Question 2

Introduction

The arms length approach considers the price that should be charged between two independent entities in their normal commercial and financial transactions. It is the approach put forward by the OECD as it has strong economic rationale and simulates market forces but at the same time, as supported by the quote in this question, it can be very resource intensive and time consuming thus posing significant difficulties to the tax payers. An alternative approach called global forumalatory appointed is rejected immediately by the OECD, and therefore significant attention is devoted in BEPS Action Point 4 to consider alternative and more practical means to the arm's length approach such as group wide rules for interest deduction.

Arms Length Approach

The arm's length principle is defined explicitly in article 9 of the model OECD treaty. It states that "where conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions have accrued to one of the enterprises, but by reason of these conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly"

It should be noted that the arm's length approach is the one supported by the model OECD treaty as far as the correct pricing of interest deductions are concerned.

This is also stated in article 11(6). The purpose of this paragraph is to restrict the operation of the provisions concerning the taxation of interest in cases where by reason of special relationship between the payer and the beneficial owner the amount of interest paid exceeds the arm's length (commentary para 32 of article 11(6)

Benefits of the Arms length approach

As already mentioned in the introduction the arm's length approach is the preferred method by the OECD. The main reasons are

a. the arms length principle provides broad parity of tax treatments for members of MNEs group and independent enterprises. It therefore puts these enterprises on an equal footing for tax purposes and it avoids the creation of tax advantages

b. the arms length principle is objective and has been found to work effectively in the majority of cases

c. most importantly though the arms length principle is very sound in theory and provides the closest approximation to the workings of open market forces

Limitation of the arm's length approach

Despite the above, the arms length principle has some shortcomings

a. in a number of cases the arm's length principle may result in an administrative burden for both the taxpayer and the tax administrators of evaluating significant numbers and types of cross border transactions

b. secondly both tax administrators and tax payers have difficulty in obtaining suitable information to apply the arm's length principle. Because the ALP required parties to evaluate uncontrolled transactions, and to compare these transactions with independent parties it required a substantial amount of data which can be particularly burdensome.

<u>Alternative Considerations</u>

Alternative to ARL pricing as far at the determination of interest payments include

A. The global forumalatory apportionment (unitary method) which would allocated the profits of an MNE group on a consolidated basis amongst the associated enterprises in different countries on the basis of a pre-determined and mechanistic formula.

Although simple to use, and administratively convenient, such formula lack theoretical sounding. Reaching agreements would be very difficult as countries may not be willing to agree to a universal formula.

The transition to such a scheme would also require huge international coordation that would be unrealistic to achieve

B. Other alternative may include thin capitalization rules which attempt to compare the equity of the entity verus its debt and deny deductions of interest if a company is deemed to have excessive debt

Although the above arguments appear simpler to use, they lack theoretical sounding, and they do not simulate market forces. The arm's length approach is still favoured by the OECD.

<u>BEPS Considerations - Action Point 4</u>

BEPS action point 4 consider base erosion and profit shifting through interest deductions and develops best practises in this respect.

The draft considers various existing approached which have been applied historically by countries to take base erosion and profit shifting through interest deductions

These include,
-rules which limits the level of interest expense or debt in an entity using a fixed ratio
- rules which compare the level of debt in an entity to the overall group position
- targeted anti avoidance rules which disallow interest expense
- arm's length rates
-withholding tax on payments
- rules which disallow a percentage of the interest expense of an entity irrespective of the nature of the payment.

With respect to arm's length approach BEPS specifically comments that "it can be particularly resource intensive and time consuming for both taxpayer and administrators. Also because the entity is considered separately the outcomes of applying a rule can be uncertain"

BEPS Action Point 4 goes on discuss a rules and interest caps which should be applied to MNEs interest deduction in an attempt to determine a fairer result in a simpler manner.

Advance Pricing Agreements

Another method which would definitely avoid the shortcomings of the arm length approach and provide certainty to the tax payer are advance pricing agreements. Still they require a lot of information but they can be really useful in terms of eliminating uncertainty.

BEPS Action Point 8-10

Beps Action point 8-10 also seek to provide more guidance as far at the application of the arm's length and therefore can be useful.

Conclusion

The arm's length principle can be problematic in terms of administrative simplicity but it remains economically and theoretically sound. Nevertheless attempts have been made by BEPS to consider its drawbacks and improve transfer pricing guidelines in this respect.

Question 4

Introduction

OECD Harmful tax Competition report recognized the difficulties in identifying a tax heaven and therefore proposed guidelines which would help states to identify tax heavens. It also emphasised that the although a state may not be a tax haven per se it may constitute a harmful preferential regime. The report went on to put forward recommendations for dealing with such tax heavers. BEPS Action Point 5 is also concerned with the identification of harmful prerential regimes and has recently completed a review of various states regimes.

OECD Harmful Tax Competition Report on Tax Havens

The OECD report first specifies that need to identify tax havens as such, as well as propose measure to counter act these harmful practises.
It argues that tax havens drive the effective tax rate significantly down as compared with other countries and cause harm by:
- distorting financial and indirectly real investment flows
- undermining the integrity and fairness of the tax structures
- discouraging compliance
- re shaping the desired level and mix of taxes and public spending
- increasing the administrative costs and compliance burden of the tax authorities and taxpayers.

The report argues that the characteristics of tax havens are
a. no or only minimal taxes
b. lack of effective exchange of information e.g. the taxpayer may be able to benefit from strict secrecy rules and other protections against scrutiny by the tax authorities
c. lack of transparency in the operation of the legislative, legal or administrative processes
d. no substantial activities the absence of a requirement that the activity is substantial is important since it would suggest that a jurisdiction may be attempting to attract investment that is purely tax drive.

Over the years the OECD has identified a number of tax havens and has put these on a Black List.

However, as the quote specifically states, it is not always clear to and straight forward to identify a tax haven. In fact in various situations, states may establish preferential tax regimes designed specifically to attract highly mobile financial and other service activities.

An example of a harmful preferential regime may be an IP(intellectual property)-Box regime which offers significant tax incentives to a business with an underling IP assets, without appropriate substance.

These preferential tax regimes are designed specifically attract those economic activities which can be most easily shifted in response to tax differentials.

Key features of such preferential regimes include
- no or low effective taxes
- ring fencing of such remiges which may explicitly or implicitly exclude resident taxpayers from taking advantage of such a regime
- lack of transparency
- lack of effective exchange of information

- an artificial definition of a tax base
- failure to adhere to international transfer pricing guidelines
- access to a wide network of tax treaty
- secrecy provisions

The OECD report goes on to make recommendation to states counter this harmful tax competition. Recommendations are on three axis
- recommendation concerning domestic legislation which includes for example enhance Controlled Foreign company rules, and adoption of more transparent process
- recommendations concerning tax treaties encouraging exchange of information and limitation of benefit provisions
- recommendation to encourage international cooperation between countries and produce a list of tax havens

BEPS Action Point 5

Beps Point action 5 on harmful tax practises attempt to provide more clarity on the definition of tax havens and or preferential tax regimes following the work of the OECD. In an effort to counter harmful tax practise it defines a substantial activity requirement and specifically considers this in the context of intangibles. It also aims to improve transparency through compulsory exchange on rulings relating to preferential regimes. Finally Beps Action point 5 enclose the conclusion on various preferential remgimes reviewed.

Conclusion

Identifying a tax haven is not an easy task because various features of a tax haven may be camouflaged/disguised in the context of a harmful preferential regime. Attention therefore need to be given to harmful tax practise of these regimes. OECD work is therefore key in this respect.

Question 5

Introduction

Dual residency of individuals arises in situation where countries apply a different set of principles or criteria in determine residence for individuals. The Model OECD tie breaker articles 4(2) provide a number of successive criteria to eventually determine residence. Although these criteria should trigger no ambiguity, in reality many duel residency conflicts remain unresolved and have to take to the Mutual Assistance Procedure for resolution.

Residency Determination for Individuals

State use a different set of rules to determine the residency of individual.

Some of the countries use qualitative criteria such as whether the individual is a national of a state, or whether he is a domiciled in a state and some other countries may use quantitative criteria to work out residency. For example Cyprus deems individuals to be resident in Cyprus if they spend more than 183 days in a calendar year in Cyprus.

Whenever an individual is considered to be resident of both contracting states, dual residency arises. e.g. a person may be a US national and hence deemed to be resident in US and also spend more than 183 days in Cyprus and hence be considered to be resident of Cyprus.

Tie Breaker Rules of the Provision (article 4(2)

Article 4(2) of the convention attempts to resolve dual residency of individuals by consider the following criteria in this order
a. whether a person has a permanent home available to him as per the commentary to the treaty the individual must have arranged this home for permanent stay, i.e. available to him continuously, and not of short duration e.g. travel for pleasure, of travel for education, attending a course etc
b. if the individual has a permanent home to both contracting states, paragraph 2 gives preference to the state with which the personal and economic relations of the individual are closest. Ascertaining the centre of vital interests gives regards to his family and social relationships, his occupation, political and cultural activities, and the place where he administers its property
c. if the state of vital interests cannot be determined or if has a permanent home to both states then the model OECD treaty established a third criterion which is the place of habitual abode (i.e the state where he stays more frequently)
d. if he has a habitual abode in both states, then consideration must be given to the state where he is a national.
e. if he is a national of both contracting states then duel residency conflict must be taken to MAP (mutual agreement procedure

Discussion on the nature of the criteria and resort to MAP

As stated in the quote of this question, ideally the dual residence criteria should be clear and result to no ambiguity as to where an individual should be taxed. In practise however reality is different, and the truth is that in many situations dual residence conflicts are not resolved effectively by the criteria of the model OECD treaty and have to be resorted to MAP. This is evident by the increasing number of MAP cases which remain open as of 2015.

MAP however is a mechanism which has inherently many limitations and therefore a dual resident conflict may not be resolved at the end. Key limitation being that authorities may only endeavour to find a solutions to the problem of dual residence and that MAP is a particularly length process which may discourages taxpayers resorting to this process.

Potential Application of the Vienna Convention on the Law of Treaty to clarify a term

It should be noted here that where ambiguity results in the definition of a term in the criteria, domestic rule provision are triggered as article 3(2) of the treaty stipulates. If domestic law provisions do not offer any clarity resort has to be made to the Vienna Law of treaties.

Article 31 of the treaty lays out the general approach to treaty interpretation arguing that the ordinary meaning in the context and light of the purpose and object of the treaty should be given to the terms of the treaty

Conclusion

The dual residence criteria of the model treaty do not always work effectively and accurately in order to determine residency of an individual as a result resort to MAP must be made.

Question 7

To: Board of Amerto
From: Tax Advisor
Topic: Possible Ways of Operation in Baronia and Relevant Tax Implication

Dear Sir,

Part 1 of this report outlines the potential tax consequence of the suggested modes of operation in Baronia while part 2 outline some important BEPS consideration

Part 1
The suggested modes of operation may trigger risks of permanent establishment (PE) in Baronia, as explicitly detailed below

a. Selling through an office of Amerto with its local sales team in Baronia

A permanent establishment as per article 5 of the model OECD treaty is a permanent place of business through which the business of the enterprise is wholly or partly carried out. The terms makes reference to 3 conditions
- existence of a place of business which must be at the disposal of the enterprise
- the place must be fixed, this entailing a permanence in its nature
- business must be carried through it which usually means that persons who in one way or another are dependent on the enterprise (personnel) conduct the business of the enteprise in the state in which the fixed place is situated.

Since Amerto has a fixed office at its disposal (fixed place of business) and it sells through its own sales team (business carried through it) a physical PE arises in this respect in Baronia.

As per provisions of article 7.1 profits attributable to this PE will be therefore taxable in Baronia. Article 7.2 of the treaty also mentions that profits shall be attributed by carrying out an analysis of the functions, risks and assets of the permanent establishment, as it were a separate and distinct entity.

b. Establishing a local Subsidiary
Article 5(7) of the Model OECD treaty states that the existence of a subsidiary does not of its self (i.e. by virtue of control) constitute that subsidiary a permanent establishment of the parent company.
However, a parent company, may be found under the rules of articles 5(1) - 5(5) to have a permanent establishment in a state where its subsidiary has a place of business. Two risks arise in this respect
i.the parent has premised belonging to the subsidiary at its disposal which may give rise to a physical PE
ii. the subsidiary habitually exercises, in Baronia, an authority to conclude contracts in the name of the parent.

In this scenario, the Director of Amerto will visit the subsidiary, use its premises on a regular basis and therefore it is likely that a physical PE will arise in Baronia.

c. Setting up a commissionaire arrangements
The issue to consider here is whether a dependent agency relationship exists with the vendor and whether an agency PE arises in Baronia as per article 5(5) of the model OECD treaty

For an agency PE to arises, the person should have the authority to conclude contracts. Commentary to article 5(5) paragraph 32.1 specifically states that the phrase "authority to conclude contracts" in the name of the enterprise does not confine the application to agents who enter contracts literally in the name of the enterprise. The paragraph applied equally to an agent who concludes contracts that are equally binding on the enterprise even if those contracts are not actually in the name of the enterprise. Also, lack of active involvement by an enterprise may also be indicative of grant of authority. e.g. an agent may be considered to possess actual authority where he solicits and received (but does not formally finalize) orders

In this case, although the vendor does not conclude contracts on the enterprise, this is not a requirement as per above comments, as he is still involved for and behalf of Amerto and assumed the risk of Amerto. However, the fact that domestic law of Boronia does not consider the contract binding on the name of Amerto, the risk of agency PE in this respect may be mitigated.

d. Independent Agents in Baronia
As per article 5(6) of the model OECD treaty where an enterprise carried on business through a broker, general commission agent, of an independent status, no PE arises and it cannot be taxed in the other state.
However care should be given here because the exemption applies only if the person
(i) is independent of the enterprise both legally and economically
(ii) he acts in the ordinary course of the business when acting on behalf of the enterprise

Determing independence requires examination of whether the person’s activities are subject to details instructions or comprehensive control by the enterprise.

Assuming therefore that the agents are truly independent no PE will arise in Boronia and no tax will be due all together.

Part II
BEPS Action Point 7 calls for the development of changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including the use of commissionaire arrangements and specific activity exemptions.

Commissionaire arrangements
Commissionaire arrangements focus on the legal interpretation of the phrase "authority to conclude contracts in the name of". Arrangements can be put in place which abuse this statement and result to no PE arising. Changes to the wording of paragraph 5(5) are therefore recommended

Specific activity exemptions
Specific activity exemptions are defined in article 5(4) of the model OCED treaty and include auxiliary or preparatory activities. Sometimes however business structure their activities in such a manner so as to specifically avoid the status of PE. Revisions in the wording of paragraph 5(4) are therefore recommended.