Question 1

The need of automatic exchange of information has been felt all over the world due to the fact that more and more taxpayers parked their income and wealth through financial institutions outside their home countries (mainly in tax heavens or low tax jurisdictions). Due to which there was a loss of revenue for countries to a great extent. Such tax evasion can be countered only by co-operation by way of exchange of information.

On the front of automatic exchange of information, during April 2013 the G20 Finance Ministers endorsed automatic exchange of information as the expected new standard.

Thereafter OECD developed a Standard for Automatic Exchange of Financial Account Information. It was developed by OECD working with G20 countries and in close co-operation with the EU.

Part II of it contains the suggested text of Model Competent Authority Agreement (called as CAA) and Common Reporting Standard (CRS). Thereafter OECD also issued detailed commentary on both CAA and CRS.

The US took a lead in this area and enacted FATCA [Foreign Account Tax Compliance Act] and insisted on disclosure of information on an automatic basis from the foreign institutions related to US citizens and other US based entities. Few more countries joined this initiative taken by US.

There are various benefits attached with the automatic information exchange initiative. This will improve the mechanism to prevent treaty abuse and enable the States to implement their domestic law as well as treaty provisions in a more realistic manner.

However, the challenge lies in the implementation of such standards and their adoptions into the legal system of various jurisdiction. Also another major factor for successful implementation is the development of a well-designed system and a portal which will enable such exchange of information and utilisation thereof. Also the standardisation of the information to be exchanged is also a key area in this regard.

Question 3

Brief introduction of two models:

Basically, there two main models of Double Tax Convention. One which is developed by OECD and another which is developed by UN. The OECD Model is widely used and UN Model and its commentary also mainly designed relying upon OECD Mode but with few differences.

It has been opined by many famous authors that UN Model focus on source based taxation whereas OECD Mode focus more on residence based taxation. Therefore, UN Model is typically preferred by the developing countries which contribute a larger share of income for foreign countries which are developed.

How are taxation rights allocated?

The allocation of taxation rights between State of Source and State of Residence are contained various articles of Chapter III of both the models. The taxation rights have been allocated mainly on the basis of nature of income earned and also on the basis of the nature of person who is earning income (e.g. entertainers or government employees etc.).

The rights have been given at some places exclusively to the State of Residence or at some places rights have also been given to the State of Source which may be full rights or limited rights.

Main areas of differences between two Models with reference to the allocation of taxation rights

The followings are the major area of differences between OECD and UN Models on the division of taxation rights between State of Source and State of Residence:

1. One of the main difference is the allocation of taxation rights with respect to the Royalty income. As per OECD Model royalty is taxable only in the State of Residence and State of Source has not been given any rights to tax Royalty. However, under UN Model the State of Source has been given a limited right of taxation with regard to the royalty income. Para 2 of Article 12 of UN Model provides that the royalty may be taxed in the State of Source at the percentage to be decided bilaterally by the States.

2. The capital gains arising on transfer of shares of a company is taxable only in the State of which the alienator is a resident according to OECD Model except where the such shares are deriving more than 50% of their value directly or indirectly from the immovable property situated in another state.

   The same holds true from UN Model. But under UN Model apart from such exception regarding the shares deriving value from immovable property there is one more exception to such general rule of taxability in the State of residence of the alienator. Such another exception under UN Model which is not found in the OECD Model is contained in Para 5 of Article 13 of UN Model it provides that the capital gains from the transfer of shares of a company can be taxed in the State where the company is a resident if the alienator held more than agreed percentage of holding in the capital of such a company, directly or indirectly (i.e. a substantial holding case).

3. UN Model specifically deals with Independent Personal Services by a separate article 14. Such separate article was also there previously in OECD Model which was deleted in 2000.

However, as per both the models, such income can be taxed in the State of Source if the person providing such services has a PE (under OECD Model) or fixed base (under UN model) in that state of source. This is because under OECD Model the definition of business has been widened to include such professional services or independent services and hence Article 7 has now been applied to such case instead of Article 14 which was earlier applicable.

The only difference arising on account of the above is that under UN Model the professional services shall be taxed in the State of Source even in the absence of such a fixed base if the stay of a person providing such professional services in the other State (state of source) has exceeded 183 days in any 12 months period commencing or ending in the concerned fiscal year.

4. Article 16 of OECD Model applies only to the members of the board of directors. However, Article 16(2) of UN Model extends the applicability also to the top-level managers of the company even though they are not the directors. Therefore, remuneration of such top-level managers can be taxed in the State where the company is a resident.

5. Pension is generally taxable only in the State where the person receiving such pension is a resident as per Article 18 of both the Models. However, UN Model makes the pension paid from the public schemes which are part of social security system of the concerned State or its political sub-division or local authority taxable only in that concerned State irrespective of residency of the person receiving such pension. Further UN Model has also provided one more alternative (at the option of the State) whereby such pension can also be taxed (simultaneous rights) in the another State if the payer is a resident of that State or PE of that State. Such provisions are missing in the OECD model.

6. There are other miscellaneous differences between two models. Like, the rates at which the dividend and interest can be taxed in the State of Source have been specified in the OECD Model whereas it has been left to the decision of the States to decide bilaterally in the UN Model. In case of shipping income in Article 8, UN Model given an alternative (at the option of the States) to tax such income in the State other than that of effective management if operation in that State are more than casual. Other income (other than those which are specifically dealt with in Article 6 to 20) can be taxed only in the State of residence as per OECD Model except income attributable to PE in the other state. However, as per UN model such other income can also be taxed in the State of Source (if it arises in that state and not the income arising from the third state which can always be taxed in the State of Residence in any case).

<u>Methods of eliminating double taxation</u>

The articles allocating taxation rights are supported by article on elimination of double taxation (article 23 more particularly). Both the models suggest two alternative methods for elimination of double taxation i.e. Exemption Method or Credit Method. The methods to be selected depends on the principles of Capital Export Neutrality (CEN) and Capital Import Neutrality (CIN). CEN suggests that the income of a domestic taxpayer should be taxed in the same manner irrespective whether he invests his capital domestically or abroad i.e. income from domestic and foreign sources are taxed at par. CIN suggests that the income arising in a country should be taxed in the same manner whether the capital has been invested by a domestic taxpayer or a foreign person.

CEN supports the credit method and CIN supports the exemption method.

Question 6

Part 1

The facts of the questions are purely evaluated in terms of the provisions of DTA between Oland and Compland which very closely follows the current version of the OECD Model Tax Convention. No reference has been made to the domestic provisions of the Oland where the questions of assessibility of the income is concerned in the absence of necessary information in that regard.

Analysis of the applicable provisions of DTA

Article 9 of the Model Tax Convention dealing with the Associated Enterprises is relevant to the facts of the case presented in the question.

It provides for the adjustments to the profit of the enterprise of one of the contracting states with regard to its dealings with its associated enterprises which are not on the basis of arm's length.

The criteria which applies to determine the existence of such associated enterprises is the participation by one enterprise in the management, control or capital (directly or indirectly) of another enterprise or alternatively, such participation by the same person in both enterprises.

The financial or commercial relations between such associated enterprises differ as compared to such relations between independent enterprises due to which the profits which would have accrued to one of the enterprises have not so accrued. In that case, the profits which did not so accrue to that enterprise shall be included in its profits and shall be taxed by the contracting state. Such adjustments on the basis of arm's length principles shall be carried out in accordance with the OECD Report - Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration.

Applicability of the relevant DTA Article to the facts of the case

Since in the given case Henna Ltd. is a wholly owned subsidiary of Harlem Inc., they are associated enterprises within the meaning of Article 9 as discussed above since there is a participation in the capital to the extent of 100% by Harlem Inc. in Henna Ltd.

Since, Henna Ltd. and Harlem Inc. are associated enterprises, each dealings between them should be on an arm’s length basis which was rightly concluded by Oland Revenue Commissioner on its prima facie application.

However, the moot question which arises here is the transaction under consideration is the issue of share capital and whether such transaction can be considered as resulting into the profits in the hands of the issuer company which has not so accrued due to under-pricing of shares as compared to its arm's length price. What is crucial here is the words of the article: "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". Therefore, what can be adjusted in the hands of Henna Ltd. is the "profits" which have not been accrued solely due to reasons of the its association with Harlem Inc. and dealings with it which is not an arm's length basis.

What is transpiring from the above discussion is that though there is a transaction between associated enterprises which is differing from the arm's length consideration but if it is not resulting into any "profit" per se then applicability of Article 9 to such transaction is out of question.

The term "profit" has not been defined anywhere in the DTC. Similar term "profit" has also been used in the Article 7 on allocation of taxing rights on business profits. As per Article 3(2), any such undefined term shall derive its meaning from the provisions of the domestic law applying the provisions of the convention. The details about the provisions of domestic law of Oland have not been given in the question. However, it is almost a universal principal accepted by almost all the countries that the receipt of money against the issue of shares can never be considered to have resulted into the profits in the hands of issuer company. Further, the inference can be drawn that such issue of shares has not been considered as resulting into profits even under the domestic provisions of law of Oland on the basis that the money actually received ($300,000) has never been attempted to be taxed by the Revenue Commissioner but only the difference is under dispute.

Therefore, merely because there is a dealing like involved in the facts of the question which is neutral as far as accrual of profits in the hands of the taxpayer the provisions of Article 9 cannot be applied unless there is a loss of profits (which is otherwise taxable under the domestic provisions and read with treaty) which would have accrued had the transaction been on the arm's length basis between the independent entities.

Relevant case law of Vodafone of High Court of Bombay (India) 2014

The facts of the case are identical with the facts of the Vodafone case which was before the Bombay High Court in India. It was held that such adjustments under the transfer pricing provisions of the Indian Income-tax Act was impermissible. The High Court interpreted the word "income" (which can be considered as akin to "profits" for this purpose at least) and held that the transaction never resulted into any income at the first place and hence the price at which the shares were issued to foreign subsidiary by the Indian company cannot be adjusted and taxed in India.

Comment on the secondary adjustment with regard to the interest

Since the primary adjustment has been concluded as contrary to the provisions of the DTC, the secondary adjustment of adding the interest income of $90,000 by considering the difference in the pricing of shares as deemed loan to Harlem Inc. does not sustain.

Conclusion

To conclude, both the amounts; $1,800,000 on account of difference between the price at which the shares were actually issued and the arm's length price of such shares and also $90,000 on account of interest by considering the first amount as the deemed loan, are not assessable as income in the hands of Henna Ltd. in Oland in accordance with the Oland-Comland DTA.

Part 2

Residency of Oil-E

First of all, in the given case, state of residence of Oil E is required to be determined. It is given that Oil-E has been established in Dairyland which treats the partnership as taxable entities.

Therefore, as per Article 4 read with Commentary in Paragraph 5 on Article 1, Oil-E is a resident of Dairyland since it has a full liability to tax on account of criteria given in Article 4. Further, it cannot be considered to be resident of Factoryland since it is not established there and the partnerships are given the status of fiscally transparent in that country.

Therefore, since Oil-E is a resident of Dairyland it is entitled to the benefits of the DTC between Dairyland-Factoryland and should be taxed accordingly.

Taxability of Management Fees received by Oil-E

It is given that Oil-E is required to manage the factories/business of its two partner companies (which are residents of Factoryland) in Dairyland. For doing so, Oil-E receives fees from both the companies and that is the only source of income.

Such management fees can only be characterised as a business profits and hence it would fall under the provisions of Article 7 of DTA. It cannot be classified as royalties since it is not received in respect of use or right to use any intellectual properties of its partner companies.

Such business profits of Oil-E which is a resident of Dairyland can be taxed only in Dairyland as per Article 7 unless it has any PE available in Factoryland. Just because it is given that the partners of Oil-E are companies resident of Factoryland it cannot be concluded that Oil-E has a PE there solely on the basis of that.

Therefore, the management fees received by Oil-E from its two partners companies is taxable in Dairyland under Article 7. This conclusion will hold good even though country of partners i.e. Factoryland treats the partnership as a fiscally transparent. This point has been clarified in the Paragraphs 6.2 & 6.3 of the Commentary of OECD on Article 1 where while interpreting the applicability of the treaty provisions to various cases of conflicts of allocation, a specific exclusion has been made to where the partnership itself is considered as a resident of the state of source. In the given case also, Oil-E is a resident of Dairyland and the income is also arising in that country.

Taxability in the hands of partner companies

Further, the share of income shall be allocated to the partner companies in Factoryland since the Oil-E partnership has been treated as fiscally transparent by it. However, even in that case it can be concluded that Oil-E constitute their PE in Dairyland. This is because the Oil-E has been given the authority to represent and bind them and also such authority has been exercised regularly by Oil-E. Therefore, in view of Article 5(5) this will constitute the dependent agent PE of both the partner companies.

Therefore, once again as per Article 7 such share of income is not taxable in the hands of the partner companies in Factoryland as it is attributable to the PE in Diaryland. Either the exemption needs to be provided as per Article 23A, or credit is required to be given as per Article 23B in respect of the taxes paid, not by them directly but by the Oil-E as a partnership in Dairyland.

Question 7

Overriding effect of residency determined as per tie-breaker rule of DTA over the domestic law

Given the fact that Fred is considered to be the resident of Littleland as per the tie-breaker rule of DTC between Littleland and Bigland, the question is how far this will override the domestic provisions of Bigland under which Fred is otherwise considered to be resident.

The basic purpose of any DTC is to avoid double taxation and therefore provides the mechanism to eliminate double taxation. There are various causes of such double taxation which can be (i) residence-residence conflict, (ii) residence-source conflict and (iii) source-source conflict. In the given facts, we are concerned with the residence-residence conflict.

Fred was considered to be resident of both the countries as per their domestic law. In such case both the countries will seek to tax Fred on his global income under their domestic provisions and hence it will result into double taxation of a type - residence-residence conflict. In such case under DTC, a tie breaker rule is provided under Article 4 whereby such conflict is resolved in favour of only one country by applying various criteria as per their order of preference as provided in that article. As per such tie-breaker provisions of DTC Fred is considered to be a resident of Littleland and not Bigland.

The effect of considering Fred as a resident of Littleland would be that he will no more be considered as a resident of Bigland and hence not liable to tax there on his global income but will be liable to tax there only in respect of income sourced from that country in accordance with the provisions of DTC. Therefore, obviously, such resolution of conflict of residence under the DTC provision shall override the domestic law of Bigland. If the domestic provisions of Bigland are still allowed to override then Fred will still be considered be a resident of Bigland which will be contrary to the provisions of DTC and also its intention to avoid the double taxation.

Impact of Article 27 (related to limitation of remittance based taxation) on the facts of the case

Littleland taxes its residents on their foreign source income only upon its remittance to Littleland. Therefore, DTC between Littleland and Bigland contains Article 27 to take care of a situation where residents of Littleland are not subject to double taxation to the extent that foreign income is not remitted to Littleland.

The impact of such remittance based taxation and suggested draft in the DTC which can be included to prevent double non-taxation arising out of it has been discussed in Paragraph 26.1 of the OECD Commentary on Article 1.

In the given case, the nature of income involved is income from employment which has been sourced from a third country. The relevant article dealing with income from employment is Article 15 of DTC. According to this Article, the right of taxation is always given to the state of residence unless the relevant employment from which the income has been earned has been exercised in the other state. Therefore, more particularly, the combined impact of tie-breaker provisions of Article 4 and Article 15 of Littleland-Bigland DTA would be that income from employment of Fred is taxable always in Littleland (State R) unless the relevant employment has been exercised in Bigland (Other State). By applying these provisions, the income of $3 million is taxable only in Littleland and not in Bigland.

However, Article 27 of DTC restricts the benefits of any relief otherwise allowed under DTC to the extent the relevant income has not been remitted to Littleland. Basically, this Article is aiming at the relief which is allowed by the State of Source. In the given case it cannot be said that in Bigland the

relief has been allowed by it as a State of Source by not taxing the relevant employment income. This is because the employment has not been exercised in Bigland and hence it can never be considered as a State of Source. Therefore, the provisions of Article 27 would not have any impact over the conclusion that the employment income is not taxable in Bigland even after considering the fact that it has not been remitted to Littleland at all.

The wordings of alternative provision which has been suggested in the OECD Commentary are very clear:

"Where under any provision of this Convention income arising in a Contracting State is relieved in whole or part from tax in that State....."

Therefore, it refers to relief given by any State in its capacity as State of Source and not otherwise. Though the actual wordings of Bigland-Littleland treaty differ to some extent, it is required to be interpreted in this context.

Any other interpretation would result into double taxation. In that case if the relief is not given by Bigland relying on this provision of Article 27 it would be taxed in Bigland and also it would be taxed by that other country where the employment has actually been exercised. The tax which would have been levied upon Fred in that third country cannot be claimed as a credit (or exemption with respect to that employment income) under any provisions of a treaty between Bigland and that other country for the simple reason that Fred is not considered to be a resident of Bigland. This is in accordance with the paragraph 8.2 of Commentary on Article 4. Such double taxation is contrary to the purpose and objectives of DTC. Therefore, such interpretation on the other side should be avoided keeping in mind the interpretative rules of VCLT. Further, another argument against such other interpretation is that Fred has been considered as a resident of Littleland under its domestic provision in spite of the fact he was taxable there on foreign sourced income only upon remittance. The very fact that he has been considered to be resident there, the tie breaker provisions were applied and conflict was resolved. Therefore, now disallowing the relief merely relying on Article 27 solely on the reasons that income from sources in third state has not been remitted to Littleland and hence not taxed effectively there would go contrary to the entire scheme of the DTC.

<u>Conclusion</u>

Employment income which was not remitted to Littleland (State R) cannot be taxed in Bigland by once again treating Fred as resident of Bigland contrary to the tie-breaker provisions of DTC.