

Answer-to-Question- 3

To: Government Department
From: Tax Advisor

Introduction

The Report is analyzing the main tax considerations for countries when considering options for nexus tests under double tax agreement. The issue is relevant for negotiating new double tax agreement, as this will directly impact on the allocation of taxing rights between the Residence and the Source jurisdiction. The analysis will first explain the main nexus tests and then delving into potential future options that countries could agree when negotiating a tax treaty. It is fundamental that principles agreed and negotiation would match country political landscape and economic development. This is relevant to guarantee stability and certainty to taxpayers and tax authorities and relevant bodies.

First of all, it's important to delineate the main definition of the nexus test. Indeed, the nexus test is a subjective / objective analysis aimed at defining the right to tax according to specific connecting factors. For instance, a company resident of a jurisdiction is treated like that because 1. it is registered/incorporated in that jurisdiction 2. it has the control in that jurisdiction. 3. It has the place of management in that jurisdiction. On the other hand, permanent establishment is the main nexus to tax non-residents operating in another jurisdiction with physical presence and other factors defined by Art 5 OECD MTC. Modern PE (digital PEs) however are most of the time not requiring physical presence and therefore the traditional PE concept would not be sufficient to assess the right to tax. To mention another nexus, OECD Pillar 1 is selecting as nexus the user base/customer base of the Group to allocate taxing rights.

Historically, the OECD Model Tax Convention has been based on the residence as main nexus test to tax individuals and companies. As detailed in Art 4 (1) of the OECD MTC, a resident of a Contracting State is any person who, according to the domestic law, is liable to tax by reason of domicile, residence, place of management. It's important to notice that only residents would be eligible to benefit from DTA (as mentioned in Art 1 OECD MTC). Article 4.1 refers to domestic tax to assess the residence. Indeed, different countries might have different interpretation of residence (registration, place of management, control). In case of 2 (or more) countries claiming the residence of a taxpayer, before 2017, the POEM tie-breaker was considered. However, after 2017, as stated in Art 4 (3), the POEM tie-breaker has been replaced by MAP. Therefore, in case of doubt of the residence, jurisdictions might agree between them with MAP procedure on the residence of a taxpayer. This example shows that the soft law / hard law are evolving (particularly due to digitigalisation, remote working, globalisation) and traditional nexus rules have to adapt accordingly to ensure that companies are taxed according to the value generated.

<u>Main considerations</u>

As requested by the Report at hand, below the main considerations that two countries might consider when negotiating a tax treaty, with particular reference to the nexus tests:

Generally speaking, two countries negotiating a new double tax agreement have to look at the status of development of their economy: indeed, countries which are developed might likely select the OECD MTC as framework to prepare their treaty (with rules more in line with Residence Taxation). On the other hand, two developing countries might opt for UN model MTC as framework for their treaty. On the other hand, in case of a negotiation between a developed economy and a developing economy, the countries might choose a compromise to avoid that the developing country will be penalized. For the following considerations, let's assume that Country A = Developing Economy and Country B = Developed Economy

Regarding the nexus tests, countries might consider the following. For the case at hand, it is considered the negotiation of Art 5 --> Permanent Establishment which is the cornerstone in terms of nexus criteria to be defined in order to allocate taxing rights

1. **Type of business:** more traditional business (in country B)would likely keep as nexus traditional PE based on physical presence. Digitalised business would likely to redefine the concept and link PE to presence of software, server (with strict application of preparatory and auxiliary activities triggering PE)
2. **Stage of maturity of tax authorities:** if the tax authority of country B is not developed in terms of capacity, likely nexus test would be linked to recover cash in the source country with application of withholding tax. If the tax authority is developed in terms of capacity, the nexus test would likely be more flexible.
3. **Presence of tax beneficial regime:** if country B (developed) is using IP regime, it is important that the nexus will be linked to the substance, presence of IP in order to obtain the benefit. No substance would likely trigger the PPT (if included in the DTA) and potential deny any benefit deriving from the treaty.

It's important to note that BEPS 2.0 has introduced the P1 provision (still to be finally agreed with the purpose of implementing it in the treaties in the future). The nexus test from this new paradigm would not be anymore linked to the residence but to the consumer / user base of the Group. Residence can be still a driving factor to determine the country with the right to tax worldwide income and as backbone of CFC rules. However, new nexus tests may prevail and also considered in the future to allocate right to tax in the negotiation of treaties. For instance a nexus test for a PE would not be based anymore based on the physical presence but on the number of user in the second jurisdiction in which the company is selling through its digital platform. There will be a shift in paradigm to make sure that value created by MNE (now in a less traditional way) is taxed fairly according to the substance and the effective value created in a jurisdiction.

Conclusion

Different options are available for nexus tests under double tax agreements. Historically, residence (based on POEM) and traditional PE (based on physical presence) were considered to be the main nexus to right tax. The tests used were traditional principles which are attached to the previous century (for instance, for a PE the test is based on the physical presence, while for residence, the test is based on the POEM). While these instruments still remain effective and still in place, it will be relevant that in the future other tests will be considered such as the number of users, the number of clicks from a server in a certain jurisdiction and the customer base.

Answer-to-Question- 1

Intro

The question is asking about the function of the PPT and the OECD MTC 2017 will be taken as reference in order to reply.

The Principle Purpose Test (PPT) is an anti-abuse measure targeting abusive (non-genuine) structures set up by the taxpayers with the main purpose of obtaining a benefit from the treaty.

The PPT has the purpose to identify artificial arrangements agreed by taxpayers with the sole purpose of obtain unwarranted benefits (such as double non taxation, deduction without inclusion) or shift the profits to low or nil-tax jurisdictions.

Rule

The PPT is covered by Art 29 of the OECD MTC which explains the procedure to apply it correctly to entities or structure which potentially lacks business rationale. The PPT is also included in the Multilateral Agreement (MLI) in the Artt. 6-7 as minimum standards to be implemented in the Covered Tax Agreements which 2 Jurisdictions decide to cover with the MLI provisions. The PPT is a quantitative test based on which tax authorities can deny treaty benefits based on the fact that a structure has put in place with genuine intentions and with the purpose of triggering tax avoidance. The PPT has been included in many double tax treaties already to substantiate the web of anti-abusive rules existing nowadays to contrast abusive arrangements. The PPT is not based on objective criteria, but more on overall review of the substance, the business rationale, the functional analysis, the review of the conditions of the structure, the agreements and the nature of the business. Contrary, the LOB clause is based on objective criteria (ie

linked to a specific test linked to personnel, publicly listed entity etc in order to allow the election to treaty benefits). Other anti-abuse clauses are the GAAR (domestic general anti-abuse rule) and the SAAR
(specific anti-abuse rule) which is targeting specific arrangements.

The most important article related to PPT is Art 29.9 of the OECD MTC 2017 which provides that States may deny treaty benefits towards the application of the PPT test if based on the review of facts and circumstances, the obtaining of the benefit from a treaty (reduced WHT) is the only reason for which the arrangement is in place.

Therefore, the PPT has the main function to tackle treaty shopping (abusive deployment of treaties with the purpose of obtaining teary benefits) and structures put in place only to obtain a treaty benefits without proper genuine commercial reason. Therefore, MNEs must carefully review structures (substance, arrangement) to avoid that benefits will be denied.

Example

For instance, as an example, Company B (Resident in Country B) is a subsidiary of Company A (Resident of Country A). B pays a royalty for the right of using a certain IP legally owned by A. Subsequently, after receiving the royalty payment, Company A upstreams the Royalty to Company C in the same day as part of the intercompany arrangement. The DTT between A and B does not include a WHT for royalties. However, with the PPT, the benefit will be likely denied because the structure artificial and Company B is not the ultimate beneficial owner of the royalty. Therefore, the benefit will be denied and the royalty payment will be exposed to full domestic (B) withholding tax (assuming no treaty in place between Countries B and C).

Application

Despite the PPT rule would seem coherent to apply, on the other hand, soft law and hard law (including jurisprudence) has also shown cases showing the practical difficulties to apply PPT. For instance, in Alta Energy Case (involving Lux and Canada) for a sale of capital gain, the taxpayer won. The DTA between Lux and Canada didn't include PPT clause and the taxpayer structure the transaction with the ordinary interpretation of Art 13 related to Capital Gain. The PPT was not applicable and the domestic GAAR was not sufficient to tackle the argument of the taxpayer. Also, the PPT is based on subjective criteria and the taxpayers would likely implement structures (ie minimum personnel, residence certificates). It's important the OECD/G20 still drives the application of the PPT and its implementation in treaties. In this regard, PPT would have also to interact with the interpretation rules of the Vienna Convention as this would also impact.

Conclusion

The PPT is a valid and useful anti-abuse tool used by taxpayer to tackle artificial arrangements. Indeed, with its implementation in Article 29 of the OECD MTC and in the MLI (as minimum standards), most of the countries are slowly implementing its application and future jurisprudence (in favor of PPT application) would also facilitate its implementation. However, with the digitization, mobile management, remote working, new nexus rules, and the new paradigm from BEPS 2.0, it will be essential that PPT (also due to its subjective nature) would adapt to the evolving scenario to target future tax planning strategies.

Answer-to-Question- 2

Intro

The issue raised by this question is whether the fact that double tax treaties based on a OECD/UN framework "template structure" can be seen still as positive (as requesting minimal negotiations under the blueprint of the Convention), or if this excessive reliance on templates would undermine the legitimacy of the double tax agreements.

In other words, it is questioned if double tax agreement would be considered as a legit instrument (ie. legit = enforceable, practically applicable, valid to tackle practical cases involving two jurisdictions) being merly the result of minimal negotiation / derives from a common template.

The critical review of this statement will consist in the review of the facts and circumstances, the positive and negative impact on the double tax treaties and a conclusion.

Rule

To effectively reply to this question, the analysis would proceed on some concepts that directly impact on the review of negative / positive aspects of the statements.

As main line to critically reply to the question, it is important to delve into the jerarchy of the DTA in the legal system.

First of all, the application of DTT in domestic jurisdiction depend on the type of system applied in the domestic jurisdiction:

a) Monist (Civil Law): DTA implemented in the domestic law once the DTA is ratified and the instruments of ratifications are exchanged between the two countries. In the monist systems, the DTA is considered international tax law and prevails over domestic law.

b) Dualist (Common Law like US): DTA implemented in the domestic law once the DTA is ratified and agreed through Parliamentary steps. In the dualist systems, the DTA is still considered international tax law and practically is not above the domestic law. Indeed, it is common in dualist systems to see "treaty override" phenomenon, where domestic law is overriding principles established in the Treaty. Treaty override can cause double taxation.

Secondly, a Double Tax Treaty must be interpreted according to the Vienna Convention, particularly with reference to Artt 31-33 on the general rule of interpretation. A treaty has to be interpreted in good faith in accordance with the "ordinary meaning", in their "context" and in light of its "object/purpose".

Thirdly, the current tax system is changing and flexibility would be key. New concept of nexus, digitalisation, new jurisprudence, new tax framework (OECD 2.0, Pillar One, Pillar Two, New Commentary to the OECD MTC in 2025) requires careful consideration.

Critical review

a. Arguments in favor of using OECD / UN Model as template

1. Standardization: the OECD/UN model are the result of lengthy negotiations between OECD/G20 and representatives of the countries. It also includes Commentary (frequently updated) which are giving clarity on the application of border line cases. As such, the OECD MTC should be considered as a valid template which should lead to minimal and genuine negotiations. Any deviation from a common template/blueprint would create massive misalignment between jursidictions and from a DTA to a DTA creting inconstencies, room to exploit loopholes in the treaties and potential double taxation.

2. Use of reservations, observations and positions as options: even through the OECD/UN model is a template, Countries have the right to express "reservations", "observations" and "positions" (at least in the OECD MTC), which are already addressing the direction at negotiation stage.

3. Certainty: negotiating a treaty is a political act as a result of participation of a jurisdiction to the global economy and in cross-border investment. Therefore, treaty negotiations should start anyway from a common ground to give certainty to taxpayers and tax authorities.

b. Arguments against using OECD / UN Model as template

1. Lack of appeal for developing jurisdiction: two jurisdictions, particularly characterised with lack of administrative resources, would find difficult to apply in practice a complex infrastructure developed to target cross-border investment originally from developed countries (in proportion). However, developing jurisdictions may rely on UN model which is more in favour of the source country.
2. Difficulty to target specificities (business/law) of a jurisdiction:
3. Lengthy application / binding: new nexus rules (P1) would require a long process of negotiation to be implemented in treaty. Although, the MLI instrument would likely facilitate the implementation of specific measures in the treaty system, some countries could still face difficulties and prefer to negotiate in order to meet the characteristics of their domestic tax system.

Conclusion

Based on the analysis above, the main question addressed is whether a double tax agreement would be considered as a legit instrument if it is the result of minimal negotiation and derives from a common template. In my opinion, yes the double tax agreement is still a legit instrument despite minimal negotiations (driven my model based drafting). Indeed, the, a DTA constitues the backbone for allocating taxing rights between two countries. However, in light of the current geopolital landscape / digitalisation / disruption to traditional structure and nexus, it is fundamental that tax treaties are not negotiated throughly and not just with minimal negotiations based on good ties between two countries and relying on the model.

Indeed, minimal negotiations might result in further issues later (particulary for more disruptive matters like PE, passive income, PPT/LOB) leading to suspension / conclusion of the DTA originally agreed (possible under article 60 of the VLCT and Art 32 of the OECD MTC). Considering the negative effect on the growth of a country/ countries derived by the suspension of a DTA, it is essential that deep negotiations happen, still on the base of the Model Tax Convention (UN/OECD). It is also important that Countries rely on traditional instruments (like the VLCT) for the interpreation of the treaties, to the more recent BEPS Actions, ATAD directives, new version of Commentaries (ie last December 2025), to determine the points a treaty requiring more in depth negotiations. The old paradigm of relying on quick negotiations would not be effective anymore. New paradigm would include consistent and coherent negotiations under the line of the OECD MTC/UN.

Answer-to-Question- 5

<u>Report for Scenario A and Scenario B</u>

Scenario A

Intro

The Scenario A is covering a case of a Company (SC) incorporate in Country S and operating a freight business (transport of goods/commodities) between two countries by way of ship (for the sea transportation) and trucks (for the road transportation). Routes are scheduled three times per week.

SC is operating between ports of two countries (S and T). SC has customers (buying delivery services) in Country T.
On the other hand, SC provides:
1. **Sea Carriage:** From Port S to Port T (by ship)
2. **Onward Delivery:** From Port T to Destination c in Country C

It is noted that 1. and 2. are invoiced separately by SC.

Analysis

The analysis will consist in the review of DTA, the category of income determined, and the allocation of taxing rights between the countries. In case of multiple right over the same income, it will be discussed how to allocate them to avoid double taxation.

1. DTT Review

Country S and T have a DTA in place identical to the UN Model DTA.

2. Delineation of the cross-border flows and application of the UN Model DTA

The Transactions at hand are two: 1. Sea Carriage and 2. Onward Delivery.

2.1. Sea Carriage qualifies as "international traffic" under Art 3.1.d of the UN MTC, according to which International Traffic means tranport by ship between two different jurisdiction. International traffic is further covered in Art 15 of the UN MTC
2.2 Onward Delivery Service qualifies either as business profit (Art 7) or Fees for technical Services (Article 12A). Considering that the mere transport does not qualify as a consideration for managerial, technical or consulting service, the onward delivery would likely qualify as

Business Profit. Potential risk of Service PE due to the physical presence (personnel driving trucks) in Country T. According to Art 5.3 of the UN MTC, indeed, the term PE encompasses also "the furnishing of service, by an enterprise through employees or other personnell (..), but only if activities of that nature continue within the contracting state for a period or periods aggregating for more than 183 days (...)

3. Delineation of the income and right to tax / allocation of taxing right.

3.1. Sea Carriage --> Art 8 --> 2 Options possible --> Option 1: right to tax the income in the Residence Country of the Company, meaning that the <u>income deriving from Sea Carriage will be taxed in Country S</u>. Indeed, based on Article 8.A. of the OECD MTC, the profits of an enterprise of a Contracting State (S) from the operation of ships in an international traffic shall be taxable only in that state (S). Therefore, income from international traffic is taxed in S.

3.2. Onward Delivery Service --> Art 7. However, considering that the SC schedules three times per week routes in Port T (3 time per week = 12 days per month --> 144 days in one year). However, assuming that the trip from the Port T to the Destination in T lasts 2 days (to go and come back) --> the presence will be extended to 6 days presence per week, which will trigger a Service PE of SC in Country T (>183 days). <u>Therefore, the income allocated to the Service PE (likely cost plus for transport services) will be taked in Country T.</u> Depending on the system in place (following domestic rules and application of 23A, 23B), Country S will exempt the income already taxed in Country T from its worldwide calculation (full exemption) to avoid double taxation.

<u>Conclusion</u>

Based on the analysis above, income from international traffic is taxed in S (Sea Carriage) in A, while income from Onward Delivery Service is attached to Service PE and therefore taxed at source in T with exemption granted in S.

Scenario B

<u>Intro</u>

- Leila (individual L-Resident), works as pilot for AF Corp (N resident)
- AF transports passengers between L and M
- Leila is paid USD 300,000 by AF.

<u>Analysis</u>

The analysis will consist in the review of DTA, the category of income determined, and the allocation of taxing rights between the countries. In case of multiple right over the same income, it will be discussed how to allocate them to avoid double taxation.

1. DTT review

Countries L, M and N each have DTAs whith the others that are identical to the OECD MTC 2017.

2. Delineation of the cross-border flows and application of the UN Model DTA

The Transaction at hand is the payment of the compensation by AF to Leila. Leila is employed by AF. Thus, her salary is covered by Art 15 OECD MTC --> Income from Employment.

3. Delineation of the income and right to tax / allocation of taxing right.

According to Art 15.3, "remuneration derived by a resident of a Contracting State (Leila-L) in respect of an **employment,** as member of the regular complement of a ship or **aircraft** operated in **international traffic (..)** shall be taxable only in the first mentioned State" This is an exception to the standard rule of taxing the employee where the employment is actually exercised. This exception has been added in 2017. As the aicraft is involved in international traffic (between L and M) and both Countries apply the treaty (no risk of inconsistent application), this exemption applies in this case.

Therefore, the salary of Leila will be taxed in L, her resident State.

<u>Conclusion</u>

Leila is an individual and the salary paid by AF. The aircraft operates international traffic and the income falls under the exception covered by Art 15.3 for the income paid to member /crew of aircraft.