THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2019

MODULE 1

SUGGESTED SOLUTIONS

PART A

Question 1

Looking at the underlying issues through the lens of the PE concept raises, for example, the argument that the very real interpretational issues caused by the amended Articles 5(5) and 5(6) of the OECD MTC are simply a manifestation of the failure by the OECD to tackle the separate legal entity principle (SLE) and the attribution of profits methodology (AOP).

The following is one possible schematic.

Introduction

There is arguably uncertainty surrounding SLE and AOP. There is an argument that the BEPS Project was an opportunity to rethink or rework these foundational concepts. Some commentators believe that the price of the failure to rethink or rework SLE and AOP is the emergence of unilateral measures, such as the Direct Profits Tax in the UK, which not only undermine the PE concept – as the balancing act between source and residence state taxation – but also threaten the very coherence of the global tax system.

The PE Concept

The PE concept relies on physical presence. Physical presence was the best nexus for economic allegiance when cross-border activity consisted mainly of trade in goods. In an increasingly digital global economy, this reliance is causing a disconnect between economic activity and taxation. The PE concept is both instrumental in source-state tax avoidance and protecting the tax base in the source state. At the time when residence taxation is in its ascendancy, it is the former that is increasingly on the minds of tax policy makers. Being the more flexible of the two PE thresholds, it is the agency PE of Article 5(5) of the OECD MTC that is currently a "battleground for taxing rights". The OECD had set out to develop a holistic approach to realign taxation with economic activities and value creation but Action 7 limited things to preventing artificial avoidance, particularly the use of commissionaire arrangements.

Separate Legal Entities

The idea behind SLE, when applied to PEs, is that an enterprise conducting business directly in the source jurisdiction should be taxed no differently from an enterprise choosing to conduct business through a separate legal person. Mitchell B. Carroll first suggested that PEs should be treated as independent entities, so that the income allocated to the branch could be treated as equivalent to that which would have been derived by an independent enterprise. This was embedded into Article 7(2) in 1933. The principle is inherently problematic in practice. It relies on the fiction that part of an integrated enterprise – the PE – acts separately and independently from the enterprise of which it forms a part. The OECD, through BEPS, has sought to reform SLE in relation to PEs by excluding closely related enterprises from the independent agent exclusion.

Attribution of Profits

Conducting business through a PE is administratively inefficient and creates a compliance burden, particularly in relation to the documentation requirements imposed by AOA**(?)**. Beyond administration and compliance, the question that underlies the attribution of profits is: where a company conducts business through a dependent agent, which is also an associated enterprise, how should the profit – particularly the pure profit – be allocated as between the residence and state jurisdiction? Multinationals, as global but single economic entities, clearly believe that the corporate group structure offers the best prospect of generating more than a normal market investment return. Accordingly, there is no controversy around PEs being remunerated for their services to the group and that remuneration being brought with the charge to tax. The real issue is what share of the residual or pure profit should the PE attract? Carroll thought the residual profit should be allocated to the 'real centre of management', which he thought the 'most vital' for generating profits. This was assumed to be the headquarters. Thus, he thought there was no point in treating dependent agents as PEs.Following Carroll's logic, where a PE is also an associated enterprise, the compensation under Article 9 should adequately reward all the functions performed, risks assumed and assets used assumed by the dependent agent PE. This reflects the single entity or zero-sum approach (see, for example, Morgan Stanley (2007)). This means the arm's-length standard under Articles 9 and 7(2) is treated in the same way.

Something to consider is whether pure profit should be attributed to the permanent establishment and whether a dual entity or taxpayer approach would be more appropriate in a more sales-oriented source taxation paradigm.

Conclusion

The OECD has arguably failed to reform the source-state threshold. This may well be because the OECD has failed to work out the kinks in the separate legal entity principle and the attribution of profits methodology. It is arguable that the PE concept will remain problematic as long as there is no agreement as to the meaning and importance of global tax equity. Perhaps, as Eisenbeiss (2016) has argued, a formulary residual profit-split method is an effective solution. It is certainly a logical compromise between global formulary apportionment and the current position.

Question 2

This question gives students a relatively open canvas to communicate their vision of a possible future for the corporate income tax given the difficulties that it currently faces, particularly in relation to the provision of digital content across borders. Students might therefore want to focus on the possible fragmentation of the global tax system given the number of states that are or seem about to 'go it alone' in this area.

The following is one possible schematic:

Introduction

Globalisation has meant that theoretical perspectives originating in an age of more closed economies now need to be rethought. Furthermore, in relation to the exercise of state sovereignty, tax competition has been encouraged where states seek to attract foreign direct investment into their jurisdictions by offering preferential tax treatments. However, neither the cross-border supply of goods and services nor the existence of jurisdictionally-based tax incentives is, though, the most compelling problem to face the global tax system. Indeed, it might be conservatively stipulated that the digitalisation of economic activity has exacerbated the attendant problems of both globalised trade and tax competition, as well as the other problems attending the corporate income tax (CIT).

Too Abstract a Tax?

Outside of the context of value creation from digital intangibles, the CIT has often had to face attacks by economists and legal theorists due to its highly artificial nature. A corporation is a *persona ficta*, which is the first level of artifice. Therefore, even today, commentators are at a loss to understand the rightful place of the corporation in a world currently dominated by civil and political 'human' rights. This is accentuated by the emergence of hybrid entities specifically set up to handle often specific offshore transactions and the fact that even a vanilla corporation still faces the unanswered question of the final/effective incidence/burden of the CIT that it pays.

The next level of artifice is the concept of income itself. Originally, income made sense when it was embodied by rent, wages and profit. However, beyond the supply of personal services and return from fixed assets, income is now embodied by a panoply of different types of yield from a variety of forms of capital. It is, perhaps, for these reasons that two of the focal points of BEPs are on establishing a nexus and appropriate classification of returns on investment.

Digitalisation

The digitalisation of economic activity has introduced, if not another level of artifice, then at least another level of complexity. While it was difficult to sometimes establish whether an entity other than an individual was connected to a particular jurisdiction or whether a particular transaction was connected to that jurisdiction, the Internet as a medium of trade has meant these issues are now at another point removed. By way of an example, if a film is 'rented' to watch by someone in Australia from, say, Apple, which entitles them to have access to what is presumably an audio-visual file on a server somewhere in California, to what extent can it be argued that – under current norms of residence and source – that payment is taxable in Australia? And yet, Apple, and other digital content providers, clearly profit from their sales in Australia. This has led to a whole raft of commentators seeking to introduce a market or destination-based approach to the CIT, **b**ecause, quite simply, sovereign states want to receive something for the market/benefit that they have made possible for and available to large multinational corporations.

There are as many theoretical perspectives on what to do in the face of the digital economy, as there are commentators. Indeed, it is not unrealistic to state that the panoply of theoretical perspectives and counterarguments in relation to each and every one of these perspectives themselves constitute a 'big data' problem. One possible interpretation of the OECD's slow progress in this space is that they are hoping to achieve a consensus-based approach to resolving the digitalisation issue. This may be sensible because when there are so many seemingly legitimate theoretical perspectives (which is no surprise given the theoretical issues thrown up by the 'corporation' and 'income' concepts), what else can prevail other than pragmatism?

Radical Tax Reform?

While consensus building is arguably an optimal strategy for the OECD, this should not prevent the OECD from keeping abreast with, and exploring its own, perspectives on radical tax reform in this space. Two of the many such perspectives include:

- At first glance, a unitary taxation system with an allocation formula that is made up of only sales might seem to make sense. However, how does one account for information freely given by users in such a system? Is that a sale in the sense that it is some kind of barter transaction? Or is it simply a secondary incidental benefit to the firm arising from the benefit of engaging in or with that platform?

- Another perspective is that the CIT should reflect benefit theory rather than ability-to-pay. As such, there is scope for aligning corporate taxation with the resolution of societal ills that are both current (e.g. wealth inequality) and impending (e.g. resource scarcity).

Conclusion

If it does not resolve the digitalisation question to the satisfaction of member and non-member governments alike, the OECD risks fragmenting the global tax system. Perhaps, as the EU did in relation to its tax strategy in the late 1990s, the OECD could propose a twin track approach. The first track, which would be the more conservative one, would be to continue with consensus-building along the lines of incremental reform to the current CIT. The second track would offer a solution of a more radical hue (like the CCCTB was the radical track for the EU). What this would look like would have to depend on the tax policy team at the OECD. However, the important thing is not what it looks like (unless, of course, we really are facing "overreach and collapse" as a species) but that the OECD is seen to offer an alternative that has as much theoretical and practical legitimacy as can be expected from any radical reform idea. This must surely go some way to silence some of its critics.

Question 3

Introduction

Article 3(2) of the OECD MTC provides that:

> *'Any term not defined therein shall, 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'.*

Article 3(2) of the OECD MTC has its origins in the wider international public law arena and is central to the interpretation of tax treaties. It is, however, not without its difficulties when seeking to apply it. In bilateral treaties, Article 3(2) expresses the logic that the parties should be able to look to their domestic law for the meaning of a term where the treaty does not grant that term an autonomous meaning as a result of the application of its 'context'.

What Comes First?

It is a controversial matter to decide whether in the framework of Art.3(2) of the OECD MTC, the courts should first look at the context or at domestic law. The idea that the context comes first is arguable from the wording of the Art.3(2) that reference to domestic law is required 'unless the context otherwise requires'. This seems to imply context is a pre-condition to *renvoi* to domestic law. The commentary also states that the domestic law meaning only applies where the context does not require an alternative interpretation. See Commentary on Article 3(20, [12]. In international public law, *renvoi* to domestic law is rare. This also supports context coming first.

The Meaning of Context

As we have just seen, the word 'context' in the interpretation and application of tax treaties is of decisive relevance. DTAs in purpose and structure aim to reconcile the domestic law of two states, so 'context' seeks the common meaning that may otherwise be interpreted differently in both States. The 'context' also seeks to capture the intentions of the parties when signing the DTA and the meaning of the term in the other contracting state Commentary on Article 3(20), [12]. Just how broad 'context' should be is a matter of conjecture. Some argue that it should be treated broadly, comprising all evidence capable of being used as an argument for the interpretation of a tax treaty term or expression.

Neto, 2018 argues for a very broad definition and suggests that three forms of context should be recognised, namely: the intrinsic context: VCLT, Art.31(1)(2). This covers all textual elements inextricably linked to the treaty (including the treaty text, preamble, annexes, protocols, subsequent agreements concluded by the CSs and also the materials prepared in connection with the convention). the primary extrinsic context: VCLT, Art.31(3). This is evidenced in mutual agreement procedures, practices followed by the States in connection to the treaty and also similar treaties (covering not only other tax treaties but also non-tax treaties). the secondary extrinsic context: VCLT, Art.32. This is the broadest of the three, including decisions by third States' case law, doctrine, Model Convention Commentaries, preparatory works, unilateral statements about the intention of the parties regarding the treaty being interpreted, as well as all facts and circumstances surrounding the signing of the interpreted treaty.

Nogueira, 2019 suggests that too broad an understanding of 'context' might conflate the evidence that may be considered context with interpretation techniques (which simply include context as an interpretation tool).

Contradictory contexts

If the context is understood too broadly there is a chance that some forms of context will point one way and some will point in the opposite direction. This means that too broad a conceptualisation of context might lead to contradictory results.

As a result of this possible problem, Neto, 2018 argues that a hierarchical approach would resolve any such issues. He suggests a three stage approach:

1. Assess the ‘formal criteria’, which are those sources legitimised in International Law and the rules defined by the CSs.

2. Assesses the ‘functional criteria’, which might be thought of as actual treaty practices that might lead to an effective outcome (‘ut res magis valeat quam pereat’) and harmonic treaty interpretation.

3. Review the ‘material criteria’ to guide the interpreter to a ‘reasonable interpretation’.

<u>Article 3(2) Domestic Law Meaning</u>

Article 3(2) provides that where a term is undefined in the DTA, the domestic law meaning only applies where the context indicates a different meaning and where the contracting states have not specifically agreed upon a different meaning.

In 1995, the wording of Article 3(2) was amended to clarify that:

a) States that are able to enter into mutual agreements (under the provisions of Article 25 and, in particular, paragraph 3 thereof) that establish the meaning of terms not defined in the Convention should take those agreements into account in interpreting those terms; and

b) The meaning of any term not defined in the DTA may be ascertained by reference to the meaning it has for the purpose of any relevant provision of the domestic law of a Contracting State, whether or not a tax law. However, where a term is defined differently for the purposes of different laws of a Contracting State, the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws.

c) There was also a clarification that it is the domestic meaning at the time the relevant tax is imposed that is relevant (as opposed to the meaning at the time the DTA was entered into). See Commentary on article 3(2), [12].

In 2017, the wording of Article 3(2) was amended to clarify that where an agreement has been reached by the contracting states on a common meaning under an Article 25 procedure, then the domestic law meaning will not apply. See also the Commentary on Article 3(2), [13.2]. However, the Commentary on Article 25(3) also notes that countries that do not consider that the competent authorities can be given the power to agree to the meaning of a term that would prevent recourse to the domestic law meaning of that term, can exclude any reference to Article 25 in their DTAs. In terms of whether the context or domestic law meaning comes first or the context, where the context is inconclusive and there is no agreement between the contracting states as to the meaning of the term then:

1. The domestic law meaning of the contracting state imposing the tax will apply;

2. Where there is a tax and a non-tax definition of that term then the tax definition will be used (as opposed to a non-definition); and

3. an ambulatory approach to interpretation will apply in that it is anticipated that the meaning at the time the DTA is applied (as opposed to the time the DTA was entered into).

<u>Conclusion</u>

The VCLT, arguably, promotes a closely-integrated single rule of interpretation. If this is the case, then Neto’s framework, in practice, would have to make the intrinsic and primary extrinsic context have equal weight, with the secondary extrinsic context working as a tiebreaker: if the intrinsic context provides a reasonable meaning, but the primary extrinsic context provides a different meaning which is equally reasonable, then whichever meaning matches that of the secondary extrinsic evidence should prevail.

In terms of the order of application of context and the domestic law meaning, Article 3(2) provides that where a term is undefined in the DTA, the domestic law meaning only applies where the context indicates a different meaning and where the contracting states have not specifically agreed upon a different meaning.

Question 4

One approach to answering this question would be to try and separate harmful tax competition from 'beneficial' tax competition. Students can either adopt the view that beneficial tax competition is the residual after harmful tax competition has been accounted for, or they can seek to outline those elements of tax competition that might be considered beneficial.

The following is one possible schematic:

Introduction

Broadly speaking, tax competition is the use of any feature of a state's tax system to enhance its attractiveness in the market for financial capital. Tax competition has important effects on taxpayers and states alike. Because domestic tax systems vary considerably, taxpayers are prone to exploit these differences to their advantage. Supranational efforts to curb tax competition are a response to what is commonly referred to as harmful tax competition. This is in the face of the view of some commentators that the effects of tax competition may not in fact be that harmful. Indeed, some commentators believe that tax competition has a net beneficial effect on the efficiency of the global tax system.

Tax Competition

Tax competition is where a state uses its tax system to attract and hold investments, business activity or assets. This may involve tax rates, tax base, the administrative system, transparency, disclosure, information sharing, and special credits, exemptions and deduction.

Tax competition also refers to the pressure to reduce the level of tax charged in respect of certain types of income, commodity or activity to the levels prevailing in other countries.

Some commentators think of tax competition as an uncooperative but interdependent process. Other commentators conceptualise tax competition as one aspect of a broader form of competition for economic activity between states (other forms of competition include security of ownership, access to resources and regulatory climates).

Still other commentators consider it to be a competition for taxing rights. Competition to have profits reported in a particular country, without any associated movement of production.

Harmful Tax Competition

The OECD 1998 Report emphasises harmful tax competition but does not distinguish harmful and beneficial tax competition. The 1998 Report seemingly considers harmful tax competition as harmful tax practices by tax havens and as a result of harmful preferential tax regimes.

The OECD considers tax havens to be national tax systems with:

- no or only nominal taxation on income (generally or in special circumstances) and the system offers itself or is perceived to offer itself, as a location which non-residents can use to escape tax liabilities in their state of residence;

- laws or administrative practices preventing the effective exchange of information with other governments on taxpayers benefiting from the no or nominal tax (e.g., bank secrecy rules). This is because such bank secrecy rules limit the access by tax authorities to the information required for the correct and timely application of tax laws;

- lack of transparency in the operation of legislative, legal or administrative provisions; and

- the absence of a requirement that the activity in the location is substantial. That is, transactions may be booked there without the requirement of adding value so that there is little real activity in the location. These locations essentially serve as 'booking centres' for purely tax-driven investments or transactions.

The OECD considers harmful preferential tax regimes to be the raising of revenue from their income tax but with harmful targeted tax incentives. The factors used in identifying potentially harmful preferential tax regimes are national tax systems with:

- low or zero effective tax rate on the income in question (very low schedule rate or low effective tax rate because of the way a state defines the tax base to which the rate is applied);

- 'ring-fenced' system as it only applies to non-resident and the domestic economy is insulated from the spill-over effect of such system;

- lack of transparency in administration of the system including negotiable tax provisions, administrative practices not generally available; and

- lack of effective exchange of information on the system, i.e. ability and willingness of a state to provide tax information to other states (e.g., bank secrecy laws; absence of annual general audit requirement for companies; no requirement for a public register of shareholders).

The OECD also lists other factors that might be present in a harmful preferential regime:

- artificial definition of the tax base;
- failure to comply with international transfer pricing principles;
- a system that exempts all foreign-source income from tax;
- negotiable tax rate or tax base;
- the existence of secrecy provisions;
- access to a wide network of tax treaties; and
- systems promoted as tax minimisation vehicles.

Commentators, however, have distinguished harmful tax competition on the basis that it:

- is targeted tax reduction granted only to foreign investors.
- promotes tax evasion as opposed to tax avoidance.
- is tax competition for portfolio investment and paper profits.

<u>More Recent Developments Regarding Harmful Tax Competition</u>

Whilst there was some initial pushback following the work of the OECD in the late 1990s and this resulted in a relatively quiet period from a policy perspective, the OECD picked up the HTP baton once more with earnest as a critical feature of the BEPS Actions and specifically Action 5.

Action 5 is one of four BEPS minimum standards, which means that work that results from its implementation is subject to peer review. Action 5 is split into two aspects: (i) identification of features of preferential tax regimes that can lead to BEPS and (ii) increased transparency through automatic exchange of information.

The OECD published a Harmful Tax Practices (HTP) report in January 2019 (candidates are not required to reference this report in their answers but it is referenced here to act as a guide for future candidates) that serves as an update to the 2015 BEPS Action 5 report and the 2017 Progress Report. The 2019 report contains the results of review of all BEPS Inclusive Framework members' preferential tax regimes that have been identified since the BEPS Project. The Inclusive Framework also agreed on a new standard for "substantial activities" (SA) requirements for no or only nominal tax jurisdictions. The SA requirements were originally set out in the 1998 work on HTP but had never been applied.

Conclusion

Tax competition, arguably, concerns both the formulation of tax policy and the operation of tax laws in an increasingly integrated world economy and attempts to eliminate *all* forms of tax competition may be conceptualised by some as global harmonisation by stealth. What is clear from the literature is that a better understanding of tax competition is needed so that a better understanding of the possible harmful effects of tax competition can be critically analysed. The extent to which the work of the OECD / G20 can effectively regulate tax competition can also only be measured and analysed following agreement on the nature of tax competition and of its harmful aspects. One clear advantage of the manner in which the OECD is tackling the issue from BEPS Action 5 is that there is now a huge amount of information about not only the type of tax rules countries introduce and the activities taxpayers with cross-border dimensions engage in available for analytical purposes. However, the precise line between competition and harmful competition may remain elusive for some time to come.

Question 5

Introduction

The Action 6 Final Report (2015) states that treaty shopping typically involves the attempt by a person to indirectly access the benefits of a tax agreement between two jurisdictions without being a resident of one of those jurisdictions.

Treaty shopping results in treaty benefits being afforded to residents of a third jurisdiction in a way the parties did not intend. This breaches the principle of reciprocity and upsets the balance of concessions between the CSs.

In its most egregious form, treaty shopping may result in the non-taxation of income.

Treaty shopping means that the state of residence of the ultimate income beneficiary has less incentive to enter into a DTA with the source jurisdiction, because residents of the jurisdiction of residence can indirectly receive treaty benefits from the jurisdiction of source without the need for the jurisdiction of residence to provide reciprocal benefits.

Pre-BEPS Approaches

In 1977, the beneficial owner concept was introduced into the passive income articles to clarify the meaning of "paid to" and to deal with situations where income is paid to an intermediary resident of a treaty country who is not treated as the owner of that income for tax purposes (e.g. agent or nominee).

In 1977, the Commentary on Art.1 was updated to include a section on the improper use of tax agreements.

In 1986, the CFA published "Double Taxation and the Use of Base Companies" and "Double Taxation and the Use of Conduit Companies".

In 2002, the CFA published "Restricting the Entitlement to Treaty Benefits".

In 2003, the Commentary (Art.1) included sample provisions that states could use to counter treaty shopping.

Domestically speaking, states have tried GAARs (purpose test) and SAARs (legal nature, ownership, and general activities) to tackle treaty shopping.

The BEPS Approach

Action 6 (Prevent Treaty Abuse) calls for the development of treaty provisions to prevent the granting of treaty benefits in inappropriate circumstances. Action 15 provided the means to do so. The MLI came into force as of 1 July 2018 and now covers over 80 jurisdictions.

The Action 6 Report sets out one of the minimum standards namely that jurisdictions commit to include in their tax treaties provisions dealing with treaty shopping to ensure a minimum level of protection against treaty abuse.

Action 6 is not just about anti treaty-shopping provisions; it is about putting an end to treaty shopping.

The Action 6 Minimum Standard

The minimum standard on treaty shopping requires states to include two components in their tax agreements:

- an express statement on non-taxation (generally in the preamble); and
- one of three methods of addressing treaty shopping.

The minimum standard does not provide how the above components should be implemented (i.e. through the MLI or amending instruments).

The minimum standard recognises that any provisions need to be agreed bilaterally and that a jurisdiction will be required to implement the minimum standard when requested to do so by another member of the Inclusive Framework.

The express statement

Action 6 (final report) at [22] and [23]: jurisdictions have agreed to include in their tax agreements an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements.

This now appears in the 2017 OECD MTC:

> *Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)*

Addressing treaty shopping

Jurisdictions have also committed to implement that "common intention" through the inclusion of treaty provisions in one of the following:

- a principal purpose test (PPT) equivalent to Art.29(9) of the 2017 OECD MTC together with either a simplified or a detailed version of the limitation on benefits (LOB) rule that appears in paragraphs 1 to 7

- the PPT alone

- a detailed version of the LOB rule together with a mechanism (such as a treaty rule that might take the form of a PPT rule restricted to conduit arrangements, or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties.

Implementation

The Inclusive Framework – with more than 120 members – is monitoring and peer reviewing the implementation of the minimum standards, as well as completing the work on standard setting to address BEPS issues. Some members of the Inclusive Framework have no DTAs in place.

The MLI, through the PPT, is the recognised primary route for Inclusive Framework members to implement anti-abuse measures. As yet, there are no agreements that comply with the minimum standard but this is due to change. The majority of states that have signed the MLI have listed almost all their treaties under it. However, at least seven jurisdictions forming a part of the Inclusive Framework have no comprehensive tax list.

Care should be taken in comparing one jurisdiction with another. While some states have made progress towards implementing the minimum standard, they might still pose a greater treaty shopping risk than a state that has not signed the MLI. An agreement between certain jurisdictions that merely lacks the modern preamble might present only a small risk of being used for treaty shopping, even though the agreement may not fully implement the minimum standard.

A jurisdiction that has done all it reasonably can to have its tax agreements meet the minimum standard could have signed the MLI, listed all its agreements, and be actively pursuing its treaty partners for bilateral negotiations where there was no match under the MLI. A jurisdiction that has not done all it reasonably can to have its tax agreements meet the minimum standard could still be considering what steps to take or could still be waiting for bilateral approaches to change its agreements.

Conclusion

Action 6 of BEPS concerns treaty abuse. Taxpayers that engage in treaty abuse effectively claim treaty benefits that were not originally intended to be available in those circumstances. Treaty shopping is a form of treaty abuse and Action 6 is all about putting an end to it. Tackling treaty shopping is one of the four BEPS minimum standards and states have committed to DTA provisions to ensure a minimum level of protection against it.

PART B

Question 6

The following is but one of a number of approaches that could be adopted when answering this question.

The following is one possible schematic:

Introduction

There are two sections below that each address the two main aspects of the question:

1. Determination of taxing rights over Marai's profits; and
2. The policy context surrounding the determination of said taxing rights.

Allocation of Taxing Rights

There is a need to consider Articles 3 and 8 OECD MTC 2017. Candidates could also note that where the relevant activity falls within Articles 3 and 8, Articles 5 and 7 do not apply and therefore Article 8 trumps Articles 5 and 7.

Candidates can note that the tie-breaker test for non-individuals was changed in the OECD MTC 2017 (from place of effective management (POEM) to a determination being made by mutual agreement) and also to the manner in which profits arising from international shipping and air transport will be allocated (from the State with the company's place of effective management to the State of the enterprise). Article 8(1) and Commentary, [2]. The result is that there is no specific need to consider the location of Marai's POEM. Rather where the relevant activities fall within Article 3 and Article 8, Mostland has the right to tax all the relevant profits as it is the most likely state to be "Contracting State of the enterprise" based on the facts.

Specific reference should be made to Article 3(1)(e) (and its Commentary) and the definition of "international traffic" found therein.

According to Article 8, Mostland has the right to tax profits derived by Marai from "international traffic", air / ship traffic within its borders and also that occurring within third countries.

The Commentary can be referenced to determine whether the activities of an enterprise fall within the relevant definitions e.g. the Commentary on Article 3 states at [6.2] that a "ship or aircraft is operated solely between places in a State in relation to a particular voyage if the place of departure and place of arrival are both in that State." This Commentary can be relied upon to determine whether profits which arise from journeys (a), (b) and (c) are relevant profits for the purposes of Article 8.

However, the Commentary also provides that where aircraft (as part of the same voyage) first flies between a place in Mostland to Novaland (leg one) and then flies from the Novaland location to another location in Novaland (leg two), both legs of the journey will fall within the definition of "international traffic". See Commentary on Article 3 [6.3]. The fact there is a connecting flight does not stop "leg two" from falling within the definition of "international traffic". In this way the definition in Article 3 is wider than the general definition of international traffic as it involves traffic that does not cross a border. Candidates should consider this aspect when considering whether flights (a), (b) and (c) fall within the definition of international traffic. The Commentary on Article 3 [6] should be referenced in this regard. See also Palente (2013).

In this case Mostland will have the right to tax any profits derived by Marai from sales made by the Novaland agent that are for travel wholly within Mostland under the Mostland / Novaland DTA (i.e. category (a) flights above) and may have the right to tax any profits wholly within Otherland (i.e. category (c) flights above). There is no mention of a DTA between Otherland and Mostland and as such this cannot be referenced herein. Furthermore, it is unclear whether (c) flights (travel within Otherland) form part of a journey that began in Mostland or in Otherland.

Students could note that as a result of Article 8's application there is no need in this case to consider the nature of the relationship between the Novaland agent and Marai in respect of these flights, as would have been the case were Article 5 and 7 to apply to the scenario.

Although Mostland has the right to tax (a) and possibly (c) profits, it does not have the right to tax the profits arising from sales of flights taking place wholly within Novaland – where these are not included in the "leg two" style flights outlined above - under Article 8 (1) as such flights do not fall within the definition of "international traffic" in Article 3. Accordingly, Novaland is therefore likely to have the primary right to tax profits arising from (b) flights. See Commentary on Article 3, [6.4]. However, where the flights taking place within Novaland constitute part of a journey that began originally in Mostland, then Article 8 would apply ("leg two").

Candidates may reference the reservations on Article 8, where some states have reserved the right to include purely internal flights in the scope of the provision (e.g. Candad, Hungary).

The allocation rule in Article 8 applies not only to the profits directly obtained from ticket sales but also to profits obtained from activities that are not directly connected with these sales provided these other activities are *ancillary* to the operation of Marai's airline business. The Commentary provides some guidance as to the meaning of both "directly connected" and "ancillary". See Commentary on Article 8(1), [4]-[4.3]. Where the activities are considered to be ancillary then profits from these activities will be taxable only in the state of the enterprise, i.e. Mostland. However, it is possible that Novaland would object to such an interpretation, see Greece and Portugal's observation on this article where they reserve their position with regards profits arising from ancillary activities.

Therefore, according to the Commentary on Article 8, [8.1] although the advertising fees may not be considered to be directly related to Marai's international traffic operations, these are derived from an activity that is *ancillary* to the operation of Marai's aircraft.

There is no mention of Marai being involved in a joint business or international operating agency (as mentioned in Article 8(2)). Such practice is generally more common in the shipping industry but airline operators may enter pooling arrangements for the purpose of reducing the costs of maintaining facilities needed for the operation of their aircraft in other countries. See Commentary [10.1]. Where this is the case any profits from such activity will fall within Article 8(2) and therefore with the "State of Enterprise" allocation rule.

<u>Policy</u>

As well as considering the allocation of taxing rights as applied to the facts in the scenario, students could consider why it is that there is a special rule for the air and shipping industries. Reference could be made to the work of the League of Nations which discussed with the shipping industry the reciprocal exemption of profits that existed within, inter alia, the USA and UK at the time (1924).

The League of Nations' 1923 Report on Double Taxation considered a number of approaches to resolving the double taxation of enterprises whose vessels may have connections with numerous states: origin; situs; enforceability; domicile. They stressed the need for a universal accepted definition of residence to be researched and proposed such that incidence of dual residence could be eliminated or at least reduced.

Originally the state in which the "real central management and control" was situated was to having the sole taxing right but over time this was changed to "place of effective management" and then most recently to "State of the enterprise" in OECD MTC 2017. Throughout, the principle of one country having a sole right to tax relevant profits has remained.

Reference could also be made to the fact that the League of Nations considered it to be difficult to apportion the shipping industry's profits as their companies often operated in a number of countries. This view continues to be echoed in submissions by relevant industries on tax policy (e.g. Qantas' submission to the OECD by Mark Bradford, General Tax Manager, where it is stated that the airline industry is complex and international in its nature and benefits, from a compliance perspective, from the manner in which taxing rights are allocated in the airline profits article, see Bradford, 2008.)

The reason for changing the nexus to profit from the state in which the enterprise has its place of effective management to the State of the enterprise appears to be a response to a review of treaty practices of both OECD and non-OECD countries.

Question 7

It is anticipated that candidates will approach this question in a variety of ways. Whilst it is important that candidates communicate that they have a clear understanding of the work of the OECD/G20 in relation to hybrid entities (and, in particular, BEPS Action 2), candidates may also reference approaches adopted by countries at the domestic taxation regime level to support points made in their discussions of relevant parts of BEPS Action 2.

Without detailed of knowledge of Countries A and B, candidates cannot provide detailed guidance as to the types of changes, if any, that should be made to their tax regimes. Rather candidates should draw some general conclusions about the types of changes they might advise Countries A and B to consider in the circumstances and should highlight areas that need to be addressed before a decision involving amendments to legislation is reached.

The following is one possible schematic:

Introduction

- Work on Hybrid Mismatches is the focus of BEPS Action 2.

- Action 2 considers approaches to dealing with both hybrid entities and hybrid instruments. The question only considers hybrid entities and as such no discussion of hybrid instruments is required.

- Hybrid entities are defined in Action 2 as "[…] *entities that are treated as transparent for tax purposes in one country and as non-transparent in another country*."

- Potential consequences of hybrid entities include: (i) deduction, non-inclusion of income (e.g. interest deduction in one country and non-inclusion of interest income in the other) and (ii) double deduction (where a deduction is claimed in two countries related to the same contractual obligation).

- The question requires a consideration of entity classification and resultant tax treatments of certain payments across borders. As noted by Ludicke (2014) entity classification represents a choice made by sovereign governments, and it is unrealistic to expect international alignment of entity classification.

- Action 2 puts forward a recommended approach to hybrid entity scenarios, which involves countries making changes to their domestic law.

- Countries A and B will need to consider BEPS Action 2 and changes already made by some countries in this area. These changes may take place at the domestic and / or treaty level.

Possible Changes to A and B's Tax Regimes

- BEPS Action 2: Action 2 recommends specific and more general rules.

- Specific rules include: denial of a dividend exemption in respect of deductible payments made under financial instruments; filing and reporting requirements for transparent entities; and amending CFC (and similar) rules such that investor income is brought within the charge to tax in the investor's jurisdiction (Action 2, Chapters 2-5).

- More general rules are contained within Action 2: (i) double deduction (ii) deduction / non-inclusion of income.

- BEPS Action 2 also considers some of the pitfalls that rules should avoid such as ensuring that double taxation does not result from the exercise and interaction of anti-hybrid rules.

- Countries A and B will need to consider the likely impact of adopting either or both sets of rules. Points for them to consider are outlined below.

The rules need to be drafted narrowly and in a way that limits double juridical and/or economic taxation. Connected with this is the view that taxpayers should not be punished due to the navigation of deficient or uncoordinated tax systems (Ludicke, 2014).

Domestic anti-hybrid rules (as envisioned by Action 2) are a type of linking rule and in this way are considered by the OECD to be similar to foreign tax credit rules, subject to tax clauses and CFC rules (Action 2, 2015).

The rules should focus on *permanent* as opposed to *temporary* double deductions or deduction/no income scenarios. A multi-year approach to analysing payments should be considered.

There may be a need for countries to consider the interaction between any anti-hybrid rule (whether primary or defensive) and those of other countries.

From a treaty perspective, countries with exemption with progression systems for overseas dividends may need to consider the impact of any anti-hybrid rules (Action 2, Part II) as well as the potential impact of non-discrimination rules on the recommendations in Part I, Action 2 (see Part II). Part II, Action 2, does not consider that any issues will arise where domestic anti-hybrid rules are properly worded.

There is a need to ensure that the *disregarded deductions rule* applies only where the deduction is allowed under domestic law and not where another rule prohibits or otherwise restricts the availability of a deduction.

There is a need to consider whether changes in value (such as forex fluctuations) are ignored for the purposes of anti-hybrid rules. Action 2 considers they should be.

There is a need to be clear about which rules are prioritised, i.e. it will not always be necessary to use the hybrid mismatch rules where other rules (perhaps in the other jurisdiction) may neutralise the mismatch.

There is a need to ensure that different accounting periods and different approaches to the timing regimes of countries' tax systems do not form the focus of the anti-hybrid rules (see Action 2, Chapter 3).

There is a need to consider whether excessive deductions (that are restricted due to the operation of anti-hybrid rules) should be carried over (in the same manner as net losses) and set off against dual inclusion income arising in that period.

There is a need to ensure that the definition of expenditure relates to deductions that are disregarded (i.e. deductions are to be disregarded in respect of expenditure on income as opposed to on capital account).

Candidates may wish to mention the treaty related rules as these relate to hybrid entities, Part 2, BEPS Action 2.

Examples of (Domestic) Anti-Hybrid Rules

Australia announced rules in 2017 that came into effect on 1 January 2019 for structured arrangements and will have effect for all arrangements as of 1 January 2020. These essentially focus upon: deduction/non-inclusion mismatches ('D/NI') where a payment is deductible in one jurisdiction and non-assessable in the other jurisdiction; deduction/deduction mismatches ('D/D') where the one payment qualifies for a tax deduction in two jurisdictions; and imported hybrid mismatches where receipts are sheltered from tax directly or indirectly by hybrid outcomes elsewhere in a group of entities or a chain of transactions.

The EU's Anti-tax Avoidance Directive (ATAD) took effect on 1 January 2019 and implements the BEPS Actions as well as bringing in rules on exit taxation and EU anti-abuse rules. ATAD introduces a minimum standard with some aspects being optional. Included within its scope are rules on hybrid mismatches. More specifically, ATAD 1 included rules applicable between member states and ATAD 2 (now replacing ATAD 1) extends the scope so as to include rules applicable between member states and third countries. The purpose of this is to ensure that the ATAD rules are as consistent as possible with BEPS Action 2.

The USA has proposed regulations that have been described as implementing the single tax principle in a similar manner to the EU's ATAD (Avi Yonah, 2018). Two new sections (section 267A and section 245(e) TRA 2017) address a number of hybrid related issues. New section 245A(e): (i) prohibits "hybrid dividends" from being eligible for the participation exemption, which is available under new section 245A for corporate shareholders who have at least 10% shares / voting rights in a Controlled Foreign Corporation (CFC); (ii) requires an automatic subpart F inclusion for "hybrid dividends" received by a CFC; and (iii) provides that where the dividend is a hybrid dividend, no foreign tax credits or foreign tax deductions are available with respect to said dividend.

New US section 267A, limits the deductibility of payments on hybrid instruments and also limits deductibility of interest and royalty payments to hybrid entities. A hybrid transaction is defined as any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for U.S. tax purposes but are not so treated for purposes of the tax law of a specified recipient of the payment. The focus is on the payment as opposed to the underlying instrument that gives rise to the payment.

The US regulations are considered to reflect a broad endorsement of core principles outlined by the OECD's work on "hybrid mismatch arrangements." Accordingly, it is likely that these regulations will be interpreted in the context of the OECD's work in this area.

Conclusion

At a more specific level, there is a need for countries to consider how they implement Action 2. Some considerations are noted above under "*Possible Changes to Country A and B's Tax Regimes* above i.e. Countries A and B will need to determine the consequences of introducing general and specific rules and what specifically their objectives are in introducing such rules.

At a general level, there is a need for countries that have, as yet, not implemented any anti-hybrid rules to consider not only the work of the OECD but also the rules that have already been implemented by other countries. Furthermore, countries that have implemented such rules will need to monitor the ways in which other countries have determined to implement the work of the OECD.

It is expected that income will be taxed somewhere (with rules for pickup of income in ultimate source or residence countries, if not elsewhere). There is a view that a global minimum tax on corporate income may be implemented, with a coordination rule to ensure that double taxation does not arise. Companies are therefore likely to spend considerable time determining where the most advantageous tax location is, albeit taking into account potentially more complex sets of rules to navigate**.** Whilst it is too early to determine exactly how much more revenue will be collected (due to the value of deductions denied), following the introduction of the above mentioned style of rules (although there is some data that in at least some countries the tax gap is reducing due to improved compliance by MNCs quite possibly as a result of the BEPS Actions more generally and that in Australia the denial of deductions over the period 2016-2019 has resulted in significantly increased revenue collection and that it has been predicted by the Australian Revenue Authority (ATO) that over the next decade approximately AUS$25 bn. worth of interest deductions will not be claimed (McIlroy, Australian Financial Review, 2019), it appears that the business of tax arbitrage is still very much alive.