THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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PAPER 1

SUGGESTED SOLUTIONS

PART A

Question 1

This question requires both description and analysis of the arm's length principle (ALP) as set out in Article 9(1) of the OECD Model Tax Convention (the "MTC"). In answer to the first of the 3 sub-questions, one approach might be a brief description of the history of the ALP and its role in transfer pricing and permanent establishment profit attribution. In answer to the second sub-question, the student may wish to frame their answer simply in terms of the disadvantages of the ALP. In answer to the third sub-question, the obvious choice would be a discussion of unitary or formula apportionment taxation. There is some scope within this question to narrow the focus of the answer. For example, a discussion of the role of ALP in relation to debt financing or intangibles might make for an interesting perspective.

The following is one possible schematic.

Importance

The ALP was first introduced by the League of Nations Model Tax Conventions in the 1920s and was later adopted by the OECD in 1963. Article 9(1) of the current MTC provides that where

> *"conditions are made or imposed between the two 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 those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".*

Under the ALP, extra profits that result from a non-arm's length transaction between related (i.e. members of the same corporate group) and 'same entity' (i.e. divisions or branches of the same company in a foreign jurisdiction) parties become taxable. The ALP applies the same pricing to cross-border intracompany and intragroup transactions that would have been agreed between independent parties under similar market conditions. Thus, the ALP is used to test the pricing applied to such international transactions.

The ALP is endorsed by the OECD Transfer Pricing Guidelines. It has been widely accepted by multinationals and tax administrations alike. In relation to certain transactions, it is recognised as an efficient and effective tool to ensure that the pricing is at market value (e.g. purchase and sale of goods, provision of services, and royalties). In order to arrive at an appropriate transfer price based on the 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.

As regards the intercompany payment of interest, which may arise in various situations (the most typical being intercompany loans and cash pooling arrangements), while the ALP is commonly used and quoted in the OECD Transfer Pricing Guidelines in this respect, there is a certain degree of debate on whether it is the best method to ensure that such financial transactions do not involve profit shifting or artificial arrangements which lead to tax avoidance.

Difficulties

- Despite being good for recognising individual circumstances, the computation of the arm's length range differs extensively for each industry and business (i.e. it is not a 'one size fits all' solution) – this is exacerbated by the fact that the application of freely available data is often challenged due to questions of reliability.
- Too many factors have to be taken into account for each arm's length transaction, hence it is extremely resource intensive and time consuming for both taxpayers and administrations – the use of specific databases (e.g. Thomson Reuters Eikon, Bloomberg, Deal Scan) is expensive and hard to use – note BEPS Action 13: that TP exercises should be carried out by the taxpayer commensurate to its means.

- It is not always effective in addressing profit stripping (especially in the case of interest payments).
- It is hard to prove an MNE is not operating at arm's length with regards to interest deductions, which is why many countries have incorporated additional ratio approach oriented thin capitalisation rules.
- The absence of comparables (especially in the case of intangibles).
- The ability of states to choose whichever method they wish to employ in any particular case and the fact that the method chosen by one state may not be agreed by the other state, which exacerbates the problem in relation to secondary adjustments.
- The need for extensive transfer pricing documentation on a transactional basis.
- The extensiveness of negotiations in order to reach Advance Pricing Agreements.

<u>Alternative</u>

- The only generally applicable alternative to the ALP is a system of unitary taxation with formulary apportionment, sometimes referred to as simply global formulary apportionment (GFA).
- GFA has not been endorsed by the OECD.
- Unlike the ALP, GFA focuses on a theoretical global tax basis for all the entities that form part of the economic unity that is an MNE group.
- GFA involves measuring the income of multinational enterprises as a whole
- GFA segments the tax base per tax jurisdiction on the basis of certain quantitative ratios (e.g. turnover, head count, assets, etc.).
- GFA reflects the functional differences and consequent differences in profitability between integrated businesses and genuinely separate entities.
- GFA avoids the administrative burden and uncertainty of transfer pricing and other anti-avoidance approaches based on the ALP, such as thin capitalisation and CFC rules – at least to the 'water's edge' of participating states.
- GFA is arguably particularly well-suited to federal or single market situations.
- The main problems arise as a result of partial adoption, particularly where states or MNEs are given the opportunity to 'opt out'.
- The likelihood of wider adoption is low due to the probable difficulty in getting states to agree on a common tax base and apportionment factors.
- Some states will consider that they are better off under the ALP, either in terms of an increased tax take or because of their perception that greater control over the tax base gives increased scope to use tax policy as a tool of social policy.
- Note the renewed focus on the draft EU CCBT and CCCBT and the positive effects this could have in terms of foreign market access for small and medium-sized enterprises.

<u>Conclusion</u>

In the absence of agreement in relation to GFA, perhaps a combination of the ALP and other more specific rules in relation to particular industries or transaction types might be better (e.g. fixed interest / EBITDA ratio thresholds with regards debt financing such as that outlined in BEPS Action).

Also, it is a proven fact that the ALP, for the most part, eliminates double taxation through the application of a DTA. However, there is as yet no consensus as to extent to which GFA would come within the scope of extant DTAs.

Question 2

In some jurisdictions, there remains some uncertainty as to the relationship between domestic anti-avoidance rules and double tax agreements (DTAs). Although the issue in these jurisdictions might only affect a small number of taxpayers, the amounts at stake tend to be quite significant. The general argument that DTAs prevent general anti-avoidance rules (GAARs) from applying seems to depend heavily on matters of interpretation. Clearly, tax authorities would prefer the view that DTAs do not prevent anti-avoidance rules from applying.

The following is one possible schematic. This answer focuses on common law jurisdictions. However, it is open to students to focus on civil law jurisdictions, where fraus legis, Rechtsmissbrauch, and abus de droit are found. These are general doctrines that pertain to the whole of the Civil Law (not just tax law). However, as in Germany (Rechtsmissbrauch), the general doctrine is sometimes explicitly evoked in a tax law context.

Introduction

- Many states have general anti-avoidance rules (GAARs) in their income tax legislation.
- GAARs effectively override other provisions of domestic tax legislation to deny the tax benefits of an arrangement when a more than incidental purpose of the arrangement is to obtain a tax benefit.
- In addition, many states also have specific anti-avoidance rules (SAARs) which override other provisions of the tax legislation in specific avoidance situations.
- Anti-avoidance rules potentially apply to all income tax transactions, including those with an international dimension .
- Double tax agreements (DTAs) are a key feature of international tax law. DTAs are international treaties that are entered into between governments primarily to prevent double taxation and double non-taxation on cross-border income.
- Generally, there is a lack of clarity as to the relationship between anti-avoidance rules and DTAs. Domestic income tax provisions that govern the domestic implementation of DTAs often state that DTAs override other income tax provisions. However, domestic law also tends to state that GAARs and SAARs have an overriding effect. In the absence of an ordering provision, it is unclear which override has primacy.
- If it were to be the case that DTAs were explicitly said to override GAAR and SAARs, this would not meet the objective of preventing tax avoidance.

The Arguments

- Revenue authorities tend to consider that a DTA does not prevent a GAAR or SAAR from applying: the GAAR/SAAR (hereinafter "GAAR") should be applied first to establish/recharacterise the relevant fact situation. Domestic tax law and the DTA then apply to that recharacterised fact situation.
- Where there is treaty abuse, such as treaty shopping, a revenue authority would naturally consider that, if the criteria of the anti-avoidance rule applies, it can be used to reconstruct the arrangement to give the appropriate tax outcome for domestic tax law purposes.
- Taxpayers take a different view. They tend to argue that DTAs override anti-avoidance rules. This means that a GAAR cannot be applied in an avoidance situation where a treaty provision is also used (i.e. tax avoidance arrangements cannot be prevented by relying on an anti-avoidance rule).
- Taxpayers might also argue that since GAARs are not a "bright line" test, providing for GAAR override could add to uncertainty
- The OECD's Commentary to the Model Tax Convention (the "OECD Commentary") is an important part of context in which these DTAs are internationally understood. The Commentary notes that states do not have to grant the benefits of a DTA where the DTA has been abused, although the Commentary also notes that it should not be "lightly assumed" that a taxpayer is entering into an abusive transaction. The OECD Commentary notes that, for some countries, their domestic GAAR (or similar rules) applies to their DTAs. Examples of countries that have made the relationship explicit

include Australia, the United Kingdom and Canada. The OECD Commentary further notes that, where the GAAR is used to determine the proper construction of facts to which the DTA would apply, then there is generally no conflict.

Jurisdictional Practice

- Canada and Australia have amended their legislation to explicitly ensure that DTAs do not override the GAAR.
- More recently, in 2014, the United Kingdom also amended its legislation to explicitly provide that DTAs do not override the GAAR.
- For those jurisdictions that have not clarified their domestic law, such inaction may support the argument that DTAs override GAARs. Accordingly, some taxpayers may be encouraged to engage in tax avoidance behaviour in an international context, if they can argue that their behaviour is sheltered by international tax agreements. This may also have implications with regard the application of penalties in avoidance situations.
- By contrast, taxpayers are generally prohibited from engaging in tax avoidance behaviour where there is no DTA. Different treatment for taxpayers operating in jurisdictions with a DTA and those without undermine the integrity of tax systems. It also means a non-level playing field, which in turn has fairness implications.
- Where the revenue authority decides to simply publish its view, rather than amend the domestic law in situations where the relationship is uncertain, this creates a problem in those jurisdictions where the revenue authority view is not binding upon taxpayers.

Conclusion

For an interesting discussion on this matter, from the perspective of a particular jurisdiction, see Elliffe and Prebble "General Anti-Avoidance Rules and Double Tax Agreements: A New Zealand Perspective" Revenue Law Journal (2009) Vol.19(1).

Whatever option is considered by those jurisdictions where the position is still uncertain, the way forward that they choose should not impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives for businesses to innovate and invest, or override fundamental common law principles.

Question 3

The international tax landscape has changed dramatically in recent years as a result of new standards that have been developed to enable countries to protect their revenue bases. The OECD and G20 have developed a comprehensive package of measures to tackle base erosion and profit shifting (BEPS): the BEPS package. Specifically in relation to non-members of the OECD or the G20, an Inclusive Framework on BEPS has been put in place by the OECD Committee on Fiscal Affairs (the "CFA"). The aims of the framework are to tackle tax avoidance, improve the coherence of international tax rules, and ensure a more transparent tax environment.

The following is one possible schematic.

Introduction

One (some suggest rather conservative) estimate is that BEPS creates estimated global annual revenue loss of USD 100 to 240 billion. Now that the BEPS package is in place and discussions with regard to implementation and further development are underway, the OECD is now seeking to implement the BEPS package on a global basis through the Inclusive Framework on BEPS. The Inclusive Framework on BEPS held its first meeting in July 2016 in Kyoto. A second meeting took place at the end of January 2017.

The Inclusive Framework on BEPS seeks to: develop standards in respect of remaining BEPS issues; review the implementation of agreed minimum standards through an effective monitoring system; monitor BEPS issues, including tax challenges raised by the digital economy; and facilitate the implementation processes of the members by providing further guidance and by supporting development of toolkits to support low-capacity developing countries.

States that join the framework are required to commit to the comprehensive BEPS package and its consistent implementation and pay an annual member's fee to cover the costs of the framework.

The BEPS Package

In September 2013, the G20 endorsed the BEPS Action Plan, developed with OECD members. Consequently, in two years, OECD and G20 countries developed and agreed upon a package of measures (the BEPS package) that are designed to be implemented domestically and through tax treaty provisions. Coordination, monitoring and transparency are key implementation features of these measures.

The BEPS package consists of reports on 15 actions:

1. Digital Economy (DE). Identifies the main difficulties that the DE poses for extant international tax rules. It proposes detailed options, taking a holistic approach and considering both direct and indirect taxation.
2. Hybrid Mismatch Arrangements (HMAs). Provides for model treaty provisions and domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities.
3. Controlled Foreign Corporations (CFCs). Contains recommendations on the design of CFC rules.
4. Interest Deductions. Concerns rules to prevent base erosion through the use of interest expense. For example, it considers the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income. It also considers other financial payments that are economically equivalent to interest payments.
5. Harmful Tax Practices (HTPs). Seeks to revamp the work on HTPs. Prioritises transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and substantial activity requirements for any preferential regime.

6. Treaty Abuse. Develops model treaty provisions and recommendations on the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.
7. Permanent Establishments (PEs). Concerns changes to the definition of PE to prevent the artificial avoidance of PE status, including through the use of commissionaire arrangements and the specific activity exemptions.
8. Transfer Pricing (intangibles). Seeks to ensure that transfer pricing (TP) rules are in line with value creation in relation to intangibles by developing rules to prevent BEPS by moving intangibles among group members.
9. TP (risk and capital). Seeks to ensure that TP rules are in line with value creation in relation to the transference of risk and the allocation of excessive capital to group members.
10. TP (high-risk transactions). Seeks to ensure that TP rules are in line with value creation in relation to high-risk transactions which would not, or only very rarely, occur between third parties.
11. BEPS data. Concerns establishing methodologies to collect and analyse data on BEPS, particularly in relation to scale and economic impact.
12. Disclosure. Concerns requiring taxpayers to disclose their aggressive or abusive tax planning arrangements through mandatory disclosure rules. Emphasis is on administrative and compliance costs.
13. TP documentation. Seeks to enhance transparency for tax administrations, taking into consideration the compliance costs for business.
14. Dispute Mechanisms. Concerns removing obstacles to the use of MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.
15. Multilateral Instrument (MI). Concerns developing MI to modify bilateral tax treaties.

In particular, four minimum standards have been agreed to tackle issues in cases where no action by some states might create negative externalities:

1. Model provisions to prevent treaty abuse (including treaty shopping) by impeding the use of conduit companies to channel investments through countries and jurisdictions with favourable tax treaties in order to obtain reduced rates of taxation.
2. Standardised Country-by-Country (CbC) Reporting that will give tax administrations a global picture of where MNEs' profits, tax and economic activities are reported, and the ability to use this information to assess transfer pricing and other BEPS risks, so they can focus audit resources where they will be most effective.
3. A revitalised peer review process to address HTPs, including patent boxes where they include harmful features, as well as a commitment to transparency through the mandatory spontaneous exchange of relevant information on taxpayer-specific rulings which, in the absence of such information exchange, could give rise to BEPS concerns.
4. An agreement to secure progress on dispute resolution, with the strong political commitment to the effective and timely resolution of disputes through MAP.

<u>Developing Countries</u>

Rather than seeking to cover all potential areas, below is a discussion of three areas, pertaining to BEPS, that particularly affect developing countries.

- Early in 2017, the Platform for Collaboration on Tax, a joint initiative of the IMF, OECD, United Nations and World Bank Group, sought to assist developing countries address the lack of comparables for transfer pricing analyses and provide supplementary material on minerals pricing. The assistance focuses on practical measures to address difficulties associated with insufficient information available on comparables: the difficulties in performing a comparability analysis; making the best of the available data and how it can be optimised through widening the criteria of data selection and comparability adjustments; and approaches and solutions in the absence of comparable data.
- Article 1(2) of the UN Model Tax Convention, as proposed at the October 2016 meeting of the UN Committee of Experts, provides:

> *For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. In no case shall the provisions of this paragraph be construed so as to restrict in any way the right of a Contracting State to tax the residents of that State.*

Dhruv Sanghavi, in "BEPS Hybrid Entities Proposal: A Slippery Slope, Especially for Developing Countries" (2017) argues that Article 1(2) does not achieve either of the principal purposes of the BEPS project. It fails to remedy situations in which hybrid entities result in less than single taxation and fails to ensure the allocation of taxing rights to the state in which the economic activities are undertaken. Sanghavi argues, further, that Article 1(2) will likely achieve the opposite result: base erosion from the state in which the economic activities are carried on and/or less than single taxation.

- Yves Smith, in "The OECD – penalising developing countries for trying to tackle tax avoidance" (2017), argues that the OECD's terms of reference to assess the implementation by countries of Action 13 related to Country-by-Country Reports (CbCR) may penalise developing countries that try to obtain by their own means the CbCR's valuable data needed to tackle MNE tax avoidance. CbCR (to be prepared by MNEs with group revenues over EUR 750 million) will offer information on MNE economic activity, profits and tax paid broken down for each country where they operate. This CbCR "map" will reveal any misalignments between the location of real activity, and where profits are ultimately declared to hold both MNEs and tax havens to account. The OECD wants this map's information to be fully confidential and to be obtained by authorities only via bilateral automatic exchange of information, in the same way as banking information. The OECD approach, based on automatic exchange of information, uses a complex framework that depends on developing countries being able to convince a developed country to sign an international agreement with them. Not only is it complex, but Smith argues that it also leads to situations where developing countries will not be able to access the CbCR information they need.

<u>Conclusion</u>

There is a growing body of literature on the possible impacts of BEPS on developing countries. Given the broad scope of the BEPS package, a brief discussion of the issues could only ever scratch the surface. One possible conclusion is that the onerous requirements in relation to co-operation between states necessarily puts developing countries at an immediate disadvantage, given the limited resource that they have available for monitoring international tax avoidance/evasion by MNEs.

Question 4

A recent Tax Court of Canada case, Oroville Reman & Reload Inc v R (2016) 19 ITLR 259, is an unusual and interesting case on the limits of tax jurisdiction. Such cases are likely to become more common as countries seek to extend their tax jurisdiction, and courts in other countries have to decide whether or not a state has jurisdiction to impose and enforce a tax. The court's approach – looking for a real and substantial link – is consistent with the academic literature. Although there is no requirement for students to be aware of this case, students should be aware of the factors involved in establishing the limit of a state's tax jurisdiction.

One possible approach when answering this question might be to explore the three kinds of jurisdiction already recognised in international law from a tax law perspective.

The following is one possible schematic.

Introduction

Historically, there has been relatively little discussion of the scope of tax jurisdiction. However, Oroville Reman & Reload Inc v R may well be the vanguard for a number of other decisions seeking to identify the limits of a state's tax jurisdiction, particularly at a time when a number of states are seeking to enforce their tax laws abroad.

Three Kinds of Jurisdiction

International law recognises three kinds of jurisdiction:

- Prescriptive jurisdiction (also called legislative or substantive jurisdiction) is the power to make rules, issue commands or grant authorisations that are binding upon persons and entities. The legislature exercises prescriptive jurisdiction in enacting legislation.
- Enforcement jurisdiction is the power to use coercive means to ensure that rules are followed, commands are executed or entitlements are upheld. As stated by Coughlan et al. in "Global Reach, Local Grasp: Constructing Extraterritorial Jurisdiction in the Age of Globalization" (2007) 6 CJLT 29 at 32; "enforcement or executive jurisdiction refers to the state's ability to act in such a manner as to give effect to its laws (including the ability of police or other government actors to investigate a matter, which might be referred to as investigative jurisdiction)".
- Adjudicative jurisdiction is the power of a state's courts to resolve disputes or interpret the law through decisions that carry binding force.
- When seeking to establish jurisdiction, the first task is arguably to determine the kind of jurisdiction that a state exercises when it seeks to bring a prospective taxpayer within its charge to tax. This is important as different preconditions attach depending on which type of jurisdiction it seeks to assert. According to R v Hape [2008] 1 LRC 551 (SCC), a state may exercise its prescriptive jurisdiction extraterritorially where it does so in accordance with binding customary principles, or even in contravention of these principles where a Parliament shows an unequivocal intention to do so. However, a state can exercise enforcement jurisdiction in a foreign state only with that foreign state's consent. Without it, a state seeking to collect tax monies extraterritorially is acting contrary to international law.

Enforcement in a Tax Context

Most attempts to bring a taxpayer within a state's taxing jurisdiction begin with a revenue authority sending a letter. Depending on the nature of the letter, this may amount to exercising enforcement jurisdiction. FA Mann distinguishes documents of notice that merely involve the supply of information with no threat of penalties in the event of non-compliance, from documents involving a compulsory process or containing a command: Mann, "The Doctrine of Jurisdiction in International Law", Receuil des Cours, 1964-I.. The latter category is enforcement jurisdiction. Akehurst writes that because the power to tax is a sovereign power, steps taken to give effect to that power in the territory of another State is enforcement jurisdiction: Akehurst, "Jurisdiction in International Law" (1972–1973) 46 BYIL 145.

If there can be no doubt in the mind of the recipient of the letters that the revenue authority was making coercive demands, this clearly points to enforcement jurisdiction. Put simply, correspondence indicating a compulsory process (e.g. the need to file), with the possibility of penalty for non-compliance, must be an exercise of enforcement jurisdiction.

Interpretation

Oroville Reman & Reload Inc suggests that domestic legislation should be interpreted wherever possible in a manner consistent with the principles of international law and comity. Those principles are sovereign equality, non-intervention, and respect for territorial sovereignty of foreign states.

The Limits of Jurisdiction

In Hape, the SCC explained that there are limits to a State's jurisdiction (at [57]):

> *jurisdiction is distinct from, but integral to, the principle of state sovereignty. The principles relating to jurisdiction arise from sovereign equality and the corollary duty of non-intervention. Broadly speaking, jurisdiction refers to a state's power to exercise authority over individuals, conduct and events, and to discharge public functions that affect them: … International law—and in particular the overarching customary principle of sovereign equality—sets the limits of state jurisdiction, while domestic law determines how and to what extent a state will assert its jurisdiction within those limits. Under international law, states may assert jurisdiction in its various forms on several recognized grounds.*

These grounds of jurisdiction are the: territoriality principle; nationality principle; passive principle; protective principle; and universal principle. Arguably, the most appropriate from a tax perspective is the territoriality principle, which is explained in Hape (at [59]) as extending:

> *to two related bases for jurisdiction, the objective territorial principle and the subjective territorial principle. According to the objective territorial principle, a state may claim jurisdiction over a criminal act that commences or occurs outside the state if it is completed, or if a constituent element takes place, within the state, thus connecting the event to the territory of the state through a sufficiently strong link … Subjective territoriality refers to the exercise of jurisdiction over an act that occurs or has begun within a state's territory even though it has consequences in another state.*

With regards the limits of territoriality, all that is necessary to make an offence subject to state jurisdiction is that a significant portion of the relevant activities took place in the taxing state. In other words, it is sufficient that there be a “real and substantial link” between an activities and the state. The factors that establish a 'real and substantial link' vary based on the facts and issues of whatever case is at hand. However, if the potential taxpayer has never been registered, has no facilities, assets or operations in the state in question, there cannot be a real and substantial link.

Conclusion

With regard to the issue of establishing the limit of tax jurisdiction, the ultimate question is arguably: what is a sufficient series of factors to constitute a real and substantial link?

The factors sufficient to establish a real and substantial link with regard to an income tax (residence or source, for example) are not necessarily appropriate to establish a link for a different type of tax. Arguably, the factors that establish a real and substantial link need to be assessed on the basis of the type of tax concerned: what is the taxable subject and what is the objective of the tax.

Question 5

In some ways this is a rather straightforward essay question. It requires students to demonstrate that they have an understanding of the scope of Article 24 of the OECD Model Tax Convention (the "MTC") and that they are aware of the particular circumstances in which it operates. Given the sui generis nature of this particular article, when compared with the other articles of the MTC, it is expected that students will also be able to not only show why it is unique (e.g. the non-application of Article 2 of the MTC) but also what this signifies in a wider context.

The following is one possible schematic.

Introduction

Article 24 of the MTC deals with the elimination of tax discrimination in certain precise circumstances. It deals with discrimination on the basis of nationality, statelessness, the situs of an enterprise, non-residence specifically in relation to the deductibility of certain payments (e.g. interest and royalties), and non-resident direct investors. Article 24 is not restricted by the provisions of Article 2 of the MTC, unlike the other articles of the MTC. This means that it applies to taxes of "every kind and description levied by, or on behalf of, the State, its political subdivisions or local authorities". One reason, perhaps, why Article 24 might said to be a unique article of the MTC. Significantly, Article 24 is also not intended to provide 'others' with a tax treatment that is better than that of nationals, residents or domestic enterprises owned or controlled by residents.

Scope

Drawing distinctions between taxpayers is an important aspect of all tax systems. For example, most common-law tax systems draw the very important distinctions between taxpayers who derive: capital receipts as opposed to income receipts; interest income as opposed to dividend income revenue; or trading profits as opposed to passive investment returns, et cetera. Furthermore, tax systems distinguish between differences in liability to tax or ability to pay. These are legitimate discriminations as they form part of the integrity of the tax system. However, there are also a number of discriminations that are perceived to be unjustified.

Article 24 of the MTC seeks to balance the need to prevent unjustified discrimination with the need to take account of more legitimate distinctions. It is this balancing act that means Article 24 is not meant to cover indirect discrimination. Just because non-residents tend to be non-nationals does not mean that a rule that is designed to affect non-residents is therefore discrimination based on nationality, per Article 24(1). This idea of not overextending the scope of Article 24 also applies to its not requiring most-favoured-nation treatment. This is supposedly because DTAs are based on the principle of reciprocity.

For the paragraphs of Article 24 to apply, other relevant aspects must be the same (e.g. "in the same circumstances" in paras 1 and 2; "carrying on the same activities" in para 3; "similar enterprises" in para 5). This is redolent of the principle of horizontal equity, which is itself derivable from the rule of law. This is a normative prescription that will not always be easy to apply in practice. The fact that Article 24 is by no means a "bright line" test, means that its application is not free from difficulty.

Article 24 is to be read alongside the other articles of the MTC. Therefore, measures that are mandated/authorised elsewhere cannot be considered to violate Article 24. Moreover, just because a measure is not discriminatory does not mean that it is not in breach of other articles.

Nationality

Article 24(1), in accordance with the principle of reciprocity, provides that the nationals of the other Contracting State (CS) cannot be treated less favourably in the other CS than the nationals of that state. All nationals of a CS are entitled to invoke the benefit of this provision as against the other CS. This holds good, in particular, for nationals of the CSs who are not residents of either of them but of a third State.

Statelessness

In relation to stateless persons, the purpose of paragraph 2 of Article 24 is to limit the scope of the clause concerning equality of treatment with nationals of a CS solely to stateless persons who are residents of that or of the other CS. By excluding stateless persons who are residents of neither CS, it prevents their being privileged in one State as compared with nationals of the other State. However, the Commentary does provide optional text for CSs to extend the application of paragraph 2 to all stateless persons, whether residents of a Contracting State or not.

Situs

Paragraph 3 is designed to end discrimination based not on the actual situs of an enterprise. It affects without distinction (e.g. irrespective of their nationality) all CS residents who have a PE in the other CS. The taxation of a PE cannot be less favourably levied in the CS concerned than the taxation levied on enterprises of that CS carrying on the same activities. The purpose is to end all discrimination in the treatment of PEs versus ‘same sector’ resident enterprises.

Paragraph 3 also specifies the conditions under which the principle of equal treatment should be applied to individuals who are CS residents and have a PE in the other State. It is designed mainly to ensure that such persons do not obtain greater advantages than residents, as a result of personal allowances or family tax credits, both in the State of which they are residents (via domestic law) and in the other State by virtue of the principle of equal treatment.

The tax treatment in one CS of the PE of an enterprise of the other CS should be compared to that of an enterprise of the first-mentioned State that has a legal structure that is similar to that of the enterprise to which the PE belongs. Paragraph 3 does not require a State to apply to the profits of the PE of an enterprise carried on by a non-resident individual the same rate of tax as is applicable to an enterprise of that State that is carried on by a resident company.

Deductions

Paragraph 4 is designed to end discrimination resulting from the fact that in some countries the deduction of interest, royalties and other such payments are allowed without restriction when the recipient is resident, but they are restricted/prohibited when they are a non-resident. It does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible with Articles 9(1) or 11(6), unless the rules themselves are incompatible with these articles and only apply to non-resident creditors (to the exclusion of resident creditors).

Paragraph 4 does not prohibit additional information requirements for payments made to non-residents if they are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents.

Ownership of Capital

Paragraph 5 prevents the discrimination of a resident enterprise that is solely based on who owns or controls the capital of that enterprise. Its object is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital. It does not apply to distributions nor to a relationship between a resident enterprise and other resident enterprises.

Conclusion

The answer covers the scope, operation and significance of the rather unique Article 24 of the OECD MTC. It seeks to eliminate tax discrimination based on nationality, statelessness, situs, and certain non-resident passive income but doesn’t give its target group better tax treatment. Article 24 seeks to balance unjustified with more legitimate discrimination and it is in line with the principle of reciprocity. It focuses on enterprises, as well as individuals, and those that own the capital of those enterprises.

It is notable that both Canada and New Zealand reserve their positions on Article 24 of the MTC. They are alone in their unqualified reservation. For example, Australia and the US reserve their position on this article only in relation to quite particular domestic tax law provisions.

<u>Question 6</u>

There is no one correct answer to Part (i) of this question. For example, it is unclear whether Anchiland and Breeland have adopted the OECD Transfer Pricing Guidelines, what domestic transfer pricing rules exist in either country and whether those countries are signatories to BEPS Action 8, etc. However, students should be able to clearly define the concepts of transfer pricing, cost contribution agreements and buy-in agreements and to consider issues relevant to these areas in their answers to Part Two of this question.

The following is one possible schematic:

<u>Part 1</u>

It is not necessary for students to be familiar with the Veritas case but marks are available for students who recognise that some facts in that case are similar to those in the fact pattern in the question. What is essential is that students acknowledge expressly that there is a need to be clear about acceptable methods of determining apportioned costs under a cost contribution agreement. In particular, there is a need for students to highlight the major issues relating to one aspect of transfer pricing aspects of buy-in agreements that involve intangible property on the one hand and other costs on the other.

From the facts, it appears that OI had adopted a reasonable methodology for determining costs under agreements (a) and (b). Given that OI is adopting the comparable uncontrolled price method and given that it does have data from similar transactions with independent third parties, it would appear that, at face value, OI will not have a case to answer. However, the question provides some indication that the ALRA will impose a different methodology and it is really this potential methodology that students should consider. There appears to be little scope for attributing pre-existing intangible property of a fast-moving, innovative software company a perpetual useful life and, whilst there is no indication from the facts that 4 years is an appropriate length of time, the ALRA's adoption of a perpetual useful life is unreasonable. So OI could argue against this. Furthermore, the fact that the ALRA is seemingly considering treating the two agreements as a sale does not appear to be consistent with existing approaches to cost contribution valuations. It was also stated in the Veritas judgment that this approach was not acceptable in the circumstances due to the fact that it included the value of, inter alia, items that were not part of agreements (a) and (b); and there was no evidence of synergies arising as a consequence of the "sale" of the overseas operations that would have been needed to substantiate the "sale" approach.

In conclusion, it would appear that OI has made a reasonable attempt at determining the appropriate amounts under the two agreements. Whilst it is not possible to state with certainty what the outcome of the investigation would yield, it should be possible for OI to make a strong case to support their methodology. Intangibles are notoriously difficult to value, and as there is a need to value the pre-existing intangibles under agreement (b), the fact that OI has applied some potentially relevant comparable prices should be highlighted in OI's report, although students could comment that it would be useful to have more information about the comparability of these two sets of intangible rights. Students could also note that generally the following characteristics will be taken into account when determining comparable values of intangibles assets: the form of transaction (e.g. licensing or sale); the type of property (e.g. patent, trademark, or know- how), the duration and degree of protection, and the anticipated benefits from the use of the property (see Transfer Pricing Guidelines [1.40]).

Students can also mention that the comparable uncontrolled price method and the transaction profit split method are both acceptable methods for valuing intangibles. OI would also need to ensure it makes clear that any valuation should not include values assigned to subsequently developed intangibles.

Students should note the policy issues in this area and these are discussed below in Part 2.

Part 2

This part requires students to demonstrate awareness of the work of the OECD on transfer pricing generally and also in relation to BEPS. As well as defining “transfer pricing”, “cost contribution agreements” and “buy-in agreements”, there is a need for students to consider the policy issues that inhabit these areas, especially with regard to intangible assets.

A cost contribution agreement (CCA) is a contractual arrangement among business enterprises to share the contributions and risks involved in joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create direct benefits for the businesses of each of the participants (see BEPS Action 8). From a purely business perspective, CCAs offer an attractive mechanism for a MNE to: obtain economies of scale; distribute risk among its constituent entities; manage cash within the MNE; and minimise the present value of global taxes.

The OECD saw fit to include a separate chapter on CCAs to the Transfer Pricing Guidelines in 1997. BEPS Action 8 has re-written the Chapter on Intangible Assets and there is a concern that the guidance on CCAs overlaps with guidance provided in the new version of the Chapter on Intangibles. It has been reported that there is a potential conflict with how some countries treat these agreements and the manner in which BEPS Action 8 envisages their treatment. For example, there are three inconsistencies with the US regime: (i) require any participant to have the capability to control the risks associated with the risk bearing opportunity, (ii) require all contributions to the agreement to be based on “value and not cost” and (iii) make it easier for authorities to disregard part or all of the terms of the agreement (see D. Ernick, “Proposed OECD Changes to Cost Contribution Arrangements Conflict with U.S. Rules for Cost Sharing Agreements”).

A “buy-in payment” can be defined as a payment made by a new entrant to an already active cost contribution (or cost sharing) agreement (see OECD, Glossary of Tax Terms). At a general level, it has been stated that the valuation of buy-in payments represents significant challenges to participants in a CCA (M. Heckel, L. Secular and D. Falk) and many countries still have not had any experience of CCAs and buy-in/out agreements (Tax Executives Institute, 28 May 2015, BEPS Action 8: CCAs, Public Comments). A number of the challenges will have been noted in answers to Part One, i.e. valuation of intangibles and especially the valuation of pre-existing intangibles in a buy-in agreement context. Industry has picked up on this and recently a pharmaceutical company has sought clarification from the OECD when discussing BEPS Action 8 stating that a “value-based” approach to CCAs requires greater compliance costs than “cost-valued” approaches and there is a view that whilst the “value-based” approach is relevant to valuing pre-existing intangibles (and cost is not) the “cost-based” approach is appropriate for ongoing costs incurred once the CCA has been entered into (see AstraZeneca, “The Value of Each Participant’s Share”, Public Comments on BEPS, Action 8, 29 May 2015).

Another view is that the “buy-in payment” should capture the value of the contributions of both parties from the beginning of the CCA, even if the parties have agreed to fund their joint development activity under a CCA with one party contributing only risk capital. Thereafter, the ongoing costs of development should be allocated according to their anticipated benefits under the CCA (BEPS, Action 8, G. Sprague and T.S. Reid, Baker McKenzie, “Unique Element of Development CCAs – the Buy-in Payment”, 29 May 2015).

These different approaches have potentially some quite significant effects on the range of transfer prices that different businesses and revenue authorities may consider to be reasonable approximations of the arm’s length standard. Country practice in this area also varies with the USA focusing on the need to value benefits arising out of the “reasonably anticipated benefits” and the USA’s tax court recently deciding a case involving “buy-in” payments in favour of the taxpayer (see Amazon 2017).

Another topic that could be mentioned here is the view that the profit split method may become the default method for valuing intangibles (Y. Brauner, “Transfer Pricing in BEPS: First Round – Business Interests Win” (But, Not in Knock Out) (2015) Intertax, 72-84).

Question 7

This question mostly concerns the meaning of 'central management and control' (CMC) as a test of corporate residence for tax purposes. Originating in the UK, this test has since been adopted by most Commonwealth countries (see, Omri Marian, Jurisdiction to Tax Corporations (2013)).

Candidates should use those case law principles that they know to support the conclusion that, like most tests of this kind, the residence of a company is a question of fact and degree to be answered (in this case) according to where the CMC of the company actually abides. This cannot be determined by reference only to the constituent documents but must be determined upon a scrutiny of the course of business and trading. The task is not to identify exceptions to a rule by reference to authority, instead each case depends on its own facts and circumstances, albeit previous cases can provide a degree of guidance.

It is also open to candidates to consider the meaning of 'place of effective management' under tax treaties, with a preliminary discussion of the approach to treaty interpretation and to the provisions of the Vienna Convention on the Law of Treaties.

The following is one possible schematic.

Introduction

In this case, there are clear findings of fact at first instance when Mr and Mrs Borgas were in fact implementing decisions taken by Mr Gould (who is, arguably acting as a shadow director) who is based in Exogenia. Assuming the Commissioner argues that the test is one of where the real business was carried out, which involves an examination of the facts to determine where the real place of CMC was located, a finding of fact to determine where CMC was really exercised, would point to Exogenia. This conclusion can be justified on the principles that emerge from the following cases.

De Beers Consolidated Mines Ltd v Howe

In De Beers, the issue was whether a company was UK resident despite having its head office in South Africa. It always held its general meetings there, it derived all its profits out of diamonds raised and sold there under annual contracts to a syndicate for delivery there, and it had some directors and life governors who lived there. The House of Lords held that the issue was to be decided according to the rule affirmed in Cesena Sulphur: that a company resides for income tax purposes 'where its real business is carried on'; that 'the real business is carried on where the central management and control actually abides', and that the question of where CMC actually abides is 'a pure question of fact to be determined, not according to the construction of this or that regulation or bye-law, but upon a scrutiny of the course of business and trading'. It was held that the company was UK resident because the majority of directors lived there and the real control of the company was exercised (in practically all the important business of the company) at meetings of directors in London determining: policy governing the disposal of diamonds and other assets; the working and development of mines; the application of profits; board appointments; and contracts with the diamond syndicates.

Bullock v Unit Construction Co Ltd (1959)

Bullock is significant for present purposes because it rejected the idea that a company must always be resident where its board is resident. There, three taxpayer companies were registered in Kenya and each company had a board of directors situated in Kenya. But the directors of the Kenyan subsidiaries did not have access to all the documents of, or information concerning, the companies of which they were directors. The minutes of the directors’ meetings of each of the subsidiaries mainly recorded only formal business (such as particulars of annual general meetings, appointments and retirements of directors, secretaries and accountants, resolutions concerning the operation of banking accounts or the affixing of the companies' seals to documents and the acquisition or transfer of mineral claims or other property) at meetings held on irregular dates. In a few instances they recorded more important business, but in each such instance a decision had in fact been taken by the directors of the London parent company and the record in the minute book of the Kenyan subsidiary merely formally records its implementation. At all material times, the whole of the trading policy of the subsidiaries was dictated by the parent board.

It was held that the real management and control was exercised by the directors of the parent in London, despite that arrangement not being authorised by the memoranda or articles of the Kenyan companies. In rejecting the contention that the CMC of the companies should be taken to be located in Kenya because the directors resided there, Viscount Simonds stated:

> *The business is not the less managed in London because it ought to be managed in Kenya. Its residence is determined by the solid facts, not by the terms of its constitution, however imperative … I come, therefore, to the conclusion, though truly no precedent can be found for such a case, that it is the actual place of management, not that place in which it ought to be managed, which fixes the residence of a company. If it were not so, the result to the Revenue would be serious enough. In how many cases would a limited company register in a foreign country, prescribe by its articles that its business should be carried on by its directors meeting in that country, and then claim that its residence was in that country though every act of importance was directed from the United Kingdom?*

<u>Wood v Holden (2006)</u>

In Wood v Holden, the court drew a distinction between cases where CMC is exercised through a company's constitutional organs on the basis of external advice or influence, but in fulfilment of the constitutional organ's functions, and cases where the functions of the company's constitutional organs are usurped by an outsider who dictates the decisions to be implemented, independently of or without regard to those constitutional organs.

The reasoning rested heavily on the factual circumstances of the case, including that the only activities of the company were to enter into a contract to purchase shares from its parent company to the sum of an amount funded by an interest free loan from the parent company, and then to hold those shares. At first instance, the judge considered that a case of that kind involved different considerations from a case involving the residence of a company with an active continuing business. Unlike in Wood v Holden, the taxpayer in the present case has an active continuing business of share trading.

The court referred to four cases (including Esquire Nominees), that were characterised as involving persons based in one jurisdiction (commonly, a high tax jurisdiction) causing companies to be established in other jurisdictions (commonly, low or no tax jurisdictions) in which the local boards did not take initiatives but responded to proposals presented to them. The court observed that, in each of those cases, Bullock had been distinguished on the basis that, whereas in Bullock the parent company itself exercised CMC, effectively bypassing the local boards altogether, in the four cases 'the parent companies or their equivalents, while telling the local boards what they wished them to do, left it to the local boards to do it'.

In Wood v Holden, the judge spoke of the difference between 'exercising management and control' and 'being able to influence those who exercise management and control'. This distinction appears to rest on whether the local board actually considers and makes a decision to adopt the parent company's recommendations as bona fide in the best interests of the subsidiary, or whether the local board just mechanically implements directions from the parent company because it is so directed.

<u>Re the Trevor Smallwood Trust, Smallwood v Revenue and Customs Comrs (2010)</u>

The same notion appears in the Court of Appeal decision in Smallwood that CMC remained with a local board, notwithstanding that the directors were in the habit of acting in accordance with the advice of an outsider, because they retained their right and duties as trustees to consider the matter at the time of alienation and did not agree merely to act on the instructions which they received. In this respect, Smallwood deviates considerably from the present case, as the only role of Mr and Mrs Borgas was to implement Mr Gould's decisions.

Conclusion

While Bullock, Wood v Holden and Smallwood all help to establish what matters are important in a decision of this kind, it is ultimately De Beers Consolidated Mines Ltd v Howe that must be followed. Clearly, it is arguable that the directorial structure of the FAR was contrived. It would appear that the constitutional organs of the company did not and were not intended to exercise CMC. This was exercised by Mr Gould. The findings of fact suggest that the directors, Mr and Mrs Borgas, play a relatively nominal role in decision-making. In this case, therefore, the likely conclusion is that the constitutional organs of the companies did not and were not intended to exercise central management and control of the company; that was exercised by Mr Gould in the capital city of Exogenia.

Note that where a subsidiary implements a strategy determined by the parent company of the group, the directors of the subsidiary know what is required of them: in many such cases it would not be open to them to take an independent line and depart from the instructions given to them. However, the directors may conscientiously exercise their discretion; they may wish to have confirmation that the acts required of them are within the competence of the company, and that there are no legal impediments to the proposed course of action. This does not mean that the subsidiary will be held to be resident in the resident jurisdiction of the parent company.