Part One

REPORT OF THE AD HOC GROUP OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS ON THE WORK OF ITS TENTH MEETING
INTRODUCTION

A. Terms of reference


   1. Formulation of guidelines for international cooperation to combat tax evasion and avoidance;
   2. Continuing the examination of the United Nations Model Double Taxation Convention between Developed and Developing Countries and consideration of the experience of countries in bilateral application of the Model Convention;
   3. Study of possibilities of enhancing the efficiency of tax administrations and formulation of appropriate policy and methodology suggestions;
   4. Study of possibilities of reducing potential conflicts among the tax laws of various countries and formulation of appropriate policy and methodology suggestions.

B. Opening of the meeting

2. The meeting started with an obituary reference to Mr. Hillel Skurnik, representative of the Government of Finland to the Ad Hoc Group of Experts, who passed away on 3 August 2001. Mr. Bouab, Secretary of the Group of Experts, referred to the long and effective services rendered by Mr. Skurnik in tax legislation and international taxation to both the Government of Finland and to the United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters. Mr. Bouab referred particularly to the profound knowledge and dedication of Mr. Skurnik to international taxation and to his distinguished services to the Ad Hoc Group of Experts as rapporteur. The members of the Ad Hoc Group of Experts observed a minute of silence in the memory of Mr. Skurnik.

3. Mr. Bouab welcomed the members to the 10th meeting despite their pressing preoccupations. He presented to the members of the Group of Experts the new edition of the UN Model Convention (2001) and the draft United Nations Manual on the Negotiation of Tax Treaties between Developed and Developing Countries, which will be examined during the 10th meeting. Copies of the revised Model Double Taxation Convention between Developed and Developing Countries have been sent to Government agencies, professional bodies, universities and academic and other higher learning institutions as well as to Members and Observers of the Ad Hoc Group of Experts. The Group of Experts will carry out periodic revisions of the Model Convention as the exigencies require.

4. Referring to the other items on the agenda, relating to transfer pricing, new financial instruments, taxation of electronic commerce, and mutual assistance in tax collection, Mr. Bouab expressed the hope that the members of the Group of Experts will find the subjects of topical interest and will exchange views on the developments taking place in this area since the last
5. Agenda item 5 concerned transfer pricing mechanisms adopted by multinational enterprises and their group companies to minimize aggregate tax liabilities as also for non-issues or political factors. The "arm's length" method using real transactions as the basis for allocating income has created difficulties in its application for developing countries and economies in transition due to limited markets in many types of goods and services and lack of availability of comparable prices. For resolving transfer prices disputes, many countries have developed procedures for Advance pricing agreements (APAs) which determine, in advance of controlled transactions, an appropriate set of indicators for the determination of transfer pricing for those transactions over a fixed period of time. But the APAs place a strain on administrative resources and may also lead to breach of confidentiality of trade practices.

6. Agenda item 6 concerned new financial instruments, such as derivatives and their variants which have posed immense challenges to tax systems of most countries. There are four objectives for an ideal system for taxing the innovative financial instruments: neutrality, equity, certainty and administrability. There has been no consensus so far regarding the appropriate jurisdiction for taxing the income from cross-border derivative transactions, that is, whether the residence basis or by withholding tax at source. The possibility of double taxation if the financial instrument is classified differently by two tax authorities also cannot be ruled out. Most countries have not so far crystallized their legal position concerning taxation of income attributable to innovative financial instruments.

7. Agenda item 7 concerned taxation of electronic commerce. In view of the exponential growth of electronic commerce and the tax revenue attributable to it, there was need to evolve firm principles of taxation which should be technology-neutral, and be based on principles of transparency, certainty, effectiveness, efficiency and non-discrimination. Electronic commerce posed several risks and difficulties of securing voluntary tax compliance from taxpayers since it provided ample scope for tax evasion. There was need to examine specific issues in international taxation in relation to electronic commerce, such as, characterization of income, place of residence of companies and others, quantifying business profits with reference to transfer pricing, trading by non-residents and attribution of profits to permanent establishments.

8. Agenda item 8 concerned mutual assistance in tax collection, an issue which was not dealt with in article 26 of the UN or OECD Model Convention, dealing with Exchange of information. Parties to the Convention on Mutual Administrative Assistance on Tax Matters, a multilateral convention drawn up by the Council of Europe have agreed to provide extensive mutual assistance and cooperation in the gathering of information and enforcement of tax liabilities due to other tax jurisdictions. Some bilateral tax treaties contained a specific provision for the Contracting States to lend assistance and support each other in the collection of taxes due to the other country. It was considered desirable to examine whether the UN Model Convention or the commentaries thereon should include provision for collection assistance.

9. Under agenda item 9 relating to "other matters", Mr Bouab referred to the Second Interregional Training Workshop on International Taxation organized by the United Nations in
Beijing in association with the Government of People’s Republic of China from 23 to 27 April 2001 in which senior tax officials from nineteen developing countries and economies in transition as also from State Administration of Taxation of China participated. He also referred to the Ad Hoc Expert Group Meeting on Strategies for Improving Resource Mobilization in Developing Countries and Countries with Economies in Transition organized by the United Nations in Montreal, Canada in association with the Association de la Planification Fiscale et Financière (APFF) from 2 to 6 October 2000. Such forms of technical assistance and training workshop provided by the United Nations resulted in enhancing the technical skills and competence of tax officials from developing countries and economies in transition.

C. Attendance

10. The following members of the Group of Experts attended the tenth meeting: Antonio Hugo Figueroa (Argentina), Ms Iraci Kahan (Brazil), Zhang Zhiyong (People’s Republic of China), Abdoulaye Camara (Cote d’Ivoire), Talaat Homam Mohamed Badr (Egypt), Paul Perpere (France), Marcellin-Edgard Mebelet (Gabon), Wolfgang K.A. Lasars (Germany), O. P. Srivastava (India), Mayun Winangun (Indonesia), Mayer Gabay (Israel), Errol Hudson (Jamaica), Armando Lara Yaffar (Mexico), Noureddine Bensouda (Morocco), Pieter J. Vogelaar (The Netherlands), J. A. Arogundade (Nigeria), Riaz Ahmad Malik (Pakistan), Babou Ngom (Senegal), Jose Antonio Bustos (Spain), Daniel Luthi (Switzerland) and Michael Waters (United Kingdom). (For details, see annex below).

11. The meeting was also attended by observers for the following States Members of the United Nations: Belgium, Cameroun, Cayman Islands, People’s Republic of China, Congo, Egypt, Gabon, Kenya, Malaysia, Morocco, Nigeria, Russian Federation, South Africa, Trinidad and Tobago and Uganda.

12. The meeting was attended by observers for the following international bodies and other institutions: Fairlight Dickinson and Valencia Universities, Commonwealth Association of Tax Administrators, Inter-American Centre of Tax Administrations, International Association of University Presidents, International Bureau of Fiscal Documentation, International Chamber of Commerce, International Fiscal Association, International Monetary Fund, Organization for Economic Cooperation and Development and World Association of Former United Nations Interns and Fellows. (For details, see annex 1 below).

13. The Secretariat gratefully acknowledges the contribution of Professor Michael McIntyre and Professor Walter Hellerstein who served as resource persons for the meeting. (For details, see annex 1 below).

D. Election of officers

14. The Group of Experts elected Antonio Hugo Figueroa (Argentina) as Chairman and Mayer Gabay (Israel) as rapporteur. Abdel Hamid Bouab served as Secretary and was assisted by Suresh Shende (Assistant Secretary) and Masa Ohyama (Economic Affairs Officer).
E. Adoption of agenda

15. The Group of Experts adopted the following substantive agenda for the tenth meeting:

1. Revision and updating of the United Nations Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries;
2. Transfer pricing;
3. New financial instruments;
4. Taxation of electronic commerce;
5. Mutual assistance for tax collection;
6. Other matters;
7. Arrangements for the eleventh meeting.

F. Documentation

16. To facilitate its work, the Group of Experts had before it the following documents:

1. Annotated Provisional Agenda (ST/SG/AC.8/2001/L.1);
2. Mutual Assistance in Collection of Tax Debts (ST/SG/AC.8/2001/L.2);
3. Considerations Fiscales pour l’Enterprise Electronique (ST/SG/AC.8/2001/L.3);
4. Electronic Commerce and the Challenge for Tax Administration (ST/SG/AC.8/2001/L.4);
5. Derivative Markets : Economic Implication for Taxation (ST/SG/AC.8/2001/L.5);
8. E-commerce : Issues in International Taxation (ST/SG/AC.8/2001/L.8);

17. A list of working papers and conference room papers is contained in annex II below.
I. Revision and updating of the United Nations Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries

18. The Chairman of the Ad Hoc Group of Experts referred to the meeting of the Steering Committee held in Beijing, PRC, on April 23-27, 2001. The Steering Committee had been appointed by the Ad Hoc Group of Experts during its 8th meeting in December of 1997 and had been entrusted with the task of reviewing and updating the draft Model Convention and Manual. Accordingly, the Steering Committee devoted extensive efforts and time reviewing the draft of the Manual prepared by the Secretariat.

19. The Secretariat reviewed the draft revision of the Manual formulated by the Steering Committee at its meeting in Beijing. It provided a general summary of the main issues addressed in the manual and noted that the latter together with the newly published Model Convention had made revisions that were necessary to remove obsolete provisions and clarify the meanings of the convention. The manual addresses some issues that arose after the Model Convention had been approved by the Ad Hoc Group of Experts, such as the omission by the OECD of Article 14 (Independent Personal Services) from its revised model. At this stage the Manual did not address in detail the various current issues, such as e-commerce and new financial instruments, which are currently topics of discussions by the Ad Hoc Group of Experts.

20. It was observed that the process of globalization affected various developing countries in different ways. It was also noted that part I of the manual was intended to provide a general background for negotiators from developing countries and economies in transition and to give a justification for the position taken by the developing countries in favour of greater taxation at source. Part II of the Manual reproduces articles of the UN Model convention (2001), provided excerpts from the UN Commentary, and gave some references to developments that have occurred since the current model was approved by the Ad Hoc Group of Experts. Part III is an update of materials included in the original manual dealing with the negotiation process and other topics.

21. The Chairman then invited comments from the members and other participants. One member sought to clarify that the Commentary on the Model Convention was the primary document and had priority over the manual. That point was fully accepted. It was suggested that the two documents serve somewhat different functions. The manual is intended to give guidance to tax officials negotiating tax treaties on behalf of developing countries and economies in transition and to serve as an educational function in government training programs. The Commentary’s primary function is to interpret the Model Convention. The Commentary, nevertheless, can serve as a valuable document in the negotiating process because understanding the meaning of the Model Convention is an important aspect of negotiating.

22. Some members noted that the globalization and international taxation included references that might be still under further consideration by various institutions, fora and organizations. Others suggested that that section was intended to present a balanced summary of an issue which
was referred to by the Millennium Declaration, namely, "... the central challenge we face today is to ensure that globalization becomes a positive force for all the world’s people ... only through broad and sustained efforts to create a shared future, based upon our common humanity in all its diversity, can globalization be made fully inclusive and equitable." In this connection it was noted that the Manual is intended for tax negotiators from developed, developing and transitional economies countries and its usefulness will be limited if it avoided mention of matters that negotiators feel was not entirely compatible with their views.

23. It was pointed out that the Steering Committee in its Beijing meeting had given extensive review to the draft manual, which is before the Group of Experts for further discussion. To enable the Members of the Ad Hoc Group of Experts to formulate appropriate recommendations for the revision of the Manual it was agreed that such a review be postponed till the end of the meeting and that detailed suggestions for revisions should be submitted in writing. Participants from developed and developing countries and countries with economies in transition expressed their appreciation for the work that was done on the revision and updating of the Manual which constitutes a major tool for educational and training purposes in international taxation for their tax administrations. They emphasized the extreme usefulness of such document to enhance their capacities and secure the availability of expertise and skills in tax treaty negotiations. Several participants from developing countries and economies in transition emphasized that their staff dealing with tax treaty negotiations are limited to a single or a few persons and that the Manual would not only avail them to train a larger number of middle level officials in international taxation but will also enhance their own capacities in treaty negotiations. Some participants, however, observed that in view of the recent publication (June 2001) of the revised United Nations Model Double Taxation Convention between Developed and Developing Countries, the contents of the draft Manual may further gain in clarity through additional updating of the commentary. This approach will result in further consistency of the contents of the Manual with the Model Convention. Accordingly, it was agreed that participants will forward comments, suggestions and editorial changes within a month of time prior to the publication of the final version of the Manual.

II. Transfer pricing

24. The Chairman initiated the discussion of agenda item with an overview of the issue of transfer pricing from the perspective of the developing countries. He noted that transfer pricing is primarily an issue in determining the income of large multinational firms, in that approximately 80 percent of international trade is conducted by approximately 60,000 firms. He also cited figures indicating that the amount of tax revenue lost to governments from the strategic use of transfer prices by multinational firms was quite large. He also noted that the issue of transfer pricing has been discussed in detail at prior meetings of the Ad Hoc Expert Group and by many other organizations.

25. It was generally agreed that a major objective of adopting transfer pricing mechanisms by multinational enterprises was to minimize the aggregate tax liabilities of their corporate group,
although other non-tax issues played some role. Moreover, the customs authorities were also concerned with the under-reporting of value of imported articles as a natural consequence of improper transfer prices. Several countries in North and South America have attempted legislative measures to overcome the adverse consequences of transfer pricing mechanisms.

26. A representative from a developed country pointed out that in order to avoid double taxation and the consequent impediment to world trade, the OECD has issued guidelines in 1995 on the methodology of determining the arm’s length price. The revision of the guidelines has continued since then by publishing new chapters relating to intangibles and services, on cost contribution arrangements, and guidelines for conducting Advance Pricing Agreements (APAs) under the mutual agreement procedure. In general, an APA is an agreement between the taxpayer and one or more governments on the methodology to be used in some specified number of future years in setting transfer prices for some or all of the taxpayer’s business. Presently, the OECD is engaged in providing guidance on the manner of application of the general principles to complex situations, such as permanent establishments, financial services, global trading, and thin capitalization.

27. A representative from a developing country discussed his country’s experiences in developing its transfer pricing procedures, beginning in 1988, when the country began to engage more fully with the outside world. The major objectives of developing the transfer pricing procedures were to create an appropriate investment climate in the country and to protect the legitimate interests of investors. There are three ways of making transfer pricing adjustments, based on the OECD guidelines and the experiences of other countries. The adjustments were not sufficient to deal with all transfer pricing problems. One reason was that there were not many comparable prices available. Second, the burden on tax officials of finding comparable prices was heavy. Third, the use of the comparable profit method, referred to by the OECD as the transactional net margin method, although relatively easy to apply, created distortions if used excessively. After putting in place its methods for auditing multinational companies, the country examined additional issues, including the use of APAs. Presently, APAs are used only on a bilateral basis, although in some cases the multinational enterprise is engaged in business activities in several different countries.

28. Another representative from a developing country discussed the problems faced by his country in determining proper transfer prices. He suggested that many developing countries, to protect their tax revenues and their balance of payments, are required to make special administrative efforts to fight against the indirect transfers of benefits outside the country through improper transfer prices. He noted that his country did not have adequate data on comparable prices and lacked sufficient human and financial resources to deal adequately with the problem. He also discussed the possible use of an arbitration mechanism to settle disputes between taxpayers and the government on transfer pricing issues. He added that the taxpayer must feel confident that information provided to the government will be kept in confidence if an appropriate relationship between the government and the taxpayer is to be established.

29. A representative from a developed country discussed the arbitration convention of the
European Union. He noted that the convention defines an associated enterprise in accordance with Article 9 of the UN and OECD Model Conventions. He noted that the scope of the convention is limited to the 15 members of the European Union. As a result, issues relating to affiliated companies resident in countries outside the EU are not within the scope of the convention. He also noted that a panel appointed to consider an arbitration case would have an equal number of members appointed by each country involved and an equal number of members drawn from experts nominated by the 15 members of the EU. To ensure an odd number of members on the panel, the chairman would be elected by the panel from that same list of experts. He noted that no cases have yet been undertaken under the convention. He suggested, however, that the convention may be judged a success to the extent that it has caused member states to conclude competent authority cases in a timely manner. One member from a developed country indicated that his country is expecting to have a case under the convention in the near future.

30. Representatives of several countries discussed their experiences with arbitration. It appears that arbitration is not used very often in practice. The main function of an arbitration option seems to be to put some pressure on governments to reach an agreement through the mutual agreement procedure based on Article 25 of the UN and OECD Model Conventions. Several representatives from developing countries expressed the view that the mutual agreement procedure should be preferred. One participant noted that an arbitration procedure was likely to give the advantage to the side that is best represented in the procedure and that the multinational companies tend to be well presented. Several members suggested increased use of mediation as an effective means for resolution of transfer pricing disputes.

31. The members gave extensive comments on the possible use of APAs in developing countries. One point, made by a representative of a developed country, was that APAs are only relevant when a country has developed the capacity to do an extensive audit of the transfer prices of a multinational enterprise. APAs were developed to reduce the cost of litigating complex cases and thus have no relevance to countries that are not litigating such cases. Some members noted that APAs could put severe strains on administrative resources because they require an extensive review of the pricing methodology of the company requesting the APA. As a result, there may be little administrative savings from an APA programme. Others noted the problems arising in a dynamic world when pricing methodologies are set for an extensive period into the future.

32. One participant suggested that developing countries might find the use of safe harbours (also called "safe havens") to be a convenient way of dealing with some transfer pricing issues. A representative from a developing country discussed the experience of his country with safe harbours. He suggested that it was most useful when the other country involved was prepared to accept the safe harbour rule. One participant suggested that taxpayers should be given an option to use an arm's length method in place of the safe harbour. It was noted, however, that much of the administrative advantage of the safe harbour might be lost if that option was provided. There was a general consensus that the use of safe harbours might be explored, but that their use should be limited to certain types of businesses and should be based on a good analysis of the profits
likely to be earned in those businesses.

33. In light of the above and despite the adoption of various adjustment methods, legislative, and other multilateral measures to overcome the adverse consequences of transfer pricing mechanisms during the past several years, the Secretariat requested and the Ad Hoc Group of Experts agreed to establish a Focus Group composed of seven members to review the current situation with respect to transfer pricing mechanisms and formulate recommendations to avert the loss of tax revenues from corporate strategic use of transfer prices. In particular, the Focus Group would concentrate on the need to adjust the various transfer pricing methods, review the mutual agreement procedures provided in the article 25 of the United Nations Model Convention, define the appropriate framework for relevant mediation and arbitration procedures and suggest means aimed at providing training and technical assistance to enhance capacities of tax administrations in dealing with transfer pricing mechanisms, particularly, in developing and transitional economy countries.

34. The Focus Group appointed by the Group of Experts on proposed work on Transfer Pricing made the following recommendations which were endorsed by the Group of Experts:

1. **To enhance policy advice, technical assistance and international cooperation on transfer pricing issues.**

   In order to provide the maximum benefits to developing countries and economies in transition, technical assistance should be directed at solving the most pressing problems while creating a framework for future developments. Such assistance should include:

   a) Policy advice in the form of short-term evaluation and a support mission to the area at the request of tax authorities from developing countries and economies in transition.

   b) Technical assistance focusing on industrial and commercial sectors of particular importance to developing countries and economies in transition. For example, the assistance should focus on natural resource extraction industries, commodity producers, or contract manufacturing.

   c) Training on transfer pricing mechanisms and techniques for settlement of disputes.

   d) Enhanced and coordinated bilateral assistance from developed countries to developing countries and economies in transition.

   e) The identification of transfer pricing experts who have the technical background required to provide practical guidance and assistance to developing countries and economies in transition.
f) Enhancement of the dialogue among the developing and transitional economy countries on transfer pricing issues by providing opportunities for countries with detailed experience on certain transfer pricing issues to share their experiences with other developing countries and economies in transition.

g) Greater coordination between international organizations and the various individual countries that provide technical assistance to developing countries and economies in transition.

h) An exploration of the possibility of developing some types of simplified rules (safe harbours) that developing countries and economies in transition might use this kind of method until they develop the capacity of applying the arm’s length principle of article 9 of the United Nations Model Convention. The goal of the simplified rules would be to approximate the results achievable under that principle. Such a possibility was discussed by the Ad Hoc Group of Experts taking into account that recent experiences show that developing countries’ tax administrations are not prepared yet to apply the OECD guidelines.

2. Avoiding and Resolving Transfer Pricing Disputes.

Developing countries and economies in transition have found that they have become involved in lengthy and costly disputes with multinational companies over the proper application of the arm’s length principle. To avoid such disputes or reduce the costs of resolving the disputes when they occur, the Group of Experts has developed the following list of possible steps.

a) Procedures should be developed for dealing in a swift and proper manner with requests for an exchange of information relating to transfer pricing under Article 26 of the United Nations Model Double Taxation Convention and the OECD Model Convention.

b) Administrative practices should be identified that would permit the tax authorities in developing countries and economies in transition to avoid disputes with taxpayers over interpretation of the arm’s length principle. One example of a possible practice would be the publication of explanatory or technical rulings, including rulings developed jointly with trading partners.

c) Ways and means of improving the working of the mutual agreement procedure of Article 25 of the United Nations Model Double Taxation Convention and the OECD Model Convention should be explored.

d) Possible alternative methods of resolving disputes, such as mediation and arbitration, should be examined to see if they are compatible with the needs and circumstances of developing countries and economies in transition.
III. New financial instruments

35. New financial instruments, such as, derivatives, including options, forwards and futures and their other variants have assisted in meeting the global demand for financing international trade and investment and also to reconcile the different needs of investors and borrowers. This financial innovation has allowed corporations to insure themselves against various types of risk by transferring that risk to the financial sector, which has the beneficial effect of reducing the consequences of currency and interest rate movements on the corporate sector. In short, financial innovation in the form of derivative products can play a powerful role in encouraging prudent risk management.

36. However, it was recognized that the new rules for the taxation of new financial instruments as used in domestic transactions will possibly not be a priority in the immediate future for developing countries and countries in transition. It was expected that most countries would monitor their applicable accounting rules to ensure that there were no serious problems in accounting for income from new financial instruments for corporate income tax purposes. Four goals were identified for an ideal system for taxing innovative financial instruments: neutrality, whereby economically equivalent instruments would be taxed in the same way, irrespective of their legal form; equity; certainty; and administrability. It was observed that countries will have to be vigilant in applying transfer pricing rules to cross-border transactions involving new financial instruments. This may require adequate legal authority to enable the tax administrations to adjust transfer prices wherever necessary and the existence of a sufficient number of tax officials who are adequately trained to deal with the complex issues. It was also suggested that countries should develop clear rules for associating new financial instruments with local branches (permanent establishments) of non-residents and ensure consistent and diligent application of rules.

37. It was observed that most countries may have an interest, consistent with the principles of existing bilateral tax treaty networks, in imposing withholding tax on cross-border payments under new financial instruments in certain circumstances, namely, where the countries impose withholding tax on cross-border payment of interest, in cases where the payments represented a return on invested capital and in cases where the payments represented excessive amounts used to siphon off earnings to related parties. It was also considered that countries which imposed withholding tax on interest paid to non-residents may extend this tax to original issue discount. There was a suggestion that the use of hybrid instruments on a cross-border basis to erode the domestic tax base can be appropriately countered by effective thin capitalization rules. In view of the fact that new financial instruments are being used to structure transactions whose legal form deviates from their economic substance, it may be necessary to introduce anti-avoidance legislation enabling tax administrations to challenge the re-characterized transactions according to their economic substance in appropriate cases.

38. It was also observed that in addition to their critical role in risk management, innovative financial instruments presented a number of serious challenges for income tax systems both in
developed and developing and transitional economy countries. The traditional income tax issues of character, source, timing, and amount of income are generally based on an initial classification of the type of income in question. It was pointed out that these systems of categorization are becoming increasingly difficult to maintain and administer in the light of emergence of instruments that reflect economic attributes of investments in diverse forms. The critical issue of determining the ownership of an instrument for tax purposes was also tested by contracts that replicate, shift, or eliminate some or all of the returns and risks of an investment. By contrast, securities lending and repurchase arrangements which transfer legal title but retain economic attributes of an investment seem to present similar problems of identification of the "tax owner" of a position. It was further stated that the tax systems are being challenged by two broad and competing concerns, namely, removing artificial tax barriers to effective risk management strategies and limiting the opportunities for tax arbitrage.

39. It was suggested that different approaches can be undertaken by tax systems, such as reliance on financial accounting rules which can offer greater consistency and reduced compliance costs, dis-aggregation of financial instruments to isolate and identify different economic components separately for income tax purposes, mandatory integration of certain offsetting transactions to prevent potential abusive transactions, and application of broad anti-abuse rules that impose "substance over form" rules to combat tax arbitrage. It was considered that the above approaches may be taken, either individually or in combination, in developing appropriate responses to the challenges presented by innovative financial transactions.

40. The reverse convertible (exchangeable) bonds were substantially normal stock exchange issued bonds with an outstanding period of about two years embodying a generally high interest bearing debt obligation. Their distinctive feature was that under the contract the issuer at maturity has the choice of either repaying to the holder the face value of the bond in cash or transferring to the holder a certain number of shares of a third-party corporation. It was observed that the treatment of the income, if any, for income tax purposes created many difficulties, since at times such instruments were treated as an interest-producing loan while another approach treated it as a portion considered as interest and a portion regarded as premium for a put option written by the holder, which was not treated as income under certain circumstances and not subject to tax. It was considered that such complex and hybrid financial instruments posed considerable challenges to tax administration.

IV. Electronic Commerce

41. The Ad Hoc Group of Experts recognized that electronic commerce was an important and rapidly growing segment of the economy that raised significant issues for both direct and indirect tax regimes. Even the most conservative estimates of the growth of electronic commerce indicate that it will play a more and more important role in the world economy for developed and developing countries alike. The principal challenges for tax administrations were identified as the erosion or disappearance of the tax base; the difficulties in identifying the taxpayer; and
problems of tax enforcement.

42. It was observed that the problems of direct taxation of electronic commerce were fundamental but not urgent whereas the problems of indirect taxation of electronic commerce were urgent but not fundamental. There is an international consensus that the rules for the consumption taxation of cross-border trade should result in the jurisdiction where consumption takes place. With respect to such taxes, it was pointed out that there were essentially four types of transactions that may be characterized as involving electronic commerce: transactions involving electronic ordering of business-to-business (B2B) supplies of tangible personal property; transactions involving electronic ordering of business-to-consumer (B2C) supplies of tangible personal property; transactions involving B2B supplies of digital products or services; and transactions involving B2C supplies of digital products or services. Only the last category of transactions was thought to provide a truly difficult challenge for consumption tax administration. There are existing mechanisms, well known to taxing authorities, for controlling and enforcing consumption taxes with respect to tangible products, even when such products are sold in cross-border transactions involving remote suppliers. Moreover, it was pointed out that there is an effective mechanism for enforcing consumption taxes with respect to B2B supplies of digital products or services in a cross-border transaction, namely, the reverse charge or self-assessment mechanism.

43. The one true challenge to tax administration was represented by B2C transactions involving digital supplies. It was pointed out that the relative importance of the problem was, for the moment at least, reduced by the fact that B2C digital commerce represents less than 20 percent of e-commerce transactions, which is dominated by B2B transactions. Nevertheless, it was emphasized that these problems are likely to become more and more significant in the coming years with the expected growth of B2C digital commerce. It was noted that there is currently considerable attention being given to the development of technology-based tax solutions to the problems raised by consumption taxation of electronic commerce. A member from a developing country raised the question whether these innovative technology-based solutions originated in tax-based or technology-based organizations and questioned the relationship between the two. In response, it was pointed out that the private sector was currently developing the technology-based solutions, which drew on both tax and computer expertise. It was further pointed out, however, that the implementations of such solutions necessarily require a high degree of cooperation between taxing authorities and these "trusted third parties," who are developing and administering these technological solutions.

44. The problems of direct taxation of electronic commerce involve more fundamental issues than the problems of indirect taxation of electronic commerce because there is not as strong an international consensus on the underlying taxing principles with respect to former as compared to the latter. Specifically, there is controversy over the application of the permanent establishment concept to the e-commerce environment, although some consensus appears to have been reached as to the circumstances under which a server or a web site may constitute a permanent establishment. More significantly, there is continuing controversy over the fundamental
questions of how various types of transactions involving digital products should be characterized for income tax purposes and, consequently, the nature of source of the income from such transactions.

45. In summary, it was pointed out that electronic commerce would inevitably become an increasingly important fact of economic life, even in developing countries and economies in transition. Despite the fact that the threat that electronic commerce currently poses to the tax regimes of developed economies C namely, erosion of the tax base C may appear, for the moment, to pose less of a threat to the tax regimes of developing countries and economies in transition, it was observed that it was of utmost importance for such countries to be actively engaged in the worldwide debate over the challenges posed by electronic commerce for tax administration. In particular, these countries may consider developing the appropriate environment and legislation to formulate the development of and taxation of e-commerce. Only if they do so, will they be in a position to deal with C and benefit from C the growth of e-commerce and its inexorable impact on their economies and tax regimes. In this connection, a member from a developing country suggested that the United Nations may undertake research and new initiatives for determining the principles for taxation of electronic commerce and, specifically, concepts of permanent establishment, which may be useful to developing countries and economies in transition. With a view to ascertaining the proposed course of action for the taxation of electronic commerce in the developing countries and economies in transition, the Group of Experts appointed a Focus Group from among the participants in the tenth meeting. After due deliberations, the Focus Group presented the following report containing recommendations, which after some discussion, were approved by the Group of Experts.

46. To a considerable extent, electronic commerce (e-commerce) does not recognize national borders. Because of this feature of e-commerce, its taxation should be considered in a cooperative manner among governments. Although income from e-commerce currently is not an important part of the tax base of developing countries or economies in transition, it is anticipated that such income will become increasingly important in the future, particularly with respect to business-to-business transactions. Moreover, the increasingly important role of e-commerce has significant implications for tax administration, namely the widespread adoption of paperless tax reporting and remittance mechanisms, which will inevitably have an impact on all taxing authorities, even those in countries without robust e-commerce economies.

47. In light of the potential importance of the taxation of electronic commerce to developing countries and economies in transition, the Ad Hoc Group of Experts recommends that the United Nations undertake a study of the tax issues involved, which study should address the following three points:

a) First, whether the concept of a permanent establishment (PE), as it is currently understood in law, needs to be changed to take account of the changes in the economic environment that have occurred since it was first adopted as a principle of taxation.

b) Second, whether particular ways of taxing electronic commerce pose a threat to the
tax revenues of developing countries and economies in transition. The study should examine, among other things, the possible impact of electronic commerce and related technological changes on traditional ways for determining the source of income.

c) Third, whether there are practical ways that the developing countries and economies in transition can respond to the potential risks to their tax revenues from electronic commerce. If the study should conclude that the PE concept in the United Nations Model Convention needs revision, then it should provide alternative treaty language that might be endorsed by the Ad Hoc Group of Experts. The study also should suggest the types of changes in the administration of taxes in developing countries and economies in transition that may be required to deal effectively with the challenges posed by e-commerce to the imposition of taxes on such income in the source country.

V. Mutual assistance in tax collection

48. The meeting began with discussion of agenda item 8, Mutual Assistance in Tax Collection. It was observed that the issue of mutual assistance in tax collection is not dealt with in Article 26, dealing with exchange of information, of the United Nations or OECD Conventions. The reasons for the failure to include a tax collection assistance clause in model conventions were attributed to the general principle of territorially limited State sovereignty. Such territorial limitations, it was pointed out, can be overcome only by authorizing and altering enforcement conditions through an international convention, making it obligatory for a State to respond to requests for assistance by another State in recovering the latter's tax claims.

49. There are, however, major obstacles to lending assistance in tax collection that have thus far prevented international administrative cooperation through the OECD and United Nations Model Conventions. These obstacles include both substantive and procedural tax problems. Jurisdiction to deal with both the substantive and procedural aspects of tax collection may involve different arrangements regarding the status of private parties vis-a-vis the faculties, powers, duties, and privileges of the tax administration in each state. This makes it difficult to establish generally applicable and agreed measures on a global basis, and it suggests the need for individual responses that are tailored to the structure and administration of the particular State in question. Furthermore, States tend to be apprehensive about the negative effects on commercial and foreign relations that potentially could result from such cooperative arrangements.

50. Despite these difficulties, it was observed that States nevertheless need to study the mechanisms and guidelines to reinforce cooperation in tax collection. It was pointed out that it is unacceptable in an era of increasing economic globalization for the international community of States to persist in an entrenched attitude based on a rigid conception of sovereignty circumscribed by territorial borders. It was noted that arrangements for cooperation in tax collection are increasingly being accepted and included in the double taxation agreements currently in force. Furthermore, it was suggested that consideration should be given to the influence of a new multilateral Convention on Mutual Administrative Assistance in Tax Matters of the Council of Europe and OECD. It was observed that there are compelling reasons for
strengthening administrative cooperation in the recovery of tax claims and authorizing such assistance in international legal agreements. Economic globalization requires appropriate use of enforcement powers by States to allow correct application of the tax system and also the need to prosecute fiscal fraud and to control tax evasion.

51. International administrative collaboration on tax matters requires explicit regulatory authorization giving the corresponding tax administration the instruments needed to obtain assistance from the other State, and making it a legal duty of the other State to respond to the request for collaboration. Several alternative methods for achieving international administrative cooperation in tax collection were considered, but no preference was expressed for adopting any specific method.

52. A member from a developed country described his country’s experiences with assistance in collection. He described the experience as entirely favourable. He noted that his country has already entered into 22 conventions that contain an assistance-in-collection article. Several treaties with developing countries are currently under consideration and at least two treaties with countries with economies in transition have been concluded. The member indicated that his country has received approximately 800 requests for assistance in collection and has made approximately 200 requests of its treaty partners.

53. One member from a developing country described the extensive experience of his country with assistance in collection. Treaties containing such an article have been concluded with many neighbouring countries and with some more distant countries as well. Although experience with these articles is limited, it appears that the process is working successfully and is a two-way street in that his country is both receiving and making requests under the article.

54. One participant from a developed country indicated that her country had 22 agreements providing for assistance in tax collection. In her view, these arrangements were working very smoothly and routinely. There was an emerging consensus that the international climate was moving in favour of an assistance-in-collection article. One developed country that had long opposed such an article was now seriously reconsidering its position.

VI. Preparations for the Eleventh Meeting

55. The Group of Experts finally suggested the following items for the agenda of the eleventh meeting of the Group of Experts:

(a) Revision and update of the United Nations Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries;
(b) Transfer pricing;
(c) Taxation of electronic commerce;
(d) Mutual assistance in collection of tax debts;
(e) New financial instruments;
(f) Intermediation and arbitration;
(g) Protocol for mutual assistance procedure;
(h) Treaty shopping;
(i) Process of financing for development.
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Annex II

LIST OF DOCUMENTS

ST/SG/AC.8/2001/L.1 - Annotated provisional agenda

ST/SG/AC.8/2001/L.2 - Mutual assistance in collection of tax debts by Dr. Francisco Garcia Prats

ST/SG/AC.8/2001/L.3 - Tax considerations for electronic-commerce companies by Mr. Pierre Bourgeois

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