Answer-to-Question-_2_

Introduction

Debt and equity characterisation has been a matter of both local legislation of Countries but also takes precedence to the international tax discussions.

Countries use different policies in relation to interest deductions to combat tax evasion (thin capitalisation rules)

The efforts OECD in its Action Plan on Base Erosion and Profit Shifting (BEPS) also made considerations as to the level of interest deductions. More specifically action point 4 focuses on limiting base erosion as a result from interest deductions and Other Financial Payments

Analysis

There has been a tendency especially across multinational enterprises (MNEs) to be financed by debt as opposed to equity. Debt financing is more tax efficient as MNEs have the right to deduct interest expense from their taxable profits.

Across large MNEs groups there is increase intra-group financing, whereby borrowers are placed on low tax jurisdictions and lenders on higher tax jurisdictions to make the most out of interest deductions.

International considerations

Following the tendency of groups placing high level of debts in hign tax jurisdictions and using intragroup interest deductions (in excess of arm’s length), BEPS actions point 4 sets out examples of best practises against abuse.

The first recommendation is on a fixed ratio rule equivalent to a percentage of earnings befor interest and taxes (EBITDA) (recommended range between 10% to 30%).

The other recomendation refers to an ‘equity escape’ rule whereby a fixed debt to equity level (or similarly equity to assets). The reports specifies that this option can be undertaken insofar there is no improper discrimination.

The BEPS considerations explains various ways to reduce the impact of these rules such as de minimis threshold which carves out of scope entities with low interest expense, and exclusion rule of interest on loans raised for public benefit projects (subject to conditions) and the option to carry forward restricted interest deductions for use in the future.

Article 9 of the Model Tax Convention provides for mere solutions in combatting this phenomenon by apllying the arm;s length principle as it comes to intra-group services. It specifically that differences between the profits stemming out of intra-group transactions compared to those between independent enterprises will be taxed accordingly.

The arm’s length principle is abided by reference to transfer pricing guidilines which employ functional analysis and observes compareable market transactions.

In consistency with the purposes of traties, Paragraph 2 of the article provides for a relied in situations of economic double taxation, insofar as an enterprise of one State are revised upwards will be subject to tax on the amounts of profit which has already been taxed in the hands of the other party. In this respect the counterparty makes an appropriate adjustment to relieve from double taxation.

Local legislations provisions

Many countries followed through the BEPS considerations and following the Anti-Tax Avoidance Directive (ATAD) have employed restrictions on interest deductions (caps) permitted. Fon instance Cyprus employs interest limitations rules which restrict borrowing costs up to 30% of EBITDA at a group level with a deminimis level of 3 million euro of interest expense and carry forward option.

Cyprus tax legislation also requires that all transactions between connected persons are carried out on arm’s length.

Many countries have used the fixed debt-to equity ratio; for instance Germany used this rule for many years now.

Conclusion

Many countries have shown interest in nterest limitation and thin capitalisation rules to counteract tax evasion through excessive interest deductions.

Albeit still in use, there are discussions against the arm’s lenth principle and shift towards a more simple ‘formulatory’ approach in transfer pricing guidelines (i.e. global formulatory apportionment)

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Answer-to-Question-1

Introduction

There have been many discussions when it comes to the interpretation of traties and case law serve as means in the determination of widely accepted practices.

Analysis

Article 3 of the MTC contains definitions and provides that the term 'enterprise' applies to the carrying on of any business. This is a relatively broad concept rather than a definition which suggests that the it is left in open interpretation on purpose. The commentary on the word enterpise explains that the 'enterpise' has been customarily interpreted according to the provisions of domestic legislation and that there is no exchaustive definition. Special reference is made to 'performance of profesional services and of other activities of an independent character'which will constitute an 'enterprise' despite the provisions of local legislation. However this clarification remains and option to the Contracting States. Accordingly, Italy and Portugal reserve the right not to include the definition of an enterprise as they make use of the article on independent personal services (currently deleted from the MTC).

Paragraph 2 of article 3 of the MTC provides that if there is no relavant definition in the treaty, the term shall have the meaning under domestic law unless the context otherwise requires or the competent authorities agree to a different meaning under the mutual agreement procedure (article 25). This translates that the contect prevails over domestic applicable laws. The addition made in 2017 provides that in case a mutual agreement is reached under article 25, the domestic law definition of the term would not be applicable (Commentary paragraphs 12 & 14 on article 3(2). Article 25 is the result of BEPS project minimum standard on dispute resolution (Action Point 14)

Case law rules on Interpretation

As per the case of Commerzbank the following should be taken into account in the interpretation of treaties:

- Purposive approach in interpretation
- International nature of the treaty
- The Vienna Convention on the law of treaties(VCLT)
- The definitions included in the treaty and commentary
- Any other protocols agreed

Articles 31 and 32 of the VCLT provide that the treaty shold be interpreted in good faith. Ordinary meaning of terms should be considered ‘ in their context and in the light of the obkect and purpose of the treaty’

The ‘content’ includes the text, preamble and annexes of the treaty itself and any other subsequent agreements and/or practices.

A special meaning might be given to a term if a greed between the two contracting states.

In situatuations where the meaning intrpreted is absurd or unreasonable, recourse may be taken to supplementary means of interpretation.

Changes made in 2000

Article 14 on taxation of independent professional services has been deleted in 2000. This was done as taxation of business profits are covered in article 7. In other words income derived from independent profesional services is now dealt under article 7. Some countries like Estonia reserve the right to include article 14.

The corresponding article still exists in the UN Model treaty

Conclusion

VCLT is a widely accepted instrument in the interpretation of treaties although commentary is widely used as well. Commentary on the Interpretation of traties gives precedent to ambulatory approach rather than a static approach.

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Answer-to-Question-6

1 - Ways to limit liability in Country X

As per article 5 of the MTC, paragraph 3, a building site or construction or installation project consitutes a Permanent Establishment (PE) only if it lasts more than 12 months. In this case the work on the platform in year 1 took place outside of country X. A PE would be created in country X in year 2 where installation will take place, provided that installation would last more than 12 months (paragraph 49)

As per the Commentary no PE will exist even of there is an office provided that the construction project is less than 12 months.

Prepatory works are defined in paragraph 54 which provides that a site for the purposes of article 5 exists from the date on which the contrctor begins his work in Country X.

It appears that the project would be a period of less than 12 months therefore no permanent establishment would be created in country X

Special consideration shall be made to the anti-abuse rule of the 12-month threshold. If the project is on purpose designed to be less than 12 month period to take advantage of the exemption, it would be overruled and ABC would be taxed in Country X by virtue of a PE therein.

Counterarguments of country X

By the reason of physical presence in country X as an office will exist there with personnel(at least in year 1) the revenue authorities of X can claim that a PE exists and ABC should be taxed accordingly.

However for this condition to hold the works undertaken by the staff working there shall not be of prepatory or auxiliary character.

However one might argue that documentation and coordination execution of delivery documents will be of prepatory and auxiliary character as the main contract has already been concluded.

Conclusion - 3

The arguments in favour of ABC seem to be stronger as the term if a construction site has a strict threshold of more than 12 months to constitute a PE.

It would be difficult to argue that the activities exercised by the staff in the office of Country X are not of prepatory and auxiliary nature.

As a result ABC would be taxable to its state of residency.

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Answer-to-Question- 3

Introduction

OECD’s action BEPS action plan 1 focuses on adressing the tax challenges of the digital economy.

Common features o digitalisation include increase in mobility and reliance on data.

The mojor issue is that enterprises are being involved in the economic life of many jursidictions without any physical presence. The issue becomes worse when new and intangible value drivers come into force.

A 2 pillar approach is recommended by the members of the

Inclusive Framework following Action Point 1 by the OECD.

This approach includes revised profit allocation and nexus rules which are more appropriate in terms of 'value creation and profitability'.

Under the first pillar taxing rights will be allocated by reference to market and user jurisdictions, i.e. where value is created. this could imply as shift against the OECD's existing transfer Pring Guidelines which focuses on the arm's lenth principle (unified approach)

Oher discuusions under BEPS action point 1 include the concepts of significant economic or digital presence, and expoitation of 'user participation and 'marketing intangibles', all in line with value creation.

Undr pillar 2 the Inclusive Framework focus is to combat BEPS to low tax jurisdictions by giving the ability to jurisdictions to tax such profits (global anti-Base erosion proposal - GLoBe). An income inclusion rule is recommended that would tax the income of a controlled entity if that icome was subject to tax at a rate below the 'minimum' rate. this is line with CFC rules.

The income inclusion rule would be supplemented by tax on payments where the corresponding income was not subject to tax (duduction, no taxation)

Conclusion

In an increasingly digitalised economy the allocation of taxing rights can no longer solely allocated by reference to physical presence.

OECD's Action Point 1 and Inclusive Framework's 2-pillar approach recognise the need to a nore fair allocation in line with a globalised work and value creation.

All these efforts work towards a global minimum tax rate for MNEs. There is a greater focus on formula-based solutions eg.EU’s proposal for Common Consolidated Tax Base (CCCTB)which proposes a shared system of tax rules for the determination of taxable income across countries.