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TECHNICAL PROFILE

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Trade liberalization and the mobilization of the production factors (capital and labor) continue to be characteristics of the world economy. It is for this reason that there are ever more increasing taxpayer cross-border economic transactions, even in less developed economies. This phenomenon has led governments to adopt changes in their legal systems in order to protect their tax bases, -thereby increasing the possibilities for taxpayers of International Juridical Double Taxation (IJDT)- and to seek greater cooperation and mutual assistance between the Tax Administrations (TAs) to prevent international tax evasion.

Topic 1: Double taxation, international tax evasion and Double Taxation Conventions (DTCs)

The risk of IJDT does not appear as high in the sphere of general consumption taxes, VAT in particular, because the model generally accepted worldwide is a consumption VAT based on the destination principle, although its application to services and intangibles (e-commerce and telecommunications) continues to generate controversy[2].

The IJDT risks are ever more frequent in the case of income, profit and capital gains taxes -hence the reason why the international tax community pays greater attention to them, as countries increasingly seek to ensure their collection by aggressively taxing the income generated in their jurisdiction and / or the foreign source income obtained by their residents.

According to Chiri (2012), IJDT is defined as the application by two (2) or more states of two (2) similar or comparable taxes on the same subject (the taxpayer), in relation to the same tax base and the same time frame[3]. The IJDT phenomenon arises from three (3) types of conflicts: Source - Source, Residence - Residence and Source - Residence.

Despite efforts to coordinate the internal policies of the countries, the latter are free to tax income as they consider best according to such objectives as efficiency, equity and revenue adequacy which they may pursue, regardless of the harmful effects of double taxation on international trade at the world level and on the movement of production factors, as well as the arbitration opportunities that arise for harmful tax planning to the detriment of the treasuries of the countries where cross-border economic transactions take place.

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[1] Document prepared by Miguel Pecho, Luis Peragon and Gonzalo Arias.

[2] These issues were addressed at the first meeting of the recently launched OECD Global Forum on VAT.

[3] International economic double taxation, on the other hand, is defined as the application by two (2) or more States of two (2) similar or comparable taxes <u>on different subjects,</u> in relation to the same tax base and in the same time frame.

As it is known, the IJDT is eliminated or minimized through provisions in domestic legislations (unilateral measures) or by entering into DTCs between countries (bilateral measures). In the first case, the source country continues to exercise the right to tax the income generated within its jurisdiction, while the country of residence exempts the foreign-source income (fully or progressively), or grants credit for taxes paid abroad (full or ordinary) or allows the deduction of taxes paid abroad as if it were any other expense. In the second case, in addition to applying in the country of residence any of the previously described methods, the IJDT is also eliminated or minimized by limiting or refusing the source countries' authority to tax the income generated within their jurisdiction.

When there is symmetry between the capital flows of countries entering into a DTC - assuming that both tax the worldwide income of their residents, the end result of this game may be close, since the loss of collection due to the limitation or refusal of the taxing powers is balanced with profits from the taxation of foreign source income obtained by the residents. However, when there is asymmetry, as when the signatories are a developed country and a developing one, usually the net capital importing country experiences, at least within the very short term, a major loss of collection by limiting or refusing its right to tax the income generated within its jurisdiction.

Therefore, countries should undertake an in-depth cost-benefit analysis to precisely determine the convenience of signing a DTC with some partner. For example, some of the literature considers that unilateral measures to relieve IJDT are more effective for developing economies. Others consider that DTCs have indirect benefits because they afford foreign investors some degree of tax certainty or a positive signal regarding the environment wherein they plan to invest, in addition to including clauses for preventing international tax evasion.

Peragon (2012) notes that international tax evasion occurs when taxpayers, in carrying out their cross-border economic transactions, take advantage of the IT base or rate differences existing in the countries where they operate, through conduit companies [4] or base companies - legal instruments that usually lack economic substance in different jurisdictions – by taking advantage of the benefits provided by DTC international networks, as part of treaty shopping[5] .

As noted, various clauses in the DTCs may prevent these behaviors. Article 9 on associated enterprises of the OECD's Model Convention (a reference for many countries), deals with the ability of a Contracting State to adjust the benefits of a company that has carried out transactions with an associated enterprise in the other State, at values other than those that would apply in the case of independent companies. Article 26, on exchange of information, endeavors to facilitate such

[4] Conduit companies, in English.

[5] Treaty shopping, in English. Abuse of convention is that situation when someone who is not entitled to enjoy the benefits provided by a DTC, uses, in the broadest sense of the word, an individual or legal entity, to obtain the benefits of the DTC, which are not directly available.

exchange between TAs of contracting States in order to preserve the taxation powers of both States. Finally, Article 27 seeks to facilitate the collection of those taxes, to which one of the contracting parties is entitled, which would otherwise be uncollectible without a DTC.

Other clauses deal with harmful international tax planning involving a low or null tax burden in the State of residence such as the hybrid entities (partnerships[6], for example), hybrid financial instruments (convertible bonds, for example), or other entities which some countries include in their domestic legislation to promote the development of certain corporate structures (coordination centers, holding companies, etc.). Similarly, clauses defining the PE concept are increasingly needed for avoiding elusive measures. For example, Article 5.5., of the OECD Model Convention has expanded the general definition of Article 5.1., to specify that a PE does exist when there is a person (an agent) who, usually, has the power to enter into contracts on behalf of the resident enterprise in the country. The purpose behind this is to avoid taxpayers from hiring an agent in the first State to perform certain activities on behalf of the resident in the second State, which would imply the nonexistence of a PE in the first State.

Regardless of the measures provided in the DTCs, some countries have introduced in their respective internal regulations, generic or specific measures, which may be applied to cross-border economic transactions. The General Anti-avoidance Rules[7] are general legal instruments designed to fight tax evasion, which empower TAs to apply the substance over form doctrine. Other specific anti-evasion rules i) seek to clarify the concept of residence, when a country taxes its residents on their worldwide income, ii) introduce international tax transparency measures[8] to prevent a company established in a high tax jurisdiction from establishing a separate (controlled) subsidiary in an area of low or null taxation in order to derive or withhold income from international transactions in said territory; iii) limit the deduction of interest paid by a resident company to its non-resident shareholders, to the extent the amount of interest corresponds to financing through debt considered excessive (under-capitalization rules) or establish transfer pricing control.

Such provisions are usually complemented in Judicial Courts through the use of the doctrine, either the -Fraud in Law - used in civil law countries - or the Substance over Form - in the case of common law countries. The first allows the TA to deliberately pass over the legal form through which a certain transaction is presented, if the taxpayer's primary purpose is to avoid taxes. In the second, the economic effects or consequences of a transaction are its "economic substance". In a legal sense, the substance is the actual underlying feature of the transaction. When the substance and form of a transaction are not identical, the transaction may have been structured in such a way that the legal form used does not correspond with the underlying critical feature.

[6] Partnership, in English.
[7] General Anti-Avoidance Rules (GAAR) in English.
[8] CFC rules in English.

Topic 2: Control of transfer pricing [9]

Transfer pricing is probably one of the most complex areas in international taxation. An immediate effect of globalization is the rapid growth of MNEs whose activities cannot be easily adapted to the tax regulations normally designed for domestic spheres. The delocalization of production, the fast growth of intangible flows (information, knowledge, design) especially among large multinational business groups, the permanent change in the financial sector and in products offered that may lead to financial decisions involving displacement of taxable bases, etc., greatly hinder the adoption of effective national tax policies, since the real economic subject, when it comes to large multinationals, are very complex economic groups and not the taxpayers partially considered by each national regulation (IDB/ CIAT/ CAPTAC-DR, 2012)

As previously mentioned, the countries have established both in their domestic law and in their DTCs, the arm's length principle as criterion for taxing cross-border economic transactions between related companies. Under this principle each member of the economic group is considered an independent company. This enables the TA to make "primary" or "initial" adjustments to the tax bases declared by resident related taxpayers under their tax sovereignty, in order to redistribute corporate benefits earned through such transactions in accordance with the normal market value.

On the other hand, and in general terms, the primary adjustment made in the first tax jurisdiction generates double international economic taxation, if it is not followed by the same downward correction of the tax obligation of the related taxpayer established in the second country affected by transfer pricing. The bilateral nature of administrative adjustments in international transfer pricing is thus established, in order to fully adapt, for tax purposes, the related transaction to the arm's length principle.

The need for a common parameter to analyze transfer pricing has always been an issue of global concern. As previously stated, it was considered that the most appropriate measure was the normal market price between independent enterprises. Legal diversity in this regard was the determinant element for deciding on said parameter, which implied the convenience of locating or systematizing a methodology that would avoid the discretionary application of unilateral rules. In particular, the OECD member countries, based on their status of MNE host or residence countries, considered it essential to establish a methodology that could be generally applied. Such methodology is currently known as the OECD Guidelines.

While there is some consensus at the doctrinal and practical level for applying the free market principle, there is no such consensus when it comes to defining criteria and methods for applying the aforementioned principle. Although the transactional net

[9] Based on Arias et al. (2012) and the material of the CIAT course on Transfer Pricing.

margin method is the one mostly used by TAs, the complexity of many of the traditional methods and the lack of information prevents their full application in the less developed countries. For example, in Latin America, there are several deviations from the traditional methods. There is the so-called Argentinian "6th. Method" applicable to commodities - which has been replicated in Ecuador, Brazil, Guatemala, Peru and Uruguay- the Brazilian "fixed margin method", and the solution found by the Dominican Republic for "all inclusive" hotels.

To some extent, this has prompted the OECD to initiate a guidelines simplification project. The purpose is to review the guidelines regarding i) safe harbor provisions, ii) development of guidelines so that the competent authorities may design better bilateral safe harbors, iii) reduction of formal requirements, iv) providing greater clarity in the treatment of little value-added services, and v) simplification of APAs.
The establishment of the Global Forum on Transfer Pricing in March 2012 was precisely aimed at simplifying the guidelines for their effective implementation.

Other technical works are still in process for reviewing transfer pricing aspects related, for example, with providing benefits to permanent establishments and business restructuring. In the first case, the main motivation arises from the MNEs practice of developing structures that involve permanent establishments. The financial sector is the best example. The motivation is clear in the second case. Restructuring involves the redistribution of functions, assets (frequently including intangibles) and risks between companies of the multinational group, thereby affecting earnings and increasing the risk of losses in the countries. Many MNEs have become mere groups of distributors or commission agents with limited risk, or subcontracted manufacturer groups, all of them linked to a related party which operates as the main group (OECD, 2012).

It is also necessary to address the issue of relationship. The transactions, relationship criteria, taxpayer obligations and sanctions to be regulated must be expressly stipulated within the transfer pricing regulations. This will result in the appropriate practice for controlling their abusive manipulation. Only practice will render possible the corrections that should be applied to the regulations established by each country. However, the experience of other countries may be useful in implementing and applying the rules. Much in the same way as applying representative or strong sanctions vis-à-vis formal or material noncompliance by taxpayers carrying out transactions subject to transfer pricing, it is also essential for avoiding income tax evasion, given the importance and magnitude of these transactions.

On the other hand, there is also a challenge in comparability. Tax administrations must establish criteria regarding adjustments to be made when analyzing transfer prices. They prepare their diagnoses with electronic databases and generate statistical data therefrom but, in general, they lack sufficient access to local or regional information for a better use of comparables in transfer pricing analysis, thereby also affecting the taxpayers. Access to such information is limited by technological resources and little or scarce public availability of such information. CIAT is currently working to fill this information gap in Latin America.

TAs actions in the area of transfer pricing is necessary and indispensable, and that is why examinations are necessary and essential for controlling the abusive manipulation of transfer pricing. It is likewise important for the TA staff to be permanently trained. In an issue as dynamic whose complexity is a challenge for taxpayers as well as the TA, a trained staff constitutes the difference in the successful implementation of transfer pricing policies in a country.

Undoubtedly, the cost could be a very difficult barrier when implementing this control measure, given the need to invest in initial staff training, development of regulations, and computer systems, among others. It would also be advisable to enter into treaties to avoid double taxation and promote the exchange of information between countries.

TAs should have the capability for collecting and analyzing statistical data for a greater and better control of transfer prices, and thus be able to determine projections of any nature, as well as the respective recommendations to change, improve or expand the national regulations existing in their countries. Similarly, more than 70% of Latin American TAs have an office specialized in international issues and transfer pricing, in particular. Thus, in the same proportion administrations are capable of managing different transfer pricing procedures, ranging from the implementation of the rules up to defending them at different instances, mainly in courts.

Topic 3: Exchange of information and mutual administrative assistance between TAs.

As first mentioned, countries have not only adopted changes in their legislation to ensure collection from taxpayer cross-border economic transactions, but in recent years have promoted greater cooperation and mutual assistance between their TAs, thereby determining a new action panorama for preventing international tax evasion.

Recent decades have witnessed an unprecedented liberalization and globalization of national economies. Countries have ever more eliminated or limited controls on foreign investments, while also reducing foreign exchange controls. Likewise, advances in information and communication technology have made it easier for investors to conceal their capital income from the tax authorities, by accessing foreign jurisdictions offering low or null taxation and, therefore, not reporting profits to their national authorities. As a result, business and financial activities take place in a world that increasingly eliminates borders.

As businesses become global, TAs remain confined in their respective jurisdictions. Sovereign powers, including tax verification, assessment and collection activities are generally limited to the territory of the jurisdiction. Thus, if they only use the internal general information sources, tax officials may only see a small part of the activities or investments of a taxpayer who operates globally. As a result, TAs are ever

more dependent on cooperation with their foreign counterparts for more effectively managing their national tax laws (CIAT / IBFD, 2011).

A key element in such cooperation is information exchange. It is an effective means for countries to maintain sovereignty over the implementation and enforcement of its tax laws and ensure proper allocation of tax rights between DTC partners. Similarly, assistance in collection is increasingly considered an important tool to protect tax revenues and increase tax compliance.

Cooperation of the TAs is currently governed mainly by the DTCs signed by the countries (Articles 26 and 27 of the OECD or UN model conventions); the specific international instruments such as the Tax Information Exchange Agreements based on such model agreements as those of the OECD (2002), Council of Europe - OECD (1988) and CIAT (1999), as well as the Multilateral Convention on Mutual Administrative Assistance in tax matters OECD / EC (1988), amended in 2010 to facilitate the adherence of the emerging countries.

In practice, there are three information exchange modalities, namely:

a) Exchange of information upon request: information is transmitted in response to a specific request from the country of residence. It involves the transfer of specific data, which are considered necessary for undertaking necessary administrative actions regarding specific and identifiable taxpayers or operators.
b) Automatic information exchange, whereby the tax authorities of the source country periodically send to the country of residence, all relevant tax information that have agreed to exchange. In these exchanges, two or more administrations agree to systematically and periodically transmit information on one or several data categories.
c) Spontaneous information exchange, whereby the authorities of a country, on their own initiative, send to tax authorities of another country, specific information (perhaps acquired in the course of a verification or investigation), assuming that it may be of interest to the other one.

It should be noted that these methods of information exchange may be combined. These are not the only possible forms of information exchange. Countries tend to regularly exchange information unrelated to specific cases. Tax authorities may share their examination experiences, when discussing specific transfer pricing issues that may have arisen in a particular economic sector. There may also be random information exchange, based on some kind of risk selection criterion. Nevertheless, for practical purposes, the following description focuses on the aforementioned three types of information exchange.

The aforementioned legal instruments are the basic requirement for the exchange not to violate taxpayer confidentiality. To protect such confidentiality, the rules generally provide that the information exchanged can only be used for tax purposes and that such information can only be disclosed to those authorities (including judicial and control), in

charge of managing or collecting the taxes comprised in the Convention. In some countries, it is also required that before the tax authorities respond to an information request from another country, they notify the affected taxpayers, although this requirement is taken into consideration in cases of tax fraud.

These instruments are binding rules, when the rights and obligations of the signatory governments are specified, although, it should be noted that there is no international organization in charge of enforcing these agreements. These types of agreements provide that information exchange is a reciprocity issue, although the exchanged information does not have to be of a reciprocal nature. The lack of reciprocity may be due to the following factors: i) the existence of legal obstacles ii) the absence of taxable activities on which to provide information, and iii) a country's reluctance to cooperate.

Based on the abovementioned reciprocity principle, the jurisdiction providing information does not usually receive any compensation (monetary) for the general expenses incurred, nor does it benefit from the additional income generated. In the case of information requests involving extra costs, the latter are usually borne by the requesting jurisdiction. In some cases, the authorities of the requesting country may visit the treaty partner country in order to be present during the verification procedures, and thereby directly sharing the expenses. Furthermore, when financial institutions are obliged to report to national tax authorities, they are usually compelled to share in part of the costs.

The main trigger for the massive signing of TIEAs seems to be the emergence of certain banking scandals and the global financial crisis, which increased the governments´ concerns regarding the tax deficits and tax revenue leakage. Overall, the OECD and the EU countries are the most active in this process. In addition, two new forums have been established for leading the process: the G20 and the Global Forum on Transparency and Tax Information Exchange. The latter one was created by the OECD, in response to concerns expressed by tax havens, which sought a voice in the coercive process of the tax haven listing and requested the negotiation of a TIEA. The Forum currently has 105 member countries, plus the EU and nine international organizations (e.g. OECD and UN), as observers. Undoubtedly, all opinions coincide in that this has been the body gathering the largest number of international organizations. This Global Forum was restructured at the meeting in Mexico in 2009, in order to provide equal voting opportunity to all member countries, even though, from a technical standpoint, the Global Forum continues to be an OECD instrument. The member countries contribute to the administration expenses, although most of the funding comes from the OECD member countries.

The Global Forum, which started with the monitoring and surveillance of the TIEAs, subsequently undertook a peer review of the Member State internal regulations, to ensure that said rules may allow the practical application of the TIEAs, by amending bank secrecy laws and facilitating the empowerment of the tax administrations for compiling and transmitting information. However, it should be stressed that the Forum

per se, lacks administrative powers and, moreover, its actions are not supported by any multilateral agreement or any other legally delegated authority.

The rule is, in some respects, inferior to that of the OECD Model Convention, since it is limited to the information exchange upon request and therefore, does not include the automatic exchange of information. Bank secrecy is only lifted based on the limited circumstances provided in the TIEA. However, through the TIEA process, this rule is now applied to a larger set of countries than the DTCs. One of the innovative characteristics in the negotiation of TIEAs is that it takes place outside the traditional diplomatic channels used by countries when negotiating a DTC. TIEA negotiations require less formality and are thus delegated to the tax administrations. The TIEA and Global Forum processes thus involve these administrations of the negotiating States, based on a series of delegation of powers that are now part of the normal activity of those tax administrations. In other words, the implementation and application of TIEAs is considered a purely administrative responsibility which, nevertheless, requires experts devoted to these tasks.

In 1988, the OECD and the Council of Europe enter into this type of Convention. Gradually, some European Union and OECD member States signed the Convention, which entered into force in April 1995. However, there was no generalized application of the Convention, since a large number of States did not ratify it, although it was not open to other countries. Since 2008, the OECD, G20 and the Global Forum have tried to establish this Convention as a genuine global legal basis for transnational administrative tax cooperation. The explanatory report of the Multilateral Convention provides for its scope of operation: "this instrument constitutes a framework that provides all possible forms of administrative cooperation between the States in matters dealing with the assessment and collection of taxes, in particular with a view to combatting tax avoidance and evasion. This cooperation ranges from information exchange to foreign tax collection."

A key goal established by the G20 is "to make it easier for developing countries to benefit from the new cooperative environment." In 2010, by means of a Protocol, it was agreed to open the Convention to non-OECD or non-European Union member countries and introduced certain amendments to expand the scope of the Convention. The Protocol entered into force in June 2011. At the G20 meeting on November 4, 2011 all other G20 countries committed themselves to sign the Convention. Although it seems likely that the Multilateral Convention may be extended to new countries, currently its coverage is still rather limited. By September 13, 2012, only 38 countries had signed the Convention, mainly developed countries, although the list of signatories also includes five Latin American economies[10] . A procedure has been established to become a party to the convention, which requires that the existing parties agree by consensus. The factors to be taken into account include the confidentiality rules and practices of the requesting country (rules which may be difficult to fulfill in some cases), as well as its participation in the Global Forum, which is open to all countries. The Multilateral

[10] Argentina, Brazil, Colombia, Costa Rica and Mexico.

Convention generalizes and expands the existing tax administrative cooperation mechanisms in a specific number of areas, although in relation to information exchange, they significantly overlap with the existing CDIs and TIEAs. Article 1 provides the different types of information exchange, as described in the Commentary to Article 26 of the OECD Model Convention and the Information Exchange Manual: upon request, automatic and spontaneous, while other rules allow simultaneous or joint audits or other forms of cooperation.

Two aspects of the Multilateral Agreement are noteworthy. First, the Convention establishes a coordinating body consisting of competent authority representatives (national tax administrations), which is in charge of supervising the implementation and development of the Convention, under the sponsorship of the OECD (Article 24.3). The Explanatory Report suggests that this body should encourage the formulation of standard solutions to problems in the application and interpretation of the provisions.... contributing its views on implementation issues in general. Second, the explanatory report provides that national tax administrations should establish specialized divisions devoted to managing the transnational tax information exchange and other types of assistance. It emphasizes the need for direct and fast contacts between tax administrations; since it is considered that this is the only way to make the assistance effective. Trends in this direction are identified, since the establishment of a central unit in each tax administration is proposed, with a view to managing tax assistance between countries, inasmuch as it is necessary to establish specific safeguards regarding the confidentiality and secrecy of taxpayer information, which can only be provided under the conditions established by the Convention.