THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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PAPER 1

Suggested Solutions

PART A

Question 1

One way of answering this question is to consider that tax treaties may have gone too far in their original motivation to encourage the free flow of investment. Teather has been writing for some time about the use of tax havens and low tax regimes as a way of creating global liquidity. However, the tide has perhaps now turned and it is fiscal avoidance and evasion, rather than freer investment flows, which informs the DTA policy agenda moving forward.

Students may wish to include some discussion of multilateral tax treaties and the modern tendency to use these instruments for the specific purposes of greater tax coordination.

The following is one possible schematic.

Introduction

A double tax agreement (DTA) is a territorial agreement, with overriding effect, which usually takes the form of a bilateral treaty in relation to the taxation of income and capital gains that has been negotiated for one or more of the following purposes:

- to provide relief from international juridical double taxation, which can be defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods;
- to remove obstacles in relation to cross-border exchange of goods and services and movements of capital, technology and persons (i.e. to prevent tax from discouraging the free flow of international trade and investment and the transfer of technology and to promote the development of economic relations between states);
- to provide relief from tax;
- to tax Contracting State (CS) source income derived by non-residents;
- to determine the income to be attributed to non-residents or their agencies, branches, or establishments within a CS;
- to determine the income to be attributed to CS residents who have special relationships with non-residents;
- to prevent fiscal avoidance and evasion;
- to facilitate the exchange of information;
- to assist in recovering unpaid tax;
- to provide a means of settling, upon a uniform basis, the most common problems which arise in the field of international juridical taxation;
- to prevent discrimination between taxpayers;
- to provide a measure of fiscal and legal certainty in international operations; or
- to determine when the DTA rules apply temporally as well as substantively.

More specific purposes in relation to the various substantive provisions are often to be found in the Commentaries to the OECD Model Convention. For example, para 27.9 provides that “Switzerland does not share the view expressed in paragraph 7 according to which the purpose of double taxation conventions is to prevent tax avoidance and evasion”.

The Shift

Some DTAs have been used to increase investment flows into other jurisdictions (such as the India-Mauritius DTA and the availability of a capital gains tax exemption: the Azadi Bachao Andolan case).

Things have changed though and there has been a shift in perspective on certain tax practices, as exemplified by the OECD’s Base Erosion and Profit Shifting (BEPS) project. DTAs should not be used as a basis for double non-taxation (where income is not taxed in either the source or residence country).

BEPS Action 6, ‘Treaty abuse’, recommends that states make a clear statement in DTAs that they intend to prevent tax avoidance and especially treaty shopping while entering into a treaty as a minimum standard.

While promoting commercial trade may have largely influenced the negotiations of some older DTAs, today, eliminating the double non-taxation has become the primary focus.

Protocols are being used to withdraw some of the most significant benefits enjoyed by the investor community. Time will tell whether these withdrawals will reduce foreign investment.

Avoidance

There is a concern that DTAs themselves are a cause of tax avoidance.

Philip Baker in 2013 wrote on "how to prevent tax treaties from being used improperly as a basis for tax avoidance".

Baker suggests that the range of tax advantages that states agree to grant to each other in order to prevent double taxation and eliminate the barrier that double taxation would create to cross-border trade, investment, movement of persons, etc, are liable to attract the attention of tax planners.

There is a need to strike a balance between legitimate and illegitimate use of a DTA.

Conclusion

Should states be cautious in entering into DTAs because they create opportunities for tax avoidance?

Administrative assistance by exchange of information or assistance in cross-border collection of taxes give states a powerful weapon to detect and counter tax avoidance or tax fraud.

DTAs relieve from double taxation by reducing taxes or exempting from taxes or granting tax credits. If tax avoidance is too readily alleged, and treaty benefits denied, then the advantages of treaties in removing barriers to trade and investment may be nullified.

Care has to be taken to distinguish between abusive arrangements and those that are consistent with the purposes for which the DTA was concluded.

Question 2

For this question, the expectation is that, in the main body of an answer, the student would provide an overview of the various tax issues that are involved in a cross-border outsourcing arrangement. The student may wish to focus on this issue from the perspective of the service provider and/or recipient. The most sensible approach would arguably be to focus on whether an outsourcing arrangement is likely to give rise to a taxable presence in the form of a permanent establishment or not. It is also expected that the outsourcing concept will be contextualised as part of the drive towards competitiveness brought about by increasing globalisation, and that reducing tax costs should be seen as simply a logical consequence of this movement.

The following is one possible schematic.

Introduction

Globalisation brings with it growing pressure on organisations to develop firm specific rents in order to enhance competitiveness (i.e. minimise costs, improve technical efficiency and innovate).

It should come as no surprise that minimising the tax burden has come to be viewed by many firms as good business practice; where a tax cost is just another business cost to be reduced.

Part of the competitiveness drive involves the outsourcing of core, as well as ancillary, business activities to third-party vendors.

These decisions are driven by the domestic tax policies of both the residence and source states, which can act as both incentives and disincentives.

In most states, there are no specific tax rules for outsourcing transactions. Accordingly, it is more general rules that are applied. However, some states do provide specific tax regimes for specific kinds of business.

The most obvious decision for a firm considering outsourcing cross-border would be what form the shifted function should take in the host state (e.g. subsidiary, PE or commissionaire structure). In other words, is a taxable presence desired or not?

Outsourcing

Cross-border outsourcing arrangements are typically in relation to contract and toll manufacturing, shared services (finance, HR, etc.), IT, call centre support, R&D, sales, and back-office functions.

Apart from cost reduction, there are a variety of factors that could lead to an outsourcing arrangement: the need for skilled workforce, the need to focus on core activities by outsourcing ancillary activities, capital risk reduction by investing less in physical assets, endowment factors, access to key markets and proximity to customers.

From a business perspective the economic relationship ranges from joint ventures to purely contractual arrangements with third parties to captive subsidiaries.

Tax affects decisions not just on the basis of cost saving but also in relation to the changeability of a particular system and/or its complexity (administrative complexity as well as the rules themselves).

PE risk

The key distinction between whether an outsourcing arrangement gives rise to a taxable presence is whether the activities conducted by the service provider are to be considered of its own business or as the business of the person sourcing the service.

A physical presence PE risk will arise if the non-resident has premises of the service provider at its disposal or if the non-resident sends its employees on a regular basis (for supervision, training, et cetera). Shifting the employment of expatriates to the outsourced service provider in the form of a secondment may help in mitigating PE risk.

An agency PE risk will arise if the service provider acts as a dependent agent of a non-resident and concludes contracts on its behalf; establishing independent status for captive subsidiaries set up in the outsourced jurisdiction is a real challenge in most cases. Agency PE risk will vary according to the nature of the activity undertaken. For example, outsourcing a front-office activity will carry a higher risk if it involves interaction with customers/clients.

A service PE risk arising from the service recipient sending employees to provide training to the service providers personnel. This creates a risk of the service recipient creating a service PE in the service providers jurisdiction, which otherwise wouldn't result in a fixed base or agency PE if the specific tests that these are not satisfied. The service PE concept, which was initially propagated under the UN Model Convention, has now also be introduced into the OECD Commentary.

An important part of the evaluation of PE risk is the approach and methodology adopted in that jurisdiction with regards to profit attribution. The 'normal' approach is to treat the PE as a hypothetically separate entity and to attribute profits on the basis of the functions, assets and risks (FAR) associated with the PE particular attention also needs to be paid to the following issues:

- deduction of head office expenses allocated to a PE, which is often treated separately from the more general treatment of other expenses by the source state;
- whether the state of residence allows credits for taxes paid by the PE in the source state. Many states refuse if they consider the PE is not constituted in accordance with their own law or their interpretation of the relevant DTA, which results in double taxation;
- the allocation of the savings arising from the change in location;
- the ownership of intangibles generated as a result of the outsourcing arrangement; and
- transfer pricing issues arising from the restructuring of functions already outsourced.

There are also risks associated with there being no PE. For example, if the source state levies withholding tax on certain payments made to non-residents, which generally includes service fees, royalties and salaries.

Some states impose higher withholding taxes as an anti-abuse measure.

<u>Conclusion</u>

Global competition for resources, markets and efficiencies drives the cross-border flow of goods, services and capital. The result is that tax authorities and supranational organisations have attempted to address the problems associated with profit shifting through harmonising international tax policies. However, policymakers need to understand that function shifting isn't always tax motivated and is often key to ensuring global competitiveness, while also ensuring good investment returns are made to the originating or state of residence. That does not mean to say that uncertainty in the tax arena will not affect the decision as to where to relocate. The fear of double taxation created by a conflict in PE and transfer pricing application will have an effect on the relocation decision, as does the stability or otherwise of a potential investment location.

Question 3

"Harmful preferential tax regimes", "harmful tax competition", "harmful tax measures", "preferential tax regimes" and "harmful tax practices" are all phrases that have been used to describe the "preferential taxation of certain activities, including foreign investment, as well as nontransparent administrative practices that can achieve the same effect" (Zodrow 2003; 651). The EU and the OECD have been active in developing policy in this area. One of the latest additions comes from the OECD as a result of its BEPS initiative in relation to "Countering Harmful Tax Practices". However, it is worth noting that of the two organisations, the EU was the first to grasp the nettle.

Students may wish to tie this issue in with the developments in relation to tax havens, however, this is not the approach adopted in the schematic provided below.

Students may also wish to reference developments between 1998 and the present, particularly if they wish to explore the developmental pathway of more recent concerns and/or provide some context for these more recent concerns.

The following is one possible schematic.

Introduction

Where states operate in an open economy environment, the reliance on income taxes has tended to produce tax competition, as taxed factors "can migrate to avoid the tax in an open economy; this produces an excess burden (the normative argument) and may lead to low or zero tax revenue in equilibrium (the positive argument)" (Goodspeed 2002; 358).

While some acknowledge the virtues of tax competition – that competition between governments should produce the same kinds of benefits in the public sector that we commonly associate with competition among private firms – there is nevertheless a very real sense in which it is thought such competition can go too far.

McLure has described the so-called 'race to the bottom') as follows:

"Suppose that the spending of subnational governments benefits primarily residents of the various jurisdictions, but is financed by a tax on capital that is geographically mobile, presumably via the local property tax or state corporation income tax. In such a situation the mobility of capital between jurisdictions results in tax competition, as the various jurisdictions attempt to avoid driving out business, which would reduce the productivity of labour or employment in the jurisdiction (or both). Tax competition, in turn, results in suboptimal expenditure by the subnational jurisdictions." (McLure 1986; 341)

Accordingly, the EU and the OECD have both been active in developing policy in this area since at least 1997.

The EU

The Code of Conduct for Business Taxation was set out in the conclusions of the Council of Economics and Finance Ministers (ECOFIN) of 1 December 1997.

The Code is not legally binding but it has political force – it is considered to be 'soft law'.

In light of the acknowledgement of the positive effects of fair tax competition, the Code was designed to detect measures aimed at providing non-resident business activity with a more favourable tax treatment than that which is generally available in the Member State concerned.

The Code sets out criteria against which any such measures are to be tested:

- an effective level of taxation which is significantly lower than the general level of taxation in the country concerned;
- tax benefits reserved for non-residents;
- tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;
- granting of tax advantages even in the absence of any real economic activity;

- the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD; and
- lack of transparency.

These criteria are based upon the idea that a level playing field within the EU is the final policy destination.

Subsequently, the EU has produced other work in relation to harmful tax practices, including:

- a 2004 Communication on Preventing and Combating Financial and Corporate Malpractice;
- a 2009 Communication identifying actions that EU Member States should take to promote “good governance” in the tax area (i.e. more transparency, exchange of information and fair tax competition); and
- reports on the action taken by the EU Commission in the field of fiscal state aid.

However, there is a sense that the OECD has become the main player in this area of policy.

The OECD

The OECD made its initial move in this area with its 1998 Report on “Harmful Tax Competition: An Emerging Global Issue”.

The OECD’s present concerns are primarily about preferential regimes that risk being used for artificial profit shifting and about a lack of transparency in connection with certain rulings.

The continuing importance of harmful tax competition/harmful tax practices informed the development of Action 5 of the Action Plan on Base Erosion and Profit Shifting (BEPS).

Action 5 committed the OECD Forum on Harmful Tax Practices to:

“Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.”

In this respect, the main focus has been on:

- agreeing and applying a methodology to define the substantial activity requirement to assess preferential regimes, looking first at intellectual property regimes and then other preferential regimes; and
- improving transparency through compulsory spontaneous exchange of certain rulings.

The substantial activity requirement is based on the “nexus approach”, which was developed in the context of IP regimes, allowing a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying R&D expenditures that gave rise to the IP income.

The nexus approach uses expenditure as a proxy for activity and builds on the principle that, because IP regimes are designed to encourage R&D activities and to foster growth and employment, a substantial activity requirement should ensure that taxpayers benefiting from these regimes did in fact engage in such activities and did incur actual expenditures on such activities.

This same principle can also be applied to other preferential regimes so that such regimes would be found to require substantial activities where they grant benefits to a taxpayer to the extent that the taxpayer undertook the core income-generating activities required to produce the type of income covered by the preferential regime.

In the area of transparency, a framework covering all rulings that could give rise to concerns in the absence of compulsory spontaneous exchange has been agreed.

The framework covers six categories of rulings: (i) rulings related to preferential regimes; (ii) cross border unilateral advance pricing arrangements (APAs) or other unilateral transfer pricing rulings; (iii) rulings giving a downward adjustment to profits; (iv) permanent establishment (PE) rulings; (v) conduit rulings; and (vi) any other type of ruling where it is agreed in the future that the absence of exchange would give rise to BEPS concerns.

For states which have the necessary legal basis, exchange of information under this framework will take place from 1 April 2016 for future rulings and the exchange of certain past rulings will need to be complete.

Conclusion

Harmful tax competition persists as a result of states believing that an incentive for foreign direct investment will benefit their economies, even if it is not in the form of (corporate) tax revenues. The policy responses by the EU, as exemplified by the common consolidated corporate tax base, has seemingly taken a back seat to the G20 and OECD initiatives (i.e. BEPS). Indeed, it is worth noting in this context the statement by Peggy Musgrave that “business income taxes present more difficulties for the process of harmonisation ... because they are imposed on an internationally mobile factor” (Musgrave 1967; 216). Accordingly, the focus is now all on BEPS and it remains to be seen the extent to which the BEPS initiative on HTPs will become concrete international tax law provisions.

Question 4

In answering this question, it is expected that students will be able to demonstrate their understanding of the difference between worldwide taxation and territorial taxation. Indeed, providing a definition of both terms would be optimal.

Students are also expected to realise that there is a difference between worldwide taxation and territorial taxation in theory and in practice. Thus, the shift towards territorial system is somewhat mitigated by the fact that the territorial systems embraced are sometimes only partial systems. In practice, the line between territorial and worldwide systems is quite grey. While many states have adopted a formal territorial system that exempts repatriated dividends, the details vary widely, and often include elements of a worldwide system. Some commentators find it difficult to identify consistent patterns even among territorial tax states.

Furthermore, the question refers to developed nations but it should be noted that it is really only their uniqueness in relation to the other G7 nations that would render the statement to be discussed a true one. For example, both Greece and Ireland are advanced economies and they to continue to embrace the worldwide system of taxation.

Students might want to consider listing the advantages and/or the disadvantages of moving away from a worldwide system towards a territorial system. For example, at least in theory, a move towards territorial system in relation to corporate income should see a benefit to capital importing states, particularly if they offer a competitive tax rate, as only the source country would have jurisdiction to tax profits deemed to arise there. Corporations will, in effect, become more sensitive to host state tax rates.

The following is one possible schematic.

Introduction

The world has been seeing a trend, whereby states have been shifting away from worldwide taxation towards territorial taxation. Indeed, all G7 countries other than the US have now adopted territorial taxation (or a partial version thereof) for active business income. However, the US is not alone in taxing worldwide income.

Definitions

A pure version of territorial taxation imposes tax on active business income earned by corporations outside their states of residence only in the source or host state, incurring neither contemporaneous tax liability in the home state, nor taxation on dividend repatriation from foreign subsidiaries.

Worldwide taxation is a system under which corporations deemed “resident” in a state are taxable by that state on their income from all over the world, normally with offset either by deduction or credit for taxes paid to source states on the same income, and sometimes, as in the U.S. case, with deferral of tax until repatriation of the income in the form of dividends from foreign subsidiaries to the home state resident parent.

Specific Countries

Due to the perceived compliance burden of the worldwide system, both the UK and Japan have moved to a modified version of the territorial system. Several proposals for US corporate tax reform propose or consider this option as well. It is argued, as it was in the cases of the UK and Japan, that the US system of worldwide taxation is unduly complex and burdensome, deters repatriation of income, and encourages foreign incorporation, particularly given its problems with foreign tax credits and deferral.

Business Roundtable (April 2011) on the Distribution of OECD Taxation Systems, where territorial signifies a broad exemption for dividends received from foreign affiliates, shows:

- Territorial (26) – Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Iceland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, UK.
- Worldwide (8) – Chile, Greece, Ireland, Israel, Korea, Mexico, Poland, United States.

Reasons in Favour of Moving Towards Territorial Taxation

There are arguably a number of reasons why states should move to a territorial system of taxing foreign earnings (Tax Foundation, May 2011):

- Parity – alignment with global trading partners.
- The experiences of Japan and UK are salutary:
    - The Japanese experience: a worldwide system combined with a high corporate tax rate was a disincentive to repatriating profits.
    - The British experience: a worldwide system and a high-by-European-standards tax rate forced companies with large global sales to relocate to lower-taxed states.

- The premise of the worldwide tax system – capital export neutrality (CEN) – is obsolete when subsidiaries have access to global capital markets and can self-fund their expansion with retained earnings.
- The worldwide tax system violates the benefit principle of taxation.
- The compliance cost of the worldwide system is excessively high relative to companies' foreign activities and the revenue which is raised from taxing foreign-source income.
- The worldwide system traps capital abroad – the "lockout" effect.
- A high corporate tax rate together with a worldwide system makes it cheaper for companies to take on debt rather than use their own profits to fund their growth.
- The current system dissuades global companies from headquartering in the jurisdiction that operates a worldwide system.

Conclusion

The difficult question of locality of profits is arguably exacerbated by the adoption of a territorial system. Whether profits arise in or are derived from the source state depends on the nature of the profits and of the transactions which give rise to such profits. Accordingly, there is an argument that increased territoriality lends itself to the adoption of a formulary apportionment system of dividing the profits of international groups of companies.

It is important to remember that there are differences in the "tax culture" of states. Some states see their multinationals engaging in aggressive tax planning, whereas others do not (e.g. Japanese MNEs). Some states are passive from a policy perspective when businesses reduce their tax liability by reporting profits overseas, whereas others (e.g. Germany) respond much more aggressively to the erosion of their tax base.

Question 5

When answering this question, students should be careful to distinguish state practice from the tie-breaker test found in Article 4 of the OECD Model Convention. Students might want to also discuss the cessation of residence.

The approach adopted in the schematic below is to select three jurisdictions that rely, in the main, on a 'facts and circumstances' test. However, this is not to suggest that these are the only jurisdictions to which students may refer in their answers; indeed, students may equally refer to other jurisdictions as appropriate.

The following is one possible schematic.

Introduction

Personal taxing jurisdiction over individuals is typically asserted on the basis of residence.

There are a number of options when determining the tax residence of an individual:

- non-tax concepts ¬– such as citizenship or nationality – residence is considered by some to imply a "closer association than citizenship between the taxpayer and the use of services provided by the taxing jurisdiction" (K. Brooks, 2010);
- a day count test – e.g. where the individual spends an aggregate of 183 days in the relevant jurisdiction over a 12-month period; or
- a 'facts and circumstances' test – e.g. having a permanent place of abode (PPOA) either in the relevant jurisdiction (New Zealand) or overseas (Australia). These tests are often used in conjunction, and it is not uncommon for one of the tests to be the primary test.

The determination of residence more often than not rests on a 'facts and circumstances' test, which looks at the various social and economic connections the individual has to the taxing jurisdiction, as well as the individual's intent with regard to his stay and his connections to other jurisdictions.

This general test is frequently supplemented with a mechanical test based on the number of days of presence in the jurisdiction – a day count test.

Tax residence may or may not be connected with residence in terms of immigration status.

The US

The US approach combines objective and 'facts and circumstances' tests.

The right to permanent entry under immigration laws (a green card) or being physically present in the jurisdiction for 183 days or more during the taxable year grants tax residence.

Being present in the jurisdiction for 31 days or more and meeting a cumulative presence test that looks to the days present in the current year and in the past two years.

If the total days in a year (and the weighted days for the past 2 years) are 183 or more, the individual will be a tax resident unless he can establish that his 'tax home', usually his principal place of business, is in another country, and he has a 'closer connection' to that country than the US.

The factors in establishing the 'closer connection' are those typically used in a residence determination. Special rules apply for students and diplomats, which allow them to be present in the US without triggering the mechanical physical presence tests. Unlike other jurisdictions, the US also asserts personal jurisdiction based on citizenship. US citizens are, in principle, taxable on their worldwide income regardless of where they are resident. This basis for personal jurisdiction increases the possibility of overlapping claims for worldwide taxation, an issue that is frequently dealt with in US DTAs.

Canada

In Canada, residence is, in general, determined on a case-by-case basis, applying a set of factors developed in case law and including the availability of a dwelling in Canada, the residence of family members, physical presence, and social and economic ties. The most important factors are the presence of a dwelling in Canada (i.e., available for the taxpayer's use) and the presence of immediate family members in Canada. Once residence is established, the intention to return to Canada is relevant in cases where the taxpayer has left the jurisdiction. In addition, a specific statutory provision deems an individual to be a resident of Canada if he 'sojourns' there for 183 days or more during the taxable period. The meaning of the term 'sojourn' is not entirely clear, but it is not synonymous with physical presence; for example, if a person is resident in Canada for part of the year, he is not 'sojourning' in Canada. Certain individuals, such as diplomats and members of the armed forces, are deemed to be residents of Canada.

Australia

Australia also applies a 'facts and circumstances' test. In addition, there is deemed residence if an individual is 'domiciled' in Australia and has no 'permanent place of abode' outside the country or if the individual has physical presence for more than one-half of the tax year and cannot establish that his usual place of abode is abroad and that he does not intend to take up residence in Australia. A special rule treats as residents certain governmental employees who would not normally be taxed under the usual residence rules but typically would be exempt from tax in the foreign jurisdiction to which they are posted.

Facts and circumstances tests generally

In relation to 'facts and circumstances' tests, the issue often revolves around whether the facts and circumstances relate to a particular dwelling, a particular location or the country more generally. If it is in relation to the particular dwelling, then the issue becomes whether that dwelling constitutes an individual's home (be it, for example, an investment property or spouse's property). If it is in relation to the country more generally, then the issue becomes whether the person has enduring personal and economic connections with that state, which may be influenced by the presence of a 'home' in a particular locality. Home need not be synonymous with the ownership of an interest in a house or property, which is consistent with the UK statutory residence test (HMRC, "Guidance Note for Statutory Residence Test: RDR3", June 2014, Example A21, 90).

Further, the Court of Appeal in New Zealand has accepted that the "integrated-home" approach should be adopted. This decision involved a review of the legislative history in New Zealand of the PPOA and its predecessor "home". What emerged is that the notion of a PPOA was introduced in order to align the New Zealand 'facts and circumstances' test with the Australian decision of Federal Commissioner of Taxation v Applegate, 79 ATC 4307. See CCH New Zealand Tax Planning Report No.5, 1 October 1980, "Determination of Residence", where it was stated that a PPOA was an individual's "fixed and habitual place of abode" and was considered to be a "home but not a permanent home ... a more enduring relationship with a particular place of abode than … his usual place of abode": Diamond [2015] NZCA 613 at [51].

Conclusion

It is perhaps unrealistic to expect any residence test based on facts and circumstances to be sufficiently certain that it can be applied as uniformly as tests based on physical presence, domicile or citizenship. In particular, it is unclear the moment at which an individual is considered to have:

- a subjective intention to reside in a country indefinitely, including a deemed intention to reside in a country indefinitely through an examination of the individual's actions including, presumably, time spent outside the country; or
- a subjective intention to reside in a country temporarily.

PART B

Question 6

The focus of the question is whether the domestic law of State B, especially the deeming provision, means that Fred's income falls within art 7 rather than art 14 of the DTC. Arguably, the best approach to answering this is to look at how the treaty terms in arts 7 and 14 are to be defined to assess whether Fred's income falls under one or the other. Some analysis should also be made in relation to the change in domestic law after the conclusion of the DTC.

It is clearly irrelevant whether Fred had been an employee or self-employed due to the application of the deeming provision, which is not uncommon in some jurisdictions (presumably because it is thought that making deductions available for skilled workers, irrespective of their employment status, will act as an incentive and either attract skilled workers to work in a particular jurisdiction or encourage the domestic workforce of that jurisdiction to acquire those skills).

The following is one possible schematic.

The Vienna Convention on the Law of Treaties (VCLT)

The starting point for the interpretation of any international treaty is art 31 of the VCLT: Avery Jones (2016) 18 ITLR 646; and Fowler v RCC [2016] UKFTT 234 (TC).

In Revenue and Customs Comrs v Anson [2015] UKSC 44 the UK Supreme Court (per Lord Reed) summarised arts 31 and 32 of the VCLT as follows at [56]:

"Put shortly, the aim of interpretation of a treaty is therefore to establish, by objective and rational means, the common intention which can be ascribed to the parties. That intention is ascertained by considering the ordinary meaning of the terms of the treaty in their context and in the light of the treaty's object and purpose. Subsequent agreement as to the interpretation of the treaty, and subsequent practice which establishes agreement between the parties, are also to be taken into account, together with any relevant rules of international law which apply in the relations between the parties. Recourse may also be had to a broader range of references in order to confirm the meaning arrived at on that approach, or if that approach leaves the meaning ambiguous or obscure, or leads to a result which is manifestly absurd or unreasonable."

Art 31(1) arguably contains one single, composite rule of interpretation rather than a series of alternatives. Article 3(2) of the DTC is a special rule of interpretation within art 31(4) of the VCLT, as opposed to the general rules in arts 31(1)-(3).

Article 3

Article 3(2) of the DTC mandates that any term not defined in the DTC 'shall' have the meaning that it has under the applicable tax laws of the contracting state applying the DTC (i.e. State B). The meaning shall be adopted for the purposes of the taxes to which the DTC applies. It is fair to say that art 3(2) has occasioned considerable debate among commentators.

As a special rule of interpretation, art 3(2) has priority over the general rules. That said, the meaning of the words used in art 3(2) are themselves to be interpreted in accordance with the principles set out in art 31 of the VCLT. Thus, in applying the provisions of the DTC, as regards undefined terms, the right of a contracting state to apply the ordinary meaning which the relevant term has under domestic law is subject to the general requirement of good faith and the need to have regard to the object and purpose of the DTC.

The use of the word 'shall' in art 3(2) indicates a mandatory requirement to apply domestic law in the case of undefined terms, unless the context otherwise requires. Throughout the OECD Model Convention the words 'shall' and' may' are used deliberately to indicate mandatory and permissive provisions. The use of the word 'shall' in art 3(2) indicates that recourse must be had to the relevant provisions of domestic tax law in priority to any other meaning, unless the context otherwise requires.
The contracting state seeking to apply the DTC is State B for the purposes of art 3(2).

Articles 7 and 14

The two relevant articles of the DTC are art 7 (Business profits) and art 14 (Income from employment). The words 'salaries, wages and other similar remuneration derived ... in respect of an employment' in art 14 are not defined in the DTC. The words 'enterprise' and 'business' in art 7 are only partially defined in art 3.

The word 'enterprise' is wide enough to include the economic activity itself: the business. Thus, the focus is on what is meant by 'business', which is partially defined in art 3(1) as a concept that 'includes the performance of professional services or other activities of an independent character'. This partial definition is presumably intended to make it clear that income that would previously have fallen under the 'Independent Personal Services' article of the OECD Model Convention (since deleted) would now fall under the business profits article (art 7).

An inclusive definition is not a complete definition. It simply identifies a specific meaning that is to be included in the more general meaning. The general meaning must therefore be given its ordinary meaning in accordance with domestic tax law. Thus, 'enterprise', 'business' and 'salaries, wages and other similar remuneration derived ... in respect of an employment', are not defined terms for the purposes of art 3(2). So, we turn to the domestic tax law of State B.

Synonymous words in domestic law are acceptable as different tax codes use different language to express the same ideas. The State B tax provision that corresponds to the "profits of an enterprise" within art 7 (business profits) is the charge to income tax on the "profits of a trade, profession or investment". The question is whether they apply to the extended meaning of that phrase (at least as regards the word 'trade') in Income Tax Act 2015, s.2. It seems likely that the phrase the "profits of an enterprise" within art 7 also includes the profits arising from the deemed trade pursuant to Income Tax Act 2015, s.2. The result of the s 2 deemed trading treatment is that Fred's income derived from his engineering activities does constitute profits under art 7 of the DTC.

Changing a domestic provision

Changing a domestic provision, so as to reallocate income from one article in a DTC to another, after the conclusion of a DTC may contravene the requirements of good faith imposed by art 31(1) of the VCLT. The fact that art 3(2) refers to the domestic tax law meaning of undefined terms does not permit State B to deprive a DTC article of its effect by unilaterally changing its domestic law to deem income to fall within another category. As State B changed its domestic law after the conclusion of the DTC so as to reallocate income from one article to another – to change the effect of the distributive rules of a DTC with respect to the particular type of income ¬– that might contravene the requirements of good faith imposed by art 31(1) of the VCLT and by international law generally ('pacta sunt servanda').

The amended meaning given by the subsequent change in domestic law would not be the 'meaning' which could be applied under art 3(2) when construed in accordance with art 31(1) of the VCLT. The argument is, therefore, that a breach of the good faith obligation might override the words 'at any time' in art 3(2), which are normally ambulatory. Alternatively, for the purposes of art 3(2), the 'context' of the DTC would require a meaning different from that supplied by domestic tax law. If State B were seeking to rely on s 2, there is an argument that they would not be able to rely upon it. However, it is Fred that is seeking to rely on s 2. Therefore, State B acting in good faith is not relevant, which effectively negates the force of these arguments.

Conclusion

Do the words in art 3(2) "unless the context otherwise requires" demand a different meaning from the domestic tax law meaning provided by Income Tax Act 2015, s.2? The word 'requires' implies the 'context' would have to present a strong case for a different meaning. 'Context' in art 3(2), arguably, has a wider meaning than that used in art 31 of the VCLT and permits internal and external contexts to be considered. However, there is seemingly nothing in the context which would, prima facie, seem to require a different meaning from that given by Income Tax Act 2015, s.2.

In view of all of the above arguments, Fred's income from his employment as an electrical engineer would seemingly be exempt from income taxation in State B due to the nonexistence of a PE, and the inapplicability of the 'context' argument.

Question 7

This question concerns conflict of laws and the Revenue Rule and, in particular, whether the Revenue Rule prevents the cross-border enforcement of taxes arising prior to an agreement on mutual assistance. It goes to the heart of the nature of the Revenue Rule.

The argument that Jaqui should perhaps put forward in these circumstances is that the 2009 Protocol cannot be retroactive in its effect and cannot apply to taxes arising in the period 2002 to 2008 because the common law “Revenue Rule” applies. The Revenue Rule prevents the cross-border enforcement of taxes that arose prior to the abrogation of the Revenue Rule by treaty. Furthermore, Jaqui is presumably entitled to order her affairs on the basis that the Revenue Rule applied until it had been abrogated.

At the very least, students should show an understanding of the Revenue Rule and discuss its displacement by the mutual assistance in collection protocol. Some students may wish to approach this question from an interpretational perspective, when looking at the temporal scope of the protocol by invoking arts 31 and 32 of the VCLT, which provide a contextual approach with regard to the construction of the DTC (as amended). This is a legitimate approach, particularly given that arts 31 and 32 of the VCLT are for many jurisdictions binding as rules of customary international law: Fothergill v Monarch Airlines Ltd (HL); Ben Nevis (CA).

Students may also wish to highlight or discuss some of the interesting policy questions that arise from this fact pattern.

The following is one possible schematic.

Introduction

This schematic is based on Hattingh (2016) 18 ITLR 44 and Krok v CSARS [2015] ZASCA 107.

A main issue is the temporal aspect of DTC clauses that enable contracting states to mutually assist each other in cross-border collection of tax debts.

- The VCLT provides binding norms for treaty interpretation.
- The nature of the Revenue Rule as a doctrine of law is not aimed at protecting taxpayers.
- The claim by a third party asserting beneficial ownership of assets brings out the intersection of private international law and tax law.

The dispute

Was the protocol's effective date clause substantially part of the DTC’s set of provisions that regulated cross-border assistance? If yes, then the protocol would probably not have retrospective effect.

If no, the cross-border mutual assistance clause would have a wide scope and a court might hold that tax claims arising in respect of years prior to 2009 could form the subject of a request for assistance in collection lodged after 2009. This would be in line with the reasoning of the UK Court of Appeal, which dealt with a similar scenario in the case of Ben Nevis (Holdings) Ltd v Revenue and Customs Comrs (2013) 15 ITLR 1003 (CA). In the Ben Nevis case, the court held that its reading of similar DTC provisions were consistent with the objective of international tax enforcement.

The Revenue Rule

The Revenue Rule (Government of India v Taylor) is that a court will not enforce the revenue laws of foreign states directly or indirectly. Jacqui may argue that the Revenue Rule entitles her to arrange her affairs with the assurance that her assets are protected against foreign tax authorities. Thus, the protocol could only operate prospectively and no effect could be given to a request under the DTC by a foreign state for assistance in collection of its tax debts as that would indirectly amount to a recognition of the foreign state's revenue law at a time when the Revenue Rule was not abrogated by treaty (i.e. before 2009).

Government of India v Taylor noted several theories to justify the existence of the rule. It is however arguable that the argument from sovereignty and the embarrassment approach are not consistent with protecting the interests of a taxpayer, in this case Jacqui, as they are aimed more at the state level.

One interesting question is whether the mutual assistance in collection protocol (or art 27 OECD Model Convention) represents an absolute or complete abrogation of the Revenue Rule. What would be the situation if, say, one contracting state subsequent to the conclusion of a DTC imposes a tax covered by the DTC on a basis unacceptable in the other contracting state (e.g. the base breaches a peremptory norm or fundamental human right in the state of collection). Can such a request be resisted, despite the DTC? The continued existence of the Revenue Rule after the conclusion of a DTC may prove to be critical as a legal means to scrutinise public policy considerations in the collection of a foreign sovereign's tax debts.

Conflict of laws

The intersection of tax law with private international law is relevant to the third party Wernita) seeking to access the assets. The private international law dimension of cross-border transactions provides a source from which tax authorities may address aggressive tax avoidance schemes. Yet surprisingly, such an approach is not often seen in practice. Arguing for the application of the sham doctrine in a cross-border context requires evidence about the acts of parties not within easy reach.

Of course, this is irrelevant to Jacqui as she is seemingly innocent of any collusion in relation to the state supervision order. Thus, the fact that the private international law dimension of a cross-border transaction is often concerned with local law only when assets are located within the jurisdiction of the tax authority (and are therefore perhaps easier to vet and investigate) becomes particularly relevant.

Advise as follows:

- It is probable that the application of art 27 to taxes arising before a DTC comes into force is not prevented by the Revenue Rule (the rule).
- The rule is concerned with the enforcement of taxes.
- The rule can and has been abrogated by many DTCs.
- The reason for the rule between two contracting states ceases to exist once the two countries agree to assist each other in the collection of taxes.
- The rule therefore has no relevance in the determination of the meaning and scope of the protocol.
- Arguably, taxpayer expectations based on the revenue rule are not relevant as it does not exist for their benefit.
- The rule reflects that the assertion of sovereign authority by one state within the territory of another is contrary to international law.
- A Namican court could not scrutinise the revenue laws of another state to examine whether they accorded with its own public policy.
- Unless the wording of the DTC says something about time limitations and the taxes to which art 27 of the DTC applies, there is arguably no ‘limitation by time’: Ben Nevis.
- As the taxes claimed here arose before 1 October 2012 (per the Namica TAA), they fall beyond the scope of the DTA and there is thus no basis for the invocation of the conservancy provisions of the TAA.

Conclusion

An important question is whether public policy can be abrogated in absolute terms by a DTC that allows the collection of a foreign sovereign's tax debts?

Also potentially important is the extent to which tax authorities consider the private international law dimension of cross-border schemes or transactions involving enjoyment of tax benefits.