THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2024

MODULE 1

SUGGESTED SOLUTIONS

PART A

Question 1

There is no single way to answer this question and the following provides one possible schematic.

Residence has provided a relatively clear basis for determining where a company should be taxed, relying on criteria such as the place of incorporation or centr management etc. However, its effectiveness as a nexus test has been called into question due to challenges related to matters such as avoidance, enforcement, and the evolving nature of business operations. Candidates' answers should include a consideration of potential reforms and alternative approaches that might enhance the efficacy of international tax systems in this new context.

Challenges to residence-based taxation - one of the primary challenges to residence-based taxation arises from the mobility of company in a globalised world. The traditional criteria for determining company residence have been described as being suitable when businesses operated predominantly within national borders (Nakayama and Perry, 2021).

There is a view that globalisation has enabled companies to easily shift their place of incorporation/management to jurisdictions with more favourable tax regimes without substantial changes to their actual business operations (Auerbach, 2021). The ability to relocate may undermine the stability and effectiveness of residence as a nexus for taxation, as companies may manipulate their tax obligations by strategically choosing their residence. Moreover, multinational enterprises (MNEs) may exploit disparities in international tax rules to generate "stateless income", where profits are reported in low or no-tax jurisdictions disconnected from the locations of actual economic activity (Kleinbard, 2011). Such practices may erode the tax bases countries and challenge the principle that taxation should align with economic substance. The phenomenon of corporate inversions, where companies relocate their residence to reduce tax liabilities without significant operational changes, exemplifies this issue (Auerbach, 2021).

The rise of the digital economy can be said to complicate the application of residence-based taxation. Digital businesses may have a significant economic presence in a market without a physical presence, making it challenging to establish a nexus based on traditional criteria. Companies may generate substantial revenue from users in multiple jurisdictions without triggering residence status or permanent establishment thresholds, leading to concerns about fair taxation and base erosion. Residence-based taxation may also result in economic double taxation, where, for example, the same income is taxed in the hands of both companies and their shareholders. While mechanisms like dividend exemptions/ tax credits may mitigate this issue, they may add complexity to the tax system and may not fully alleviate the tax burden (Risso, 2019). This complexity can hinder compliance and enforcement and may further undermine the effectiveness of residence-based taxation.

Continued relevance of source-based taxation - given the perceived limitations of residence-based taxation, source-based taxation may be considered to remain an essential component of international tax systems. Taxing income where it is generated can be considered to align tax obligations with the location of economic activities and value creation, adhering to the benefits principle (Kane, 2015). This approach seeks to ensure that countries providing the infrastructure and legal systems etc. that facilitate business activities receive appropriate tax revenues and so can be thought of as promoting fairness and equity. Strengthening the permanent establishment (PE) concept has been considered a crucial feature of enhancing source-based taxation. Initiatives like the BEPS Actions aim to, inter alia, prevent the artificial avoidance of source taxation by updating PE definitions to capture significant economic activities that may not involve a substantial physical presence (OECD, 2015). By reinforcing source-based taxation, it is thought that countries can better address tax avoidance strategies that exploit gaps in residence-based systems. On this basis, the reliance on source taxation is likely to continue as it may fill some gaps left by residence-based approaches and aligns with the notion of taxing businesses where they operate and generate income.

Potential reforms and alternative approaches - to address the challenges posed by globalisation and the digital economy, several reforms and alternative taxation models have been proposed. One approach is to strengthen residence-based taxation by enhancing Controlled Foreign Company (CFC) rules, which broadly, tax passive income earned by foreign subsidiaries to reduce profit shifting (OECD, 2015). Although BEPS Action 3 sought to coordinate an improved approach to CFC regimes, the recommendations did not become minimum standards and remain optional. The lack of mandatory implementation may limit their effectiveness and may highlight the need for more coordinated efforts. Another proposal involves redefining company residence by adopting a shareholder-based definition. This could provide a clearer nexus for taxation by linking company tax obligations to the residence of shareholders (Risso, 2019). However, implementing such a system may presents challenges, particularly in identifying and tracking shareholders in publicly traded companies such that the complexity of modern ownership structures could hinder the practicality of such an approach.

Alternative models may shift the focus from residence to the location of consumption e.g. a Destination-Based Cash-Flow Tax (DBCFT), which broadly seeks to tax companies based on where their goods and services are consumed, regardless of the company's residence (Auerbach, 2021). By taxing cash flows from sales within a jurisdiction, the

DBCFT aims to reduce incentives for profit shifting and tax competition, aligning tax obligations more closely with economic activities in consumer markets. Such an approach may simplify taxation and reduce the opportunities for tax avoidance. The OECD's BEPS 2.0 initiative, Pillar One, proposes reallocating taxing rights to market jurisdictions based on where consumers are located (OECD, 2021). This model seeks to, broadly, acknowledge the value created by consumer bases and seeks to allocate tax revenues more equitably. Another model is the proposed Residual Profit Allocation by Income method, which, broadly, allocates routine profits to countries where business activities occur and residual profits to market countries based on sales, less the cost of sales (Devereux, 2021). Broadly, this approach seeks to align taxation with both production and consumption locations, applying to all businesses above a certain threshold. It aims to capture a fair share of tax revenues for both source and market jurisdictions, potentially reducing tax competition and enhancing fairness in the international tax landscape.

Addressing Enforcement and Compliance Challenges - implementing these reforms / alternatives requires addressing enforcement and compliance challenges. Enhanced international cooperation and information sharing among tax authorities are vital for improving enforcement, particularly when it comes to digital transactions. Unilateral measures, such as digital services taxes introduced by some countries, attempt to tax revenues from digital activities. However, such measures may lead to trade tensions and there is a view that they do not align with international tax principles, which highlights the need for coordinated multilateral solutions. From a practical perspective, taxing non-resident entities may present practical challenges re: tax collection. Ensuring compliance from entities without a physical presence requires robust international legal frameworks and cooperation. Developing mechanisms to effectively tax digital businesses and enforce tax obligations across borders is essential for the success of any new nexus approach.

Conclusion

While residence remains a foundational element of international tax systems, there is a view that its effectiveness as a nexus test appears to be increasingly undermined by the realities of globalisation and the digital economy. The challenges of mobility, tax avoidance strategies and digital business models may lend weight to arguments that a re-evaluation is needed of how tax nexus is determined. Candidates may conclude by referring to, for example, the need to consider strengthening source-based taxation / exploring alternative models as potential pathways toward a more effective and equitable tax system. They may also note that international consensus and cooperation are needed to ensure that tax policies align with economic realities and address the complexities of a globalised economy. The extent to which new nexus tests are adopted and reduce existing challenges remains to be seen.

Question 2

There is no single way to answer this question and the following provides one possible schematic.

BEPS Action 4 is a critical component of the OECD's BEPS initiative and broadly, seeks to reduce instances of BEPS by way of restricting the deductibility of excessive interest payments. It introduced a fixed ratio rule as a primary rule and a group ratio rule as an optional rule (both using an earnings basis – EBITDA). The concerns are, broadly, that international groups may manipulate their taxable income by ensuring that they (i) allocate high levels of third party debt in high tax country operations; (ii) use intra-group loans to get higher interest deductions country by country than their third party debt levels actually generate; and (iii) use third party or intra-group finance to fund tax exempt income (Walker, 2016). The popularity of using intra-group debts as a tax avoidance tool is further enhanced by the fact that these debts may not recognised under accounting standards and in turn may not affect the consolidated financial statements of MNEs (Ting, 2017). Interest deductions have been used as a means of shifting profits to low-tax jurisdictions as "interest is generally deductible to the payer and included in computing the recipient's income", which facilitates BEPS (Duff, 2018). Intra-group debt arrangements have been stated to be particularly attractive due to their ease of implementation; and can be established "with the wave of a pen or keystroke" circumventing the need for complex transactions or third-party involvement (Ting, 2017).

Action 4

By introducing a fixed ratio rule that limits the deductibility of net interest expenses to a percentage of earnings before interest, tax, depreciation, and amortisation (EBITDA) - typically within a corridor of 10% to 30% - Action 4 aims to curb profit shifting through inflated interest expenses. This approach seeks to align interest deductions with genuine economic activity in each jurisdiction, thereby preserving the integrity of national tax bases. A group ratio rule sits alongside the fixed ratio rule and allows an entity to deduct interest beyond the fixed ratio, aligning its deductions with net interest / EBITDA ratio of its worldwide group (Chapter 7). There are also some targeted anti-avoidance rules that seek to protect the integrity of the framework and address risks not covered by the rules.

Discussion

The fixed ratio rule may assist in the restriction of interest deductions as it is considered to enhance transparency and simplicity, facilitating compliance and enforcement compared to the complexities associated with the ALP, which has been stated to not constitute best practice in tackling BEPS related to interest / payments equivalent to interest (Action 4, Final Report, 2015, [15]). The fixed ratio rule can be said to offer simplicity and predictability, reducing compliance costs for taxpayers and administrative burdens for tax authorities. By capping interest deductions at a set percentage of EBITDA, the rule is stated to "limit interest deductions to what is economically justified", aligning taxable income more closely with economic substance and value creation (BEPS Action 4). This cap may then curtail the artificial inflation of interest expenses used to erode tax bases in high-tax jurisdictions, effectively addressing the lack of market discipline in intra-group loans where inflated interest charges "would not be accepted" by independent lenders (Ting, 2017). The adoption of the fixed ratio approach may also be seen to enhance consistency across jurisdictions, as a number of countries have implemented the recommended 10-30% corridor - by providing a standardised measure, the fixed ratio rule may reduce opportunities for manipulation and profit shifting through excessive interest deductions. This coordination may also support a claim that the fixed ratio rule restricts excessive interest deductions.

A further concern is that the 30% ratio is considered to be too generous with some data showing that the majority of the largest MNEs (outside the financial sector) have lower than a 10% ratio and that many MNEs can claim interest expenses at a higher rate than their net interest expense (Ting, 2017). The 30% ratio appears to have been included on the basis that countries would have other (targeted) measures in place to protect the tax base against excessive interest deductions, which highlights the fact that the fixed ratio alone may not be able to address all relevant tax reduction concerns (Ting 2017). There is also a concern that because the fixed ratio rule does not link to a group's net third party interest expense, it may not prevent a group from claiming interest deductions in excess of its "real" interest expense (Ting 2017).

In terms of flexibility, the fixed ratio rule also allows for local flexibility (Duff, 2018) by e.g. the corridor of 10 -30% as noted in BEPS Action 4, Chapter 6, [24], a de minimis threshold, Chapter 5, [54]-[56] and the ability to carry forward unused capacity, (Executive Summary)). This flexibility is considered to be needed given the relationship between currencies and interest rates and permits a country to vary the percentage over time as leverage and interest rates rise and fall (Burnett, 2023). However, rule may not accommodate the legitimate financing needs of certain industries, particularly those that are capital-intensive or operate with inherently higher debt levels. For these sectors, the fixed cap may unduly restrict legitimate interest deductions, thereby impeding genuine economic activity. Moreover, during economic downturns, fluctuations in EBITDA could result in disallowed interest deductions despite the commercial necessity of the financing. The rigidity of the fixed ratio rule is implicitly acknowledged in BEPS Action 4, Chapter 7, [115] and is considered a suitable price to pay for the relative simplicity and predictability of a fixed ratio (Burnett, 2023).

Group ratio rule

At least partly because groups may be highly leveraged with third party debt for non-tax reasons (Executive Summary and Chapter 7, [115]), BEPS Action 4 provides for an optional worldwide earnings-based group ratio rule as a supplement to the fixed ratio rule. This rule allows an entity to deduct net interest expenses above a country's fixed ratio to deduct up to the level of the group's overall net third-party interest expense, proportionate to its share of the group's EBITDA (Executive Summary). The group ratio rule may help entities deduct interest in line with their group's overall economic activities, reducing excessive tax burdens, (BEPS Action 4, Chapter 7) and was considered to have the greatest potential to tackle BEPS using interest deductions, at least theoretically (Discussion Draft, 2014, [60]. While there have been concerns that it may be possible to manipulate the relevant figures in the relevant financial statements (when determining the group's net interest expense), there is also a view that the likelihood of this occurring may be reduced by the subjection of such consolidated financial statements to audits (Keidranen, 2016). Accordingly, there is some support for the view that the group ratio rule may assist in restricting excessive interest deductions and indeed appears to be the preferred approach albeit theoretically.

However, the perceived effectiveness of the group ratio rule comes at the price of simplicity, with the rule being considered to be complex due to its more extensive calculations. This complexity may then add to the administrative burden of the relevant group(s). There is a view that the design of the rules may also increase the prevalence of the uptake of the group ratio rule (and in turn an increase in the administrative burden) in circumstances where a country adopts a fixed ratio that is at the lower end, companies may feel compelled to adopt the group ratio rule (Keidranen, 2016). So, while the existence of an alternative rule can be seen as providing a layer of flexibility for groups, it may also increase their administrative burden. It is also open to candidates to note that there is also scope for other group ratio rules to be used in place of the group ratio rule (e.g. equity escape (a balance sheet approach), which may be better suited for a loss-making entity, (Chapter 7, [118])) or for a choice to be made not to introduce a group ratio rule (Executive Summary and Chapter 5, [84]) with the option to introduce alternative group ratio rules being seen as also factoring in an element of flexibility.

Conclusion

There is some support for the view that BEPS Action 4 has been designed in a way that limits excessive interest deductions by introducing a standardised, straightforward approach that reduces opportunities for base erosion through inflated intra-group interest payments. There is also a hope that it may prove more successful relative to other measures (such as thin capitalisation, Ting 2017). However, the approach may not fully balance the need for legitimate financial flexibility among MNEs. The fixed ratio approach may be overly restrictive for certain industries and may not always align with the economic realities at the group level. The group ratio rule may offer some relief but challenges appear to remain in accommodating diverse business models, financing needs and increased administrative burdens. While BEPS Action 4 allows for some flexibility in approach and notes that the aim is for countries to use the fixed ratio rule consistently, using the same fixed ratio for most sectors (with some exceptions) (Chapter 6, [86]), the reality is that there may be differing outcomes under different country regimes and therefore implementation of BEPS Action 4 may increase the compliance burden for MNEs with business operations across multiple countries where those countries adopt different approaches to restricting interest deductions.

Since the publication of BEPS Action 4 in 2015, it may be noted that an updated version was published in 2016 which addresses both the operation of the group ratio rule and features of the banking and insurance sectors which can constrain the ability of groups to engage in BEPS involving interest together with approaches to deal with risks posed by entities in these sectors where they remain (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 - 2016 Update). Candidates may conclude by noting that coordination among jurisdictions and adaptability in implementation will be essential to ensure that the objectives of preventing BEPS are met without unduly hindering legitimate economic activities of MNEs.

Question 3

There is no single way to answer this question and the following provides one possible schematic.

Double Taxation Agreements (DTAs), commonly known as double tax treaties, are pivotal instruments in international taxation. They aim to mitigate double taxation, facilitate cross-border trade and investment, and combat tax evasion and avoidance. However, complexities inherent in these DTAs, especially concerning developing countries, have sparked debate regarding their efficacy and fairness. Candidates should critically analyse the nature and purpose of DTAs, evaluate their benefits and challenges within the global tax framework amid shifting international economic dynamics.

Broadly, DTAs are bilateral or multilateral agreements between sovereign states establishing rules for allocating taxing rights over income and capital. They have been described as possessing a dual nature - contractual and statutory - functioning as international contracts and as instruments within domestic law (Li & Lamarre, 2024). Under the principle that "every treaty in force is binding upon the parties to it and must be performed by them in good faith," there is a view that contracting states (CS) are obliged to honour their DTA commitments (Vienna Convention on the Law of Treaties (VCLT), Article 26). DTAs can override domestic tax legislation to the extent of any inconsistency where properly incorporated into national law.

The primary objective of DTAs is to prevent international double taxation, which occurs when multiple jurisdictions tax the same income or capital. There is a view that by providing clear rules for allocating taxing rights and methods for relief - such as exemptions or foreign tax credits - DTAs aim to eliminate tax obstacles to cross-border economic activity (Petkova et al., 2019). This fosters international trade and investment by providing certainty and reducing excessive taxation risks. Additionally, DTAs promote cooperation between tax authorities through information exchange and mutual assistance, essential in combating tax evasion and avoidance (Kysar, 2020) and have more recently sought to ensure that DTAs do not provide opportunities for unintended reduced taxation and double non-taxation.

There are a number of considerations when evaluating DTAs:

- Shift towards multilateralism. While DTAs are predominantly bilateral, there is a view of a growing trend towards multilateralism in addressing international tax issues. Instruments like the MLI, signed by over 100 countries, reflect a preference for coordinated approaches to complex tax challenges, such as those addressed in the BEPS initiatives. This indicates a possible shift towards more standardised international tax practices.

- Shifts in the international tax regime. The international tax regime has been described as having been transformed from a standards-based to rules-based systems and back to s standards-based system since 2015 (Baistrocchi, 2021). This is evident as DTAs now include specific rules (e.g., OECD MTC 2017 definitions) and broader standards e.g. the principal purpose test (PPT), requiring case-by-case interpretation. While standards offer flexibility in addressing complex tax avoidance, they introduce uncertainty due to imprecise definitions.

- Challenges for developing countries. Developing countries face challenges in DTAs due to limited resourcing and the absence of dedicated tax policy units in some countries. There is a view that this can lead to suboptimal outcomes, where these countries may yield taxing rights or enter DTAs not fully serving their interests (International Monetary Fund (IMF), 2019). The IMF recommends that developing countries critically assess whether a DTA is truly reciprocal, examining both DTA provisions and underlying economic relationships (both current and prospective).

- DTA Shopping and its impact. DTA shopping is a concern where multinational enterprises exploit DTA networks to minimise tax liabilities. There is a view that "if a country has several tax treaties, MNEs will take advantage of the 'worst' one" (Petkova et al., 2019). This undermines the tax base of many countries, especially developing nations, by allowing companies to exploit loopholes and reduce tax obligations, frustrating DTAs' intended purpose.

- Anti-abuse measures. A key development has been the introduction of anti-abuse measures as part of the MLI and OECD MTC (2017). There is a view that these include the PPT and Limitation on Benefits clauses, aiming to prevent DTA shopping by denying benefits in inappropriate circumstances (Baistrocchi, 2021). While enhancing the fight against tax avoidance, they increase complexity and uncertainty in application. The PPT, being a pure standard, lacks ex-ante meaning; its interpretation arises ex-post through case law. The OECD MTC 2017 Preamble, reflected in the MLI (Article 6), plays a critical role in guiding interpretation. There is a view that it emphasises eliminating double taxation and preventing tax abuse, stating DTAs are not intended to create opportunities for "non-taxation or reduced taxation through tax evasion or avoidance" (OECD, 2017), reinforcing the balance between promoting economic activity and safeguarding against abuse.

- Benefit-cost analysis for developing countries. For countries entering DTAs, the IMF emphasises conducting benefit-cost analyses to assess uncertain costs associated with ceding taxing rights. There is a view that historically, many developing nations have not done so, potentially resulting in DTAs that do not adequately balance benefits and revenue losses (IMF, 2019). This underscores the importance of a strategic approach to DTA negotiation, particularly where the economic impact is substantial.

- Global shifts in power and impact on DTAs. Global economic shifts, notably the rise of economies (e.g. China), have been stated to have impacted DTAs' structure. There is a view that historically shaped by capital-exporting countries, there is now a push for greater emphasis on source-based taxation (where income is generated) over residence-based taxation (where the taxpayer resides) (UNMDTC, 2021). This shift is reflected in changes to the UN Model Double Taxation Convention, increasing source-based taxing rights and supporting DTAs' evolving nature as global power dynamics change.

- Effectiveness of DTAs. The effectiveness of DTAs depends on whether they reduce tax burdens below domestic law and network conditions. There is a view that DTAs have failed to meet their objectives, either by facilitating unintended reduced taxation - compromising countries' rights to tax amounts that may have a nexus in their jurisdiction - or by not providing reductions beyond domestic laws (Baistrocchi, 2021). Relief from double taxation may be available under domestic law without a DTA, making some DTAs less effective in attracting investment and facilitating trade. Consequently, DTAs' purposes may not always be achieved, which may call into question their overall efficacy.

<u>Conclusion</u>

Reflecting a global commitment to alleviating double tax burdens, the DTA network continues to grow. Countries like the United Kingdom are party to over 125 DTAs, showcase widespread international dedication to mitigating the risk of double taxation (Lang, 2021). With approximately 3,000 DTAs worldwide, DTAs remain central to cross-border taxation, aiming to prevent overlapping tax liabilities and foster international economic cooperation while reducing opportunities for unintended reduced or double non-taxation. DTAs are crucial tools in international taxation, designed to prevent double taxation, foster investment and combat tax evasion and avoidance. Notwithstanding these positive features, global economic shifts, complex tax systems and a focus on tax avoidance have necessarily expanded their scope and challenged their effectiveness. Developing countries in particular may need to approach DTA negotiation / adoption with caution, conducting thorough analyses to ensure balanced and mutually beneficial outcomes. As the global tax regime evolves, DTAs must adapt to balance their original purpose with addressing tax avoidance, ensuring fairness and stability across borders.

Question 4

There is no single way to answer this question and the following provides one possible schematic.

The OECD Transfer Pricing Guidelines 2022 (TPG 2022) address the complexities of MNE group synergies by classifying them into incidental synergies and deliberate synergies. This classification is intended to promote fair taxation and mitigate tax avoidance by ensuring that transfer pricing practices reflect the true economic contributions of MNE group members. TPG 2022 acknowledges that "[c]omparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies" (TPG 2022, Chapter I, [1.177]). MNEs often benefit from synergies that independent enterprises may not be able to achieve, such as streamlined management, integrated systems and enhanced purchasing power. These synergies can stem from and are afforded different treatment:

- Incidental synergies. Passive benefits arising from mere group association and without deliberate concerted action of group members or the performance of any service or other functions by group member (such as improved credit ratings or purchasing power due to the group's overall size). Such incidental benefits need not be separately compensated or specifically allocated (TPG 2022, Ch. I, [1.178]).

- Deliberate synergies. Benefits resulting from intentional, coordinated actions within the MNE group, such as centralised purchasing or coordinated marketing strategies. Where important group synergies exist and can be attributed to deliberate concerted group actions that provide a clearly identifiable structural advantage or disadvantage, the benefits of such synergies should generally be shared by members of the group in proportion to their contribution to the creation of the synergy. This will be determined by way of a functional and comparability analysis (TPG 2022, Ch. I, [1.179] - [1.182]).

The classification into incidental and deliberate synergies aims to align transfer pricing outcomes with value creation, in accordance with the ALP. By differentiating between passive and active contributions, the TPG 2022 seeks to ensure that profits are attributed based on actual economic activities. This approach simplifies compliance for MNEs by not requiring adjustments for benefits that arise passively and may promote fairness by recognising that such benefits are inherent to group membership and do not reflect additional value creation by individual entities.

For deliberate synergies, TPG 2022 recommends a detailed analysis: "[w]here corporate synergies arising from deliberate concerted group actions do provide a member of an MNE group with material advantages or burdens not typical of comparable independent companies, it is necessary to determine (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the MNE group" (TPG 2022, Ch. I, [1.181]). Such an approach may help to ensure that profits are allocated according to each entity's contribution to the relevant synergy, which can be said to promote equitable taxation across jurisdictions.

By requiring deliberate synergies to be appropriately valued and allocated, the TPG 2022 can be said to seek to achieve the following and may therefore assist in mitigating tax avoidance:

- prevent profit shifting and other tax avoidance strategies (by seeking to accurately allocate profits opportunities for MNEs to shift income to low-tax jurisdictions artificially may be reduced);

- enhance transparency (the need for detailed documentation and analysis increases transparency, allowing tax authorities to scrutinise transfer pricing arrangements effectively); and

- align profits with economic reality (where the true economic activities and value creation within the MNE are reflected, the approach can be said to enhance the integrity of the tax system).

While the classification offers a structured approach, its effectiveness in promoting fair taxation and mitigating tax avoidance has limitations, including:

- Definitional ambiguity. While the historic active / passive dichotomy is generally accepted as a practical necessity from a tax administration viewpoint, the revised TPG has been stated to transform what was once a black or white issue into infinite shades of grey, suggesting that even transactions of an overall active character (such as explicit guarantees or procurement services) should be bifurcated into passive and active elements (Osborn and Khripounova, 2016). A further example of boundary issues, and in particular boundary overlap, is intra-group financing where passive association and deliberate actions are considered to overlap (Vilaseca, 2020). These ambiguities may lead to inconsistent application and potential disputes between taxpayers and tax authorities.

- Changed object of inquiry. The OECD's guidance on group synergies has been said to effectively change the object of inquiry from what unrelated parties would charge to what related parties in question would charge -

this has been described as a “subjectivisation” of the ALP in relation to group synergies, which may lead to greater interpretative uncertainty and ultimately inconsistent applications (Osborn and Khripounova, 2016).

- Administrative burden. The detailed analysis and documentation required for deliberate synergies can be onerous, especially for large MNEs with numerous intercompany transactions.

- Continued potential for tax avoidance remains. Despite the TPG 2022’s inclusion of synergies and its reliance on the delimitation of deliberate and incidental synergies, sophisticated MNEs may still find ways to structure transactions to minimise their tax liabilities.

Conclusion

The TPG 2022's classification of MNE group synergies into incidental and deliberate synergies can be viewed as a significant step towards promoting fair taxation and mitigating tax avoidance. By aligning transfer pricing practices with the economic realities of MNE operations, the TPG 2022 can be viewed as seeking to increase integrity in the international tax system. However, challenges in defining and applying the TPG 2022’s classification may limit the TPG 2022’s effectiveness. Ongoing efforts to clarify definitions, simplify compliance, and enhance cooperation between taxpayers and tax authorities are likely to remain necessary.

Question 5

There is no single way to answer this question and the following provides one possible schematic.

Hybrid mismatch arrangements exploit disparities in tax treatment between jurisdictions, that may lead to instances of double non-taxation. Such arrangements have the potential to undermine the integrity of international tax systems, erode tax bases and distort economic competitiveness. Addressing these mismatches is considered essential to ensure fairness and maintain the stability of global tax systems. Two primary approaches have emerged to tackle this issue: tax harmonisation, which seeks to align tax laws across jurisdictions; and linking rules, which adjust tax outcomes based on the treatment in the counterparty jurisdiction.

Tax harmonisation

Harmonisation aims to eliminate the differences in tax laws that give rise to hybrid mismatches. There is a view that harmonisation provides a comprehensive solution by globally aligning tax treatments, thereby removing opportunities for double non-taxation (Dalton, 2012). Significant challenges impede the practical implementation of harmonisation. Firstly, national sovereignty over taxation is a fundamental principle that countries are reluctant to relinquish. Differences in economic structures, fiscal policies, and political priorities make global harmonisation of tax laws difficult to achieve. There is a view that national interests and concerns over economic competitiveness prevent effective harmonisation (Dalton, 2012).

The EU's attempt to implement the Common Consolidated Corporate Tax Base (CCCTB) exemplifies the obstacles encountered in pursuing tax harmonisation. Moreover, harmonisation may disproportionately affect developing countries (where they are often reliant on source-based taxation and could be disadvantaged by harmonisation efforts aligning with residence-based taxation principles prevalent in developed (Parada, 2018)). Smaller economies may also resist harmonisation due to concerns over loss of fiscal sovereignty and potential adverse impacts on their revenue base. Given these complexities, tax harmonisation may continue to be impractical.

Linking rules

Broadly, linking rules adjust a jurisdiction's tax treatment based on how the transaction is treated in the counterparty jurisdiction. The OECD endorses linking rules as a means to neutralise mismatches without requiring countries to harmonise their tax systems (BEPS Action 2). There is a view that linking rules are effective in ensuring that income is taxed once, thereby preventing double non-taxation (Dalton, 2012) and that the flexibility of linking rules may allow jurisdictions to respond to specific hybrid arrangements. By implementing primary and defensive rules, countries can seek to, broadly, deny deductions or require income inclusion to counteract mismatches. This approach is considered to be consistent with national sovereignty and enables countries to tailor their responses without overhauling their entire tax system.

Despite their practicality, linking rules have some limitations. There is a view that the underlying concept of "full taxation" that supports linking rules lacks conceptual clarity and coherence (Parada, 2023). The indeterminacy of what constitutes adequate taxation complicates the application of linking rules, potentially leading to arbitrary taxation outcomes. There is a view that "full taxation" is a vague normative aspiration rather than a practical standard, resulting in jurisdictions potentially applying linking rules instrumentally to impose tax where another jurisdiction does not, regardless of the underlying economic activities (Parada, 2023). Such an outcome-driven approach may conflict with the principle of tax neutrality.

Moreover, reliance on the tax treatment in another jurisdiction introduces complexity and uncertainty. Taxpayers may face difficulties in predicting tax liabilities, and disputes may arise over the interpretation and application of linking rules. The complexity of linking rules has been described as hindering effective enforcement, as each transaction must be individually analysed to determine if the income is taxed in the corresponding jurisdiction (Hey, 2024). This is particularly problematic when tax effects occur in different periods, increasing the compliance burden (Hey, 2024). Furthermore, at a more generic level, it can be said that linking rules may violate key tax principles, such as the ability-to-pay principle and the objective net principle (Hey, 2024) and the consequent shift in taxing jurisdiction may not align with the value creation principle, leading to unintended consequences, including potential double taxation. A further concern is that the hybrid mismatch rules may overlap with and other measures (such as interest limitation rules), which can result in excessive taxation and unintended burdens on taxpayers.

Conclusion

Tax harmonisation, though theoretically comprehensive, may be impractical due to significant obstacles. Linking rules may be a more feasible solution but may lack coherence and could lead to arbitrary taxation if not carefully designed (Parada, 2023) and their complexity and enforcement challenges, may undermine their effectiveness (Hey, 2024). It may also be noted that the potential for overlaps with other measures highlight the need for international coordination.

While linking rules may currently appear to be a more effective solution to address the risk of double non-taxation arising from hybrid mismatches, they continue to require refinement and careful implementation.

PART B

Question 6

There is no single way to answer this question but the following provides one possible schematic.

Candidates should consider the possible implications of each alternative situation and consider the potential application of Article 13 OECD MTC 2017 (Article 13) with a focus on Article 13(4). It is not anticipated that candidates will spend any time discussing the residence of either company under the DTA as this information is provided in the question.

Article 13 provides for the allocation of taxing rights in respect of gains derived from the alienation of immovable property (IM). The definition of IM is found in Art 6 OECD MTC 2017. The land situated in Country Y will be IM under Art 13 and would also be expected to fall within domestic law definitions of real property or IM. The focus is on the operation of Art 13(4) DTA. While it is necessary to examine the consequences of Danica's potential alienation of the shareholding in Laurio, the first step is to determine whether any gains made by Danica arise from property disposals that do not fall within Art 13(4) (in which case Country X would have sole taxing rights) or whether the gains fall within Art 13(4) because Laurio (the company in which the shares are held) qualifies as "land-rich." This would be based on whether Laurio holds an interest deriving 50% or more of its value directly or indirectly from IM situated in Country Y, thereby effectively treating the shareholding disposal as one of IM. In such a situation Country Y could also have taxing rights over the gain. Gains falling under Art 13(4) are in a class of income and gains that may be taxed without limitation by the source or situs state (Introduction to the OECD MTC 2017, [21]) and are an exception to the general rule in Art 13(5), which prevents taxation of gains from shares or securities in the source state.

Candidates may note that some countries reserve the right not to include Art 13(4) in their DTAs e.g. Belgium, Luxembourg, and the Netherlands (Reservations on Art.13, [51]).

Where Danica's shareholding in Laurio is disposed of on day 365 of tax year 2, the disposal needs to be classified as either falling within Art 13(4) or not. The first ask is to consider the asset composition of Laurio as there is a need to consider its asset composition in the 365-day period preceding the date Danica disposes of its shares in Laurio i.e. count back 365 days from Day 365 of year 2 to day 1 of tax year 2.

Laurio's asset composition on day 1 of tax year 2 is as follows: land situated in Country X with a value of $100 million; land situated in Country Y with a value of $400 million; shareholding in entities resident in countries other than Country X and Country Y that hold assets that do not derive their value directly or indirectly from land in either Country X or Y with a value of $100 million.

When looking at Laurio's assets there is a need to do the following for each situation:

(i) Work out the 365-day period.
(ii) Calculate the total value of Laurio's assets.
(iii) Calculate the value of Laurio's assets that derive their value directly or indirectly from IM in Country Y.
(iv) Determine the ratio of (iii) to (ii).

Candidates may note that Art 13(4) does not refer to the method of determining the relevant value (e.g. mark to market value or book value). While there is support for a book value approach - as there may be greater certainty and a reduced compliance burden relative to mark to market - there is also a concern that book value may not accurately reflect the value of the relevant entity's assets (e.g. where financial statements may not adjust for relevant considerations such as depreciation) (La Canida and Catinari, 2024). Daily mark to market valuations may be considered to be more onerous and this burden may increase when there is a need to ascertain the values of the underlying assets of an entity. The following relies on the information given in the question to determine the relevant values.

<u>Where Laurio enters into the arrangement</u>

Where Laurio acquires shares (anticipated market value of $300m) in the various travel companies on day 355 of year 2 with the intention of selling these in the first week of year 3, then the proportion of assets that are IM in Laurio's hands will change during year 2.

Counting back from the date of disposal of Danica's disposal of its shares (day 365 of year 2) in Laurio, the 365-day period is: day 1 of tax year 2 until day 365 of tax year 2.

It is necessary to ascertain whether during the 365-day period, Danica has held any shares that derive more than 50% of their value from IM in Country Y.

On day 365 of year 2, Laurio continues to hold IM in Country Y with a value of $400 million and its total assets will likely have a value of $900 m if it acquires the shares in the travel companies.

Therefore, "at the time" that Danica disposes of its shareholding in Laurio, the value derived from IM in Country Y will represent 400/900 = 44% i.e. less than 50%.

Danica may be under the impression that if it sells its shareholding in Laurio at a time when the shares derive less than 50% of their value from IM in Country Y that Country X will have exclusive taxing rights over any gain on disposal. However, the 365-day test applies on an "at any time during the preceding 365-days" basis. Between day 1 of tax year 2 and day 365 of tax year 2 Laurio had assets that were IM in Country Y and that constituted 400/600 of its total assets i.e. more than 50%. Accordingly, Art 13(4) is likely to apply and Country Y is likely to have taxing rights over any gain made on Danica's disposal of its shareholding in Laurio.

Candidates may note that the change to the 365-day test was made to the OECD MTC 2017 so that it operated on an "at any time" basis rather than on an "at the time" of the disposal basis (and it can also be noted that it also features in the MLI, Article 9(1)). Had this change not been made to the OECD MTC 2017 then any gain Danica made on the disposal of its shares in Laurio may have fallen outside (a pre-2017 version of) Art 13(4)).

Candidates may also note that there is no information about whether the shares here were listed and countries may determine to exclude shares in listed companies from Art 13(4) but this does not arise on these facts (Commentary on Art 13(4), [28.7]).

<u>Where Laurio does not enter into the arrangement</u>

Where Laurio does not enter into the arrangement then on the basis of the information provided there is a need to consider only the assets held by Laurio on day 1 of tax year 2.

Counting back from the date of disposal of Danica's disposal of its shares in Laurio, the 365-day period is: day 1 of tax year 2 until day 365 of tax year 2.

As noted above, it is necessary to ascertain whether during the 365-day period, Laurio has held any assets that derived more than 50% of their value, either directly or indirectly, from IM in Country Y.

The facts reveal that on day 1 of tax year 2 Laurio had $400 million of IM in Country Y out of total assets of $600 million i.e. 2/3. Where Laurio does not make any acquisitions or any disposals then throughout year 2 Laurio has assets that derive more than 50% of their value from IM in Country Y. Candidates may note that it is not necessary for the value of the IM to be more than 50% throughout the 365 day period in order for Article 13(4) to apply as there is only a need for it to exceed the threshold "at any time" during the preceding 365 day period but in this scenario the threshold is met both throughout the period and also "at any time" during the period.

Accordingly, Danica has disposed of a shareholding that is "land-rich" and Country Y is likely to have taxing rights over any gain made upon its disposal of its 12.5% shareholding in Laurio.

<u>Conclusion</u>

Country Y is likely to having taxing rights under both scenarios (i) and (ii). It is unclear whether Country X will tax any resulting gain but where it does, it will need to provide relief from any double taxation.

Question 7

There is no single way to answer this question but the following provides one possible schematic.

The following provides an overview of some of the issues that candidates may raise in their answers. While it is open to candidates to reference DTAs in practice, domestic law, relevant case law and to contrast the approaches under the OECD and UNMTCs, the below provides an overview of some of the considerations that may arise when determining whether the payments may be more or less likely to fall within Article 12 / 7 OECD MTC 2017 (with references to the Commentary) and which contracting state(s) may be more likely to have taxing rights. Given the minimal facts in the scenario and the nature of the subject matter it is anticipated that responses may be nuanced. Candidates may note that where the payments are classified as royalties or business profits, Country A, as the state of residence, is likely to have sole taxing rights unless SA has a PE in Country B under Article 5 (in which case, Article 12(3) or Article 7(1) may apply). References to "Articles", the "Commentary", "Reservations" and "Positions" below are references to the OECD MTC and its Commentary respectively, unless otherwise stated.

Article 12

Given that Article 12 is a "special allocation norm", there is a need to first consider whether the payments may fall within Article 12. Article 12(2) provides a definition of royalties (described as not relying on domestic law (unlike Articles 10 and 11), (Taylor (2021) and providing an autonomous definition (Valta and Langner, 2022)). It is considered preferable for the term to have an autonomous DTA meaning (taking into account the changes to the Commentary on Article 12 in 1999/2000, Chatel 2021; Jimenez 2021 (Butani and Kerjwani, 2021)) as reliance on domestic law may lead to classificatory mismatches (Orrego 2023).

Article 12(2) provides that "[t]he term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience." It is acknowledged that in practice the boundary, especially regarding software payments, can be complicated by, for example, differing national approaches with references being made to domestic law (including IP law); countries reserving their Positions (e.g. Democratic Republic of Congo and Malaysia, Positions, [12.2]) or making Reservations that reserve the right to amend DTA royalty definitions to align with domestic law (e.g. Australia, Reservations on Article 12(2), [39]); some divergent approaches in the OECD MTC and UNMTC / their Commentaries (with, for example, the UNMTC having introduced Articles 12A and 12B); court decisions being highly dependent on the facts at issue; and tax administrations issuing interpretative rulings that may add further complexity and uncertainty.

Lump sum payment

Candidates may note that Article 12(2) does not explicitly refer to software. There appears to be support for the view that copyright in software cannot reasonably be separated from other copyright (software is generally protected by copyright), furthermore software may fall under "literary work" (Article 10, Agreement on Trade Related Aspects of IP Rights (TRIPS), 1994) and Valta and Langner, 2022), or may fall within "scientific work" (OECD, Tax Treatment of Software, 1992, [40] and Commentary on Article 12(2), [13.1]). Furthermore, some country regimes may classify software as a literary / scientific work for IP law purposes.

Although there is no information regarding Country B's classification of software as a literary / scientific work, the TRIPS reference, the Commentary on Article 12(2) and the fact that Country B's domestic law protects software means that it is possible that the payments may fall within Article 12(2). Candidates may refer to the Commentary and the distinction it makes between, broadly, rights to operate software (more typically not classified as royalties), [14] and rights to use the copyright (i.e. use in a way that would be the sole prerogative of the copyright holder etc) (more typically classified as royalties), [13.1]. The character of the payment may then turn on the nature of the rights acquired by CAI regarding use and exploitation of the software, [12.2]. It may be unclear that CAI has been granted rights to exploit rights that would otherwise be the sole prerogative of the copyright holder (Commentary, [13.1]) as CAI is not allowed to license nor distribute the beta version to third parties nor may it reverse engineer, decompile, disassemble, nor modify the beta version. It is open to candidates to consider whether CAI is allowed to reproduce the software when testing it or demonstrating its operation to clients. Where such reproduction is viewed as merely enabling effective operation of the software then it may be disregarded for classificatory purposes (Commentary, [14]). While the beta version may be shown to clients, it may not be clear that this would amount to a "public display", although a draft revenue authority view suggests that a display made to a "section of the public" in a commercial setting might be included (Australian Tax Office, TR 2024/D1). Overall, the payment may be more likely to be classified as business profits. In any event, absent a PE in Country B, Country A would then be likely to have sole taxing rights.

Hourly payments

As these are stated to be for SA's advisory services and are chargeable on a "time spent basis" these payments may be more likely to fall within Article 7 as business profits and on that basis Country A is likely to have sole taxing rights unless SA has a PE in Country B. Candidates may note that generally, where payments are made for, for example, technical assistance or after sales services then such payments may be more likely to be classified as payments for services (Commentary, [11.4]) and so may fall within Article 7 and where, for example, payments are made for the transfer of proprietary information (e.g. information behind the relevant software such as algorithms / logic that is subject to any available trade secret protection etc), such payments may then be classified as royalties and so may fall within Article 12, Commentary, [11.5] – although this type of arrangement has been described as being unusual. In any event, absent a PE in Country B, Country A would then be likely to have sole taxing rights.

Permanent Establishment (PE) in Country B

SA may be unlikely to have a PE in Country B under Article 5(1) as access to CAI's premises is controlled and there is evidence that SA's employees were denied access to CAI's offices such that the premises may not be at SA's disposal. Access to third party hotdesking facilities may well also be restricted but this information is not provided in the facts. There may be an argument that the very short-term nature of the visits by SA's employees may also support a finding that there is unlikely to be a PE in SA even though the activities conducted in Country B are unlikely to be considered to be preparatory / auxiliary as they appear to form part of SA's main business activity.

Conclusion

It is possible that both payments arising under the contract may constitute business profits under Article 7, granting Country A sole taxing rights in the absence of SA having a PE in Country B. Candidates may note that under the OECD MTC 2017 royalties are solely subject to tax in the residence state under Article 12(1) and in this sense the allocation of taxing rights is the same whether the payments are classified as royalties or business profits (with the proviso that where a SA was found to have a PE in Country B then Country B may have taxing rights in relation to the two payments). On the facts it is unlikely that SA has a PE in Country B. Candidates may conclude by placing the boundary issue in context and noting that while there is support for the view in the Commentary regarding use of the copyrighted product / use of the copyright distinction, this has been referred to as a "restrictive capital exporting countries' approach" (Orrego, 2023), which can be contrasted with a "broader capital importing countries' approach" (e.g. in some DTAs in practice).

It is also open to candidates to note the difference in allocation of taxing rights -vis-à-vis the UNMTC as well as interpretative issues relating to the Article 7/12 boundary more generally. A further point is that it is not clear that the allocation would be disturbed on the basis of DTA anti-abuse rules, given that there is no indication that the transactions were entered into for the (principal) purpose of accessing DTA benefits nor is there anything to suggest the two companies are related.