THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2022

MODULE 1

SUGGESTED SOLUTIONS

PART A

Question 1

There are a number of ways to approach this question and the following provides one possible schematic.

Overview

The quote suggests that the MLI has some features that will benefit governments, businesses and citizens, as well as the international tax system as a whole. Whilst it is not clear whether the statement is made in relation to OECD governments, businesses and citizens, the fact that the quote was made in 2020 and the Inclusive Framework, which was formed in late 2015, at the very least formally involves non-OECD members in the various projects involving BEPS related matters means it is possible to interpret the quote more widely than just referencing the OECD governments, businesses and citizens. Whether candidates interpret the quote widely or narrowly, there is scope for a consideration of the extent to which it can be said that the MLI has: (i) reduced the burden on countries having to renegotiate their tax treaties; (ii) resulted in more certainty and predictability for businesses; (iii) produced a better-functioning tax system; and (iv) benefited the world's population. Should candidates choose a narrow interpretation, their answers will consider the benefits from the perspective of a smaller sub-set of countries, businesses and people. Answers should begin by describing the MLI as a means of providing context for their subsequent analysis.

The MLI

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) is a multilateral treaty that enables jurisdictions to swiftly modify the operation of their double tax agreements (DTAs) to implement BEPS related measures designed to better address multinational tax avoidance and more effectively resolve tax disputes (Alschner 2019). DTAs modified by the MLI are referred to as covered tax agreements (CTAs). The MLI is a multilateral opt-in treaty that up-dates CTAs in substance and procedure in order to reduce double non-taxation (Alschner 2019). As explained below, the MLI allows countries to determine which of the MLI's provisions will amend the provisions of which of their CTAs. DTA partners may also submit the "synthesised version" of their CTAs. According to the OECD,'s Matching Database, 99 countries have signed the MLI as at August 2022 (with both Thailand and Vietnam signing in 2022) and 21 of these have yet to ratify the MLI. By May 2020, the OECD reported 1,680 matched CTAs (OECD, MLI Information Brochure, May 2020).

The Journey

The MLI was recommended as part of the BEPS 2013 Action Plan. It was recognised there was a need for certain measures to be implemented by way of timely modifications to the existing DTA network. Action Point 15 recommended the development of an MLI within two years and, by February 2015, negotiations with more than 100 countries on the MLI had begun. These negotiations ran until November 2016, with the MLI being signed in June 2017 and entering into force on 1 July 2018. For individual countries, the MLI enters into force on the first calendar day of the month after three months of their deposit or ratification, acceptance or approval of the MLI (OECD, MLI, Information Brochure 2020).

Mechanics

Countries that sign the MLI are required to identify which of their DTAs will be modified by the MLI. Both DTA partners need to identify their DTA as a CTA in order for that DTA's operation to be modified by the MLI. In the event that only one jurisdiction (or neither jurisdiction) identifies a DTA as a CTA, the provisions of that DTA will remain unmodified. Each country is required to notify the OECD Secretariat of its set of provisional choices (referred to as their MLI position) at the time of signing the MLI and to confirm these choices at the time of ratification. Countries' MLI choices are uploaded to the OECD website with links to the synthesised texts of the relevant CTAs, where these have been provided by both signatories (e.g. UK/Australia) or by only one signatory (e.g. the Netherlands/Israel where only the Netherlands had provided the synthesised text as of August 2022).

MLI as a creature of International Law

The legal mechanics underlying the MLI are inspired by general international law. According to the Vienna Convention on the Law of Treaties (VCLT), Art.30(3), a later treaty will prevail over an earlier one covering the same subject matter provided all parties to that later treaty are also party to the earlier one. Art.30(3) is a conflict rule, which means the later treaty does not amend, suspend, or supersede the earlier one, but rather displaces it to the extent that the earlier treaty is incompatible with the later agreement. Differently put, the later treaty coexists with the earlier agreement, albeit in a hierarchical relationship (Alschner 2019). This legal relationship between existing DTAs and the synthesised texts of the CTAs as modified by the MLI is of central importance to the MLI's function.

Burden of bilaterally re-negotiating these treaties

Outside an MLI context, changes to DTAs occur by way of bilateral negotiation and the negotiation process may take considerable time and require significant resourcing. Countries cannot practically negotiate more than a few DTAs per year (Brauner 2020). It is therefore unsurprising that, given the need for certain BEPS related measures to be implemented via DTA changes, the size of the DTA network (approx. 3,000 DTAs) and the length of time and resourcing required for DTA negotiation on a bilateral basis, a recommendation for a multilateral treaty was made in 2013 as a key aspect of the BEPS Action Plan. The MLI is "a creative solution to square bilateralism with multilateralism" (Alschner 2019). It should be noted there are other methods of streamlining the DTA negotiation process such as parallel (or bulk) tax treaty negotiation whereby, in the case of emerging economies, groups of countries with similar economies could agree to sign a DTA with a particular OECD country that has different economics (Falcao 2021).

More certainty and predictability for businesses

The MLI adds complexity to an already complex area of tax law but it operates in a way that is perhaps less burdensome than it could have been. The co-existence of the MLI and DTAs creates additional complexity as CTAs are not formally altered. Rather the text of CTAs is unchanged but must be read in light of any modifications introduced by the MLI. Whilst this has been somewhat ameliorated by the publication of synthesised CTA texts and the various resources available on the OECD's website, the compliance cost associated with this additional layer of complexity cannot be underestimated. The compliance cost is borne by governments and businesses as they allocate resources to the task of determining which DTAs are CTAs that are "MLI modified" and which provisions apply in a given scenario. The speed with which the MLI was introduced and with which widespread uptake has been witnessed can be described as assisting the certainty and predictability of DTA changes to implement BEPS measures for businesses (and governments alike). However, it is far from clear whether these changes will be final changes or whether as some predict the MLI is the first step towards far greater multilateral changes to the international tax landscape (Brauner 2021). Compliance costs may apply directly to businesses both established and not established in countries that have "MLI modified" CTAs.

Whilst many countries have signed and ratified the MLI, this is not true of all countries. The USA has not signed the MLI because its existing domestic provisions are sufficiently similar to those in the MLI. Given the significance of the US economy, not signing supports a conclusion that the existence of the MLI itself may not necessarily create more certainty and predictability for businesses. There was a significant amount of feedback during the process that a number of the MLI provisions would increase compliance costs and suggestions that government should not adopt the provision. (e.g. Inland Revenue NZ, Base erosion and profit shifting – Policy reports, Cabinet papers and regulatory impact assessments, NZ 2017).

Better functioning international tax system

It is too soon to assess whether the MLI has resulted (or will result) in a better functioning international tax system. Also, it is far from clear what constitutes a functioning international tax system. If the MLI is successful at curbing BEPS and does so in a way that is consistent with the following points, perhaps it can be viewed as having been improved.

- It generates much needed revenue for countries at the lower end of the income scale.
- It does not stifle business innovation nor generate large compliance costs.
- It does not generate large compliance costs for businesses and governments alike.
- It has brought about an irreversible inclusion of non-OECD members to the international tax dialogue table.

If, on the other hand, these outcomes do not manifest, it may be harder to justify the added complexity brought about by the additional layer of extensive legal analysis required to effect the MLI changes.

The distributive articles are not directly impacted by the MLI, which was a key contributor in the uptake of the MLI (Broekhuijsen 2017). The limited focus of the MLI adds further complexity without addressing what some would consider to be a central issue with DTAs: the allocation of the international tax base.

Benefit to citizens

The expectation is that signing the MLI will result in BEPS activity being reduced. Thus governments may anticipate greater (or at least not lower) revenue. It is yet to be seen how this will play out. What can be said is that the OECD's move towards inclusion by way of the Inclusive Framework has been described as a positive step and one that will benefit citizens of countries that may not have previously been involved in the design of an international tax system that directly impacts their ability to raise revenue. However, there is concern that the Inclusive Framework is at best only formally inclusive. Noting that not all OECD members signed the MLI, Brauner lists four groups amongst the original MLI signatories. He notes that the first two groups – (i) 35 OECD members plus Costa Rica (a candidate member) and (ii) non-OECD members that are effectively committed to BEPS in a similar manner – dominated the MLI process. First movers were predominantly OECD members. Later movers (lower income countries) made little strategic impact. The first movers appear not to have been negatively impacted by the later involvement of lower income countries.

EOI has been described as being of central importance to the development of co-operation and ultimately the development of the international tax regime. Yet its importance to countries of different economic wealth is not uniform. EOI is of particular relevance for wealthier countries whose residents invest significant amounts overseas. It is less relevant for lower income countries, who are more interested in source taxation and what investment happens in their countries (Brauner and Pistone, 2015).

Conclusion

Candidates can conclude by summarising their key points and ultimately stating clearly whether they consider that the statement in the question to be reflective of the current position. There are arguments either way and it may be too soon to know whether the MLI has triumphed. If it is the case that outdated treaties contribute to inconsistent interpretations and facilitate treaty shopping and abuse, all of which are at the heart of the international tax regime's current legitimacy crisis (Alschner 2019), then arguably the MLI may have helped improve the international tax regime's legitimacy at least in the meantime. The MLI has co-ordinated some things (e.g. there is support for the view that the adoption of the minimum standards will result in high uniformity across the DTA network). As at April 2022, 99 signatories had accepted the application of the principal purpose test in order to fulfil the minimum standard on DTA abuse (Bravo 2022). A further consideration is whether the MLI constitutes the end of the road in terms of significant multilateral efforts to co-ordinate tax systems or if it is merely a significant first step towards further changes.

Question 2

There is no one correct way of answering this question.

A good start is defining juridical double taxation (JDT) and differentiating it from economic double taxation (EDT). Thereafter candidates could outline a number of differing approaches to relieve JDT. Candidates might consider both unilateral methods of relief, as well as referencing the relevant articles within the OECD MTC 2017/UN MTC 2021. Whilst no mention is made of Manualia's existing system of relief, if any, nor of Manualia having entered into any DTAs, candidates may "read this in" or otherwise explore the possibility of Manualia entering into DTAs that feature the relevant OECD/UN MTC article(s) where they do not "read this in".

Within this discussion it would be expected that candidates would consider the various options open to countries' considering the appropriateness of a given method of relief from JDT. Candidates may also consider the differing types of income and how tax systems often apply a combination of double taxation relief (DTR) based on the type of income at issue. In terms of policy considerations, there are numerous ways to address these, one being a discussion that includes: capital export neutrality, capital import neutrality and national neutrality (other types of neutrality are also considered below). Candidates may conclude by providing a summary of their discussion and whilst there is no requirement to suggest a preferred approach, it is open to candidates to reflect on the benefits/disadvantages of different methods of DTR.

Introduction

At a general level, JDT refers to the inclusion of the same income in the hands of the same taxpayer in the tax base of one or more countries. By contrast, where the same income is included in the tax base in the hands of different taxpayers this is referred to as "economic double taxation" (EDT). Whilst the focus of the question is JDT, EDT may occur within a country's tax system (e.g. where there is no imputation system) but also in the international context (where there is no provision for the underlying tax paid on profit distributions or where transfer pricing adjustments made by one country's tax administration do not correspond with those made by that of another country on the profits of an enterprise that is associated with the enterprise that has profits that have been subject to an adjustment). On the other hand, JDT typically arises in an international context:

- a country A resident company is subject to tax on its worldwide profits in country A (including its Country B profits) and Country B subjects Country B profits to tax such that the Country B income (where defined in a similar way in both countries) is subject to tax in Country A and B

- where a branch of Country A resident parent company operates in Country B and Country B adjusts the profits attributable to the branch (where it satisfies the definition of a permanent establishment) and Country A does not adjust the Country B profits it includes in its tax return there is scope for JDT as the branch and the parent (that are part of the same legal entity) may be subject to tax in both Country A and B.

Policy Reasons for Addressing DTR unilaterally and through DTAs

JDT is a potential barrier to international trade and investment flows and thus it plays a vital role in facilitating investment flows and thereby benefitting countries' economies. Historically, JDT was not a huge concern as countries' tax rates were relatively low. However, the rate increases both during and after World War One (whilst war levies were subsequently removed, tax revenue was much needed and rates on company profits were 20% in the UK and Germany and 15% in France), meant countries began to address the issue of JDT. It was recognised that preventative measures could "lighten the drag on international trade and the circulation of capital" (Carroll, 1927). The approaches at the time were various and included unilateral, bilateral and collective measures. Ultimately, the League of Nations addressed these issues. Candidates need not delve into the history, save that the justification for DTR has remained fairly constant over time.

Typically, a cost benefit analysis will be undertaken by the relevant government body of the country seeking to introduce DTR unilaterally and/or where this forms part of its entering into a DTA with a relevant DTA partner. One change that could be drawn out is that, at a general level, DTR is viewed as a "benefit" or even a "concession" and the design of tax systems at both the domestic and international level has increasingly considered the availability of such a benefit only to those taxpayers that are the "intended" targets of these benefits. Thus, it can be seen that access to DTR may be limited either by domestic rules or DTAs. Accordingly, any discussion of DTR availability will be likely to include a consideration of how to ensure such benefits are only accessible to the intended beneficiaries.

Candidates may refer the Manualian Government to the following economic principles, which, if adopted, may impact the method of DTR implemented:

- Capital Export Neutrality (CEN) is a public finance concept that refers to the situation where international tax policy is designed in such a way that a resident has no incentive or disincentive to invest in or outside its state of residence. As we will see when we consider the credit method below, CEN is realized when the amount of tax that a resident must pay on their worldwide income to their state of residence is the same whether they invest in the state of residence or outside of the state of residence. CEN is considered to be desirable as it facilitates the expansion of the resident state's residents into foreign markets. The idea behind CEN is that the tax expense of investing in a country should not feature in that resident's decision to invest in a particular country (whether it be home or overseas). However, CEN is more difficult to realise when the rates of the residence state are lower than those in the state of foreign investment. Furthermore, CEN can only be achieved when either a full credit is provided or an ordinary credit is granted by a state that has a tax rate higher than the state of investment.

- Capital Import Neutrality (CIN) is a public finance concept that provides that investments within a country should be subject to the same level of taxation regardless of whether those investments are made by a resident or a non-resident. States that wish to ensure that all investment within their countries is treated equally for tax purposes generally exempt all overseas income from their tax base. In other words, they exempt all overseas income of their residents from taxation and only subject to tax the domestic source income of residents and non-residents.

- Capital Ownership Neutrality (CON) is evidenced when international tax policy does not influence who owns assets. In other words, international tax policy satisfies CON when the ownership pattern of assets is efficient. This is based on the view that the ownership of assets affects the productive use of those assets and therefore international tax policy should not distort the decision to own assets. Hines further adds that CON may result in advances in national welfare (Hines, 2009). Adoption of CON may result in an exemption of foreign source income approach.

- Market Neutrality (MN), the overriding objective of which is to produce a result where two residents compete with each other in the same market, they should face the same overall effective tax rates. By being subjected to the same effective tax rate, the theory is that competition between the two firms is not distorted.

- National Neutrality (NN) focuses on the need for a state to maximize its own national interest. NN operates to effectively disincentivize its residents from investing overseas. States that wish to ensure that their residents maximize their investment domestically frequently adopt the deduction method of relief from double taxation. National neutrality has its critics. It is considered that adopting states are focused on the advancement of their own economies at the expense of non-residents, who are considering investing within their borders. The main difference between CEN and NN is the way in which overseas taxes are treated under the respective states' tax regimes. CEN is indifferent as to which state (residence or overseas) receives the tax revenue, as long as the overall tax burden for their residents is the same irrespective of the location of their investment whilst NN focusses on the tax value added to their own government.

Different Methods of JDTR

Deduction Method

Whilst the deduction method is more similar to the exemption method than the credit method (as it focusses on the stage before the tax rate is applied to the income of the taxpayer), it still operates in a distinct manner to the exemption method. The deduction method does just what the name implies: it provides a deduction against assessable income for foreign tax paid. This means the foreign tax paid is treated just like any other allowable business expenditure. Clearly, this method cannot fully relieve double taxation and it is not recommended by the OECD as a form of relief.

Exemption Method

Like the deduction method, the exemption focuses on the income derived as opposed to the tax payable (as is the case with the credit method). In other words, instead of reducing the amount of tax payable by the resident, the reduction in income brought within the resident state's tax net reduces the amount of income that is ultimately subject to tax. Where a resident state operates an exemption system, the resident state excludes from its tax base income derived from overseas. The exemption method has variants with some countries using full exemption and others using "exemption with progression". Some countries fully exempt some types of overseas income and subject other types of overseas income to exemption with progression. Exemption with progression involves the resident state including the exempt overseas income in their residents' tax returns but only for the purposes of determining the relevant tax rate (where that state has adopted a progressive rate structure) that is to be applied to their residents' taxable income (i.e. the income that is to be subject to tax where this income excludes the relevant overseas income).

Credit Method

Unlike the exemption and deduction methods of relief, the credit method focuses on reducing the tax payable by its residents as opposed to reducing the income derived by their residents. Countries seeking to adopt DTR method that also adopt a worldwide basis of taxation often use the credit method: Residents with foreign source income include that foreign source income in their tax return of their resident state. The relevant income tax rates are then applied to the resident's worldwide income. Once the tax liability has been calculated, the resident may be granted a tax credit in relation to the foreign tax paid / liability on the income derived overseas. There are often eligibility criteria associated with the availability of a credit for foreign tax paid / liability (the fact the amount of foreign tax must have been paid being a common criterion), which may include that the foreign tax is of a similar nature to the domestic tax (or is covered by the relevant DTA) and limits may be placed on the amount of the credit (i.e. it can be no larger than the domestic tax that would have been payable had the foreign source income been derived in the resident state). This type of limitation is described as resulting in an "ordinary credit" being available as opposed to a "full credit", which would cover the full amount of the foreign tax paid even where the non-resident state imposes tax at a higher rate than the resident state.

It is possible for a state to provide a credit for foreign tax to which their resident is initially liable but due to the regime of the overseas jurisdiction that resident has not actually paid (often due to the availability of tax incentives in the overseas jurisdiction). Where a resident state provides a credit in these circumstances the credit may be referred to as a "tax sparing "credit. These are controversial. Those who support them cite it being in the interests of countries at lesser stages of economic development to set their own tax policy agenda (including enabling investors into such economies to access the incentives that these countries have sought to introduce to attract their investment) without this being undermined by the lack of availability of tax credit in the resident state (due to the foreign tax not being paid). Those who do not support them consider that they do not increase foreign investment in the longer term (i.e. beyond the incentive period). Art 23B is the relevant article of the OECD MTC that provides the details of the mechanism for the credit method under a DTA but this article will often work in conjunction with domestic law provisions detailing the calculation mechanism, etc. for the credit.

Residence, Territorial Systems and Neutrality Considerations

Countries with territorial tax systems often depend on the exemption method as the primary means of DTR though its use for certain types of income is commonly found in tax systems that tax residents on a worldwide basis (Larkins, 2001). In contrast, countries that rely on the credit method, tax both the income derived at home and overseas but permit their residents a reduction against their tax payable, which is representative of the foreign tax paid and thus reduces their overall income tax payable (Larkins, 2011). As noted above, the manner in which the credit and exemption methods operate varies across countries and countries are likely to select a particular variant depending on their overall policy objectives:

the ordinary tax credit is often correlated with capital export neutrality in that the object of the ordinary credit is to ensure that all investment (whether made in the resident state or not) faces the same tax consequences, which in turn is considered to "neutralise" the impact of tax considerations when residents are considering investing overseas (i.e. exporting capital); and
the exemption method is correlated with capital import neutrality in that the object of the exemption method is to ensure that all investment into its country (whether made by a resident or a non-resident) faces the same tax consequences, which in turn is considered to "neutralise" the decision to invest into that particular country.

Conclusion

Without tax rates and tax bases being the same across all nation states it is impossible for CEN and CIN to be achieved simultaneously. CEN and CIN are necessarily incompatible. A report by the American Bar Association on International Tax Reform (2006) reviewed the various neutrality policies and concluded that there was insufficient evidence to reach a consensus that any of the neutralities provided certainty as to the USA's potential welfare gains and losses (Shay, 2009). The exemption method is considered to be easier to apply (Molenaar, 2005) but has always been described as leaving open opportunities for double non-taxation. Increasingly states are moving towards exemption systems in relation to certain types of overseas income (such as from business profits of subsidiaries that are being repatriated or overseas income of their temporary residents where this is considered to be an incentive to move or invest in a particular jurisdiction). This increased use of the exemption method also features alongside increased attempts at closing "double non-taxation" or "reduced taxation" loopholes across countries in large part as a result of the BEPS Actions.

The credit method has also faced criticism, being described as overly complicated. On the plus side, it is associated with reduced opportunities for double non-taxation (or reduced taxation) relative to the exemption method. However, and as noted above, this method may not fully relieve double taxation (e.g. where only an ordinary credit is provided and tax sparing credits aren't available).

In sum, the debate as to which international tax policy should prevail is still very much alive and is well-documented in the literature. The MRA will need to consider a large number of topics and have at the forefront of its decision-making the policy outcomes it seeks to achieve in order to weigh up the benefits/disadvantages of introducing a system of double taxation relief. The MRA will also need to consider whether it will effect this system unilaterally or will also enter into DTAs. Where it considers the latter it will need to factor in the various commitments that entering into a DTA involves and carry out a thorough cost benefit analysis that includes the potential impact of the MLI if it chooses to sign the MLI. Furthermore, and when the time comes, the MRA may also need to consider whether BEPS 2.0, a priori the possibility of a multilateral convention being entered into in respect of Pillar One, may also impact any aspect of JDT relief it may determine to provide.

Question 3

There may be a number of ways to answer this question but candidates' answers should include an overview of BEPS Action 1; Pillar One and in particular Amount A; as well as the exemption for regulated financial services. Whilst there is no requirement to reference the July 2022 Progress Report nor the October 2022 Progress on the Administration and Tax Certainty Aspects of Amount A of Pillar One, it is anticipated that answers would refer to relevant OECD work in this area up to and including "Public Consultation Document, Pillar One – Amount A: Regulated Financial Services Exclusion", released in May 2022.

Overview

Pillar One is a reference to one of two Pillars that were originally established as part of the OECD's work on the digital economy (BEPS Action 1). More specifically, Pillar One envisages a formulaic reallocation of residual profits that the largest multinational enterprises (MNEs) earn in countries where their consumers are located even if those MNEs lack a permanent establishment therein (Johnston, 2022).

Broadly:

- Amount A is a reference to the "in scope" profits of in-scope MNEs; and
- The exemption for regulated financial services (RFS) is a reference to a specific carve out from Pillar One.

Both Amount A and the exemption for RFS are considered below.

The following considers the backdrop to the exemption for regulated financial services by briefly considering BEPS Action 1 and a number of relevant developments since 2015.

BEPS Action 1

BEPS Action 1 (Final Report, 2015) addressed the tax challenges of the digital economy and noted a number of features of the digital economy including:

- the mobility, reliance on data, network effects, spread of multi-sided business models, a tendency toward monopoly or oligopoly and volatility are key features of the digital economy and its business mode;

- that it encompasses a wide range of business models in the digital economy e.g. e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading and online payment services.

Of particular relevance is the statement in Action 1 that "[b]ecause the digital economy is increasingly becoming the economy itself, it would be difficult, if not possible to ring fence the digital economy". This provides some context as to why it was recognised that there was a need to continue to monitor the area as the potential solutions identified could involve changes to the tax framework that go beyond those required by BEPS (Patel, 2015).

2016-2021

Various Action 1 related "milestones" are released, including: Interim Report in March 2018, a Public Consultation in February to March 2019 (and also in November (Pillar One) and December (Pillar Two) 2019), a "Blueprint of Pillar One and Two" in October 2020. Various statements were published in 2021, including Statement on a Two Pillar Solution to Address the Tax Challenges Arising from the Digital Economy, 8 October 2021 (with the agreement of 137 members of the Inclusive Framework) and Global Anti-Base Erosion Model Rules (GloBE) in December 2021.

2022

Developments in the area of the digital economy are ongoing with 2022 delivering, inter alia, a Commentary to accompany the GloBE Model Rules in March 2022; a Public Consultation on (i) the Progress Report on Amount A of Pillar One (July 2022 Progress Report) and (ii) the Administration and Tax Certainty Aspects of Amount A of Pillar One (October 2022 Progress Report).

Pillar One and Amount A

Whilst consultation on Pillar One is still ongoing, a recent progress report (OECD July 2022) sets out the broad approach to determining "Amount A" (i.e. when a market jurisdiction can tax profits of an "in scope" MNE) and the administrative approach (October 2022).

Amount A implementation requires a multilateral convention (MLC) and Amount B involves the determination of a fixed return for baseline marketing and distribution activities in market jurisdictions in line with the arm's length standard and tax certainty mechanisms. Also, countries agree to remove unilateral measures that target digital activity and refrain from introducing new ones (Johnston, 2022).

It is anticipated that Pillar One would reallocate 25% of in-scope multinational enterprises residual profits (profits exceeding 10% of revenue) to jurisdictions in which they have a nexus using a revenue-based allocation key. The October 2022 Progress Report, includes administrative rules that have been released for public consultation for the first time and "do not reflect the final agreement of the Inclusive Framework".

Amount A

Amount A involves a new taxing right that is described by the OECD (OECD, Progress Report July 2022):

- applies to a portion of the residual profit of large and highly profitable enterprises (i.e. Amount A) for the benefit of jurisdictions in which goods and services are supplies or consumers are located (hereafter "market jurisdictions");

- operates as an overlay to the existing profit allocation rules, and therefore includes a mechanism to reconcile the respective different profit allocation systems and prevent double taxation; and

- includes improved tax certainty processes that bring increased certainty for enterprises on Amount A and matters related to Amount A.

Exemption for Regulated Financial Services

The OECD Secretariat Proposal for a Unified Approach under Pillar One 2019, was to consider three proposals and select one by 2020. The need to consider whether carve-outs for financial services were warranted was noted at this time. The OECD Blueprint, October 2020, described fintech as finance enabled or provided by new technologies i.e. the application of new technologies to financial services. The difference between regulated (falling within the exclusion) and non-regulated fintech companies was noted as was the fact that many countries' regulations in the fintech space are at an early stage of development.

Pillar One exempts both extractive industries and regulated financial services (RFS) from its scope. The justification for the exclusion of RFS appears to be due to the fact that this industry sector is already subject to capital adequacy requirements that reflect a company's risks (OECD Public Consultation, May 2022) and that are considered to align with those entities' economic activity.

Amount A is to be determined on the basis of a number of steps, which involve excluding relevant revenue and profitability derived by RFS from "in scope" revenue and profitability from the revenue and profitability thresholds. The exemption is currently stated to apply to seven types of RFS (depositary institution; credit institution; investment institution; insurance institution; asset manager; mixed financial institution and RFI service entity) each of which must display three elements to qualify as being "out of scope": (a) a licensing requirement, (b) a regulatory capital requirement, and (c) activities requirement. The activities requirement involves an MNE, which falls within one of the seven categories, being "out of scope" for the purposes of Pillar One where its total gross income that is attributable to "permitted activities" is more than or equal to 75% of the group's total gross income for the period. There are modifications for certain types of RFS, e.g. a depositary institution activities threshold will be achieved where at least 20% of the liabilities of the MNE consist of deposits as at the balance sheet date for the period.

The October 2022 Progress Report briefly refers to the exemption for RFS (e.g. the discussion of Article 13, Content of the Amount A Tax Return where it is noted that information will be needed to be provided for the purposes of determining what amounts fall under the exclusions and references are made to RFS and groups).

<u>Support for Exemption for RFS</u>

There is wide support from business for the exemption. The issues raised appear to have been on expanding the entities that fall within the exclusion and not the impact of excluding financial service providers from Amount A. Many of the reported justifications involve: highlighting the special nature of financial service provision in that the financial reporting differs from other types of reporting as trading revenue is reported net of trading costs and interest net of interest expense; banks are too complex to include in Pillar One due to their vast and potentially linked transactions, large numbers of separate entities and business lines (Devereux, 2021); capital adequacy requirements adequately matching economic activity; digital financial services are merely a substitute for an activity previously carried out manually and so nothing new and accordingly no new taxing right is created by the digitalisation of financial services (SIFMA, 2021).

There was pushback when certain categories of financial service were not initially contained within the exclusion from Amount A (i.e. initially asset management and reinsurance were not included within RFS). Numerous calls to broaden the exclusions were made during the 2022 consultation process (see submissions made on the OECD, Public Consultation Document, Pillar One – Amount A: Regulated Financial Services Exclusion, May 2022). For example, City UK, which represents UK lending and professional services firms, stated that the non-inclusion of asset management and reinsurance was arbitrary and undermines the policy rationale for the exclusion. Arguments were also made that reinsurers are already prudently regulated based on capital adequacy in a similar fashion to primary insurers and thus reinsurance should be included (USCIB, 2022). The USA supported a carve-out for reinsured and asset management from Pillar One (Wallace, 2022). These concerns appear to have been allayed, to some extent, as the most recent progress report includes asset managers as a category of RFS and also included reinsurance within the Insurance Institution category of RFS. Notwithstanding this expansion in scope of the exclusion, there are still concerns as to scope (that "the definitions set out in Section 20 of Schedule C, which are intended to encompass insurance and reinsurance, may not fully do so, because they do not include all the types of insurance policies which insurers and reinsurers are licensed to write: CIOT, 2022). Accordingly, whilst there is considerable support for the exclusion of RFS, there are still some issues that need to be ironed out in relation to scope.

<u>Concerns</u>

There are those who consider that the carve-out is too wide and undermines the intention of the Inclusive Framework's 2021 agreement. South Centre (2022) has raised concerns with the "predominance test" i.e. where the 75% threshold is met, an MNE may fall within the exclusion even though the MNE may well generate the majority of its revenue from "in-scope" activities. Furthermore, South Centre notes that as a matter of principle only the revenue from excluded activities should be removed from the Amount A allocation and recommends a 90% threshold. South Centre also noted that the rise of fintech blurs the boundaries between the tech and financial sectors and that the exclusion of financial services may also end up meaning a de facto exclusion of many digital services. South Centre also notes that the financial sector is just as responsible as the tech sector for promoting tax avoidance and so this further justifies reducing the scope of the carve-out. A further suggestion is that only the institutions that face macro-economic prudential regulation should be included in the carve-out. At a more general level, there is a concern that signing on to Pillar One for developing countries may reduce their ability to mobilize sufficient resources to meet the human rights needs of their people.

Whilst the OECD estimated that USD $125billion would be reallocated to market jurisdictions, apparently only $10 billion will be reallocated to low and middle-income countries. (UN Experts Letter reported in Johnston, 2022 and OECD, Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, July 2022)

<u>Conclusion</u>

Pillar One applies to fewer than one hundred of the largest and most profitable MNEs. It has been described as leaving in place the current defective rules for attributing the remaining profit of these in-scope MNEs, as well as for all others (BEPS Monitoring Group, 2022) and may result in a weakening of Art 9 (Pennelle, 2022). It increases complexity as the new Amount A structure sits on the top of the existing system, which is based on the separate entity concept and transfer pricing rules (BEPS Monitoring Group, 2022). In terms of the limited reach of Pillar One in its current form, candidates could cite a study that has estimated that the decision to exclude financial companies reduces the total Amount A allocation by around half (the same authors acknowledge that the differing accounting treatment of banks complicates matters) (Devereux et al., 2021). In terms of total Amount A allocation, it is also estimated that approximately 45% of the total ($39bn) would be generated by technology companies and around $28bn would be from the largest 5 US Technology companies (Alphabet, Apple, Facebook, Intel and Microsoft). The limited reach (78 out of the 500 Fortune 500 Companies are anticipated to be directly affected) of Pillar One can be contrasted with the 131 MNEs that would fall within the exclusion (RFS (121 MNEs) and extractives (10 MNEs) on the basis of the scope as outlined by the OECD in 2021, which is arguably wider in its current form. Accordingly, the exclusion of RFS clearly involves a series of very important policy considerations. As Pillar One has yet to be finalised one cannot be sure exactly of either how serious the consequences of its implementation will be nor the extent to which it will achieve its objectives.

Question 4

Candidates must ensure they consider the extent to which Art 13 is reliant on domestic tax law and the manner in which it interacts with the other OECD MTC 2017 (OECD MTC) articles. The following provides an overview of one approach to answering the question and it is anticipated that answers may adopt a number of different approaches.

Article 2 OECD MTC 2017

Taxes on gains from the alienation of movable or immovable property are expressly referred to in Art 2 OECD MTC and are therefore envisaged by the OECD as being covered taxes for the purposes of a DTA. Not all countries tax capital gains on a comprehensive basis (e.g. New Zealand) and some countries whilst taxing capital gains do not have a separate capital gains tax (e.g. Australia). Where a country's CGT provisions form part of that country's charge to income tax, and where that country does not expressly refer to CGT in Art 2 of its DTAs, it has been held on at least one occasion that those provisions form part of the income tax, which is itself a covered tax (Virgin Holdings 2006) and therefore the charge is a covered tax under the relevant DTA. Such an interpretation is also supported by the OECD Commentary, which states that "the word 'income' must be given [a] wide meaning... for the purposes of the Convention and therefore applies to the various items of income that are covered by Chapter III … including for example profits of an enterprise and capital gains" (Art 1 Commentary, [8]).

Art 2 applies to the entire gain and not just to an amount that has accrued after the entry into force of a DTA (subject to contrary provisions that could be agreed to during bilateral negotiations), even in the case of a new DTA that replaces one that did not allow such taxation (Art 13 Commentary [3.1]).

General Approach to the Allocation of Capital Gains

The right to tax capital gains on property of a given kind is the right to tax both the property and the income derived therefrom (Art 13 Commentary [4]). The result is that there is no need to have special provisions that determine whether the relevant amount is subject to Art 7 or 13. Generally, the right to tax is conferred by Arts 6, 7 and 21 to the state in which the alienator of the property is resident, unless the property is immovable or movable property forming part of the business property of a permanent establishment (PE), in which case the right belongs to the state in which that property is located (Art 13 Commentary [9]).

Art 13(1) provides the general rule that gains from the alienation of immovable property (including that forming part of the assets of an enterprise) may be taxed in the state in which that property is situated; this corresponds with Art 6 and 22(1) (Commentary on Art 13(1) [22]). Clearly Art 13 does not apply to a situation where the immovable property is situated in the residence state or in a third state (Art 13(5) would apply in such a situation). Art 13(1) is supplemented by Art 13(3), which broadly provides that gains of a contracting state that operates ships or aircraft in international traffic derives from the alienation of such ships and aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that state, which applies to gains from the alienation of shares or comparable interests that derive more than 50% of their value from immovable property (Commentary on Art 13(1) [23]).

Art 13(2) deals with movable property that forms part of the business assets of a PE of an enterprise. Here movable property is a "mop-up" category of property in that it includes all property that is not immovable property under Art 13(1) (Commentary on Art 13 [24]). Due to the nexus of the PE with the non-resident state, such gains may be taxed in the state in which the PE is situated. Where the property forms part of the business property of the PE, Art 7/22 may apply. Where however, the property is not so attributable, it falls within Art 13(5), which provides that gains from the alienation of any property, other than that referred to in paras 1 2, 3 and 4, shall be taxable only in the contracting state of which the alienator is a resident. Note that some DTAs do not contain a provision along the lines of Art 13(2) such that domestic law may be applied in an "unlimited" manner and therefore double taxation relief may only apply if granted unilaterally, e.g. Australia/Germany 1972 (Reimer 2022).

Art 13(3) provides that gains of a contracting state that operates ships or aircraft in international traffic derives from the alienation of such ships and aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that state. This is consistent with the allocation rule in Art 8.

Domestic Tax Law of Contracting State Applying the DTA

Domestic Law Treatment of Capital Gains

As alluded to above and noted by the Commentary, Art 13, [1], the taxation of capital gains varies considerably across countries. Some countries do not include capital gains in the tax base, others treat firms and individuals not running businesses differently (i.e. the former include capital gains in their tax base and the latter do not); and even where there is a charge to capital gains there are often differences in the manner the gains are subjected to tax. The OECD makes it clear that it is left to the domestic law of each contracting state to decide whether capital gains are taxed and if they are taxable how they are taxed (Commentary on Art 13 [3]).

Definition of Capital Gains

Whilst this is left to domestic law to determine, the OECD Commentary does state that the words "alienation of property" are used to cover capital gains from the sale or exchange of property and also from a partial alienation, expropriation, transfer to a company in exchange for stock, sale of a right, gift and even passing of property on death (Commentary on Art 13 [5]). The Commentary also notes that although subject to domestic law, gains arising from a steady improvement in economic conditions as well as those accruing in a very short period are covered (Commentary on Art 13, [11]). Art 13 is not however intended to apply to prizes in lottery or to premiums and prizes attaching to bonds and debentures (Commentary on Art 13 [19]).

Timing

Many countries tax capital gains on a realisation basis. However, this is not true of all countries and as such it will be for the relevant domestic tax law to determine whether a realisation event has occurred (Commentary on Art 13, [6]&[7]). If a country taxes without the need for a realisation event (e.g. on the basis of capital appreciation and revaluation) of business assets, the OECD notes that the same principle applies to the alienation of such assets (Art 13 Commentary [4]&[9]). Austria and Germany have made an Observation and consider that where a new DTA is entered into, any capital appreciation that occurred before the new DTA was entered into continues to fall within Art 13 for the new DTA. This has the result that the new DTA applies to the capital appreciation that occurred before the DTA was entered into.

Calculation

As with other features of capital gains, the calculation of the gain is left to the applicable domestic law (Commentary on Art 13, [12]). Capital gains typically involve reducing the selling price by the cost, which is likely to include all relevant incidental costs associated with the purchase as well as any improvement costs. The fact that the tax base may be different across contracting states is acknowledged and is referred to as a "special problem" (e.g. one state may tax capital gains due to the situs of the property whilst the other state may have the right to tax because the enterprise is a resident of that state: Art 13 Commentary [13]). A further issue is that of currency gains and their taxation. The issue that arises is whether the state, which applies the exemption method, of which the taxpayer is a resident, must refrain from taxing such gains. The Commentary notes that whilst Arts 7, 13 & 23A would be applied, where there is no resolution as between the contracting states then the matter may be referred to the Mutual Agreement Procedure (MAP).

Anti-Avoidance Rules

The Art 13 Commentary considers the impact of (i) exit or departure taxes that may apply to prevent the avoidance of capital gains tax through a change of residence before the realisation of a DTA exempt gain (Art 1 Commentary [69]) and (ii) dividend stripping rules that may prevent the avoidance of domestic withholding taxes (WHT) through transactions designed to transform dividends into DTA exempt capital gains (ibid). These anti-abuse rules are subject to the relevant DTA having its intended effect and accordingly these domestic anti-abuse rules may be consistent with the purpose of the DTA as opposed to being in conflict with the relevant DTA.

Interaction with Other DTA Provisions

- Business Profits Art 7: the sale of assets produced or refined by the taxpayer do not fall within the ambit Art 13 but fall within Art 7 (Reimer, 2022).

- Dividends Art 10: an amount may fall within Art 10 (e.g. where a company redeems shares a shareholder may be treated as deriving dividend income).

- Art 11: it may be that an amount may fall under Art 11 as, whilst Art 13 may cover amounts that are not only due but caused by the alienation of the underlying asset (i.e. loan), Art 11 applies to any amount paid by the debtor in consideration of the loan is irrespective of the whether that amount if recurrent or not (e.g. Delhi High Court held that gains arising from the transfer of a compulsorily convertible debenture did not constitute interest but rather were to be treated as a capital gain: High Court of Delhi of 30 July 2014, W.P.(C.), 1648/2013 & CM NO. 3105/2013 – Mauritius DTA on Art 13 of the India/Mauritius DTA).

- Art 15 Employment Income: stock options may potentially fall under either Art 13 or 15. Typically, these fall within employment income (Art 15 Commentary [12.2] to [12.5]), as will the sale of the stock option where this is permitted. Where, however, the actual shares are sold at a later point in time, there is less of a (or no) connection between the employment and the proceeds of sale. Thus, the investor shareholder is typically treated as any other shareholder (Commentary on Art 15 [12.2]).

- Art 21 Other Income: where amounts are derived that do not fall within Arts 7, 8, 10-12, 13, 16 or 17, they fall under Art 21. Whilst there may not be many amounts that fall outside the aforementioned Arts, one potential example is life-long alimony payments in connection with an inter vivos transfer of an asset (Reimer 2022).

- Art 22 Capital: taxes on capital and capital gains tend not to overlap to any great extent, as capital taxes are typically levied on a regular, periodic basis and on the net value of the relevant asset. The similarity between Art 13 and 22 is exhibited in their structure in that they follow the same principles with regards the allocation of taxing rights (Reimer 2022).

Relief from Double Taxation (DTR)

Given that capital gains are not taxed by all states, it is reasonable to avoid only actual double taxation. CSs may specify in their DTAs that where a state is required to forego its right to tax that exists under its domestic law, this only applies where the other state makes use of its right to tax. These have been referred to as “open distributive rules” in that they assign primary and unlimited taxing rights to the source state but remain silent with regards the residence state (Reimer, 2022). The residence state must provide DTR by way of exemption or credit under Art 23A/B. This is in contrast to Art 13(3)&(5), which address both the source state and residence rights and grant the exclusive right to the residence state (Reimer, 2022). In such a case there is no prima facie requirement to provide DTR.

Conclusion

Candidates may conclude by summarising the key features of Art 13 and the extent to which Art 13 refers back to domestic tax law. At a general level, it can be said that Art 13 does not "regulate the quantification and computation of capital gains" (Reimer 2022). Furthermore, apart from the need to adopt the relevant computation frameworks in Arts 7(2) and 9 OECD MTC 2017, it is exclusively for the contracting states concerned to determine the issue (Reimer 2022). More generally, the domestic law treatment of capital gains is referred to in relation to the definition of capital gains, calculation of the relevant gain and the timing of the gain. Relief from double taxation may be available under a DTA and this depends under which paragraph of Art 13, the taxing right arises. A brief mention of the potential interaction between specific domestic anti-abuse rules and Art 13 could also be made and candidates may note that such rules may be consistent with the purpose of the DTA and may therefore be compatible with the relevant DTA.

In terms of the interaction between Art 13 and other Arts, some of the boundary issues were noted above. Given the fact that not all countries tax capital gains, some tax such gains within their existing income taxes and others have separate capital gains taxes all potentially with differing tax bases and computational rules, it is unsurprising that Art 13 is relatively clear about the allocation of taxing rights but places considerable reliance for its operation on the domestic law of the relevant contracting states.

Question 5

The following provides but one possible schematic. In terms of content, it is expected that candidates would outline the nature of CFC rules at a general level and note what mischief these rules seek to counteract: the notion of "extended jurisdiction to tax" – where a country taxes its resident shareholders on income that is derived by a foreign company that those shareholders (in)directly own by attributing the income to the relevant shareholder. Candidates might also consider the tax implications of the separate legal entity approach in an international tax context. Answers should provide an overview of different approaches to CFC rules and outline the OECD's position with regards the manner in which CFC rules interact with DTA provisions. It is expected that the relevant Commentary on Arts 1, 7, 10 (and indirectly Art 23) be considered. Candidates may conclude by summarising their view as to the compatibility or otherwise of CFC rules and DTAs. It is also open to candidates to cite examples from domestic regimes and DTAs. However, this is not a requirement.

History

CFC rules were first introduced in the US approximately 60 years ago (the 1962 rules widened the scope of the 1937 Foreign Personal Holding Company regime). When first introduced, it was understood their introduction aligned with capital export neutrality (Bussotti 2021). The US rules were tasked with preventing the deferral on the profits realised by controlled foreign entities with US shareholders. Since that time, the rules have a further focus – anti-avoidance – reducing income shifting (Vanistendael 2017).

Prevalence

Not all countries have CFC regimes. Only certain ASPAC countries have CFC rules (Australia, China, Indonesia, Japan, Korea, New Zealand and Taiwan) whilst India, Hong Kong, Singapore, Malaysia, Philippines, Thailand and Vietnam do not. Japan and Indonesia have further tightened their CFC rules since October 2015. China's proposed update to its CFC rules (set out in Sept 2015) has since stalled, though there has been a steady increase in reported enforcement cases. In Latin America, before the publication of BEPS in 2013, Brazil and Mexico already had CFC rules addressing base erosion, which are aligned with some of the recommendations on BEPS Action 3. Colombia introduced a law with CFC rules that were influenced by the BEPS recommendations in late 2016 (KPMG 2022). The OECD provides a CFC Dataset where different countries' regimes can be viewed and compared: Dataset Controlled Foreign Company Rules.

Jurisdiction to Tax

As the nature of CFC rules involves effectively looking through the relevant foreign company and asserting jurisdiction to tax over that foreign company's shareholders (i.e. a resident state (Country A) may seek to tax the foreign source income derived by a non-resident company (resident in Country B) in the hands of its resident shareholders (Country A resident shareholders)). Given that companies are not transparent entities, the formal effect of such rules is to "extend the jurisdiction to tax" of the resident state (Country A) such it includes the foreign source income in the tax base of non-residents (i.e. the company resident in Country B). This clearly conflicts with general principles of international tax whereby non-residents are not typically subject to tax on their foreign source income by the non-resident state. However, in a situation where the foreign company is controlled by shareholders who are themselves within the resident state's jurisdiction to tax (i.e. the shareholders are residents of Country A) and a substance over form approach is adopted then those shareholders can be treated as having received the income or otherwise being entitled to the income that is derived outside Country A (i.e. foreign source income of the company is attributed to the shareholders and so becomes subject to tax in Country A).

Approaches to CFC regimes

The particulars of different CFC regimes around the world are not considered. At a general level, countries may adopt a particular CFC approach and they may provide an exemption from the CFC regime for active business income generated by genuine economic activity carried on by the foreign company (e.g. ATAD Directive (Council Directive (EU) 2016/1164 of 12 July 2016). From a CFC/DTA interaction perspective, the OECD Commentary on Arts 1, 7 & 10 notes some of the more common concerns about the manner in which this type of "extended jurisdiction to tax" interacts with DTA provisions. Approaches include:

- 'Lifting the corporate veil' approach, where the CFC is treated as transparent and its shareholders are taxed on the income that the company would have derived in its own capacity "but for the" CFC rules (Bravo 2021). This approach may be used when the resident state of the shareholders exempts from taxation dividends that are received by its residents from overseas companies. The mischief that this approach seeks to prevent is the non-taxation of income (in the hands of the foreign company) when that income would have been included in the shareholder's assessable income in the resident state had the shareholder received that income directly.

- The "deemed dividend approach", whereby notional distributions of profit from the foreign company to its shareholders is assumed, i.e. the income is attributed to the shareholders by way of a "fictitious distribution" (Bravo 2021). This approach may be used when the mischief the CFC rules are seeking to prevent is deferral of income earned by and accumulated in the CFCs until distributed (Skreblin 2021).

- Less frequently countries may use a "diverted attribution approach" (DAA). Broadly, the DAA recognises the CFC as opaque for tax purposes but its income is attributed to the shareholders. This approach differs from (a) above as the DAA retains the CFC's separate legal personality and residence status but does not normally attribute losses to the shareholder (Skreblin 2021).

- Less frequently countries may use a "notional sum approach" (NSA), which involves taxing resident shareholders on the increase in value from the income derived by the CFC. This increase in value may correspond to either (i) the notional sum that corresponds with the portion of the CFCs profit calculated based on the state in which the shareholder is resident or (ii) the notional sum that corresponds with the fair value of the participation in the CFC (Skreblin, 2021).

- The USA operates the Passive Foreign Investment Company Regime, introduced in 1986.

<u>Double Taxation</u>

For territorial systems (Germany, France, Spain), the main focus is on ensuring that double taxation on foreign income is avoided as much as possible and CFC rules and double taxation undermine capital import neutrality (CIN) (Bussotti 2021).

<u>BEPS Action 3 2015</u>

Designing Effective Controlled Foreign Company Rules: recommended that countries review their CFC legislation, to ensure these regimes: (i) are more effective, (ii) are more consistent with both anti-deferral and anti-avoidance purposes and (ii) eliminate double taxation of CFC income. The stated concern was that existing CFC rules have often not kept pace with changes in the international business environment, and many of them have design features that do not tackle base erosion and profit shifting risks effectively. The OECD 2015 Action 3 report set out recommendations in the form of building blocks for the design of effective CFC rules, which include the definition of a CFC, exemptions and thresholds, approaches for determining the type of income subject to the rule, computation of CFC income, the attribution of CFC income to shareholders and measures to eliminate the risk of double taxation. These recommendations are not minimum standards but are designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from inappropriately shifting income into foreign subsidiaries.

CFCs and OECD MTC 2017

The compatibility of CFC rules and DTAs was first admitted by the OECD in L´evasion et la Fraude Fiscales Internationales (1987), where it consented to the application of defensive measures like CFC regimes, and then by the OECD MTC Commentaries (Teijeiro 2015). The OECD MTC 2017 Commentary recognises that many countries have CFCs and provides some detail as to the interaction between Arts 1, 7, 10 and 23 and CFC rules as outlined below:

Art 1

Commentary on Art 1, [81] notes that many countries adopt CFC legislation and that there is no conflict between DTAs and CFC legislation. More specifically, it is noted that there is no conflict under Art 1(3) as the effect of states implementing CFC rules is that they are taxing their own residents. Note however, that Switzerland has made an "Observation" on CFC rules in relation to Art 7's Commentary and states that depending on the "relevant concept", CFC rules may be contrary to Art 7(1), Commentary on Art 1, [110].

Art 7

The purpose of Art 7(1) is to restrict the right of a contracting state to tax the business profits of an enterprise of the other contracting state. The Commentary on Art 7(1), [14] notes that Art 1(3) does not restrict a contracting state (Country A) from taxing its residents under CFC rules and this is the case even though those CFC rules may result in the relevant contracting state (Country A) attributing income of a non-resident enterprise (i.e. an enterprise of the other contracting state, Country B) to that resident shareholder (Country A resident). It is further stated that the tax so levied by Country A on its residents does not reduce the profits of the enterprise (resident of Country B) and therefore no profits can be said to have been taxed in the hands of the profits of that enterprise.

Art 10

The OECD MTC 2017 also notes that Art 10(5) does not restrict the operation of CFC rules as Art 10(5) is not concerned with residence but rather with source (Commentary on Art 10(5), [37]). However, the Commentary notes that there may be an impact on the manner in which Art 23 (relief from double taxation) operates when a country has domestic CFC legislation. Broadly, where the income is:

- attributed to the taxpayer then each item of income is treated under the relevant DTA provisions e.g. Art 7 Business Profits, Art 11 Interest, etc.; and

- treated as a deemed dividend then it is clearly derived from a base company thus constituting income from the country of the base company.

The interaction of (ii) above may be complicated by the fact that it may be unclear whether the "deemed dividend" amount is classified as a "dividend" (Art 10) or "other income" (Art 21). Some countries may treat the "deemed dividend" amount as a dividend and thus apply the participation exemption to the relevant income but the Commentary does not consider this is required by the relevant DTA (Commentary on Art 10(5), [38]). However, the Commentary recognises that where a country does not provide such relief, that country may be accused of frustrating the operation of the relevant participation exemption.

Where the dividends are actually distributed by the base company the view in the Commentary is that the normal DTA allocation rules apply to the distributions of dividends (Commentary on Art 10(5), [39]) i.e. the country of the base company may apply a withholding tax and the country of residence of the shareholder may provide relief from double taxation. It is recognised that issues may arise where withholding tax is applied and relief is provided by the shareholder's residence state when the dividend is distributed in circumstances where the CFC rules have previously subjected the distributed income to tax (Commentary on Art 10(5), [39[). Ultimately, the effect of this interaction and whether a credit is made available for the relevant withholding tax will depend upon domestic CFC rules and more specifically rules that focus upon matters such as the relevant time between the deemed dividend and the actual dividend. There is also an acknowledgment that anti-avoidance rules (over and above the relevant CFC regime) may affect the ability to access relief (Commentary on Art 10(5), [39]).

Conclusion

It has been seen that the approach to CFC rules varies across countries and the precise manner in which CFC regimes and DTAs interact is dependent upon the manner in which the relevant regime operates. A key question is whether the rectification under certain circumstances (e.g., accumulation of tainted income) of the deferral principle, might constitute an illegitimate or ultra vires exercise of tax jurisdiction by the residence country of the controlling shareholders, as well as whether such a correction might be compatible with the application of DTAs (Teijeiro 2015). Considering the OECD's position, it appears that there is scope for a country to implement its CFC rules and for these not to be necessarily incompatible with its DTA network. It could also be noted that the precise nature of CFC regimes is contested. There is a view that CFC regimes have been accepted as forming part of the custom (opinio iuris) of the international tax community in situations where certain commonly-shared objective conditions are met i.e.

- shifting of easily re-allocable targeted (tainted) income, including passive (interest, dividends, royalties, rents, and capital gains) or trading income to a foreign entity in a no or low-tax jurisdiction, or

- focusing on privileged tax regimes (of a general or specific nature), whether defined objectively or by comparison to the level of taxation in the shareholder's home country.

However, there is no consensus as to whether CFC regimes form part of customary international law (e.g. Kokott and Pistone (2022) query whether states' adoption of CFC regimes demonstrates the requisite "opinion juris"). In sum, it would appear that, at a general level, (i) CFC regimes may be broadly consistent with DTAs but the extent to which this is the case is dependent on the specific case at hand and (ii) the role that CFC style rules play in addressing profit shifting may be here to stay albeit in modified forms. To support this latter point it could be noted that (a) the Income Inclusion Rule (IIR), has been described as being similar in concept to CFC rules in that broadly it triggers additional tax at the level of the parent company of a consolidated group where the income of a foreign subsidiary is taxed below the minimum effective tax rate (PWC 2021) and (b) on closer examination the IIR may also differ in a number of ways from CFC rules, e.g. the IIR when implemented will operate in a coordinated manner, which is typically not the case for CFC rules (OECD. Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS, 2020).

PART B

Question 6

The following provides an overview of one approach to answering the question and it is anticipated that answers may adopt a number of different approaches.

A: Tie-Breaker Test

It is clear that Algero is tax resident under the domestic law of both countries and finds itself in a dual resident situation vis-à-vis the Country A/B DTA. In this situation, there is a residence-residence conflict and, as such, reference must be made to a tie-breaker test as "no solution of the conflict can be arrived at by reference to the concept of residence adopted in the domestic laws of the States concerned" (Commentary on Art 4, [5]). As the DTA mirrors the OECD MTC 2017, it will already contain the "new" Art 4(3) tie-breaker test introduced in the OECD MTC 2017.

New tie-breaker test: this was changed in the OECD MTC 2017 from the place of effective management (POEM) to a test that involves the competent authorities of the CS being required:

> "to endeavour to determine by mutual agreement the CS of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors."

Furthermore, Art 4(3) provides where no such agreement exists, such person shall not be entitled to any relief or exemption from tax provided by the relevant Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the CS. This change in tie-breaker test has also had knock-on effects for other provisions, such as Art 8, which previously used POEM, but now simply references "the state of the enterprise". The Commentary on Art 4(3), [21], notes that dual residence of companies may be rare but is possible where, for example, incorporation is used as a domestic tax residence test in one CS and place of effective management (or some other facts and circumstances test) in another.

The Commentary [22] also notes that when Art 4(3) was first drafted a formal criterion, such as place of incorporation, was not considered appropriate. Following the launch of the BEPS Actions, the OECD appears to have acknowledged that instances of dual residence of companies are now "relatively rare" but there had been a number of tax avoidance cases involving dual resident companies (Commentary on Art 4(3), [23]). Accordingly, the tie-breaker in the OECD MTC 2017 involves a case by case consideration of whether a company that is resident under the tax laws of both CS is resident in one of those CS for the purposes of the DTA.

Application of the new tiebreaker test

When applying Art.4(3), relevant factors to be considered during the mutual agreement procedure include: "where the meetings of the person's board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention, etc." (Commentary on Article 4(3), [24.1]). Countries may consider that the competent authorities should not be given the discretion to solve dual residence cases without an indication of the factors to be used for that purpose to supplement Art.4 by referring to these or other factors that they consider relevant. (Commentary on Article 4(3), [24.1]). Given the reliance on MAP, it is necessary for candidates to reference and discuss, albeit briefly, the mechanics of Art.25.

The Commentary notes that some CS may choose to include the POEM test in place of the test in Art 4(3) OECD MTC 2017 and that where those CS have agreed upon how to establish POEM and how to ensure the test is not manipulated could include an alternative wording in Art 4(3) (Commentary on Art 4(3), [24.5]). However, there is no indication that Country A and Country B have agreed upon such alternative wording. Clearly, this does not affect the position that POEM may be considered as part of Country A and B's agreement over Algero's residence status under Art 4(3) Country A/B DTA.

Application of the tie-breaker tests to Company A

It has been noted that the new tie-breaker test has shifted from a test of substance to a test of "process". Accordingly, it is necessary for candidates to consider some of the relevant steps in the process involved in determining residence under Art 4(3).

Process

Typically, Algero would be expected to request that the dual residence matter be considered by the competent authorities under the Art 25(1) process (Art 4(3) Commentary [24.2]). However, it is possible that the competent authorities of Country A and B could instigate MAP themselves under Art 25(3). On the basis that Algero makes the request then it should do so as soon as it is aware that its resident status under Country A's and Country B's domestic tax laws is likely to render it "dual resident". More specifically, the request should be made within three years from the time Algero is notified of the tax measures taken by one or both states that indicate reliefs or exemption may not be available to Algero because of its dual residence status (Commentary on Art 4(3), [24.2]). The competent authorities of Country A and B would then be expected to deal with Algero's request as expeditiously as possible and communicate their response to A as soon as possible. This communication should include the time period to which the determination applies. This is necessary as it is anticipated by the OECD MTC Commentary that the facts upon which a decision is made may change over time.

Factors

Art 4(3) requires certain factors to be considered, including POEM (POEM should be given its DTA meaning). The factors that may be considered to create a nexus between Algero and the CS when considering whether the competent authorities are likely to be able to resolve the resident status of the Algero for the purposes of the Country A/B DTA are as follows:

- Country A connections: one of six directors resides in Country A but the directors' role is formal only in that it signs off decisions made by the management team; a management team who are resident in Country A (note it is unclear where decisions made by this management team are made); and directors meet occasionally in Country A, but often meet outside Country A; Country A considers that the residence of Algero's management team (as opposed to the location where the decisions are made, which is not revealed in the facts) in its jurisdiction is the critical connection and so justifies its jurisdiction to tax).

- Country B connections: one of six directors resides in Country B but the directors' role is formal only (see above); directors meet in Country B occasionally but often meet outside Country B; Algero is incorporated in Country B (which forms the basis of Country B's jurisdiction to tax under its domestic tax law); Algero is headquartered in Country B; and Algero's contracts are governed by the law of Country B.

Given that Article 4 Country A/Country B DTA mirrors Art 4(3) OECD MTC 2017, Country A and B should have communicated to each other the factors that they are likely to consider to be relevant to their determination of whether dual resident companies are resident for the purposes of a DTA tie-breaker test that relies on the MAP. There is no evidence this has occurred in connection with Country A and Country B. Accordingly, candidates will need to weigh up the factors they consider are most likely to support a finding of residence in either CS. This process would be anticipated to involve referencing the Commentary on Art 4(3). Other references could include any Reservations or Observations as well as country practice.

Whilst Algero clearly has operations across the world, there is no information about the extent to which these operations occur within Country A or B. The reference to “operations” implies that there is some active business activity. Some countries consider the need for business activity itself to have a nexus and some countries may include this within their determinations of whether a company is resident under its domestic tax law. In this case, the lack of information about this aspect would appear to be a void that should be filled and, as such, Algero should be prepared to provide such information, ideally in advance of making the MAP request.

In terms of the information that is available, the directors' residence and the location of their residence does not appear to be conclusive (they seem to have the same level of connection with both Country A and B) and not critical (as they only play the above-mentioned formal role within Algero A). Rather the fact that the management team is [deleted] responsible for all of Algero's key commercial decisions, points to a potentially relevant nexus with Country B. However, the facts only reveal the residence of the management team and do not provide details about where these key commercial decisions are made. Given their residence is in Country A, it could be inferred that these decisions take place in Country A. Algero may place store on this fact as it is made clear that Country A asserts its jurisdiction to tax on the basis that key commercial decisions are made by residents of its jurisdiction. However, the place where these commercial decisions should be determined as this could lend weight to the finding of residence for the purposes of the Country A/B DTA in one or other CS (e.g. note that India has introduced POEM in its domestic law and describes it as the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made Income-Tax Act, 1961 and Guiding Principles for determination of Place of Effective Management of a Company.)

Reservations on Art 4(3) OECD MTC 2017

- Place of incorporation: USA has a reservation that it may rely upon the place of incorporation and deny dual resident companies DTA benefits (Reservations on Art 4, [31]). Estonia and Latvia reserve the right to include place of incorporation or similar criterion in Art 4(3) (Art 4 Reservations [34]).

- Head of Main Office: Japan and Korea reserve their right to use “head or main office” in place of POEM (Reservation on Art 4, [28]).

<u>Denial of DTA Benefits</u>

If neither Country A nor Country B can agree on the resident status of Algero for the purposes of the Country A /B DTA then it is possible that Algero may be denied access to DTA benefits arising from that DTA. However, Art 4(3) OECD MTC 2017 includes the possibility that the competent authorities may agree otherwise (and thus grant relief) even where the dual residence issue remain involved. Japan has placed a reservation on this aspect of Art 4(3) and notes that it reserves the right to omit this aspect of Art 4(3) (“except to the extent and manner as may be agreed upon by the competent authorities of the CS” (Reservation on Art 4, [35]). The Commentary also contemplates a situation where an agreement is not forthcoming and, in such a case, a dual resident company would still be resident under the DTA in each CS e.g. the company will be considered to be a resident of each State for the purposes of the application of Article 10 to dividends that it will pay. (Commentary on Art. 3, 24.4]).

<u>B: Exemption</u>

The impact of such a change in domestic tax law is at best unclear. It could be stated that there is (i) evidence that both CSs consider Algero to be tax resident under their domestic laws due to “objective factors” and (ii) no evidence that either country exempts any of Algero's foreign income. It is possible that the domestic law change may have no impact. It is open to candidates to refer to the fact that the Commentary on Art 4(1), [8.2] states that a “conduit” company may not be treated as resident in a CS for the purposes of the DTA. This is because "conduit company rules” (or similar), are excluded from the “wording and spirit of the second sentence [of Art 4(1)] such that a conduit company that benefits from an exemption from taxation of foreign income may be excluded from the definition of resident in a particular state for the purposes of the relevant DTA. The effect of such exclusion is that DTA access may be denied as the “resident gateway” may be blocked. The Commentary on Art 4(1), [8.2] also notes that where such rules exist, spontaneous exchange of information may be needed in order to ensure that no unintended DTA benefits are provided to companies in such situations.

Conclusion

It is difficult to be sure which CS is likely to “come out on top” given the wording of Art 4(3). Given the need to refer to OECD MTC 2017, it may be acknowledged that the approach adopted by Art 4(3) has been described as an adoption of “worst... proposal” with regards dual residence companies as it involves a “two-tier mutual agreement procedure” (Ismer and Blank, 2022). Furthermore, the OECD MTC does not provide any guidance on the ranking of factors to assist competent authorities (ibid). Other issues with Art 4(3) include the fact that constitutional issues may arise where a CS gives a government body the power to decide the legal effect of DTA provisions (as opposed to the government body interpreting the law and applying it), which are themselves part of international law (ibid). Furthermore, Art 4(3) still includes POEM, a notoriously difficult term to apply consistently and one that leaves open considerable scope for differing interpretations (Avery Jones, 2009) as a relevant factor and, although there is no hierarchy in the factors that are included in Art 4(3), it is notable that POEM is listed first.

Question 7

The focus of this question is on changes made to Art 5 OECD MTC 2017 (reference to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI) is not required). Candidates' answers could begin by setting the scene, which may include: a brief mention of the changes brought into Art 5 by the OECD MTC 2017 and by providing some context to the 2017 changes i.e. BEPS Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status, Final Report 2015).

Changes to Article 5 OECD MTC 2017: General Points

Given that business profits are not subject to tax in the source state without the finding of a PE, the manner in which a PE is defined is of critical importance to a country interested in the impact of rules it adopts on its ability to tax the business profits of overseas entities in its jurisdiction. The OECD MTC 2017 made various changes to the OECD MTC 2014 to the finding of a PE under Art 5 (as well to the Commentary). More specifically, the provisions introduced into the MTC (and some of the changes to the Commentary) that target the artificial PE avoidance and prevention of exemption in the source state of the enterprise are:

- Art 5(3) Commentary, [52]: seeks to prevent the splitting-up of contracts to circumvent the rule provided by Art 5(3), which establishes a 12-month threshold to create a PE (especially in building and construction sites). The method adopted is an aggregation rule whereby periods of time during which all closely related companies carried on activities at the same place are aggregated.

- Changes to the wording of Art 5(4)(e)&(f) involving the removal of some of the wording in these subparagraphs and the addition of the following sentence following Art 5(4)(f): "provided that such activity, or in the case of subparagraph (f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character." The effect of this change is to emphasise that there is a need for all of the activities listed to be preparatory and auxiliary but it is arguable that the 2014 version already required the activities to be preparatory and auxiliary whether alone or in combination.

- Art 5(4.1). Artificial avoidance of a PE through specific activity exemptions. This introduces an anti-fragmentation rule, which seeks to ensure that a PE is not avoided where, broadly, one place of business is used by the taxpayer and a closely related enterprise; two places of business are used by the taxpayer; or one place of business is used by the taxpayer and another is used by a closely related enterprise (Reimer 2022).

- Art 5(5). Artificial avoidance of a PE due to commissionaire (or similar) arrangements. See the discussion of Art 5(5) below in part (iii) of this solution.

- Art 5(6). Seeks to exclude independent agents from the definition of PE but excludes from the scope of an independent agent: an independent agent who acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related. It is this latter aspect that forms the 2017 change to Art 5(6).

- Art 5(8) provides a definition of a person "closely related "to an enterprise. This provision has been described as involving a "substance over form" approach ("based on all facts and circumstances" and involving control) that includes a number of "un-rebuttable presumptions" that involve certain majority participations (Reimer, 2022).

Candidates may mention that Art 5 Commentary, [4], notes that the Commentary related to the 2017 modifications that were made as a result of BEPS Action 7 are "prospective only, and as such, do not affect the interpretation of the former provisions of the [MTC] and of treaties in which these provisions are included, in particular as regards the interpretation of paragraphs 4 and 5 of the Articles as they read before these changes." Salia may, therefore, be advised that notwithstanding that the Commentary has changed in line with the changed 2017 provisions, this does not result in the 2017 Commentary on these new/modified provisions affecting Salia's existing Art 5 provisions (i.e. those mirroring Art 5 OECD MTC 2014). However, other changes to the Commentary are considered to apply to DTAs entered into before the relevant change to the Commentary in 2017 as these other changes are clarificatory and reflect the consensus of the OECD as this Commentary is considered to relate to existing provisions (Commentary on Art 5, [3]).

Source State Taxing Rights

Commentary on Art 5(3): the residence jurisdiction has the right to tax, subject to the contract splitting exception. Where this applies, the right to tax is allocated to the source jurisdiction and accordingly there may be scope for increased source state taxing rights.

Art 5(4)

As noted above, the changed wording emphasises the limit to the operation of the exclusion from the finding of a PE. Whether the changed wording increases source state taxing rights is dependent upon one's view as to whether Article 5(4) OECD 2014 should have been interpreted in this way without the 2017 changed wording.

Art 5(4.1)

The residence jurisdiction has the taxing right under specific activity exceptions. However, the scope of the specific activity exception is narrowed under the OECD MTC 2017 to cope with the e-commerce challenges as a result of the Action 7 final report. Consequently, the source state's taxing right is expanded. Broadly, the source state is allocated the right to tax the income derived from activities carried on by closely related enterprises.

Art 5(5)

This may substantially lower the threshold for the recognition of a PE as the right to tax is allocated to the source jurisdiction and as such the source state taxing right is expanded and the source state is allocated enhanced taxing rights.

Art 5(6)

This narrows the concept of "independent agent" and so increases the likelihood that a PE will be found (by determining that when a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is "closely related", that person shall not be considered to be an independent agent).

Art 5(8)

A definitional provision ("closely related enterprise") and where it applies it may widen the scope for the source state to assert its jurisdiction to tax.

Article 5(5) OECD MTC 2017: Commissionaire Arrangements

At a very general level, a commissionaire agreement is the arrangement between two companies established in different jurisdictions through which a company resident in one country (Company A) sells the products/services of the non-resident company (Company B) to the third party customers, without attributing the sale to the non-resident company (Company B). The arrangement is different from that of:

- A distributor – as the commissionaire does not hold title to the products until they pass directly to the customer so the principal bears the financial risk; and

- An agent – as the commissionaire arrangement involves two contracts: one between Company A and Company B and then another with between Company B and the third-party customers whereas there is only one contract between Company A and the customers in an agency relationship.

The tax treatment of a commissionaire arrangement varies depending on whether the commissionaire is located in a common or civil law country (Parada 2013). Common law countries generally treat the undisclosed agent as binding the principal, whereas in civil law countries the principal is not bound unless the commissionaire is acting in the name of the principal and not in its own name. Typically, a commissionaire arrangement will be deemed to give rise to a PE in common law countries. The risk of having a taxable presence would only arise when domestic law treats the commissionaire as binding the principal.

The result is that where (i) Company A (resident in state A) has an agent in State B (Company B, resident in State B); (ii) Company B acts as an agent of Company A) but this does arrangement does not result in Company A having an agency PE in state B as Company B concludes contracts in its own name and (iii) State B has a tax rate higher than the rate in state A, then Company A may benefit from the arrangement. Art 5(5) OECD MTC 2017 seeks to prevent such a situation by deeming Company A to have a PE in Country B where the Company B satisfies the expanded conditions under which a dependent agency PE will be found. Broadly, these conditions involve Company B acting on behalf of Company A and in so doing "habitually concluding contracts or habitually playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification by Company A, and these contracts are in the name of Company A or are for the transfer of ownership of, or for transferring of, or granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise". There are exceptions to Article 5(5) in Article 5(4) and Article 5(6).

Candidates could cite the case of Conseil d'État, N° 420174, 11 December 2020, Sté Conversant International in which the Supreme Court considered that while the template of client contracts, as well as pricing conditions, were determined by the Irish company, the decision to conclude a contract with a client, as well as all related tasks, were actually made and performed by the employees of the French affiliate, with the Irish enterprise merely rubber-stamping the contracts. As such the Irish tax resident that performed digital marketing activities was found to have a PE in France through its French affiliate in spite of the fact that the contracts were not formerly concluded in France by the affiliate. This decision has been described as evidence of an extension of the dependent agent PE to situations where the agent plays a principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.

Conclusion

Having outlined the changes to Art 5 (and related parts of its Commentary) candidates may proffer a view as to whether they consider Salia should seek to amend its DTA network in line with (all or some of) the changes. As it is open to candidates to refer to the potential for Salia to sign and ratify the MLI, some mention can be made of the fact that the MLI includes provisions on the artificial avoidance a PE (and so creates the potential for increased source state taxing rights where such provisions modify covered tax agreements). Candidates could note that at a general level it would appear that at least some countries are reluctant to apply the full suite of OECD MTC 2017 PE related changes in their DTA networks (as evidenced by the number of reservations on the relevant PE provisions within the MLI). There is also the option for Salia to renegotiate its DTAs (or a selection thereof) and, of course, to make clear, through the use of Reservations on the OECD MTC 2017 and Observations on the Commentary, that it does not agree with a particular provision or aspect of the Commentary.

It would also be pertinent to advise Salia of the potential impact of BEPS 2.0 and the market jurisdiction nexus concept that it contains (as well as the global minimum tax). The market jurisdiction nexus test may also have the potential to impact countries' DTA networks in the future (through the introduction of a separate multilateral convention) and, depending on Salia's circumstances, may increase its source state taxing rights.