Chartered Institute of Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2015

PAPER 1

PRINCIPLES OF INTERNATIONAL TAXATION

Suggested Solutions

PART I

Question 1

This question asks students to address two issues. First, students need to give an overview of the recent developments in relation to the automatic exchange of information that have taken place at the level of OECD/G20. Secondly, they should be prepared to demonstrate their analytical skills by discussing the main benefits and challenges of automatic exchange. It is important that students read this question carefully and do not address the recent developments in the field of exchange of information more broadly as they are asked to focus exclusively on automatic exchange. The question can be approached differently, so what follows is only one possible narrative.

Introduction

The exchange of information between tax administrations is vital in the fight against tax evasion and aggressive tax avoidance. Cooperation in this area has been promoted by the OECD for a long time, generating significant improvement in all three forms of exchange (on request, spontaneous and automatic). Automatic exchange of information has increasingly become the centre of political attention since 2012. The major developments, benefits and challenges of automatic exchange, will be discussed in turn.

Part 1: The progress made by the OECD/G20 in relation to automatic exchange of information

The recent progress builds upon earlier work of the OECD in the area of automatic exchange of information, such as its 2001 Recommendation for the use of a Model Memorandum of Understanding for automatic exchange and the development and update of standard formats for automatic exchange. The EU laws, global anti-money laundering standards and the US Foreign Account Tax Compliance Act (FATCA) have trigged deeper cooperation in a multilateral context.

In 2012, the OECD released a report to the G20 Leaders Summit 'Automatic Exchange of Information: What it is, How it works, Benefits, What remains to be done'. In April 2013, France, Germany, Italy, Spain and the UK declared their intention to exchange FATCA-type information amongst themselves in addition to exchanging information with the US. This was followed by the commitment of the G20 Finance Ministers to make automatic exchange of information the new global standard. In June 2013, the OECD presented a report to the G8 Leaders that identified the steps that are needed for the implementation of this intention ('A step change in tax transparency'). In September 2013, the G20 Leaders expressed their commitment to automatic exchange of information and their support for the OECD work that aimed at presenting a single standard in 2014.

The Common Reporting Standard for automatic exchange of tax information was endorsed by the G20 Finance Ministers on 23 February 2014. This was followed by growing political support from other countries. On 6 May 2014, all 34 member countries and several non-member countries adopted the Declaration on Automatic Exchange of Information in Tax Matters and committed to implement the new global standard on automatic exchange swiftly and on a reciprocal basis. The full version of the Standard for Automatic Exchange of Financial Account Information in Tax Matters was released by the OECD on 21 July 2014 and subsequently endorsed by the G20 Finance Ministers. On 29 October 2014, 51 jurisdictions, almost 40 of which were represented at ministerial level, signed a multilateral competent authority agreement to automatically exchange information based on Article 6 of the Convention on Mutual Administrative Assistance in Tax Matters.

The Global Forum on Transparency and Exchange of Information for Tax Purposes plays a crucial role in the process. It was entrusted to monitor the implementation of the new OECD standard on the automatic exchange of financial account information and to provide help to developing countries. In order to facilitate developing country participation, the Global Forum Secretariat presented a Roadmap to the G20 Development Working Group. It also collected commitments from its members to implement the new standard. By March 2015, nearly 60 countries and jurisdictions committed to implement the standard by 2017 (early adopters), 35 – by 2018, and 5 have not indicated a timeline or have not yet committed. The Member States of the European Union have already amended the EU Directive on Administrative Cooperation in order to implement the new OECD standard in the EU as early as 2017 (except Austria).

Part 2: Main benefits and challenges

Automatic exchange involves the systematic and periodic transmission of 'bulk' taxpayer information by the source country to the residence country concerning various categories of income (dividends, interest, royalties, etc.). The standard invites governments to obtain detailed account information from their financial institutions and exchange it automatically on an annual basis. It sets a minimum standard as regards the financial account information to be exchanged, the financial institutions that need to report, the types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions.

The main benefits of automatic exchange are as follows. First, the prime advantage of automatic exchange is that it can flag up non-compliance even where tax administrations have had no previous indications of it. It can reveal timely information where tax has been evaded either on an investment return or the underlying capital sum. Secondly, it carries a strong preventative effect. By putting additional pressure on taxpayers that information is exchanged automatically, it contributes to voluntary compliance and may increase the quality of reporting to tax authorities. Thirdly, the progress in this area has generated significant public attention, which increases the awareness of taxpayers about their reporting obligations. Fourthly, standardisation in this field brings simplification, higher effectiveness and lower costs. To sum up, automatic exchange of information is expected to have a positive impact on tax compliance, generate additional tax revenue and increase public confidence in the fairness of tax systems.

However, automatic exchange is also associated with several challenges. These challenges are recognised by the OECD and a number of steps have already been undertaken to mitigate the risks involved. The main challenge is associated with various aspects of effective implementation and, in particular, achieving its globally consistent execution. The capacity of developing countries needs to be addressed with a particular care as they require technical assistance and capacity building training to participate in the automatic exchange, meet the standard and be able to benefit from this process. Countries involved in the process of exchange through multiple legal instruments should ensure their coordination and effective practical use. The implementation process needs to be closely monitored. As mentioned above, the G20 has mandated the Global Forum on Transparency and Exchange of Information for Tax Purposes to perform this task and it is crucial that a peer review process is carried out smoothly. The necessity to secure confidentiality, data safeguards and proper use of the information constitutes another important challenge. This issue is closely linked to the protection of taxpayer rights more generally. Finally, the process of exchange should strike a balance between input and output. Several economic studies, as well as OECD's own analysis of voluntary disclosure programmes, have already confirmed the effectiveness of greater transparency and better exchange of information at the global level but further monitoring and research in this field is required to determine the directions of further progress.

Conclusion

To conclude students may want to express their opinion about the progress made by the OECD/G20 in relation to automatic exchange of information and/or reiterate their main claims made earlier.

Question 2

This question may be addressed in a number of different ways. It is expected, however, that students will provide an overview on the principles guiding the interpretation of double tax treaties and illustrate their understanding of the problems associated with the process of interpretation. The skeleton solution provided below draws a general picture. Various practical examples may be used by students to support their analysis and evaluation of the current position. What follows is one possible schematic.

Introduction

The interpretation of double tax treaties is of fundamental importance for their successful application. Divergent interpretation may prevent the achievement of the central goals set by double tax treaties, leading to the instances of double taxation or non-taxation.

Notwithstanding this great importance, as the quotation from Miller & Oats rightly suggests, the issue of interpretation remains complex and controversial.

Part 1: The complexity of context in which double tax treaties operate

The complexity of treaty interpretation is created by the variety of contexts in which it needs to be interpreted and by the fact that double tax treaties aim to regulate the interaction between two tax systems which are quite complex themselves. Unlike domestic tax legislation that usually contains thousands of pages, tax treaties are fairly concise. The wording of tax treaties is quite general and abstract to allow their universal applicability. It does not always fit smoothly into domestic tax laws. The definition of terms, characterisation problems and the application of anti-abuse doctrines are just a few of many examples that can be given to illustrate the type of problems that arise in this context.

There are approximately 4,000 tax treaties worldwide. The wording of tax treaties has been greatly influenced by the OECD and UN Model Conventions, which makes them somewhat different from other types of international treaties (Philip Baker). Although discussions have been lengthy, there is no international court or arbitration commission that would exercise a general judicial authority over treaty cases and set the principles of interpretation (the history of this debate can be found in, e.g. Edwardes Ker, Tax Treaty Interpretation). The interpretation of tax treaties thus falls within the jurisdiction of national courts. Each country develops its own approach to the interpretation and construction of domestic tax laws. In general, common law countries often adopt a more formal interpretation than civil law countries, even if it seems to evolve gradually into a more purposive approach (Peter Harris). The rules for treaty interpretation are governed by public international law and are often broader.

The UK approach to treaty interpretation was summed up in IRC v Commerzbank [1990] STC 285 and approved in Memec plc v IRC [1998] STC 754. A judge ought to look first for a clear meaning of the words, bearing in mind that 'consideration of the purpose of an enactment is always a legitimate part of the process of interpretation'. It should be kept in mind that the language of a treaty differs from the legal language found in domestic law and does not necessarily use domestic legal precedent or technical rules. The 'in good faith' principle should be respected. 'Supplementary means of interpretation', including travaux préparatoires, can be used where appropriate. Subsequent commentaries 'have persuasive value only, depending on the cogency of their reasoning', and a judge needs to bear in mind the reputation of foreign courts when relying on their judgments. These principles have been developed on the basis of Fothergill v Monarch Airlines (1980), where the court famously said that 'the language of an international convention has not been chosen by an English parliamentary draftsman'.

Part 2: Controversial issues surrounding the means of treaty interpretation

The situation is made even more complicated by some controversial issues of treaty interpretation, such as what materials should the court look at when a treaty is interpreted?
The guiding principles of treaty interpretation are set by the Vienna Convention on the Law of Treaties 1969. In particular, Article 31 requires that an international treaty be interpreted in good

faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context, and in the light of their object and purpose. The ‘context’ is defined as including any associated agreements and instruments (in addition to the text, including its preamble and annexes). It also permits reference to subsequent agreements and any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation. Article 32 stipulates that travaux préparatoires provide supplementary means of interpretation and may be used to confirm the meaning resulting from the application of Article 31, or to determine it when Article 31 leaves any ambiguity or generates manifestly absurd or unreasonable results. Finally, when a treaty has been authenticated in two languages, equal weight is attributed to each language unless the agreement states otherwise (Articles 33). Although the Convention provides the guiding principles that are generally accepted by courts, it does not offer a comprehensive solution for a common interpretation (Wim Wijnen). Furthermore, the question remains to which extent these provisions are to be followed by those states that have not ratified the Convention.

Tax treaties themselves include limited guidance on interpretation. The key terms are defined in the text (e.g. ‘person’, ‘permanent establishment’), and Article 3(2) of the OECD Model and the UN Model provides a general rule of interpretation for terms used in the treaty but not defined in its text. Such terms, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State. Even if this provision enables the two independent tax systems to work together, it does not solve all problems. For instance, the meaning of the ‘context’ that may require an alternative interpretation is ambiguous. Tax treaties usually also envisage that the treaty partners may resolve interpretative problems through a mutual agree¬ment procedure (Article 25 of the OECD Model and the UN Model).

One of the central roles in the process of interpretation is played by the Commentaries on the OECD Model and the UN Model. Since 1963 each version of the OECD Model has been published with a Commentary. However, domestic courts are not bound by them. In various countries different importance is attributed to this source of interpretation. Some OECD member countries, such as the UK, authorised the use of the OECD Commentaries to the OECD Model Treaty and attach persuasive value to them (Sun Life Assurance of Canada v Pearson), whereas others, such as France and Italy, will consider them less significant. Similar differences in approaches can be found between non-OECD countries (Wim Wijnen). Although the Commentaries are generally accepted as valid means of interpretation, legal grounds for such acceptance remain weak. The Vienna Convention does not refer to the Commentaries directly, allowing debates as to whether these instruments follow under Article 31 or 32. The question arises whether the court should look at the commentaries to resolve an ambiguity, or more permissively without regarding whether or not there is an ambiguity. The issue of which Commentaries should guide interpretation also needs to be addressed, and the OECD gives preference to the ‘ambulatory principle’. Finally, it should not be assumed that the Commentaries clarify all the ambiguities: they may also generate divergent interpretations.

Another controversial aspect is the use of foreign court rulings for treaty interpretation purposes. The 1993 IFA Congress General Report on Interpretation of Double Taxation Conventions pointed out that ‘one Contracting State should look at decisions made by courts... of the other Contracting State when confronted with problems of interpretation’ and ‘test whether their interpretation can be transferred’. In 2008, the IFA returned to this issue. It concluded that even though generally it is accepted that a foreign decision may be taken into account where it lays down a general principle (e.g. Indofood), the practice of various countries differs. The UK can be given as an example of a more ‘open’ jurisdiction, whereas in the Netherlands such practice is uncommon. The desirability of a common interpretation provides compelling reason for taking into account the decisions of foreign courts at some level.

<u>Conclusion</u>

Students are expected to illustrate their own opinion here. For instance, they can conclude that a number of principles and tools have been developed in order to assist the parties in applying tax treaties and in resolving the problems of interpretation. Although the existing system is functional, the overall situation remains far from satisfactory. The complexity of the tax treaty network makes it difficult to achieve the convergence of the interpretation of tax treaties.

Question 3

Students should use this question as an opportunity to compare the UN and OECD models. They might also be inclined to think about allocation of taxing rights in the context of the purposes of DTAs generally. In the skeleton solution provided below, the structure chosen is to focus on the three mechanisms that DTAs adopt in this regard. It also gives two examples of how a UN/OECD comparison might fit within such a structure. What follows is one possible schematic.

Introduction

International tax is arguably concerned, principally, with the allocation of the taxing rights of countries. As with other forms of international law, the principles that guide understanding of these rights have their foundation in jurisdictional conflict. States can claim taxing rights in respect of the same transaction on the same basis (e.g. residence) or on different bases.

Where there is no DTA

Capital importing (source) countries have the first right to tax all income sourced within the jurisdiction. Assuming a desire to avoid double taxation, this means that capital exporting (residence) countries are left with a residual right to tax income to the extent its rates are higher.

Where there is a DTA

The models and extant treaties use 3 mechanisms to divide taxing rights:

First Mechanism: to remove the source country's right to tax a particular type of income derived in its territory. The right is then assigned exclusively to the investor's state of residence, for example, business profits: remove the source country's taxing rights over locally sourced business income derived by non-residents unless they earn it through a PE – both the OECD and UN Models adopt this rule but there are substantial differences in relation to when a PE results.

Is this a harsh rule for capital importing source countries? Arguably, it is not. Tracking all business transactions is difficult – more so for less developed countries with more limited administrative capacity. Giving up taxing rights over business profits in these situations makes sense, except for:

- certain highly visible businesses that need local enterprises for their transactions (e.g., entertainers and sportspersons) – hence, in this respect, the DTA carve out from the business profits rule
- income related to ownership of land – mere ownership of (interests related to) land, such as mining or forestry rights is not included in PE definition under either model
  - both models allow the source country to retain full taxing rights over profits from dealings in land
  - the OECD Model (and the later UN Model) provide an exception to the business income rule for these profits
  - since 2003, both Models also include profits from the sale of land-owning companies.

Second Mechanism: to allow the source country capped taxing rights for income repatriated to foreign investors.

This mechanism is used for the three main types of passive investment income: interest, dividends and royalties. Because of the practical difficulties of assessing foreign investors for tax and collecting tax on their receipts, particularly when they have no other assets in the source jurisdiction (except for the intangible property generating the return), tax is commonly collected through a withholding tax (WHT).

Under a WHT system, the law formally imposes tax on the non-resident recipients of income but requires the payer to withhold a flat rate tax from the payments and remit the withheld amount to the tax authority. The law then states that the non-resident recipient of income has fully met the tax obligations with respect to the income provided the payments were subject to withholding tax – the lower the maximum WHT rate that can be imposed by the source country, the greater the room for the residence country to impose its tax rates on the income.

Third Mechanism: for some types of income, tax treaties allow the capital importing country to retain its full taxing rights.

The capital exporting country in which investors and businesses are resident also retains its ordinary taxing rights on income derived by its residents but must give priority to the source country's taxing rights. If the residence country wishes to use its residual rights and impose tax on the foreign source income, it must provide residents with a credit for the tax imposed by the source country.

Conclusion

It is difficult to analyse in general terms whether the source or resident state derives a greater benefit in non-tax terms as a result of any of these mechanisms. It has often been said that one of the more general aims of concluding DTAs is the removal of barriers to trade and investment and facilitating the free movement of the factors of production. In other words, DTAs are also an aspect of global free trade policy.

While it is true that the UN Model places more emphasis on the taxing rights of source states, it is an open question whether capital importing countries have the wherewithal to negotiate greater taxing rights given the bargaining power of most capital exporting countries. It is also an open question whether a capital importing country would be right to seek to do so given the global competition for foreign direct investment.

Question 4

This question requires candidates to be conversant with the revisions to the OECD MTC published in July 2014 and to be able to place the revisions within the context of ongoing reform of international taxation. Candidates should be able to clearly demonstrate that they understand the mechanisms for revisions to the OECD MTC, including timeframes. The following is one possible schematic.

Introduction

OECD MTC provides the basis for many DTCs and has done so for almost 4 decades. There are in the region of 4,000 double tax agreements in force, and at least 70-80% of those follow the OECD model pretty closely (Heather Serle, Pinsent Masons). Since 1991, the OECD MTC has been an ambulatory MTC that is updated periodically. The most recent updates have been published and constitute a partial response to issues that require attention. These 2014 updates do not include subjects that are contained with the BEPS Action Plan.

Historical Context

In 1956, the Fiscal Committee of the OEEC set out to study the fiscal questions relating to double taxation. The OEEC became the OECD and published the ‘Draft Double Taxation Convention on Income and Capital’ in 1963. The first revision came in 1971 as the “Model Convention and Commentaries”. The OECD realised in 1991 that the revision of the MTC had become an ongoing process. Since 1977, there have been updates in 1995, 1997, 2000, 2003, 2005, 2008 and 2010 (plus 2014).

The OECD MTC is updated every few years. Updating is a major task, involving consultation with OECD member countries, the European Community, non-member countries and the public. Therefore, rather than make piecemeal changes every time a particular amendment has been consulted upon, the OECD likes to group together the changes so that the MTC is not in a constant state of flux. There may well be delays, for instance, the entertainer and sportsman changes were consulted upon back in 2010.

The Changes

On 16 July 2014, the OECD released the contents of 2014 updates to the MTC. [Changes were included in a revised version of MTC later in 2014. Updates approved by Committee of Fiscal Affairs on 26 June 2014 and by OECD Council on 15 July 2014. The most notable change are:

- Beneficial Owner: 29 April 2011, OECD Discussion Draft, “Clarification of the meaning of Beneficial Owner in the OECD MTC”. CFA, through a working party, made changes to the proposals and released revised proposals on 19 October 2012. This now clarifies that BO is not to have a narrow technical meaning in the sense it is does under the trust law of some common law jurisdictions (paragraph 12.1 of the Commentary).
    - Paragraph 12.1 of the Commentary on Article 10 reminds us that the term beneficial owner was introduced to address potential difficulties arising from the use of the words “paid to a… resident” in paragraph 1 of Article 10, particularly where payments are made to intermediaries. The term is intended to be interpreted in this context, not with reference to a technical meaning per domestic law.
    - Paragraph 12.4 of the Commentary on Article 10 explains why agents and nominees acting as conduits are not beneficial owners.
    - Note also the changes in paragraphs 12.5, 12.6 and 12.7 of the Commentary on Article 10.

- Exchange of Information:
    - Wording added to Article 26(1) provides that the competent authorities of the contracting states “shall exchange such information as is foreseeably relevant for carrying out the provisions of this convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description

imposed behalf of the contracting states…”. The addition of the standard of “foreseeable relevance” requires that there be a reasonable possibility that the requested information will be relevant. It does not oblige the requested state to provide information in response to fishing expeditions (i.e. “speculative request that have no apparent nexus to an open enquiry or investigation”). See para. 5 of the Commentary on Article 26.

- Wording added to Article 26(2) considers when information may be considered relevant for the purposes of information exchange in spite of the fact that that information is not to be used primarily for tax purposes (“when such information may be used for such other purposes under the laws of both states and the competent authority of the supplying state authorises such use”).
- Paragraph 10.4 of the Commentary contains an optional provision for contracting states that wish to improve the timeliness of exchange of information. The provision establishes default time limits for the supply of information: within two months of the receipt of the request, where the authorities are in possession of the information; and within six months in other cases.
- Paragraph 11 of the Commentary clarifies confidentiality rules in paragraph 2 of Article 26. It also explains that where the requesting state does not comply with its confidentiality duties, the requested state may suspend assistance.
- Paragraph 15 of the Commentary notes the principle of reciprocity applies where a contracting state applies measures not normally foreseen its domestic law or practice.
- Paragraph 19.7 of the Commentary clarifies that paragraph 4 of article 26 requires the requested state uses information gathering measures regardless of whether the requested information could be gathered or used for domestic tax purposes.

- Introduction to MTC: Para 21 now includes a reference to gains from the alienation of shares deriving more than 50% of their value from immovable property situated in the source state (Article 14(3) MTC).
- Termination Payments: CFA released DD on 25 June 2013. Paragraphs 4 to 6 of the Commentary on Article 18 note that “various payments may be made to an employee following cessation of employment” and provide guidance on the extent to which such payments fall within the scope of Article 18.
- Emissions Permits and Credits. The 2014 update includes guidance that addresses the potential tax treaty issues that could arise in connection with a national regional authorities issuance of emission permits, the purchase or sale of such permits across borders, and the issuance and trading of certified emission reduction units and emission reduction credits. The background to these changes is included in the report “Tax treaty issues related to emission permits/credits” (26 June 2014).
- Application of article on Artistes and Sportsmen: Article 17 wording is altered. Now “entertainers and sportpersons”. In general terms, the 2014 update provides guidance to the broad range of questions that have arisen over the years on the interpretation and application of Article 17.
- New reservations: several from countries to aspects of Articles 3-5 as well as some deleted reservations, e.g., Israel reserves the right to include a trust within the definition of a person (Commentary on Article 3, [16]).
- Commentary on the meaning of company: Commentary to Article 3, [3], provides that, in addition to “any body corporate”, a company is taken to mean “any other taxable unit that is treated as a body corporate for the purposes of the tax law of the CS of which it is resident”.

The changes are unlikely to have a great impact on taxpayers and their advisors. Rather they are considered to be part of setting the framework within which governments negotiate. As such, the BEPS Action Plan is likely to have a considerably larger impact than the recent updates.

Areas Not Included

- Those changes proposed in the discussion draft of 15 Nov. 2013 on proposed changes to the provisions dealing with the operation of ships and aircraft in international traffic (except for a change to the introduction).
- Those changes put forward in the Discussion Draft of 19 Oct. 2012 on revised proposals concerning the interpretation and application of Article 5 (Permanent Establishment). As it is expected that work on Action Point 7 (Prevent the artificial avoidance of permanent establishment status) of the BEPS Action Plan will result in changes to Article 5, the proposed commentary changes included in that discussion draft will not be finalized until the work on Action Point 7 has been completed.

<u>Question 5</u>

Students may choose to interpret this question in a number of different ways. Perhaps, the most obvious interpretation is the extent to which consolidated group taxation (CGT) is compatible with the existing bilateral tax treaty network. Students might also choose to:

- make the very general argument that the separate legal entity approach (SLA) and the arm's length principle (ALP) form part of customary international law and are binding even in the absence of a treaty;
- adopt a developing country focus.

The following is one possible schematic.

CGT is arguably compatible with most tax treaties. Moreover, developing countries can implement CGT with or without a tax treaty.

Transfer pricing is governed by Article 9, which assumes the SLA because it addresses business between associated enterprises. If CGT were adopted, Article 9 would be irrelevant. Article 9 ignores transactions between related parties and treats them instead as part of a single enterprise.

The application of CGT would be governed by Article 7. A dependent agent can be a PE if the principal exercises legal and economic control over the agent. An agent subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent. Generally, for MNEs that operate as unitary businesses, a strong argument can be made that the parent exercises both legal and economic control over the subsidiaries, especially where they bear no real risk of loss and acquire goods exclusively from the parent or other related corporations (e.g., eFunds Corp. v ADIT, Income Tax Appellate Tribunal, Delhi, 2010; Lucent Technologies v DCIT, Income Tax Appellate Tribunal, 2008).

If the subsidiary is an agent of the parent, Article 7(2) requires the attribution of the same profits to the subsidiary "that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions." Arguably, the application of CGT satisfies this condition because in the absence of precise comparables (which almost never exist) it is not possible to determine exactly what profits would have been attributable to the subsidiary under SLA.

CPM and profit split arguably violate DTAs because they do not rely on exact comparables to find the arm's length price. In the case of profit split, no comparables are used to allocate residual profits. Since it can be argued that in the absence of comparables, the result reached under GFA is equivalent to what could be reached under SLA, CGT seems to be applicable for dependent agent PEs.

<u>The argument from customary international law</u>

The SLA and ALP are embodied in all DTAs. But embodiment in the treaties is not enough to create a customary international law ban on CGT, since Article 7(4) is embodied as well. The key issue is what countries actually do. Many of them follow CGT approaches in practice. In addition, in this case countries should be free to follow the UN Model, which does not adopt the same approach in relation to the apportionment of PE profits made by the OECD.

The OECD may also be revising its approach. The authorized OECD approach may have marked the high water mark of OECD commitment to SLA. With the beginning of BEPS, which is influenced by countries like China and India, the OECD may be stepping back from its total commitment to SLA. Specifically, the potential adoption of country-by-country reporting can be the basis for implementation of CGT.

CGT and Developing Countries

If there is no DTA (or if the treaty contains Article 7(4) type language), the biggest obstacle to implementation may be obtaining the information needed to apply CGT. The recent redraft of the UN Transfer Pricing Manual recommends that among the documentation which a tax administration should request for a Transfer Pricing audit should be the "Group global consolidated basis profit and loss statement and ratio of taxpayer's sales towards group global sales for five years'" (para. 8.6.9.12). This provides a good basis for application of CGT.

The rejection of CGT in the OECD Transfer Pricing Guidelines is based on its definition of FA as `applying a formula fixed in advance'. This leaves considerable scope for adoption of CGT approaches with ad hoc formulae, which are not based on a fixed formula. Specifically, allocation according to operating expenses would be clearer and easier to administer, and most importantly would fit within the current rules of international tax.

Developing countries should be encouraged to draft their transfer pricing laws to include powers to adjust the accounts of any foreign-owned local company or branch, if the Revenue Authority considers that its accounts do not fairly reflect the profits earned locally, to bring the taxable profits into line with those which such a business would be expected to earn, having regard to:

- similar businesses either in that country or elsewhere, and
- the relationship of the local business to the worldwide activities of the corporate group of which it is a part.

This would involve analysis and comparison of provisions in the tax laws of appropriate countries.

Conclusion

The transition from SLA to CGT is likely to be a long process, and it may require ultimately renegotiating DTAs or even drafting a multilateral treaty like the EU's CCCTB. However, a constructive beginning may be made now by exploring how developing countries can adopt CGT principles within the context of the existing tax treaty network.

PART II

Question 6

Part 1

Before students consider embarking on a transfer pricing analysis, they first must determine whether the relevant amount falls within the definition of profits that can be adjusted for Transfer Pricing purposes. As the title of Article 7 of the OCED Model suggests, the initial concern is with profits, which are by definition on income account (OECD Commentary to Article 7 (para.1) and OECD MTC Article 9(1)). Therefore, it follows that the transfer pricing rules can only be applied following a prior determination that the payment in question is, in fact, in the nature of income. Students should be able to determine that the relevant amount – arising from the issue and subsequent sale of shares to an associated enterprise - is not made on income account.

There are two points to make here: (i) not only is the relevant amount not classifiable as an item of income (because it is made on capital account) but also (ii) even though the relevant amount could be treated as an item of deemed income, this would need to be expressly referred to in national legislation, which it is not.

Accordingly, given that (i) the amount is made on capital account and (ii) there is no deemed income provision mentioned in the fact pattern, the relevant amount cannot be said to be made on income account and so prima facie fails to satisfy the requirement that amounts adjusted for transfer pricing. In essence the issue of shares in the fact pattern appears to be a tax nothing and was treated as such by the High Court.

Marks will be lost by students who answer this question without questioning whether the initial payment of $300,000 is in the nature of income and, therefore, capable of being subject to Articles 7 and 9.

In Vodafone India Services Pvt Ltd v Union of India (2014) 17 ITLR 209, it was held that a condition precedent for the application of the transfer pricing regime is that income must in fact have arisen. The transfer pricing regime was a measure of tax but, first, it had to be shown that the payment was subject, or within the charge, to tax. As the ITLR stated:

> *"The Vodafone IV ruling establishes the primacy of the charge to tax over the measurement of arm's length price (ALP). Accordingly, in the absence of the charge to tax, the question of determination of ALP does not arise."*

There is a strong argument that the amounts received on the issue of share capital are on capital account and any amount foregone is not included in the concept of income or notional income. For these purposes, Oland's domestic law will need to be taken into account. However, given the nature of most developed income tax systems, share capital is more often than not on capital account. This would mean that Article 7 would be inapplicable in the current situation. Again, as the ITLR indicated:

> *"corporate actions such as capital issues and share conversions do not give rise to income, and hence, should not be subject to ALP determination."*

On the other hand, the domestic tax law of Oland may provide certain deeming provisions, such that amounts that are ostensibly on capital account become income insofar as there is a disconnect with a market valuation or safe harbour provision. In which case, Articles 7 and 9 are brought into play.

Students who choose to answer this question, principally, through the application of the transfer pricing rules must, at the very least, demonstrate an awareness of the income/capital issue. This approach is acceptable insofar as it is made clear that the application of the transfer pricing rules requires an assumption that the underlying payment is income.

Part 2

Under the provisions of Article 7 of the OECD MTC, the two margarine manufacturing companies are not taxable on their business profits in Dairyland, unless they have a PE in that state.

Oil-E is a legally separate entity in Dairyland and as such distinguished from a branch or office: Article 5(7) OECD MTC. Thus, Oil-E is separately taxable in Dairyland on its profits (the management fees). Will Dairyland recognize the management fees as constituting an arm's length price? Oil-E would need to demonstrate that it had undertaken a transfer pricing study and complied with documentation formalities in Dairyland. If not, Dairyland might seek to adjust the price under Article 9 principles read with the OECD Transfer Pricing Guidelines 1996, as amended, by focusing on functions performed, assets used and risks assumed by the subsidiary in Dairyland. Prospectively, consideration should be given to reaching an advance pricing agreement or other form of informal clearance with the tax authority of Dairyland.

Another issue is whether the management fees constitute fees for technical services or royalties. This would have an impact on whether the state of source can tax them (technical services fees) or the state of residence can tax them (royalties).

Does Oil-E constitute a PE?

The two margarine manufacturing companies are probably also taxable in the state of source, Dairyland, because Oil-E constitutes a PE:

- Oil-E probably constitutes a dependent agent of the two margarine manufacturing companies under Article 5(5). Such a dependent agent can be an individual or a company (Commentary on Article 5, para 32). Oil-E has and regularly exercises authority to contract on behalf of the two margarine manufacturing companies (Article 5(5)). The contracts relate to the core business of the two margarine manufacturing companies and are not simply a preparatory or auxiliary activity. Oil-E need not even formally sign contracts on their behalf: merely soliciting and receiving orders without finalizing them can be enough (Commentary on Art 5(5), para 32.1).
- If Oil-E has a fixed place of business and regularly make its premises available for visiting staff of the two margarine manufacturing companies, it could also constitute a fixed place of business of the two margarine manufacturing companies even though no formal legal right existed on the part of the two margarine manufacturing companies (Commentary on Article 5, para 4.1). Simply seconding staff for a significant time to monitor the activity of the partnership could constitute a PE of the two margarine manufacturing companies (Commentary on Article 5, para 4.3).

Question 7

There are arguably three main issues raised by this question:

1. In general, how far the purposive approach to interpretation should be taken.

2. In relation to Article 4, the issue is whether the residency provision of a DTA, tie-breaker or otherwise, takes a person out of the charge to tax in the country in which they are deemed to be non-resident in relation to income taxes generally.

3. In relation to Article 27, given the prospect of future remittance, might there not be double taxation if Bigland taxes the unremitted amounts. This is accentuated when the likelihood of the availability of any type of double taxation relief from Bigland is considered were remittance to take place in the future.

If DTAs exist primarily to defeat double taxation, then the articles of DTAs, unless their express wording provides otherwise, should be interpreted in light of their "object and purpose". This logic, when applied to Article 4, in particular, has some interesting implications.

In relation to Article 4, the outcome is ostensibly that Fred should not be taxed in Bigland because Littleland has not given up its rights to tax the income, it has simply deferred the time of taxation. Therefore, if Bigland were to tax the unremitted amounts, there is a serious risk that the amounts would be taxable in future by Littleland. Moreover, the chance that Bigland could provide relief from the resulting double taxation is remote given both the limited circumstances in which relief is given under a DTA. It is unlikely that it could be argued that the definition of juridical double taxation requires tax to be imposed in the same period. For example, the following definitions contain no such requirement:

- "taxation of the same income twice in the hands of the same taxpayer": Opinion of Advocate General Geelhoed in Case C-513/04 Mark Kerckhaert and Bernadette Morres v Belgische Staat (2006) at para. 2.
- "the imposition of income taxes in two (or more) States on the same taxpayer in respect of the same income": OECD, "Manual on Effective Agreement Procedures (MEMAP)" (2006) at 1.1.2.

Any counterargument might begin by suggesting that DTA's now have more than one main purpose, possibly three. There is, of course, the relief of double taxation. However, customary international law may well now mean that even longstanding DTA's also have the purpose of preventing double non-taxation, as well as the allocation of the taxing power between the source country and country of residence. It is certainly evident in the literature that a tripartite functionality for DTAs is acceptable. This, of course, introduces potential problems were a more purposive approach to interpretation adopted.

However, if, indeed, the logic that the purpose of a DTA also concerns the distribution of taxing rights is accepted, there is still a further issue, which is directly relevant to Article 27 as stated in the Bidland-Littleland DTA. It has already been suggested that Littleland has not given up its right to tax the income. It has merely deferred the timing, which may mean that Article 27 is not applicable. Furthermore, unless Littleland's rules only apply to amounts remitted in the same year that the income was earned, there is still a potential for double taxation were the amounts to be remitted in future tax years.

It should be noted that Rip C.J. came to a very different conclusion in the Canadian case of Conrad Black v Her Majesty the Queen (2014) TCC 12. In a similar fact pattern, he opined that in applying a liberal and purposive approach to Article 4(2) of the Convention, the tie-breaker rule at issue merely provided a preference to the taxing authority of the UK, but did not extinguish Canada's claim to tax.

Students will have a wide discretion in answering this question. Nevertheless, coherency in the arguments made and a discussion of at least one of the important issues raised in the question are fundamental.