Chartered Institute of Taxation
Excellence in Taxation

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PAPER 1

Suggested Solutions

PART A

Question 1

This question relates to the interaction between private international law and taxation. Ultimately, classification as a taxable entity under domestic law also often determines that entity's entitlement to treaty benefits. Recognition or qualification as a taxable entity typically has the effect that the entity's profit is taxed only in the hands of the entity, rather than being attributed and taxed on a transparent basis to its owners. Indeed, in many ways, this issue boils down to one of drawing a line between transparent and opaque tax treatment.

The following is one possible schematic.

Introduction

This question relates to how different jurisdictions classify vehicles as taxable or non-taxable entities. However, the topic of entity classification does go further than that. It is also about identifying likely sources for qualification conflicts in different jurisdictions, i.e. when a certain vehicle is classified as a taxable entity in one jurisdiction while it is seen as a non-taxable entity in another. This question therefore is one of the first stages in identifying and understanding why it is that issues of entity qualification exist.

The foreign nature of an entity

Domestic tax laws do not tend to define "foreign entity".

Many jurisdictions treat foreign entities as a default or residual group, i.e. it is a foreign entity if it is not a domestic one (e.g. the US).

Some jurisdictions rely on a single criterion, such as place of incorporation or place of effective management, in order to determine the domestic or foreign nature of an entity.

Other jurisdictions rely on multiple criteria, which muddies the line between domestic and foreign (e.g. if place of incorporation and central management and control are the determining criteria and the other contracting state uses the same criteria, there is a chance that the entity will be found to be domestic in both places).

Dual resident companies have proved to be very difficult to categorise when it comes to the tax classification of an entity.

Criteria for classifying foreign entities

If an entity is a foreign one, the next issue is how the entity is classified as a taxable entity in a given jurisdiction; there are a broad range of fundamentally different concepts applied by different states.

Some countries have a list of foreign entities as part of the legislation and inclusion in that list means it is a foreign taxable entity (e.g. the US). This approach means the list must be regularly updated and raises the issues of whether the inclusion creates a rebuttable presumption and whether the list is exhaustive or not. Some countries have lists but not as part of the legislation.

More frequently, there is no list of specific legal forms and reliance is placed on equivalence, or comparability to or with domestic taxable entities:

- Equivalence means that the test is a rather strict one (e.g. Australia and Spain).

- Comparability is less strict and simply requires that the key structural elements are the same (e.g. Germany, Austria, The Netherlands and Luxembourg).

Some countries place rather more emphasis on the internal organisation of the entity (e.g. Denmark and India).

Some countries look at the legal personality of the entity, granting taxable status to an entity that is a legal person (e.g. Belgium, Finland, Mexico, Poland and Russia).

Some countries look at whether the investors in the entity are personally liable for its debt (e.g. Norway and Switzerland).

Some countries prefer a more ambiguous but more overarching approach (e.g. the UK "nature of the entity" and Canada "nature the relationship of the parties and their rights and obligations under the applicable laws and agreements"). These more general approaches may not produce much certainty/predictability for the taxpayer.

Some countries simply adopt the classification adopted in the foreign jurisdiction (e.g. Czech Republic and France).

Some countries grant taxable entity status to all foreign entities, irrespective of the legal form or other characteristics (e.g. Greece, Italy and Portugal). This approach has the advantage of simplicity.

There is clearly no trend to be discerned from state practice.

Focusing in on comparability tests

Comparability tests are by far the most common approach.

In general, the nature of these tests are to be found in case law rather than statute.

More emphasis seems to be given to the legal aspects of a foreign entity and to its tax status in the other country.

The following is a list of the various elements that are to be found across the globe:

- no personal liability for the entity's debt;
- profit distributional in accordance with invested capital;
- the entity has separate articles of association;
- separate annual accounts;
- separate decision-making bodies;
- the possibility of expanding the number of 'owners';
- the existence of share capital;
- centralised management and representation;
- limited liability;
- free transferability of shares;
- a life in perpetuity;
- legal personality in the home jurisdiction;
- having rights and obligations in its own name;
- the possibility of competition between owners and entity;
- agency; and
- entitlement of the owners to receive financial reward (noting beneficial ownership and LOB provisions).

Conclusion

The great variety of practices identified above highlights there is no certainty when it comes to foreign entity classification for tax purposes. One only has to look at the considerable work done by the OECD on the BEPS project in relation to hybrid mismatches to know both that this is true and the problems that it can cause.

Question 2

This question provides an opportunity for students to consider the arm's length principle (ALP) and thin capitalisation. It also provides them with an opportunity to consider the recent proposals of the OECD's Final Report on BEPS Action 4 in relation to thin capitalisation (October 2015) and, in particular, their fixed ratio approach. Students should define ALP and thin capitalisation and consider the significance of each concept before considering their inter-relationship or lack thereof.

The following is one possible schematic.

Definition of Thin Capitalisation

A company is typically financed (or capitalised) through a mixture of debt and equity.

Thin capitalisation refers to the situation in which a company is financed through a relatively high level of debt compared to equity.

Thinly capitalised companies are sometimes referred to as highly leveraged or highly geared.

Significance of Thin Capitalisation

The way a company is capitalised will often have a significant impact on the amount of profit it reports for tax purposes.

Country tax rules typically allow a deduction for interest paid or payable in arriving at the tax measure of profit.

The higher the level of debt in a company, and thus amount of interest it pays, the lower will be its taxable profit. Accordingly, debt is often a more tax efficient method of finance than equity.

Multinational groups are often able to structure their financing arrangements to maximise these benefits; not only are they able to establish a tax-efficient mixture of debt and equity in borrowing countries, they are also able to influence the tax treatment of the lender which receives the interest - for example, the arrangements may be structured in a way that allows the interest to be received in a jurisdiction that either does not tax the interest income, or which subjects such interest to a low tax rate.

Operation of Thin Capitalisation Rules

Thin capitalisation rules often operate by limiting, for the purposes of calculating taxable profit, the amount of debt that can give rise to deductible interest expenses. The interest on any amount of debt above that limit (excessive debt) will not be deductible for tax purposes. Countries take different approaches to determining the maximum amount of debt that can give rise to deductible interest payments, but there are generally two broad approaches:

1. The *"arm's length" approach*: the maximum amount of allowable debt is the amount of debt that an independent lender would be willing to lend to the company (i.e. the amount of debt that a borrower could borrow from an arm's length lender). The arm's length approach typically considers the specific attributes of the company in determining its borrowing capacity (that is, the amount of debt that company would be able to obtain from independent lenders). The arm's length approach can also encompass a determination of the amount of debt that a borrower *would have* borrowed if the lender had been an independent enterprise acting at arm's length (OECD, Thin Capitalisation Legislation, 2012).

2. The *"ratio" approach*: the maximum amount of debt on which interest may be deducted for tax purposes is established by a pre-determined ratio, such as the ratio of debt to equity. The ratio or ratios used may or may not be intended to reflect an arm's length position (OECD, Thin Capitalisation Legislation, 2012).

Definition of ALP

ALP is found in Article 9 OECD MTC and is the method recommended in the OECD's Transfer Pricing Guidelines.

ALP provides that the prices charged within multinational groups of companies or between groups of companies and their permanent establishments must be comparable to those that would have been charged between independent enterprises (Miller and Oats, 2016).

In order to arrive at an appropriate transfer price based on ALP one of a number of approved methods must be used: comparable uncontrolled price (CUP); resale price minus; cost plus; profit split; and transactional net margin.

CUP has generally been used for loans (Bakker and Levy, 2012).

Advantages of ALP

Much closer approximation of the debt the corporation could borrow at arm’s length and thus removes asymmetrical treatment between companies that are members of multinational enterprises and those that are not.

Tailored to the facts and circumstances of each case and allows a more tailored approach.

May allow the elimination of double taxation through the application of a tax treaty, if it is accepted by both treaty partners that the approach represents the application of the arm’s length principle and thus falls within the associated enterprises article of the relevant treaty. However, there is no consensus as to extent to which thin capitalisation provisions fall within the scope of DTCs (OECD, Thin Capitalisation Legislation, 2012).

Disadvantages of ALP

Large resource and skill requirements: the tax auditor needs to understand the processes third party lenders use to determine the maximum amount they would lend to a specific taxpayer. Tax authorities need to have expertise to step into the role of the third party lender and establish the specific characteristics of the group affiliate to determine an appropriate amount of debt.

Likely that a degree of judgment will influence the assessment (OECD, Thin Capitalisation Legislation, 2012).

Comparability arguably requires more than a comparison of the relevant interest rates. There is a need to consider the broader circumstances of the relevant parties including creditworthiness, probability of default, economic impact of any default, amount of intercompany debt (Bakker and Levy, 2012).

Inflexibility when it determines the amount of deductible interest expense by reference to a specified ratio, such as the ratio of debt to equity. For example, rules may permit interest payments on debt of up to two times the total amount of equity invested in the group affiliate with any interest over this ratio not being deductible.

Approaches differ among countries. For example, Kenya uses a debt to equity approach and employs a 3 to 1 ratio, while Ghana and Canada, for example, use a 2 to 1 debt to equity ratio.

Some countries use only related-party debt in the equation, whereas others apply this approach using total debt as the basis.

Advantages of Ratio Approaches

The advantage of a ratio approach is that it provides a great deal of certainty and reduces compliance costs to companies and taxing authorities.

The rule is considered to be simple to implement and reduces the resource costs of tax authorities (OECD, Thin Capitalisation Legislation, 2012).

Disadvantages of Ratio Approaches

Does not necessarily reflect economic reality and may distort behaviour by group affiliates.

A fixed ratio approach does not always take into account specific market situations or industries, and may result in inconsistent treatment of members of multinational enterprises in comparisons to independent companies.

There is no agreed international standard for the formulation of an appropriate ratio.

Potential for corporations to attempt to avoid the application of thin capitalisation rules through what is sometimes known as a 'bread and breakfast' practice, whereby the group affiliate's debt level (or another financial indicator) is reduced immediately before a reporting period (financial year, calendar year, monthly, etc.) to avoid triggering scrutiny, but then increased again immediately after the reporting period (OECD, Thin Capitalisation Legislation, 2012).

Conclusion

Students could conclude by referring to the OECD's 2014 proposals and 2015 recommendations on BEPS Action 4 that the "fixed ratio" rule and a group ratio rule be adopted. Given this move away from ALP, it would appear that the OECD has deemed ALP too difficult to use in deciding whether interest deductions within a group of companies are justified.

Students could elaborate a little on the recommended approach in the OECD's Final Report on BEPS Action 4, which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortisation (OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report).

The Final Report considers that the fixed ratio approach apply to multinational groups at the very least and provides a "corridor of possible ratios of between 10% and 30%". In order to prevent double taxation countries are "permitted" to apply a 10% uplift to the group's net third party interest expense.

Banks and insurance groups will be the subject of modified ratios and a report on the application of the ratio to these industries is expected in 2016.

The OECD's move away from ALP has not been received well by all. For example, the International Chamber of Commerce (ICC) in February 2015 voiced concern that ALP was being discarded by the OECD in relation to interest deductions and other financial payments. The ICC suggested that where there is concern that interest is deductible at too high a rate and income subject to tax at a low rate then this should be tackled by CFC rules, transfer pricing and work surrounding harmful tax practice. Similar concerns were raised by The Hundred Group (who were concerned that the ratio approaches do not involve a consideration of actual circumstances of transactions).

Question 3

This question requires students to have a general understanding of the operation of double tax conventions (DTCs) and, more specifically, the "Entry in Force" Article of the OECD MTC, which is one of the two final provisions of the OECD MTC (OECD MTC 2014, Intro., para.17).

Extra marks are awarded to students who are able to cite country practice/case law pertaining to the application of relevant treaty provisions.

Students may make mention of the following points when discussing the Article:

- DTCs are instruments of international law and most are governed by the Vienna Convention on the Law of Treaties (VCLT) (Miller and Oats, 2016).

- Generally DTCs enter into force when ratified by the relevant CS, i.e. the CSs have adopted the provisions of the DTC in their domestic law (Articles 11 and 14 VCLT).

- The entry into force article receives little attention: very brief commentary on Article 30 consists of several short paragraphs and so does not provide much guidance: J. Sassesville, *Tax Polymath – A Life in International Taxation* (IBFD, 2010), 550.

- OECD MTC appears to follow general treaty law in requiring that a treaty must be ratified and that there is a need for there to be an exchange of instruments in order for ratification to take place.

- There is however some room for flexibility in that it is clearly for the CSs to determine from which date the treaty provisions take effect.

- OECD MTC does reference some of the main events that constitute the process through which the provisions of a DTC become operative.

The following is one possible schematic.

Events

1. Negotiation and Authentication
2. Date of Signature
3. Date of Entry into Force
4. Effective Date

Negotiation and Authentication

The initial negotiation of a DTC tends to be carried out by representatives of the ministries of finance, treasuries and/or revenue authorities of the CSs (Holmes, 2015).

Authentication requires the text of the relevant DTC to be "established as authentic and definitive" (Article 10 VCLT).

Date of Signature

Date when the representatives of each contracting state (CS) sign the treaty.

Article 18(a) Vienna Convention on the Law of Treaties (VCLT) attaches some importance to the signature of the treaty in that it requires a CS to refrain from acts that would defeat the object and purpose of the treaty where that CS has signed the treaty (or exchanged instruments constituting the treaty subject to ratification).

The date of signature is the date to which a DTC will generally be referred (Miller and Oats 2016).

The signing of a DTC has been described as expressing:

- an indication that the negotiators of the two CSs are satisfied with the wording of the DTC (Miller and Oats 2016); and

- a commitment to present the treaty for ratification as opposed to a commitment to conclude the treaty. Furthermore, the signature of the treaty does not in and of itself provide taxpayers with any rights arising under the treaty terms (Sasseville, 2010).

Accordingly, a DTC that has been signed will still need to be ratified.

In the UK, the Foreign and Commonwealth Office is responsible for negotiating treaties under Royal Prerogative and these treaties must be signed by Queen Elizabeth II (ratification). Parliament is given 21 days' notice of impending ratification and thus the date when the treaty is binding is "the entry into force" date.

Date of Entry into Force

Generally, the same date as the date of conclusion: Arts. 30(2) OECD MTC and 24(2) VCLT.

Article 24(1) & (2) VCLT provide that a treaty enters force in such a manner and upon such date as it may provide or as the negotiating States may agree or where there is no such agreement or provision then the treaty enters force "as soon as consent to be bound by the treaty has been established for all the negotiating States".

Article 24(3) VCLT provides that where such consent is established after the treaty has come into force then the treaty enters force on that later date.

Effective Date

Arguably, the most important date for taxpayers and administrations (Sassevillle, 2010).

OECD MTC leaves it to CSs to decide what that date will be and some treaties include extensive provisions on this issue.

Provisions of a DTC can become effective, before, with or after entry into force of a DTC (Zembala, 2015).

An exchange of (ratification) instruments generally brings into effect the provisions of the relevant DTC, however, some CSs have their own procedures e.g. the United States requires Senate approval as well as an exchange of instruments before the provisions become effective (Miller and Oats, 2016).

Article 28 VCLT provides that CSs may agree upon the effectiveness starting before the date of entry into force (retrospectively). The legitimacy of retrospective effect of DTC provisions ultimately depends upon national law (Zembala, 2015).

To deal with the interaction of retrospective effect and the introduction of a new DTC, CS may provide that the favourable terms of an old DTC will apply until such time as the new DTC enters into force (Zembala 2015 and Liesenfield 2008).

Many CSs distinguish between the effectiveness of provisions relating to taxes withheld at source and other taxes (Article 3(2) France/UK DTC 2008; Article 32(2) Finland/Netherlands DTC 1995; and Article 30(2) Austria/Switzerland DTC 1970/2009).

Norway/Russia DTC 1996 entered into force on 20 December 2002 but Article 29 of that DTC provided that the provisions could not be relied upon by Norwegian taxpayers until the year after the treaty came into force (1 January 2003).

The Commentary to OECD MTC makes reference to the fact that certain aspects of the OECD MTC may take effect irrespective of the date that the relevant DTC enters into force, e.g.:

1. *Art.13*, where Art.2 permits a CS to tax a capital gain. This right is stated by the Commentary on Art.13, para 3.1, to apply to the entire gain and not only to the part that has accrued after the entry into force of a treaty;

2. Commentary on *Art.25,* para 36, where there are memoranda of understanding or mutual agreements that are concluded after the entry into force, DTCs terms may be interpreted on the basis of those agreements; and

3. Commentary on *Art.26*, para 10.3 where exchange of information can only take place once the DTC has entered into force and the provisions have become effective but the information exchanged can relate to information that dates back to before the entry into force of the DTC.

<u>Conclusion</u>

Students may mention the following points:

- Article 30 of OECD MTC and UN MTC are identical.

- The interaction between DTC rules and domestic tax law, where domestic law has been passed after the DTC has entered into force, has been considered by Croxatto (1965): where domestic tax law is in force *before* the international rules and domestic tax law passed by parliament after the entry into force of a tax treaty then DTC rules prevail; and where domestic tax law is passed by parliament *after* the entry into force of a tax treaty then the DTC rules prevail (as the pre-existence of the treaty implies limits on the domestic legal system's power to override the treaty such that the treaty rules prevail).

- Clearly, the date at which treaty enters into force is highly dependent upon domestic law of the CSs. Some CSs assess tax on the income received during the current year, others on income received during the previous year and others on a fiscal year that differs from the calendar year (Commentary on Art.30, para. 5).

- Taxes that are withheld at source often have different application dates.

- Assistance in collection provisions, introduced into a pre-existing DTC, are effective in relation to taxes in existence before the amending assistance in collection provision was introduced where they are in existence at the time the DTC entered into force. However, the assistance itself can only take place once the relevant amending provisions is ratified. See the Supreme Court of South Africa in *Mark Krok and Another v Commissioner for the South African Revenue Service* 2015 and the UK decision of *Ben Nevis (Holdings) ltd. and Metlika Trading Ltd. v Commissioner for HMRC* with regard to the taxpayer's argument about retrospective effect.

- Certain countries significantly modify the entry into force provisions in their DTCs. For example, the United States' Model Tax Convention includes a Savings Clause (Art.1(4)), which provides that the United States can tax its' citizens as if the DTC had not entered into force. A savings clause along the lines of the US Savings Clause formed one of the proposals to amend the OECD MTC (BEPS Draft on "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances", 21 March 2014).

Question 4

The object of this question is to allow students to demonstrate their understanding of the concepts of tax haven within the international tax framework and to engage in a discussion about the relevancy of the various factors that tax havens are generally considered to exhibit. The quote concedes that there is no one comprehensive definition of a tax haven and it is open to students to explore the various definitions and form a view as to whether the statement made by Orlov in 2004 still holds in 2016. The work of the OECD, EU and broader literature can be cited to support students' responses.

There are a number of different ways in which students could answer this question. The answer below is one possible approach and includes a number of points that students could make in answering the question.

The following is one possible schematic.

Introduction

Students could begin by outlining the significance of having a clear definition of a tax haven. Students could also place the concepts of tax havens within the context of the recent initiatives of the OECD's BEPS project and general public interest in the tax contribution taxpayers make.

Main Body

Students should consider the defining characteristics of a tax haven as espoused in the literature; how the relative importance of these characteristics has changed over time; and how the OECD considered that notwithstanding its outlining of the nature of a tax haven, its view that it was necessary to distinguish tax havens from "uncooperative tax havens".

Students might also want to discuss the difference and similarities between harmful tax practices/regimes on the one hand and tax havens on the other.

Defining characteristics of a tax haven have been described as: (i) no or nominal tax on the relevant income; (ii) lack of effective exchange of information; (iii) lack of transparency; and (iv) no substantial activities. However, (i) no or nominal tax was *not* sufficient in itself (OECD, Harmful Tax Competition: An Emerging Global Issue 1998).

Students could mention the fact that athough the lack of taxation was cited as being an insufficient factor in 1998 by the OECD, a tax haven has been described, as recently as September 2013, as a place where an entity discloses income as arising in a place where it is "*taking advantage of the absence of a corporate profits tax*) PWC, 2013, commenting on BEPS.

J.G. Gravelle (Tax Havens: International Tax Avoidance and Evasion, 2015), adopting the broader view for the purpose of her paper, notes that tax havens tend to be defined narrowly – e.g. tax havens have low or non-existent tax rates on some types of income, or more broadly – e.g. tax havens have a broad range of features including low or non-existent tax rates on some types of income, also have such other characteristics as the lack of transparency, bank secrecy and the lack of information sharing, and requiring little or no economic activity for an entity to obtain legal status.

Evers et al. (2011) consider that tax havens exhibit the following characteristics: (i) (consciously or not) giving residence status to entities that avoid tax due to that residence status; (ii) no or almost no taxation; (iii) hosting corporations with a lack of substance; and (iv) lack of transparency or willingness to exchange information.

This broader view also appears to be supported by the Economic and Social Committee, which has described tax havens as territories that "*display a number of common features, such as the lack of transparency on how they function and the low levels of taxation for nonresidents who, in fact, do not carry out any activity there*." The effect of tax havens gives rise to harmful competition with a hidden structure, creating a legal status entirely lacking in transparency (Official Journal of the European Journal, "Opinion of the European Economic and Social Committee on "Tax and Financial Havens: a Threat to the EU's Internal Market" C 229/02, Vol.55, 31 July 2012, 2.1).
What emerges is that lack of transparency, lack of exchange of information, lack of economic substance and low or no taxation appear to be common themes as it would appear that these factors all provide opportunities for profit-shifting.

Students should mention the work of the OECD in the area of information exchange. Lack of effective exchange of information has been said to have played a key role in the identification of tax havens and harmful tax practices (Oberson, 2015). In particular, reference could be made to the previous need for countries to have signed a minimum of 12 agreements on information exchange (whether a DTC with an Article 26 equivalent or a TIEA) in order to be placed on the OECD's "white-list" of cooperative jurisdictions. The development of tax information exchange agreements (TIEAs) began in the 1990s. Between the period November 2008 and November 2011, 700 TIEAs were signed, and by 2011 this figure was reported to have reached over 1,000 (Stewart, World Tax Journal, 2012).

Students could also mention that there is a general move towards to country by country reporting as a method of minimising profit shifting opportunities but this is not met with universal support in that there is a view that tightening transfer pricing regulations is likely to yield better results (Evers *et al*, "Transparency in Financial Reporting: Is Country-by-Country Reporting suitable to Combat International Profit Shifting", 2015).

<u>Conclusion</u>

Students could conclude that although the statement above by Orlov was made over a decade ago (2004), there is still no consensus as to what the term tax haven means. Whilst it is clear that there is a focus upon transparency and the need for effective exchange information, it is not clear whether the lack of transparency and/or effective exchange of information is/are the only relevant factor(s) when considering whether a country is to be classified as a tax haven. Consequently, it is difficult to analyse which countries are to be classified as tax havens and if they are classified as tax havens then what this says about the relevant jurisdiction.

Question 5

Students could answer this question in a variety of ways. The following provides the outline of but one possible answer.

The following is one possible schematic.

Introduction

Article 4 OECD Model Tax Convention on Income and on Capital (OECD MTC) is intended to define the meaning of a resident of a contracting state and solve cases of dual residence.

The concept of residence of a contracting state in OECD MTC has 3 main functions (Commentary to Article 4, paragraph 1): (i) determining person's scope of application; (ii) solving cases where juridical double taxation arises in the case of a dual resident; and (iii) solving cases where juridical double taxation arises as a consequence of taxation in the state of residence and in the state of source.

However, Article 4 OECD MTC does not define tie-breaker tests and the Commentary provides minimal guidance as to the meaning of the tests.

Lack of guidance as to the meaning of the tests has resulted in uncertainty for taxpayers and it is difficult to reconcile the view that these terms have a unique treaty meaning when there are a variety of interpretations being adopted by courts across the globe.

Main Points

Article 4(2) OECD MTC sets outs a hierarchy of test, which are applied progressively until an individual's residence is determined (K. Holmes, 2014):

- permanent home;
- centre of vital interests;
- habitual abode;
- nationality; and
- mutual agreement.

Looking at each test in turn and examining the extent to which countries have sought to include the terms, as well as their own judicial interpretation of these terms, in combination highlight the lack of clarity surrounding the meaning of these terms.

That the tests are to be applied in order was raised in a case involving the competent authorities of France and the USA (P. Baker, DTCs, 2015, 4B.11).

The concepts appear to have a grounding in the domestic law of European continental countries, and in particular France cf: common law countries (P. Baker, DTCs, 2015, 4B.10).

Permanent home: Permanent home is the taxpayer's home but can be a house, apartment or furnished room (Tax Court of Canada 28 September 2007: 2006-2458(IT) regarding the US/Canadian DTA). There is no requirement that the taxpayer lives in the home all the time (Finanzgericht Berline (Tax Court of First Instance) 18 June 2002, 5 K 5386/00: Germany / Spain DTA). The home must be a vital interest to the taxpayer and must be permanent (K. Vogel on DTCs, 2015, p. 271). Furthermore, the taxpayer must have retained it for his permanent use (Tax Court of Canada 28 September 2007: 2006-2458(IT) regarding the US/Canadian DTA). Legal title is not determinative but the taxpayer must have a home available to him as a matter of fact (Hoge Raad (Supreme Court) 3 October 1985, IR 274/82 Netherlands/Spain DTA).

Centre of vital interests: appears to be particularly problematic as there appears to be uncertainty over several aspects of the term (P. Baker in Maisto (ed.) "Residence of Individuals under Tax Treaties and EC Law", 2010, 179). In particular, it is not clear as to what factors should be taken into account and the relative weight to be afforded to each factor. Personal and economic relations are relevant, including: house, family home, furnishings, legal title, passport, children, spouse, drivers licence etc. K. Vogel outlines a method for limiting the number of factors that are to be treated as relevant factors: reading permanent home and centre of vital interests together (p.275).

Habitual Abode: where the taxpayer stays more frequently (Finanzgericht Munchen 4 April 2003, 12 K 2867/96 Germany Greece DTA). But the question remains whether the taxpayer's stays are to be judged on the basis of frequency or quality. However, there is a view that a quantative assessment is preferable (K. Vogel, 278).

Nationality: where an individual has an habitual abode in both CSs or in neither that individual is deemed to be a resident of the CS of which he is a national. Nationality provides a strong connection between a country and an individual. In contrast to the other tie-breaker tests nationality has its own domestic meaning and does not require a territorial relationship (Ismer and Riemer, 2015). It requires no legal interpretation.

Mutual Agreement: Where the individual is a national of both CSs or neither CS then the MAP, as per Article 25 OECD MTC, must be used. The inclusion of the words "shall settle" in Article 4(2)(D) OECD MTC requires MAP as opposed to this being optional. If the matter is not settled within 2 years, then mutual arbitration must be initiated (where the MAP was initiated by the taxpayer). It is unclear what criteria should be applied under MAP. Some CSs give precedence to personal over economic relationships.

<u>Conclusion</u>

The objective that a person's residence, for the purposes of a DTA, is clearly satisfied by the application of the hierarchy of tests is arguably frustrated by the lack of certainty surrounding the interpretation of the terms permanent home and, to a lesser extent centre, vital interests and habitual abode.

With the exception of nationality, the tie-breaker tests of permanent home/centre of vital interests/habitual abode are considered to be treaty terms in that recourse should not be had to national law (and public international law where relevant) in their interpretation (K.Vogel on DTCs (2015, p. 269).

Of the various tie-breaker tests the permanent home test appears to provide relatively more certainty than the centre of vital interests and habitual abode tests (P. Baker, 2013, commenting on *Yates v HMRC* (2012)).

The scope of centre of vital interests test is difficult to determine as "court decisions from various States all very much rely upon the specifics of the particular case" (K. Vogel, p. 276).

The scope of the tie-breaker rules can be limited as was recently seen in 2013: Swiss residents, who are non-Swiss nationals, that are taxed as per the forfait regime (taxed on a lump sum basis) are no longer able to benefit from the France/Switzerland DTA. The effect of this is that certain benefits arising from access to the DTA will not accrue to such residents. In particular, the tie-breaker rules in Article 4 of the DTA will not apply to those Swiss residents subject to the forfait regime.

The fact that Article 4 OECD MTC provides a mutual agreement procedure as a requirement ("shall settle") indicates not only that the OECD MTC implicitly envisages that it may not be possible to ascertain an individual's residence on the basis of the tie-breaker tests but also that it is fundamental to the operation of the DTA network that dual residence issues are resolved that it words Article 4(2)(d) in the imperative.

It is of interest that the tie-breaker rule for corporations has received significantly more attention in recent times than that of individuals; a case by case analysis of the residence of dual resident entities other than individuals has been suggested (Public Discussion Draft, BEPS ACTION 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, April 2014).

A preference criterion that ensures that the person concerned will satisfy the tie-breaker test in one State only appears to remain an elusive objective; this may continue to be the case at least until such time as the Commentary to Article 4(2) is expanded or a definition is added to the text of Article 4 itself. Furthermore, until such time that amendments are made it is difficult to see how a universally accepted set of tests (that are consistently applied) can emerge.

PART B

Question 6

This question concerns the application of Article 26 OECD MTC. Sub-questions (1)-(4) will allow students to demonstrate their awareness of the major conditions envisaged by Article 26 OECD MTC and apply them in various contexts. The final sub-question (5) tests analytical skills by asking students to discuss whether a notification procedure should be put in place. This question seeks to distinguish particularly strong students who will be able not only to set out the definition of "spontaneous exchange", but also explain conflicting considerations that may drive different regulatory choices. Some traces of this debate can be found in the OECD Commentary. The use of other sources and own opinion will be rewarded.

Part 1

The exchange of information is governed by Article 26 OECD MTC. In a nutshell, under Article 26(1) the competent authorities of the Contracting States shall exchange such information as is foreseeably relevant to secure the correct application of the provisions of the Convention or the domestic law of the Contracting States concerning taxes of every kind and description imposed in these States. The reference to "foreseeably relevant" seeks to provide for exchange of information to the widest possible extent. Yet, at the same time, Contracting States may not engage in "fishing expeditions" or request information that is unlikely to be relevant to define the tax liability of a particular taxpayer. In this respect, the Commentary recommends looking for a reasonable possibility that the requested information will be relevant. On the given facts, the relevance of the open-ended request for information submitted by State B can be questioned. State B seems to be engaging in "fishing expeditions" (in other words, has made a speculative request that has no apparent nexus to an open inquiry or investigation). In these circumstances, State A is not obliged to provide a response. This conclusion is confirmed by paragraph 8.1(b) of the Commentary to Article 26(1) that includes a similar example.

Part 2

This factual scenario satisfies the conditions set out by Article 26 OECD MTC. The requested information appears to be foreseeably relevant to secure the correct application of laws in State C. Even if the information about accounts opened in the name of Chloe Palero may turn out to be immaterial, the Commentary to Article 26(1) in paragraph 5 clarifies that it does not matter whether the information (once provided) will actually prove to be relevant. Therefore, a request in an ongoing investigation, where a definite assessment of the relevance can only be made upon receipt, cannot be refused. Hence, State A is obliged to provide the requested information. This conclusion can be supported by a similar example included in paragraph 8(e) of the Commentary to Article 26(1).

In relation to the possibility of refusing the request on the ground that such information is held by ArgoBank, Article 26(5) stipulates that a Contracting State shall not decline to supply information to a treaty partner solely because the information is held by a bank or other financial institution. In effect, paragraph 5 overrides paragraph 3 of Article 26: the latter would otherwise permit a requested Contracting State to decline to supply information on the grounds of bank secrecy (paragraph 19.11 of the Commentary to Article 26(5)). Any further comments on international developments concerning transparency and/or bank secrecy will be rewarded by a higher mark.

Part 3

According to Article 26(3)(c), paragraphs 1 and 2 of this article cannot be construed so as to impose on a Contracting State the obligation to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process. However, secrecy in this context should not be interpreted too broadly in order to make sure that the overall effectiveness of Article 26 is not undermined. A Contracting State should carefully weigh whether the interests of the given taxpayer really justify the application of this provision (Commentary to Article 26(3), paragraph 19). State A in these circumstances is given a certain discretion as to whether it should refuse the request. If it does choose to supply the information, the taxpayer cannot allege an infraction of the rules of secrecy (Commentary to Article 26(3), paragraph 19).

As made clear by paragraph 19.2 of the Commentary to Article 26(3), in limited circumstances the disclosure of financial information might reveal a trade, business or other secrets. In this situation, the Commentary recommends that details of the trade or other secret should be excised from the document and the remaining financial information should be exchanged accordingly.

Part 4

As paragraph 9 of the Commentary to Article 26(1) explains, the exchange of information can happen in three ways: (i) on request, (ii) automatically and (iii) spontaneously. The latter occurs when, for instance in the case of a State having acquired through certain investigations, information which it supposes to be of interest to the other State. This definition corresponds with the given scenario. However, one should consider the limitations set out by Article 26(2). The information received by a Contracting State may not be disclosed to a third country unless there is an express provision in the treaty between the Contracting States allowing such disclosure (paragraph 12.2 of the Commentary to Article 26(2)).

Part 5

Some relevant considerations can be found in paragraph 14.1 of the Commentary to Article 26(3). It acknowledges the differences between countries in that some domestic laws will envisage a notification procedure, whilst other countries would not notify the taxpayer that is subject to the enquiry prior to the supply of information. On the one hand, such procedural guarantees may be important. It may enable voluntary cooperation between taxpayers and the tax authorities of the requesting state or mitigate potential mistakes. On the other hand, the OECD has been concerned that in some circumstances notification procedures may hamper investigations by delaying or in other ways preventing the effectiveness of exchange. Students should demonstrate their understanding of these conflicting considerations. The knowledge of any additional literature on this topic will help to gain additional marks. In this respect, *IFA Cahiers 2015 - Volume 100B: The practical protection of taxpayers' fundamental rights* (General Report by Philip Baker and Pasquale Pistone) may prove useful. For instance, students may mention that even though Article 26 OECD MTC usually protects any trade, business and other secrets from disclosure, the enforcement of these safeguards could not be effective if the taxpayer is not aware of the proposed exchange and has no opportunity to challenge the exchange on these grounds. Any sensible conclusion on which approach should be prioritised and/or how to balance these conflicting approaches would suffice.

Question 7

Part 1

Selling through an office of Amerto and its own local sales team in Baronia

As a starting point, it should be mentioned that Amerto will not be taxable on its business profits in Baronia unless it has a PE there (Article 7(1) OECD MTC). In this example, Amerto will have a PE in Baronia. Under Article 5(1) OECD MTC the term "PE" means a fixed place of business through which the business of an enterprise is wholly or partly carried on. This definition includes an office (Article 5(2) OECD MTC). Sales are not preparatory or auxiliary activities under Article 5(4) OECD MTC. The profits generated by the office and the sales team will thus be taxable in Baronia.

It is important that students acknowledge their understanding of tax consequences for Amerto and conclude that relying upon this approach is likely to produce to a high tax liability.

Establishing a local subsidiary in Baronia (a buy-sell arrangement)

According to Article 5(7) OECD MTC, the fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a PE or otherwise), shall not of itself constitute either company a PE of the other. Therefore, as a starting point, the local subsidiary is separately taxable in Baronia on its profits, and Amerto will remain taxable on its profits in Arbella.

Yet, Amerto should make sure that the subsidiary does not constitute a PE. From the outset, it appears that under this scenario the local subsidiary will purchase goods from its foreign parent and will take fully responsibility for selling the goods to customers in Baronia. It should not constitute a dependent agent of Amerto under Article 5(5) OECD MTC. Any relevant considerations on this point will be duly rewarded. Furthermore, the visits of the quality director to Baronia need to be considered in the light of the Commentary to Article 5(1), paragraph 4, which addresses the situation of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g. a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a PE of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" (paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in Article 5(4) OECD MTC. Students need to apply this interpretation to the factual scenario in order to gain a high mark.

The disadvantages of this model should be made explicit. It is likely that under this arrangement the local subsidiary could get substantial profit margins from selling the goods (e.g. it controls business activities and bears the associated risks). Therefore, given that the tax rate in Baronia is higher than in Arbella, the total tax cost of the multinational enterprise would remain high.

Setting up a commissionnaire arrangement

An arrangement where a person sells products in a State in its own name but on behalf of a foreign company that is the owner is described as a commissionnaire arrangement. It allows a foreign company to sell its products in a State without technically having a PE to which such sales may be attributed for tax purposes.

The starting point for this analysis is Article 5(5) OECD MTC. Students should consider whether this arrangement will be captured by the notion of dependant agents and, in particular, discuss the Commentary on Article 5(5), paragraphs 32 and 32.1. Students should explain that Art. 5(5) OECD MTC relies on the formal conclusion of contracts in the name of the foreign enterprise. The application of this article can be avoided to the extent that the contracts concluded by the person acting as a commissionnaire are not binding on Amerco. If put in place, this arrangement may allow Amerco to remain not taxable in Baronia on the profits derived from such sales. Furthermore, since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services.

Selling through several independent agents in Baronia

In this context, Article 5(6) and 7(1) OECD MTC would apply. If Amerco, as a foreign enterprise, carries on business dealings through an agent of an independent status in Baronia, it cannot be taxed there in respect of those dealings if the agent is acting in the ordinary course of his business (Commentary to Article 5(6), paragraph 36). Hence, there will be no PE of Amerco in Baronia. Having said that, student should also demonstrate their knowledge of the associated conditions (Commentary to Article 5(6), paragraph 37), namely that a person will not constitute a PE of the foreign enterprise on whose behalf he acts only if: (a) he is independent of the enterprise both legally and economically, and (b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

Part 2

In October 2015, a two-year G20/OECD Project against base erosion and profit shifting (BEPS) has culminated in a 2000-page final report, promising the most significant change in the field of international tax regulation in a century. Action 7 sought to develop changes to the definition of PE to prevent the artificial avoidance of PE status, including through the use of commissionaire arrangements. Commissionnaire arrangements and similar strategies were identified as such that erode the taxable base of the State where sales took place. The final report proposes changes to the wording of Article 5(5) and 5(6) in order to address such strategies. Students are not required to provide the details of these proposals. Yet, acknowledging the fact that such arrangements are faced by many tax administrations and have been dealt with by the OECD is necessary for a higher mark.