in the B-C treaty.

6. Over-all aspects

There are a variety of over-all factors affecting the exchanges of information that the competent authorities will have to consider and decide upon, either as to their specific operational handling in the implementation of the exchange of information or as to their effect on the entire exchange process itself. Among such over-all factors are:

-25-
(a) Factors affecting implementation of exchange of information

(a) The competent authorities should decide on the channels of communication for the different types of exchanges of information. One method of communication that may be provided for is to permit an official of one country to go in person to the other country to receive the information from the competent authority and discuss it so as to expedite the process of exchange of information.

(b) Some countries may have decided that it is useful and appropriate for a country to have representatives of its own tax administration stationed in the other treaty country. Such an arrangement would presumably rest on authority, treaty or agreements other than that in the guideline article on exchange of information (though, if national laws of both countries permit, this article would be treated as covering this topic) and the arrangement would determine the conditions governing the presence of such representatives and their duties. In this regard it should be noted that it would not seem necessary that the process be reciprocal, so that it would be appropriate for country A to have its representatives in country B but not vice versa if country A considered the process to be useful and country B did not. If arrangements do exist for such representatives, then the competent authorities may want to co-ordinate with those representatives where such co-ordination would make the exchange of information process more effective and where such co-ordination is otherwise appropriate.

(c) Some countries may decide it is appropriate to have a tax official of one country participate directly with tax officials of the other country in a joint or "team" investigation of a particular taxpayer or activity. The existence of the arrangement for most countries would presumably rest on authority, treaty or agreements other than that in the guideline article on exchange of information, although, if national laws of both countries permit, this article could be treated by the countries as authorizing the competent authorities to sanction this arrangement. In either event, if the arrangement is made, it would be appropriate to extend the safeguards and procedures developed under the exchange of information article to such an investigation.

(d) The process of exchange of information should be developed so that it has the needed relevance to the effective implementation of the substantive treaty provisions. Thus, treaty provisions regarding intercompany pricing and the allocation of income and expenses produce their own informational needs and requirements for effective implementation. The exchange of information process should be responsive to those needs and requirements.

(e) The substantive provisions of the treaty should take account of and be responsive to the exchange of information process. Thus, if there is an adequate informational base under the exchange of information process to support allowing one country to deduct expenses incurred in another country, then the treaty should be developed on the basis of the substantive appropriateness of such deduction.

(f) The competent authorities will have to determine to what extent there should be cost sharing or cost reimbursement with respect to the process of exchange of information.
(b) Factors affecting structure of exchange of information process

(a) It should be recognized that the arrangements regarding exchange of information worked out by country A with country B need not parallel those worked out between country A and country C or between country B and country C. The arrangements should in the first instance be responsive to the needs of the two countries directly involved and need not be fully parallel in every case just for the sake of formal uniformity. However, it should be observed that prevention of international tax evasion and avoidance will often require international co-operation of tax authorities in a number of countries. As a consequence, some countries may consider it appropriate to devise procedures and treaty provisions that are sufficiently flexible to enable them to extend their co-operation to multicountry consultation and exchange arrangements.

(b) The competent authorities will have to weigh the effect of a domestic legal restriction on obtaining information in a country that requests information from another country not under a similar domestic legal restriction. Thus, suppose country A requests information from country B and the tax authorities in country B are able to go to their financial institutions to obtain such information whereas the tax authorities in country A are generally not able to go to its own financial institutions to obtain information for tax purposes. How should the matter be regarded in country B? It should be noted that the guideline article here permits country B to obtain the information from its financial institutions and transmit it to country A. This is the interpretation given to article 26 (2) of the OECD Draft Convention in revised Commentary paragraphs 13, 14 and 15 and is the interpretation given by the Group to its guideline article paragraph 2. Thus, country B is not barred by its domestic laws regarding tax secrecy if it decides to obtain and transmit the information. It thus becomes a matter of discretion in country B as to whether it should respond, and may perhaps become a matter for negotiation between the competent authorities. It should be noted that many countries in practice do respond in this situation and that such a course is indeed useful in achieving effective exchange of information to prevent tax avoidance. However, it should also be noted that country A, being anxious to obtain information in such cases from other countries, should also recognize its responsibility to try to change its domestic laws to strengthen the domestic authority of its own tax administration and to enable it to respond to requests from other countries.

(c) In addition to situations involving the legal imbalance discussed above, the competent authorities will have to weigh the effects of a possible imbalance growing out of a divergence in other aspects of tax administration. Thus, if country A cannot respond as fully to a request as country B can because of practical problems of tax administration in country A, then might the level of the process of exchange of information be geared to the position of country A? Or, on the other hand, in general or in particular aspects, should country B be willing to respond to requests of country A even when country A would not be able to respond to requests of country B. This matter is similar to that discussed in the preceding paragraph and a similar response should be noted.

(d) It should be noted that the guideline article authorizes a transmitting country to utilize its administrative procedures solely to provide information to the requesting country, even when the person about whom information is sought is not involved in a tax proceeding in the transmitting country. Moreover, the transmitting country can, for the purpose of exchange of information, utilize its
own administrative authority in the same way as if its own taxation were involved. (This is also the position noted in the OECD revised Commentary, paragraphs 13 and 14.

(e) The competent authorities will have to weigh the effect on the process of exchange of information of one country's belief that the tax system or tax administration of the other country, either in general or in particular situations is discriminatory or confiscatory. It may be that further exploration of such a belief could lead to substantive provisions in the treaty or in national law that would eliminate the problems perceived by the first country and thereby facilitate a process of exchange of information. One possible example of this is the treatment of non-permanent residents.

(f) The competent authorities will have to weigh the effects that the process of exchange of information may have on the competitive position of taxpayers of the countries involved. Thus, if country A has a treaty with country B providing for exchange of information, country A will have to weigh the effect on the structure or process of that exchange of the fact that country C does not have a treaty with country B, so that firms of country C doing business in country B may be subject to a different tax posture in country B than firms of country A. Similarly, even if a treaty with an exchange of information article exists between countries C and B, if the tax administration of country A has more authority to obtain information (to be exchanged with country B) than does the tax administration of country C, or is otherwise more effective in its administration and therefore has more information, then a similar difference in tax posture may result. As a corollary, it seems clear that the adequate implementation of exchange of information provisions requires a universal effort of tax administrations to obtain and develop under national laws a capacity for securing information and a competence in utilizing information that is appropriate to a high level of efficient and equitable tax administration.

(c) Periodic consultation and review

Since differences in interpretation and application, specific difficulties and unforeseen problems and situations are bound to arise, provision must be made for efficient and expeditious consultation between the competent authorities. Such consultation should extend both to particular situations and problems and to periodic review of the operations under the exchange of information provision. The periodic review should ensure that the process of exchange of information is working with the requisite promptness and efficiency, that it is meeting the basic requirements of treaty implementation and that it is promoting adequate compliance with treaty provisions and the national laws of the two countries.
Chapter II

CONSIDERATION BY THE GROUP

A. International Income Allocation

1. Procedural Aspects

The Group had decided that business relationships between related entities should be governed by the arm's length standard and that taxable profits may be adjusted where this standard is violated. At its fifth meeting, the Group had further considered that the competent authorities of the respective countries would consult with each other on the allocation of income and expenses.

The treaties include only very general terms. They must be implemented in a variety of ways. For this reason the Group had decided to formulate guidelines that could be used by the competent authorities of the various countries. It was felt that, while detailed rules have not been spelt out in treaties, they could be worked out by the competent authorities utilizing appropriate guidelines. The Group requested the Secretariat to suggest an inventory of techniques which the competent authorities could use for this purpose.

The inventory suggested that the guidelines would depend to a large extent on the volume of business which the competent authorities had to carry out. If there were few cases requiring adjustment there would be no need to work out much detail, whereas more sophisticated techniques should be applied if there were a heavy caseload. It would be for the competent authorities to decide to what extent they would utilize this inventory of allocation techniques. It was felt that it would be preferable for the Group to consider a large number of issues involved, even if some of them had not been met by some members in actual practice. The Group was in effect engaged in pioneering for the future.

The suggested inventory had two aspects, namely procedural and substantive. Procedural aspects form the first part of the suggested inventory.

An important issue is whether a country that makes an adjustment to the income or expense of a taxpayer that has repercussions on another country should notify the other country at the time of the proposed adjustment or after the adjustment has been concluded.

Some members from developed countries felt that a notification procedure should not be rigid. Developed countries are more likely to initiate adjustments and if they were required to notify developing countries on each occasion, the latter would find their limited resources overwhelmed.

Some members from the developing countries also felt that notification of proposed adjustments would increase the work at the competent authority level to unmanageable proportions and that discussion of proposed adjustments between competent authorities would delay assessments which might get barred by statutes of limitations.
Some members thought the above aspects were significant because they would keep the flow of documents and cases to developing countries to a tolerable level. Nevertheless, in unusual cases that might involve serious revenue consequences, the developed country should take the initiative in notifying the developing country when it undertakes an adjustment.

Some members asserted that there might well be an obligation on a country to make a correlative adjustment if it agreed with the adjustment made by the other country. In such a case, it might actually be to the advantage of the first mentioned country to receive early notification. The decision should be made from case to case depending on the relationship between the countries and the type of case involved.

Some members from developing countries agreed that the indiscriminate transmittal of notices might be too voluminous to handle and that it would be preferable for the taxpayers in the country making the initial adjustment to come to a conclusion on the proposed adjustment before notifying the other Government. The proposed adjustment in the adjusting country might be exploratory, in which case it would not be necessary to notify the other Government. Therefore the potential outcome between the taxpayer and the "adjusting" country should be explored first.

Article 25 of the OECD Draft Convention prescribed that the taxpayer may take his case to the proper authority and that this authority is obliged to take action. The procedural principles laid down in the suggested inventory have no legal basis at present. Therefore, binding guidelines should be formulated on the basis of delegation by the treaty. It was felt that the Group should return to the consideration of article 25 of the OECD Draft Convention at the end of its discussion. It could then be decided what needed to be added to article 25 in order to create an adequate juridical basis.

Some developed countries' administrations endeavoured to inform its taxpayers at an early time of reallocation they had under consideration so that the taxpayers could in turn inform the related firm in the other treaty country and the latter could submit the case to its own Government. If the Government of the other country found the proposed adjustment unacceptable, it would invoke the competent authority procedure on its own initiative. Some countries have administrative regulations giving the taxpayer an early opportunity to discuss his case with the competent authority.

The feeling seemed to prevail that it would be preferable not to have rigid guidelines on all proposed adjustments. There should perhaps be an early warning of significant cases. The rules should be flexible and in many cases taxpayers should have the opportunity to protect themselves under local law.

Some members from developed countries considered that if a taxpayer feels that the adjustment made violates the Convention he should first file a complaint with the authorities of his country.

One issue is whether a taxpayer could raise such a complaint with respect to adjustments proposed by his own Government or whether he should induce the related taxpayer in the other country to submit the matter to the other Government. According to the OECD Draft Convention the competent authority procedure is open to a taxpayer to object to a proposed adjustment.
In reference to the time-limit, if one exists, some members felt that the time should be counted from the conclusion of negotiations with the second country if that country refused to make a correlative adjustment.

Some members from developed countries pointed out that article 25 is a general procedural article and is not specifically designed to deal with issues arising from income allocation. If a proposed adjustment is made against a taxpayer, he would not generally be able to use the treaty procedures against actions of his own tax authority. Article 25 merely gives one possible way of handling disagreements; it is not the only way or the prescribed way to handle income allocation problems. Internal law should apply first.

The question is whether the competent authority procedures should be activated at the first stage, when one of the countries has proposed an adjustment, or at the second stage, i.e., when one country has already made an adjustment. At this latter stage it may be more difficult to come to an agreement.

Some members from developed countries felt that the country of residence of the taxpayer should normally take the lead in initiating competent authority procedures (see articles 9 and 25 of the OECD Draft Convention). Some members thought that to initiate competent authority procedures at a very early stage is a new approach which requires careful drafting of procedural provisions. In some countries the administrations request taxpayers to inform the authorities of proposed or completed adjustments made in the other country so that the taxpayer country could initiate consultation procedures. In many cases it is premature to raise procedural questions at the beginning. Competent authority procedures should be invoked only if there is actually double taxation or conflict of opinion between the two Governments.

The Group wanted to go beyond article 25 and to supplement it with a mechanism to deal with international income allocation. It was felt that exchange of information and competent authority procedures have always been linked together. The Group is advancing further than others in seeking for concrete solutions to the implementation of treaties.

A member from a developed country explained that his Government was reluctant to hold its taxpayers to strict procedural rules such as those laid down in paragraphs 1 and 2 of article 25. He reminded the meeting that paragraph 3 of article 25 could be used to get the competent authority procedure under way.

The special adviser remarked that taxpayers were aware of the fact that competent authority procedures become more and more significant as time goes on. The arm's length rule in treaties is a substantive rule and disregarding it constitutes a violation of treaties. In fact new international law is being worked out here on the procedural question.

(a) Parent and subsidiary relationship

The allocation problem has further been considered in terms of a parent and subsidiary relationship.

There are a number of interrelated questions. One is the extent to which a correlative adjustment must be made in one of the countries if a primary adjustment
is made in the other country. Article 9 of the OECD Draft Convention has recently been revised to the effect that if an adjustment is properly made in one country, a correlative adjustment shall be made in the other country.

The remaining question is the mechanism of adjustments. If a treaty prescribes a correlative adjustment, the taxpayer in the other country can request it. Assuming that the authorities of that country refuse to make the adjustment because in their opinion the first country makes unreasonable demands, then the question is by whom competent authority procedures should be invoked, the taxpayer in the first country or the one in the second country. The question falls into two parts, namely (1) must a correlative adjustment be made in the second country if a proper adjustment is made in the first country? (2) how is the adjustment to be implemented?

First, the question arises whether under the revised article 9 of the OECD Draft Convention a correlative adjustment is obligatory or not. Some developed countries had filed reservations to the article on this question.

It was the view of some of the members of the Group that correlative adjustments must be made in proper cases. Assuming that a taxpayer requests a correlative adjustment in its country and the administration refuses to make the adjustment, the taxpayer has to go to the competent authorities presumably of its own country. If the matter is taken up by the two Governments involved, they will endeavour to resolve the problem in some way so as to eliminate economic double taxation.

Assume that a parent selling to its subsidiary makes no charge or an entirely inadequate charge intentionally. In such a situation, one may fear that the parent, if not acting fraudulently, was engaged in gross abuse and that double taxation should be the penalty. This case is, however, exceptional. In the average situation the taxpayer will feel that he acted according to the law of his country. If the taxpayer acted in good faith, he should be protected against double taxation. The correlative adjustment is simply a device to prevent double taxation. There is no automatic reallocation of income even in cases where competent authority procedure has been instituted. One member pointed out that legal situations may vary (e.g., in case of hidden distributions of a subsidiary or of the deemed payment of capital by the parent) and that correlative adjustments may not always be necessary.

In some countries, the law permits a company to file a protective claim for refund in cases where the company suffers a loss as a result of its relationship to a company in a co-contracting country proposing an adjustment, and the statute is due to expire.

In other countries the problem is not so much the statute of limitations but the finality of assessments, which can bar any adjustment in subsequent years. Under the law of those countries a final assessment cannot be set aside if the competent authority agrees on an adjustment. It was the general feeling that if correlative adjustments are to be made, such barriers under national law must be overcome by international agreement.

Some members felt that if the agreement were to be binding, the taxpayer must waive his right to present his claim in the national courts. Others felt that this
was not necessary and that the taxpayer need not forgo other remedies available to
him; many problems would arise if a taxpayer were bound to accept a determination
of the competent authority.

A treaty can be so worded as to require the taxpayer to forgo recourse to the
local courts if he resorts to the competent authority procedure. On this point
the competent authority procedure is in a sense similar to arbitration.

Another question to be examined is whether the taxpayer should take part in
the competent authority procedures, either to participate in it as a party or at
least to be able to present his case. Some members felt that the taxpayer should
have the right to appear and participate in the proceedings.

In some countries the procedures for reaching mutual agreements between
competent authorities start with written memoranda and are followed by a meeting
during which the taxpayer may ask to be heard. The final decision is taken in the
absence of the taxpayer, who, however, may be called to provide additional
information if necessary. The procedure described in section 39 of the Commentary
to article 25 of the OECD Draft Convention as amended, includes the right of the
parties to be heard and the right to be assisted by counsel.

The mutual agreement procedure is only one of the functions of the competent
authorities. Whether or not such procedures are successful depends largely on the
powers and willingness of the authorities to come to an agreement.

It was pointed out that parent and subsidiary companies situated in different
countries sometimes look for the cheapest tax route. They consider that, even if
the Government did catch up with an understatement of income, the taxpayer would
not suffer because he would be protected from double taxation under the treaty.
Should the taxpayer be protected from the double taxation which he brought upon
himself or should the double taxation be accepted as an appropriate consequence?
Should a caveat to that effect be put into article 9?

Some members felt that the issue of double taxation should not be confused with
the issue of fraud or abuse. The question of fraud should be handled under
different procedures.

(b) Consensus

The consensus has been that the competent authorities should work out details
of consultation procedures, subject to the following considerations.

Flexibility should be a major consideration. There is no need for elaborate
procedures unless required by the volume of cases. However, certain minimum aspects
of procedure will have to be recognized. Taxpayers have a right to know when they
can invoke the procedures and what time-limit they are subject to, whether the
decisions are binding and the extent to which they are permitted to participate in
the proceedings.

What should be the extent to which information should be exchanged between the
competent authorities regarding proposed or concluded adjustments? The
communication of adjustments at an early stage could be burdensome and unproductive.
There should perhaps be an early warning system where a serious case or a trend of
cases begins to emerge.
The taxpayer should also know what his rights are as regards resorting to competent authorities procedure at the proposed adjustment stage. It was felt, however, that at such an early stage of proposed adjustment, invocation of the procedure might overload the consultation procedure. The proposed adjustment might not even result in a final adjustment.

The Group felt that an adjustment concluded in one country should lead to correlative adjustments required by the legal situation in the other country if, and to the extent that, the latter considered the first adjustment proper. There was also agreement that correlative adjustments necessitate removal of procedural barriers under local law, such as statutes of limitation and final assessment. Most members felt that such barriers should be overriden. The members of some countries commented that domestic law may constitute barriers to such adjustment. The Group also considered whether a correlative adjustment should have an escape clause if the competent authorities felt that the taxpayer had committed a gross abuse bordering on fraud. Some members felt that the elimination of double taxation is critical at this stage and that prevention of evasion should be dealt with separately. Other members felt that the Governments should not co-operate with taxpayers abusing their position, and that to allow double taxation in such cases would discourage evasion.

The question of the method of operation of the competent authorities may vary with the number and type of cases. In particular, the competent authorities should settle the question of which entity, as in a parent-subsidiary case, should invoke the competent authority. Other items which have to be agreed on are the time-limit, the form, and rights of the taxpayer to participate in the consultation and the requirement to provide pertinent and relevant information. The discussion could be formal or informal. The establishment of a joint commission might be considered. In sum, it was anticipated that, as experience accumulated and practical difficulties were dealt with, the competent authority procedure would become a more settled procedure.

There was basic understanding among the members that the competent authorities should endeavour to reach solutions to the problems presented to them.

With respect to time-limit on both the taxpayer presentation and the competent authorities' consultation, it was felt that this matter should be clarified. If a time-limit on taxpayer presentation is required, there must be definite rules as to the event which starts the running of the time-limit for the taxpayer. However, it would probably not be advisable to impose a time-limit on the decision of competent authorities, as the time required will depend on the seriousness and complexity of the cases. Some countries have an absolute time-limit for refunds. In this connexion, some of the recent conventions entered into by Canada were mentioned (which provide that reallocations of income or expenses should not go back for more than three or five years). This time-limit would also apply for correlative adjustment under competent authority procedures. Such provisions provide further protection for the tax administration.

Some members felt that according to OECD article 25, the competent authorities are not required to agree but should only endeavour to agree. It was pointed out that the inability to agree would further produce double taxation and that, possibly, there was a need for further procedures, e.g., the ability to call on representatives from a panel of experts to act as advisers or arbitrators. Such procedures do not exist at present, although their possibility in the future is envisaged in the OECD Commentary.
The Group briefly discussed the possibility of having an international tax court to deal with the issues which the competent authorities are unable to resolve. It was generally felt that substantive rules have not been developed as yet to the extent that such a court would be feasible and that the idea was premature. On the other hand, some members felt that a panel of experts or simply a list of names of persons who could act as advisory parties might be useful in cases where the competent authorities were unable to agree. Experience with the Customs Council in Brussels, which is active in a closely related field, was also mentioned in this connexion.

Some members felt that it might be advantageous for a country to issue unilateral procedural rules for competent authority operation within its own country. Such rules would assure uniformity under that country's various treaties.

There are, at this time, no publication facilities for competent authority decisions in tax cases which are made public in a number of States. The suggestion was made that such decisions might be published by the United Nations as an annex to its International Tax Treaties series.

It was finally concluded that the objective of the procedure is to avoid economic double taxation. However, no agreement was reached concerning the obligation of the competent authorities to reach an agreement in this context. It was concluded that formal arbitration would not be practical except perhaps in closely knit regional groups. However, competent authorities might find it useful to have available a group of outside experts to whom they could turn for technical advice and assistance.

The Group felt that it would be able to write guidelines for a suggested competent authorities procedure which could be used and supplemented in the future.

(c) Experience with application

In a joint meeting of the Group of Experts with the International Fiscal Association (IFA), the scope and problems of competent authority procedures were explored in the practice of a number of countries. A number of officials responsible for administering the competent authority procedures elaborated on their experiences.

In the United States of America a large number of cases of double taxation have been settled under this procedure. Particular impetus has been given to the procedure since the issuance of procedural steps in 1970 (Revenue Procedure 70-18) and a substantial staff has been established in Washington D.C., assisted by agents from the United States Internal Revenue Service located abroad.

In the past five years, 80 out of 84 cases involving income allocation and providing relief in the amount of more than $70 million, have been closed by the competent authority. 1/ Another 70 cases involving other issues were handled.

1/ The following categories were involved: intercompany pricing, 19 per cent; allocation of management fees, 19 per cent; allocation of general business expenses, 18 per cent; imputation of interest, 16 per cent; allocation of royalties, 14 per cent; allocation of gross revenue, 14 per cent.
Total relief in all cases was in the amount of over $124 million or an average of about $960,000 per case. The sum of $57 million represents United States adjustments and $48 million represents the other country's adjustments. The sum of $19 million represents reciprocal adjustments by both countries. A very great number of these cases (101) involved Canada.

A substantial improvement has been achieved in the time taken to close cases. Allocation cases closed since 1973 have taken an average of six months. In order to expedite cases, the Office of International Operations has a special branch of technical analysts to whom cases are assigned and who negotiate directly with technicians at lower levels in the other country. Provisional agreements reached at the technical level are reviewed and usually approved with only minor changes by the competent authorities.

Efforts to avoid the procedure in cases of de minimis adjustments (in the region of $25,000) are being made. Also, the competent authority is endeavouring to formulate rules of thumb so that the time of settlement on a case-by-case method can be reduced. The United States of America generally withdraws proposal adjustments when the statute in the foreign country has expired. Furthermore, agents in the field are obliged to warn taxpayers when they propose adjustments which will result in double taxation and must suggest that he seek remedies in the other country. The United States of America is trying to obtain a waiver of domestic statutes of limitation incorporated in all new treaties. The competent authority can obtain jurisdiction of cases already in the process of litigation if the litigants agree to a suspension. The taxpayer loses no rights or benefits by applying to the competent authority.

In Canada, an agreement would normally continue to apply for subsequent years if the facts remained unchanged. Additionally, the competent authority may explore new issues if they are relevant to the issue under review.

By contrast, some other countries in Europe, e.g., France and the Federal Republic of Germany, have less formalized procedures. Problems under treaties are usually brought to the attention of the competent authority by taxpayers. These cases are often handled by personal phone calls and correspondence between the officials. The advantage of proximity, personal contact and acquaintance with the officials through regional organizations was stressed. The case load in one of these countries was 50 or 60 cases a year, involving both simple cases, which can be settled at the local level, and more complex, controversial cases, including income allocation. The general principle in these cases was fair play and goodwill. Yet, in some instances discrepancies resulted where a mutual agreement procedure had involved more than one foreign country.

In the experience of the tax administration of the Federal Republic of Germany, most cases coming up for mutual consultation are dealt with successfully. There is no case in the experience of experts in which a solution was not reached, thus resulting in double taxation.

The Federal Republic of Germany engages in competent authority consultation under the provisions of all her tax treaties, even when the terms of the treaty do not mention specifically that this is available. This procedure is even available where there are no treaties. An important barrier to the implementation of a correlative adjustment in the Federal Republic of Germany may be the final
assessment, which is closed once it is made. Under recent regulations, however, it is now possible to reopen a final assessment in order to carry out a mutual agreement procedure.

A member from a developing country said that his country entered into the field of double taxation agreements in 1970. From that year until 1975 only eight conventions signed by the country have entered into force. That is the reason why they do not have experience in the problems related to mutual agreement procedures and exchange of information.

2. Interest on Loans

1. After completing the discussion on procedural aspects, the Group considered the possibilities of developing rules on substantive matters. Some member countries have elaborate guidelines to assist tax authorities and taxpayers in arriving at an acceptable income allocation. Such rules are needed because of the volume of cases. Other countries prefer to approach the problem on a case-by-case basis, but it appears that even in those countries the tax authorities must also have some guidelines, however informally expressed, to deal with their cases. Other countries may apply the arm's length standard on an over-all basis, i.e., not on a transactional basis. The question is how to harmonize the different practices of various tax authorities and how to establish some standards. The tax authorities of the various countries may approach the problem from different standpoints and the question is how these approaches are to be harmonized for the purpose of reaching a mutually acceptable solution.

In considering the substantive rules concerning income, the Group focused first on the allocation of interest on loans. This was a less complex issue to start with than that of transfer pricing, for example. Furthermore, since the OECD had given consideration to this issue, it was felt it might be easier to reach agreement on this topic.

The following basic issues arise in the case of a loan between related companies.

(a) Should interest be charged and, if so, should interest be charged at an arm's length rate?

(b) If so, how is the arm's length rate to be determined?

(c) Can there be a range of "safe havens"?

(d) When is a loan really a loan or, in substance, equity capital?

There are also subsidiary questions as to whether interest should be charged on sales receivables and how affiliates in financial difficulties should be handled.

The question was approached from the standpoint of the parent company's country, where the question of the imputation of interest arises and from the subsidiary point of view where the question of deduction of interest arises.

From a parent country's point of view, the question arose whether the interest rate to be charged by the parent company is the rate prevalent in the parent's
country or in the subsidiary's country. Assuming that the subsidiary is in a
developing country, the interest rate in the parent's country would normally be
lower than in the subsidiary's country. Some members felt that if the parent's
country is prepared to accept the going rate in the parent's country, the tax
authorities in the subsidiary's country should be prepared to accept that rate
for tax deduction purposes. Furthermore, if the parent's country has a safe haven
rule which is more generous, i.e., lower than the prevalent interest rate in the
parent country, then this interest rate should be satisfactory to the developing
country's tax authorities. Some members felt that, where capital was raised by
the parent on the international capital market at a lower interest rate than the
rate in the parent's country, the lower rate should be considered the arm's length
rate.

There arises the question of deductibility of interest in the subsidiary's
country, particularly in those cases where the parent had initially made a
management decision not to charge interest but had subsequently been required to
charge interest by its tax authorities. The difficulty in such a case was in
persuading the tax authorities in the subsidiary's country that there should be a
deduction for the interest imputed by the tax authorities. Some members from
developing countries felt that no deduction for the interest imputed should be
made where a legitimate interest-free loan had been made by the parent company to
the subsidiary.

In some developing countries there was no question of imputing interest because
of the one-way flow of capital from the developed, capital-exporting countries,
but the questions of allowing deduction for interest and the rate of interest to
be deducted were relevant.

A basic question is whether the funds transferred by the parent to the
subsidiary are loans or, in substance, equity. A number of approaches exist in
developing countries. In some cases the question of debt versus equity was dealt
with on a case-by-case basis, either by tax authorities or by the exchange control
authorities or by internal regulations. Thus, when an investment is made in such a
country by an investor, the ratio of debt to equity or the interest rate to be
charged would be determined in advance. One member felt that a debtor-creditor
relationship cannot exist between related entities because in reality a purported
loan constitutes a contribution of capital.

There is also the question of the mark-up or spread charged by the parent
company on its borrowings when these are reloaned to subsidiaries. It was felt
by some members that such a spread constitutes an additional profit.

The question was also raised as to whether the arm's length rate should be that
at which the subsidiary on its own could have borrowed or whether the financial
capacity of the group as a whole should be considered. The group as a whole would
normally be able to borrow at a lower rate than any of its affiliates and,
possibly, the arm's length rate in such a case should be the parent country's rate
and not the rate at which separate unaffiliated entities would be able to borrow.
This was simply another view of what an arm's length rate might be.

To some developing countries the allowance of deduction for the cost of
capital is to some extent a policy decision and depends on whether a country wants
to encourage the inflow of capital. A number of other members from developing
countries felt, nevertheless, that there might be sound business reasons why a parent company would not charge interest to its subsidiary on the same basis as it would charge unrelated parties and that, in those cases, the tax authorities should not impute interest to the parent company. Such an imputed interest might be considered as a donation or contribution to the capital of the subsidiary. Some members felt that, instead of imputing interest, the country of the parent company could disallow expenses on such loans.

The interaction of imputed interest with the books of the subsidiary was then considered. The question was raised whether a subsidiary could be required to pay the interest which had been imputed by the foreign tax authorities. It was pointed out that for tax purposes the actual transfer of funds was not necessary. The purpose of the imputed charge was to increase the income of the parent company for tax purposes. The objective would be to have a correlative deduction allowed for tax purposes in the subsidiary. However, such a deduction need not be reflected on the books of the company and need not be paid. The result would depend on how the books of the subsidiary were maintained. In effect, in some countries a subsidiary would not necessarily be permitted to treat a subsequent payment as interest. Although a correlative adjustment might be allowed in determining the subsidiary's taxable income, the subsequent distribution might still be treated as a dividend. Even the OECD Draft Convention does not follow the transaction through to its ultimate effect.

A reference was made to the OECD consideration of tax treatment of interest on loans between affiliated companies. Here it was suggested that interest should only be imputed where there is an intention to shift profits and where there is consequently a significant difference in the rate of interest charged and the market rate. For example, interest may not be charged to companies in financial difficulties or during their start-up years. Presumably, in such situations, there may be no intention to shift the profits.

In conclusion it was agreed that the guidelines must proceed against the background of the two clauses in the treaty: (a) that the arm's length standard should be applied in cases where there are dealings between the related entities and (b) that there can be an adjustment if a transaction has not been conducted at arm's length. If there is an initial adjustment in one country, there should be a correlative adjustment in the other country if both competent authorities agree that this is proper.

The arm's length standard as applied to interest income is capable of various interpretations. Some members inclined towards the view that the rate of interest prevailing in the creditor's country, generally the developed country, would be the appropriate point of reference, and hence there should be no allocation or denial of deduction if the level of interest charged did not materially differ from the market rate in the developed country. A question raised by some members was whether there should in fact be an imputation of interest in the case of interest-free loans or whether there should instead be a disallowance of interest expense to the lending company.

Some members from developing countries felt that in the case of an interest-free loan there should not be a subsequent deduction of interest to a subsidiary merely because the parent company's tax jurisdiction had imputed interest. It was pointed out, however, that this view is contrary both to the basic concept of a correlative adjustment and to the idea that a correlative adjustment clause in a
tax treaty should override barriers in domestic laws. In practice, however, if the parent company is aware that there is a rule requiring interest to be formally charged if the interest is to be deductible, then the parent company will charge interest from the outset.

It was then proposed that the Group should agree on a general guideline governing the treatment of interest on intercompany loans for the guidance of taxpayers and tax authorities. The proposed guidelines would affirm the arm's length standard as governing intercompany loans and interest rates. However, an arm's length interest rate cannot be defined as if a subsidiary had to borrow in the local market. In practice, the parent company can borrow at more favourable rates and make the funds available to the subsidiary. Therefore, the arm's length standard should reflect the ability of the entire group of which the subsidiary is a member to borrow at favourable rates.

It was recognized that there might be certain intercompany balances on which it may be the practice not to charge interest to unrelated parties. But if it is the custom to charge interest in such cases, the interest rate available to the parent, which would normally be lower than that available to the subsidiary, should form the basis for intercompany interest rates. This should be acceptable to the parent's country and should also be acceptable to and deductible in the subsidiary's country. The alternative of disallowance of interest expenses, in the view of the Group, was a simpler method because there would be no problems of correlative adjustment in the country of the subsidiary nor of foreign exchange remittances from that country.

It was pointed out that there might be further complications in arriving at an arm's length rate. A parent company could borrow in three markets: in its own country; in the subsidiary's country; and in the international market. Furthermore, rates could vary with the nature and purpose of the loan, the credit standing of the borrower, the security offered, the currency in which the loan is denominated, and other terms of the loan. It was suggested that, although the proposed principle of looking at the creditor country was a good starting point, the guideline should be sufficiently flexible to allow special factors to be taken into consideration.

It was suggested that one problem in applying the arm's length standard was that it asked the parties to consider themselves hypothetically as unrelated entities, an extremely difficult task of simulation in practice. One member suggested that, in view of these difficulties, the guidelines should remain simple and non-specific. However, other members felt that the Group should endeavour to arrive at some concrete result.

One way of overcoming the above practical difficulties may be for competent authorities to agree on a range of "safe-haven" interest rates. Several members felt that this would be difficult to arrange on a bilateral basis because it could result in a country's having arrangements with different safe-haven ranges, thus distorting the flow of investment funds. Safe-haven rates could possibly be set on a regional basis, e.g., within the European Economic Community, the Organization of American States or the Nordic Group. Other members expressed general support for safe-haven rules as between competent authorities and felt that countries could negotiate bilateral provisions including safe-haven rates. It was pointed out that safe havens are particularly useful in treaties between the developed and developing countries in view of the developing countries'
limited administrative resources. Under a safe-haven rule, a developed country would accept a somewhat lower rate of interest than the going rate, and the developing country would thus find the rate more acceptable. It was suggested that the safe haven should be expressed not as an absolute range but as a percentage variation margin from an agreed rate which would be open to revision from time to time.

The issue arose of how to proceed in cases where the parent company had made a completely interest-free loan to the subsidiary, particularly a short-term advance originating from the parent company’s internal funds. One aspect was whether in such a situation, viewing the corporate group as one economic unit, a tax authority could impute an interest charge to the parent. Some of the members felt that there is always a cost to the parent company regardless of whether the funds are borrowed or internally generated. Although from an economic standpoint one might regard the group of companies as a single economic unit, most members recognized the separate existence of entities operating in several countries. It is thus necessary for the group’s profits to be allocated to each country, even if the rules of allocation required the application of hypothetical concepts. Although even profits shifted to a subsidiary would ultimately be returned to the parent company in the form of dividends, nevertheless the form in which the profits are received would have different tax consequences both at the parent and subsidiary levels. Thus, from the tax authorities’ point of view, it is essential to allocate profits on the basis of recognizing separate entities and arriving at rules which would be acceptable to tax jurisdictions of both the parent company and the subsidiary.
It was appropriate that the Group should review first the issues of interest allocation from the standpoint of borrower or payee of the interest, as the OECD had done. Apparently, most adjustment cases have arisen from that perspective. Furthermore, approaching the issues from the payer side is of special value to the developing countries because of their concern that the payment of excessive interest to lenders could drain the resources of subsidiaries located in their countries.

It is useful to establish principles to provide a guide to taxpayers and tax administrations on a reasonable interest charge. In general, the Group inclined to the view that the appropriate standard for interest rates between related entities should be found in the capital markets available to the parent-lender rather than in the national market of the subsidiary-borrower, since the latter are normally higher. Although it is difficult to set forth a fixed rate of interest as a standard, since interest charged depends on many factors, nevertheless, there was general agreement that the rate of interest available to the parent-lender should serve as a basic starting point.

Although no particular rate can be set, it might be helpful for the competent authorities to agree as to what general rate or range of rates would be acceptable, except in unusual circumstances. Some may find it useful to adopt a safe-haven approach to avoid overburdening their administrative machinery; others may prefer a case-by-case approach; still others may prefer a combination of the two, i.e., safe-haven ranges subject to individual consideration of exceptional cases.

Recently, consideration has been given to the other side of the coin - the parent (lender) charging no interest on a loan to its subsidiary. This creates a possibility for the parent company to shift profits, and the imputation of interest income to the parent would be a useful technique to combat such tax avoidance. This technique has been focused upon in Canada, France, the Federal Republic of Germany and the United States of America in the case of loans to a company in a "tax haven". The recent OECD considerations also reaffirm that loans should be treated in the same way as other intercompany transactions as regards both excessive and insufficient interest charges.

One reiterated view was that, from an international tax standpoint, it is not possible to regard an international group of companies as one economic unit. If one departed from the arm's length principle in these guidelines, one would merely be avoiding the whole problem and there would be a serious risk that no guidelines of any value would be established. The practice in one developed country indicated that a parent lending funds to a subsidiary might on its books either charge or not charge interest according to its own auditors' method of keeping intercompany accounts. There could be accounting reasons for either position. However, from a tax standpoint, an interest-free loan or an unrealistic interest rate would be challenged by the tax authorities for the purpose of computing the taxable profits of the parent company. As long as the interest actually charged is reasonable, the tax authorities would not insist on an adjustment. However, that rate of interest might not be considered reasonable in the country of the subsidiary. Thus, one would have a situation where the two countries were unable to reach agreement to accept the parent company's interest charge made by the tax authorities in the parent country. In such a case, one compromise might be for the competent authorities to agree to a working rule under which the subsidiary's country would allow a deduction of at least one half, or two thirds, or some other appropriate
percentage of the interest imputed to the parent company. This approach would, in
effect, treat the charge as two separate transactions for tax purposes and would
result in two rates of interest being applied, one for the lender and one for the
borrower.

Others felt that this proposal would result in double taxation, although on a
reduced scale, which would discourage investment in developing countries by making
it less attractive than internal investment. If this concept were accepted for
interest it might also be extended to other intercompany transactions.

Various arguments for and against imputation of interest were advanced. One
member put forward a suggestion that the developed countries should accept the
granting of interest-free loans to developing countries' enterprises as a form of
preferential tax treatment similar to the preferential tariff granted by developed
countries to exports from developing countries. Others felt that investments move
to developing countries only when there are good business reasons and the objective
of the Group is to remove the specific obstacle of double taxation. Others pointed
out that there might be non-tax consequences to interest imputation, i.e., loss of
tax revenue to the developing countries and outflow of exchange if the parent
company asks the subsidiary to transfer the cash with which to pay the parent's
tax.

Other members questioned the need for the imputation of interest in all cases
where there had been an interest-free loan. There could be many reasons other than
tax avoidance for making an interest-free loan, e.g., a subsidiary might have no
profits in its start-up years with which to pay interest. Further, when a
subsidiary is in financial difficulties, interest-free loans from the parent
company would normally be made for the protection of the parent's equity interest.

It was suggested by some members from developing countries that, instead of
imputing income to the parent, it would be simpler merely to disallow the parent
company's interest expense. This would yield the same results for the parent
company and would avoid correlative adjustments and exchange control problems in
the event of a remittance. Others pointed out, however, that although the
disallowance of expenses might result in the same tax on the parent company if the
rates of interest expense and interest imputed were the same, it would not have
the same result for the subsidiary, which would pay a higher tax. Double taxation
would thus not be avoided. In addition, the division of over-all profit would be
inappropriate.

Several countries, whose exchange control authorities must approve loans from
abroad, will at the same time fix the interest rate to be charged. Some countries
permit the practice of paying net of withholding tax, in which case the borrower
bears the cost of any withholding tax.

Many developing countries felt that the income practices of transnational
corporations result in an unfair drain on their resources and that foreign parent
companies are charging too much not only for interest but also for intercompany
prices and royalties. Thus, developing countries viewed the essential problem as
one of overcharging. Often, however, transnational companies work in the other
direction, charging no interest and royalties for the purposes of shifting funds
around the world. It would be dangerous to depart from the arm's length principle
which comes closest to providing fair guidelines in the international income
allocation area. The effort of protecting the interest of developing countries
should be directed to other provisions of tax treaties by adopting source principles on investment income and dealing with the problem of frustration of tax incentives. It is preferable for the tax administrations to have agreed guidelines on income allocation rather than to leave this entirely to the discretion of the companies, thus allowing them to control the diversion of revenues.

The Group then focused on the need to differentiate between a genuine loan and a contribution to capital, an essential distinction which must be made in practice in determining whether interest should be deductible. When a parent company makes an investment in a subsidiary, it has the choice as a controlling shareholder to make the investment in the form of equity capital or loan or both. From a tax standpoint, the treatment of these two forms of investment by the same shareholder are quite different. The income which a shareholder derives from equity capital is in the form of dividends, which are normally a distribution of profits and non-deductible in arriving at the taxable income of the paying company. The income which a lender derives from a loan is interest, which is deductible to the paying company. The withholding rates on these two items could also be different. From a tax standpoint, corporate management will often choose the form of investment which results in the most favourable tax treatment. For these reasons it is very important for tax purposes to determine whether an investment by a parent company is a loan or equity capital.

This is a difficult problem which most countries have been unable to resolve under their national laws. One member even questioned whether it is possible to make a genuine loan from a parent to a subsidiary and whether all such transfers should not be treated as equity contributions. Another member pointed to the need to distinguish between loans to separately incorporated subsidiaries, on the one hand, and to branches, on the other.

In many countries the tax authorities do not have the right to change the character of a transaction and to substitute their judgement for the businessman's commercial choice. In other countries, the exchange control authorities make the determination in the course of giving approval to the incoming investment. In these cases, the exchange control authorities determine the distinction between a loan and equity and what the interest terms are to be. These administrations generally take into consideration what is best for the country from an exchange point of view.

Other countries have attempted to formulate some criteria under their internal tax laws. Some have based these to some extent on objective tests, such as the ratio of debt to equity. For instance, one country would accept debt not in excess of equity capital. Another country might set the ratio of debt to equity when it exceeds 3:1. Other countries use a combination of criteria rather than a ratio test. Others approach the problem on a case-by-case basis, and compare debt and equity ratios of companies in similar situations.

It was suggested that a rigid, narrow rule would not be helpful to the developing countries in encouraging the inflow of long-term funds. If long-term loans were treated as capital, there would be a tendency for capital to flow in on a short-term basis as loans. Some members pointed out the distinction between the investment in a wholly owned subsidiary and the investment in a partly owned company or joint venture, e.g., where the parent shares control with indigenous
capital. In the latter case, the debt should be recognized as such, because it is often not possible for the parent to make an equity investment without diluting the interest of minority shareholders who are unable to contribute funds.

It was considered important to establish guidelines to distinguish between debt and equity for the assistance of taxpayers and tax administrations. It was generally agreed that the guidelines should be flexible and that they should be available to the competent authorities in the course of negotiating a treaty and in the consultation process.

3. Services

A member reported on the status of the work done recently by the OECD working party on charges for services and use of intangible property between related parties. He reported that the working party had not yet completed its work.

The transfer of a patent or similar intangible right was often accompanied by a contract providing for continuing technical services. In the case of contracts between related companies it was necessary to determine a fair charge for the use of the property and for additional services. When a parent company transferred a patent or similar intangible there were generally two methods of compensation. Under the first method the right to use the patent or intangible property was transferred to the subsidiary either for a lump sum or for a royalty which was a percentage of the subsidiary's gross revenue or production or some similar base. A second method, common within the transnational corporation, was the so-called "cost-sharing" arrangement, under which the costs of world-wide research were shared among related companies around the world.

There were a number of problems of definition as to what constitutes research and there were questions on how to determine the arm's length royalty in cases where royalties were charged. However, the tax administration's work was relatively easier in the case of royalties than in the case of cost-sharing arrangements, because the activities in the latter case were spread around the world and no single tax administration had adequate information. Thus, the first conclusion from the work of the OECD working party was that a solution could not be unilateral and the problem could only be solved with the co-operation and the exchange of information between the tax authorities.

The second subject being considered by the OECD working party was services for subsidiaries in general. If the services are rendered for the benefit of the subsidiary, it should be permitted to deduct charges for them, but if they were rendered for the benefit of the parent company, the expenses should be borne by the parent company. Complex problems arise when there is some benefit to both parties. An example of this was the expense of the independent audit of the subsidiary. The audit would be partly for the benefit of the parent as a shareholder and partly for the benefit of the subsidiary because it gives it better internal information for management.

Another question on services arose in connexion with the regional liaison and service officers, which rendered services to members of the Group in different countries. The first question was whether these expenses should be charged to the affiliates and, if so, whether the charge should be at cost or should include an arm's length profit. In general, the working party was inclined to the view that
if the services were ancillary and not the kind of services being rendered to customers, then the allocation should be at cost. If similar services were also being rendered to customers, a profit element should be included.

The members expressed their views on the problems faced by countries making payments to countries with a more advanced technology. Although this was a problem of particular concern to the developing countries, the developed countries were also concerned with the issue, since they too were paying for technology. The first question to be considered was whether royalty payments were justifiable on the grounds that they were being made for the use of property and not for information which was in the public domain and generally available. If a payment were made for an outdated technology the royalty charge might be excessive.

The developing countries were in many cases unable to satisfy themselves that the royalty charge was correct for the rights being transferred. To combat excessive charges, which are in fact transfers of profits, some countries impose a high withholding tax on royalties and remuneration for the rendering of technical services, or they do not allow a deduction for these payments. Some countries felt that, if the parent company had already written off its research costs in an earlier year, there should be no charge. Others were not in agreement with such a rule.

On the subject of technical service fees, some members felt that, if the parent were charging a royalty, there should not be an additional charge. However, one member from a developing country which had substantial experience with such contracts pointed out that in practice there were usually two contracts, one providing for a royalty and the other providing for continuing technical assistance. In his country no deduction was permitted for payments of royalties or remuneration for technical service made by a subsidiary to a parent in another country. However, a developing country could not refuse a deduction for payments to obtain technology. The difficulties arose because the developing countries were unable to determine whether the services were really rendered and what the proper payment for the services should be. There was also a concern that the existence of minority shareholders would encourage the parent company to charge excessively for technology. Since newly-developed technology is used first by the developed countries, cost-sharing arrangements result in the developing countries paying for the development of technology which they will not use for many years.

In spite of consultations with experts, one member had concluded that its tax administration was not sufficiently sophisticated to apply the arm's length standard. It had thus been obliged to take arbitrary measures to deal with these practical problems to protect the country from disguised distributions of profits. Reference was made to a study which is being conducted by the Latin American Free Trade Association on payments of royalties and remuneration of technical services by companies located in Latin American countries to their parent companies located abroad. Since the parent company had the choice of what technology a subsidiary would receive and pay for and since the developing countries had generally not reached a sufficient stage of administrative sophistication and since, furthermore, the case-by-case method was impractical for a country with many contracts to review, it was suggested by that member that the burden of proof should be placed on the company. The payments of royalties and technical service fees should initially be disallowed until such time as the subsidiary proved the appropriateness of the charge.
Some countries controlled the payments for technology through their exchange control authorities and industrial development ministries, thus placing the problem of determining the charges on other government departments who were faced with the same questions. However, additional considerations unrelated to tax matters were involved in their decisions, since these agencies would be concerned with foreign exchange and the social benefit of the technology. Another member pointed out that from a purely tax standpoint there would not be an incentive for a taxpayer to charge excessive royalties to a developing country because tax rates in the developing countries were often lower than those in the developed countries. In such a case, the parent company charge would more likely be the result of an income allocation by the tax administration in the developed country.

A number of suggestions were made to deal with the practical problems raised. It was suggested that the tax administrations of the developed countries should assist their treaty partners in developing countries. It was suggested that the Group of Experts should study the problem and the Secretariat should collect useful information on the subject and make it available to the Group. An example of such information was the report of the 1975 International Fiscal Association Congress which, in one country report, listed minimum and maximum royalty rates for various properties. It was also suggested that the Group should review some concrete examples and consider the use of safe-haven ranges in the area of services. Such safe havens could be established with reference to a reasonable percentage of net income prior to deduction of such charges. Another possibility for dealing with specific cases was the use of independent auditors to verify the reasonableness of the expenses. If independent auditors or other experts were used for this purpose, they would have to review not only the books of the subsidiary but also those of the parent company.

In conclusion, it was noted that this was one of the most complicated subjects dealt with by the Group. It was first necessary to determine when it was appropriate for a parent company to charge its subsidiary for activities incurred by the parent company. It was noted that in the International Fiscal Association resolution of 1975, the services of benefit to the shareholders should be deductible by the parent company and not by the subsidiary. However, services rendered for the benefit of the subsidiary should be charged for as appropriate and it could be presumed that, in the absence of an appropriate charge, the parent's country could impute income and the subsidiary should allow deduction.

The next question was how much the charge should be. Both the developed and developing countries had difficulties in determining whether the amount charged to a subsidiary was correct. However, developing countries felt that their tax administrations were less sophisticated in dealing with the problem. It had thus been suggested that the burden of proof should be put on the taxpayer. Other countries were prepared to accept the verification of independent auditors.

It was clear that tax administrations in the country of the subsidiary felt a lack of confidence in this area and that some had imposed higher withholding rates and had disallowed deductions as a consequence, although in some cases the withholding tax could not reach all services because of source rules. This was further evidence of the interrelationship of the various treaty provisions. If there were an adequate exchange of information, some countries might have more reasons to allow the deduction of these kinds of expenses.
It would be useful if the developed and developing countries would provide more data on contracts and the charges which were being made, since it is evident that much further work remains to be done.

The Group was asked by a member from a developing country to study the use of subsidiary companies located in tax haven countries and which are residents of countries having tax treaties for purposes of tax evasion.

B. Exchange of information

1. Inventory of possible arrangements

The Group in its previous session stressed strongly the importance, particularly for developing countries, of an article on the exchange of information. The Group agreed at its fourth session on the terms of a draft article providing that the competent authorities shall, through consultations, develop appropriate conditions, methods and techniques concerning the matters respecting which such exchange shall be made. The article should also extend to the exchange of information regarding fraud and tax evasion. This wording expanded the scope of the OECD Draft Convention and represented a delegation to the competent authorities to work out their own arrangements for the exchange of information. Thus, the arrangements between any two countries could differ from the arrangements between two other countries, and one country might have different arrangements with different countries under separate treaties. These arrangements would depend on the informational needs of tax administrations, the tax problems peculiar to those countries, the nature of trade and investment flows between the countries and other factors. The Group expressed its desire to have a compendium of all possible arrangements from which the competent authorities might choose; an inventory of such arrangements has been drawn up by the Secretariat and is contained in document ST/SG/AC.8/L.14/Add.1. In its preparation the Secretariat was assisted by members of the Group who, in reply to a questionnaire, outlined their present experience and commented upon their practices with respect to exchange of information.

The inventory divides the information to be exchanged into three types:

(a) Routine transmittal. Here are listed items of information which could be routinely exchanged, including, e.g., investment income flowing between the countries and information on taxpayers' activity (such as the establishment of a branch or subsidiary or a bank account). The exchanged sources of income items could be rotated from year to year; i.e., dividends might be reported one year and interest the next year. The routine exchange need not be reciprocal in nature, since one party may be interested in receiving one type of information and the other party may want another type. Apart from the provisions of paragraph 2 of the agreed article, consideration must also be given both to the ability of the transmitting country to obtain the information and to the administrative ability of the receiving company to use it;

(b) Specific requests. Items of information transmitted on specific requests could relate to a particular taxpayer or could involve information on economic factors, such as commodity prices, in the other country;

(c) Transmittal of information on the discretionary initiative of the transmitting country. The competent authorities should also decide whether they
want a transmittal of information on the discretionary initiative of the transmitting country. An agreement to do this would give a legal basis for the transmittal of this information. Since it is impossible to write specific rules as to when competent authorities must transmit such information, it may be helpful to give them this discretionary power.

The competent authorities must decide what restrictions to place on the use of the information by the receiving country. An important issue arises where States A and B have a treaty and States B and C have a treaty, but no treaty exists between States A and C. The competent authorities must decide whether State B can give information received from State A directly to State C. The present treaties do not go that far, and the question is whether they should be extended. The draft treaty article formulated by the Group also does not permit such an exchange. Thus, if it were desired in bilateral negotiations to extend the treaty in this regard, an appropriate change would have to be made in the text.

When viewing the general factors affecting the exchange of information, the question of reciprocity of exchange should be looked at in a broad sense. If the tax administration in State A cannot respond fully to State B, the question arises as to whether B would withhold certain information from State A or nevertheless give A full information even though the flow would not be completely reciprocal.

It was noted that after the Group agreed on the draft article, the OECD made some changes in article 26 of the Draft Convention which seem to have been in the same direction in which the Group was moving. For example, the article was stated to have as its purpose the carrying out not only of the Convention but also of the domestic laws of the contracting States. The Group essentially expressed the same purpose in agreeing that the exchange of information could be used for the prevention of tax fraud evasion or, where appropriate, the avoidance of taxes.

Some of the arrangements listed in the inventory may be beyond the scope of the present treaty article, such as giving information to another country in a three-party exchange, and may thus require amendment of the article itself when incorporated into a bilateral tax treaty.

It was pointed out that the mere conclusion of a tax treaty containing an article on the exchange of information is not sufficient in practice to ensure a flow of information. Apparently only one developed country routinely collects and transmits information on regular income items going abroad. However, a possible abolition of withholding tax in that country could result in the drying up of information on payments to foreign investors. In other countries much of this information is obtained through claims for refunds made by individual residents of the receiving country. However, in case of bearer securities, no information can be obtained unless a claim for refund is made. If routine information is to be made available to developing countries, the developed countries will have to make significant changes in their procedures. A tax treaty alone could not bring about these changes in the practices of developed countries.

It was also pointed out that there were other practical aspects to be considered. In the first place, the exchange of information must be embedded in the tax structures of both parties down to the lower ranks of tax administration. Certain technical factors must also be taken into account in connexion with structuring the exchange of information procedures, such as the fact that the
withholding tax procedure in some countries does not produce names of recipients. Furthermore, taxpayers could react to routine transmittal of information by transferring their investments to accounts in another country which does not have such a provision in its tax treaty in order to avoid the disclosure of information.

Another practical point is the usefulness of the information received by the developing countries in combating tax fraud or evasion. Residents of these countries who make investments abroad which are forbidden by their exchange control regulations would in any event not be making these investments openly. It is therefore unlikely that any routine flow of information would assist the developing countries in taxing their residents. A further practical point is the administrative burden arising from such routine flow both on the transmitting and receiving parties. It may therefore be more useful to some developing countries to concentrate on specific requests for information rather than routine requests.

Some members from developing countries confirmed that specific requests were more fruitful than the routine requests. It was suggested that sending representatives to other countries would be useful in obtaining specific information. Other members felt that the developing countries were more and more able to cope with information transmitted to them.

The importance of secrecy in the use of information was emphasized by a number of members. The important factors considered were that care should be taken that information is not passed on to other agencies of government, which is forbidden in some countries, and that information should be restricted to as few people as possible. The question of secrecy of technical information was mentioned, and it was agreed that professional secrets should not be transmitted.

Where information concerns transactions between many branches and subsidiaries of a transnational corporation, a bilateral treaty would be of little use unless the country of the parent company agreed to exchange information on transactions such as pricing and royalties. Some members suggested that a change in the basic treaty article was called for to facilitate such an exchange, while others opposed such a broadening of the article.

The question was raised as to whether copies of original documents or mere summaries should be transmitted, since the former could be used more readily as evidence in the courts of the recipient country.
2. Restrictions on the obligation to 'transmit information

One problem with the existing draft article of the Group was that there was no provision for multilateral consultation between competent authorities, and it was agreed that article 26 would require modification by countries who wish to provide such consultation. Subparagraph 2 (b) of the OECD article provides that there is no obligation on the part of the contracting States to provide information in circumstances listed in paragraph 2. The drafting of paragraph 2 of article 26 of the OECD, however, had not been examined extensively by the Group of Experts in previous meetings.

Some members pointed out that 2 (b) would not require the contracting State to supply information which was not obtainable under the laws or in the normal course of administration of either contracting State. The members from the developing countries suggested that this limitation would prevent the developing countries from taking full advantage of the inventory arrangements under treaties with developed countries since the tax administrations generally have unequal information systems. As noted in paragraph 16 of the Commentary to the OECD revised article 26, where such systems differ significantly, perhaps little information can be exchanged.

It was suggested by several members from the developing countries that paragraph 2 should be excluded from the draft. Some members from developed countries, recalling the general agreement reached in the fourth session, gave several reasons for including paragraph 2 in tax treaties. Subparagraph 2 (b), they maintained, was intended to deal with such situations as, for example, when one country may obtain information from its banks, but the other country may not ask its banks for similar information. If the latter country were able to ask the former to provide information from its own banking sources, several problems would arise. The country with a higher degree of investigative power would be flooded with requests for information, a service which it would be providing without benefit. This would be detrimental to the countries with more sophisticated investigative powers. Paragraph 2 is required because of the above illustrated need for reciprocity, a principle fundamental to the negotiation of tax treaties. It would seem self-evident that information should not be made available to a country which is not prepared to change its own laws in order to obtain similar information. Another disadvantage for the transmitting country, in cases of bank secrecy, for example, is that the conclusion of such a treaty would result in the investors shifting their accounts into other countries.

It was pointed out by other members from developed countries that, despite the problems raised above, article 26 had in practice been used satisfactorily for many years. Changes in this well-proven text could raise doubts about the meaning of the text as applied in other treaties; it was doubtful whether a change in the wording would in practice improve the exchange of information. Therefore paragraph 2 (b) should be retained.
Several members who had had experience with this article pointed out that paragraph 2 was generally interpreted in a broad sense and that treaty partners generally took into consideration whether the other party had the power to obtain information in special cases even if not in the normal way. In general, a transmitting country would look at the merits of the case. The general atmosphere or spirit was more important that the formality.

One member from a developed country commented that even if a treaty partner of his Government had no power to obtain information from banks in its country, this would not prevent his Government from giving information obtained from its banks to the treaty partner. While no country would wish to institute a mandatory information collection service for another country without reciprocity, nevertheless, in practice treaties had been applied on the basis of general reciprocity. It was conceivable that a taxpayer might sue the competent authorities in such a case; but the member pointed out that so far no problems had arisen although most of his country's treaties were in fact worded more broadly than the OECD draft.

One member from a developing country suggested a compromise by which, if a domestic statute prohibits the transmittal of information requested, a State should not be required to supply it.

It was further pointed out that, according to paragraph 15 of the Commentary, the OECD article 26 (2) does not impose an obligation to provide the specified kinds of information, but was intended to protect those competent authorities who, nevertheless, chose to give it. The implication was that the competent authorities may in fact give such information even though paragraph 2 could release them from the obligation. However, some members from developing countries felt that the liberal interpretation of paragraph 15 of the Commentary applies only to paragraph 14 (normal course of administration) and not to paragraph 13 (information unobtainable under the laws of one of the States). Some members, on the other hand, maintained that it applies to both paragraphs 13 and 14. In the end, a consensus appeared to emerge that article 26 (2) allows but does not obligate the requested country to supply information to a requesting State which does not have itself the power to obtain similar information, and to do so without facing a domestic challenge, and that the OECD Commentary in paragraph 15 should be considered for purposes of this Group as covering both paragraphs 13 and 14.

Several members from developing countries expressed the view that, in spite of assurances that paragraph 2 would not in practice inhibit the exchange of information, the draft article should be enlarged so that it would become more useful in helping to prevent tax evasion and avoidance. Several members stated that their countries had severe problems of tax evasion, and they felt that such evasion could only be prevented if the treaty made the exchange of information more obligatory than paragraph 2 implied. Since many of these countries had local laws preventing the giving of tax information, the reciprocity requirements would always enable the other country to refuse to give information. This would result in giving protection to tax avoidance and tax evasion. If there were no paragraph 2, then paragraph 1 would override the national laws and the treaty would prevail.

Prior informal arrangements had possibly been sufficient to deal with this matter in the past, when there were no income allocation cases. But now that such
income allocation cases exist, the language should be more specific. Reference was made to the difficulties which developing countries were experiencing through the outflow of hidden wealth. It was for this reason that the phrase "in particular for the prevention of fraud or evasion of such tax" was included in the draft treaty of the Group of Experts, a phrase which is not included in the OECD draft. The addition of paragraph 2 would nullify the efforts of the developing countries to combat tax evasion by their nationals. Some members further felt that subparagraph 2 (c) of article 26 of the OECD Draft Convention, which exempts from the exchange of information such economic information as might disclose trade secrets, would sufficiently serve to protect the transmitting State. However, in the end it was agreed that interpretation in a broad sense as discussed above, should meet these problems.

3. Routine and specific requests

A number of general points were discussed on routine and specific requests. In connexion with the form in which the request must be made, it was suggested that the inventory should comment on the language to be used. The normal diplomatic rule in international exchanges is that a country expresses its requests in its own language and the response is made in the language of the responding country. However, some members stated that they were prepared to accept requests for information in their language and, in the case of requests received in a foreign language, might also respond in the foreign language. Some delays result from translations of a request in a foreign language. Some countries required translations of the requested information to be made in the language of the requesting country and also required certification of the translated documents. It would be useful if the inventory would contain a reference to the need for the competent authorities to agree on the legal form and the language in which the information has to be requested and transmitted, particularly if it is to be used under the other country’s legal system.

Reference was made to the transmittal of general economic information on the volume of exports and imports. Since it was general economic information, it would not need to be transmitted on a routine basis. Such information should ordinarily be available in the requesting country, whose own sources of information should be exhausted before a request is made to the other country. Such requests should therefore be made on a specific basis only.

General statistics on the volume of exports and imports would not normally be helpful to the other country in administering its tax laws. Rather, the need was for more specific information on subjects such as transfer prices. Those members who had had experience on transmitting and requesting information on transfer prices reported that the system of exchange had been operating reasonably well. Information available in published financial statements of transnational companies was also a source of useful information for the tax administrations of developing countries. One member pointed out that, under the proposed accounting rules of his country concerning financial reporting for segments of a business enterprise, the parent companies would be required to give separate information for an enterprise’s foreign operations in the aggregate. Information on the foreign operations might require further breaking down by groups of countries or by individual country if the business conditions differed significantly. Although this information was intended for the assistance of shareholders and regulatory authorities, it would also be useful to foreign tax administrations.
Although it may appear on the surface that the substantive rules should govern the procedural rules, there is a possibility that the exchange of information arrangements could have some effect on the substantive tax rules of the parties. The inadequacy of information is sometimes the motivating factor behind substantive tax rules; for example, some countries do not allow deductions for business expenses incurred abroad, presumably because such expenses cannot be verified. If the information exchanged were to include data on such claimed expenses, the reasons for disallowing the deduction might be removed. It was agreed that this point should be mentioned in the inventory.

Several members suggested that the guidelines should contain a reference to the possibility of joint or team investigations of a particular taxpayer by more than one tax authority. This would be an effective method of auditing a taxpayer operating in several countries. One country had already conducted team investigations with its treaty partners and under these arrangements one country was permitted to inspect the books of a taxpayer in the other country. Another method might consist of the requesting country sending a tax official to the other country who could explain the request and examine on the spot the results of the requesting country's investigations. This procedure may expand in the future as a method of facilitating and expediting the exchange of information. It has the advantage of enabling the requesting country to obtain the information directly while using the resources of the transmitting country, thus saving time and money.

Reference was made to the Nordic Group agreement on administrative assistance in tax matters designed to assist in the tax collection process for the Nordic Group States. In a proposed amendment to the agreement, which is expected to become effective in 1976, each State would have the right to send officials to the other State to take part in an investigation of a taxpayer of that State. Procedurally, it was proposed that the minister of finance of the requesting country would ask permission to inspect original documents in the other country. This type of agreement, allowing simultaneous investigations by tax experts in several States, was considered to be especially effective in obtaining information on the activities of transnational corporations.

It was suggested by some members that the stationing of tax officials of one treaty country in the other would facilitate the exchange of information and was necessary to combat tax evasion. However, it was not suggested that these foreign tax officials should have direct contact with domestic taxpayers. The line of communication had to run between the competent authorities. In one country, foreign tax officials were permitted to contact their nationals residing in that country solely for the purpose of determining the tax liability in their own country.

It was suggested that foreign tax officials might be permitted to visit the tax offices and be given access to the tax returns. However, it was also pointed out that most countries were not permitted to throw open the tax returns of their taxpayers to foreign officials and that tax information must be secret even as between government departments or between tax officials. In the case of a joint investigation, a foreign official might be permitted to look at the tax return of a taxpayer from his country. However, tax authorities should be allowed a certain amount of discretion in deciding what information they would supply to other tax authorities. If foreign officials were permitted unfettered access to taxpayers' records, this essential discretion would have been removed, thus doing violence to
the sovereignty of a country. The question of sovereignty was considered to be of importance, but it has to be considered in the context of broadening the scope of a tax convention to deal more effectively with tax fraud.

The developing countries would welcome assistance in combating tax evasion in their countries and feel keenly the need for co-operation between the tax authorities. It was therefore suggested that the possibility of joint investigations should be included in the inventory. Some members from developing countries also felt it desirable to review the requirements for secrecy in light of the need for stronger measures to combat international tax avoidance. However, some members felt that secrecy of tax information was not incompatible with effective tax enforcement but, in fact, was essential to it. If information given to the tax authorities can easily become public knowledge, then taxpayers will simply refuse to provide information. The same is true on the international level. Exchange of information must therefore be governed by secrecy, and information should be exchanged only between tax authorities for their use and with appropriate safeguards.

It was finally agreed that distinction must be made between internal tax secrecy and the transmittal of information under an exchange of information agreement in a tax treaty. The tax officials of the receiving competent authority would also be bound by secrecy, and thus the information would not be improperly disseminated.

It was suggested by some that the inclusion of joint investigations in the inventory might not have a substantial practical effect. In practice, so far, it has been extremely rare for even neighbouring countries, e.g., the Nordic Group, to agree on combined action in tax matters. Some thought it unlikely that there would be many such agreements on an international basis, while others considered such arrangements would increase in the future.

It was pointed out that article 26 of the OECD Draft Convention specifically provides several safeguards to protect the rights of the competent authority in exchanging information. This article requires the competent authorities to deal with each other and prevents direct contacts between foreign officials and a taxpayer. The OECD safeguards would not, however, prevent personal visits from foreign officials seeking oral exchange of information. The stationing of foreign representatives in another jurisdiction is probably for many countries beyond the scope of guideline article 26 and is therefore a matter for further agreement between the countries. Article 26 does not place an obligation on the competent authorities to agree to a joint investigation nor to give a foreign tax auditor access to all information. Thus, while it might be useful and effective for the countries to embark on joint investigations, each country would have to decide whether it is juridically possible to do so within the terms of article 26.

In conclusion, it was generally agreed that the inventory of possible arrangements should be sufficiently broad to encompass all possibilities, and that the countries could adopt which aspects they chose; the inventory is not a binding obligation in future negotiations. Furthermore, the exchange of information article agreed on by various countries can go beyond the terms of the OECD Draft Convention, as indeed the Group of Experts has done. However, any arrangement agreed on would have to be within the legal framework of the treaty.
It was agreed that some modification in the concept of secrecy is needed to cope with modern business conditions. If there were to be any expansion in the exchange of information, the treaty would have to explicitly overcome domestic legal obstacles. On the question of joint investigations, since this might be considered an extension of the exchange of information procedure, the inventory should include this possibility and leave the matter open to the negotiating parties.

C. General relief from double taxation: tax incentives

At the fifth meeting a discussion took place on the frustration of tax incentives adopted by developing countries as a consequence of the mechanism in some developed countries for giving relief for taxes in a foreign country. Some countries using the foreign tax credit mechanism grant a tax-sparing credit to reduce such frustration. Other countries are not willing to grant any credit for spared taxes. In this context the Secretariat asked Professor Shoup, as a consultant to the Secretariat, to make a broad study of the extent and impact of tax incentives.

The following represent remarks made at a discussion of his preliminary paper. His initial work finds that incentives involve tax laws of both developed and developing countries. The main issues that arise are:

(a) What are the developing countries doing in offering incentives?
(b) What are developed countries doing to encourage investment in developing countries?
(c) What disincentives are there in the laws of developed countries?
(d) What disincentives are there in the tax laws of developing countries?

In general, the developing countries use the approach of tax holidays to encourage investment, while some of the developed countries use accelerated depreciation investment credits.

The following questions are to be considered in this context:

(a) How can a developing country get the most for its incentive?
(b) How can one deal with the businessman's fear of the risk of loss?
(c) What should be done to prevent fruitless competition in the offering of tax incentives?

The effectiveness of tax incentives was questioned by some members on several grounds. Some members felt that many investment incentives of a non-tax type

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2/ This credit, however, is usually restricted to spared withholding taxes; it rarely covers the underlying corporate tax.
were probably more important than tax incentives. Others pointed out that, unless a credit were given for spared tax, the home country's Government took away, through taxes, the benefit that had been given to the firm when the profits were repatriated.

A view was expressed that use of the source principle by some developing countries inadvertently favoured the outflow of capital from such countries. If a developing country, now using the source principle, were to adopt the world-wide principle in order to induce its own domestic capital to stay at home, it would need information from tax administrations in other countries regarding the income obtained there by such investors. For this reason as well as others, the exchange-of-information procedure now being studied by the tax group is of great importance.

The question was raised whether some developing countries used tax incentives not only, and perhaps not even chiefly, to attract foreign capital but to stimulate investment by domestic capital. A distinction perhaps may have been drawn between inducing domestic capital not to flow elsewhere and inducing the formation of more capital.

In conclusion, there is the need for developing countries to agree among themselves, at least on a regional basis, as to how far they are willing to go in generating tax incentives. Such agreements might reduce some wasteful competition among the developing countries.

One member tentatively placed before the Expert Group an informal plan for an "investment recovery allowance" designed to secure substantially the same benefits for developing countries and investors as those produced by a "tax-sparing credit". In brief, the plan contemplates that a capital-exporting country would give its taxpayers, in addition to the customary credit for foreign taxes paid, a special credit for the difference between the tax it normally imposes and the tax levied in the developing country, whether the latter is the normal tax or has been reduced or eliminated as an inducement to attract investment.

It is contemplated that the Group will, at its next meeting, consider on a broad basis the aspect of interaction of tax incentives and the rules regulating the treatment of foreign income.

D. Future work programme

The Group adopted the agenda for the next meeting, including the following unfinished topics:

Guidelines for tax treaties between developed and developing countries:

(a) International income allocation
   (i) Services
   (ii) Transfer pricing
   (iii) Intangibles
(b) Prevention of tax evasion (including tax havens)
(c) General relief provisions (including incentives and disincentives)
(d) Non-permanent residents
(e) Non-discrimination
(f) Capital gains
(g) Mining taxation
(h) Other items
### Annex I

**LIST OF DOCUMENTS**

**Agenda Item:** Guidelines for tax treaties between developed and developing countries

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<td>Replies to questionnaire on international income allocation between corporations in different countries, submitted by the members from the Federal Republic of Germany and Japan</td>
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<td>ST/SG/AC.8/R.36</td>
<td>An analysis of taxation of mineral resources in developing countries (mining royalties and other fiscal measures)</td>
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SUMMARY OF THE STATEMENT BY THE REPRESENTATIVE OF THE SECRETARY-GENERAL

The Deputy to the Under-Secretary-General for Economic and Social Affairs in charge of development planning and statistics, in an opening statement, stated that tax administrators in developing countries were becoming increasingly aware of the shortcomings of the existing tax agreements to which they were parties, whose provisions were still patterned to a large extent after those of tax treaties concluded prior to 1950 between developed countries, in which each party was simultaneously an exporter of capital to and an importer of capital from the other party. Such treaties, he said, could not serve as appropriate models when one of the aims was to encourage the flow of capital only in one direction, that is, towards the developing countries, so as to speed up their development. Moreover, he added, even when tax treaties were negotiated between parties whose fiscal sovereignty was absolute, the parties were not always equal in other important respects, such as economic power, technical fiscal expertise and negotiating experience. Thus, realizing that treaties based on absolute reciprocity between unequal partners were not adequate to meet the needs of the developing countries, the United Nations was seeking to formulate fiscal guidelines that would effectively help to increase the flow of resources to those countries.

The Deputy to the Under-Secretary-General referred to the valuable work already done by the Expert Group on Tax Treaties between Developed and Developing Countries and to a number of related developments in other United Nations forums. However, he stressed, some delicate and knotty problems, going beyond the tax treaty instrument itself but relating to international taxation, required attention. Those problems concerned mainly the implementation of the general provision of tax treaties. One example, he pointed out, was the difficult set of problems of international income allocation. Those were dealt with only in general terms in tax conventions, which basically endorsed the arm's length principle to given transactions between related enterprises. In practice, however, many complex questions arose in applying that principle to the pricing of goods and the transfer of intangibles or services for the purpose of arriving at a fair charge. To cope with such intricacies of international transactions, further guiding procedural provisions and substantive norms were needed. Similar problems arose in the area of exchange of information to prevent international tax evasion and avoidance and in the interaction of tax incentives offered by capital-importing countries with the tax systems of capital-exporting countries.

It was clear from the nature of such problems that the task before the Expert Group was a complex one, but the very complexity of the task rendered it challenging. The Deputy to the Under-Secretary-General expressed his conviction that the Expert Group would take up the challenge.
Annex III

ATTENDANCE

A. Participants

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Part Two

ISSUES RELATING TO TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

Report of the Secretary-General to the Group of Experts

In pursuance of Economic and Social Council resolution 1765 (LIV), the Secretary-General prepared a series of studies to assist the Group of Experts at its 6th meeting. These included particularly detailed reviews of such matters as international income allocation and international tax evasion and avoidance.
Chapter III

SUGGESTED INVENTORY OF POSSIBLE ARRANGEMENTS BETWEEN TREATY COMPTENT AUTHORITIES REGARDING INCOME AND EXPENSE ALLOCATION, INCLUDING TRANSFER PRICING, BETWEEN RELATED ENTITIES 1/

The present paper presents a suggested inventory of possible arrangements regarding income and expense allocation, including transfer pricing, between related entities, from which inventory the competent authorities under a tax treaty may select the particular arrangements which they decide should be utilized to implement the treaty provisions governing such allocation.

Under the conclusions previously recorded by the Expert Group, transactions between related entities are to be governed by the standard of "arm's length dealing". As a consequence, if an actual allocation is considered by the tax authorities of a treaty country to depart from that standard, the taxable profits of the entity involved may be redetermined. Further, the competent authorities under the tax treaty are required to consult on such redeterminations. These conclusions apply both to the relationship between an enterprise and a permanent establishment and to the relationship between a parent corporation and a subsidiary corporation.

These general conclusions are set forth in the fifth report of the Group. 2/ That report also suggested a further study having as its goal the development of guidelines and techniques covering the matter of allocation of income and expense. These guidelines should be so formulated that they could be utilized in treaty negotiations between countries desiring to use guidelines that would serve to amplify and further develop the customary "arm's length" article contained in the usual treaty.

Under the general position taken by the Group, the implementation of the income allocation treaty provisions rests with the competent authorities, who are in effect required to work out the arrangements necessary to that implementation. An inventory of possible arrangements to be drawn upon for this purpose is suggested herein, together with comments on some factors relevant to the use of possible arrangements. The inventory items or factors mentioned are not intended to be exhaustive of all the possibilities. Indeed, the enumeration is intended to be open-ended, to be added to as experience indicates.

1/ In the preparation of the present paper, the Secretariat had the assistance of Stanley S. Surrey, Harvard Law School, who acted as consultant.

2/ Tax Treaties Between Developed and Developing Countries: Fifth Report (United Nations publication, Sales No. E.75.XVI.1).
A. Procedural aspects

The competent authorities should develop a procedural structure for the handling of income allocation matters. The following are various aspects that the competent authorities should focus on in developing this procedural structure.

1. Information on adjustments

The competent authorities should decide on the extent and timing of information to be given by one competent authority to the other on adjustments involving income allocations. Thus, this information could cover:

(a) Adjustments proposed by the tax administration of one country, the related entities involved and the general nature of the adjustment. However, the competent authorities may decide that routine transmittal of this information at such a preliminary stage is not required, and that only cases falling within certain prescribed categories of importance should be reported, or perhaps that, in the discretion of the tax administration involved, only significant cases should be reported on;

(b) Adjustments concluded by the tax administration of one country, the related entities involved, and the general nature of the adjustment. As in (a) above, routine transmittal of such information may not be required, and other criteria may be applied to determine whether and what information on concluded adjustments should be transmitted.

The decision on the aspect of transmittal of information discussed above is related to the question of who can invoke competent authority consultation and when this can be done.

2. Invocation of competent authority consultation

The competent authorities should decide on the parties that may invoke competent authority consultation, the timing of the request and the terms of the request.

(a) Proposed adjustments

The competent authorities may determine that a taxpayer against whom an adjustment is proposed by the tax administration of one country may request competent authority consultation. If such request is permitted, then the terms of the request should be specified, covering such matters as:

(a) The form of the request and the competent authority to which it is to be addressed;

(b) The timing of the request;

3/ In the present paper, the term "income allocation" refers generally to allocation of items of income or expense, including transfer pricing.
(c) Whether and to what extent the taxpayer will in advance accept a determination reached by the competent authorities (presumably, if the taxpayer does not decide to be bound, the national law will determine his rights to resist the proposed adjustment; also, a decision not to be bound may in turn affect whether the competent authorities will accept the request):

(d) The obligation of the taxpayer to provide information desired by the competent authorities.

Further, the competent authorities must decide on the extent to which they will accept such requests, i.e., either automatically or at their discretion, and, if the latter, what factors are relevant to a favourable response.

(b) Concluded adjustment with which taxpayer disagrees

The competent authorities should determine the procedure for making their consultation when an adjustment has been concluded in one country, and the taxpayer disagrees, in the belief that the action is contrary to the treaty. The terms of such request should be specified, covering such matters as:

(a) The form of the request and the competent authority to which it is to be addressed;

(b) The timing of the request;

(c) Whether and to what extent the taxpayer will in advance accept a determination reached by the competent authorities:

(d) The obligation of the taxpayer to provide information desired by the competent authorities.

(c) Concluded adjustment for which taxpayer seeks correlative adjustment

The competent authorities should determine the procedure for invoking their consultation when an adjustment has been concluded in one country and the taxpayer or its related entity is seeking a correlative adjustment in the second country. (It is assumed under subhead 4 below that a correlative adjustment must ordinarily be made if the competent authorities agree on the basic adjustment and hence the proper party must therefore be able at the proper stage to obtain competent authority consultation.) The terms of the request should be specified, covering such matters as:

(a) Whether the initial taxpayer or the related entity may make the request;

(b) The timing of the request: should it precede action by the tax administration of the country on the correlative adjustment or should it await a decision by that tax administration? In either case, the time period after the concluded adjustment in which the request for the correlative adjustment must be made should be specified, whether it be to the second tax administration or to the competent authorities (and whether it be made to them initially or only after decision by the second tax administration);
(c) The form of the request;

(d) Whether and to what extent the party will in advance accept a determination reached by the competent authorities;

(e) The obligation of the party to provide information desired by the competent authorities.

(d) Information submitted by taxpayers

The competent authorities should require that information submitted by taxpayers be prepared according to prescribed accounting standards. Those standards should follow the international accounting standards being developed for multinational companies.

3. Method of consideration by competent authorities

The competent authorities must determine how they will proceed to consider matters placed before them. This aspect involves the process for handling the matters, for obtaining information and for reaching a determination. It also involves the question of whether the discussions between the competent authorities are to be exclusively intergovernmental, and thus not directly involving the taxpayers, or whether the taxpayers may be allowed a role in such discussions.

The process for handling the matters presumably will be closely related to the substantive rules adopted for the resolution of the matters (see section B).

The method of consideration need not require a joint examination by the competent authorities of every initial adjustment. Thus, it may be decided that if an initial adjustment falls within a permissible range agreed to in advance, then the second country's tax administration will be obligated to make the appropriate correlative adjustments without resort to joint competent authority discussion, except where that administration decides the discussion is advisable. (This assumes that an appropriate correlative adjustment will follow if an initial adjustment is made.)

4. Aspect of reaching agreement between competent authorities

The competent authorities will have to determine what procedure to follow if the discussions between them do not produce an agreement on the terms of the initial adjustment. Some alternative approaches are:

(a) That "economic double taxation" will not result and the related entities involved will not be caught between differing competent authority views on the propriety of the initial adjustment or of any correlative adjustment. This approach assumes that if the initial adjustment is agreed to by the competent authorities, it will be made and also that the proper correlative adjustments will be made. It also assumes that if the initial adjustment is not so agreed to, it will not be made. Such an approach may be implemented by the competent authorities binding themselves either:
(i) To reach an agreement in some ad hoc manner in the particular case, i.e., they must agree to agree; or

(ii) To follow an arbitration procedure developed in advance (perhaps choosing arbitrators from other competent authorities or from a panel maintained by the United Nations or some other group);

(b) An approach similar to (a), except that if the competent authorities both agree there is fraud or intent to evade taxes on the part of the related entities, then full correlative adjustment is not required. (Whether such a rule may be adopted depends on the substantive terms of the treaty and on national law.) If this exception is adopted, then the approach should contain any procedures necessary to implement this exception:

(c) That failure of the competent authorities to agree on the initial adjustment will still permit the first country to make that adjustment and, if it does so, the second country must permit the proper correlative adjustments to be made;

(d) That failure of the competent authorities to agree on the initial adjustment and consequent correlative adjustment leaves the related entities to their rights under national law as to both the initial adjustment and correlative adjustments, with the recognition that "economic double taxation" may result. If this approach is followed, presumably the competent authorities will take steps to examine the substantive rules involved or consider what other action is needed to keep such situations to a minimum;

(e) That failure of the competent authorities to agree on the initial adjustment will require the first country not to proceed with adjustment.

5. Procedures to implement initial adjustment

The competent authorities must determine what procedures or rules are required to implement the initial adjustment made by the first country. Some aspects to focus on are:

(a) The first country may consider deferring the adjustment if, for example, payment or reimbursement of an expense charge by the related entity is prohibited at the time because of currency or other restrictions imposed by the second country;

(b) The first country may consider steps to facilitate carrying out the adjustment and a payment of a reallocated amount. Thus, if income is to be charged to the parent corporation because of service to a related foreign subsidiary, the related subsidiary may be allowed to establish an account payable in favour of the parent, and the parent will not be subject to tax in its country on the establishment or payment of the amount receivable. Such payment should not be considered a dividend by the country of the subsidiary corporation;

(c) The second country may consider steps to facilitate carrying out the adjustment and payment of a reallocated amount. This may, for example, involve recognition, as a deductible item, of the payment made, even though prior to the adjustment there was no legal obligation to pay such amount, e.g., where the adjustment involves imputed interest.
6. Procedure to implement correlative adjustments

The competent authorities must determine the procedure to be followed in implementing correlative adjustments, where such adjustments either may or must follow if an initial adjustment is made (see subhead 4 above):

(a) The correlative adjustment is to be made despite procedural barriers, such as a statute of limitations on refunds, that would ordinarily bar the adjustment (the competent authorities may decide to put limitations on such a setting aside of procedural barriers, but presumably such limitations should ordinarily not be made);

(b) The competent authorities must determine the nature and scope of the various correlative adjustments required and the manner of their execution by the tax administrations of the two countries.

7. Publication of competent authority procedures and rules

The competent authorities should make public the procedures they have adopted with regard to income allocation matters.

The competent authorities should also presumably make public the substantive rules they may have adopted (see section B) regarding income allocations.

B. Substantive aspects

The competent authorities should develop guidelines for the substantive determination of income allocation matters.

Most tax administrations under their national tax systems follow the arm's length rule as the standard for income allocation cases. However, tax administrations differ in their application of that standard. Thus, a tax administration may have decided to follow an ad hoc approach, judging each case on its facts, and therefore will not have prescribed any substantive rules to be applied. On the other hand, another tax administration may have decided to develop fully articulated substantive rules for the various types of income allocation situations that arise. In between, there can be variations of either approach.

The initial task of the competent authorities is to harmonize the approaches already being applied in the two countries. Clearly, the difficulties in the task of harmonization will depend on the degree of variation between the approaches used by the two countries. The attitude taken toward the task of harmonization will also be affected by the number of cases requiring consideration by the competent authorities. Perhaps if there are few such cases and, in addition, each country utilizes an ad hoc approach, then the competent authorities may themselves use that approach. But if the cases are likely to be frequent or if one country is already using an approach involving articulated rules (a situation likely, because inevitably necessary, when a country has a significant volume of income allocation cases) then the competent authorities will presumably have to utilize an approach that involves rules rather than an ad hoc consideration. Moreover, since income allocation problems are increasingly becoming a highly important part of international tax relationships, it is desirable that competent authorities develop the appropriate guidelines to handle those problems.
In addition, it is likely that even an ad hoc approach must have its own internal rules. Administrators must base their judgements on something, and precedents, written or unwritten, would seem bound to develop. Perhaps in many situations the recorded experience of administrators using an ad hoc approach and the recorded expression of the concepts and attitudes they bring to each decision would not, once they were so recorded, differ markedly from the rules set forth in countries using an articulated and prescribed set of rules.

In carrying out their substantive tasks, the competent authorities involved will presumably be aided by consultation with other competent authorities facing similar problems.

1. **Approach using over-all factors**

   The competent authorities may decide to approach income allocation cases on the basis of over-all factors in the relationship of the related entities involved. This use of over-all factors could be an end in itself and thus a guide to the decision. Such a utilization of over-all factors would contrast with a method of consideration that focused on particular income allocation aspects, e.g., the transfer price of a particular product, the amount to be charged for a particular service etc. The second approach emphasizes fragmentation of the income and expense relationship of the related entities and focuses on particular fragmented aspects. The first approach focuses only on the over-all relationship. But probably even a fragmented approach may utilize resort to over-all factors as one of its guidelines, perhaps to indicate the boundaries of an acceptable range for decision on the particular aspect, or perhaps to offer a basis for decision when the usually applied guidelines are not available for lack of data or otherwise. Hence, the development of the over-all factor approach may have significance even for competent authorities ordinarily using a fragmented approach.

   In developing over-all factors, the competent authorities may focus on:

   (a) A pro-rata assignment of the profits of an international enterprise, computed as a whole, to its component subsidiaries or branches according to formulae developed in advance. Such formulae may be open-ended, and allow for the presence of special aspects in a particular use and the use of an agreed-on ad hoc formula for that case;

   (b) An examination of the method of income allocation used by the related entities and a judgement that such method is appropriate. This presupposes confidence on the part of the competent authorities that they have full information regarding the method used, full access to the business records and data showing the results of the application of the method, and evidence that the application was carried out in good faith for the basic operations of the enterprise and is not just a tax allocation method;

   (c) An analysis of the economic posture of the related entity involved in the initial adjustment and an examination of that posture against a background of appropriate experience and data in the relevant country. Thus, if a selling subsidiary is involved, an examination of its profit to sales ratio, or its profit situation considered in other ways, in comparison with the general economic experience of sales companies may be utilized. This approach presumably involves an accumulation of background data and experience describing various over-all
industry or product norms or, more likely, a range of norms. Here, as elsewhere, it may be helpful for the competent authorities involved to communicate with other competent authorities.

2. Approach focusing on particular items of income and expense

The competent authorities may decide to formulate guidelines for allocation of particular items of income and expense, such as transfer prices for goods, interest on loans etc. 4/ In the development of these guidelines, they should consider the extent to which it is possible and desirable, in each area, to establish "safe havens" or norms within which there will be no need to consider a reallocation, and the taxpayer's accounts will thus be accepted. The aspect of development of these safe havens presumably will depend on the experience accumulated by the competent authorities.

The areas in which guidelines may be developed include the following.

(a) Sales of tangible goods

Various possible factors to be considered for guidelines as to the transfer pricing for sales of tangible goods already exist in the experience of tax administration. Briefly stated, some possible factors include:

(a) Comparable "uncontrolled" prices. The use of comparable prices as a norm includes the use of adjustments to produce reliable comparability by taking account of differences such as quality, time of sale, quantity, level of the market etc;

(b) Resale price method, under which an appropriate "mark-up" factor is applied downward to the actual sales price of the selling entity to obtain the proper purchase price to be paid to the producing entity. Obviously guidelines are required to determine the computation of the mark-up;

(c) Cost plus method, under which an appropriate gross profit percentage is added to relevant direct and indirect costs to obtain a proper selling price to be charged by a producing company. Guidelines are needed to govern the determination of costs and the appropriate profit percentage;

(d) Other approaches based on various over-all factors considered in B (1).

(b) Loans

In fixing an appropriate interest charge on loans between related entities, the competent authorities may determine such charge:

(a) On the basis of an arm's length standard;

(b) On the basis of an arm's length standard, but considering such standard as

4/ Considerable experience with this approach has been developed under the "Section 482 Regulations" of the United States of America. Since this experience is described in the background papers, no effort is here made to elaborate upon that experience.
being satisfied by an interest rate within a range agreed on by the competent authorities (this rule would not apply where the creditor is in the business of making loans). Such range may have to be adjusted from time to time as economic conditions vary;

(c) If no interest is being charged, the competent authorities will have to establish a proper rate.

In establishing the range under (b) or the rate under (c), the competent authorities will have to consider what weight is to be given to interest rates in the countries of both the creditor entity and the borrowing entity. Further, if the loan is based on a previous borrowing by the creditor, the rate of interest on that previous borrowing could be considered by the competent authorities.

The competent authorities will have to determine which loans must carry an interest charge, presumably in this regard excluding short-term sales credit situations, and which loans are really equity investments or other special situations.

(c) Transfers of intangibles

The intangibles involved cover patents, copyrights, trademarks, systems, know-how etc. A factor to be considered as a guideline for transfer pricing of such intangibles, either on sale or licence, would be the comparable uncontrolled price method. Thus, as to licences, resort may be made to comparable royalty charges.

If a cost-sharing arrangement exists between the related entities under which each participant, for example, bears its arm's length share of the cost of research and development in return for a stipulated interest in intangibles produced, then presumably no reallocation would be needed on the transfer of the intangibles.

(d) Use of tangible property

In fixing a charge for the rental of tangible property, competent authorities may distinguish between situations where the related entities are in the business of renting the type of property involved or are not so engaged.

Where neither entity is engaged in the business of renting, the competent authorities may determine to fix an appropriate charge for the rental of tangible property:

(a) On the basis of an arm's length standard;

(b) On the basis of an arm's length standard, but considering such standard as satisfied by a rental charge made up by adding: depreciation; a percentage of the depreciable basis of the property (in lieu of any interest charge); and maintenance expenses, taxes, management expenses and similar expenses being paid by the lessor during the rental period. This method of fixing the imputed rental does not include a profit element.

If the lessor is itself first leasing the property, then that rental charge plus added expense can be used to fix the imputed rental figure for the lease by the lessor.
If the lessor or the lessee is in the business of renting the kind of property involved, then a profit element presumably could be considered in fixing the imputed rental.

(e) Services rendered

In fixing a charge for services rendered by one related entity to another, the competent authorities will have to classify the activities of the entity engaged in the services between, on the one hand, services being engaged in for the particular benefit of the other entity, such as specific legal, accounting and financial services, and, on the other hand, general supervisory services not designed to benefit the second entity but instead engaged in as part of the management of the first entity itself. Only the first class of services - those for the particular benefit of the second related entity - would require a charge, and hence are the type of services involved in reallocation situations. Such a charge would be required where it would be made in an arm's length situation and, presumably, would be so made except where the benefit of the service was so indirect and remote as not to support an arm's length charge.

In determining a charge for services, the competent authorities may distinguish between situations in which neither entity is engaged in the business of providing services of the type involved and situations in which either entity is so engaged. When the entities are not engaged in the business of providing the type of service involved, the competent authorities may determine to fix an appropriate charge for a service provided by a related entity:

(a) On the basis of an arm's length standard;

(b) On the basis of an arm's length standard, but considering such arm's length standard as being satisfied by a charge equal to costs incurred in rendering the service (including all direct costs and a proper allocation of indirect costs such as overhead and administrative expenses). This method of establishing the proper charge does not include a profit element.

If a proper cost-sharing arrangement is in effect between the related entities, then presumably no reallocation situation would arise.

If either related entity is engaged in the business of rendering the type of service involved, then a profit element presumably would be considered in fixing the appropriate charge for the service.

(f) Other special aspects involved

Where the relationship between the related entities is being considered on a fragmented basis, the competent authorities may determine to permit the entity involved in the initial adjustment to demonstrate that the allocation it actually made for one type of activity between the related entities, though inadequate in itself, was in fact offset by an actual allocation on another activity between them in the same year which was over-adequate in itself. Thus, services performed at no charge by a parent for a subsidiary could be offset by services performed by the subsidiary without charge for the parent or by the sale of goods to the parent by the subsidiary at an offsetting discount, or by the purchase of goods by the subsidiary from the parent at an offsetting price in excess of an arm's length price.
Chapter IV

SUMMARY OF REPLIES TO THE QUESTIONNAIRE ON INCOME ALLOCATION BETWEEN CORPORATIONS IN DIFFERENT COUNTRIES

The responses of members from the following countries are covered in the present summary: Ghana, India, Israel, the Netherlands, Pakistan, the Philippines, Sri Lanka, Switzerland and the United States of America. 1/ The summary follows the numbering in the questionnaire (ST/SG/AC.8/L.13/Add.3).

Most of the members replying to the questionnaire indicate that their countries have specific provisions for adjustment of reallocation. The difficulties in combating international tax avoidance and tax evasion do not arise from the lack of necessary legal powers of reallocation on the part of tax authorities. The real problem is the lack of exchange of information between the tax authorities of different countries which would facilitate the obtaining of the necessary data on international transactions carried out by their taxpayers. Only in rare cases special provisions can be found in tax treaties with regard to the exchange of information between tax authorities.

1/ Members of the Group of Experts on Tax Treaties between Developed and Developing Countries supplied the information requested for their respective countries. Hence, throughout the present chapter, the term "member(s)" refers to members of the Group and not States Members of the United Nations.
Part one. General

I. Specific provisions for adjustment or reallocation, versus general rules for determining taxable income

A. Specific provisions for adjustment or reallocation

1. Statutes

Members from Ghana, India, Israel, Pakistan, the Phillipines, Sri Lanka and the United States of America stated that their statutes contain specific provisions concerning transactions between related entities or residents and non-residents (India). It appears that India, Israel and the United States of America have the most detailed legislation as far as apportionment and reallocation are concerned. In general, all statutes are broad in wording, relating to all transactions. Moreover, the tax codes of India and the Philippines contain detailed provisions for different types of transactions (e.g., business transactions with non-residents, transactions of transfer of assets, shares and securities). The Swiss statutes, on the other hand, do not contain any specific provisions concerning adjustment of profits arising from transactions between related entities. Adjustments are achieved by applying general rules governing the determination of income.

2. Administrative regulations

Administrative regulations have been issued in India, the Philippines and the United States of America. They are broad in wording and, in the Philippines, contain definitions of certain terms (such as "organization", "group", "controlled taxpayer" and "true net income"). In India, the rules issued under the Income-tax Act have a statutory effect. Furthermore, the tax authorities issue circulars and instructions binding the assessing officers. They are in the nature of clarifications or directions on points of general interest.

B. General rules for determination of taxable income

1. Statutes

Except in the cases of the Netherlands and Switzerland, all replies state that the adjustment or reallocation is achieved by the above-described specific provisions. However, the general rules for determination of taxable income can apply to specific cases and may also be applicable to the adjustment or reallocation of income.

The members from India and Sri Lanka stated that, apart from specific provisions concerning related entities, it is possible to achieve an adjustment or reallocation by applying the general rules governing the determination of taxable income. The basic principle is that deduction for expenses is permitted only in respect of expenditure incurred wholly and exclusively for the purposes of business or for earning income.

One member (the Netherlands) reported that no precise criteria have been set down defining fair transfer prices; however, it is a principle that transfer prices between related entities should be comparable with those between unrelated parties. This principle is based on judicial decisions. Following this interpretation,
profits are determined in conformity with sound business reasons. In Switzerland, adjustment and reallocation of profits are achieved only by applying the general rules of the Income-tax Law and the Defense Tax Decree of 1941, dealing with the determination of taxable income.

2. Administrative regulations

Regulations and rulings have been issued in only a few countries. Most of the members indicated that no regulations or rulings have been issued so far.

C. Combining or overlapping of specific provisions and general rules

Members indicated that there is no overlapping or duplication between specific statutes and regulations concerning the adjustment or reallocation of income and the general rules dealing with the determination of taxable income. The specific provisions apply only to specified transactions, or there are no specific provisions for specified types of transactions.

D. Usefulness in practice

The replies showed agreement that the present provisions and regulations have been found useful. Five members (Ghana, India, Sri Lanka, the Philippines and the United States of America) reported that they have been used frequently. One member (India) mentioned that the statutes, administrative regulations and rulings provide useful guidance to non-residents interested in doing business in his country. One member (Switzerland) stressed that the actual situation is satisfactory for both taxpayers and tax authorities, in general; however it appears that these provisions are rarely applied.

II. Nature of administrative regulations and rulings

A. Administrative regulations and rulings

The only replying members from countries which have administrative regulations or rulings (the Philippines, Switzerland and the United States of America) reported that these are generally published. Regulations and rulings are extensive in the United States of America and give detailed guidelines on the different methods to be used to determine transfer prices of goods. Furthermore, in the United States, safe havens are also provided for and a case law exists in this area. In Switzerland, regulations and rulings are not extensive; they offer detailed guidelines but not specifically for transfer prices of goods. Regulations in the Philippines are extensive but do not give detailed guidelines on different pricing methods. In Switzerland it appears that a case law exists with regard to the basic principles but not regarding rules for specific cases. The Philippines member mentioned one case.

B. Ad hoc practices

Generally, the members reported that there are no considerable ad hoc practices. One member (India) reported that in cases where the actual income
cannot be definitely ascertained, the law authorizes the assessing officer to compute income in an ad hoc manner. This ad hoc practice is based on: (a) reasonable percentage of the turnover; (b) a fraction of the global profits, depending on the receipts in India and the global receipts; or (c) any other principle the assessing officer may consider suitable.

Another member (Switzerland) pointed out that large discretion is left to enterprises for fixing prices. The tax authorities intervene only in cases where they have the impression that a price manipulation has taken place.

The principle of market price (at arm's length price) is the basis for establishing the "normal" profits. Where prices in a market or comparable prices fixed with independent partners or between other unassociated parties are not available, other criteria are used to determine whether the price arrangements are sound and reasonable. The starting point is to cover not only costs for goods or services but also a mark-up for reasonable return on the capital invested and an appropriate remuneration of the personal activity exercised. Another member (Israel) mentioned that in cases dealing mainly with reallocation of income in transactions between related enterprises and with fictitious and artificial transactions, guidelines have been laid down for the assessing officer's use. Where a particular case is of general interest, a professional circular is sent to the assessing officers and to the professional bodies dealing with tax matters. These circulars are available to the public. The member from the Philippines referred to the practice of applying percentage of profit to turnover.

III. Tax avoidance as a necessary motive

Most of the replying members mentioned that, in general, the existence of a tax avoidance motive is not necessary for sustaining any reallocation of profits; on the other hand, members from Ghana, Sri Lanka and the United States of America indicated that a tax avoidance motive is necessary. Therefore, in the view of the majority of members, the existence of a tax avoidance motive need not be proved by tax authorities; however, in the view of the member from Pakistan, its existence may strengthen the case for reallocation. In Switzerland, the price must deliberately depart from the arm's length price to justify reallocation.

IV. Domestic versus foreign transactions

A. In general, domestic and foreign transactions of related taxpayers are treated alike (except where the wording of the provisions indicates that they apply only to transactions between domestic and foreign taxpayers or entities). In the Philippines, however, differences may occur; for instance, the corporate veil may be pierced to frustrate tax evasion. In India, certain special provisions govern the case of non-residents (e.g., sect. 9 (1) (i) and 92, and reallocation in the case of industrial undertakings in backward areas (sect. 80 HH)). In Ghana, specific provisions apply to non-residents carrying on trade in Ghana.

B. In Switzerland and, apparently, in the Netherlands, for practical reasons tax authorities may dispense with making adjustments in cases of transactions between domestic taxpaying profit-making corporations. In Switzerland, this applies as long as the total tax burden will not be affected (shifting of profits between
domestic parents and subsidiaries). One member (India) stated that adjustments can be made in the case of transactions between domestic taxpayers. However, the need for adjustments in those cases would usually be much less. The answers indicate, however, that the tax authorities would examine cases where international transactions are involved with greater scrutiny; in Sri Lanka, domestic taxpayers are subjected to the same scrutiny and necessary adjustments are made under the general provisions of the statute.

C. It appears that there are no specific provisions which disallow deduction of certain payments by a domestic subsidiary to a foreign parent company. One member (India) reported that interest payable out of the country, on which no tax has been withheld at the source, as required by domestic law, is not allowed as a deduction in the computation of the taxpayer's income. In Switzerland, some cantonal laws do not allow deduction of domestic mortgage interest paid to foreign creditors.

D. The territorial principle is used in the countries of only two members (India and Israel). In general, it does not affect the apportionment of business expenses in Israel, except in some special cases (e.g., apportionment of deductions to income which is tax exempt or taxable at a lower or preferential rate because the right to receive income is waived. In India, all expenses incurred in the country or abroad are allowed as a deduction, provided these are not specifically disallowed under various statutory provisions.

V. Extent and pattern of adjustment and reallocation in practice

A. 1. Effect

Members from seven countries (Ghana, India, the Netherlands, Sri Lanka, Pakistan, the Philippines and the United States of America indicated that they are losing revenue as a result of the allocation of income made by international companies in their transactions. The other members indicated that owing to a lack of experience, an adequate reply is not possible.

2. Particular types of transactions

The most frequent types of transactions in which the countries are losing revenue are the following:

(a) Transfer prices for goods and services which do not correspond to the normal prices on international markets; inflated charges for head office expenses, management fees, interest, misallocation of research marketing expenses etc.; and charging of disallowable expenses;

(b) Undeclared commissions;

(c) The claiming of amortization by falsified or inflated purchase prices for machinery and equipment;

(d) The payment of dividends disguised as royalties;

(e) Licensing and supply of technical know-how;

(f) Non-declaration of income by foreign technicians.
3. **Domestic legislation or international co-operation**

Most replying members proposed a close international co-operation in the provision of constant and detailed information between tax authorities. The exchange of information could be provided for in tax treaties (the Philippines). Some members were in favour of broader exchange of information. The member from India mentioned that it would be helpful to domestic authorities to obtain detailed authoritative information on costs, retained profits and transfer prices charged to unrelated parties. Furthermore, information about investigations or other proceedings, such as for restrictive business practices, could be of considerable importance to the domestic tax authorities. Some members (India, Israel and Pakistan) felt that there is need of additional provisions in the internal tax legislation giving the tax authorities additional powers with regard to the apportionment of expenses and the reallocation of income or the prescription of ceiling limits on expenses on royalties. In Sri Lanka legislation is being framed to disallow deductions to non-residents for expenses incurred in management of a resident company. The member from Ghana considered that free exchange of information among tax agencies of all countries, irrespective of the existence of tax treaties, was necessary to deal with the present situation. The member from Pakistan felt that it would be useful to compile international prices in independent markets for various goods.

**B. Number of cases**

Members from Pakistan, Sri Lanka, Israel and Ghana indicated that reallocation is rarely practised. However, adjustment of income is more often practised than reallocation of profits (Israel). Israel mentioned specifically adjustments of capital gains resulting from the transfer of shares between related entities. Three members (the Netherlands, the Philippines and the United States of America) mentioned that they practise adjustment and reallocation frequently. This is especially so in cases of domestic branches and subsidiaries of foreign companies (the Philippines and Sri Lanka).

**C. Threat of possible adjustment**

Some members (Israel, Ghana and the Philippines) assumed that the threat of possible adjustment or reallocation has an effect on the actions of the taxpayers.

**D. Basis**

Some members (India, the Netherlands, Pakistan and Switzerland) reported that adjustment or reallocation usually results from bilateral negotiations between tax authorities and taxpayers. Unilateral adjustments by tax officials are made in Ghana, Israel, the Philippines and Sri Lanka and sometimes in India and Pakistan. The taxpayers have recourse to courts.

**E. Length of discussions**

If there are bilateral negotiations, they are generally not lengthy and complex (India and Pakistan). However, the length of discussion varies from case to case (Ghana and Switzerland).
F. Prior treasury authorization

Certain international monetary transactions require prior treasury or central bank authorization (Ghana, India, Israel, Pakistan, the Philippines and Sri Lanka). Sometimes these are not challenged by tax officials (Pakistan), but sometimes they are scrutinized by them (India, the Philippines and Sri Lanka). Some transactions require approval of the board of trade (Israel). The information service of the income-tax commission collates the information regarding transactions carried out within the cognizance of government department agencies and companies and other public bodies. Such information finds its way to the tax files for use by the assessing officers. Information of this sort, however, does not necessarily have any bearing on, or connexion with, the allocation of income (Israel).

G. Tax rate abroad

All responding members stated that adjustment and reallocation rules for affiliates are the same for those in countries with a high tax rate as for those in countries with a low tax rate.

H. Special scrutiny

In the Netherlands and the Philippines, the tax authorities subject transactions in countries with a low tax rate to special scrutiny. Another member (Pakistan) mentioned that this is only done when there is an abnormally low profit or some doubt about the correctness of the accounts.

I. Exchange control

With the exception of Ghana and Sri Lanka, members did not indicate any evidence that existence of exchange controls has influenced the transfer prices between related companies. But they assume that exchange control constitutes a factor which is taken into account by the parties concerned. Members from India and the Philippines indicated that, while the principal motive is reduction of tax, parties sometimes resort to exchange control evasion from time to time.

VI. Correlative adjustments

A. One member (the United States of America) stated that, if the country initiates a reallocation of income from a foreign affiliate to a domestic taxpayer, a correlative adjustment to the income of the foreign affiliate is made. The member from Ghana stated that a correlative adjustment is to be made if the reallocation affects the foreign affiliate's liability to Ghana tax.

Three members (Pakistan, the Philippines and Sri Lanka) indicated that there have been no cases in their countries where a correlative adjustment to the income of a foreign affiliate was made. Members from Israel and Switzerland noted that when their countries initiated reallocation of income to domestic taxpayers, the income reallocated to a domestic taxpayer (e.g., subsidiary) will be taxable as a dividend distributed to him by the foreign parent. In the reverse case (reallocation to parent) no such tax can be similarly levied.
B. Relief for substantial participation

In the Netherlands, dividends from foreign affiliates are tax exempt on the condition that the affiliate is liable to foreign corporation tax and the holding is not a mere investment. Members from Pakistan and the Philippines indicated that there is no partial territorial system of taxation. Furthermore, members from India, Israel and Sri Lanka indicated that there is no exemption from tax with regard to dividends received from foreign entities. In Ghana a territorial tax régime is adopted but income from foreign sources is subject to tax if remitted to Ghana.

VII. Response to the adjustment of the other country

A. Binding force

In none of the replies is it indicated that adjustments made in foreign countries resulting in smaller profit for domestic companies would be binding on domestic tax officials. However, one member (Israel) mentioned that a domestic taxpayer may request within a limited period the revision of his assessment where the tax credit granted him in Israel is reduced as a result of adjustment of his tax abroad.

B. Statutory authority

Mostly, adjustments may be made until the assessment of domestic companies is final (Switzerland and Israel). Only two members (the Netherlands and Ghana) indicated that the lack of statutory authority does not represent a bar to any adjustment for prior years. In Israel the commissioner can reopen a final assessment within a period of six years after the declaration of income has been submitted, if there are sufficient grounds. In Sri Lanka there is a specific statutory period of prescription. In India and Switzerland a final assessment can be reopened under certain conditions. However, the adjustment made by foreign tax authorities is not regarded as a reason which can justify the reopening of a final assessment except under treaties (see below).

C. Tax treaties

Some members (Ghana, India, the Netherlands, Pakistan, the Philippines and Sri Lanka) stated that their tax treaties do not contain any provisions creating a right for adjustment in favour of a domestic taxpayer on the basis of allocation made in a foreign country. The member from Israel indicated that some tax conventions contain articles (on related entities, interest and royalties) relating to the apportionment and reallocation of expenses and income between related entities. These agreements further establish mutual agreement procedures. If a taxpayer regards himself as having been aggrieved by a decision of a tax authority

2/ Under the mutual agreement procedure in Swiss tax treaties, an adjustment in favour of a Swiss company may be agreed to. Switzerland, however, opposes automatic adjustment in case of reallocation of profits to foreign affiliates and has made a reservation to article 9.2 of the OECD Draft Convention.
in another contracting country, he may request the tax authorities in his country to put into operation the mutual consultation machinery as provided for in the convention, but these provisions do not grant him additional rights. The member from the United States of America indicated that the latest agreements provided for correctional authority procedures to avoid double taxation.

D. Agreement on adjustment

In all responding countries, domestic authorities can agree on corresponding adjustments before final assessment is made. If a final assessment is made, a foreign country’s action cannot be reviewed with regard to an appropriate adjustment unless a mutual agreement was achieved under a consultation article in a tax treaty (Israel and Switzerland). In Pakistan, no review for any reduction of income is possible after final assessment except to rectify errors or to implement decisions. A review to increase assessed income is possible.

E. Statute of limitation

Replying members indicated that an application for relief can only be entertained for years which are not barred by the domestic statute of limitations. In the case of the United States of America, this is so unless the treaties specifically provide for waiver of the statute with respect to refunds. The period of limitation varies from four years (Pakistan) to five (Switzerland) and six years (Israel). In Israel the commissioner may, but is not obligated to, reopen the final assessment within the statute of limitation period (in case of foreign tax credit, assessment may be reviewed even after the period of statutory limitation). Only one member (the Netherlands) indicated that an application for relief will be entertained at any time. The statutory limitations provided in the domestic tax law do not bar such an application.

F. Experience

Most of the replying members stated that there have been no substantial experiences with adjustments of this nature. Two members, however (Switzerland and the United States of America), pointed out that claims based on adjustments in other countries are not rare and are becoming more frequent. In Switzerland, problems arise where foreign tax authorities have made an adjustment of profit of the foreign parent company, and Swiss subsidiaries have entered corresponding adjustments in their own books and credited the foreign parent for the amount of profits imputed by the foreign tax authority. The domestic tax authorities do not recognize those corrections once the balance sheet and profit and loss accounts have been adopted by the general assembly of shareholders. Moreover, adjustments and credits to the foreign parent may be considered taxable dividends in Switzerland.

VIII. Competent authority provisions

A. Request for corresponding adjustment

Replying members, with the exception of the United States of America,
indicated that their tax treaties do not have provisions under which, when their country has initiated an adjustment in the income or expense of a local taxpayer, a related taxpayer in the other country may request its own tax authority to make a correlative adjustment in its tax liability. However, under the competent authority provisions (e.g., in India and the Netherlands), the tax treaties are generally designed to ensure that the actions of the tax authorities are in accordance with the other provisions of the treaty and do not result in double taxation. It is open to a resident taxpayer to present his case if he considers that the action of one or both of the contracting States would result in taxation for him which would not be in accordance with the terms of the treaty. One member (Switzerland) indicated that his country is against an automatic adjustment and opposes article 9.2 of the OECD Draft Convention. It is of the opinion that, in accordance with article 25 of the OECD Draft Double Taxation Convention, if a foreign tax authority imputes profits shown in the books of a Swiss subsidiary to the profits of the parent in such foreign country, the objection should be presented to the competent authority of such foreign country rather than to the Swiss competent authority. The reason is that the Swiss competent authority could normally not arrive at a solution without consultation with the competent authority of the other country and that it would be difficult for the Swiss authority to defend the interest of a foreign parent in its own country. The situation is quite different in the reverse case, where profits are allocated under article 9 to the foreign subsidiary of a Swiss parent; in such a case the objection should be presented in Switzerland.

B. Standards

So far none of the replying countries has established specific standards in tax treaties which are to be applied by competent authorities in arriving at solutions to the substantive issues involved in readjustment and reallocation. Nor have any such standards resulted from consultations between the competent authorities. Some members (India, Israel, the Netherlands, Sri Lanka, Switzerland and the United States of America) reported that solutions have been found on a case-by-case basis. It seems difficult to derive from case-by-case decisions any general guidelines which could be applicable.

C. Procedural barriers

Some members (Israel, Pakistan, Sri Lanka and the United States of America) indicated that provisions in their treaties do tend to reduce or remove the procedural barriers in the path of agreements between the tax authorities concerned. One member (Switzerland) expressed the opinion that no further provisions are required to remove or reduce procedural barriers, since the provisions are modelled on article 25 of the OECD Draft Double Taxation Convention.

D. Implementation form

With the exception of the United States of America (for sect. 482 only), no procedures to implement the competent authority procedures have been formalized. However, one member (Israel) assumes that, as the number of cases increases, such procedures and rules will be formulated.
E. Practice

Except in the United States of America (for adjustments other than sect. 482), no standards under administrative practice have been developed. 3/

F. Time-limit

Most replying members reported that the filing of a claim of a resident taxpayer is not limited to any period of time before the expiration of the statute of limitation. However, two members (India and Israel) indicated that a claim must be filed within a reasonable period "so as to enable the tax authority to examine the matter before too long a period has elapsed". Two treaties of the Netherlands provide a specific period in which the taxpayer must file his claim. In the United States of America, some treaties can set aside expired statutes of limitations.

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3/ The member from Switzerland noted that normally the implementation of a mutual agreement is made subject to the acceptance of such agreement by the taxpayer involved.
Part two. Transfer prices for goods

I. A domestic parent makes sales to a foreign subsidiary

A. Practice

In a number of countries, allocation of profit to the parent company may be made with respect to profits on sales to a foreign subsidiary (Ghana, the Netherlands, the Philippines and the United States of America). The member from Israel stressed that this is so to ensure that sales are made in accordance with the arm's length principle. In India cases of suspected underinvoicing of exports can be investigated and, if underinvoicing is established, tax is levied with reference to the full selling price. In Ghana, profit is expected in cases of such sales and, if not declared, must be identified, since such sales constitute normal business of the domestic parent. In Switzerland the allocation is made only if goods are sold to the foreign subsidiary at an excessively low price. In Pakistan and Sri Lanka there are no cases of domestic parent companies making sales to their foreign subsidiaries and in India and Switzerland such cases are rare.

B. Allocation on the net income basis by aggregating the income of the parent and of the subsidiary and allocating part of the consolidated income to the parent

1. Formulas used to determine the amount of adjustment, in terms of assets, sales and location of employees

In Ghana, generally the profits declared for Ghana tax should be in the same ratio to the consolidated group profit as the Ghana turnover is to the group world turnover. In the Philippines, the net income to the parent is used and not the allocation basis. However, if allocation is used, the proportion of assets or sales is considered but seldom used. In the United States of America, this method is not applied; neither is it the primary approach in the Netherlands. In Switzerland, the allocation of aggregate profits with respect to goods is rarely made. If transfer prices lead to an inappropriate sharing of the total profits, manufacturing and commercial profits, this may be a valid argument for an adjustment, subject, however, to proof that special circumstances prevent one company from making profits. In India, in cases where it is felt that the profits of the domestic parent have been understated, the authorities try to estimate the correct profits on a transaction-by-transaction basis. In Israel the profit is reallocated, where the parties to the transaction are related parties, only on the basis of current market prices. Only in cases of unrelated parties may the assessment be less than on the basis of current market prices agreed to by the parties.

2. Allocation of consolidated net income, in terms of division of total profits between the manufacturing and sales profit or an allocation of net income on the basis of expenses

In Ghana, the commissioner is not restricted to the use of the turnover formula described above; however, he is authorized to take into account other relevant criteria such as size of the payroll, expenses etc. In the Philippines, the formula of division between manufacturing and sales profits could be used. Most of the other members replied negatively (India, Israel, Switzerland and the
United States of America); neither is this the primary method employed in the Netherlands. In India the profits would be estimated on a transaction-by-transaction basis.

3. Transaction-by-transaction basis

Most members indicated that the allocation is made on the transaction-by-transaction basis (the Netherlands, the Philippines, Switzerland, the United States of America and, where applicable, India and Israel). In Ghana, however, this is not the case. The allocation is made to cover all transactions in a taxable year.

(a-c) In India, the principal factors to be taken into consideration in allocation are the market prices charged in arm's length transactions, reasonableness of other charges and any other special features of the transaction. In Israel the basis of reallocation is the current market price, as if the parties to the transaction were not related entities. No other factors are taken into consideration. In Switzerland, also, the principle is that the parent should charge its subsidiary the same price as independent customers and each case is decided on its merits. In the United States of America the methods set out in the regulations are used. Regulations apply pricing formulae which include allowance for profit. In the Netherlands, also, the guiding principle is the arm's length basis. Only if there is no comparable price are the net profits of the related corporation taken into account. In that case, all kinds of factors are given weight such as profit margins, return on investment, number of employees and amount of cost. In the Philippines factors taken into account are the selling price in other countries, the selling price to local buyers and the rate of gross profit of the parent company. The Philippines applies pricing formulae based on standard costs.

(d) Some members indicated that the fact that the parent or the subsidiary is operating for the time being at a loss is not relevant in determining transfer prices (India and Israel). Other members indicated that this factor is relevant (the Philippines and the United States of America). In the Netherlands, where there is a net operating loss during some successive years, this may be an indication that transfer prices are not correct. In Switzerland it is assumed that any industrial and commercial activity is run for profit. Operational loss may be an argument for adjustment (subject to proof that the loss is due to special circumstances affecting the seller).

(e) Comparable uncontrolled sales formulae - i.e., the price at which the parent sells to a foreign subsidiary goods of the same kind as those sold to independent distributors in the parent's country - is the pricing method taken as a starting point in a number of countries (Israel, the Netherlands, Switzerland and the United States of America and, apparently, the Philippines). In India there are no standard price formulae but transactions in similar goods entered into by other parties may give some indication.

(i) Relevant differences between the two types of sales can be asserted by the parent as the basis for charging lower prices in a number of countries (the Netherlands, the Philippines, Switzerland and the United States of America); such assertion must be substantiated by
evidence in India and also in Israel, where such assertion may be legally rejected.

(ii) Factors that may be taken into account to determine whether or not the relating parties are dealing at arm's length and whether the sales are comparable are: (a) relative profits of the two companies; (b) amounts invested; (c) volume of trade with the subsidiary; (d) private competition in the subsidiary's market; (e) an effort to achieve market penetration; (f) advertising expenses of the subsidiary. A number of members replied that all these factors are taken into account (the Netherlands, the Philippines, Switzerland and the United States of America). In India factors such as the relative profits of the two companies or the amounts invested are not relevant but the other factors may be taken into consideration. In Switzerland there are additional factors that are taken into account: price control in the subsidiary's country; sale of supplementary output to make use of otherwise unused capacity; and supporting costs by the subsidiary which normally would be borne by the seller. In Israel, under the law, consideration need not be given to the factors listed above, but in practice they would be taken into account, provided of course that there was no doubt that they were bona fide arguments and not just put forward in order to avoid tax.

(iii) Marginal analysis of prices and costs relating to foreign sales may be an additional factor in determination in a number of countries (Israel, the Netherlands, the Philippines and Switzerland). In the United States of America this is so only in determining whether the sales are comparable.

(iv) As to other formulae that may apply, in the United States of America, if the comparable price method cannot be used because there are no sales to independent distributors, or comparable prices for the resale price method and the cost-plus-profit method apply in that order of priority. The regulations provide that other methods may be used where they are clearly appropriate and none of the specified methods can be reasonably applied. In Switzerland, also, the resale price method applies and the cost-plus method, in that order (see below). In the Netherlands, where comparison with prices of transactions of third parties are not feasible, the net profit position of the related enterprise may be an important factor. Various methods including the cost-plus pricing methods have been used in allocating profits. In Israel no formulae have been worked out as an alternative to the market price basis but it may be assumed that, in a specific case in which the cost-plus basis or the resale basis was relevant and appropriate, it would be agreed to apply one or the other.

(f) The resale price method - which allows the foreign subsidiary the profit margin or appropriate mark-up representing that earned by unrelated distributors of similar goods - is used as an auxiliary method when a comparable uncontrolled sales formula cannot be applied in the Netherlands, the Philippines and the United States of America. In India the resale price
method is not used for reallocation of the profits of the domestic company. However, in cases where arm's length prices are not available, the resale price formula, duly adjusted after making allowance for reasonable profit of the subsidiary, may be used. In Switzerland the resale price method is rather unusual for manufacturing corporations except if used, e.g., to compare profit margins of domestic selling and foreign buying corporations.

(i) The appropriate mark-up percentage can be determined as a percentage of gross sales earned in similar transactions that are uncontrollable on either the buying or the selling end, or

(ii) As the mark-up percentage earned by domestic resellers if information on resales by other resellers in the same foreign market is not available.

In the United States of America both methods are used. The method under (ii) may be used if adjustments for functional and marketing differences can be ascertained. In the Netherlands there are no special rules for the application and the methods indicated may be used. The member from Switzerland indicated that the resale price in the subsidiary's country may be unknown or depend on special facts as mentioned under (ii). The member from the Philippines indicated that in the resale price method the most convenient and reasonable method would be the percentage on gross sales earned on similar transactions that are uncontrollable both by buyers and sellers as under (i). The second method may also be used if appropriate.

(g) The cost-plus method

In Israel, the Netherlands, the Philippines, Switzerland and the United States of America when the resale price method is not appropriate, because the transferee is not just a merchant, the cost-plus method is utilized - that is, an appropriate profit margin is added to the parent's cost of production.

(i) In the Philippines and the United States of America adjustments are made to the appropriate profit margin, and similarly in the Netherlands this method may be used although there are no special rules for its application.

(ii) Application of the profit margin may be applied only to direct costs of production or to full costs of production including indirect costs. In the United States of America, the cost which enters into the computation of the appropriate gross profit percentage must be computed in a consistent manner. If full costs are used in computing the appropriate gross profit percentage, then full costs are used in computing the costs in controlled sales. On the other hand, if direct costs are used in computing the appropriate gross profit percentage, then the cost involved in the controlled sale must be comprised only of direct costs. The member from the Philippines indicated that the profit margin applies to full costs of the production including indirect costs. In Switzerland normally a profit margin is applied to turnover or to costs of production (similar to value added) or to full costs, depending on the kind of
manufacture. In Israel it may be assumed that in the process of determining the current market price, when additional income is allocated to the parent company, the tax authorities will also consider such criteria as the cost-plus method in such a way that the marginal profit takes into account both direct and indirect costs according to the particular circumstances of the case.

C. Intercompany transfers

A number of replies indicated that the prices for intercompany transfers cannot be negotiated in advance (Ghana, India, the Philippines and the United States of America). In Switzerland the intercompany prices may be negotiated in advance with the tax authorities. Any arrangement is of course subject to control so that it may be applied in good faith. This may be so to some extent in the Netherlands. In Israel the law contains no provision with regard to advance rulings. Thus, while there is nothing in the law preventing an assessee from requesting such a ruling, there is nothing to ensure that the tax authorities will give one. In practice such rulings are given in cases in which a foreign entity is involved.

II. A domestic subsidiary is purchasing from a foreign parent

A. All replying members indicated that the domestic tax authorities do not consider themselves bound by actions taken by foreign tax authorities.

B. Adjustments

(a) The replies indicated that in general adjustment, if any, will be made on the basis of criteria generally applied in the domestic law.

(b) Replies indicated that the question of cost to the subsidiary is not approached generally in a different manner than the question of proper selling price by a parent corporation (Ghana, India, Israel, the Netherlands, Pakistan, Sri Lanka, Switzerland and the United States of America). The member from India further indicated that the general approach is to arrive at the proper cost or proper selling price of the goods. For this purpose the test of the arm's length transaction is used. In Israel, if the price paid by the domestic subsidiary appears excessive and was fixed so as to transfer the greater part of the profit abroad, a provision may be applied under which the non-resident person may be assessable and chargeable to tax in the name of the resident person, as if that person were an agent of the non-resident person. The member from Switzerland observed again in this connexion that the resale price method is rather unusual for manufacturing corporations and the cost-plus method appears more appropriate.

(c) Most replies indicated that the domestic authorities compare the subsidiary's profit on resale to the profits of other domestic companies engaged in similar activities (Ghana, India, the Netherlands, Sri Lanka and the United States of America). In the view of the members from India and Pakistan, this is a good way to find out whether the profits as returned are reasonable. In Switzerland such comparisons may give strong arguments for or against adjustment. Also, in Israel such comparison may be made to find out whether the profits were exaggerated and fixed so as to disguise the transfer of profits abroad.

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A number of replies indicated that the price question is viewed in the light of other payments by the subsidiary such as fees and royalties (India, Israel, the Netherlands, the Philippines, Sri Lanka and the United States of America). In Israel, where the other payments between the two entities are of an exceptional and unreasonable nature, this may very well lead the assessing officer to conclude that the transfer prices of goods should be examined. It is not, however, a simple matter to establish a connexion between the various sorts of payments. In Sri Lanka other payments will not influence the price question unless there is a link between them or the over-all question of whether there is a departure from the arm's length principle is being determined. Similarly, in Switzerland, where there is a link between the purchased goods and the fees or royalties paid, the latter payment will influence the price question. Prices may be fixed at a lower level where selling activities, such as marketing and advertising, are served by the seller and the appropriate costs are charged separately. The same rule need not apply necessarily if the goods have to be processed by the buyer and if this processing gives rise to payment of royalties. If there is no such link, the price question is to be viewed independently from fees and royalties. In Ghana, the fees and royalties are not related to the question of price.

In a few countries payments higher than the parent's cost are considered to be hidden dividends, if they are higher than the profit margin allows (the Netherlands), and depending on facts and circumstances (the United States of America). In Switzerland, if excessive prices are paid by a subsidiary to its parent, the excess amounts are considered to be dividends. In Israel prices are generally not so considered unless they are excessive compared with those paid in similar transactions. In India, and apparently also in the Philippines and Sri Lanka, there are no provisions for treating higher payments as hidden dividends. In Pakistan such higher payments are not considered as hidden dividends; instead, the excess prices will be reduced to increase the profits. This is also the case in Ghana, where, however, the question of treating excess prices as hidden dividends depends on whether the amount involved has been already remitted abroad.

No retroactive adjustment, such as for increases in a subsidiary's allowable cost deductions, can be made for years prior to adjustment in Pakistan, Sri Lanka and the United States of America. In India, only mistakes and misinterpretations can be rectified. Adjustments are allowed in the Netherlands and in Israel and the Philippines provided that the statutory limitation does not prevent the revision of assessment. In Switzerland, if a foreign parent retroactively adjusts prices for goods sold to a domestic subsidiary, these increases in costs can only be deducted if such retroactive adjustments were possible under contracts between unrelated parties. In the case where the assessment is already final after the adoption of the balance sheet by the shareholders, a change in the balance sheet or of the assessment is normally rejected. Clauses in sales contracts reserving adjustment of prices in accordance with decisions of the parent's tax authorities are generally not accepted for tax purposes.

In most countries such retroactive adjustments are not considered as excessive and treated as dividends (Ghana, India, Israel, the Netherlands, Pakistan, Sri Lanka and apparently, the Philippines). In Switzerland such an adjustment is considered as excessive if it is not at arm's length. The excess payment is treated as a dividend if made by a subsidiary to its parent but not in the reverse case. In the United States of America it may be treated as a dividend depending on facts and circumstances.
C. (a) In Ghana, Israel and the Philippines, in reviewing the transfer prices used by a domestic subsidiary, customs duties valuations of imported goods are referred to the income tax authorities for verification. In the Netherlands and Sri Lanka the values the customs officials have placed on goods sent to a domestic subsidiary by a foreign parent may be considered by the tax authorities. In India this is not a routine matter and does not preclude income tax authorities from examining the reasonableness of transfer prices; they are not bound by valuation adopted by other authorities. In Switzerland customs duty is not based on values of goods.

(b) Since some countries do not levy export taxes (Israel, the Netherlands and Switzerland), no valuation of goods exported by the domestic subsidiary is made. In Ghana, India, the Philippines and Sri Lanka, export value for purposes of export tax may be consulted in reviewing transfer prices. In Pakistan no such cases have come to notice.

(c) In the Netherlands and Switzerland there is no foreign exchange control, and therefore imports and exports of domestic subsidiaries or parents are not valued for that purpose. The values assessed by exchange control authorities may be consulted by income tax officials in Ghana, India, Israel and Sri Lanka; in the Philippines this is done infrequently. In Pakistan no cases have come to notice.

D. Difficulties with tax credit arising from narrow definition of profit

Most members (Ghana, India, Israel, Pakistan, the Philippines and Sri Lanka) indicated that no difficulties have arisen so far with domestic subsidiaries because the foreign country's tax officials had so narrowly defined profit arising within their country that part of the foreign country's credit to the parent company for tax paid in the subsidiary's country by the subsidiary becomes unusable by the parent. Apparently this is so because so far there has been little practice in this field. The member from Ghana anticipated that if such a problem were to occur, the unusable tax credit could be converted into a deductible expense. In the Philippines, possible conflicts are avoided through co-operation with officials in the parent country rather than with foreign tax officials. The Netherlands experienced difficulties in this respect through domestic subsidiaries.

In Switzerland the narrow definition of the subsidiary's profits is only one means by which tax credit is denied to the foreign parent. Other foreign tax measures taken by foreign tax authorities against parents of Swiss subsidiaries were cited as: the adjustment of prices charged, leaving smaller profits to the Swiss subsidiary; the addition of part or all profits shown in the books of the Swiss subsidiary to the profits of the parent (cf. subpart F of the Internal Revenue Code of the United States of America); the entire disregard of the existence of the Swiss subsidiary.

E. Territorial principle

It has not been possible to determine whether it is relatively easier to reach agreement on transfer prices when the parent corporation is located in a country exempting foreign income (the territorial principle).

Some members indicated that they had no experience to warrant an answer (India,
Israel, the Netherlands, Pakistan, Sri Lanka and Switzerland). The member from Ghana felt that the type of jurisdiction adopted by the country of residence of the parent is immaterial to the allocation problem.

III. Appropriate approaches and rules regarding the transfer of prices of goods which could be used as a basis for formulating internationally acceptable guidelines to be followed by treaty countries to govern the adjustments in the area of transfer pricing.

All replying members mentioned that the transfer of goods between related entities is causing many problems to domestic tax authorities. There is a need to develop methods and rules to combat international tax avoidance and tax evasion. The answers and proposals differ. However, there appears a consensus that the adjustment and the reallocation of income should be made on the basis of the arm's length rules or uncontrolled market prices.

Proposals differ with regard to the achievement of this general aim. Similarly, views vary as to when and to what extent an adjustment is regarded as useful and practicable. It would appear that any adjustment or reallocation requires an intensive co-operation between the tax authorities of the countries concerned. But there appears to be considerable opposition against the automatic acceptance of decisions made by tax authorities of a foreign country.

The member from India proposed the following approaches and rules to govern the adjustments in the area of transfer pricing:

(a) The adjustment should prevent a loss of tax revenues, export/import duties and foreign exchange;

(b) The transactions between the parent and the subsidiary should satisfy the arm's length standard. In computing the profit, direct and indirect costs and a reasonable profit mark-up should be taken into consideration at a reasonable percentage to be specified for the various types of goods. There should be clear specification of the costs supported by duly certified documents; uniform terminology should be evolved for this purpose. When all the indirect costs have been allocated, there should be no separate charge for general and administrative expenses;

(c) Where all the operations comprised in a transaction are not carried out in one country (e.g., manufacturing operations in one country and distribution in another), there should be rules for apportionment of income attributable to different operations. Specified percentages for the different operations would be useful;

(d) Suitable machinery should be evolved to exchange adequate information, including prices charged in transactions on similar goods;

(e) The competent authority provisions in tax treaties should be amplified to ensure resolution of disputes arising in reallocation of transfer prices. Also, national laws should be amended to give effect to the decisions of the competent authorities (e.g., waiver of period of limitation, compensating adjustments made in the income of the party at the other end of the transaction).
The member from Israel made the following suggestions:

(a) The basic arm's length principle should be supplemented by rules providing for uniform application of the principle;

(b) The comparable market price method is preferable from the three tests laid down in section 482 of the Internal Revenue Code of the United States of America. However, it appears that the application of these tests has not been conspicuously successful and, in effect, in the majority of cases a fourth guideline was applied;

(c) The criterion applied in the case of the transfer of trading stock is the current market price. No hard and fast rules have been laid down as to how this price is to be determined. However, when dealing with related entities, the current market price will always and inevitably be the determining factor, if it has been fixed by tax authorities on the basis of expert opinion;

(d) The safe-haven method used in the United States of America could serve as a guide in examining whether or not declared profits are reasonable. The following could serve as criteria for such rules:

(i) The accepted margin of profit or level of expenditure on the basis of those found in the files of other assesses engaged in the same sort of transactions or businesses;

(ii) The comparison of the margin of profit in a particular country with the margin of profit on the over-all turnover of the entity concerned;

(iii) The relation between expenditure on raw materials and turnover, where industrial enterprises are concerned;

It should be pointed out that using these criteria would necessitate the detailed analysis of stock movements;

(e) Unreasonable trading results may serve as grounds to disqualify assessees' accounts, or serve as grounds for reallocation of profits and the adjustment of prices;

(f) In case of the sale of goods to foreign entities, guidelines are needed to determine when departure should be permitted from the market price. This should allow the purchaser (the foreign entity) a reasonable profit to cover costs and expenses, where market prices abroad differ considerably from those in the seller's country. Similar guidelines are needed where the foreign entity is new in the foreign market and needs to fix special prices to establish itself as a market factor;

(g) Finally, the question of transfer prices cannot be separated from the question of international co-operation in connexion with the fullest possible exchange of information between tax authorities.

The member from Pakistan felt that establishing fair transfer prices of goods between related international entities is a difficult and costly exercise for
developing countries which do not have ample administrative resources. For them the
apportionment methods or the adoption of profit percentage basis would be easier to
administer than any transactional approach and would also provide sufficient
safeguards against tax evasion.

The transactional approach has to be based on the arm's length principle
which has been generally accepted in tax treaties. An arm's length price will
normally include some margin of profit as in the case of transactions between
unrelated parties. For application of the arm's length principle certain standard
tests may be applied either to an individual transaction or to the whole set of
transactions.

The most reasonable basis would be the comparison with a similar uncontrolled
transaction. This would require suitable adjustments in prices based on the facts
of each case. This may call for compilation of market rates for different
commodities each year, possibly by an independent international agency.

If the uncontrolled transaction formula cannot be applied, the resale price
method may be applied, starting from the resale price to an uncontrolled party by
the transferee and deducting the normal profit margin of the transferee, which will
be established from independent sales transactions.

The resale price method will not be applicable if the transferee sells after
subjecting the goods to certain manufacturing processes. In such a case, the cost
to the transferor, plus a reasonable margin of profit, would have to be worked out
to find the arm's length price to the transferee. In the alternative case, the
resale price by the transferee would have to be adjusted backwards not only in
respect of the element of profit but also for the cost incurred in making additions
to the value of the goods in question.

If the arm's length value of individual transactions cannot be established
with any reasonable accuracy, the transactional approach may be given up and either
the over-all apportionment of profits method or application of a fair rate of
percentage profit as disclosed by similarly placed taxpayers may be adopted. Any
reallocaion of profits would also require approval through the competent authority
machinery between the countries concerned and under the tax treaty.

In the view of the member from the Netherlands, prices for intragroup
transfers should be determined as far as possible on an arm's length basis. To
realize that aim, the prices as negotiated between independent firms in comparable
transactions on the world market should be taken as standard. Where such a
comparable price does not exist, or cannot be determined with any accuracy, the
cost-plus, resale price or indirect method should be used as an auxiliary means.

The member from Switzerland made the following suggestions:

(a) The taxation of the profits of a company should normally be based on
the true profits as shown in the books. It should not be based on a
computation of profits according to presumption figures. Tax authorities may
increase the profits shown by a company in its books, if there are reasons
to believe that they are too low and do not reflect the real situation. Such
a rectification is required if profits have been shifted from a taxpayer
to another related person. Rules may differ as regards such reallocation
and are subject to provisions of article 9 of the OECD Draft Convention.
the other hand, the taxpayer cannot ask for a reduction of the profits alleging that profits have been shifted excessively from another enterprise. The taxpayer is bound by the profits shown in the books, subject to relief under the new paragraph 2 of article 9 of the OECD Draft Convention. However, Switzerland is reluctant to accept adjustments under these provisions, as they may tempt a country to increase arbitrarily the profits of its enterprise, anticipating that the other contracting State has to give a corresponding adjustment to the associated enterprise located in its territory;

(b) It would be against the principle of free trade to substitute the judgement of a tax authority for the broad range of business considerations in transactions between parties, whether related or not. On the other hand, an enterprise which does not itself observe the rules of the free play of market forces and whose transactions are guided by fiscal rather than economic motives and which makes an excessive use of its ability to fix prices cannot expect approval of its arrangements with related persons. However, a business transaction or arrangement cannot be disregarded only because it allows fiscal advantages;

(c) There is no generally applicable "absolute" price for any good or service.

(i) The opinion that a price is high or low is not, of itself, a sufficient reason for a reallocation of profits for tax purposes. It would be wrong to substitute a price established according to guidelines or methods for the price effectively agreed upon and shown in the books or, in reverse, to accept automatically a price because it is within the range set by the rules or methods. Considerable flexibility is needed.

(ii) In auditing a price, all factors, internal and external, have to be taken into account and weighted.

(iii) Even where there is a differing market price, this should not give rise automatically to a reallocation of profits. The taxpayer should have an opportunity to justify the departure from the market price. This applies also to prices established according to other methods, such as resale price or cost-plus method. No method is preferable, but they may all be useful criteria for auditing transactions and profits.

(iv) Criteria should be sought under which prices are fixed in normal trade and business. The result could be a pragmatic compilation of such criteria, a scheme for auditing and discussing prices actually agreed upon between associated enterprises.

(d) There are two main approaches for a verification of the profits:

(i) The verification may start with the enterprise as a whole by examining the total profits, particularly in cases of trading enterprises. The total profits may be compared with profits made by other similar enterprises engaged in similar activities under similar conditions. Or, if not available, the estimation has to rely on customary auxiliary methods, such as yield of the capital invested, percentage of the turnover or total expenditure;
(ii) The verification may also be limited to one activity of the enterprise, to specific kind of goods or to particular transactions in relations between related enterprises. In such a case, the comparable uncontrolled sales price agreed with independent customers or between other partners dealing independently with each other may be used for comparison. If not available, auxiliary methods may be used, such as profit margin, resale price or cost-plus method.

In both instances, allocation may proceed from the comparison of one enterprise with the aggregate profits resulting from the consecutive activities of the one and the other associated enterprises. Once a normal price is established, it may be discussed between the taxpayer and the tax authorities, within the main arm's length principle. The amount of possible profits depends both on the internal business policy of the enterprise and on external facts, such as market conditions, competitive situation, price control and restrictions, fluctuation of currencies, high cost of initial period or special actions, need of special allowances, provisions for losses, losses due to insolvency of customers and changes in cost or market position between the conclusion of the contract and its execution.

It may be the policy of the enterprise to make no or only marginal profits. Another reason for reduction or even absence of profits may be special actions to break into a new market.

The difference in tax rates in the various countries cannot, by itself, be a valid argument for reallocation of profits. However, where invoices are routed through an affiliate created in a low-tax country mainly to shift profits, or where companies are crediting such affiliate for services which are fictitious or rendered by other members of the group, profits of such "intermediary companies" may be allocated to another company in so far as they exceed a fair and reasonable remuneration for the activity of the intermediary company.
Part three. Furnishing of services

I. A domestic parent renders services to a foreign subsidiary

A. Allocation of income to the parent in the form of a charge for performance of services

Members indicated that, if services are performed by the parent company, income should be allocated to the parent in the form of a charge for the performance of these services. In Israel, this is apparently rare; and in Sri Lanka no such cases have arisen.

1. Nature or type of services

In the United States of America, an allocation will only be made to reflect an arm's length charge for services which are of direct benefit to the subsidiary. If the services are related, primarily to the parent's stock ownership, they are considered supervisory in nature and are not subject to allocation. Allocation for technical, financial and marketing services are subject to an allocation, if the services directly benefit the subsidiary and are not a duplication of services performed by the subsidiary. In India, ordinarily, only the actual charges for the service would be liable to tax. However, if the evidence discloses any indirect consideration or a collusive arrangement with a view to avoiding tax, the income will be taxed on an estimate basis. The quantum of income to be attributed to the domestic parent will be determined on the facts of each case, depending on the type and nature of the services rendered. For example, a charge may be allocated to the parent for technical, financial or marketing services rendered to the subsidiary. However, no charge may be imputed to the parent for supervision or management of the parent's own investment in the subsidiary; on the other hand, any expense incurred by the parent for this purpose will be allowed as a deduction in computing the dividend income from the subsidiary. Similarly, in Ghana, a determination as to what income, if any, is due must depend on the nature of the services rendered. For instance, while there is no doubt that services of a technical, financial or marketing nature should attract a charge against the subsidiary, it is doubtful whether the management or supervision of the parent's own investment in the subsidiary should also be charged against the subsidiary.

In Israel there is a difference in the amount allocated, depending on the nature or type of services. In the case of services of a technical nature, financial services, or market research services, there is a greater likelihood that the domestic parent will be deemed to have received income as a result. In Switzerland the amount to be allocated will take into account the nature of the services performed and their importance to the corporation which benefits therefrom. There are no general rules. Experience has shown that domestic enterprises charge other members of the group an appropriate share of the overhead expenses incurred in the interest of the whole group and not of the parent only (e.g., cost of general management, legal services, accounting and financing, technical services, research development, marketing, advertising etc.). Allocation of direct costs to a given subsidiary normally takes place only if those costs are of some importance and services are specifically or exclusively rendered to a certain subsidiary. Tax adjustments should only be made where the parent has omitted to charge the subsidiary the appropriate cost in order to reduce its own profit. Another member (Pakistan) indicated that the amount allocated should depend on the costs for those services, irrespective of their nature.
B. Deduction of cost of furnishing services to the parent

Most members (India, the Netherlands, Pakistan, the Philippines, Switzerland and the United States of America) indicated that the cost to the parent in furnishing services to the subsidiary, both direct and indirect, are allowed as a deduction to the parent. In India, examples of indirect expenses are management expenses, financial charges and housekeeping expenses. In the United States of America, direct costs specifically identified with a particular service are included. Indirect costs which are not specifically identified with a particular activity but which relate to the direct costs for the services in question will be allocated. In Ghana only direct expenses are admissible. In the Philippines, overhead miscellaneous expenses related to direct costs are mentioned as indirect expenses. In Pakistan, the research expenses of foreign subsidiaries are so mentioned. In Switzerland the allowance of the expenses depends on whether they are commercially justified. In Pakistan a profit mark-up may also be allowed if the parent company is furnishing services in the normal course of business. In Israel expenses incurred in rendering services to the subsidiary (both direct and indirect expenses such as management and general expenses) would be disallowed. The problem is how to identify such expenses among the total expenditures of the domestic parent.

C. Imputation of income

Some members indicated that, if allocation takes the form of imputation of income to the parent, it would involve reimbursement of the costs for the services including indirect costs (Israel, the Netherlands, Pakistan and Switzerland). In Ghana, income will only be imputed where the parent claims against its taxable profits expenses connected with the services, and where income would have accrued if the services were rendered by an unrelated person.

In the Netherlands and Switzerland an element of profit will be included. In the United States of America, the imputation of income to the parent includes a profit only if the services are an integral part of the business activity of the member rendering the service or of the member receiving the service. The amount of the charge shall be the amount which was charged, or would have been charged for the same and similar services in independent transactions between unrelated parties in similar circumstances. Administrative services are generally supportive in nature and are not subject to the profit element. It is not necessary that the parent be engaged in furnishing similar services to unrelated parties in order to include the profit element; it is sufficient if the services are an integral part of the business activity. In India, where there is evidence of indirect consideration, or of a collusive arrangement with a view to avoiding tax, a profit element is included, based on the charges for furnishing similar services to unrelated parties. In Israel and in Pakistan, no imputed profit is included in the imputed income. However, an element of profit may be included if the parent company is engaged in providing the same services to non-related entities.

Another member (Switzerland) indicated that, in a reverse situation, where a domestic subsidiary renders services to the foreign parent (as when special subsidiaries are created for rendering services), special rules were set up for companies which are predominantly engaged in the business of furnishing services. An element of profit must be included if the profits are too low and an adjustment made. The minimum net profits are calculated mostly by reference to cost.
II. A domestic subsidiary receiving services from a foreign parent

A. Deduction

In most countries, if a domestic subsidiary receives services from a foreign parent, the amount paid to a parent for such services will be allowed as a deduction. Conditions attached usually provide that the services be ordinary and necessary (United States of America) or expended wholly and solely for the production of income (Israel) and are reasonable (United States of America and India), not excessive (Switzerland) and do not exceed fair market value of such services (India).

B. Elements

In most countries the allowed deduction will include the parent's direct and indirect costs of such services provided they are reasonable. A profit mark-up will be allowed as deductible, provided that it is reasonable (India, Israel, the Netherlands, the Philippines, Sri Lanka and Switzerland), or if the domestic subsidiary can establish the charge at arm's length (United States of America), or if the parent is in the business of furnishing such services (Pakistan).

C. Foreign determination

In most countries the domestic tax authorities are not bound by the foreign determination of the charge. But one member (Israel) mentioned that the domestic tax authorities would take such a decision into account as long as there were no conflict between the decision in the foreign country and the domestic tax law. In Sri Lanka the foreign determination of the charge is not questioned unless apparently unreasonable.

D. Localization of services

For the allowances of such a deduction, it is immaterial whether the services were rendered in the parent's country or in the subsidiary's country (Ghana, India, Israel, the Netherlands, Pakistan, Sri Lanka, Switzerland and the United States of America). They will be carefully scrutinized if the services are rendered abroad (the Philippines).

E. Withholding tax

Most members (Ghana, India, Israel, Pakistan and the Philippines) stated that a withholding tax will be applicable when the services are performed in the subsidiary's country. In the Netherlands and Sri Lanka the remuneration for services rendered is not subject to withholding tax or other income tax, nor is it in Switzerland except where the parent performed the services through a permanent establishment. If the payment exceeds reasonable remuneration, the excess part of the payment may be reallocated to the subsidiary and subject to withholding tax on dividends. In the United States of America, if the services constitute engaging in trade or business in the country, the service charge will be subject to the domestic withholding on services performed by the foreign parent within the country.
F. Deduction for prior years

Some members indicated that a deduction of expenses for prior years is not allowed (Pakistan) unless justified (the Philippines). In Sri Lanka, deductions for any year of assessment are allowed against the profits earned for that year of assessment only. In the United States of America, all allowable deductions ordinarily must relate to the year in which the service was rendered. Payments must be analysed under the domestic law and accounting principles. One member (Israel) reported that in so far as expenses relate to previous tax years, it is legally possible under certain conditions to reopen and revise the assessments made in respect of those tax years. Another member (Switzerland) indicated that a parent company can make a retroactive charge for services rendered to the subsidiary only if such a charge were possible under a civil contract between unrelated parties. However, a deduction will not be allowed after the adoption of the balance sheet by the assembly of the shareholders. In the Netherlands, in most cases, and certainly in cases where a final assessment has not yet been made, the profit for the year will be adjusted. In Ghana, deduction for prior years is determined on the basis of regulations prevailing in those years.

III. Proposals for approaches and rules regarding the furnishing of intercompany services to be used as a basis for formulating internationally acceptable guidelines to be followed by treaty countries in the area of intercompany services

The replying members felt that remuneration for intercompany services rendered should be deductible. Main problems are to ascertain whether services were performed at all and whether the services rendered have any connexion with the activities of the paying corporation. Rules must also be laid down as to which services should be taken into account for deduction of direct expenses, indirect expenses, head office costs, etc. A differentiation should be made among various types of services or according to whether the parent company furnishes services to related and unrelated partners.

The member from India felt that for the purposes of arm's length standard, direct and indirect costs plus a profit mark-up should be taken into consideration at a reasonable percentage to be specified for various services. The computation of such costs should be supported by duly certified documents; uniform technology should be developed for this purpose. When all the indirect costs have been allocated, there should be no separate charge for general and administrative costs. The types of services should be clearly enumerated, showing the services on which the profit mark-up would be allowed. No imputation of income should be allowed to the parent for supervision of its investment in the subsidiary and no deduction allowed the subsidiary for such expenses. A suitable machinery should be developed for exchanging adequate information, including prices charged in transactions involved in the rendering of similar services. The competent authority provision in tax treaties should be amplified to ensure resolution of disputes arising in reallocation of service charges. National laws should be amended to allow the decisions of the competent authorities to have effect.

The members from Israel and Pakistan felt that in the case of the rendering of services, income should be reallocated on the basis of costs without any profit being imputed (except when such services are performed in the normal course of the
business and are rendered also to unrelated companies). The member from Israel felt that rules must be laid down as to which expenses should be taken into account, direct expenses, indirect expenses, head office costs etc.

Consideration should also be given to the question of differentiating among various types of services and to the possibility of regarding the services provided to a subsidiary in the early days of its existence as additional investments by the parent company, instead of dealing with them within the framework of reallocation and adjustment.

The member from Pakistan felt that the first thing to ascertain is whether any services were performed. This should be evident from benefits accruing from such services. If the benefits to the related concern are remote, no allocation for services should be made. In the case of a branch office, no head office charges for supervisory functions should be allowed (especially when the arm's length principle has been adopted for transfer prices, and profit margins have been allowed as in the case of unrelated parties). When services are performed, the cost of such services should be determined as an arm's length charge. This cost will also include an appropriate share of indirect or overhead costs which relate to the direct cost. When added up among various users, such indirect costs should not exceed the total of such indirect costs. The appropriate share may be worked out on a proportionate basis according to total turnover or similar criteria.

The member from the Netherlands felt that the cost of all intercompany services should be allocated to the related companies to which the services are rendered, including a reasonable profit mark-up. At the same time that amount should be deductible in computing the profits of those related companies.

The member from Switzerland made the following suggestions:

(a) Services should be treated the same way as goods, though some particular aspects arise:

(i) In a group of enterprises there are few situations comparable to the situation between independent partners;
(ii) Parent corporations often have special organizations within the group to provide services to members, and have to support their cost without regard to the extent of the actual use of the offered services;

(iii) Thus, it is difficult to determine exactly whether and to what extent a subsidiary took advantage of the services rendered by the parent.

It would be unreasonable to prescribe precise rules and to apply them strictly and "reciprocally" in both situations, when imputing income and when disallowing expenses.

(b) As regards possible flexible guidelines, two main categories of services should be distinguished: specific determinable services; and general services (central expenses).

When one corporation provides specific services for another specific corporation, a remuneration should be paid. As in the case of sales of goods, if there is no "comparable uncontrolled" remuneration, the cost-plus method may be appropriate. In general, the remuneration should be allowed as a deduction of cost to the paying corporation (provided the payment is not of a capital nature). The deduction should be disallowed if it is excessive, i.e., if the other corporation did not provide any corresponding services, if the services have no connexion with the activity of the paying corporation, if they are not needed by such corporation, or if they are rather in the interest of the parent (supervision or management of its investments) than of the paying subsidiary. Tax authorities should disallow deduction of a remuneration for services only if there are valid reasons to assume that the service contract was concluded for tax reasons rather than for economic reasons.

It is assumed that the corporation rendering services will receive remuneration for them. If no such remuneration is charged to the affiliated company, either an appropriate income will be imputed to the company rendering the services or the deduction of costs related to the services will be disallowed. As in the case of the paying company, some flexibility must be left to the company rendering the services. Sound economic reasons may justify waiving of charges for specific services. As regards the amount of the remuneration, many countries take into account only costs and do not necessarily require a mark-up.

The method of charging other companies of the group with a share in the costs of the general services is widespread for affiliated enterprises, but rather unusual between unrelated companies which rather rely on fixed or determinable remuneration. The arm's length principle is hardly applicable. There are many problems, such as the amount and nature of costs to be apportioned, the computation of costs (including a profit margin) and the criteria for correct apportionment of total costs. As regards the last point, many methods have been developed in practice. The central expenses are distributed generally, on the basis of the turnover or other adequate criteria, among members of the group, or specifically according to the nature of expenses and according to specific criteria appropriate for such expenses.
Part four. Interest on loans

I. A domestic parent loans money to a foreign parent

A. Imputation of interest

In the Netherlands and Switzerland an interest-free loan will normally lead to the imputation of interest to the parent company. In the United States of America this is so, provided the transaction is not an equity investment. In Israel only in rare and exceptional cases is a parent company deemed to have received interest income from non-interest-bearing loans made by a domestic parent to a foreign subsidiary. These cases would consist of some fictitious and artificial transactions; in such cases, an interest-free loan would be regarded as an additional investment in the foreign subsidiary by the domestic parent. In Pakistan and Sri Lanka, there are no known cases in which domestic parents loan money to foreign subsidiaries. Other members (Ghana and India) indicated that, in general, no interest is imputed on an interest-free loan from a parent company to its subsidiary. However, if there is any evidence of indirect consideration, the value of such consideration will be taxed; further, if the domestic parent claims deduction for interest paid on borrowed capital, a proportionate amount of such interest will be disallowed (India).

B. Special considerations

In India, Israel and the Philippines, the reason for not allocating income in the form of interest is to be found in the domestic tax law, which does not contain provisions on imputed loan interest. In Ghana it is common practice to give an interest-free loan and, provided the parent does not recoup the forgiven interest in some other form, the transaction will be accepted as genuine. In Switzerland there are cases where the domestic tax authorities refrain from normal imputing of interest for economic reasons, for example, where the debt claims result from the ordinary business connexion between parent and subsidiary (a practice also applicable in the case of unrelated parties) or where the debtor is not in a position to pay interest because of financial difficulties.

C. Deduction

In Ghana, India, Israel (and apparently in the Philippines), a domestic parent will not be allowed to deduct as an expense the interest it paid on loans to a third party and which it loaned to its subsidiary without charging interest. In Switzerland and the United States of America, the deduction of interest as an expense of the parent is not disallowed because the funds borrowed by the parent have been reloaned to the subsidiary. In the Netherlands the interest expense paid by the parent on its own borrowings is deductible. However, in the case of a reloan to its subsidiary, the parent is imputed interest income from the subsidiary and is then taxed accordingly.

D. Exchange control

Members from Ghana, India and the Philippines indicated that prior approval is required under exchange control measures for loans made to foreign subsidiaries. In Israel, the Netherlands and Switzerland this is not the case.
E. Amount of imputed interest

In Israel there is no accumulated practice with regard to the rate of interest or amount of imputed interest income. Where it may be imputed, the rate will be at least that which the parent company paid on the loans it received. In the Philippines, while there are no provisions regarding imputed interest, where it is justified the amount imputed will be based on the prevailing interest. 4/ In the Netherlands the amount imputed to a parent as interest income is based generally on the domestic market rate. If a direct relation can be established between the loan to the subsidiary and the money taken up by the parent as a loan, the imputed interest will at least amount to the interest which is payable by the parent. In the United States of America, in cases where the parent is not regularly engaged in the business of making loans, a rate of 5 per cent per annum will be imputed where no interest rate is charged or the rate is less than 4 per cent or in excess of 6 per cent, unless the taxpayer can establish a more appropriate rate under the standards prescribed in the regulations.

II. A domestic subsidiary borrows money from a foreign parent

A. Deduction

1. Actual interest

If a domestic subsidiary borrows money from a foreign parent, the actual interest paid is allowed as a deduction (Ghana, Pakistan, the Philippines, Sri Lanka and Switzerland), and provided the rate is at arm's length (United States of America), or is not too high in comparison with the current rate in the

4/ In Switzerland, the Federal Tax Administration has issued rules primarily designed to allocate so-called "disguised dividends" to shareholders. For loans in Swiss francs, the following rates have been allowed since 1971:

(a) Loan to shareholders out of equity capital: 5.5 per cent;
(b) Loan to shareholders out of borrowings: 5.5 per cent or cost plus 0.25-0.5 per cent (whatever amount is higher);
(c) Loan from shareholders: mostly 6.75 per cent, but in case of investment or holding companies, average yield less 0.25-0.5 per cent.

It is immaterial whether or not the debtor or creditor is residing in Switzerland. The rates are reviewed in the light of prevailing rates in the Swiss capital market.

If the loan is in a foreign currency, normally the rates are applied which are usual for similar loans in such foreign currency.

Where investments are financed by loans, a mark-up of 0.25 to 0.5 per cent is left as profit to the corporation. In the reverse case, where a domestic subsidiary loans money to the parent, the criteria for imputing interest may be applied in a stricter way than described above. The granting of a loan to a parent in financial difficulties or the full and partial waiver of a debt claim may be considered as a disguised dividend, according to the arm's length principle. Interest-free loans or loans at a low rate of interest or the full or partial deferral or waiver of interest may require an imputation of interest to the subsidiary and of the levy of anticipatory tax (as withholding tax on dividends) on the same amount.
country (Israel and the Netherlands). In India the subsidiary would be allowed a
deduction for the actual interest paid, subject to the tests of reasonableness,
commercial necessity and the tax having been withheld at source.

2. **Imputed interest**

In Ghana, India, the Philippines and Sri Lanka there are no provisions
regarding imputed interest. In Pakistan imputed interest, if payable, may also be
allowed as a deduction on the facts of the case even if the loan was originally
interest free. In Switzerland, if no interest or interest at a very low rate is
charged, no higher amount will be allowed as a deduction from the profits of the
debtor. In Israel, apparently, the imputed interest income will be taken into
account only in rare cases. In the Netherlands imputed interest may be deducted
provided correlative allocation is made by the authorities of the foreign parent.

   (a) The decisions of a foreign parent's tax authorities imputing interest
income to the parent are not considered binding on the domestic subsidiary's tax
authorities (Israel, Pakistan, the Philippines and Switzerland). In Israel where
the foreign parent is deemed to have received imputed interest income and the Israel
tax authorities are prepared to take this into account, they will do so according
to the prevalent interest rates in the country.

   (b) When the parent's authorities allocate interest income to the parent in a
later year, the interest will not be deductible to the subsidiary for an earlier
year (Switzerland and, apparently, Israel, Pakistan and, particularly after the
statute of limitations has run out, the Philippines). In Israel the interest will
be allowed as a deduction only for the year in which it is deemed to be received by
the parent.

B. **Review of reasonableness**

Some members reported that the domestic tax authorities may review the
reasonableness of the amount charged on non-interest-free loans (India,
the Netherlands, Pakistan and the United States of America) and in the light of
prevailing rates in the country (Israel). In Switzerland and Sri Lanka, in the case
of interest-free loans, no interest is deducted from the profits of the subsidiary;
therefore, there is no ground for reviewing the reasonableness of the imputed
interest. Authorities may review reasonableness of interest claimed as a deduction
in India, Israel and Pakistan.

C. **Legal agreement**

In Ghana, the Netherlands, Sri Lanka and the United States of America, no
legally enforced agreement to pay interest is required. In Israel, interest
actually paid is deductible and for the deduction of interest by the domestic
subsidiary, a legally enforceable agreement to pay interest is required. In India,
documentary evidence of approval of a reserve bank is required.

D. **Withholding tax**

In Ghana, India, Sri Lanka and Switzerland there is no provision for imputed
interest; therefore, withholding tax is not applicable to these cases. In Israel,
the Netherlands, Pakistan, the Philippines and the United States of America, the
foreign parent is subject to withholding tax if interest is paid.
E. Excessive interest

In Ghana, India, Israel, Pakistan, the Philippines and Sri Lanka, if an interest charged by the parent company is regarded as excessive by the subsidiary's tax authorities, the excessive amount may be disallowed as expense to the subsidiary. In India, the entire amount of interest paid to the foreign parent would be considered as arising in India. In Israel, the Netherlands, the Philippines and the United States of America, an excessive amount may be regarded as a hidden dividend to the parent. In Switzerland the excessive amount is reallocated to the profits of the subsidiary and subject to corporation tax and withholding tax on dividends.

F. Loans treated as equity capital

The concept of imputed interest is not recognized in Ghana, India and Sri Lanka. In the Netherlands and the United States of America, the interest-free loan is regarded as an equity capital investment. The amount of the loan compared with the total capital is of no significance. In Israel, if imputed interest is not allowed as a deduction, it is because the interest-free loan is regarded as additional investment in the subsidiary. The amount of the loan is not a relevant factor. In Pakistan imputed interest, if payable, is deductible.

In Switzerland, disallowance of the deduction of imputed interest is not based on treating loans as equity capital. The profit and loss account is the starting point for establishing taxable profits. On the other hand, deduction of interest charged by a parent to its subsidiary may exceptionally be disallowed because the loan is treated as equity capital (cases of undercapitalization). In Switzerland, maximum ratios of debt to equity have been fixed for some categories of companies but not for manufacturing or trading companies (where the general criterion of "unusual financing" applies):

(a) In the case of companies in which non-residents have a substantial interest and which hold participation in other companies or grant loans (except banks), debts may not exceed an amount of six times the share capital and the reserves;

(b) In the case of companies holding primarily immovable property, debts may not exceed 80 per cent of the market value of the assets of such company.

Where the limit is not observed, measures may be taken against such corporation (no refund of withholding tax on dividends and interest received or no deduction for interest paid on loans).

III. Approaches and rules regarding interest on intercompany loans which could be used as a basis for internationally acceptable guidelines to be followed by treaty countries in the area of intercompany loans

Three basic questions arise in connexion with intercompany loans:

(a) Under what circumstances should a subsidiary be allowed or disallowed to deduct interest on loans granted by the parent company?
(b) In what cases should interest income be imputed to the parent?

(c) What rates for intercompany loans are internationally acceptable?

The general view is that the subsidiary should be allowed to deduct interest actually paid to a foreign parent, provided the interest is not excessive. Therefore, the deduction of interest should be based on actual payment. A deduction should not be allowed if the loan was arranged exclusively or primarily with a view to reduce profits. In general, loans are only recognized if interest is paid by the debtor. In cases of interest-free loans, a rectification of the creditor's profit may be justified. If intercompany loans are granted interest-free, an interest should be imputed to the parent company. The lending entity should be regarded as having received interest income. It appears to be difficult to set up a series of internationally acceptable standards for rates of intercompany loans. The rates may depend on various factors of the capital market which change rapidly from country to country. The starting point would be the rate prevailing in domestic markets. Any principles and guidelines should be flexible in order to avoid arbitrary results. The member from India suggested the following criteria for intercompany loans:

(a) The approach should be such that it would not result in a loss of tax revenues or foreign exchange;

(b) The parent and the subsidiary should be treated as two distinct and separate entities;

(c) Where interest is charged, the loan transaction between the parent and the subsidiary should satisfy tests of arm's length standard, the reasonableness of the interest rate charged and the commercial necessity for the borrowing. This should preferably be evidenced by a legally enforceable agreement for the payment of such interest. Any interest charge below the market rate should have been approved by the Government of the lending country;

(d) Where the loan transaction is interest-free and has the approval of the Government of the lending country, there should be no imputation of interest unless there is evidence of indirect consideration. If the lender has borrowed funds on interest, a proportionate amount of interest on advances given interest-free by it should be disallowed in computation of its income.

The member from Sri Lanka suggested that interest on intercompany loans should be on actual payments based on rates prevailing when the loan was made. The member from Ghana suggested that where loans are contracted as interest-free, they should be accepted as such unless it is proved that the lender derives from the borrower some other benefits in lieu of the interest supposed to have been forgiven. In the view of the member from the Netherlands, interest for intragroup loans should be determined on arm's length basis. Therefore, interest rates on intercompany loans should be adjusted to the rate as negotiated between independent parties for the same kind of loan on the same market. The member from Israel made the following suggestions:

(a) Guidelines should be flexible. No single fixed rate of interest should be set as a criterion. But the lending entity should be regarded as having received interest either at the rate prevailing at home or at the rate prevailing in the borrower's country, whichever is lower.
(b) As an alternative in the case of interest-free loans, any interest deduction should be disallowed for tax purposes. In other words, any adjustment or reallocation should be carried out not with respect to income but with respect to expenses.

In case the lender of the money has borrowed from a third party, the arm's length charge should cover the costs of borrowing, both direct and indirect. No profit may be added to cost unless the business of either party is to lend money. If the lender himself has not borrowed, the rate of interest being charged by unrelated parties in the countries concerned may be adopted. Safe havens in the form of standard interest rates may be unrealistic because arm's length charge may vary from year to year.

The member from Switzerland indicated the following:

A. Payment of interest

1. Loans made to a related foreign enterprise

The fact that an enterprise does not charge interest on a loan-related enterprise may justify a rectification of the profits of the creditor. The taxpayer may, however, allege good business reasons for not charging interest such as:

(a) Trade credits. There is no obligation to specify interest on deferred credit sales, instalments or late payments, although parties may do so. The interest element may be included in the price for the goods or rights sold. It is quite usual between unrelated enterprises not to charge interest for late payment, within a reasonable time-limit. Also, interest is normally not paid on advance payments. No interest should be imputed if the payment is deferred for less than six months. Interest will be imputed (except in cases mentioned below) if it is specified in the contract but not charged to the related enterprise. These principles should be applied both ways, for loans to a parent as well as to a subsidiary;

(b) Subsidiary's start-up period. Interest has to be imputed to the parent if it is not charged to a foreign subsidiary with respect to its start-up period. On the other hand, it could be argued that the parent is not suffering a loss because lack of interest is compensated by higher profits of the subsidiary and thereby by an increase of the value of the participation in the subsidiary, and later payments of dividends by the subsidiary are subject to tax in the hand of the parent. Such an assumption is not always valid, e.g., where the subsidiary is not fully owned by the parent; moreover, dividends from subsidiaries may qualify for a specific relief (tax exemption or indirect tax credit) which is not granted to interest. Except in special circumstances, tax authorities should not permit tax advantages to be derived from such treatments, especially in the case of loans to subsidiaries in developing countries;

(c) Financial difficulties. Financial circumstances of the debtor may not permit paying interest. A stricter attitude is appropriate when the waiver of interest favours directly or indirectly a parent company. The inability of the subsidiary to serve the loan can be admitted only if all creditors are dealt with in the same way. The granting of a loan to a parent by its subsidiary may be
regarded as a distribution of dividends where the parent will not be likely to be able to pay back the loan. In the case of a loan granted by a parent to its subsidiary, the proof of equal treatment of all creditors should not be asked for. It must be left open to a parent to waive interest payments or even to abandon fully or partly the debt claim in cases of financial difficulties of the subsidiary;

(d) Contribution to capital. Contribution to capital is no reason for a tax authority to disregard the loan contract and to refrain from imputing interest;

(e) Foreign exchange. Foreign exchange control and other restrictions in the law of the debtor's country may be a valid reason for waiving or deferring interest payments; here, too, a more flexible attitude is justified for loans to a subsidiary than for loans to a parent;

(f) Safeguards. Notwithstanding the above, the tax authorities must have the right to make adjustments, to impute interest or disallow the deduction of interest, if the loan was arranged exclusively or primarily with a view to reduce the profits of the enterprise. In most cases it will be a question of an adequate rate of interest rather than of the payment as such.

2. Loans made by a related foreign enterprise

If the payment of interest is charged on intragroup loans, normally the tax authorities would allow its deduction as an expense of the debtor. There is a temptation to argue that the rules mentioned under (1) for the situation of the creditor should apply equally to the debtor. That would mean that deduction of interest has to be disallowed to the debtor in situations where the creditor admitted waiving interest payments. Such "both ways" application of the same criteria would, however, lead to unsatisfactory results.

B. Arm's length rate of interest

1. The rate of interest

The rate of interest depends on many factors, such as:

(a) Nature and conditions of the loan: size, maturity, currency, guarantees (resulting from the capital market situation);

(b) Situation of the debtor: reputation, credit standing, need for money;

(c) Situation of the creditor: financial means and resources (cash funds, reloaned money).

Thus it is difficult to set up a list of rates generally applicable and acceptable to the taxpayers and the tax authorities. But an acceptable set of rules and rates may be necessary as guidelines for safe havens.

2. Capital market

The comparison with the capital market offers a basic guideline. One would first rely on the capital market of the domestic taxpayer, particularly if the loan is denominated in domestic currency; if denominated in a foreign currency, the capital market for such currency may be used as a first guideline. The
following departures may be acceptable from this principle: if the loan is
denominated in the currency of the debtor's country, a higher rate of interest than
the rate of the domestic capital market is acceptable to the debtor's tax
authorities if the debtor shows proof that he could not get the loan on the domestic
capital market and that the rate agreed upon is the rate of the capital market of
the creditor. In the case of the debtor, if the loan is not denominated in the
currency of the debtor's country but in a foreign currency, and the rate of the
capital market for such foreign currency is higher than the rate of the capital
market of the debtor's country, then it should be examined whether it was necessary
to borrow money outside the country and in a foreign currency. In the case of the
creditor, similar examination is justified when the rate of interest is lower than
the rate of his domestic capital market: the minimum rate must be the rate of the
creditor's capital market. If a foreign currency is used, the higher rate of such
foreign capital market may be disregarded if the creditor shows proof that the
debtor could have received the same loan in such foreign currency in the creditor's
capital market.

3. Standard rates

Many countries have set up a series of standard rates. Such rules necessarily
reflect the situation of the capital market of the country issuing such standards.
It will hardly be possible to find internationally acceptable standards.

4. Special situation of the creditor or the debtor

Here several considerations may be put forward for higher or lower rates by the
taxpayers and the tax authorities, e.g.:

(a) That the money lent out was reloaned and that an "intermediary" would
always look for a reasonable profit margin;

(b) That the loan was a temporary investment of cash;

(c) That the debtor did not need the money.

The tax authorities will generally object when the loan and its conditions are
arranged exclusively or primarily to reduce the profits of the creditor or the
debtor.
Chapter V

SUGGESTED INVENTORY OF POSSIBLE ARRANGEMENTS BETWEEN TREATY COMPETENT AUTHORITIES REGARDING EXCHANGES OF INFORMATION

The present paper presents a suggested inventory of possible arrangements regarding exchanges of information, from which the competent authorities under a tax treaty may select the particular arrangements which they decide should be utilized to implement the treaty provision governing exchanges of information.

Under the guidelines of the Expert Group, the exchange of information provision is as follows:

"The competent authorities of the Contracting States shall exchange such information as is necessary for the carrying out of this Convention and of the domestic laws of the Contracting States concerning taxes covered by this Convention, in so far as the taxation thereunder is in accordance with this Convention, in particular for the prevention of fraud or evasion of such taxes. The competent authorities shall, through consultations, develop appropriate conditions, methods and techniques concerning the matters respecting which such exchange shall be made, as well as exchanges of information regarding avoidance of tax where appropriate. Any information so exchanged shall be treated as secret, but may be disclosed to any persons (including a court or administrative body) concerned with the assessment, collection, enforcement or prosecution in respect of the taxes which are the subject of the Convention." 2/

Under this provision the implementation of the provision rests with the competent authorities, who are, in effect, required to work out the arrangements necessary to that implementation. An inventory of possible arrangements to be drawn upon for this purpose is suggested herein, together with comments on some factors relevant to the use of particular arrangements. The inventory items or factors mentioned are not intended to be exhaustive of all the possibilities. Indeed, the enumeration is intended to be open ended, to be added to as experience indicates.

A. Routine transmittal of information

A method of exchange of information that is in current use is that of the routine or automatic flow of information from one treaty country to another. The following are various aspects that the competent authorities should focus on in developing a structure for such routine exchange.

1/ In the preparation of the present paper, the Secretariat had the assistance of Stanley S. Surrey, Harvard Law School, who acted as consultant.

1. **Items covered**

(a) **Regular sources of income**

The items covered under a routine transmittal or exchange of information may extend to regular sources of income flowing between countries, such as dividends, interest, compensation (including wages, salaries, fees, commissions), royalties, rents and other possible items whose regular flow between the two countries is significant.

(b) **Transactions involving taxpayer activity**

A routine exchange of information may cover certain significant transactions involving taxpayer activity:

(a) Transactions relevant to treaty itself:

(i) Claims to refund of TC tax made by residents of RC; 3/ 

(ii) Claims of exemption or particular relief from TC tax made by residents of RC.

(b) Transactions relevant to special aspects of TC law:

Items that receive exemption or partial relief under special provisions of TC national law.

(c) Transactions relating to activities in TC of RC residents:

(i) Opening and closing by RC resident of branch, office etc. in TC;

(ii) Creation or termination by RC resident of a corporation in TC;

(iii) Creation or termination by RC resident of a trust in TC;

(iv) Opening and closing by RC resident of bank accounts in TC;

(v) Property in TC acquired by RC resident by inheritance, bequest or gift;

(vi) Ancillary probate proceedings in TC of RC residents.

(d) Economic relationships between the countries:

(i) Volume of exports from TC to RC;

(ii) Volume of imports into TC from RC;

(iii) Names of banks in TC dealing with branches, subsidiaries etc. of RC residents in TC.

3/ The term TC refers to the country transmitting information; RC refers to the country receiving information.
(e) General information:

(i) Tax laws, administrative procedures etc. of TC;

(ii) Changes in (i) above, especially as they affect treaty, including administrative interpretations and court decisions on treaty provisions and administrative practices or developments affecting treaty application;

(iii) Activities that affect or distort treaty application, including new patterns or techniques of avoidance or evasion used by TC or RC residents;

(iv) Activities that have repercussions regarding RC tax system, including new patterns or techniques of avoidance or evasion used by TC or RC residents that significantly affect RC tax system.

2. General operational aspects to be considered

The competent authorities should consider various factors that can bear on the operational character of the routine exchange, including its effectiveness, such as:

(a) The information transmitted by the TC presumably should be that available to its authorities in the normal course of administration;

(b) The information transmitted by the TC presumably should not extend to trade, business, industrial, commercial or professional secrets;

(c) A minimum floor amount may be fixed to limit minor data;

(d) The routine source of income items may be rotated from year to year, e.g., dividends only in one year, interest in another etc.;

(e) The information to be exchanged routinely need not be reciprocal in character. Country A may be interested in receiving information on some items but not others; the preferences of country B may extend to different items. It is not necessary for either country to receive items in which it is not interested. Nor should either country refuse to transmit information on certain items simply because the country is not interested in receiving information on those items;

(f) While the information to be exchanged on income items may not always be significant in itself as respects the income flows escaping tax, the routine exchange may provide indications respecting the degree to which the capital or other assets producing the income flows are escaping tax or whose existence abroad is in violation of other laws, such as exchange-control laws;

(g) Whether the information as to income items should cover payee only or also payor;

(h) Whether the information should extend only to residents of RC or also to those domiciled therein or citizens thereof;
(j) The degree of detail involved in the reporting, e.g., name of taxpayer or recipient, profession, address etc.;

(j) The form in which the information should be provided.

3. Factors to be considered by TC

The TC may desire to give consideration to factors affecting its ability to fulfill the requirements of a routine exchange of information. Such a consideration would presumably lead to a more careful selection of the information to be routinely exchanged rather than to a decision not to so exchange any information. Among the factors to be considered are:

(a) The administrative ability of TC to obtain the information involved. This in turn is governed by the general effectiveness of its administrative procedures; its utilization of withholding taxes; its utilization of information returns from payors or others; the over-all costs of obtaining the information involved;

(b) Legal factors affecting the obtaining and supplying of the information, such as bank secrecy laws. This aspect may involve the question of whether a treaty may affect national law restrictions.

4. Factors to be considered by RC

The RC may desire to give consideration to factors affecting its ability to utilize the information that could be received under a routine exchange of information, such as:

(a) The administrative ability of RC to use the information on a reasonably current basis and to effectively associate such information with its own taxpayers either routinely or on a sufficient scale to justify the routine receipt of the information;

(b) Legal restrictions that may affect the ability of RC to acquire information by treaty if such acquisition is under circumstances that would not permit a direct acquisition by RC in its own territory. This aspect may involve the question of whether a treaty may affect national law restrictions.

B. Transmittal on specific request

A method of exchange of information that is in current use is that of a request for specific information made by one treaty country to another. The specific information may relate to a particular taxpayer and certain facets of his situation or to particular types of transactions or activities. The following are various aspects that the competent authorities should focus on in developing a structure for such exchange of information pursuant to specific requests.
1. Items covered

(a) Particular taxpayers

The information that may be desired from a TC with respect to an RC taxpayer is essentially open ended, and depends on the factors involved in the situation of the taxpayer under the RC tax system and the relationship of the taxpayer and his activities to the TC country. A specific enumeration in advance of the nature or type of information that may be within the scope of an exchange pursuant to specific request does not seem a fruitful or necessary task. The agreement to provide information pursuant to specific request may thus be open ended as to the range, scope, and type of information, subject to the over-all constraints to be discussed herein.

The request for specific information may arise in a variety of ways. For example:

(a) Information needed to complete the determination of a taxpayer's liability in the RC, when that liability depends on: his world-wide income or assets; the nature of the stock ownership of an RC corporation; the amount or type of expense incurred in the TC country; the fiscal domicile of an individual or corporation;

(b) Information needed to determine the accuracy of a taxpayer's tax return to the RC tax administration or the accuracy of the claims or proof of the taxpayer asserted in defence of the tax return, where the return is either regarded as suspect or under actual investigation;

(c) Information needed to determine the true liability of a taxpayer in the RC country when it is clear that his reported liability is wrong.

(b) Particular types of transactions or activities

The exchange on specific request need not be confined to requests regarding particular taxpayers, but may extend to requests for information on particular types of transactions or activities. For example:

(a) Information on price, cost, commission, or other such patterns in the TC country necessary to enable the RC tax administration either to determine tax liability in a particular situation or to develop standards for investigation of its taxpayers in situations involving possible under- or over-invoicing of exported or imported goods, payments of commissions on international transactions, and the like;

(b) Information on the typical methods by which particular transactions or activities are customarily conducted in the TC country;

(c) Information as to whether a particular type of activity is being carried on in the TC country that may have effects on taxpayers or tax liabilities in the RC.
2. Rules applicable to the specific request

The competent authorities should develop rules applicable to the transmission of specific requests by the RC and to the response by the TC. These rules should be designed to facilitate a systematic operational procedure regarding such exchange that is efficient and orderly. While the rules may be general in character in the sense that they set standards or guidelines governing the specific request procedures, they should also permit discussion between the competent authorities of special situations that either the RC or TC believes require special handling.

The rules should pertain to:

(a) The specificity of detail required to be stated in the request by the RC and the form of such request;

(b) The extent to which the RC must pursue or exhaust its own administrative processes before making a specific request;

(c) The conditions affecting the nature and extent of the responsiveness by the TC.

C. Transmittal of information on discretionary initiative of transmitting country

The competent authorities should determine whether, in addition to the routine and specific request methods of exchange of information under which a TC country is automatically transmitting information or systematically responding to specific requests by the RC, they desire a transmittal of information on the discretionary initiative of the TC. Such a transmittal could occur when in the course of its own activities the tax administration of the TC country obtains information that it considers would be of importance to the RC country. The information may relate to facets of a particular taxpayer's situation and the relationship of that situation to his liability in the RC country or to the liability of other taxpayers in the RC country. Or the information may relate to a pattern of transactions or conduct by various taxpayers or groups of taxpayers occurring in the TC or RC that is likely to affect the tax liabilities or tax administration of the RC country either in relation to its national laws or to the treaty provisions.

The competent authorities will have to determine whether, under the standards governing the exchange of information developed pursuant to the treaty, there is a duty on a TC affirmatively to develop a procedure and guidelines governing when such information is to be transmitted, or whether such transmittal is to be considered by the TC but is fully discretionary, or whether such transmittal need not even be considered by the TC. Even if it is agreed there is a duty on the TC to develop a system for such transmittal, presumably the decision on when the conditions under that system have been met would rest on the discretionary judgement of the TC.
D. Use of information received

The competent authorities will have to decide on the permissible use of the information received by the RC. The decisions on this matter presumably will depend to a considerable extent on the requirements of national law regarding the disclosure of tax information or on other security requirements regarding tax information. This being so, it is therefore possible that the extent of the disclosure or the restrictions on disclosure may vary as between the two countries. However, such possible variance need not be regarded as inappropriate or as negating exchange of information that would otherwise occur.

1. Recipients of information received through exchange

The competent authorities will have to specify, either in detail or by reference to existing comparable rules in the RC, who are the qualifying recipients of information in the RC, for example:

- Administrators of the taxes covered in the Convention;
- Administrators of other taxes;
- Administrators of other revenue or control systems, e.g. customs, foreign-exchange control authorities, bribery commissions, comptrollers or auditors general and other enforcement officials;
- Administrative tribunals;
- Judicial tribunals, either specialized or general;
- The public in RC;
- The competent authority of another country (see E below).

2. Form in which information is provided

The permissible extent of the disclosure may affect the form in which the information is to be provided if it is to be useful to the RC. Thus, if the information may be used in judicial tribunals, and if to be so used must be of a particular character or form, then the competent authorities will have to consider how to provide for a transmittal that meets this need.

E. Consultation between competent authorities

Since differences in interpretation and application, specific difficulties and unforeseen problems and situations are bound to arise, provision must be made for efficient and expeditious consultation between the competent authorities. Such consultation should extend both to particular situations and problems and to periodic review of the operations under the exchange of information provision. The periodic review should ensure that the process of exchange of information is working with the requisite promptness and efficiency, that it is meeting the basic requirements of treaty implementation and that it is promoting adequate compliance with treaty provisions and the national laws of the two countries.
The treaties should permit, and the procedures developed by the competent authorities should provide for, consultations covering more than the two competent authorities under a particular treaty. Thus, if countries A, B and C are joined in a network of treaties, there should be provision for the competent authorities of A, B and C to hold a joint consultation. This should be provided for whether all three countries are intertwined, as where there are A-B, A-C and B-C treaties, or where one country is a link in a chain but not fully joined, as where there are A-B and B-C treaties, but not an A-C treaty. There should also be provision for exchanges of information in these situations. (The ability to exchange information in the latter situation would require a change in the provision itself.)

F. Over-all aspects

There are a variety of over-all factors affecting the exchanges of information that the competent authorities will have to consider and decide upon, either as to their specific operational handling in the implementation of the exchange of information or as to their effect on the entire exchange process itself. Among such over-all factors are:

1. Factors affecting implementation of exchange of information

(a) The competent authorities should decide on the channels of communication for the different types of exchanges of information.

(b) The competent authorities may decide it is useful and appropriate for a country to have representatives of its own tax administration stationed in the other treaty country. If so, the conditions governing the presence of such representatives and their duties should be determined. It would not seem necessary that this process be reciprocal, so that it would be appropriate for country A to have its representatives in country B but not vice versa, if country A considered the process useful but country B did not.

(c) The process of exchange of information should be developed so that it has the needed relevance to the effective implementation of the substantive treaty provisions. Thus, treaty provisions regarding intercompany pricing and the allocation of income and expenses produce their own informational needs and requirements for effective implementation. The exchange of information process should be responsive to those needs and requirements.

(d) The substantive provisions of the treaty should take account of and be responsive to the exchange of information process. Thus, if there is an adequate informational base under the exchange of information process to support the allowance by one country of expenses incurred in another country, then the treaty should be developed on the basis of the substantive appropriateness of that allowance.

(e) The competent authorities will have to determine to what extent there should be cost sharing or cost reimbursement with respect to the process of exchange of information.
2. Factors affecting structure of exchange of information process

(a) The competent authorities will have to weigh the effects of a possible lack of reciprocity upon the structure of the exchange of information process. Thus, if country A may not be able to respond as fully to a request as can country B, either because of legal restrictions on the tax administration in country B or because of practical problems of tax administration in country B, then should the level of the process of exchange of information be geared to the position of country B? Or, on the other hand, in general or in particular aspects, should country A be willing to respond to requests of country B even where country B could not, as stated above, respond to requests of country A?

(b) The competent authorities will have to weigh the effect on the process of exchange of information of the belief of one country that the tax system of the other country or the tax administration of the other country, either in general or in particular situations, is discriminatory or confiscatory. It may be that further explanation of such a belief could lead to substantive provisions in the treaty or in national law that would eliminate the problems perceived by the first country and thereby facilitate a process of exchange of information. One possible example of this is the treatment of non-permanent residents.

(c) The competent authorities will have to weigh the effects on the process of exchange of information that the process itself may have on the competitive position of taxpayers of the countries involved. Thus, if country A has a treaty with country B providing for exchange of information, country A will have to weigh the effect on the structure or process of that exchange of the fact that country C does not have a treaty with country B, so that firms of country C doing business in country B may be subject to a different tax posture in country B than firms of country A. Similarly, even if a treaty exists between countries C and B, if the tax administration of country A has more authority to obtain information (to be exchanged with country B) than does the tax administration of country C, then a similar difference in tax posture may result. As a corollary, it seems clear that the adequate implementation of exchange of information provisions requires a universal effort of tax administrations to obtain and develop under national laws a capacity for securing information and a competence in utilizing information that is appropriate to a high level of efficient and equitable tax administration.
Chapter VI

ISSUES INVOLVED IN PREVENTION OF TAX EVASION THROUGH EXCHANGE OF INFORMATION 1/

A. Scope of the problem

1(a) Undeclared interest, dividends, rental or royalty income from foreign sources accruing to residents of a country

Information about income earned by a resident of one country in another country by way of interest, dividends etc., is of great importance to the tax authority of the first country. By itself the amount of such income may not be substantial and as such its non-declaration may not mean much of a revenue loss to the country of residence. That is why countries such as India, Israel, Pakistan, Philippines and Sri Lanka admit of evasion under this category of income but do not consider the loss to be of such a magnitude as to cause concern. In their case, of far greater consequence is the evasion involved in income invested in foreign countries, investments which yield interest, dividends etc. To a tax authority, the source of this investment is vital. The source may be legitimate, in which case the matter is simple, but most of the time, in the case of developing countries, the source consists of funds secreted by a variety of illegitimate activities such as smuggling, under-invoicing of exports, over-invoicing of imports, secret commissions and rebates earned from transactions of purchase and sale of capital equipment, raw materials etc. Tracking down the source and determining evaded incomes, transaction by transaction, is not an easy matter as compared to getting at it from the income items which emanate from the source investments. This proceeds on a reasonable presumption that evaded incomes are invested and yield incomes which need to be returned for tax purposes in the country of residence. This is, therefore, one area where there is a great potential for detecting tax frauds if only the information as to investment income were available. The proposition is obvious but not simple. All investments are not necessarily made in an overt fashion. Nominees, holding companies, investment trusts, bearer securities, numbered bank accounts are employed to escape detection. All countries also do not necessarily have a uniform procedure of obtaining full information about the recipients of income by way of interest, dividends, rents and royalties so that they could be in a position to transmit information about the residents of other countries to the tax authorities of those countries. A powerful weapon in the armoury for combating tax evasion and avoidance thus gets blunted because of the subtle avenues of investments and varying laws and procedures of different countries.

1/ In the preparation of this paper the Secretariat had the assistance of Ramanlal Dahabhai Shah, retired Chairman, Central Board of Direct Taxes, New Delhi, India, who acted as consultant. The opinions expressed therein do not necessarily reflect those of the Secretariat.
Even where the source of income is not in doubt (which in fact would be rare), there is still reason to believe that this category of income escapes taxation to some extent in the country of residence as is observed in Fiji, Iran, Luxembourg, Madagascar, Nigeria, Tunisia and Zambia. This is possibly so because taxpayers do not feel unsafe in not declaring this category of income which arises outside the territorial bounds of their taxing jurisdiction.

A member from a developed country discussing the limited utility of exchange of information as regards these items added that his country required "all payers of fixed or determinable income to file certain information with the Government. This information was sent once a year to the treaty countries in which the recipients of the income were resident. Such a system would obviously be a very useful source of information if it were adopted by other countries." 2/

With all its limitations, the information in respect of incomes by way of interest, dividends, rents etc. is still useful and needs to be exchanged on a routine and automatic basis. It provides a check on the correctness of the return. Any omission or inaccuracy would straightway trigger off an investigation causing specific and detailed inquiries to be made with the country of investment.

All developing countries suffer from a continuous drain on their foreign exchange resources as a result of certain illegitimate practices, the beneficiaries being the developed countries. It would to some extent ease the problem of developing countries if all developed countries, as in the above case, adopted a uniform procedure of obtaining information in regard to fixed or determinable incomes and transmitted the same on a continuing basis to their treaty partners. In all such cases, routine exchange of information would act as an automatic check on possible tax evasion. Tax authorities in the United States of America are of the view that the knowledge that there is reporting of income from foreign sources under the automatic exchange of information provisions of tax treaties has prompted taxpayers to report these incomes for taxation.

Countries where foreign investments are controlled (presumably effectively) by their Governments have no problem; since the investment is known to the Government, income from such investment is also known and this knowledge is available to tax authorities. Japan and Spain are instances in point.

In countries where there are no restrictions on foreign investments - in other words, where investments are not controlled or regulated through official channels - the problem of tax avoidance of investment income assumes seriousness. France reports the problem in the following terms:

"It is probably in this field that tax evasion is greatest, since interest and dividends can easily be collected anonymously at a financial institution in a third country where the securities are held in custody. This category of income also lends itself to many fraudulent practices through the skilful use of certain special provisions of domestic law. Thus, certain institutions whose prime purpose is economic or financial are frequently used to facilitate tax evasion.

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2/ Tax Treaties between Developed and Developing Countries, Fourth Report (United Nations publication, Sales No. E.73.XVI.1), para. 123.
"In this connection the situation created by investment trusts (fonds de placement) and holding companies respectively will be discussed below.

"Investment trusts are pools, lacking juridical personality, whose purpose is to manage a portfolio of securities belonging to third parties (individuals or companies). The rights of the owners are represented by certificates issued by the trust, generally in bearer form.

"The anonymity of the owners of the securities held by the trust is assured by the form of the certificates and also by the fact that the trust has no liability towards the tax administration of the country in which it is established. Since the trust is not itself a taxable entity, it pays no tax on profits from its dealings or on income. The bearers of the certificates, who are the true recipients of the profits and income, are not subject to personal taxation, since the tax administration is not aware of their identity. The preferential tax regime applied in some countries to holding companies also encourages the creation of legal structures, the consequence - although not always the purpose - of which is to facilitate tax evasion with respect to the income from holdings in companies anywhere in the world. As in the case of investment trusts this situation results: first, from the fact that no tax or very little, is payable by the holding company in respect of the income which it receives and redistributes; and secondly, from the total lack of information as to the identity of the individuals or companies among whom the distributions are made." 3/

The problem is not that of France alone. Almost all countries similarly placed have the same problem. For countries - in particular, developing countries - in whose case investments themselves are a subject matter of tax fraud, the problem is compounded. Sri Lanka thinks that the secreted income is invested in Swiss banks (in numbered accounts) or in foreign government securities or, less often, in public commercial securities. Belgium finds the problem because of the failure of holding companies properly to report royalties, interest and personal services income. It believes that the most important area of evasion is the use of portfolio investment and banking abroad in order to avoid Belgian taxes.

In the United States of America, the problem is not so much the non-declaration of this category of income as the utilization of techniques for diverting such income to corporate and trust entities, which are resident in tax-haven countries. These techniques are largely resorted to by taxpayers in high-income brackets. There is no problem concerning small taxpayers, for whom the provisions in tax treaties for exchange of information of these items of income act as a deterrent or a motivation to report. Evasion through tax-haven countries forms a separate subject matter of the present paper and shall, therefore, be dealt with at its appropriate place.

Having recognized the fact that residents of a country can evade taxes in respect of their foreign-source income from interest, dividends, rents and royalties for want of information from the source country, exchange of information on a

routine and automatic basis would suggest itself as the only solution. However, this is not effective enough because it is not possible for the reporting country to obtain all the necessary information for transmittal about the names, addresses, amount and nature of payment. It is this fact that detracts from the effectiveness of the approach. Laws and procedures differ in different countries and that makes the compilation of data on a uniform basis impossible for many countries. Some of the important reasons for this situation are detailed below:

(a) Countries where there are no requirements for furnishing information about payment of specified items of income such as interest, dividends etc. do not have data for transmittal. Even where there is a requirement to furnish information in regard to some of the items, there still are other items which remain uncovered by this procedure. For example, no information is furnished to authorities in the United States of America on exempt bank deposits owned by non-resident aliens. Similarly, the United States tax authorities do not obtain information on interest in the form of original issue discount, or commissions or self-employment income earned by a foreign person;

(b) Information is ordinarily collected in respect of items of income from which there is withholding of tax. Where tax withholding is restricted to some items, the information would be available in respect of these items only. For example, in the United States of America, tax is withheld from dividends but the withholding is only in respect of dividends paid to residents of other countries. This situation is open to tax abuse as discussed below. There is no withholding of tax at source on amounts paid on the redemption of interest coupons detached from bearer bonds issued by a United States corporation where the real owner of the underlying bond is unknown to the United States withholding agent;

(c) In some countries, investments in bearer shares and securities are possible and the Government has no powers to call for details as to names and addresses of the recipients (unlike in the United Kingdom);

(d) Sometimes income is collected through nominees, holding companies and trusts located in tax-haven countries;

(e) Sometimes bank secrecy prohibits disclosure;

(f) Even where information as to the name and address of the payee is required to be furnished or tax is required to be withheld so that information in regard to such items at least can be furnished, there is no guarantee as to the correctness of the information. The recipient may choose to give a local address to avoid withholding or deliberately omit to claim refund of taxes withheld at source to avoid detection in the country of source or of residence or both. Similarly, a payer may choose not to disclose the name of the payee, for example, of a commission paid (evidently) to a non-resident alien, and pay the tax imposition himself.

These are some of the important reasons why it may not be possible for a country to transmit full information in compliance with the provision for the automatic exchange of information. Even with these limitations, automatic exchange of information for this category of income is useful. The automatic exchange of third party information is a much more useful device for detecting tax evasion than the exchange of specific information upon request because the latter normally occurs only after a tax administrator has knowledge or suspicion of evasion.
1(b) Evasion of income tax on income from interest, dividends etc., in the source country by non-residents

The problem is fairly simple as compared to the reverse problem - evasion by residents of taxes on their income from foreign sources. The initiative lies with the country itself who can impose an obligation on the payer for withholding tax from all payments made by him whether to residents or non-residents, or may impose a limited obligation in respect of payments made to non-residents only. The latter approach poses some problems and has a potential for tax manipulations. For example, the de facto non-resident may give his (false) address within the country and escape tax withholding or may collect the income through collusion with a resident nominee or through financial institutions or trust entities or through foreign holding companies established in the country. To a large extent the problem can be mitigated by imposing an obligation to withhold tax from all payments of fixed or determinable income to all recipients, whether residents or non-residents. This, however, depends entirely upon the fiscal policies of the country which can balance its needs for revenue with other considerations of facility of commerce, administration etc. However, the procedure in the United Kingdom is worth considering. The United Kingdom law empowers revenue authorities to require nominees (holding companies etc.) to declare details of those on whose behalf income from the United Kingdom securities (including bearer shares) has been received. This provision would prevent dishonest taxpayers from availing themselves of opportunities to conceal some of their income. 4/}

4/ Bearer securities, collection of income through favourable tax-haven treaty or non-treaty countries, exploitation of differing rates of withholding in regard to different incomes by wrong categorizations are some of the methods by which non-residents escape tax in a source country. These can be remedied to a degree by internal law and administrative competence. Circumvention through the intermediary of a tax-haven country will be dealt with separately.

Countries where there are varying rates of tax for different items of income find that items subject to a higher rate of tax are camouflaged as items subject to a lower rate of tax. For example, Mexico finds that non-residents taking advantage of favourable tax treatment of income from interest, float companies with small equity capital and more borrowed money with the result that what would have passed as dividends would now pass as interest, which is a deductible item in the computation of income and is taxed at a concessional rate. Mexico and the Philippines find royalty income often camouflaged as technical assistance fees for which the tax rate is lower. These again are internal matters and are well within the legislative powers of the country to remedy.

2(a) Non-declaration or under-declaration by resident of a country of his business profits from foreign sources

This does not seem to be a major problem with most countries, at least in its direct form.

There can be complete failure to report such income unless information reaches the country of residence of the taxpayer through exchange of information provisions.

The member from Japan suggests inclusion of information about opening of branches or setting up of businesses or opening of bank accounts for purposes of routine exchange. This would prevent a taxpayer from concealing altogether his business activities in a foreign country though he may still conceal a part of his foreign income.

The existence of business activities in foreign countries can come to light when the foreign-source profits get invested and yield incomes falling in categories 1 and 2 and get reported through the routine and automatic exchange of information procedures. However, evasion in this field can be minimized by suitable incentives provided by law. For example, a citizen of the United States of America may claim an exclusion of income earned abroad to a maximum of $25,000 per year and is entitled to a credit against his United States tax liability for income taxes paid to foreign countries. Even so, there is some evidence that some United States citizens operating abroad may not be reporting their income from foreign sources.

The United States approach may help to minimize tax evasion but does not add to the revenue resources of the country. Where, however, the aim is principally the violation of foreign exchange control and not tax evasion, which is only incidental, the incentive just would not work.

2(b) Non-declaration or under-declaration of business profits in a country by a non-resident of that country

This case is on a par with that of a resident of the country. The strength or weakness of administration would control the extent of evasion. Where, however, the non-resident's business activities have links outside the country of his activity, he has also the same scope as a resident for evasion or avoidance through the artifices of under-invoicing and over-invoicing, setting up of dummy businesses or agents or affiliate concerns in foreign countries (frequently tax havens), so as to whittle down the profits and evade taxes both in the source country and the country of his residence. The scope for the non-resident is almost the same as for a resident; he may have more facilities. He may be able to start a business with little capital but with funds largely borrowed in one country, whereas the borrowing would be suspect and might constitute evaded income in his country of residence or in other countries. Account books can be camouflaged to show evaded monies as third party loans from persons of verifiable or non-verifiable identity or as loans from banks, with whom secret collateral securities may have been lodged.

Interest on such loans would in fact be disguised dividends and would constitute a major tax-avoidance technique in the source country. Interest would be deductible in the computation of taxable income in the source country and might also obtain treaty benefits or benefits arising out of preferential rates of tax in the source country. It may also represent evasion for the country of residence if the loans in their open or camouflaged form are made out of untaxed profits, geographical and jurisdictional barriers providing a safe screen for the taxpayer.

As discussed in the course of dealing with techniques in categories 1 and 2, automatic transmittal of information would go a long way towards alerting tax officials of the country of residence of a possible fraud and might trigger off an investigation. However, if the loan is camouflaged as a bank borrowing and interest is paid to the bank, possibly in a third country, even that possibility of detection disappears.
This type of evasion, therefore, cannot be fully covered by automatic exchange of information. There can be little reason for a specific request for information to emanate from the country of residence which has no data which might arouse suspicion. In other words, it is here that both routine and specific exchanges of information fail to work and the answer lies in discretionary transmittals. Officials in the country of source, while auditing accounts of the non-resident, would notice these loans which might even be supported by documents from abroad. Experienced officers who are by training sensitized to fraud situations may reasonably suspect the genuineness of these loans. They may not be concerned so long as the loans are genuine and interest is a proper charge on profits, but to the country of residence of the taxpayer the information may be a vital clue to a potential tax fraud. What is necessary for the tax officials of the country of source is to take the initiative and transmit the information suo motu to the home country of the non-resident.

By their very nature, discretionary transmittals lack uniformity and depend entirely on the initiative, enthusiasm or competence of the concerned officers. They bear all the imprint of the strength or weakness of the concerned administration. A weak administration may fail to react and locate items which would prove of immense help to another country's administration and, if that administration were a strong one, it would have missed getting useful clues to tax frauds that they could have vigorously pursued. On the other hand, a strong administration may locate important clues and transmit the same to another weaker administration which may fail to make full use of all the information received from the transmitting country. These are normal limitations, whatever the system of transmittal, and should not prevent treaty countries from including discretionary transmittals in the article on exchange of information if a specific mention is necessary. Developing efficiency in administration is a matter of time and all administrations may be expected to reach reasonable standards of efficiency in course of time.

A resident with business links outside his home country and a non-resident with links in his home country can both manipulate their profits through various devices commonly employed for the purpose. These will be specifically dealt with while dealing with tax frauds in category 5.

Certain types of frauds, however, can be dealt with successfully only through discretionary transmittals. A provision has, therefore, to be made for this in treaty articles on exchange of information if these frauds are to be effectively dealt with.

3(a) Wages, salaries and other earned income from foreign source accruing to residents of a country and remaining undeclared

Evasion in this field is believed to be marginal by most countries. In some countries the income of a resident arising outside the country is not taxable unless remitted, as in the case of Ghana, so that the question of tax evasion in respect of such income does not arise (at least in the initial stages). In some countries the concessions offered to earned incomes abroad are such that there is hardly any incentive for evasion, e.g., the United States of America. For a resident of any country, occasions for accrual of income abroad from wages, salaries etc., are limited so that evasion could also have limited dimensions. For example, in Sri Lanka it may be the journalists deriving income from articles contributed to
foreign publications. In the case of France, it may be payments abroad for services such as technical studies or advice, fees for occasional work and payments to managers or partners of foreign firms, pensions and annuities.

The country of source can impose deduction of tax at the time of payment (as in the case of dividends) and may also transmit information to the country of residence of the payee. This would protect the interests of both the source and the home country; otherwise, there is a possibility that such income may escape taxation altogether.

3(b) Evasion and avoidance of taxes on wages, salaries and other earned incomes by non-residents of a country

The normal approach adopted by most of the countries is to deduct tax at the source at the time of payment. Botswana finds taxes evaded in respect of payments made to contractors and labourers drawn for their work projects from neighbouring areas. Even where assessments are raised successfully, taxes remain uncollected. Such a situation can be effectively dealt with by domestic legislation imposing tax deduction at the source.

There are two aspects of the problem which need special mention. Non-resident employees of foreign firms or employees with temporary residence in countries where they are treated on a par with residents have a strong tendency to declare only the salaries and wages etc., offered in the country of employment and not the part wages, salaries, other benefits perquisites provided in the home country. The home countries of such employees would not like to co-operate by supplying information on a routine basis or on specific request unless they were assured that such employees would receive a reasonable tax treatment which was in keeping with their status of temporary residence. There is an element of inequity in treating persons, who become residents of a country because of the operation of law but who in fact are to revert back to their home country, on a par with the permanent residents of the country. Unless an equitable solution is reached to this genuine problem which arises in international taxation, home countries will feel inclined to protect the interest of their nationals and refuse to supply information. The solution is either to develop taxation based on different grades of residence or restrict seeking of information only to the nationals of the requesting country. In any case, ways and means of meeting the problem need to be studied.

There is another technique of tax avoidance to which reference needs to be made. Under many tax treaties of the United States of America, an alien would not be taxed on his income from personal services rendered in the United States if he were not present in the United States for more than 183 days during the tax year and were employed by an employer who was a resident of the country with which the United States had a treaty. Normally, an alien person satisfying the condition of residence and employed in the United States would expose himself to United States taxation; but if, instead, he became an employee of a foreign corporation (of non-resident aliens) deriving income from performance of services in the United States and such corporation lent his services to the United States employer, he would avoid United States tax. He may also succeed in avoiding the tax of his country depending upon the treaty provisions or the laws of his country of residence in regard to income from foreign sources. Such tax escapes are implicit in the law or the tax treaties and have to be accepted as such unless the law and the treaties change accordingly.
4. Overstatements - by non-resident taxpayers doing business within a country, or by tax-exempt enterprises controlled by non-residents doing business within the country, or by domestic enterprises operating abroad - of expenses for services rendered within the country to such taxpayers by non-resident technicians and experts not affiliated with such taxpayers.

This category refers to expenses for services rendered by non-affiliated technicians. The problem of expenses between affiliated persons such as parent and subsidiary, head office and branch etc., is almost similar and will be considered here, although it is covered in category 5. Most of the responding countries - particularly the developing countries - have distinguished the question of technicians' fees and other head office charges from pricing of goods and supplies because in the former case there is little scope of getting comparable data while in the latter such data can be had, at least theoretically, by applying the arm's length principle.

Laws of almost all countries provide for admissibility of expenditure only to the extent it is genuine and is justified with reference to the business requirements. For example, the law in Mexico sets forth:

"That in the case of payments to persons resident abroad for technical assistance, proof must be submitted to the Ministry of Finance and Public Credit that the party providing such assistance possesses the technical facilities to provide it, that it is furnished directly and not through a third party, and that services are actually provided and not merely made available." 5/

In the United States of America, tax returns of domestic enterprises and non-resident taxpayers doing business in the United States are subject to audit, and expenses which are not found to be ordinary and necessary for the business can be disallowed.

Spanish law permits allowance of such expenses only when payment can be justified as effected under normal circumstances, taking into account the special relationship between the payer and the recipient, and the taxpayer is responsible for proving that such circumstances exist.

In fact, laws and procedures of almost all countries provide for allowance of only that much of expenditure as is considered reasonable and necessary. However, the difficulty is in the application of the legal provisions and not in their lack. One needs data to form a judgement as to the reasonableness and necessity of such expenditure. Even where data is available, the task of evaluating it is not an easy one because a tax official is not a technician himself and there is always scope for allowing much more than what the realities of the situation would demand, even if one were to examine the matter critically. In the ultimate analysis, the taxpayer gains; but maybe his gains are not to the full extent.

The question of over-payments of technical services fees can now be examined with reference to affiliated and non-affiliated technicians.

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5/ Tax Treaties between Developed and Developing Countries, Fourth Report (United Nations publication, Sales No. E.73.XVI.1), pp. 136-137.
If payments are made to independent technicians rendering technical services, there can be no suspicion attached to such payments. Such payments are on a par with the arm's length prices in case of goods and are beyond reproach. There is, however, a subtle difference between the two. Import or export of goods is a verifiable fact being physical in nature and prices of such goods are amenable to comparison with international prices. That is not so in regard to technical services, which are more or less intangible and are incapable of being subjected to strict proof as to their actual rendering or their quality or their utility to the enterprise. In case of international transactions, there are also questions as to whether those rendering services are genuine persons or dummies and whether they are competent and qualified to render such services. These are questions which have to be answered before a judgement can be formed about the reasonable value of such services. If there is a suspicion that charges for technical services rendered abroad are fictitious or inflated, there has to be a mechanism to settle such a suspicion. This mechanism is provided by the exchange of information provisions. A specific inquiry could be addressed by the requesting country soliciting information on the qualifications of the technical expert, the field and extent of his activity in the country of his residence, receipts from technical fees during the year (to evaluate the quantum with reference to his annual income), whether he is really independent or is affiliated directly or indirectly to the taxpayer and so on. In other words, the emphasis of the inquiry would be to ascertain whether the technician is a genuine person or a dummy and whether he is competent enough to render such technical services as are stated to have been rendered. A specific exchange of information is the only answer to the question. If the technical expert is qualified or otherwise competent to render technical services and he is really independent, the need to question the quantum of his fees would ordinarily not arise. If he were qualified and competent but not independent, the quantum could be determined with reference to charges in similar cases or in similar circumstances.

The question of allocation of indirect costs of head office in the case of branches in host countries is admittedly a difficult one. The general trend is to inflate the allocation to host countries if their rates of tax are higher. These expenses being for intangible services, it becomes difficult to challenge the correctness of such allocations for want of adequate data. Further, this question is closely linked to the transfer pricing policies of the parent organizations. Data on transfer pricing or the need for such intangible services can best be obtained from the tax administration of the home country under a comprehensive programme of exchange of information.

5(a) Imports and exports by residents of a country at unrealistic prices

This is one area where there is a wide prevalence of tax evasion. The problem, in so far as it relates to non-affiliated enterprises, is examined here while that relating to affiliated entities is examined under a separate category because the problem in that case is vastly different and falls largely in the area of tax avoidance.

When a transaction is between two non-affiliated entities, it would normally be presumed to be genuine because it prima facie satisfies the arm's length test. In such a situation, there should ordinarily be no reason for further questioning, but the experience of almost all developing countries has been otherwise. They have found that they suffer most both as regards their tax revenues and foreign exchange
resources in the two areas of tax avoidance and evasion covered by categories 4 and 5. For example, Ghana finds that "inflation of invoices for imports is a common feature of business practice ... A random examination of only 24 invoices in March 1972 showed increases in prices ranging from 1% per cent on a consignment of refined sugar, to the extraordinary figure of over 1,600 per cent on drugs." 6/ Pakistan's experience is no different. According to it, "foreign enterprises operating in Pakistan through subsidiaries are reported to have sold semi-processed goods to their subsidiaries in Pakistan at 1,000 times the normal price." 7/

Developed countries also have the same problem. It may not be as serious for them and the motivations may be different but the problem still exists for them as much as it does for developing countries. There is no complete answer to it. However, exchange of information is possibly the best solution, taking all circumstances into account.

In the absence of treaty provisions, there are difficulties in getting even elementary and basic information from taxpayers themselves. Sri Lanka expresses this difficulty in the following terms:

"In the investigation of such practices the Ceylon (Sri Lanka) Revenue Department has experienced difficulties in obtaining, even through taxpayer, certificates from the taxing authority in the country of domicile of the taxpayer giving details of gross receipts, taxed income, tax paid etc., relating to the parent business." 8/

Where the import is from an independent entity, there can be no question of over-invoicing unless there is collusion between the local importer and the foreign exporter. The collusion could be direct or through an intermediary or a dummy set up in the foreign country for passing on inflated invoices, or there may be an agent of the foreign exporter (only as a front for the local importer) to receive commission on exports made to the local importer, the amount of commission being embedded in the invoice which is thereby inflated to that extent. Inflation in the invoice price would help the importer to reduce his profits in the country of his residence and further help him siphon off the foreign exchange to the extent of inflation in the invoice price. If import is of a trading commodity, benefit in tax accrues to him in the same year or at the latest when he effects the sale. If the import is of a capital plant or machinery, benefit accrues over a number of years by way of extra depreciation and investment allowances with reference to the inflated value. Over-invoicing of imports, therefore, has two consequences to the country of the importer. It loses on revenue as also on its precious foreign exchange resources.

An importer, however, resorts to many subtleties to achieve his aim of shifting income and foreign exchange (usually out of developing countries to developed countries), balancing his over-all interests in relation to other impositions such as customs duties, trade conditions, etc. For example, he may

6/ Ibid., p. 143.
7/ Ibid., Third Report, p. 60.
8/ Reply of the Government of Ceylon (Sri Lanka) to the "Questionnaire on international income-tax evasion or avoidance" (ST/SG/AC.8/R.12).
resort to misleading descriptions, quality and quantity variations etc. in
documents, but all such subtleties necessarily involve active co-operation of the
foreign exporter or the importer's dummy in the foreign country.

In order to judge or even to have a reasonable suspicion of over-invoicing of
imports, the basic requirement is to have commercial intelligence about
international prices of imported goods. There are many shades of differences in
quality; market conditions vary from time to time or from one geographical area to
another so that even the utility of commercial intelligence is limited. As has been
observed in relation to Mexico:

"There are many products which have no international price or whose
international price is difficult to determine exactly; again the manipulation
may involve other cash components - for example, freight charges in the case
of an international enterprise which is also engaged in the transport
business." 9/

Despite these limitations, there is no doubt that the information would be of
immense help to tax administrations, which could detect with ease cases of
flagrant inflation of import prices of the type reported by Pakistan and Ghana.
This could be the starting point for an intensive inquiry. Without such data, there
could be no inquiry and even where one was undertaken, it would be of an exploratory
or fishing nature. Commercial intelligence, therefore, provides a firm base for any
inquiry that may have to be initiated. International prices as disclosed by
commercial intelligence can be adjusted suitably in the light of various factors
affecting prices so that a realistic appraisal can be made of the import prices of
specified items of import and in respect of specific importing countries.

Apart from commercial intelligence, there are other sources as well, such as
audit of taxpayers' accounts, inspections and searches, which throw up definite
evidence of over- or under-invoicing. The under-invoicing of jute goods, referred
to in the case of India 10/ establishes the importance of exchange of information
without which it is not possible to prove conclusively the under-invoicing. One
needs evidence from the other end to corroborate the evidence locally gathered in
order to sustain an assessment and also to prove a fraud in a court of law.

Commercial intelligence has to be gathered on a routine basis but
investigations into specific cases can be made only through evidence collected on
specific request. Specific request has two facets: one, where the request is made
for information in a specific case on specified point or points; and the other,
where the technique is of such wide prevalence that one can reasonably presume that
a case falling in this area is a potential tax fraud case and start inquiry on the
basis of this presumption.

So far as the first type of case is concerned, one can draw up a general list
of points on which information would be necessary. Take, for example, the case
where there is a definite suspicion of over-invoicing of imports. Points on which
information would be necessary would be somewhat along the following lines:

9/ Tax Treaties between Developed and Developing Countries, Fourth Report,
p. 133.
10/ Ibid., p. 118.
(a) In cases where the transaction is directly entered into between the local importer and the foreign exporter:

(i) Date of contract/order;

(ii) Specification of goods contracted;

(iii) Price contracted;

(iv) Prevailing market price on or about the contract date as determined from local sales or sales contracted for by other importers in the same country and importers in a few adjoining countries (depending upon the circumstances, a few random instances should suffice); whether the contract price is the same as invoice price and, if not, how it differs and how the difference is accounted for;

(v) If there is any payment towards discount, commission, rebate, price difference and/or quality difference or damages in regard to these imports to any person in the country of export or if there is any remittance on account of any of the aforesaid reasons to any person other than the actual importer in the country of import or in any other country, give:

   a. The name and address of the payee, date of payment, amount paid and the nature of payment;

   b. If the payee is a firm, also give name and address of partners; if the payee is a private company, name and address of shareholders, date of registration of the company, its issued and paid up capital;

   c. If the recipient is the importer himself, amount, date of payment and nature of payment.

Since the case is for investigation, detailed information along the above lines, which may vary depending upon the actual facts of a case, would be necessary.

(b) Similarly, where the transaction is presumably between a so-called agent of the exporter, and not the exporter himself, points on which information may be necessary to conduct further investigations would be somewhat along the following lines:

(i) Name and address of the agent, consignor or the entity which makes the invoice;

(ii) Constitution of the entity, whether individual, firm or a company with details as in (a) above;

(iii) Nature of business and sources of its supply (if intermediaries are introduced to make investigations difficult, please trace some items of exports right to the real exporter, price billed by the real exporter and ultimate price charged in the invoice made to the importer);

(iv) Other points of inquiry as in (a) above.

These are specific cases, in which investigations are undertaken on the basis of
definite evidence but which need to be substantiated by facts obtained from
country of export.

Tax officials in the country of export can come across clues while auditing
the exporter's case or the case of the dummy agent of the exporter or importer and
if they were to transmit relevant facts as to over- or under-pricing of exports and
imports and the modus operandi employed for the purpose on a discretionary basis of
exchange of information, it would help the importer's country a great deal. They
would have a picture of manipulations at the other end and with that data it would
be easy for them to uncover the tax fraud. In this important field of tax evasion,
discretionary transmittal of information can play a vital and effective role.

The second facet of specific exchange of information is the one which relates
to a class of cases where there is a well-founded belief of a certain type of
manipulation; in other words, where the manipulation is of a specific type though
there may not be evidence for suspicion in a specific case. The most common class
consists in the practice of giving a commission or a kick-back to the importers of
capital plant, machinery, spare parts, etc. The practice is so widely prevalent
that one can almost presume tax fraud and start off an inquiry to ascertain the
facts. The points on which inquiry need be made would be somewhat along the
following lines:

In case of import of machinery, etc.: is there any discount, commission or
rebate paid to any one in the country of export or remittance to any one etc.? There
cannot be routine exchange of this information because, being secret in
nature, no Government is likely to have it in a manner which can be transmitted
automatically. However, if the importer's country desires to probe into such
purchases even on a selective basis, it can make a specific request for information
on the lines detailed above in regard to some specific items of import by
taxpayers of doubtful reputation or in respect of some of the representatives of
companies and Governments who are authorized to make purchases abroad on their
behalf. This aspect of tax fraud can also be effectively covered under
discretionary transmittals by the country of export.

5(b) Transactions of purchase and sale, royalty and interest payments, management
fees etc., between affiliated taxpayers (such as parent and subsidiary, head
office and branch) at unrealistic prices

This is an area where there is vast scope for tax avoidance by shifting income
from one country to another, according to the policy the parent company or the head
office wishes to pursue in its relations with its subsidiary or branch. The
elasticity and the complexity of the "pricing" mechanism is as much a help to the
taxpayer in achieving the desired income allocation between affiliated concerns as
it is a hindrance to him in having his allocations accepted by the tax authorities
even when there are good reasons in support. It is, indeed, a complex problem
which has no solution that is simple and fair to all the taxpayers and the tax
administration. These transactions are always viewed with suspicion by the tax
administration and their treatment of them often smacks of arbitrariness. But it
would not be fair to blame any administration, because the problem has to be
judged on facts which are incomplete, sometimes absent and most of the time
nebulous.

A review of the replies to the United Nations questionnaire shows that almost
all countries have a feeling that they lose their due share of revenue from international profits on account of manipulations in income allocations. Developing countries have an added reason to feel aggrieved because this also results in loss of their valuable foreign exchange resources. Ghana, India, Israel, Mexico, Pakistan, the Philippines etc., estimate substantial losses on this account. It was pointed out by a member from a developing country "that the annual loss of tax revenue and, in particular, foreign exchange suffered by his country was of major proportions even in relation to the foreign aid that the country received." 11/

Developing countries' views on the matter can be summed up by the following extracts from a study on exchange of information and international tax evasion and avoidance in Mexico:

"The very same free enterprise, freedom to set market prices and unrestricted recognition of private property which have been protected and encouraged at home by so many countries become, when projected into international markets, instruments of exploitation and of steady flows of wealth progressively enriching the rich countries and impoverishing the weaker countries." 12/

"Developing countries which trade with developed countries are the ones that suffer the harmful consequences of such arrangements, which make their imports more costly, reduce their export profits and deprive them of the tax benefits which they should receive from an equitable attribution of profits." 13/

Unrealistic and artificial income allocations and transfer pricing policies followed by parent companies and head offices in relation to their subsidiaries and branches pose a big problem for the developing countries. It is also a problem for the developed countries which are affected by manipulations in transfer prices through the mechanism of tax-haven countries; only the extent and motivations differ. In the case of developing countries, factors influencing adverse transfer pricings may be unstable political conditions, apprehension about expropriation or devaluation of currency control on remittance of profits etc. There a number of tax and non-tax factors that go into the determination of transfer pricing. In case of developed countries, the major consideration is the over-all tax liability. Of course, when transactions are between developing and developed countries, the consideration that weighs is the one which governs dealings with developing countries in the light of the conditions prevailing there. In regard to transactions between developed countries or between developing and developed countries, there may be a further minimization of their tax liabilities through the mechanism of tax-haven countries.

Almost every country, whether developed or developing, has provided in its laws measures to counteract the effect of this pricing mechanism. The United States of America has evolved complex and sophisticated rules promulgated under section 482 of the Internal Revenue Code to determine transfer prices between

11/ Ibid., Third Report, para. 151.
13/ Ibid., p. 133.
related entities acceptable to the Internal Revenue Service in regard to tangibles and intangibles such as: (a) interest charges; (b) service charges; (c) charges for use of tangible property; (d) charges for transfer or use of intangible property; (e) charges for sale of tangible property. Other countries have mostly followed the general principle of arm's length test. A few examples of the type of legislation provided to counteract the effects of the pricing mechanism are given below:

(a) Article 19, section VI(b), of the Income Tax Act of Mexico states that taxable income shall be deemed to include "the difference between the prices declared by the taxpayer and those specified by the Ministry of Finance and Public Credit, whenever prices declared do not correspond to true market prices. In such cases, the Ministry shall, for the purposes of this Act, specify the prices, taking into account the invoice price, official prices and prevailing price on the domestic or foreign market". As regards deductions for the purpose of determining taxable income, it is laid down that "whenever the purchase price declared by the taxpayer in respect of imported goods does not correspond to true market prices, the Ministry of Finance and Public Credit shall specify the price, taking into account the invoice price, official prices or prevailing prices on the domestic or foreign market"; 14/

(b) Sri Lanka has necessary provisions made in section 15(1)(a)(ii) and sections 57, 58 and 59 of the Inland Revenue Act No. 4 of 1963. Their approach to the problem is as follows:

"There are cases where the allocation of income to the enterprise in Sri Lanka is either difficult or the method of costing and accounting as between the local enterprise and the non-resident corporation results in transfer of income away from Sri Lanka. Special provision has been included in the tax law to empower the assessment of a fair percentage of the turnover as the income arising in Sri Lanka. This rule is applicable in a case where an enterprise is closely connected with the parent or other non-resident organisations and the profits disclosed in the accounts of the local enterprises are lower than what is expected in the case of an independent merchant in the same line of trade." 15/

India, Israel, Pakistan etc., have provided suitable machinery in their laws and rules to deal with this problem. The United Kingdom has similar provisions made in section 485 of the Income and Corporation Taxes Act, 1970.

Principle underlying arm's length test

Following is a very cogent analysis of this principle:

"A correct determination of business profits is essential to imposition and collection of an income tax. Net profits are the tax base; without a tax base, there is no tax. The legislature that imposes an income-tax on business profits necessarily assumes that the tax will be borne in relation to net

14/ Ibid., Fourth Report, p. 133.
15/ "International income allocation" (ST/SG/AC.8/L.7)
profits determined in some consistent, uniform and reasonable manner. In the most fundamental sense, rules of allocation seek only to ensure that the business profits against which the income-tax is levied are correctly measured and reported in accordance with neutral and objective criteria.

"When profit-seeking transactions occur across national borders, no special problems arise for income-tax purposes if the parties to the transactions are unrelated to one another. Net profits of a taxpayer from such international transactions are determined by market forces similar to those that operate domestically, and the tax administrator must take those profits as he finds them. When the transaction involves related entities, however, market forces may not be the only element at work. The tax advantage in having profits arise in one entity rather than another could affect, for example, the price set by the controlling entity and 'agreed to' by the subordinate entity, or the rate of interest, if any, paid on a loan from one controlled entity to another. Rules of allocation seek to articulate general standards against which a wide variety of transactions among commonly controlled entities are measured in order to determine whether the split of net profits which the controlled parties arrive at accurately reflects the full profits to which each is entitled solely on the basis of business function and market forces." 16/

Granting that arm's length price is a reasonable answer to the pricing problem, the question still remains as to what is arm's length price or the market price.

"One view of this rule is that 'arm's length' refers to the firm's selling price to its 'largest domestic customer, reduced by domestic selling expenses, freight, advertising, and a portion of home office expense normally allocated to advertising, marketing, and distribution functions ... We believe that this calculation can be defended in any discussion with IRS'. Another firm defines 'market price' as being 'either (a) the minimum price at which the supplying unit of the company would sell to an unrelated buyer, or (b) the maximum price at which the purchasing unit would buy from an independent supplier'." 17/

Determination of arm's length price is thus no easy matter. There are chronic difficulties in administering and complying with a rule based upon comparables. No two transactions can be identical. There could be differences in time, geographic market, market level, quantity and quality of the product which may go to account for the difference in prices even for otherwise comparable products.

Even the most sophisticated regulations in the United States of America have not solved the problem to the satisfaction of the taxpayers and the tax administration. True, it has brought about a certain amount of certainty and uniformity in judgement which otherwise would be more or less empirical and subjective.

16/ "International allocations of income" by Louis M. Kauder (ST/SG/AC.8/L.5), p. 5.

In view of the difficulties involved in a fair determination of the transfer prices of tangible and intangible properties charged among related entities, it would be necessary to prepare guidelines on the subject of allocations by the present Group of Experts. On the basis of these guidelines, it would be better if the treaty countries would spell out acceptable principles of allocation, preferably in the protocol or the notes exchanged along with the treaty. The treaty should simultaneously consider provisions to mitigate hardship to taxpayers involved in double taxation of income which follows income reallocation. For example, if part X of income assessed to tax in country A is now included on reallocation to country B, there would be taxation of part X of income in both countries A and B. In fairness, to the taxpayer, there has to be a satisfactory provision in the treaty (including waiver or relaxation of time limits) to alleviate the hardship.

The treaty will also have to provide for assistance in tax collection because manipulations in transfer pricing have the inevitable effect of removing funds out of the jurisdiction of the country which may succeed in raising a firm assessment without finding funds to collect the tax liabilities so determined.

To sum up:

(a) Some definite guidelines on transfer pricing of tangible and intangible properties between related entities deserve to be laid down by the treaty countries;

(b) Steps are necessary to alleviate hardship which income reallocation would lead to, inasmuch as there would be double taxation of a portion of the income;

(c) Provision needs to be made also for assistance in collection.

Once the guidelines are agreed upon by the treaty partners, exchange of information, whether on specific or routine basis, would be necessary for the implementation of these guidelines.

Until such time as the guidelines are decided upon or such time as the treaty countries agree on a bilateral basis on the criteria for determining arm's length prices, it would be necessary to obtain information on comparable prices for tangible and intangible property on the lines similar to those detailed under category 5(a). Sometimes it may be better for a country to resort to ad hoc evaluations based on percentages of turnover or on a proportionate basis of local turnover to world turnover. For that purpose, it would be necessary to obtain details of world turnover, world profit, details of head office expenses proposed for apportionment etc.

6. Use of "holding companies" or other agents located in foreign countries to receive income directly or indirectly accruing to residents of a country from sources situated in foreign countries

The survey of replies to the United Nations questionnaire on international income-tax evasion or avoidance shows that the problem concerns only some of the developed countries. It does not seem to be much of a problem for developing countries. The reason seems to be that accrual of profits and flow of funds is in favour of residents of developed countries who, therefore, continue to minimize their over-all tax liability through the mechanism of holding companies established mostly in tax-haven countries. Stringent foreign exchange regulations and control
on foreign investments, as in Japan, also prevent formation of holding companies as instruments of tax avoidance.

Some developed countries have not felt this to be much of a problem because they can deal with it through domestic legislation designed to deter tax avoidance. To them the problem is more domestic than international. Some countries, however, have found techniques of tax avoidance through the instrumentality of holding companies set up in tax-haven countries so widespread as to cause them serious concern. Such countries have dealt with the problem through domestic legislation and vigorous enforcement. For example, the United States of America adopted special legislation in 1962 (known as the "subpart F" provisions of the Internal Revenue Code) to tax certain categories of operating and investment income of foreign corporations controlled by United States citizens and to treat indirect repatriations as constructive dividends. The United Kingdom deals with the problem through section 478 of the Income-Tax Act which empowers the authorities to tax directly a resident individual where he transfers to or creates in a foreign person property or rights of any kind and retains simultaneously the "power to enjoy" (either immediately or at a future date) the income of the foreign person. Canada and Germany have also adopted suitable legislation to deal with the problem.

In other words, the problem of tax avoidance through holding companies set up in tax-haven countries is of such a nature that it can be dealt with by a country through unilateral domestic tax legislation. This solution may not be wholly satisfactory, but that is so in the very nature of things. Whatever the legislation, there would be tax avoidance within certain limits; what can be tackled is the blatant case.

There are four factors which contribute to facilitate tax avoidance in this category: (a) flexibility of available legal forms such as personal holding companies, holding companies in general, trusts etc.; (b) tax-haven countries with low or zero income-tax rates or tax exemption of foreign-source income; (c) favourable tax treaties with other countries; and (d) secrecy laws. Through use of these facilities, tax avoidance is achieved by a variety of techniques which include (a) the transfer of income-producing assets (stocks, securities, rental properties etc.); (b) the transfer of income producing functions; (c) the payment of excessive deductible expenses to or for the benefit of a tax-haven entity. Favourable tax treaties coupled with provisions of domestic tax laws such as those which relate to income of "permanent establishment" or the application of the "title passage" test for determination of income source foster tax avoidance under this category.

It is not the intention of the present paper to discuss the techniques of tax avoidance in detail through tax-haven countries. These are dealt with at great length in various United Nations reports which unravel the intricacies of this mechanism. This brief reference is intended only as an aid in understanding the nature of tax avoidance and how far and in which manner the exchange of information provisions can help in counteracting it. The type of information required to be exchanged towards this end is discussed below.

18/ Tax Treaties Between Developed and Developing Countries, Third Report, p. 54.

19/ Ibid., p. 71.
Cases where the host country has a treaty

We assume that there is a treaty between the country of residence of the taxpayer and the foreign country usually the tax haven where the holding company or other agency is set up. In order to counteract tax avoidance through this mechanism, it seems necessary that the following information be transmitted on a routine basis by the host country (i.e., the tax haven):

(a) Name and address of the company, agent, investment trust etc.;

(b) In case of company, issued and paid-up capital, names and addresses of shareholders for proper identification together with details of their shareholdings; in case of other entities, information regarding persons concerned and their financial interest;

(c) Amount of loans and bank borrowings: in case of loans received and advanced, necessary details as to the persons concerned and the amounts in each case; in case of bank borrowings, details of collateral securities wherever deposited; in case of advances, securities against which advances have been made; details of securities to show their ownership (information is required in respect of those whose addresses fall within the home country; in case of shares held by nominees of a corporate entity or any other person, further information is required as to persons whose nominees hold the shares);

(d) Nature of business, whether holding investments, manufacturing, trading or servicing;

(e) Countries with which substantial activities are carried on. This is the basic data which needs to be transmitted on a routine basis. It is then that the home country can consider the applicability of its measures to deter tax avoidance. To obviate unnecessary strain on the administration of the host country in reporting the information, it would be better to transmit complete information in the first year and thereafter only the changes until enough changes have accumulated to make it desirable to repeat the complete information - say, every four or five years.

A scrutiny of the routine information may be required to be followed up by inquiries on specific points. They are likely to be somewhat on the following lines:

(a) In case of assets (such as stocks, securities etc.) held in the host country, names and addresses of the real owners with full details of their holding including specification and nature;

(b) In case of tangible assets for manufacturing operations, details of machinery, names and addresses of the vendors or transferors with sale or transfer price, products manufactured, cost of manufacture, sale price, gross profit percentage, total profit (gross and net);

(c) In case of servicing activities, whether these activities are carried on by technical personnel of the host country, name of entity, the base of their operation and their location (i.e., whether they are stationed in the host country or home country, though employees of the host country entity); whether these activities are carried on through servicing facilities consisting of technical
personnel or property belonging to and provided by the controlling entity, the host country company merely acting as a conduit for accepting orders and arranging for actual services to be rendered by other organizations (evidently belonging to the controlling company); in the latter case, state charges paid to the controlling entity and charges received from those to whom services are rendered.

(d) Details of management fees, technical service fees etc., paid to the controlling entity in the home country; total expenditure of the host country company under administrative and other heads so as to determine the expense component of payments made to the home company in relation to the total expenditure of the host company.

These are only illustrative of the types of information necessary to formulate findings and arrive at conclusions. They would vary with varying circumstances and cannot be spelt out exhaustively. The illustrative list can be expanded or abridged depending upon the nature and volume of tax avoidance activities and the extent of co-operation agreed upon between the treaty partners in the programme for exchange of information.

Cases where the host country has no treaty

In the absence of a treaty, there is no way of getting information from the host country where the holding company and other similar entities are set up as a part of the scheme of tax avoidance. Whatever information can be obtained is only through the taxpayers themselves, who may be either shareholders of the company in the host country, vendors of tangible assets, licensors or patent holders of intangible assets given for exploitation to the entity in the host country (tax haven). However, there would be no check on the correctness or completeness of the information received at the home country end in the absence of information or data from the other end.

7. Use of "bearer shares" issued by enterprises situated in a country by non-residents of that country to evade taxes

8. Use of "bearer shares" issued abroad by residents of a country to evade taxes of his country on his income from foreign sources

Replies received from various responding countries show that this is hardly a problem with them. Theoretically, it is a fertile area for investment of tax-evaded funds but in practice the problem does not seem to exist. The reason for this appears to be that most of the countries do not issue "bearer shares"; there are alternative channels of investment such as numbered bank accounts or facilities for investment and collection of income in an anonymous manner. For example, financial institutions such as investment trusts and holding companies in third countries are used for the purpose of keeping securities in their safe custody and collecting resulting incomes. These institutions issue certificates in bearer form against the securities kept by them in safe custody.

This problem can be tackled only through legislation such as is embodied in section 24 of the United Kingdom Taxes Management Act, 1970, according to which United Kingdom revenue authorities are empowered to require nominees to declare particulars about those on whose behalf income from United Kingdom securities has
been received and this power extends also to "bearer shares". Thus, anyone by or through whom income from such shares has been paid must, if required, disclose the identity of their beneficial owner.

This tax avoidance technique is adopted to escape detection. Bearer shares or bearer certificates bear no name and are negotiable by delivery and do not need an endorsement. The only way to tackle this problem is to institute legislation along the lines of United Kingdom legislation in countries where such practice exists or on a global basis if exchange of information provisions are made multilateral.

Legislation alone does not solve the problem, which has many administrative angles. Are all "nominees" located in a country to be asked to furnish information about all the beneficial holders? If not, which of them should be required to furnish the information? Should they be asked on a selective basis or on a rotational basis? Unless information is collected from the "nominee" and collated, there can be no transmittal of information to the countries of beneficial owners. It is an administrative problem which can be tackled by a country depending upon its administrative capacity and capability. There can also be no specific request except in rare cases where the requesting country has information and desires to verify it. However, discretionary transmittals can play an important role. Where tax authorities of a country have obtained information from the "nominee" holders, they can transmit voluntarily information to their treaty partners in respect of persons (beneficial owners) whose addresses fall within the treaty country. Such a procedure is simple and does not involve any extra burden on the country's tax administration provided it is authorized to do so by the exchange of information provisions of the treaty.

B. International co-operation through exchange of information

Analysis of the predominant patterns of international income tax evasion or avoidance establishes beyond doubt that exchange of information on a comprehensive basis and by all modes of transmittal - routine, request or discretionary - is the only effective answer to these malpractices. Complex and sophisticated devices employed to circumvent or bypass legal provisions of treaty countries and treaty articles by routing transactions through non-treaty or tax-haven countries call for a multilateral or preferably a global approach to exchange of information. If all States co-operated closely, it might be possible to deal with tax fraud and evasion effectively. A convincing case for co-operation has been made out as follows:

"Such co-operation would take the form of joint administrative action in various fields where unilateral action, such as the traditional treaty assistance, proves inadequate. Psychologically, a public declaration by a number of States of their refusal to acquiesce in the growth of international fraud and of their common determination to take action to reduce its scope would undoubtedly produce great effects.

"The adoption of such a stand would impel States which now acquiesce in irregular fiscal practices to reconsider their position. More generally, it might induce States which earnestly believe in fiscal justice and are resolved to apply the necessary measures to join the group which first took the initiative. The practical expression of such co-operation would be an
improvement in exchanges of information and a broadening of the scope of routine exchanges." 20/

1. Routine transmittal

The responses of different countries to routine transmittal of information are not uniform. While some consider it to be an unnecessary strain on their scarce and overstrained administrative resources, whether they are receiving or transmitting the mass of material under routine exchanges, others find it useful and have, therefore, provided for it in their tax treaties. The latter view is best expressed as follows:

"The routine exchange of information, where stipulated, is the most effective procedure for assistance in reviewing tax assessments. Under this procedure, each State is supplied with information concerning taxable resources or events giving rise to tax liability, the existence of which it might not even have suspected, so that it would have been quite unable to set in motion the machinery for exchange of information on request." 21/

The analysis of patterns of tax fraud in section A establishes that it is not one method alone that can provide a satisfactory answer but it is a combination of all methods of transmittal that can prove effective:

"Where the agreement provides both for routine exchange of information and for exchange on request, the latter form of assistance in assessment is an indispensable complement to the former and the aggregate of the measures taken enables a systematic check to be made; in practice, specific requests for information will refer to documents already transmitted as a matter of routine and will be aimed at obtaining additional details regarding the information contained in those documents; in this way, errors will be rectified, omissions made good and cross-checks carried out much more readily, since the previous routine exchanges of information will have enabled both countries to constitute basic files.

"If, on the other hand, provision is made for the exchange of information only on request in particular cases, the effectiveness of exchanging information will be appreciably reduced, and all that will be possible through this procedure will be test checks of the actual or assessed amount of taxable resources the existence of which is already known to the applicant administration." 22/

The analysis in section A shows the nature and type of information that has to be available before an investigation can even be contemplated. It is the ignition point which triggers off an inquiry. On the basis of the section A analysis and the replies received from various responding countries to the United Nations questionnaire, a list of all those items of information which are considered necessary for routine transmittal can be compiled as follows: (a) interest;

20/ Ibid., p. 133.
21/ Ibid., p. 123.
22/ Ibid., p. 125.
(b) dividends; (c) rent; (d) royalties; (e) commissions; (f) technical fees; (g) transactions in movable or immovable properties over specified limits; (h) earnings of artists, athletes and professionals; (i) salaries and wages; (j) assets like shares, securities deposits and house property; (k) duplicates of claims to repayment of tax made by non-residents; (l) details of non-residents receiving income relieved from the country's tax at source; (m) details of non-residents who have claimed exemption from tax; (n) information as to property acquired by inheritance, bequest or gift, opening of a branch, an office etc. (including an establishment with substantially similar functions), creation of a subsidiary, and names of banks etc., which deal with above branch, office, subsidiary etc.; (o) information as detailed in section A 7.

The list is fairly comprehensive. If the routine exchange is implemented through bilateral treaties, the treaty countries can agree upon those items relevant for their purpose and include them in the protocol or the notes to be exchanged at the time of entering into the treaty. In case a machinery is created for a multilateral or a global transmittal of routine information, the list will have to be severely restricted to essential items only, leaving treaty countries to supplement them in keeping with their requirements through bilateral treaties.

The information to be routinely transmitted should pertain only to the nationals of the receiving country and contain such details as are necessary to identify the recipient and the payment in his hands. Concerning the full name and address of the recipient of income or the owner of the asset, such details could be:

(a) In the case of income items, name and address of the payer, amount paid, date and nature of payment; in case information relates to income accrued over a period, the period to which it relates;

(b) In the case of information relating to assets, description, value and location of property and, where necessary, dates of transactions.

Apart from the above types of information, treaty countries also need to exchange information as a matter of routine about their tax laws and procedures and significant changes, if any. Even for the implementation of agreements on avoidance of double taxation, this exchange of information is necessary and is found incorporated in treaty articles. For the reasons discussed in section A while dealing with category 5(a), provision for routine supply of information of commercial intelligence through some centralized agency is also very necessary.

2. Transmittal on specific request

There are two aspects of such transmittals:

(a) Cases where they are consequential to information received under routine or discretionary transmittal;

(b) Cases where, in consequence of certain information having come in possession of tax officials in the course of their activity, such as audit, internal investigations or searches (where such powers exist), it becomes necessary to obtain further information and also evidence in a form acceptable to courts.
These circumstances are detailed in section A and cannot be listed because they depend entirely on the facts of each case. However, reference may be had to discussions in section A on categories 4, 5(a), 5(b) and 6 which detail circumstances under which specific inquiries are necessary and the nature of such inquiries.

Information on specific request would be necessary for both the residents and non-residents of the receiving country. There is no reason to restrict it only to the nationals of the receiving country.

3. Discretionary transmittal

This mode of transmittal, where applicable, is very effective and less onerous. The transmitting country has the information which it considers necessary to the treaty partners and it has merely to take the initiative to communicate. However, the greatest difficulty about this mode of transmittal is that it depends solely on the investigative capacity of the transmitting country and its initiative. Even so, some possible areas of its operation can be earmarked, as, for example, categories 2(b) and 5(a) in section A.

To sum up, routine transmittal of information is of utmost importance, being the only effective means of dealing with international tax evasion and avoidance and the prime source of information for initiating specific inquiries. There are also circumstances, as pointed out in section A, where only specific information obtained on request or where discretionary transmittal can help. Each mode of transmittal has its own importance and a definite place in the scheme for exchanges of information. Most often they are complementary to each other and cannot be isolated without detriment to the effectiveness of the other.

4. Conclusions

A comparative study of the proposed draft article on exchange of information and article 26 of the OECD Draft Convention 23/ bring out the following salient points:

(a) In both, information to be exchanged is what is necessary for the carrying out of the Convention and of the domestic laws of the contracting States concerning taxes covered by the Convention, in so far as the taxation thereunder is in accordance with the Convention;

(b) The proposed draft article, however, proceeds to specify that the information to be exchanged would be "in particular for the prevention of fraud or evasion of such taxes". The merit of the modification is that it draws pointed attention to frauds and evasion and puts the matter beyond doubt.

(c) The proposed draft goes further to add that "the competent authorities shall, through consultations, develop appropriate conditions, methods and techniques concerning the matters regarding which such exchange shall be made, as well as exchanges of information regarding avoidance of tax where appropriate".

In the light of the foregoing discussion, if exchange of information is to be made really effective for combating tax evasion and avoidance, the following steps suggest themselves for implementation:

(a) The exchange provisions should be mandatory;

(b) An effort should be made to obtain treaties covering exchange of information even in those cases where more comprehensive treaties are not yet feasible;

(c) Domestic laws may be modified to obtain fiscal information of the same kind and to supply it;

(d) Information may be made available in a form that would make it admissible in legal proceedings, without any further processing. Before information can have evidentiary value, a good deal of procedural and legal formality has at present to be gone through which would be time-consuming and troublesome to the country receiving the request. A special study may be needed to evolve appropriate procedural steps for this purpose as well as to simplify the process.

5. Assistance in collection

The purpose of a comprehensive exchange of information is to provide material to establish a proper assessment of taxable income and to prosecute tax dodgers where fraud is involved. However, merely raising an adequate assessment is not the only aim of a tax administration; its aim is also to collect the revenue that is legitimately due to it. Most of the tax frauds involve siphoning off of funds from the country of assessment, so that a situation can arise that, having raised taxes, there are no funds to recover the tax dues. Where the tax treaty follows the principle of taxation in the country of residence, there can be a real difficulty in collection because the source country will have funds and the country of residence will raise the tax demand. If, therefore, the benefits of exchange of information are to be real and not illusory, it is essential that the machinery for exchange of information to deal with tax frauds should be supplemented by provisions for assistance in collection of taxes at least to the extent of funds illegally removed. There are problems of jurisdiction and varying powers of attachment of assets and enforcement of tax dues in different countries so that this aspect of the matter calls for a detailed and specialized study.

To establish tax fraud is a complicated issue even for a domestic legislation and administration to tackle. It is much more complicated in the international field where laws, procedures and powers differ. Each State is a sovereign State so that its frontiers act as a natural barrier to successful enforcement of tax laws of another State. While there is complete mobility in movement of commerce and individuals, the rigidity of jurisdictional barriers creates a problem which can be surmounted only by the joint goodwill and co-operation of all countries under the aegis of the United Nations.
Chapter VII

SUMMARY OF REPLIES TO THE QUESTIONNAIRE ON AUTHORITY OF TAX ADMINISTRATIONS TO OBTAIN INFORMATION

Most of the countries replying to the questionnaire appeared to have authority tied to the tax liability asserted. Thus, a general qualification which must be kept in mind is that differences in taxed items will have an effect on information which can be obtained. India, for example, specifically mentioned this in connexion with information obtainable from residents and non-residents. As a suggestion for any future questionnaires, Governments might be asked if there are any areas in which they lack power to obtain information, but would like to gain that power. Perhaps this would elicit negative statements, and avoid the problem of determining when negative inferences can be drawn from the failure to make a positive statement that particular information is available.

The responses from members of the Group of Experts from the following countries are contained in the present summary: India, Israel, Japan, Pakistan, and the United Kingdom of Great Britain and Northern Ireland. The summary follows the numbering in the questionnaire (ST/SG/AC.8/L.6).
I. Authority to obtain information from a taxpayer resident in, or a citizen of, your country

A. General authority

In general, each country indicated that it had broad authority to obtain information, though such authority was related to potential or asserted tax liability. Clearly available was information related to tax returns of the taxpayer, or information related to returns that should have been filed. In some cases, information could also be obtained as to capital holdings of the taxpayer, even though no income or capital gains were derived from such holdings during the taxable period, and in certain situations the capital holdings of relatives or business associates could also be elicited. Taxpayers can generally be required to appear and testify before the taxing authority, and can be required to produce books and records for inspection. Israel and Pakistan mentioned fairly extensive requirements for reporting payments to others, such as payments of rent or interest, presumably whether or not these items are deductible by the taxpayer. Israel mentioned extensive powers to obtain information from other Government agencies, even including information not related to the asserted liability of any particular taxpayer.

Each country mentioned the relevant income-tax statute as their authority, and some countries mentioned other general statutes such as the criminal code and the corporation act.

In general it appears that each of the reporting countries has authority to issue summonses and demands for information. Israel, in its answer to A (1) mentioned that revenue officials have authority to seize books, records etc. where tax avoidance is suspected. Most countries apparently start the process with informal requests in writing.

While the responses were rather sketchy, it appears that the two most often accepted taxpayer defences are irrelevance to asserted tax liability and loss or destruction of the desired records. Israel mentioned that self-incrimination was not a ground for refusal, as the tax inquiry is considered civil, rather than criminal. The United Kingdom mentioned a formal appeal procedure, apparently on the ground that the information would not be relevant to the determination of a tax liability. India noted that there is no present statutory record-keeping requirement, but that such legislation is under consideration.

Generally fines and imprisonment can be imposed on the taxpayer for failure to provide information. Japan specifically mentioned that penalties can be imposed against both the taxpayer corporation and its officers for failing to provide relevant information. India and the United Kingdom shift the burden of proof if information is not provided.

India and the United Kingdom do not have record-keeping requirements in their tax statutes, though in each case some records are apparently required under relevant corporation statutes that would provide information similar to that required under tax record-keeping statutes. The other countries have record-keeping requirements in their tax statutes. Both India and the United Kingdom mentioned that the failure to keep adequate books and records, though not required, would make it harder for the taxpayer to overcome any proposed assessment by a tax official.
Japan indicated that there is no provision requiring such information (see paragraph 6 above for the authority of India and the United Kingdom). The Indian answer noted that the general corporation statute requires information relating to foreign property etc. Pakistan and Israel have broad requirements, but in Israel, the taxpayer may resist a demand for such information on the ground that it has nothing to do with his Israel tax liability, suggesting that this is a problem area for that Government. Israel also mentioned that the authority to require information about capital holdings of the taxpayer and others (see para. 1 above) extend for foreign holdings.

B. Disclosure of information

Israel reported that it may not disclose tax information to the tax authorities of other countries; presumably, this rule can be modified by treaty. For Pakistan, the United Kingdom and, presumably, Japan, the authority to disclose is linked to agreements on the prevention of double taxation, and not to tax avoidance agreements, so it is unclear what the scope of disclosure to other tax authorities can be. The Government of India is specifically authorized under statute to enter into agreements for the exchange of information to prevent avoidance, whether of tax owed to India or to another country.
II. Authority to obtain information from domestic third parties relating to a taxpayer resident in, or a citizen of, your country

A. General authority

1. The authority to obtain information from third parties is extensive in some situations and limited in others. Where payers, brokers etc. are required to provide information about payments, such as wages and interest, information is readily available. Some countries, such as the United Kingdom, however, do not appear to have general authority to require information from third parties as a matter of course. The Government of Israel indicated that it has broad authority over third parties only when the taxpayer protests asserted tax liability. A distinction apparently is not generally drawn between information available from relatives and from unrelated persons, except when a mandatory joint-income return for a husband and wife is required (United Kingdom), or when a return of capital holdings which includes such holdings of family is required (Israel).

2-5. There was apparently some confusion as to how this should be answered, and most seem to have felt their answers to the questions under I and II (A) covered most pertinent aspects. The usual procedure for obtaining information is request, followed by demand, and then by formal process. Defences open are exceeding authority, and loss or destruction of the information.

6. There do not seem to be requirements that such books and records be kept as to the possible liability of others unless the third party is required to make reports. For example, an employer might be required to keep information as to the income of an employee if he is required to report payments of wages to the tax authority. Most of the answers noted, however, that the records a taxpayer is required to keep with respect to his own tax liability would cover most information which would be desired as to situations in which he is a third party. Even in countries where there is no general requirement that books and records be kept as to one's own tax liability (for example, in the United Kingdom), it would appear that it is customary to keep them so as to prevent adverse inferences being drawn by the tax authority, and presumably such books and records would serve where the taxpayer keeping the records is a third party.

7. The same situation exists as to records outside the country as to those within the country.

B. Disclosure of information

There is apparently no difference from the situation under I (B).
III. Specific aspects of authority to obtain information

A. 1. The answers indicated reservations about the ability to obtain information on bank accounts directly from the bank.

2. Pakistan indicated that bearer securities are not issued, and the United Kingdom indicated that issuance is not customary. Israel and Pakistan indicated that they could not get this information. Japan indicated that a return of income from bearer securities is required, but did not indicate what happens if it is not made, or how information about ownership etc. could be obtained. As to foreign bearer securities, the United Kingdom indicated that where such securities are held by banks, the information as to the true owner can be obtained if the owner is a resident of a country with which the United Kingdom has a double tax treaty. India indicated that securities similar to bearer securities are customary (securities are sometimes initially issued with the name of the owner indicated on corporate books and on the face of the security, but later transferred without registration of a new owner; information could be obtained from the registered owner as to his transferee) and that such securities are required to be disclosed in some cases in tax returns by residents of India.

3. Each Government except Japan indicated that it has the authority to obtain information as to the ownership of property held by a nominee. Generally, Governments can obtain the information from the nominee or from taxpayers. India indicated that taxpayers are required to report property held in the name of a nominee, and Israel indicated that cross checking other government agencies is possible to see if they have information as to the true owner.

4. (a) All can obtain such information as to the payments of wages and salaries. Some get it automatically in connexion with required returns under withholding requirements.

(b) All indicated information as to professional fees can be obtained from the payor unless the payee is suspected of tax avoidance. The United Kingdom has a minimum (£15) and any excess must be reported; some other Governments require the payor to report, and some withhold on payments to foreign residents.

(c) In most cases it appears that information on pensions and dividends is available to about the same extent as wages. Several replies noted that returns are required from the payor, and this would reveal the payee and the amount. Israel noted a distinction between employer payors and insurance company payors, information as to the latter being available only where the taxpayer (payee) is contesting asserted liability.

(d) Information as to dividends is generally available. In most cases it appears a return by the payor is required for payments above a certain amount, this usually being connected with a requirement of withholding by the payor. The United Kingdom noted that shareholder lists are a matter of public record. Israel noted that information is more readily available where the taxpayer contests asserted liability.

(e) Information as to interest is similar to dividends. Apparently the reporting requirements for payors are a bit more extensive than with dividends, so more information would be available. The United Kingdom has a provision that
interest less than a certain amount is not reportable by the payor, and the payee can request that such payments not be reported to the Government.

(f) Withholding on royalties is apparently less frequently required than on interest and dividends, though information can be obtained from the payor upon demand. India noted that withholding is more extensive for payments to non-residents. Israel noted that information from the payor may be available only where payee contests asserted liability for tax.

(g) Generally it appears that insurance payments (such as payments to beneficiaries) are not taxable, and so information cannot be obtained because authority is linked to tax liability. Some countries may tax gains on the disposition of an insurance policy, and in these cases information could readily be obtained (United Kingdom).

(h) The answers as to government payments for medical expense reimbursements were unclear. Apparently such payments do not exist in many countries, and in those where they do they may not be taxable. Where they are not taxable, information would not be readily available because authority is linked to taxability.

5. Information on the sale of stocks or other securities is available from the taxpayer and from the purchaser. Information is available from brokers and agents as to other assets. In some cases it was indicated that other governmental agencies (such as the land registration office) might have information which would be available. There do not appear to be extensive reporting requirements for stockbrokers, so information would have to be requested from them, and would not be available on regularly filed returns.

B. 1. In most cases it was indicated that information on the invoicing of goods moving in international trade could be obtained, if at all, only with great difficulty. Several answers indicated that the co-operation of the country at the other end of transaction would be required for any sort of verification. Israel indicated a general lack of confidence in its ability to get information about the specific items listed. Most countries indicated general concern over their inability to get this kind of information.

2. Pakistan and the United Kingdom indicated that information on payments to foreign officials or persons not ordinarily parties to a commercial transaction might be available if the payor attempted to take the payment as a deduction, but Pakistan went on to indicate that such payments could easily be concealed. India indicated that currency controls might provide information about such payments.

3. The answers to the question on information on intercompany pricing transactions were sketchy. Concern was expressed over the absence of jurisdiction over the foreign company, and the consequent lack of power to force the production of full records of transactions.

4. Apparently there is a little more confidence that information on home office expenses and their allocation can be obtained. The availability of the information was tied to the possible disallowance of deductions for such expenses if records and other substantiating information were not forthcoming.
5. Almost all replies indicated that on the domestic ownership of stock of a foreign corporation, information usually would not be available unless the taxpayer or the tax authorities of the country in which the company was located produced it.

6. Information on the foreign shareholders of a domestic corporation would apparently be available.

7. Information on the domestic grantors or beneficiaries of a foreign trust would generally be available unless the taxpayer reported income from the trust in his return, or currency restrictions required him to register the original transfer to the foreign trust (India mentioned such a requirement).

8. Information on the foreign beneficiaries of a domestic trust would generally be available, and the payor might be required to withhold tax on the payments of income to the foreign beneficiary. Currency restrictions are a factor here, and a country with extensive restrictions of that nature (such as India) might get information as a matter of course.

9. Information on the domestic partners of a foreign partnership would not be generally available unless the taxpayer reported income from the foreign partnership, or unless transfers of money to the foreign partnership were subject to currency transfer restrictions.

10. Information on the foreign partners of a domestic partnership would be available because of jurisdiction over the domestic partnership. Such information might also be available in countries, such as India, where application must be made before foreign ownership of a domestic enterprise may be secured.

11. Only India indicated that information on foreign currency transactions would be available, because of their currency restrictions.

IV. Other aspects

Only India commented, and indicated that its problem was getting information from foreign tax authorities, which were under restrictions as to disclosing information.
Chapter VIII

SUMMARY OF REPLIES TO THE QUESTIONNAIRE ON EXCHANGE OF INFORMATION

This summary is based on the replies to the questionnaire on exchange of information which have been received from members from the following countries: Argentina, France, India, Israel, Japan, the Netherlands, Norway, Pakistan, the Philippines, Sri Lanka and the United Kingdom of Great Britain and Northern Ireland. The summary follows the numbering in the questionnaire.

I. Routine transmittal

Most of the members agreed that routine transmittal of certain kinds of information may be useful, although they were aware of the difficulties involved in exchange. Some gave detailed answers regarding items of particular concern to them and at the same time noted the probable difficulties inherent in the exchange of information on these matters. Nevertheless, there was consensus that exchange of information is feasible.

A. From the standpoint of the administration receiving the information

1. Kind of information desired to be routinely received

In regard to routine transmittal as one form of exchange of information between tax administrations, the first aspect explored, from the standpoint of the administration receiving the information, was that which concerned the type of information desired to be received regularly.

(a) Types of income and property shown on returns: dividend payments, interest payments, real estate, shares etc.

Some members indicated that all this information is relevant (Pakistan, Israel). These are generally sources from which the withholding tax is paid routinely and information in respect of these items could be readily supplied. This information is useful to the receiving administration to check tax evasion by its residents (Sri Lanka).

The member from the United Kingdom felt that information about all types of

1/ Members of the Group of Experts on Tax Treaties between Developed and Developing Countries supplied the information requested for their respective countries. Hence, throughout the present chapter, the term "member(s)" refers to members of the Group and not States Members of the United Nations. For the questionnaire, see Tax Treaties between Developed and Developing Countries, Fourth Report (United Nations publication, Sales No. E.73.XVI.1), part two, annex I.
income received by United Kingdom residents from overseas may be useful, particularly if the amounts involved are substantial or if the information concerns sources of income where exemption or partial relief from tax is given under a convention or under special provision of the country's domestic law. The United Kingdom already receives routine information from many overseas countries under the exchange of information article in double taxation conventions.

The member from France also indicated particular interest in obtaining as complete information as possible on income obtained abroad directly or indirectly, as these are the cases in which it is easiest to avoid reporting in his country.

The member from Argentina indicated less interest in income obtained from abroad by Argentine residents, because those types of income were not taxable by his country.

In addition to the items listed (dividend payments, interest payments, real estate, shares) some members specifically listed further items such as income from employment or profession (France, Japan, India, the Philippines), business income (France, the Philippines), income from immovable property (France), capital gains and property acquired by inheritance, gift or bequest (Japan). The member from Japan also mentioned such property acquired by non-residents as well as such items as opening of branches, offices, subsidiaries by domestic taxpayers and the names of banks dealing with them, provided such information appears in returns or is obtained through investigation. The member from the Philippines listed such items shown in the returns as total sales and business deductions of enterprises and total capital invested, immovable property, bank deposits and copies of balance-sheets.

The member from Argentina felt it was relevant to obtain information about income derived from exports and imports, since wholesale prices in the country of destination (for exports) and sale prices in the country of origin (for imports) are taken into account. Also useful was information not strictly related to income tax matters, such as that related to foreign exchange, capital movements, smuggling etc.

One member (Norway) indicated that any information is of interest in so far as it serves the purposes of controlling taxpayers. On the other hand, there should be a reasonable limitation, taking into account the burden placed on the country supplying the information.

Another member (the Netherlands) did not favour exchange of information on a routine basis under present circumstances, "in which international trade and financial transactions have assumed very substantial proportions and the resources of the administrative apparatus of the modern State are strained to the utmost". The practical significance of such exchange in the few cases in which the Netherlands exchanges information on a routine basis, under the provisions of a convention, was regarded as minimal. In any case, it would not be advisable to make an exchange on a routine basis the subject of a multilateral arrangement. Even where a special bilateral relationship exists, the need for specific information with respect to one or more types of income or property is likely to extend to other similar categories. This will make it impossible to confine the routine exchange of information to specific categories.
(b) **The amount of tax due or paid in another country**

Although some members did not reply to this question, this was considered significant by a number of members (France, Pakistan, the United Kingdom). The member from France was also interested in the nature of the tax, whether global or personal. Another member (the Philippines) showed interest in total income tax paid or similar taxes. The member from Sri Lanka felt that the amount was not always relevant.

(c) **The nature of the information**

(d) **Information leading to a recipient's identification, name and address or addresses**

(e) **Information related to taxpayer's identification, name and address or addresses**

Some members answered broadly that the information should contain particulars needed for taxpayers' identification in addition to the kind of income or capital to be taken into account (Norway). Others paid particular attention to the recipient's address in the country receiving the information (Pakistan, the Philippines, Sri Lanka, the United Kingdom). Another member (India) expressed interest in the period to which the income relates, description, as well as value and location of property in cases where the information relates to transactions in movable or immovable property.

2. **The use that may be feasibly made of the information received, routinely or by specific selection**

Most members felt that information is a useful means of control or verification of tax returns. International tax evasion and fraud may be detected and minimized through the exchange of information (France, the Philippines). Existence of routine exchange of information will act as a deterrent to non-reporting of foreign income (France, India). The receipt of information is used to check that the amount of income and tax paid in the other country have been reported correctly for the purposes of domestic taxation (Israel, Japan, Sri Lanka, the United Kingdom). The most likely type of evasion to be detected would be a failure to declare foreign income for domestic tax purposes (the United Kingdom). The information might also lead to a discovery of a more sophisticated type of tax avoidance.

In some countries (e.g., India), because of stringent foreign exchange regulations, there is a tendency among taxpayers not to report their foreign income fully and to maintain secret funds and investments outside India. Routine exchange of information would facilitate detection of tax evasion in a wide area.

One member (Sri Lanka) pointed out that the taxpayer's purpose in not declaring income or assets outside his country of residence is not merely to evade tax on that income but mainly to avoid inquiry into the origin of the resources. Inquiries generally bring to light particular methods of evasion that a taxpayer has adopted and the study of these methods enables more successful investigation in other cases.
Another member (Argentina) stressed routine transmittal as a means to combat certain economic crimes which are particularly troublesome for developing countries.

The member from Japan specifically referred to three types of evasion as most likely to occur: (a) income from property located abroad which is difficult to identify; (b) inheritance, bequest or gift of property, although located in Japan, from a decedent or a donor who has no domicile in Japan; and (c) creation and activities of a branch etc., which is established abroad.

The member from Sri Lanka listed non-remittance of commission, non-reporting of foreign bank interest and investment in real estate from concealed income.

B. From the standpoint of the administration transmitting the information

1. Kinds of information that may be feasibly transmitted in a routine manner

(a) Limitation of law or practice

A number of members pointed out that the tax administrations are bound by law to secrecy in tax matters (Israel, Pakistan, the Philippines, Sri Lanka, the United Kingdom). Some referred to penalties, fines or imprisonment for violation of secrecy (the Philippines). An exception is information supplied under the provisions for exchange of information in the double taxation agreements (Pakistan, Sri Lanka, the United Kingdom). The United Kingdom member pointed out that this is so because these agreements have obtained the necessary parliamentary approval required for disclosure.

The member referred to the wording of the relevant article which specifies that only such information can be exchanged as is at the disposal of the competent authorities under their respective taxation laws in the normal course of administration.

The Norwegian member also referred to the clause prohibiting disclosure of any trade, business, commercial and professional secrets and processes.

The member from India reported that the existing law in India provides for a wide variety of information concerning taxpayers in India, and it should be feasible to transmit such information routinely. The general secrecy provision in the direct tax law has been abolished and the disclosure of information is regulated by certain legal provisions and procedures. Adequate protection should be given to business and professional secrets. The receiving country should be bound to treat the information received as secret. A world-wide convention on these matters would greatly facilitate the matters.

The member from France indicated that the exchange should be within the framework of strict reciprocity both with respect to category and nature of the information. Since such exchange infringes upon secrecy in tax matters, such derogation can only be undertaken against a promise of equivalent reciprocal assistance.

The recipient State must observe the rules of administrative secrecy and can utilize this information for the purpose of assessment and collection of taxes.
which are the subject of the convention or, if it is so provided, specifically for
the prevention of fiscal fraud. Finally, the exchange of information is predicated
on the observance of secrecy of business affairs and non-infringement of the
interests of public order.

The member from France indicated that France could not take measures
conflicting with domestic law or administrative practice or transmit information
which could not be obtained within the framework of its law or administrative
practice. The obtaining of such information should not impose on taxpayers a
greater burden than that imposed on them by the provisions of the French law.

(b) Difference in the kind of information requested

A number of members indicated that they would transmit information in terms of
the provisions of existing or future conventions. They were ready to supply
routinely information requested that is available in the normal course of
administration and can be collected without the undue administrative burden of
further investigation (France, Israel, the United Kingdom).

In Israel the law does not permit special investigation for purposes other
than obtaining full information related to an assessee's income, or to make a
proper assessment of his income. In Norway, that information is supplied under tax
conventions. However, where internal Norwegian legislation exempts from tax at
the source (interest, royalties), it would be administratively difficult to supply
information.

One member (the Philippines) feared that, due to the diversity of tax systems,
information transmitted might not be useful to the requesting country. Another
member (Pakistan) felt that there should be no substantive differences in the kinds
of information required by various countries for making proper assessments.

In the United Kingdom such information includes at present the following items
claimed by overseas residents: (a) duplicates of claims to repayment of tax;
(b) details of United Kingdom income relieved from United Kingdom tax at source;
(c) details of interest received in the United Kingdom; (d) details of fees and
commissions paid to entertainers; and (e) details of claims of exemption from tax.

In France such information included: (a) information regarding property,
documents relating to real estate sales, division of inheritance, marriage
contracts, loan agreements etc.; (b) information concerning industrial, commercial
and professional activities (corporate by-laws, increases and reductions in
capital); (c) documents relating to taxpayer's personal status (secondary
residence, servants, motor vehicles owned, race horses, sailing boats, planes etc.)
and names and addresses of individuals and legal entities in France and the amount
of revenues from immovable property, dividends, interest and royalties, wages and
salaries, pensions, travelling expenses and other periodic income fixed or variable
which is derived by these persons from French sources.

Japan transmits the following information on income and property appearing
in returns or obtained through investigation: dividends, interest, rent and
royalties, remuneration from employment, capital gains, inheritances, bequests
and gifts of non-residents derived from Japan and of residents from such
properties abroad. It also transmits details related to the opening of branch
offices and subsidiaries by non-residents and indicates names of banks dealing with them provided such information appears in returns or is obtained through investigation.

(c) **Effect on competitive position of taxpayers involved as a result of differing practices concerning the disclosure of information by requesting countries and responses to requests by other countries**

Some members pointed to the wording of the exchange of information article in their conventions which ensures that information exchanged shall be treated as secret and disclosed only to persons concerned with the assessment, collection, enforcement or prosecution in respect of taxes which are the subject of the convention. Under the article no information shall be exchanged which would disclose any trade, business, industrial or professional secret or any trade processes (e.g., France, the United Kingdom; see also above under limitation of law and practice).

A member from the Philippines felt that such information must be kept secret by all exchanging countries as its disclosure would have serious effects on the position of competing taxpayers.

The member from Israel favoured transmitting information in a standard way so that an assessee in a country which provides full and accurate information would not be placed at a disadvantage with an assessee residing in a country which provides less detailed information.

The member from Norway felt that the effect of disclosure on competitive position of taxpayers should not be overstressed — in the rare instance that illegal disclosure may occur.

The member from India felt that there was no basis for the apprehension that the competitive position of the taxpayers involved might be affected as a result of differing practices regarding the disclosure of information in requesting and responding countries. This could be prevented by adequate safeguards for trade and professional secrets.

2. **Advantages and disadvantages of routine transmittal of information to the transmitting administration**

The member from the United Kingdom considered the advantages to be in the main twofold: in the general sense of reciprocity, i.e., information would be received from the partner country in return for the information sent out; another point was that routine information supplied by one country about a particular case may lead to further information being given to that country in return regarding the same case.

Some members (e.g., France) considered routine transmittal as the most effective way to control tax assessment. The flow of regular information would discourage certain individual or corporate taxpayers from using irregular procedures.

A general advantage was seen in reciprocity or mutual exchange as a means to obtain similar information from requesting countries. Since broader scope of information is thus secured, benefits are greater for both countries involved.
Another member (Norway) felt that a request for information from the other State will sometimes disclose facts which might be useful to the State which supplies the information. However, he feared that information would only be of interest to the requesting State.

Other advantages mentioned were combating international tax evasion, discouraging connivance between taxpayers from one country and those from other countries, acquisition of experience and improvement on tax administration and winning of international goodwill and co-operation (the Philippines). One member (Israel) also indicated that a country transmitting information would enjoy advantages resulting from the fact that the information it transmits would be checked and verified in the receiving country, and where it was found to be faulty it would receive the resulting "feed-back".

Although some members indicated no particular disadvantages, other members feared that routine transmittal of information would mean an increase in clerical work and an extra burden for their tax administrations, resulting in an increase of cost (Israel, Pakistan, the Philippines). This extra cost, however, was likely to be more than compensated by the increase in revenue derived from receipt of information from other countries (Pakistan) and the advantages of such programmes would certainly outweigh the disadvantages, if any (India).

Another member (the Philippines) also mentioned that opposition is likely to be encountered from dishonest businessmen to an exchange of information; to a certain extent, exchange of information would discourage business activity by international tax evaders, but since honest businessmen will declare their true income, disclosure of information would not hurt them.

Another member (the Netherlands) strongly opposed the routine exchange of information for the reasons mentioned above.

3. Other relevant aspects

Some members (e.g., the Philippines) held the view that the arrest of international tax evasion was of greatest importance in spite of the disadvantages arising from exchange of information, and that no country should accord sanctuary to a tax evader since such an action would be detrimental to the welfare of other countries.

II. Specific requests

Another form of exchange of information is upon a specific request by a tax administration for information regarding a particular taxpayer or situation.

A. From the standpoint of the administration making the request

The scope of such specific request procedure is explored first from the standpoint of the administration making the request.
1. Assuming that there is no routine transmittal of information

(a) Kinds of cases in which information is likely to be requested, purpose of seeking the information and types of information generally involved

The purpose of seeking the information

Some members (i.e., France, Israel, the Netherlands, Norway and the United Kingdom) indicated that the purpose of seeking the information is to ensure the proper administration of domestic tax both under the domestic law and tax conventions. This involves the verification of the correct amount of tax due on the basis of information obtained. The tax administration seeks the information in order to supplement the information obtained through domestic investigation (Japan).

Cases in which information is likely to be requested

The member from the Netherlands indicated that the nature of the specific cases on which information is desired is determined by the nature and scope of the financial and trade relations with the other country. Thus in the case of royalties, information may be requested on the identity of the recipient, in order to establish whether there is a special relationship between the payer and payee, which would permit question of the amount of royalty indicated. Similarly information regarding prices charged between enterprises or establishments in different countries could be used to allocate the proper taxable income between related enterprises or establishments (France). The member from the United Kingdom indicated the following kinds of cases where information is likely to be requested: (a) those where some form of tax avoidance is suspected; (b) those where there may be some difficulty in establishing the residence status of the taxpayer; (c) those where it is suspected that there may be a special relationship between a company in one country and a company in the partner country; (d) those where there may be some difficulty in establishing the source of foreign income. The member from Japan indicated that information is likely to be requested in the following cases: (a) information on dealings of a subsidiary or a permanent establishment in the other country with the Japanese parent company; (b) information on dealings of a resident in the other country with a resident of Japan; (c) other information on the taxation of a resident or company of the respective country. The member from India felt that information is likely to be requested in suspected cases of tax fraud or legal avoidance and also in cases where claims for tax reliefs are made. In the case of tax frauds, the purpose of seeking information would be to obtain satisfactory or conclusive evidence required for establishing tax evasion or fraud. In the case of under-invoicing or over-invoicing of exports or imports, authoritative information regarding price patterns and trade practices will be helpful. Information regarding payments received and retained abroad would bring to light not only tax evasion but also violations of foreign exchange regulations. Information regarding the real status, constitution and activities of the party abroad with whom the taxpayer under investigation had dealings, would reveal if artificial arrangements existed resulting in tax evasion or avoidance. If information regarding routine transmittal is in operation, specific requests for information are bound to be less frequent and more precise.
Types of information generally involved

The member from the Netherlands felt that, although the particular categories of income and property on which information is required can vary from time to time, depending on the specific requirements of the case, income from movable capital such as dividends, interest and royalties will always be of particular interest. The member from the Philippines listed income from dividends, interests, royalties, salaries, compensations, bonuses, fees, commissions and other service income; volume of exports and imports, including prices; volume of sales and cost of goods sold; income tax paid and property holdings. The information would be derived from taxpayers' income-tax returns but also from other documents. The member from Japan listed contracts, records of a bank account, profit and loss statement, a balance-sheet, a debit and credit account book, an order sheet, an official copy of registration, minutes of a board of directors' meeting, an official copy of registration, an invoice, a bill of lading, a letter of credit, an application for export or import licence etc. The member from Israel listed the following types of information that should be transmitted: the amount (sum) of income received abroad, the value or cost of property held abroad, payments made to suppliers or received from customers abroad, taxes paid abroad etc. The member from Pakistan referred to conventional devices used by taxpayers from developing countries investing in shares of companies of other countries. These devices usually involve bank accounts, real estate and commissions, which would be the main types of information to be requested.

(b) Agencies in the requesting country likely to have access to information

These are mostly the same agencies mentioned in routine transmittal cases, namely, the national tax administrations and particularly offices or agencies and income-tax authorities concerned with assessment and collection of taxes and dealing with particular cases. Members from Japan, the Netherlands and the United Kingdom mentioned also that they would permit disclosure of the information to a court or an administrative tribunal concerned with the assessment of taxes. The member from Sri Lanka mentioned also the Bribery Commissioner. The member from France indicated that the exchange takes place between central authorities since local authorities are not authorized to communicate with each other.

(c) Other relevant aspects, including the form and average frequency of such requests in any given year

One member stressed that the request be made in writing while another member (Sri Lanka) indicated that they would usually give full name and address of the party concerned and any other party in the country likely to provide such information and the particular matter in respect of which the information is required. Some members (e.g., Norway) indicated that no particular form is required. Some members felt that the form depended mainly upon the nature of the case and one member (India) feared that it would not be feasible to evolve any standardized format for exchange of information.

Some members indicated that they were unable to tell how many cases they handled since no statistics existed or records were kept of the numbers or the nature of inquiries made (Norway and the United Kingdom). Others indicated that cases were few (Israel and Sri Lanka). The member from Japan stated that there were no requests from 1968 to 1971 and in 1972 there was only one request. Some members suggested that the average frequency depended on the two countries.
(Pakistan) or on the nature of the bilateral relationship (the Netherlands); another member (the Philippines) indicated that these cases were not frequent except in relations with the United States of America where many Philippine citizens are employed. The member from India indicated that the frequency could be restricted by requiring that the requesting country bear the administrative cost.

2. Assuming that routine transmittal is already in operation

(a) Kinds of cases in which information is likely to be requested, purpose of seeking the information and types of information generally involved

The specific request may supplement the routine exchange of information by obtaining details on matters already routinely communicated (France). Where there are discrepancies arising from routine information received, specific requests may verify the amounts of income shown on the routine notification or they may involve a request for more detailed information of income notified under the routine arrangement (the United Kingdom). Specific request can facilitate settlement of particular cases (France). The information routinely received can trigger off a detailed investigation. In such cases the information requested is likely to be more specific and definite than where there is no routine information in operation (India). On the basis of routine information, a specific request could clarify the discrepancies or suspicions of tax evasion or assist a special investigation.

(b) Format of such requests, channels of communication, delay in answering

Information is exchanged directly between central authorities indicated in the Convention (France and the United Kingdom). There is usually no delay (the United Kingdom). However, if the administration needs help from the local authorities, delays may occur (France). Delay of course reduces the effective value of the information, but the authority must be allowed adequate time to trace, collect and transmit the information (Israel). The channels of communication should be direct between tax authorities of the two countries. Resorting to diplomatic channels will result in delays that may defeat the investigation (India). It was suggested by one member (India) that countries desirous of participating in an international information exchange programme on a comprehensive scale may wish to set up a special organization for securing, processing and transmitting the information as well as for receiving and utilizing it.

B. From the standpoint of the administration receiving the request

1. Considerations shaping the nature of the response to a specific request for information

The main consideration is whether specific information requested is available in the normal course of administration (Israel, Japan, the Netherlands and the United Kingdom). Other limitations are set up by the wording of conventions (France, the Netherlands, the Philippines and the United Kingdom) and limitations of law and practice (India, Israel and Japan). The member from Japan mentioned specifically the consideration of whether or not the information would disclose trade, business, industrial, commercial and professional secrets. The member from Israel also referred specifically to protection of public interest and competitive position of the assessee.
2. Advantages expected to be gained by the transmitting administration from its co-operation

Encouraging reciprocity and mutual co-operation was generally viewed as the main advantage expected to be gained from transmitting information. Fighting international tax evasion (the Philippines) and maintenance of fast channels of exchange of information (India) were also specifically mentioned.

III. Discretionary transmittal

A third suggested method of exchange of information is that of transmittal by a tax administration of information discovered by it in an audit or other investigation, if such information could reasonably be considered to be of importance to the tax administration of a treaty partner.

A. Factors involved in considering whether it is feasible and desirable either: to place an obligation in a treaty on tax administration to follow such a procedure; or to consider it appropriate that treaty countries endeavour to follow such a practice as a voluntary matter

Some members (e.g., India, Japan and the Netherlands) were in favour of including a clause to this effect in bilateral agreements. The member from Japan felt that both alternatives depended on the scope of information to be transmitted. The member from Israel felt that preference should be given to a voluntary discretionary transmittal method, without any specific provision in a tax convention, so that proper weight may be given to various special considerations (the public interest, limitations laid down in the law or arising out of tax practice, etc.).

The member from the United Kingdom felt that it was not considered feasible to place an obligation in a treaty on a tax administration to forward information which could reasonably be considered to be of importance to the tax administration of a partner. An obligation of that kind would be extremely difficult to draft, and the tax officials dealing with a particular case would not normally know enough about the other country's tax system to decide what information would be useful. Moreover, the tax administration in the receiving country may not be able administratively to process all the information which might be transmitted. It is therefore better for the two contracting countries to decide between themselves on any informal arrangements they wish to make. The member from Pakistan pointed out that both systems would involve the need for a rigid set of guiding principles on a country-to-country basis, which may not be feasible, nor would it be feasible if the practice were placed on a voluntary basis.

B. Extent to which such transmittal would prove less - or more - burdensome than routine transmittal

Several members (India, Israel, Japan) indicated that discretionary transmittal would be less burdensome than routine transmittal and more effective (Japan). The member from India felt that such transmittal is not likely to prove more burdensome than routine transmittal, as the volume and frequency of the transmittal is bound to be much lower. Further, unlike transmittal on specific request, the process does not involve collection of any new information.
Information that has already been obtained in the course of investigation need only be transmitted and the only additional operation involved is to screen the information with a view to judging its suitability for transmission from the point of view of utility to the receiving country and the national interests of the transmitting country. The member from the Netherlands clearly preferred this method of transmitting information to the routine transmittal. Another member (Pakistan) felt that there could not be much difference in the burdens involved in such transmittal, the difference being probably that the discretion given to individuals may create a more erratic situation.

C. Safeguards to protect the interest of the transmitting country or to avoid hardships to individuals

There was a consensus in regard to the need of a clause to be included in exchange of information treaties in order to protect and safeguard taxpayers' rights. Disclosure of information which would damage trade, industrial or professional secrets and the interest of the State or public policy, should not be allowed. One member (Japan) added that, in order to protect the interests of the transmitting country, in addition to treating the information as secret, it is necessary not to disclose the existence and the source of the information in using it in the receiving country; individual taxpayers should not be singled out in connexion with information to be transmitted in order to avoid undue hardships.
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