

TAXING INDIRECT TRANSFERS: IMPROVING AN INSTRUMENT FOR STEMMING TAX AND LEGAL BASE EROSION

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Numerous countries (e.g., Canada, Australia, and Japan) tax foreigners on the gains realized on transfers of interests in foreign entities that invest directly or indirectly in real estate in those countries. In the last few years, actions taken by tax authorities in India, China, Brazil, Indonesia, and other *non-Organisation for Economic Co-operation and Development* (OECD) countries have highlighted the possibility of taxing a broader range of indirect share transfers by foreigners. This article argues that taxing indirect transfers can have vital policy significance in countries where foreign inbound investments are actively traded in offshore markets: it not only deters tax avoidance, but may also stanch legal base erosion — the substitution of offshore investment structures for legal mechanisms in onshore markets. The successful implementation of a broad policy of taxing indirect transfers, however, depends crucially on securing voluntary taxpayer compliance. To this end, this article proposes to rationalize existing practices for taxing indirect transfers in two major ways: (1) striking a better balance between ex ante and ex post lawmaking; and (2) consistently treating taxable indirect transfers as sales of underlying target companies (thus allowing conforming adjustments in tax basis). These improvements better target tax avoidance, eliminate arbitrary consequences, and generate market incentives that facilitate compliance.

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I. INTRODUCTION

A fascinating recent development in the world of international taxation is the adoption by several major non-OECD countries, including India, China, Indonesia, and Peru, among others, of a policy of taxing foreigners on the sale of interests in foreign entities that hold assets indirectly in these

countries.¹ In September 2007, Indian tax authorities notified the U.K.-based multinational telecommunications company Vodafone that the acquisition, by a Vodafone Dutch subsidiary, of the shares of a Cayman company from the Hong Kong telecom conglomerate Hutchinson was taxable in India, because the acquisition was made for the purpose of acquiring the Indian telecommunications businesses indirectly owned by the Cayman Islands Company. Vodafone challenged the notice in Indian courts and, after a protracted legal battle that was widely watched by the global tax community, won a favorable verdict from the Indian Supreme Court in January 2012.² The drama only escalated at this point. The Indian legislature responded to the ruling by adopting general legislation, purported to have retroactive effect back to 1962, that embodies a policy of taxing indirect transfers (i.e., via the transfer of interests in foreign entities) of the shares of Indian companies.³ Offering fewer courtroom and legislative spectacles, but attracting no less attention from the international business community, China has pursued a similarly controversial policy of taxing indirect share transfers after the issuance of an informal piece of administrative guidance⁴ in December 2009.⁵ As other countries join India

¹ India's and China's policies for taxing indirect share transfers are discussed in detail in Parts IV through V, *infra*. For Peruvian practice, see *Latin America News Alert, Peru*, PRICEWATERHOUSECOOPERS (Feb. 22, 2011), available at <http://www.publications.pwc.com/DisplayFile.aspx?Attachmentid=4267&Mailinstanceid=19687> (stating that indirect transfers of shares in Peruvian entities owned by a foreign companies are taxable if the foreign company holds assets over fifty percent of the fair market value of which comprises the shares of a Peruvian entity). For Indonesian practice, see Dwi Ary Retnani, Presentation on Developments in International Anti-avoidance in Asia Pacific at Asia-Pacific Regional Tax Conference, Singapore (Apr. 2, 2013) (on file with author). Brazilian tax authorities also displayed a willingness to tax abusive indirect transfers in a 2009 case. Pedro Vianna de Ulhôa Canto & Antonio Luis H. Silva, Jr., *Brazil*, 34 TAX MGMT. INT'L FORUM, no. 2, June 2013, at 14.

² News reports and writing by practitioners on the Vodafone case in India are voluminous. See, e.g., D.P. Sengupta, *Vodafone*, in TAX TREATY CASE LAW AROUND THE GLOBE (M. Lang et al. eds., 2012); Vispi T. Patel & Rajesh Athavale, *The Vodafone Controversy: International Ramifications of Where Gain Accrues On the Transfer of Shares*, INT'L TRANSFER PRICING J., July/Aug. 2009, at 244–54; Jack Grocott, *Vodafone Wins \$2.5 Billion India Battle*, INT'L TAX, REV., (Jan. 20, 2012), <http://www.internationaltaxreview.com/Article/2964952/Vodafone-wins-25-billion-India-battle.html> (citing overwhelming response by practitioners in favor of the Indian Supreme Court's decision and, by implication, against the Indian tax administration). Nonetheless, few scholarly or policy analyses of the case have emerged.

³ See Draft Report on Retrospective Amendments Relating to Indirect Transfer, Expert Committee (2012) (India) [hereinafter Shome Report], available at http://www.incometaxindia.gov.in/archive/DraftReport_10102012.pdf.

⁴ *Circular on Strengthening the Administration of Enterprise Income Tax On Incomes From Non-resident Enterprises' Equity Transfers*, KPMG, <http://www.kpmg.com/CN/en/>

and China by adopting similar practices,⁶ a policy trend seems to be emerging. Some interpret the trend as evidence that developing countries are beginning to define new norms of international taxation that deviate significantly from the norms championed by the OECD and its member countries.⁷

In truth, the intuition behind taxing indirect transfers by foreigners of domestic assets and the shares of domestic companies is exceedingly simple, transparent even to the laymen once explained, and in some limited ways already accepted by policymakers and tax professionals around the world. Numerous OECD countries (e.g., Canada, Australia, and Japan, among others) already implement such a policy with respect to narrower categories of assets such as domestic real estate.⁸ The concept of taxing indirect transfers of real estate is even enshrined in the capital gains articles of both the OECD and U.N. Model Tax Conventions.⁹ Nonetheless, the

services/Tax/ Global-Transfer-Pricing-Services/ Documents/Circular-20091210-0698-1e.pdf (last visited Apr. 3, 2014) [hereinafter *Circular 698*] (translating Circular on Strengthening the Administration of Enterprise Income Tax On Incomes From Non-resident Enterprises' Equity Transfers (promulgated by the State Administration of Taxation, Dec. 10, 2009, effective Jan. 1, 2008) GUOSHUIHAN [2009] No. 698 (China)). Specific aspects of the circular are discussed *infra* Parts III through V.

⁵ Practitioners writing on Circular 698 have been similarly voluminous as writing on the Vodafone case in India, while academic or policy analysis is equally lacking. *See, e.g.*, Lawrence Sussman et al., *China's Controversial New Disclosure Rule*, 2009 WORLDWIDE TAX DAILY 241-1 (Dec. 18, 2009); Jinji Wei, *China Receives Single Largest CGT Payment From Indirect Share Transfer*, 2010 WORLDWIDE TAX DAILY 123-1 (June 28, 2010) (discussing a tax imposed on a U.S. company for an indirect transfer of shares in a Chinese resident company through a wholly owned Hong Kong subsidiary); Jinji Wei, *Goldman Sachs Facing Chinese Tax Investigation for Indirect Stock Transfers*, 59 TAX NOTES INT'L 635 (Aug. 30, 2010).

⁶ *See Latin America — Tax Consequences of Indirect Share Transfers*, KPMG, (Aug. 23, 2013), <http://www.kpmg.com/global/en/issuesandinsights/articlespublications/taxnewsflash/pages/latin-america-tax-consequences-indirect-share-transfers.aspx> (discussing policies of taxing indirect transfers in Chile, Panama, the Dominican Republic, and Peru). Moreover, the practices of many (especially non-Organisation for Economic Co-operation and Development (OECD)) countries of taxing indirect transfers may simply not be well known.

⁷ The International Fiscal Association, the largest international organization of tax professionals, has planned a special session on taxing indirect asset transfers for its 2014 annual meeting to be held in Mumbai, India. *See Seminar Topics*, IFA INDIA 2014, <http://www.ifa2014mumbai.com/ws/index.php/business-program/seminar-topics> (last visited Apr. 22, 2014).

⁸ See the discussion of relevant rules in Canada, Japan, and Australia, *infra* Part IV.

⁹ U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES art. 13, U.N. SALES NO. E.12.XVI.1 (2011) [hereinafter U.N., MODEL CONVENTION]; ORG. FOR ECON. COOPERATION & DEV., MODEL TAX CONVENTION ON INCOME AND ON CAPITAL art. 13 (2012) [hereinafter

policy of taxing indirect transfers of domestic assets seems easy to describe initially, but difficult to come to full terms with subsequently. Even after exposure to the concept for decades, the attention of the international tax and business communities still seems to linger on the notion *that* indirect transfers may be taxed, while discussions of *how* indirect transfers should be taxed have barely begun. As this article will show, the actual practices for taxing indirect transfers, even those adopted by countries with otherwise sophisticated systems of business income taxation, remain remarkably crude.¹⁰ There is a concern, therefore, that developing countries with significant markets are now eagerly embracing what is in substance an old and stagnant idea.

This article suggests that this sense of stagnation is ultimately unwarranted and can be attributed to two causes. First, policymakers have typically considered taxing indirect transfers either only in the abstract (e.g., when drafting provisions for model tax conventions) or in reaction to perceived tax avoidance in specific countries. They have not reflected, more generally, on *when* indirect transfers are likely to be pursued for purposes of tax avoidance. Additionally, because the factors that determine the prevalence of indirect transfers may vary from country to country and even during different periods for the same country, a shared sense of the urgency or importance of taxing indirect transfers has never developed. Second, the core difficulty for a policy of taxing indirect transfers is enforcement. Even countries with developed systems of tax administration have neither fully settled on the tools for enforcing the tax nor ascertained the actual levels of compliance. Much of the developing countries' enthusiasm for the policy may therefore eventually be undermined by under-enforcement and noncompliance, which legal and tax advisors in different markets may have little incentive but to acquiesce in.

Once we confront these two issues directly, however, the appearance of stagnation falls away. This article argues that designing better rules for taxing indirect transfers has vital policy importance for two reasons. First, we need to take a step back from tax policy and recognize that the prevalence of indirect transfers by foreigners of domestic assets with respect to a given jurisdiction depends on whether there is an active offshore market for foreign investments into that jurisdiction. The choice of indirect transfers as a tax avoidance device is generally complementary to the choice of an offshore market for carrying out investment activities. In turn, whether an active offshore market for foreign investment exists for a given country depends on many aspects of the country's markets and legal

OECD, MODEL CONVENTION].

¹⁰ See *infra* Parts IV–V.

system. Understanding this point allows us to appreciate not only that some countries' decision to tax indirect transfers need not be a matter of taking a "more aggressive" stance than others that do not, but also that taxing indirect transfers may have benefits beyond deterring tax avoidance. This article highlights an important class of cases in which active offshore markets have emerged for nontax reasons, and in which these offshore markets divert resources away from the development of onshore legal systems. In these cases, a policy of taxing indirect transfers can be viewed also as a way of taxing their complement — the use of offshore markets. The tax may serve as a tool to prevent not only tax avoidance and tax base erosion, but also what one might call legal base erosion;¹¹ it can help bring market resources back onshore, into building legal systems in real economies.

Second, the difficulty of enforcement implies that the best way to implement the tax on indirect transfers is by improving voluntary compliance. An important step towards that goal is rationalizing the rules for taxing indirect transfers: if the rules produce too many arbitrary consequences and are perceived as irrational, they may drive tax avoidance behavior into the sphere of outright evasion. This article recommends several major modifications of the existing rules adopted by both developed and developing countries for taxing indirect transfers. For example, most countries that have adopted bright-line rules should consider narrowing the scope of such rules, while relying on tax authorities' power of making ex post determinations to deal with taxpayers who try to game the bright-line rules. Moreover, all countries should consider adopting an approach that treats a taxable indirect transfer of shares as an asset sale, with consequent adjustments of and conformity among the tax cost or basis of the underlying target company's shares and the basis of the shares of offshore holding companies. This method would produce more rational tax consequences than does the conventional approach, which treats the shares of each offshore holding company as independently taxable. As this article shows, such rationalization should improve compliance.

The article proceeds as follows. Part II explains the intuition for taxing indirect transfers and poses a puzzle: why do we not observe the practice of taxing indirect transfers more often around the world? Part III considers the various reasons why the use of indirect transfers poses problems for tax policy in some countries but not in others, contrasting two extreme cases, foreign investments in U.S. real estate and in China. I will argue that the choice of indirect transfers as a tax avoidance device is likely to be complementary to a more basic decision to use the offshore market for

¹¹ See *infra* Part VII for a specification of the idea of "legal base."

making investments. Part IV discusses how the frequency of indirect transfers might affect the choice of the form of law for taxing them, particularly whether rules or standards are more appropriate.¹² I will contrast actual practices for taxing indirect transfers in light of this dichotomy and suggest that a better balance in the use of rules and standards can be struck. Part V analyzes methods for rationalizing the consequences of taxing indirect transfers and shows that many problems encountered under the approach taken by India, Canada, and other countries can be avoided under the Chinese approach, which purports to treat all taxable indirect transfers as transfers of the underlying Chinese companies' shares. By combining the analyses in Parts IV and V, one arrives at a method of taxing indirect transfers that is superior in many aspects to all existing practices. Part VI then demonstrates how rationalizing the rules for taxing indirect transfers can improve compliance. Finally, Part VII examines the broader policy objectives of a tax on indirect transfers — beyond discouraging avoidance of a tax on direct transfers. Part VIII concludes.

II. WHY DO WE NOT OBSERVE TAXATION OF INDIRECT SHARE TRANSFERS MORE OFTEN?

Many countries tax the capital gain, realized by residents and nonresidents, on the sale or disposition of assets located within their borders. Many of them also subject the transfer of shares or equity interests in domestic entities (e.g., partnerships, corporations, et cetera) holding such taxable assets to the same tax on capital gain. There is a fundamental connection between these two practices: if the sale of business entities is not taxed, then the tax on sales of (other) assets can often be avoided simply by having business entities hold such (other) assets and selling the entities instead. It has indeed been argued that much of the complexity of business entity taxation is attributable to the need to tax both asset sales and share sales,¹³ while at the same time to avoid over-taxing assets held by entities.¹⁴

¹² Part III discusses the distinction between rules and standards drawn in Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L. J. 557 (1992).

¹³ I will speak generally of taxing the transfer of shares, but the reference to shares can be understood broadly as including any type of equity interest in an entity.

¹⁴ See David A. Weisbach, *The Irreducible Complexity of Firm-level Income Taxes: Theory and Doctrine in the Corporate Tax*, 60 TAX L. REV. 215 (2007), especially Part III. David Weisbach develops this argument generally, regardless of whether corporate distributions are subject to tax: the necessity of taxing share sales is thus unrelated to the imposition of tax on both the corporation and its shareholders under the classic corporate income tax. *A fortiori*, the character of the firm holding the taxable asset — whether it is a corporation, partnership, or some other form — also does not matter.

The idea that an entity may be formed simply to avoid the tax on the transfer of assets invites two obvious extensions. First, it is not enough to tax the transfer of shares of an entity that directly holds a taxable asset (i.e., an asset the gain accruing to which would, in the first instance and without regard to the issue of tax avoidance, be taxable). To prevent easy tax avoidance, one must also tax the transfer of shares of entities that themselves hold taxable shares. The tax on share sales must be made recursive. Second, it is not enough to tax just the shares of domestic entities, especially if nonresidents are to be subject to tax on gains realized on assets. The transfer of shares of foreign entities that hold taxable assets must also be taxed, lest the simple imposition of a foreign entity defeats the goal of taxation. This tax on the transfer of shares of foreign entities must also be made recursive.

The recent policies pursued by India, China, and other countries thus seem only to follow what is logically inevitable: since these countries generally tax foreigners on the gain realized on the transfers of the shares of domestic companies,¹⁵ they would surely want to prevent tax avoidance that uses offshore holding companies formed to hold the taxable shares. The solution is to tax foreigners on the transfer of foreign entities, if such entities hold (directly or indirectly) taxable shares of domestic companies. For our purposes in this article, this is what “taxing indirect transfers” means.

Until recently, however, the idea of taxing indirect transfers has been considered only infrequently in international tax practice. Although the capital gains articles of both the OECD and U.N. Model Tax Conventions afford the authority to tax nonresidents on both the capital gain realized on the disposition of immovable property located domestically and the gain realized on the disposition of the shares “deriving more than 50 per cent of their value directly or indirectly from [such] immovable property,”¹⁶ only a small number of countries appears to have enacted domestic laws to impose such a tax.¹⁷ Perhaps as a result of this, many tax treaty specialists view the

¹⁵ For India, see _____. For China, see _____.

¹⁶ OECD, MODEL CONVENTION, *supra* note 9, art. 13, § 4; *see also* U.S. DEP’T OF TREAS., MODEL INCOME TAX CONVENTION, art. 13, § 2 (2006) [hereinafter TREAS., MODEL CONVENTION] (setting forth a similar provision); U.N., MODEL CONVENTION, *supra* note 9, art. 13, § 4, cl. b (same). These provisions all permit the country where the immovable property is located to tax the sale of shares of foreign entities that are possibly formed to avoid taxes on their underlying real estate assets.

¹⁷ *See* discussion of related rules in Canada, Japan, and Australia, *infra* Part IV. Tax treaties typically limit the taxing power of countries that enter into the treaties: what is not taxable under domestic law would not become taxable merely because the tax treaties permit taxation.

specific rules for implementing the tax treaty provisions regarding indirect transfers of immovable property as insufficiently worked out.¹⁸ There is thus a strong contrast between the apparent conceptual inevitability of a policy of taxing indirect transfers, on the one hand, and the apparent infrequency with which countries actually do adopt such policies, on the other. If entities can be formed with ease to avoid taxes on direct transfers by nonresidents, why do we not observe rules for taxing indirect transfers *more often*?

Pointing to this question as a puzzle by no means implies that we should expect to see a tax on indirect transfers as a universal phenomenon. A significant number of countries, as a matter of tax policy, simply do not tax capital gain realized on investment assets by residents or nonresidents.¹⁹ Even in countries that do tax capital gain realized by residents, taxation of nonresidents may be regarded as special from an enforcement perspective. When assets in country A, or the shares of a company resident in country A, are transferred by a foreigner (including, often, to another foreigner) and the transferor is made liable for tax, the tax authority in country A may have difficulty not only to detect the transaction, but also to collect tax from the foreign transferor if the latter does not pay the tax voluntarily. The cost of enforcement against a foreigner would be significantly higher than the cost of enforcement against domestic taxpayers. This has discouraged some countries from taxing nonresidents on the sale of shares of domestic companies.²⁰ Broadening the tax net against foreigners by taxing indirect transfers is obviously even more ambitious.

It is important to acknowledge here another possible explanation for the fact that many countries do not tax foreign investors on the capital gain realized by selling shares of domestic corporations. There is a familiar argument that the tax on share sales is needed to back up the tax on

¹⁸ Letter from Jacques Sasseville, Head, Tax Treaty Unit, Fiscal Affairs Division, OECD (on file with author); *see also infra* notes 60–62 and accompanying text.

¹⁹ Examples of tax avoidance through indirect transfers are not limited to income taxation, however; indirect transfers can be a technique to avoid stamp duties and other transfer taxes as well. For instance, many Hong Kong holding companies that are shell companies (deployed to take advantage of the tax treaties that Hong Kong has entered into in recent years) have themselves shell companies in the Virgin Islands or the Cayman Islands as parents. The reason is the Hong Kong stamp duty imposed on the transfer of shares of Hong Kong companies: investors who want the option to exit through share sales intend to avoid the Hong Kong stamp duty by selling the Virgin Islands (or Cayman) parent's shares instead.

²⁰ This was a major reason why the United States abandoned taxing nonresidents on capital gain realized on the sale of U.S. securities in 1936. *See* Stanford G. Ross, *United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments*, 22 TAX L. REV. 277, 293–95 (1967).

dividends: if there was no tax on share sales, it would be possible for shareholders to realize the value of retained earnings but avoid the dividend tax by selling shares.²¹ This argument thus ties taxing share sales to the “classical” corporate income tax system (i.e., where income accruing to a corporation is taxed both when earned by the corporation and when distributed as dividends). By implication, if a country has abandoned the “classical” corporate income tax, for example, in favor of some way of integrating the taxation of corporate income at the entity and shareholder levels, then there is even less justification for taxing share sales. In recent decades, many countries in Europe and elsewhere (mostly OECD countries) have indeed stopped taxing both dividends paid to, and capital gains from share sales made by, foreigners.²²

For the purpose of this article, it is readily admitted that those countries that do not tax the sale of shares of domestic companies by foreigners would *a fortiori* not be interested in taxing indirect share sales. A broader perspective, though, reveals at least two reasons why it nevertheless remains puzzling that taxation of indirect share transfer is not more prevalent. First, the justification for taxing share sales does not have to rest with the classical corporate income tax.²³ I have already offered an alternative, and fundamental, justification for the policy at the beginning of this part, namely to prevent tax-deferral planning whereby taxpayers contribute assets expected to appreciate into a business entity and sell the entity tax-free. This justification is valid even with respect to the sale of interests in noncorporate entities and is entirely independent of the system

²¹ For a recent argument along this line for taxing share sales by foreigners investing in U.S. companies, see Reuven S. Avi-Yonah, *Money On the Table: Why the U.S. Should Tax Inbound Capital Gains*, 63 TAX NOTES INT’L 41 (July 4, 2011). It should be pointed out that although tax practitioners are keen to point to the possibility of arbitraging between dividend and share sale if one is taxed but not the other, the design of many corporate tax systems contradict the assumption that these are close substitutes for each other. For example, it is common to see tax systems (e.g., in United States and Canada) that exempt inter-corporate dividend distributions but that do not exempt corporations from tax on capital gain realized on the sale of shares. Conversely, it is common to see countries enforcing taxes on dividends paid to foreigners (and maintaining significant dividend tax rates) while at the same time exempting foreigners from capital gain on share sales (again, the United States and Canada are examples).

²² This may reflect either an intention to moderate the effects of the classical corporate income tax, or a policy of “promot[ing] an ‘orderly,’ non-discriminatory residence-based tax system” within a framework of international coordination (e.g., within the European Union), or both. Harry Huizinga, *Commentary* to Alan J. Auerbach et al., *Taxing Corporate Income Commentary*, in DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW 895 (Inst. for Fiscal Studies ed., 2010); see also *id.* at 894–903 (discussing this possibility in greater detail).

²³ Again, as observed *supra* note 21, other taxes, such as the stamp duty face, problems of avoidance created by indirect transfers.

of corporate income taxation. It is true that those countries that do not tax share sales by foreigners do not seem compelled by this justification,²⁴ but there is no *a priori* reason why they should not be. Put differently, there is no *a priori* reason to believe that preventing the systematic deferral of tax liability is an insufficient justification for the policy of taxing share sales, even if such policy may not be compelling in particular circumstances.

The second reason why policies of taxing share sales (direct or indirect) should not be summarily dismissed (especially by those in OECD countries) is that there is no *a priori* reason even to believe that a tax on share sales within a “classical” corporate income tax system is unjustified. A traditional policy justification for the corporate income tax itself is that it allows a given country to tax foreigners on economics rents earned in that country.²⁵ Yet in many developing countries, that the appreciation of foreigners’ investments in domestic companies has to do with special opportunities in the local economy can be an undeniable fact.²⁶ Taxing such gain can thus be justified straightforwardly as a matter of taxing location-specific rent.²⁷ Such a view may certainly stand in contrast to perspectives from OECD countries, where it is now common to argue that corporate residence is largely a matter of legal form, and to argue that “sourcing” to that corporation’s state of residence the gain that has accrued to the shares of a corporation is consequently also formalistic. Both views may be correct in specific circumstances, and neither is universally or even predominantly valid.

The foregoing discussion of a well-known debate regarding tax policy is not meant to justify conclusively a policy of taxing foreigners on share sales, but only to establish that there is no *prima facie* case against such taxation. This is just to say that we can assume that many (especially non-OECD) countries that in fact tax share sales by foreigners are justified in adopting that policy. This brings us back to the puzzle raised earlier: all of

²⁴ Still, it is possible that the difficulty of enforcing a tax against foreigners is a key consideration.

²⁵ See Auerbach et al., *supra* note 22, at 872; Huizinga, *supra* note 22, at 901; Jack M. Mintz, *Commentary* to Auerbach et al., *supra* note 22, at 907.

²⁶ That is, firm shares may appreciate not because of accrued earnings, but because of improved prospects for future return.

²⁷ If one can identify underlying assets that generate location-specific rents (e.g., exclusive licenses to operate telecommunication networks within a particular country), then the taxation of indirect transfers may be justified even without any reference to a tax avoidance motive: the shares of any company, anywhere in the world, that derive their value from that specific instance of economic rent may be taxed by that country, were this administratively feasible (and if appropriate measures are taken to avoid cumulatively high, i.e., greater than 100 percent at the extreme, tax on the same rent). I am grateful to Steve Shay for this point.

the justifications for taxing direct share sales by foreigners should also justify the taxation of indirect share transfers. From this perspective, it is the customary practice of *not* taxing indirect transfers that is puzzling.

The rest of this article suggests a solution to the puzzle, in the *frequency* with which indirect transfers occur with respect to a given jurisdiction. It turns out that three issues are interconnected: the frequency of indirect transfers, how indirect transfers are taxed, and how such a tax is enforced. The frequency of indirect transfers may obviously determine whether a country needs to design rules for taxing indirect transfers in the first place. It will also affect whether those rules should operate *ex ante* or only *ex post*. The greater the frequency of indirect transfers, the greater need there is for *ex ante* determinations. In turn, whether rules for taxing indirect transfers can be applied *ex ante*, and whether they are designed to produce rational consequences, have crucial implications for the choice of enforcement tools and the taxpayers' incentives to comply. To trace these connections, we start with the question: what determines the frequency of indirect transfers?

III. WHEN DO TAX-AVOIDING INDIRECT TRANSFERS OCCUR?

The United States offers an interesting example for analyzing the policy of taxing indirect transfers. The United States does not generally tax foreigners on the gains realized on the sale or disposition of shares of U.S. companies.²⁸ Since 1984, however, the United States has, under the Foreign Investment in Real Property Tax Act (FIRPTA) provisions of the federal income tax,²⁹ subjected foreigners to a high tax — generally thirty-five percent at the federal level — on any gain realized on the disposition of any U.S. real property interest (USRPI), including the shares of U.S. real property holding companies (USRPHCs) (essentially U.S. companies with substantial U.S. property holdings).³⁰ This FIRPTA tax is enforced by requiring U.S. transferees of USRPIs (including the shares of USRPHCs) to

²⁸ This is initially the result of a Congressional view in 1936 that taxing transfers of U.S. company shares by foreigners is administratively difficult, *see* Ross, *supra* note 20, and has perpetuated until today largely due to the long-standing policy of attracting foreign portfolio investment in the U.S. *See* David R. Sicular & Emma Q. Sobol, *Selected Current Effectively Connected Income Issues for Investment Funds*, 56 TAX LAW. 719, 725–27 (2003).

²⁹ I.R.C. §§ 897, 1445.

³⁰ Before the enactment of the Foreign Investment in Real Property Tax Act (FIRPTA), foreigners were able to avoid tax on the disposition of U.S. real estate assets not just by putting such assets into a U.S. corporation, but also by relying on the general utilities doctrine to obtain a basis step up in the assets even when the corporation is liquidated and sold. *See* Alan L. Feld, *Is FIRPTA (Partially) Obsolete?*, 35 TAX NOTES 607 (May 11, 1987).

withhold from the gross proceeds paid to foreign transferors, and by requiring the transferors to file federal income tax returns to report FIRPTA gain.³¹ Over the years, the Department of the Treasury and the Internal Revenue Service (Service) have adopted extensive regulations to lay out the details for implementing FIRPTA,³² coordinating it with a large number of provisions in other parts of the Internal Revenue Code. As an important part of U.S. tax policy towards foreign investments in the United States, FIRPTA law and regulations have obtained a reasonably high degree of compliance (at least with their literal terms) from taxpayers and tax advisors alike, even though well-known techniques exist to reduce the effective tax burden under FIRPTA.³³ Insofar as the direct transfers by foreigners of shares of USRPHCs are concerned, therefore, the United States has developed a system of law and administration for enforcing a (high) tax that is arguably as respectable and “serious” as one can find anywhere in the world.

Nonetheless, the United States has made no attempt to tax nonresidents on gains realized on the transfers of foreign companies that themselves hold USRPI (including USRPHC shares).³⁴ Consequently, in theory, foreigners can escape the FIRPTA tax on gain simply by forming offshore holding companies that hold USRPIs, or otherwise structuring their investments so that the main return on the investments takes the form of (untaxed) gain on the sale of the shares of such foreign entities.

Remarkably, for all intents and purposes, this is simply not done. There is no significant trading of USRPI through offshore transactions, so there is no readily available opportunity for tax avoidance by using them.³⁵ This phenomenon has received little commentary from U.S. tax practitioners, and therefore one cannot easily point to an explanation of the phenomenon that can be said to draw wide consensus. Yet one plausible explanation is perhaps sufficiently compelling. The most active and lucrative market for USRPIs has always been in the United States itself.³⁶ For sellers of USRPIs, the most likely and most desirable buyers, throughout the recent decades, has been U.S. persons. There may be both tax and nontax explanations of this phenomenon. Previous scholarship has suggested that

³¹ I.R.C. § 1445.

³² See Treas. Reg. §§ 1.897-1 to -9T, 1.1445-1 to -11T (1988).

³³ See generally David J. Herzig, Rethinking FIRPTA (Oct. 12, 2012) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2163146.

³⁴ This is not on account of any concern with extra-territoriality. The United States has long imposed a tax on dividends paid by foreign companies that derive a substantial amount of “effectively connected income.” I.R.C. § 861(a)(2)(B).

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U.S. investors may have a tax-based comparative advantage over foreign investors (both individual and corporate) in investing in U.S. real estate.³⁷ Putting tax aside, given the size and level of development of the U.S. economy, and assuming “home bias” on the part of both U.S. and foreign investors, et cetera, it should not be surprising that U.S. investors dominate in U.S. real estate market. For such persons, it is obviously inefficient to hold USRPI through foreign corporations. Foreign companies holding FIRPTA assets are subject to both corporate-level tax and withholding tax on the return they realize from U.S. property, all of which can be avoided by U.S. persons when they hold U.S. real property interests through partnerships or other pass-through entities.³⁸ In addition, U.S. persons are generally taxed on their worldwide income, including capital gain realized on the sale of foreign corporations.³⁹ There is thus no advantage to routing U.S. investments offshore. When U.S. investors dominate foreign investors in investing in U.S. real estate, we can therefore expect that the tax-based preferences of U.S. investors for onshore transactions dictate the result that an offshore market for USRPI is nearly nonexistent.

In summary, although foreign investors should have very strong incentives to avoid FIRPTA tax on their U.S. real estate investments (since the tax rate is high), and although the Service has taken substantial measures to maintain the integrity of the FIRPTA tax regime and ensure adequate compliance with withholding and reporting requirements, neither side has given much thought to tax avoidance through the use of foreign companies that invest in USRPIs. The United States has thus not followed Canada, Australia, and Japan, which (as discussed subsequently) have enacted special rules for taxing indirect transfers of Canadian and real properties located in these countries. Nonetheless, it is unlikely that this can be interpreted as evidencing weaker interest on the part of the Service to protect the U.S. tax base.

It is instructive to contrast the U.S. example with that of another large single economy: China. For more than twenty years, there has been an active offshore market for foreign direct investments (FDIs) into China —

³⁷ See Michael S. Knoll, *Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds to Invest in the United States?*, 82 S. CAL. L. REV. 703, 74244 (2009).

³⁸ Moreover, by holding U.S. assets through U.S. and not foreign entities, U.S. persons can make use of a large variety of tax rules, relating to depreciation, loss carry-forward and carry-back, group consolidation, et cetera, to lower the effective tax burden on the returns of a single U.S. investment. Any offshore holding company used by foreigners to avoid FIRPTA, by contrast, is likely to isolate investments in U.S. real property interests through special purpose vehicles.

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indeed, it is the market for FDIs with which international law firms and high-end Chinese legal service providers are most familiar.⁴⁰ Moreover, it is these providers' preferred market, compared to the onshore markets of mergers, acquisitions, and stock listings.⁴¹ Some of the most widely discussed Chinese regulatory developments targeted at FDIs in recent years sought to regulate this offshore market.⁴² Given the liquidity of this market, even though the tax on capital gain on the transfer of Chinese company shares by foreign entities is only ten percent, the tax was regarded as optional except for a minority class of cases⁴³ before China's State Administration of Taxation adopted Circular 698, which penalizes abusive instances of indirect transfers of Chinese company shares.⁴⁴

Why is there such an active offshore market for FDIs into China?⁴⁵ Traditionally, the answers given by practicing lawyers are that FDIs are

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⁴² See, e.g., Guojia Waihui Guanli Ju (国家外汇管理局) [Notice of the State Administration of Foreign Exchange on Printing and Distributing the "Operating Rules for Foreign Exchange Administration Concerning Financing and Round-trip Investment by Domestic Residents Through Overseas Special-Purpose Companies"] (promulgated by the St. Admin. of Foreign Exchange, May 20, 2011, effective July 20, 2011, repealed May 30, 2013), HUI FA 19 (China) (updating guidance regarding reporting obligations of Chinese residents for foreign currency transactions arising from offshore holding entities and referring to a series of previous guidance on the same subject); Guanyu Waiguo Touzi Zhe Binggou Jingnei Qiye De Guiding (关于外国投资者并购境内企业的规定) [Provisions on Foreign Investors' Merger with and Acquisition of Domestic Enterprises] (promulgated jointly by the Ministry of Commerce, State-owned Assets Supervision and Administration Commission of the State Council, State Administration of Taxation, State Administration for Industry and Commerce, China Securities Regulatory Commission, and State Administration of Foreign Exchange, Aug. 8, 2006, effective Sept. 8, 2006) (China) (adopting extensive provisions regarding reporting requirements for offshore mergers and acquisitions with respect to Chinese assets).

⁴³ These include types of foreign direct investments in China where the foreign investor must satisfy certain eligibility requirements. For example, only a foreign insurance company can set up a insurance subsidiary in China, thus no foreign-invested insurance company in China can have a mere holding company as a parent.

⁴⁴ See Circular 698, *supra* note 4, arts. 56.

⁴⁵ This question really has to be answered in two parts, because the sellers and buyers in the offshore market can be either foreign or Chinese. One question is whether Chinese investors prefer the offshore market to the onshore market. The second is whether, and why, foreign investors prefer it. The answer to the first question is straightforward: the majority of Chinese investors probably do *not* prefer the offshore mergers and acquisitions market. Because China still has a capital control regime, the percentage of Chinese individuals and entities that are able to accumulate funds outside China and participate in offshore mergers

subject to substantial Chinese government regulation,⁴⁶ and the organizational laws regarding foreign invested enterprises (FIEs) are much less flexible than the organizational laws of traditional offshore holding company jurisdictions such as the Cayman Islands, the Virgin Islands, Bermuda, and Hong Kong.⁴⁷ Investors naturally would prefer to minimize unnecessary engagement with regulators and to attain an adequate level of flexibility in the governance and financing of their investments. As far as merger and acquisitions activities with respect to FDIs into China are concerned, however, these answers have never been fully satisfactory and have become less so in recent years. First, many crucial regulatory requirements applicable to FDIs into China — e.g., compliance with China's industrial policy, foreign exchange requirements (which, among other things, limit the capital structures of FIEs), and so on — cannot be avoided simply by adding layers of holding companies in offshore jurisdictions. Foreign investors have to deal with these core regulatory requirements regardless of the offshore structures they adopt.⁴⁸ Second, it is true that offshore structures remove many types of commercial dealings (e.g., shareholder agreements) from China's jurisdiction. Insofar as these dealings do not contravene Chinese government policies, however, the disadvantage of subjecting them to the review of Chinese regulators is mainly a matter of coping with red tape. For example, Chinese regulatory requirements for mergers and acquisitions with respect to FIEs are largely procedural and not substantive.⁴⁹ Subjecting oneself to such red tape may not always be unacceptable to foreign investors, and may indeed be worthwhile if the payoff is exposure to a more active merger and acquisition market and more efficient onshore structures. Third, it is also unclear whether Chinese organizational law is really unacceptably inflexible, unsophisticated, and unpredictable. China has tried to borrow from advanced jurisdictions in designing its corporate and partnership laws,

and acquisitions is still relatively small. Like the United States, the onshore market in China is much more densely populated with sellers and buyers. Thus Chinese sellers and buyers of Chinese investments come to the offshore market mainly in order to accommodate foreign buyers or sellers. The crucial question therefore is why foreign investors would not prefer to buy and sell on the thicker, onshore markets.

⁴⁶ See generally DANIEL C.K. CHOW, *THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA IN A NUTSHELL*, ch. 10 (2009).

⁴⁷ See generally Paul, Hastings, Janofsky & Walker LLP, *Using a Chinese Entity for an All-foreign Joint Venture in China — Does It Make Sense?*, CHINA LAW & PRAC., May 2005.

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⁴⁹ See Regulations on Merger and Divisions of Foreign-invested Enterprises (promulgated by the Ministry of Foreign Trade and Economic Cooperation and the State Administration for Industry and Commerce) WAI JING MAO FA FA 395 (1999) (China).

and there is a clear tendency towards having less regulation and greater flexibility in organizational law.⁵⁰ There is also a growing body of corporate litigation,⁵¹ generating potentially useful interpretations of Chinese corporate and commercial law (even if they are still largely neglected by international firms and most FDI lawyers). By contrast, the Cayman Islands, the Virgin Islands, Bermuda, and even Hong Kong, unlike Delaware, actually do not boast of strong organizational law to guide merger and acquisition activities (or courts for enforcing them).⁵²

Considerations of the structure of the market for legal services for FDIs into China suggest a fuller explanation. Like numerous other countries, China regulates the market for legal services and prohibits international firms from practicing Chinese law.⁵³ As a result, most international law firms practicing in China lack Chinese law expertise and generally are ill prepared to pursue innovation in Chinese law.⁵⁴ It is very much in the *interest* of these law firms to push transactions to offshore jurisdictions with generic and minimalist corporate laws, since executing such transactions would not require jurisdiction-specific legal expertise. It is very much in the interest of such firms to portray Chinese regulatory and corporate law as unsophisticated and inflexible, and any approach involving regulatory approval as a dead-end. In other words, it may be the legal advisors themselves, and not necessarily their clients, who prefer the paths of least resistance that mindlessly wind through the Cayman Islands and the Virgin

⁵⁰ See, e.g., *China Relaxes Capital Requirements for Some Firms to Cut Red Tape*, REUTERS, <http://www.reuters.com/article/2014/02/19/china-reforms-capital-idUSL3N0LO0G720140219> (Feb. 18, 2014); Li Jiabao & Zhao Yinan, *Foreign Investment Laws Will Be Revised*, CHINA DAILY, http://usa.chinadaily.com.cn/epaper/2014-04/14/content_17431891.htm (last updated Apr. 14, 2014, 11:09AM).

⁵¹ See, e.g., Nicholas C. Howson, *Judicial Independence and Company Law in the Shanghai Courts*, in JUDICIAL INDEPENDENCE IN CHINA: LESSONS FOR GLOBAL RULE OF LAW PROMOTION 134–53 (Randall Peerenboom ed., 2009).

⁵² See, e.g., Tony Freyer & Andrew P. Morriss, *Creating Cayman As an Offshore Financial Center: Structure & Strategy Since 1960*, 45 ARIZ. ST. L.J. 1297, 1360 (2013) (noting that the Cayman Islands had to hire judges from other jurisdictions to form its Court of Appeals in the 1980s because “no Caymanian has the qualifications probably at this time to sit on that Court” (quoting James Bodden)).

⁵³ See Mark A. Cohen, *International Law Firms in China: Market Access and Ethical Risks*, 80 FORDHAM L. REV. 2569 (2012).

⁵⁴ The Chinese-law-related transactional experience of many lawyers in such firms typically comprises only setting up offshore structures and foreign investment enterprises (FIEs) in China and handling the disposition of shares of the FIEs or offshore companies. Asset sales and purchases, mergers and spin-offs, and other corporate transactions that are reasonably active in China lie beyond these lawyers’ skill set. Refined knowledge of Chinese corporate and contract law is rare.

Islands of the world. Insofar as these international firms succeed in keeping their foreign clients away from competing Chinese law firms and insofar as the Chinese law firms, partly as a result, do not find sufficient rewards for legal innovations in the onshore market, transactional options in China may remain limited. In other words, the regulation of legal services may be as important a culprit for the under-development of the onshore market for foreign investors as are the regulations on corporate and FDI activities in general.

I do not claim that the foregoing two examples — foreign investment in U.S. real estate and FDI into China — are typical of cross-border investments around the world. They were chosen merely to illustrate the idea that there may be systematic reasons why indirect transfers pose a problem of tax avoidance in some jurisdictions and not others.⁵⁵ This idea sheds light on the puzzling fact that there seems to be not much more than a handful of examples around the world of attempts at taxing indirect transfers of domestic assets by nonresidents.⁵⁶ We may speculate that, generally, for foreign investments into each target jurisdiction, there are what one might call centripetal and centrifugal forces that push investment structures alternatively onshore and offshore. Centripetal forces that attract foreign investors onshore include an active onshore market thickly populated with domestic parties (who typically would find offshore structures for investing in their own jurisdictions inefficient) and facilitated by an effective legal regime for mergers and acquisitions.⁵⁷ When such forces dominate, tax avoidance through indirect transfers will often not be commercially attractive. Centrifugal forces, by contrast, include unfriendly (and easily avoidable) domestic regulatory regimes and undeveloped law for mergers and acquisitions, as well as comparatively lower quantities of domestic parties in the onshore mergers and acquisitions market. When these forces prevail, the synergies among them and the motive of tax avoidance will encourage the practice of indirect transfers. It is mainly in those circumstances that maintaining the integrity of a tax on the capital gain accrued to onshore assets requires taxing indirect transfers.

⁵⁵ In sectors involving natural resource extraction, for example, it is not uncommon for local companies even in large economies like Australia and Canada to be largely owned by foreign parents. Offshore mergers and acquisitions in these sectors may thus be normal.

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⁵⁷ They may also possibly include high onshore income tax rates, which increase the tax benefits of depreciation deductions and basis step up generally, and therefore accentuate the attraction of asset deals as opposed to share deals. The prevalence of active onshore buyers with sophisticated tax profiles (e.g., corporate consolidation, loss carryover, et cetera) may also be relevant.

Of course, extensive offshore structures for foreign investment into a target jurisdiction are often the result of features — intended or unintended — in the tax law of the target jurisdiction itself. The exemption of foreign investors from taxation on dividends and capital gains, commonly practiced in Europe,⁵⁸ facilitates and encourages structures with stacks of holding companies. A permissive attitude toward, or at least ineffective enforcement against, tax treaty shopping also famously spawns offshore structures. For countries that do not tax capital gains realized by nonresidents or that willingly condone treaty shopping and other forms of base erosion,⁵⁹ taxing indirect transfers would serve no policy purpose. Only countries that do not adopt such policy stances face the problem of taxpayers' abusive use of offshore structures.

This speculation, and the two examples in support of it, are illustrative of the general idea that whether a particular type of tax planning or avoidance technique is adopted depends on whether such techniques are compatible with other aspects of market practices.⁶⁰ One way of describing this phenomenon is to say that tax-planning techniques are *complementary goods* to more basic transactional choices that market participants make.⁶¹ If the demand for offshore market activities decrease, the demand for tax planning involving offshore transactions would surely also decrease. The complementarity between offshore markets and offshore tax planning and avoidance suggests a perhaps more provocative idea than the concept of frictions for tax planning: where a “frictionless” offshore market has developed mostly for nontax reasons, for example, to circumvent the real or perceived difficulties of an onshore market, and where such an offshore market as a secondary matter facilitates tax avoidance and erodes a country's tax base, a country's attempt to tax activities in that offshore market can *generate* frictions for avoidance maneuvers with respect to non-tax law. To the extent that the offshore market is socially not optimal (e.g., that it suppresses the development of the onshore legal regime), an attempt

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⁵⁹ See ORG. FOR ECON. COOPERATION & DEV., ADDRESSING BASE EROSION AND PROFIT SHIFTING (2013), available at http://www.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en (formally enshrining the base erosion concept).

⁶⁰ This idea has been explored in previous scholarship that highlights the fact that high transactional costs (frictions) of all varieties may defeat tax avoidance schemes. See, e.g., David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001). Whether a market exists at all for certain transactions that would serve tax planning or avoidance purposes (e.g., sales of offshore companies holding onshore assets) can certainly raise one type of barrier or “friction” for tax planning or avoidance.

⁶¹ Basic examples of complementary goods are half-and-half to coffee, hotdog buns to hotdogs, et cetera. See N. GREGORY MANKIW, PRINCIPLES OF ECONOMICS 70 (6th ed. 2008).

to tax activities in that market may have positive effects aside from protecting the tax base. I will explore this idea further in Part VII.

More immediately, I will turn in the next part to the idea that the frequency of indirect transfers that potentially contain a tax avoidance component has implications for the design of rules combating such avoidance. Sometimes, even where rules for taxing indirect transfers are appropriately enacted, the infrequency of such transfers may render the enforcement or elaboration of the rules a low priority. Conversely, the frequent occurrence of indirect transfers dictates that, from a social perspective, anti-avoidance rules with regard to such transfers must be designed in particular ways.

IV. EX ANTE V. EX POST DETERMINATIONS OF TAXABILITY OF INDIRECT TRANSFERS

A number of scholars have recently hypothesized that the “extent of the market” may predict how likely legal rules are to emerge.⁶² The idea is that a greater volume of social activities will more likely justify the fixed social cost of designing rules governing such activities and of creating mechanisms for propagating and implementing such rules.⁶³ More influentially, it has been argued from a normative perspective that the greater frequency with which a certain type of behavior takes place in a society, the more likely it is that it would be socially optimal to specify the content of rules regulating such behavior (if regulation is desirable) in advance, or *ex ante*.⁶⁴ Specifying the content of legal rules before relevant behavior takes place may generate a greater upfront social cost in designing appropriate legislation. Nonetheless, it will save later costs, incurred both by regulated subjects in trying to determine the content of law applicable to particular anticipated behavior, and by those responsible for enforcing the law. Moreover, because *ex ante* legislation, by lowering the costs of subsequent determinations of the content of law, may produce greater compliance by some regulated subjects. The more frequently transactions of a given type requiring regulation take place in a society, therefore, the more likely it is that *ex ante* lawmaking is preferable to *ex post* lawmaking from a social perspective.⁶⁵

⁶² See, e.g., Kevin E. Davis, *Law-making in Small Jurisdictions*, 56 U. TORONTO L.J. 151 (2006); Casey B. Mulligan & Andrei Shleifer, *The Extent of the Market and the Supply of Regulation*, 120 Q.J. ECON. 1445 (2005).

⁶³ See generally Davis, *supra* note 62; Mulligan & Shleifer, *supra* note 62.

⁶⁴ Kaplow, *supra* note 12; David A. Weisbach, *An Economic Analysis of Anti-tax-avoidance Doctrines*, 4 AM. L. & ECON. REV. 88 (2002).

⁶⁵ The distinction between *ex ante* and *ex post* lawmaking is captured in (one

These seemingly academic ideas can shed a surprising amount of light on the real-world practices of taxing indirect transfers and current controversies about them. Traditionally, countries that tax indirect transfers of real properties located in them have not hesitated to formulate the relevant rules in simple, bright-line terms that did not require extensive interpretation.⁶⁶ For example, Canada taxes nonresidents on taxable income derived from the disposition of “taxable Canadian property,”⁶⁷ including the shares of foreign corporations that, at any particular time during the sixty-month period before the disposition, derive more than fifty percent of the fair market value of their shares “directly or indirectly” from real or immovable property situated in Canada or certain other Canadian property.⁶⁸ Taxpayers themselves can determine the shares of which foreign corporations constitute “taxable Canadian property.” Similarly, Australian tax law provides that foreign residents would be liable for Australian capital gains tax (CGT) in relation to “taxable Australian property.”⁶⁹ “Taxable Australian property” is defined to include direct or indirect interests in Australian real property,⁷⁰ and an indirect Australian real property interest will exist where a foreign resident has an equity interest which passes a “non-portfolio interest” test and a “principal asset” test.⁷¹ Again, such provisions allow nonresidents to self-assess whether a taxable transfer of indirect Australian real property interest has occurred. Japanese provisions for taxing indirect transfers of real property interests are similar in character.⁷²

understanding of) the dichotomy between rules and standards. *See, e.g.*, Kaplow, *supra* note 12; *see also* Weisbach, *supra* note 64 (applying this distinction in the tax avoidance context).

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⁶⁷ Income Tax Act, R.S.C. 1985, c. 1, § 2(3)(c) (Can.). For a discussion, see Elie S. Roth, *Canada*, in *TAXATION OF COMPANIES ON CAPITAL GAINS ON SHARES UNDER DOMESTIC LAW, EU LAW AND TAX TREATIES* 479–558 (Guglielmo Maisto ed., 2013).

⁶⁸ R.S.C. 1985, c. 1, § 248(1).

⁶⁹ *Income Tax Assessment Act 1997*, s 716.855 (Austl.). For a discussion of these provisions of Australian tax law, see Ken Spence & Richard Shaddick, *New CGT Exposures and Exemptions for Non-residents*, Taxation Institute of Australia, 22d National Convention (Mar. 17, 2007) (on file with author). I am grateful to Mr. Brendan Sullivan of Level 10 Selborne-Wentworth Chambers for directing me to the primary and secondary sources on Australian tax law in this and the following footnotes.

⁷⁰ *Income Tax Assessment Act 1997*, s 855.15.

⁷¹ *Id.* s 855.25. The nonportfolio interest test is passed if the direct participation interests held by the foreign resident and its associates in the test entity is in the aggregate ten percent or more. The principal asset test is passed when more than fifty percent of the value of the test entity’s assets is attributable to Australian real property.

⁷² *See* Order for Enforcement of the Corporation Tax Act, Cabinet Order No. 96 of 1965, art. 177, para. 2. cl. iv (Japan); *id.* art. 187, para. 1, cl. iv; *id.* art. 187, para. 8. I am grateful to Professor Yoshihiro Masui for guiding me to information on this aspect of

India's new policy for taxing a broader range of indirect transfers has been formulated along the same lines. In the 2012 amendment of the Income Tax Act of India, the Indian legislature provided that "any share or interest in a company or entity registered or incorporated outside India shall be deemed to be . . . situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India."⁷³ Therefore, the transfer of such shares would result in the realization of income accruing or arising in India and taxable to a nonresident transferor.⁷⁴ It has been proposed that "substantially" be defined to mean fifty percent or more of the total value of a company's assets.⁷⁵

In contrast with these examples of what one might call the "conventional" approach for taxing indirect transfers, China determines the taxability of an indirect transfer on the basis of an ex post determination. Under Circular 698, in cases where an offshore investor makes abusive uses of organizational forms or arrangements indirectly to transfer the equity interest in a Chinese resident enterprise, and such arrangements are without a reasonable business and entered into to avoid enterprise income tax obligations, tax agencies are authorized to recharacterize an equity transfer according to its business substance and disregard the existence of the offshore holding company that is used for tax planning purposes.⁷⁶ That is, only a tax authority can determine the taxability of an indirect transfer, and such determination is to be made explicitly on the basis of a finding of tax avoidance motives. Chinese tax practitioners have generally attributed the legal authority for Chinese tax agencies to make such determinations to the general anti-avoidance rule (GAAR) in China's Enterprise Income Tax Law,⁷⁷ since the policy of taxing indirect transfers otherwise lacks statutory

Japanese tax law. *See also* Yuko Miyazaki, *Japan*, 34 TAX MGMT. INT'L FORUM, no. 2, June 2013, at 50–3.

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⁷⁴ See Shome Report, *supra* note 3, § 3.1, .5.

⁷⁵ *Id.* § 4.3.

⁷⁶ Circular 698, *supra* note 4, ¶ 6.

⁷⁷ *Enterprise Income Tax Law of the People's Republic of China*, INVEST IN CHINA, http://www.fdi.gov.cn/1800000121_39_3339_0_7.html (last visited Apr. 2, 2014) (translating Law on Enterprise Income Tax (promulgated by the Standing Comm. People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) art. 47 (2008) (China)). ("In case an enterprise makes any other arrangement not for any reasonable commercial purpose, which causes the decrease of its taxable revenue or income, the tax organ may, through a reasonable method, make an adjustment."). An arrangement "without a reasonable commercial purpose" has been defined as one "where the main purpose is reduction, exemption or deferral of tax payments." *Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law*, INVEST IN CHINA, http://www.fdi.gov.cn/1800000121_39_

basis.⁷⁸ This attribution is appropriate⁷⁹ insofar as Circular 698's approach is consistent with the application of GAAR as generally and internationally understood, i.e., the tax consequences of a transaction are determined after the fact, and the result of applying specific, ex ante applicable rules to the transaction may be overturned if an overall review of the facts and circumstances dictate a contrary result.

This novel aspect of China's approach⁸⁰ — that the taxability of indirect transfers can be determined only after the facts of the indirect transfers have been fixed — has been somewhat obscured by another aspect of Circular 698, which requires foreign transferors of shares of companies that are formed in certain "suspect" types of jurisdictions⁸¹ and that hold, directly or indirectly, the shares of Chinese companies, to report the transfers to Chinese tax authorities.⁸² Under current Chinese domestic tax law, this reporting requirement technically lacks legal basis, and many Chinese tax practitioners as well as tax administrators have come to view

1563_0_7.html (last visited Apr. 2, 2014) [hereinafter *Enterprise Income Tax Regulations*] (translating Regulations on the Implementation of the Enterprise Income Tax Law (promulgated by the St. Council Gaz., Dec. 6, 2007) art. 120 (China)).

⁷⁸ Circular 698 is an informal piece of administrative guidance. See Wei Cui, *Foreign Administrative Law and International Taxation: A Case Study of Tax Treaty Implementation in China*, 64 ADMIN. L. REV. 191, 201–03 (2012).

⁷⁹ Circular 698 does not itself cite the general anti-avoidance rule (GAAR) as its statutory authority. Nor does it cite certain general guidelines for making GAAR investigations and adjustments promulgated earlier by China's State Administration of Taxation. See *Circular of the State Administration of Taxation on the Issuance of the Implementation Measures of Special Tax Adjustments (Provisional)*, KPMG, <https://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/special-tax-adjustments.pdf> (last visited Apr. 2, 2014) (translating Circular on the Issuance of the Implementation Measures of Special Tax Adjustments (Provisional) (promulgated by the State Administration of Taxation, Jan. 8, 2009, effective Jan. 1 2009) GUOSHUIFA [2009] No. 2, ch. 10 (China)). Under this earlier guidance, tax authorities may apply GAAR to deal with abuses of tax preferences, tax treaties and the corporate form, and the use of tax havens and other arrangements without a reasonable business purpose. *Id.* art. 92. Tax agencies are to adopt a substance-over-form approach in investigating abusive transactions. *Id.* art. 93. Entities without business substance may be disregarded. *Id.* art. 94.

⁸⁰ India has considered but has deferred the adoption of a GAAR in its tax law. If and when adopted, the GAAR may be deployed to deal with Vodafone-like cases without using the rule that deems capital gains from indirect transfers to be Indian-source. Letter from D.P. Sengupta, former Chief Comm'r of Income Tax of India, to Wei Cui (Feb. 2013) (on file with author); see also *supra* notes 1–3 and accompanying text.

⁸¹ These are jurisdictions that either impose a corporate income tax rate lower than twelve and one-half percent or exempt foreign-source capital gain from tax for resident companies. *Circular 698*, *supra* note 4, ¶ 5.

⁸² *Id.*

the “requirement” as not legally compulsory.⁸³ One does not need to grasp the esoteric details of Chinese tax law to appreciate why this might be the case: if the taxability of an indirect transfer can be determined only by the tax authority *after* the review of all relevant facts and circumstances, *before* such a determination is made, the foreign transferor may have derived no Chinese-source income, and therefore the jurisdictional basis for imposing a reporting requirement may be lacking. As I will discuss more generally in Part VI, when the taxability of indirect transfers is determined on an ex post basis, there may generally be legal obstacles to imposing reporting and (more importantly) withholding requirements for purposes of enforcing the tax. Other mechanisms may therefore be needed to produce compliance.

Before exploring the subtler implications of China’s ex post approach for taxing indirect transfers, some more obvious contrasts with the conventional, bright-line, ex ante approach require comment. Two general contrasts pertain, in order, to the scope of taxable transactions under each of the two approaches and to the cost of making determinations about taxability.

A. *The Scope of Taxable Transactions*

Since the rules adopted by Canada, Australia, Japan, India, et cetera characterizing taxable indirect transfers do not make any reference to a tax avoidance motive,⁸⁴ they can subject more transactions to tax than is necessary for the purpose of anti-avoidance. That is, relative to the goal of preventing tax avoidance through the making of indirect transfers, these rules seem overly broad and insufficiently targeted.⁸⁵ One of the long-standing complaints about taxing indirect transfers of real property — as permitted under article 13(4) the OECD Model Tax Conventions — is that the foreign investor may be a member of a corporate group in its home

⁸³ For an analysis, see Wei Cui, *The Unauthorized Decision to Tax Indirect Equity Transfers in China*, 2 DIRITTO E PRATICA TRIBUTARIA INTERNAZIONALE 1075 (2010).

⁸⁴ See generally sources cited *supra* notes 66–71.

⁸⁵ This is not to dispute that it has been commonly accepted that countries have the right (in terms of international law) to tax indirect share transfers, blunt as such a tax instrument might be. Another possible response to this critique is that a country’s rules for taxing the sale of shares of foreign companies that hold substantial real estate in the country need not be motivated by anti-avoidance concerns. It is simply based on the view that companies (domestic or foreign) that derive their values substantially from real estate in the country are as fair a target for taxation as the real estate itself. Yet it is unclear how (1) this view should not apply more generally to non-real-estate assets as well, and (2) countries that do tax indirect transfers can be so nonchalant about the problems of multiple taxation, see *infra* Part V.A, if they actually view foreign and domestic companies’ shares as equally fair to tax.

country and the execution of corporation reorganizations within the home country could trigger a tax on indirect transfers in another country where a real property investment is located.⁸⁶ It is felt that “innocuous” intra-group transfers within one country should not trigger a tax in another country where some investment assets happen to be located.⁸⁷ Of course, many indirect transfers, not just those involving corporate reorganizations, may be said to be “innocuous” by some standards for judging the existence of tax avoidance. Another example is the transfer of a company that is listed on a major stock exchange. If the relevant standard for tax avoidance is whether an arrangement has business substance, then a company listed on a recognized stock exchange seems to possess ample business substance, even if such company has no or few employees, no assets other than shares of subsidiaries, and no operations of its own. If a listed company were not a meaningful nexus of contracts among managers and shareholders, shareholders and creditors, or among shareholders themselves, there would be no point in regulating the listing of companies. It seems implausible to consider a listed company as a mere device for avoiding the tax on direct transfers.⁸⁸

Yet this point is for the most part not recognized under the conventional approach for taxing indirect transfers.⁸⁹ For example, Canada appears to regard the taxability of the transfers of shares of a listed foreign company as a matter of administrability. Shares of a corporation listed on a designated stock exchange are generally exempt from the tax on indirect transfer, unless the nonresident (together with non-arm’s-length persons) owned twenty-five percent or more of any class of the capital stock of the

⁸⁶ See OECD, MODEL CONVENTION, *supra* note 9, art. 13 cmt. on § 28.7 at C(13)-11. Currently, both Indian and Chinese tax authorities are being heavily lobbied to introduce an exemption in their respective policies for taxing indirect transfers within corporation reorganizations. See Shome Report, *supra* note 3, § 4.8.

⁸⁷ Since corporate reorganizations benefit from deferral treatment under the income tax systems of a number of countries, some taxpayers accustomed to such treatment may feel disappointed if a tax on indirect transfer is triggered by a host country of an investment. Nevertheless, the momentum for treaty-based coordination to ensure that corporate taxpayers obtain deferral treatment for reorganizations simultaneously in different jurisdictions has been weak. This is perhaps not surprising in light of the weak policy justification for deferral treatments of corporate reorganizations generally.

⁸⁸ See Shome Report, *supra* note 3, § 4.7 (recommending that India exempt shares of a company frequently traded on a recognized stock exchange from the tax on indirect transfers, on the ground of both administrability and that such a company “should not be considered as a shell or conduit company.”).

⁸⁹ *Contra* TREAS., MODEL CONVENTION, *supra* note 16, art. 13, § 2(c) (excluding from the category of taxable real property interest “shares in which there is regular trading on a stock exchange.”).

corporation at any time in a five-year look-back period.⁹⁰ In relation to such substantial shareholders, the fact that a listed company is unlikely to serve the main purpose of facilitating the avoidance of the tax on direct transfers is given no weight.

By contrast, the *ex post* approach, which rests the taxability of an indirect transfer on the finding of a tax avoidance motive, is inherently better-targeted at tax avoidance — if it can be reliably applied. Thus the Chinese policy of taxing abusive indirect transfers potentially covers a much narrower range of transactions than other recent efforts (e.g., by India and Peru) to tax indirect transfers of resident companies' shares. The main question is whether the open-ended criteria proposed by Circular 698 (i.e., an "abusive use of organizational forms," an absence of reasonable business purpose, and a motive to avoid tax) can be consistently applied. Taxpayers and tax advisors in China have complained about such criteria being "vague and unclear."⁹¹ If that complaint simply points to the difficulty of applying the criteria *ex ante*, it goes to a fundamental characteristic of a standard (as opposed to a rule). One might also counter by asking whether those taxpayers and advisors would instead prefer many indirect transfers be made categorically taxable, as they are under Indian law. Presumably, the answer is no. The real issue then is whether a rule for taxing abusive indirect transfers can be designed to be both narrowly tailored and predictable.

B. The Costs of Determining Taxability

One salient problem with China's current approach for taxing indirect transfers — although not one that tax advisors are heard often to complain about — is that it leaves the question of taxability unnecessarily open. Indirect transfers of shares of Chinese companies occur quite often, since the preferred market for trading investments into China is located offshore.⁹² As also discussed earlier, it is unclear whether the offshore market thrives really because of unacceptable red tape and inflexibility associated with Chinese regulators and/or the backwardness of Chinese corporate and commercial law, or instead, because international law firms, prohibited from developing expertise in Chinese law, prefer to direct clients

⁹⁰ Income Tax Act, R.S.C. 1985, c. 1, § 248(1) (Can.) (definition of "Taxable Canadian Property," subparagraph (e)).

⁹¹ See, e.g., WHITE & CASE, CHINA TAX BULLETIN (Feb. 2010), available at http://www.whitecase.com/files/Publication/f100bfb6-16b2-4da3-bcf6-5603978ba23d/Presentation/PublicationAttachment/6b087381-05c1-42b6-8fff-5b0c83b23657/China_Tax_Bulletin_February_2010.pdf.

⁹² See *supra* text accompanying notes 40–41.

offshore because these firms are most advantaged there.⁹³ What is clear is that many of the entities used in offshore structures for investing into China simply reflect investors' preference for the path of least legal resistance and neither serve substantial functions nor display a bona fide, operational business purpose. As a result, many parties carrying out indirect transfers that face potential scrutiny under Circular 698 have been hard-pressed to define business purposes for their offshore holding companies (and have probably been surprised by their Chinese tax advisors' suggestions about what flimsy claims of business purposes might be accepted by Chinese tax authorities).⁹⁴ In this context, the determination that many of the holding companies serve no genuine business purpose, or that whatever business purpose they serve pales in comparison to the potential tax savings an indirect transfer could secure, can be made in a much more routine fashion than Circular 698's case-by-case examination permits.⁹⁵ More streamlined determinations can be made, perhaps at the expense of little loss of fairness or accuracy.

There are anecdotal reports of a backlog of "Circular 698 cases" across China, in which foreign entities have reported indirect transfers already carried out and prepared to make tax payments, but kept waiting indefinitely by local tax authorities who have yet to make the determination that the transfers are taxable. This phenomenon exactly fits the theory cited at the beginning of this part regarding the cost structures for implementing law in the form of either rules or standards. When transactions of a certain type occur with sufficient frequency, it is socially inefficient for the law applicable to such transactions to be couched in terms of standards as opposed to rules. Enforcement officials, regulated subjects, and legal advisors all need to incur costs in working out the content of a standard applicable to each transaction. The aggregate costs of these efforts can be significantly reduced if the content of law is set out in the form of a rule with easily determinable content. Given the frequency of indirect transfers of Chinese investments, if China wants to tax such transfers, the law for imposing such a tax should be formulated to a greater extent as ex ante applicable rules. If that remains not done, inefficient tax administration and low degrees of compliance may follow as a consequence.⁹⁶

⁹³ See *supra* Part III.

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⁹⁵ See Circular 698, *supra* note 4, art. 6.

⁹⁶ The reason that a higher cost (inherent in the use of a standard as opposed to a rule for formulating law) for determining the content of applicable law to particular transactions may lead to less compliance is that some subjects may decide not to acquire legal advice or otherwise learn about the content of law because of the high cost. See Kaplow, *supra* note 12, at 577–78.

Furthermore, over-reliance on legal standards, such as those associated with GAAR, for combating tax-avoidance may create too many opportunities for negotiation between taxpayers and authorities. Since taxpayers typically deploy significantly greater resources than tax authorities (e.g., taxpayers derive better support from legal and tax advisors), it has been plausibly suggested that the odds may be stacked against tax authorities in such negotiations.⁹⁷ While the tax authority can be “tough” in some particular cases, it may not have the resources to follow through with its “tough” stance in most cases. This hypothesis has unfortunately been borne out by the implementation of Circular 698 in China in the last few years. An industry of tax advisors on Circular 698 has emerged, whose routine tool of trade is to persuade foreign parties that have made indirect transfers to hire them to report such indirect transfers (even though the reporting “requirement” under Circular 698 is not legally compulsory),⁹⁸ and to pay them literally to “negotiate” with Chinese tax authorities about the taxability of the transfers, sometimes regardless of whether the position of nontaxability has any merit.

C. Striking a Better Balance of Ex Ante and Ex Post Devices Against Tax Avoidance

From this comparison, it should be obvious that room exists for improvement for all existing practices of taxing indirect transfers — located along the dimension of ex ante and ex post law-making, between the conventional approach for taxing indirect transfers (traditionally applied only where foreign investment in domestic real property is concerned), and the approach China adopted under Circular 698. On one extreme, if a tax authority, for purposes of preventing tax avoidance, were to make a complete specification of which indirect transfers are taxable ahead of time without retaining any power to make a determination ex post, it might understandably err toward over-inclusiveness. Yet as the examples of home country reorganizations and of a transferred company that is traded on a recognized stock exchange show, the bright-line rules adopted by several countries for taxing indirect transfers can be manifestly over-broad.⁹⁹ That over-breadth creates two kinds of problems. First, when tax authorities try to combat tax avoidance by taxing indirect transfers of a broad range of foreign investment in domestic assets, the error of over-breadth is greatly

⁹⁷ Weisbach, *supra* note 64, at 107.

⁹⁸ See *supra* note 83 and accompanying text. As discussed in Part V, however, incentives may be created for parties to report indirect transfers through the proper design of basis adjustment rules, even in the absence of an effective legal requirement for reporting.

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magnified and becomes hard to neglect. The policy of taxing indirect transfers becomes unnecessarily controversial.¹⁰⁰ Second, rules justified on the ground of anti-avoidance that are obviously ill targeted create greater incentives for ignoring the rules. As a result, tax authorities are under pressure to devote greater resources to enforcement in order to maintain credibility for their anti-avoidance efforts.¹⁰¹

A superior approach seems to be specifying a narrower scope of taxable indirect transfers through rules that taxpayers can themselves apply, while reserving to tax authorities the power to apply an anti-avoidance standard after the fact. China's grounding of the taxability of indirect transfers on a criterion of business substance (or lack thereof) is an example of the use of the latter power.¹⁰² Nonetheless, when a standard is the only guidance regarding which indirect transfers may be taxable, it may turn out to be too weak a tool to achieve optimal compliance. Specifically, that is a context in which presumptively taxable indirect transfers occur with greater frequency than tax authorities have the resources to monitor unilaterally under an open-ended anti-avoidance standard.¹⁰³ Taxpayers and tax advisors are likely to exploit such governmental weaknesses by engaging in socially wasteful tax planning to create smoke and mirrors masking tax avoidance ex ante and by negotiating favorable tax outcomes ex post. In such a context, it is more sensible to devise specific anti-avoidance rules describing transactions that are highly likely to lack business substance and that make such transactions per se taxable. In the meantime, it would also make sense to offer safe harbour provisions (e.g., for listed companies) describing transactions that are either categorically or presumptively nontaxable.

Although the policies regarding taxable indirect transfers of real estate assets in OECD countries like Canada, Australia, and Japan have the inconspicuous air of settled law, a question that has remained unanswered is how well they are enforced. This question, however, is likely to be crucial for countries like India and China that attempt to tax a broader range of indirect transfers to combat tax avoidance. This is because offshore markets for investments into these countries are likely to be much more active,¹⁰⁴ and because the capacity for tax administration in these countries are more limited. Poorly designed rules that encourage noncompliance and/or wasteful tax planning may well defeat the countries' anti-avoidance efforts.

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The next part shows that there is another aspect of the conventional approach for taxing indirect transfers that is likely irrational and which irrationality becomes magnified when a broader range of indirect transfers is subject to tax.

V. THE “SOURCE” V. “LOOK-THROUGH” APPROACHES TO TAXING
INDIRECT TRANSFERS

A. *The Conventional Approach and the Problem of Multiple Taxation*

An important aspect of the conventional approach for taxing indirect transfers is that transfers of shares of foreign entities by nonresidents are treated as giving rise to items of per se taxable income: any capital gain on such transfer is explicitly stipulated to have a domestic source.¹⁰⁵ Take Canada for an example. If foreign company *A* derives more than fifty percent of the fair market value of its shares directly or indirectly from real or immovable property situated in Canada, then the shares of *A* constitutes “taxable Canadian property.”¹⁰⁶ Suppose now that *A* is wholly owned by another foreign company, *B*, and *B* has no assets other than *A*’s shares. The shares of *B* would also constitute “taxable Canadian property.” Any capital gain realized on the disposition of *B*’s shares is therefore also taxable income in Canada, and is legally distinct from the capital gain that has accrued to or been realized on *A*’s shares. If Canada has taxed the capital gain on the disposition of the shares of *A* (by *B*), that does not prevent the capital gain realized on the disposition of the shares of *B* (by *B*’s shareholder) from being taxed in Canada (or vice versa). There is obvious irony in this, if taxing indirect transfers is motivated by the policy of anti-avoidance. Presumably, the reason why, in order to protect a source country’s ability to tax the capital gain realized on the transfer of its domestic assets, indirect transfers at indefinitely many layers “above” the domestic assets must be taxed, is that such additional layers may not represent anything of economic substance. The approach just described (which we might call the source approach), however, essentially treats each such layer as creating a new taxable asset for the source country.

Interestingly, neither the governments of Canada, Australia, and Japan, nor the bodies responsible for the Commentaries on the OECD and U.N. Model Tax Conventions¹⁰⁷ have been sufficiently perturbed by the

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¹⁰⁶ Income Tax Act, R.S.C. 1985, c. 1, § 2(3)(c) (Can.).

¹⁰⁷ See U.N., MODEL CONVENTION, *supra* note 9, art. 13, cl. 4 (providing for the taxation of indirect transfers of real estate assets by the source country where such assets are located); OECD, MODEL CONVENTION, *supra* note 9, art. 13, cl. 4 (same).

consequences of this choice.¹⁰⁸ In the case of the OECD countries, one might conjecture that this is because indirect transfers by foreigners of domestic real property are insufficiently frequent (because of either the narrowness of the asset class or the absence of an active offshore market for that asset class) to make concerns about anomalies arising from the source approach too pressing.¹⁰⁹ Recent policy debates in India about the taxation of a broader range of indirect transfers have highlighted many problems with that approach, however. For example, an Indian expert committee report on indirect transfer (the Shome Report) recommends taxing any gain realized on a taxable indirect transfer under a principle of “proportionality,” i.e., only in proportion to the value of the Indian assets relative to the entity’s global assets.¹¹⁰ As noted by the Shome Report, the OECD and U.N. Models do not suggest such proportional taxation in connection with transfers of real estate assets by the source country where such assets are located,¹¹¹ nor have the OECD countries practicing the source approach adopted it.¹¹² Thus, if the shares of non-Canadian company *A* derive only fifty percent of their fair market value from Canadian real property, *all* of the capital gain realized on the sale of *A* shares is taxable in Canada.¹¹³ An equally arbitrary consequence is the multiple taxation of the same economic gain, as the example of the shares of companies *A* and *B* in the previous paragraph illustrates. In the Indian context, the Shome Report recommends mitigating this problem with respect to transfers of investments in offshore entities that are regulated “foreign institutional investors”¹¹⁴ by exempting

¹⁰⁸ It may be noted that under section 897 of the Internal Revenue Code (Code), the entire capital gain on a sale of the shares of a U.S. real property holding company (USRPHC) is also taxable to a foreigner even if only fifty percent of the USRPHC consists of U.S. real property interests.

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¹¹⁰ Shome Report, *supra* note 3, § 4.3. This is still different from taxing the gain on the transfer only to the extent attributable to gain realized on the underlying Indian assets.

¹¹¹ See generally U.N., MODEL CONVENTION, *supra* note 9, art. 13, cl. 4; OECD, MODEL CONVENTION, *supra* note 9, art. 13, cl. 4.

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¹¹³ For objections to similar consequences under Australian rules for taxing indirect share transfers of Australian real estate assets, see Spence & Shaddick, *supra* note 69, at 7.

¹¹⁴ *Id.* § 4.9. The fact that these foreign institutional investor (FII) entities, which actively trade in the Indian securities market, are registered with and regulated by India’s securities exchange regulator suggests that they are unlikely to be formed primarily for tax avoidance purposes. Taxing transfers of interests in such entities may thus be an instance of the over-breadth of the conventional approach for taxing indirect transfers criticized in Part III. That may be the more important argument for exempting indirect transfers of interests in FIIs, and not multiple taxation: many of the FIIs are formed in jurisdictions (e.g., Mauritius and Singapore) whose treaties with India prevent the latter from taxing capital gain realized on direct trades in Indian companies’ shares. Letter from D.P. Sengupta, *supra* note 80.

those transfers.¹¹⁵ The problem remains, however, in a variety of other scenarios.

Are governments justified in their indifference about the problem of multiple taxation of the same economic gain in taxing indirect transfers? One argument in the affirmative is that the decision of how many layers of intermediate companies are interposed between the domestic asset and ultimate investors is in the control of the taxpayers, as are decisions to make dispositions at different levels. If governments are wary of convoluted and opaque offshore structures to begin with, they have no reason to go out of their way to make sure that tax is neutral with respect to the choice of organizational structure in offshore corporate groups.¹¹⁶ While this argument is probably correct in itself, there is an important competing consideration. As discussed in Part II (and more fully in Part VI below), taxing foreigners on both direct and indirect share transfers raises significant challenges for enforcement: when tax authorities have to actually enforce tax collection against foreign taxpayers as opposed to relying on voluntary compliance, the cost of enforcement is likely to be much higher than for domestic taxpayers. If the tax on indirect transfers leads to arbitrary tax consequences because of unmitigated multiple taxation, however, taxpayers may respond not by simplifying offshore corporate structures, but by noncompliance and evasion. If a government wants to maintain the credibility of its anti-avoidance regime without committing indefinite resources to enforcement, it should try to maximize voluntary compliance. Rationalizing the rules for taxing indirect transfers — including by mitigating the multiple taxation of the same economic gain — is the most obvious strategy for increasing voluntary compliance.

B. The “Look-through” Approach: Basis Adjustments When Taxing Indirect Transfers

China’s policy for taxing indirect transfers under Circular 698 again has suggested an alternative to the conventional “source” approach. This is an inadvertent — and, as of yet, incompletely developed — consequence of Circular 698’s primary departure from the conventional approach discussed in the last sub-part, namely its ex post determination of taxability. Under current Chinese law, indirect transfers are not per se taxable.¹¹⁷ What is per

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¹¹⁶ Advanced income tax systems tend to aim to be neutral with respect to such choices when the structures are domestic or “onshore,” adopting special regimes such as corporate consolidation and disregarding intra-group transactions.

¹¹⁷ *Circular 698*, *supra* note 4, art. 6.

se taxable is still the direct transfer of certain assets by nonresidents.¹¹⁸ Indirect transfers become taxable only after they have been determined by tax authorities to be, in economic substance, direct transfers.¹¹⁹ Precisely because there is currently no legal basis for taxing indirect transfers other than the GAAR,¹²⁰ the asset that is taxed when an indirect transfer is subject to tax must of necessity be the underlying shares of a Chinese resident company. In contrast to the “source” approach, layers of offshore holding companies would not create separately and distinctly taxable assets under Chinese law.

This approach has two minimal implications. First, if the shares of a Chinese company are treated as having been disposed of indirectly through the transfer of an offshore entity, the fact that the indirect transfer has been subject to tax should be reflected by adjusting the tax cost or basis for the Chinese company’s shares.¹²¹ For example, suppose that foreign investor *S* forms an offshore company *P* with equity capital of 200. *P* in turn contributes 200 of equity capital to Chinese company *Q*. When the value of *Q* shares grows from the initial value of 200 to 250, *S* sells the shares of *P* for 250 to buyer *B*. If China decides to disregard the existence of *P* to tax *S* on the sale, and *S* is liable for tax on the gain of 50, then the tax basis or cost of *Q* shares in the hands of *P*, and of *B*, should each be adjusted to 250. If either *P* disposes *Q* shares now for 250 or *B* disposes of *P* shares for 250, there should be no further tax for either *P* or *B*.

Second, since only the direct transfer of the shares of a Chinese company is per se taxable (i.e., only the capital gain from such a transfer has a source in China), Chinese tax authorities need to be able to disregard not just the offshore entity whose shares are transferred but also any intermediate offshore entity or entities between the directly transferred offshore entity and “indirectly transferred” onshore entity. Thus, suppose that in the above example, *P* invests in Chinese company *Q* indirectly through another offshore company, *P_I*. For China to tax *S*’s transfer of *P* shares under Circular 698, it must be able to disregard the existence not only of *P* but also *P_I*. Moreover, if *P* and *P_I* are both disregarded, then the transfers of shares of *P*, *P_I*, or *Q* should all result in an adjustment in the tax basis for the shares of *P*, *P_I*, and *Q*.

¹¹⁸ *Enterprise Income Tax Law of the People’s Republic of China*, *supra* note 77, art. 7, § 512.

¹¹⁹ *Circular 698*, *supra* note 4, art. 6.

¹²⁰ See *supra* note 77–79 and accompanying text.

¹²¹ Keeping track of the tax basis or tax cost of an asset is a common device under most income tax systems for ensuring that income associated with (and including capital gain accruing to) the asset is taxed (and taxed only once).

Let us call an approach that accepts the foregoing two implications the “look-through” approach for taxing indirect transfers. Insofar as Circular 698 follows this approach,¹²² China can be said to have found a solution to many of the problems that arise under the “source” approach. For example, the tax on an indirect transfer would always necessarily be proportional under the “look-through” approach. The source country will only get to tax any gain represented by the excess of (1) the portion of the purchase price paid on the indirect transfer that is allocable to the shares of the target company in the source country regarded as transferred indirectly, over (2) the tax basis, for the source country’s purposes, of such shares of the target company. Moreover, by simultaneously making adjustments to the tax cost or basis of the shares of the ultimate target company and the shares of the “disregarded” entities above it (as illustrated by the simple example above), the “look-through” approach can fundamentally eliminate the possibility of taxing the same economic gain multiple times as a result of multiple layers of indirect transfers.

In more technical terms, disregarding an offshore entity and taxing an indirect transfer is essentially a matter of treating a sale of shares (of the offshore entity) as a sale of underlying assets (i.e., the shares of a target resident company). To implement this approach consistently may be quite complex, and it has been argued that adjusting the tax basis of assets held by an entity to reflect the transfers of interests in the entity by its owners (so as to avoid multiple taxation of the same economic gain) is practically infeasible for entities with many owners.¹²³ Yet if publicly listed entities are excluded from a tax on indirect transfers so that most taxable indirect transfers only involve entities with few owners, the complexity may be manageable. A useful analogy is a type of rule available in several countries that allows the seller and buyer in a merger and acquisition transaction to elect to treat the sale and purchase of the shares of a corporation as the sale and purchase of the corporation’s assets.¹²⁴ There are various details to be worked out to consistently implement this approach, including the proper treatment of all of a disregarded entity’s assets and liabilities.¹²⁵

¹²² Not all Chinese tax policymakers, administrators, or advisors have grasped these implications. Since the adoption of Circular 698, parties have been more focused on *when* indirect transfers are taxable and not *how*.

¹²³ See Weisbach, *supra* note 14, at 227.

¹²⁴ In the United States, rules of this type can be found in section 338 of the Code. So-called “check-the-box” entity classification elections can also have the effect of converting a share sale into an asset sale. See Treas. Reg. § 1.338-4 (2001). Another analogy is the basis adjustment of partnership assets under section 743 of the Code.

¹²⁵ The rules on domestic deemed asset sales can serve as guides for designing similar rules for taxable indirect transfers. See, e.g., Treas. Reg. § 1.338-4 (2001).

The analogy shows also that disregarding offshore entities for purposes of taxing an indirect transfer need not imply disregarding the entities for *all* tax purposes. It is consistent with the “look-through” approach for taxing indirect transfers that, for purposes other than determining whether or how to tax an indirect transfer, the offshore holding companies are respected. Thus, in the above simple example, a regular dividend or an interest payment from *Q* to *P* may still be respected as such (instead of being treated as a payment to *P*’s shareholders) and the source country may impose a withholding tax with respect to *P* on such payments.¹²⁶

C. An Ex Ante Look-through Approach

As discussed above, the look-through approach implicit in China’s Circular 698 is a result of tax authorities applying anti-avoidance standards to particular transactions. The discretion to apply the look-through method rests not with the taxpayer — this is an important dis-analogy with rules allowing taxpayers’ elections to treat share sales as asset sales found in various income tax systems. In Part IV, however, I argued that it may be desirable for countries like China to develop some ex ante rules for taxing indirect transfers (just as it may be desirable for other countries to narrow the scope of their current ex ante rules but to maintain the strength of their anti-avoidance policy by reserving the power to make ex post determinations). If taxpayers can self-assess the taxability of some indirect transfers on the basis of such ex ante rules and if the tax on an indirect transfer is still implemented through a look-through approach, a new type of design for taxing indirect transfers emerges.

The following table shows four policy options that result from the different ways of combining the choice between using ex ante and ex post rules with the choice to adopt a source or look-through approach. The conventional approach and that of China’s Circular 698 represent two of the possible combinations. Each of the possibilities can be assessed in terms of: (1) whether the policy is well targeted at tax avoidance behavior; (2) whether the policy solves the problem of arbitrary and multiple taxation; and (c) whether the policy is too unpredictable, costly to implement, and generative of perverse incentives for tax avoidance. The conventional approach falls short on criteria (1) and (2), while China’s approach can be faulted under (3). The most attractive combination, which would do well

¹²⁶ For a further discussion of this point, including an argument that a disregarded entity for purposes of Circular 698 may still be respected as a taxpayer eligible for treaty benefits, see Wei Cui, *Taxing Indirect Transfers: Rules and Doctrines*, in TAXATION OF COMPANIES ON CAPITAL GAINS ON SHARES UNDER DOMESTIC LAW, EU LAW AND TAX TREATIES, *supra* note 67.

under all three criteria, is the ex ante look-through approach in the lower left quadrant,¹²⁷ provided that well-targeted safe harbours and specific anti-avoidance rules can be designed and ex post standards are deployed only to serve as a backup.

Table 1. Possible Approaches of Taxing Direct Transfers.

	Look-through	Source-based
Ex post, anti-avoidance-based rule requiring tax authority intervention	China Circular 698. ¹²⁸	Not yet adopted.
Ex ante rule allowing taxpayer self-assessment	Not yet adopted.	The conventional approach, adopted by Canada, Australia, Japan, et cetera, with respect to real property, and India, Peru, et cetera, with respect to resident company shares.

At the present, no country yet has appears to have adopted — or even publicly considered — the option corresponding to the lower left quadrant. The merits of this option may be worth considering regardless of whether a country's policy of taxing indirect transfers is targeted at only real estate ownership or at foreign investment more generally. The payoff for making the improvements implied by the option will be greater, of course, the more frequently the relevant types of indirect transfers would otherwise tend to occur. As suggested in Part I, however, to give momentum to any reform proposal, two fundamental questions need to be addressed. One is how to secure compliance with a policy of taxing indirect transfers. The other is why taxing indirect transfers can be a good idea for some countries even if most other countries (especially OECD countries that traditionally set international tax norms) do not do so. The remaining two parts of this article address these two questions in turn.

VI. SECURING COMPLIANCE WITH THE TAX ON INDIRECT TRANSFERS

Securing compliance from nonresident taxpayers can be challenging when the taxable transactions and the flow of funds all take place outside

¹²⁷ More precisely, the most attractive combination would lie between the upper left and lower left quadrants, since a combination of ex ante rules and ex post standards is recommended.

¹²⁸ Circular 698 only suggests this combination of the approaches but does not work it out in detail. See *Circular 698*, *supra* note 4.

the source country — which is frequently the case for indirect transfers. Such factual configurations are often present even for taxable direct transfers of the shares of resident companies by nonresidents, and the difficulties they pose for taxing capital gain on direct transfers, at least for limited and well-targeted asset classes and transactions (e.g., FIRPTA assets in the United States),¹²⁹ are not regarded as insurmountable. What new problems of compliance arise for the new, more expansive efforts by India, China, and others to tax indirect transfers of a greater range of assets? In this part I examine that question, with a particular focus on how the rationalization of existing practices for taxing indirect transfers proposed in Part V.C might affect compliance.

A. Traditional Issues in Securing Compliance

Conceptually, there are three legal mechanisms that enable tax authorities to detect offshore (direct or indirect) share transfers: (1) reporting and self-assessment by the transferor; (2) mere reporting without withholding by the transferee (or third parties); and (3) withholding by the transferee. Each of these mechanisms can operate on the basis of both explicit sanctions and implicit economic incentives.

The first mechanism, the reporting of a taxable transfer by the transferor, is the most basic mechanism for producing detection. At the present, Australia, Japan, and China rely on this method exclusively in their policy of taxing indirect transfers.¹³⁰ To foster compliance, the source country may impose penalties on nonreporting transferors. Nonetheless, if the chances of detection of taxable transactions are otherwise very low, the expected cost of a penalty for nonreporting may also be too low to be effective. If most taxpayers do not comply and the tax authority fails to detect most instances of noncompliance, imposing a heavy penalty on the few detected cases will also seem unfair. Finally, if the compliance decision is only at the private discretion of taxpayers, the perception of widespread noncompliance may easily develop, regardless of the actual level of compliance.

The stagnation of the idea of taxing indirect transfers is probably attributable in part to the weakness of seller reporting and the questions that it leaves unanswered. How does one know what percentage of taxpayers are complying (even in Japan and Australia)?¹³¹ Before moving on to the

¹²⁹ See *supra* notes 22–26 and accompanying text.

¹³⁰ For Australia and Japan, see *supra* notes 69–72. For China, see *supra* notes 76–83 and accompanying text.

¹³¹ For practicing tax advisors, not knowing the actual level of compliance is reflected in experiences such as receiving calls from clients about the taxability of indirect transfers

conclusion that legally mandated transferee reporting or withholding is necessary, however, we should consider two factors that could alleviate the tax authority's predicament under the transferor-reporting regime. First, when taxing the capital gain realized on direct or indirect share transfers, the source country generally needs to keep track of the tax cost or basis of the shares transferred (of either domestic or foreign entities). If the capital gain realized on a transfer has been subject to tax, the basis of the shares transferred should be stepped up for purposes of future source country taxation.¹³² Conversely, one can imagine a rule providing that if a transfer has not been taxed (other than in a case where the capital gain on a transfer is positively exempted from tax, for example, under an applicable treaty), then the basis of the transferred shares would, for the purpose of source country taxation, remain what it had been. That is, the transferee would not obtain a basis in the shares it acquires equal to the consideration it pays unless the acquisition has been taxed. It does not appear that Japan, Australia, or China has explicitly adopted such a rule in their statutes or written guidance.¹³³ Nonetheless, any silence of the law on such matter and the possibility of tax authorities to take such a position in practice may constitute a sufficient threat.¹³⁴ With such a rule in place, the failure to report a taxable transfer would result in the risk that the transferee, in the future when it acts as a transferor, would be taxed on gain that accrued to and was realized by previous owners.

Of course, the future transfer itself will be reported or detected. That future transfer may itself be exempt from tax (e.g., under treaty protection). Both the tax authority and the nonresident taxpayer may have difficulty determining what the original basis of the shares of a foreign entity was in the hands of previous owners. Nonetheless, the risk of the conversion of a seller tax liability into a potential tax liability of the buyer (as a future seller) may well be unacceptable to many buyers. They would then either seek indemnity from the seller or require, as a matter of contract, the seller to report the sale to the tax authorities¹³⁵ and, in addition, to pay the tax on it if required by law.

A second type of market dynamic that increases compliance has to do with legal and tax advisors. Taxing indirect transfers expands the

and never hearing back again.

¹³² See discussion *supra* Part V.B.

¹³³ See generally sources cited *supra* notes 4, 66, 71.

¹³⁴ Part VI.B *infra* recommends explicitly adopting this approach in combination with the look-through approach.

¹³⁵ The report of an indirect transfer by a seller will at least put tax authorities on alert as to the new owner. This, however, does not necessarily mean increased chances of future transfers being detected.

jurisdiction of the legal system of the source country, and one would expect that advisors in such a country stand to gain, to varying degrees, from such expansion. Even a system of compliance that relies only on transferor self-reporting and sanctions for nonreporting creates legal risks for transferors, some of whom will consequently want to consult advisors to assess such risk. If the rules for taxing indirect transfers are robust, then the advisors should generally be better off, or at least be no worse off, by advising compliance compared to advising noncompliance. If rules for taxing indirect transfers contain loopholes or are too weak, advisors may benefit from counseling clients to exploit such loopholes and weaknesses, and advice for such exploitation would always be more lucrative, the higher the compliance bar is raised.

Because the penalties for nonreporting under Circular 698 are very low,¹³⁶ most compliance with the circular that has taken place in China since 2009 likely has been based on the two market mechanisms just described. This reminds us that the transferor/taxpayer's game regarding the source country tax authority is typically played out not in isolation, but in the company of both buyers and advisors. The effect of implicit economic incentives for tax compliance (as opposed to explicit sanctions) has other examples in tax design. For example, under European value added tax (VAT) law, non-European providers of services to European customers are required to register in a European country in order to pay VAT chargeable on the services.¹³⁷ The failure to register is penalized.¹³⁸ The real downside to not registering, however, has been said not to be the penalty per se, but being penalized for a cost that one could have charged to the customer.¹³⁹

Consider now what the requirement of transferee reporting adds to this mixture of incentives. First, assuming that the transferee is a nonresident as well, the failure of transferee reporting would be just as hard to detect as the failure of transferor reporting. Any sanction imposed upon a transferee's failure to report a taxable indirect transfer would be similar to increasing the penalties on a transferor's failure to report — in both cases, the aggregate penalties on nonreporting are increased. The difference is that the transferee usually has nothing to lose by reporting, since it is not the party paying the

¹³⁶ See Zhonghua Renmin Gongheguo Shuishou Zhengshou Guanli Fa (中华人民共和国税收征收管理法) [Law on the Administration of Tax Collection] (promulgated by the Standing Comm. Nat'l People's Cong., Sept. 4, 1992, effective Jan. 1, 1993) art. 62 (China); Cui, *supra* note 83, at 1077–78.

¹³⁷ See Howard Lambert, *VAT and Electronic Commerce: European Union Insights into the Challenges Ahead*, 17 TAX NOTES INT'L 1645, 1646 (Nov. 23, 1998).

¹³⁸ *Id.* at 1651.

¹³⁹ *Id.* at 1653.

tax. This may be sufficient to create compliance by transferees.¹⁴⁰ Interestingly, however, no government seems to have instituted transferee reporting alone (without further requiring withholding) for taxing either direct or indirect transfers. This might be seen as pointing to the perceived magnitude of the enforcement problem: simply having information that some foreigner engaged in a taxable transaction is of little value, and the government still has to do everything to collect the tax.

Transferee withholding is clearly a more powerful tool for enforcement than transferee reporting. The United States, Canada, and India each requires the transferee in a taxable direct (and, in the case of India and Canada, indirect) transfer to withhold from gross proceeds paid to the transferor.¹⁴¹ Each also makes the amount required to be withheld the personal tax liability of the transferee if the transferee fails to withhold. Note, however, that if the transferee is a nonresident, the imposition of a withholding obligation alone does not necessarily enhance the transferee's likelihood of compliance. Moreover, withholding on capital gain also cannot be expected to be accurate with respect to the ultimate tax liability and therefore will likely trigger either an application for refund or the tax authority's examination. Any obligation to withhold thus can only be sensibly formulated as with respect to the gross amount paid and not the capital gain realized by the payee.¹⁴² Finally, note that when the transferee is made personally liable for failing to withhold a tax that was in the first instance imposed on the transferor, one has merely made the implicit penalty of the no-basis-step-up treatment (which is possible even under transferor reporting) explicit.

The foregoing review shows that when direct or indirect share transfers occur among nonresidents, even withholding, the most powerful tool for

¹⁴⁰ It should be noted that this is a distinct incentive from the implicit economic incentive above produced by the mechanism of basis adjustment: presumably, government would not regard the mere reporting of the taxable transaction as sufficient for the basis of the transferred shares to be stepped up in the hands of the transferee.

¹⁴¹ The United States rule requires withholding of ten percent from gross proceeds. I.R.C. § 1445. The Canadian rule requires a significantly higher (twenty-five percent) rate of withholding, but allows the transferor to prepay or post collateral with the government based on the amount of capital gain. Income Tax Act, R.S.C. 1985, c. 1, § 116 (Can.). The Indian rule requires withholding simply of the amount of the tax owed, without addressing the issue of how the transferee would know how much tax is owed. The Income Tax Act, No. 43 of 1961, INDIA CODE § 195(1) (1993).

¹⁴² It is only infrequently that a seller would tell a buyer how much profit the seller has made. *But see* The Income Tax Act, § 195(1) ("Any person responsible for paying to a non-resident . . . any interest . . . or any other sum chargeable under the provisions of this Act . . . shall, at the time of credit of such income to the account of the payee or at the time of payment thereof . . . deduct income-tax thereon at the rates in force . . .").

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securing compliance, differs from voluntary transferor reporting only marginally. An important corollary of this is that overall enforcement improves with voluntary compliance. The table below compares the various possible incentives that may attach to the three mechanisms for procuring compliance:

Table 2. A Comparison of Enforcement Mechanisms for Taxing Indirect Transfers.¹⁴³

	Transferor reporting	Transferee information reporting	Transferee withholding
Penalties for transferor nonreporting	✓	✓	✓
Implicit penalty on transferee of no basis step up	✓	✓	X ¹⁴⁴
Penalties on transferee nonreporting	X	✓	✓
Revenue protection	X	X	✓
Accurate determination of tax liability	✓	X	X
Advisor preferences for reporting	✓	✓	✓

B. Effects on Compliance of Reformed Rules

The proposed improvements to existing practices of taxing indirect transfers discussed in Part V.C above impact compliance in two ways. One proposed change is either to introduce or to retain certain powers for tax authorities to make ex post determinations about the taxability of indirect transfers. This would allow tax authorities to be more comfortable in narrowing the scope of their ex ante rules, which in turn could produce better compliance by targeting tax avoidance more accurately. The compatibility of the ex post component with some traditional compliance mechanisms may be questionable, however. If an indirect transfer is taxable only as the result of an ex post determination by the tax authority (e.g., that the transferred entity lacks sufficient economic substance), until the tax authority makes such a determination, the nonresident transferor may have merely derived foreign source income. The imposition of a reporting

¹⁴³ Check marks represent the presence of a feature, whereas cross marks represent its absence.

¹⁴⁴ Assuming transferee is made liable for failure to withhold.

requirement on either transferors or transferees would involve the source country's assertion of jurisdiction over transactions that may well be not taxable. This may seem unusual,¹⁴⁵ and the tension becomes greater when withholding is at stake: if a transaction has not been determined to be taxable, could a tax authority really take revenue protection measures requiring transferees to withhold and remit? The adoption of an ex post approach to taxing indirect transfers thus seems to have a mixed effect on compliance: while it should increase compliance by better targeting avoidance behavior, it might decrease compliance by weakening some of the tax authorities' deterrence tools.

A solution to this problem is to require transferee withholding on transactions that are not excluded from the tax base under ex ante rules (e.g., safe harbors for listed companies), and to allow a refund of the withheld tax for those transactions that are determined, ex post, to be nontaxable. For this to work, the ex post determination must be made by a neutral party, otherwise the temptation for the tax authority to make determinations that allow it to keep funds collected may be (perceived to be) too great. No analogue for this mechanism under any existing institution of tax administration has been found, however, and it is uncertain that it would work.

Nonetheless, the discussion earlier in this part suggested that even when no withholding is required, one should not overestimate the deterrence effect of explicit legal sanctions nor underestimate the effect of market dynamics (e.g., transferees' and tax advisors' spontaneous enforcement) or implicit penalties (e.g., not allowing basis step up for nonreported transfers) for producing compliance. This is where the second proposed improvement to existing practices of taxing indirect transfers can make a substantial difference. Part V showed that by applying the look-through method to taxable indirect transfers, one can avoid multiple taxation on the same economic gain as well as other arbitrary consequences of the source approach. Such rationalizing of the consequences of a tax on indirect transfers may improve compliance incentives for all,¹⁴⁶ but it may especially accentuate the economic incentive of buyers/transferees to require the reporting of an indirect transfer.

This is so for several reasons. To begin, it is especially natural under the look-through approach to explicitly adopt the rule that unless an indirect transfer has been subject to tax, the cost basis of the target resident

¹⁴⁵ What is a country doing by threatening or imposing sanctions on the failure to report transactions that may not be taxable anyway?

¹⁴⁶ For example, the intrinsic complexity of the look-through approach may be favored by tax advisors.

company's shares (i.e., what are regarded as the assets actually transferred under the look-through approach) would not be adjusted. The look-through treatment of offshore entities would not apply generally (e.g., it would not apply to dividend, interest, or royalty payments made to offshore entities), but is adopted only for determining the amount of gain in a taxable indirect transfer. The parties to the transfer can thus be viewed as having an affirmative duty to follow the procedures for reporting indirect transfers and computing associated tax liabilities. It seems perfectly fair that if such procedures are not followed, the look-through treatment would not apply. Moreover, very often, when indirect transfers are carried out, there is no change of direct ownership of the target resident company.¹⁴⁷ It is thus generally easy to identify the original cost basis of the target company's shares.¹⁴⁸ Therefore, the market-based penalty for making transferees implicitly liable for any tax that the transferors failed to pay can be especially effective under the look-through approach.

The "upside" to compliance is also magnified for the buyer under the look-through approach. This is because the source country would allow the imposition of tax to lead to the adjustment in basis of all offshore assets (e.g., shares of each holding company among layers of holding companies), the values of which are attributable to the ultimate target company shares. The buyer would thus be assured that, whatever indirect transfers it makes in the future, it would be taxed on only any further capital gain that has accrued to the target company in the source country.

VII. BEYOND ANTI-TAX-AVOIDANCE

Part III suggested that indirect transfers as a tax-planning technique may be complementary to the choice of offshore markets and offshore investment structures. Where there is little demand for such structures and where the offshore market of sales and purchases does not really exist, as seems to be the case with respect to U.S. real estate, tax avoidance via indirect transfers simply is not a concern. Conversely, the jurisdictions in which indirect transfers may appear to be commercially appealing ways of avoiding taxes are often precisely jurisdictions with respect to which active offshore markets have emerged for nontax reasons. Sometimes, such offshore markets exist despite the important attractions offered by the economy in these jurisdictions, e.g., a large population of domestic investors.¹⁴⁹ Regulatory restrictions (including those on the practice of law)

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¹⁴⁸ By contrast, as pointed out earlier, it may be difficult for taxpayers and tax authorities to identify the cost basis of transferred shares in the hands of previous owners.

¹⁴⁹ See *supra* Part III (discussing China).

and resulting market incentives have separated the onshore and offshore markets, with tax avoidance both fueling and benefiting from the offshore markets.¹⁵⁰

In economic theories of taxation, it is well known that one way of taxing something that is hard to tax directly is to tax its complement.¹⁵¹ Taxing indirect transfers, therefore, could be a way of taxing the use of offshore structures and offshore markets — if the latter effect is desired. Are there reasons why governments would want to impose a tax on transactions carried out in offshore markets with respect to investments in their own countries? A positive answer to this question would imply that taxing indirect transfers can have policy significance beyond combatting tax avoidance.

Such reasons indeed seem to exist. We can think of the use of offshore legal systems (e.g., the corporate laws of the Cayman Islands, the Virgin Islands, et cetera) as a substitute for engaging with onshore legal mechanisms in a country with a real economy as a form of the erosion of the “market base” for the country’s legal system. Legal systems do not simply come out of nowhere. The public costs — financed by taxes and user fees — associated with legislation and the administration of justice are worth expending only when people make use of the legal system and incur private costs associated with seeking legal advice, contracting, litigating, et cetera. In other words, sufficient economic justification for a society to undertake legislation, adjudication, and other activities that develop the law exists only when there is sufficient social demand for the law.¹⁵² When commercial transactions are driven or diverted away from the places where real economic activities occur, this market base for affording the cost of developing law is eroded. This, of course, may in part be the fault of the inefficiencies of the legal and regulatory systems of the countries where the economic activities take or would have taken place. Nonetheless, the fact that economic actors naturally want to avoid inefficient legal systems does not mean that their “opting out” of such systems is not problematic for the countries and other economic actors that must rely on such systems.

There are numerous analogies between the idea of the erosion of a market base for law and the idea of tax base erosion. We ordinarily refer to

¹⁵⁰ See *supra* Part III.

¹⁵¹ The most important application of this idea in tax design is to tax goods that are complementary to leisure, since the taxation of work but not of leisure generates the most fundamental and substantial type of economic distortion among all economic distortions produced by taxation. See, e.g., W.J. Corlett & D.C. Hague, *Complementarity and the Excess Burden of Taxation*, 21 REV. ECON. STUD. 21, 26 (1953).

¹⁵² See Mulligan & Shleifer, *supra* note 62 (noting that legal systems develop as a function of “the extent of the market”).

the economic activities — and the result of economic activities, such as income and wealth — to which taxes apply as the tax base. The revenue generated from taxing such activities supports government expenditures. The instruments of taxation and their administration, as well as the ways in which public revenue is spent, can be efficient or inefficient. By analogy, we may call the market base for a legal system the “legal base.” The costs of engaging with the legal system can be analogized to the tax collected by the government, and benefits offered by a legal system can be analogized to the benefits of public spending funded by tax revenue. The combined costs and rewards of a legal system can also be evaluated as efficient or inefficient.

While many relatively immobile economic activities must engage with both the tax/spending and legal systems in the country in which they are situated, mobile economic activities can pick and choose. Mobile economic activities (e.g., transactions in capital) tend to migrate away from high-tax jurisdictions either if the mix of spending and taxes is unsatisfactory or if such activities can avoid taxes but at the same time benefit from the markets (supported in part by public spending) of the countries that impose such taxes. The latter constitutes erosion of the tax base.¹⁵³ Similarly, market activities that engage directly with the economy of a country but that opt out of that country’s legal regime — through the use of offshore investment structures, international commercial arbitration as opposed to domestic dispute resolution, and so on — can be said to erode the legal base of the country. The tax havens that mobile economic activities migrate to tend to offer the combination of low or no tax and little government spending.¹⁵⁴ Similarly, for the offshore legal advisors of the world,¹⁵⁵ structuring transactions often may involve choosing the simplest, not the best (in terms of, e.g., versatility, predictability, and inherent rationality) set of legal rules to apply.¹⁵⁶

¹⁵³ See ORG. FOR ECON. COOPERATION & DEV., ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING 17 (2013), available at <http://www.oecd.org/ctp/BEPSActionPlan.pdf>.

¹⁵⁴ See James R. Hines, Jr., *Do Tax Havens Flourish?*, 19 TAX POL’Y & ECON. 65 (2005) (observing that government size in tax havens appears to be close to the world’s average, but smaller countries ought to have larger governments relative to the size of the economy).

¹⁵⁵ I mean here not just, or even primarily, the legal advisors from the Cayman Islands, Bermuda, the Virgin Islands, Jersey, et cetera. Instead, it is the law firms from advanced legal systems, such as the United States and the United Kingdom, that do businesses in other countries but that are not (or that are insufficiently) rewarded commercially (sometimes because they are prohibited from being rewarded) by the development of the legal systems in these other countries.

¹⁵⁶ When disputes actually arise, it is the legal systems of real economies — courts and arbitral bodies in Europe and North America — that are requested to apply their

Tax and legal base erosion are not only analogous but often complementary. This has been amply illustrated in China, during the initial years of the implementation of Circular 698.¹⁵⁷ The resources devoted to enforcing Circular 698 by Chinese tax agencies, and the revenue consequently collected, are still low relative to the high frequency and value of indirect transfers with respect to Chinese investments.¹⁵⁸ Nonetheless, it has not only caught the attention of all Chinese tax advisors, but has also become perhaps the most widely-known aspect of Chinese tax law among legal advisors working on investments into China. Lawyers who otherwise have negligible interest in Chinese taxation have compared Circular 698 to some of the most prominent Chinese regulatory measures targeted at the use of offshore structures.¹⁵⁹ Up until now, partly because Circular 698 is too weak,¹⁶⁰ it may simply have generated higher (and socially wasteful) costs for offshore transactions but not reduced their volume. Nonetheless, if better enforcement is achieved (both as a result of better rule design and the dedication of real resources), it may actually fulfill the prophecy made by some that the circular would “usher[] in a new era in the China cross-border transactional landscape.”¹⁶¹

Putting the tax on indirect transfers in this greater context allows us to appreciate the potential of this policy tool to generate social benefits beyond reducing tax avoidance. Better enforcement of the tax on indirect transfers will likely increase the cost of using, and therefore eventually reduce demand for, offshore transaction structures. Very often, this will not mean that deals cannot be struck and commerce will be blocked. Instead, it may mean only that the paths of least resistance are not available (and that the subpopulation of offshore legal and tax advisors do less well. Market resources may then instead be devoted to supporting the development of more sophisticated legal systems in the target jurisdictions).

There are other potential benefits to the policy of taxing indirect transfers as well. One benefit has to do with the complexity and opacity of offshore group structures of multinational companies, which has recently

jurisprudence and legal tradition to resolve the disputes.

¹⁵⁷ For a discussion of Circular 698, see *supra* Parts IV and V.

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¹⁵⁹ See, e.g., *Clients and Friends Memo: Circular 698: The China's Anti-tax Avoidance Measures for Offshore SPVs*, CADWALADER, WICKERSHAM & TAFT LLP, at 1 (Aug. 23, 2010), http://www.cadwalader.com/CN/assets/client_friend/CWT_C&FMemo_SAFECir698%29.pdf (claiming that Circular 698 “represents the most recent challenge for offshore holding companies or special purpose vehicle . . . structures in the [People’s Republic of China].”).

¹⁶⁰ See discussion *supra* Part IV.

¹⁶¹ *Clients and Friends Memo*, *supra* note 159, at 1.

generated much controversy.¹⁶² These structures are essentially premised on the absence of tax “frictions” in multiple tiers of offshore holding companies.¹⁶³ When a tax on indirect transfers is imposed, the offshore structures are no longer frictionless, and tax enforcement can throw a good amount of light on such offshore structures. This is not to say that countries that do not tax capital gains realized by foreign investors should tax indirect transfers merely so as to obtain information about offshore structures, but only that those that do tax indirect transfers would already have a natural way of obtaining such information — one example of an ancillary benefit from such a tax regime.

VIII. CONCLUSION

Tax policy instruments, if they are well designed for the purpose they intend to achieve, do not have to be widely adopted by many countries to obtain legitimacy. The problem with the policy of taxing foreigners on indirect transfers of domestic assets and the shares of domestic companies is that its purpose has heretofore not been well articulated (e.g., why should the policy be limited to taxing profits from real estate?); nor have the rules adopted to implement it been well-designed. Thus, even though the policy is recommended with respect to cross-border real estate investments by several model tax conventions, and even though numerous OECD countries have adopted such a policy, as soon as other countries have tried to expand its scope, it has fallen into controversy.

Reflecting on when the type of avoidance taxing indirect transfers targets is relevant reveals the tax’s purpose. It appears that indirect transfers would constitute a realistic way of avoiding a tax on direct transfers only if there is an active offshore market where foreign investments into the source country are traded. In countries like India, China, and many non-OECD countries, there are systematic reasons why such offshore markets would develop that may not be present in OECD countries. In those contexts, taxing indirect transfers may be not only necessary to combat tax avoidance, but also beneficial in addressing negative externalities of offshore markets, such as the erosion of the economic base of the legal system of the source country. The policy possesses a vitality that could not be inferred from aged formulas of model tax conventions.

The single most important criterion for evaluating the design of rules for taxing indirect transfers is the likelihood of compliance. Unfortunately,

¹⁶² Edward D. Kleinbard, *Through a Latte, Darkly: Starbucks’ Stateless Income Tax Planning*, 139 TAX NOTES 1515, 1521 (June 24, 2013); see also ORG. FOR ECON. COOPERATION & DEV., *supra* note 153, at 22.

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very little is known about the degree of compliance countries have been able to achieve with respect to their rules on taxable indirect transfers. Several ways of redesigning the tax — which would require significant legislative changes in all relevant countries, old hands and newcomers alike — that would improve compliance exist. These changes are worth considering not because they lead to conceptually pleasing results, but because they are likely to affect real incentives in compliance.