THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2023

MODULE 1

SUGGESTED SOLUTIONS

PART A

Question 1

The question requires candidates to demonstrate an understanding of the BEPS IF minimum standards (MS) and to evaluate/analyze their effectiveness in improving: the alignment of taxation with substance and value creation, transparency while promoting increased certainty and predictability, and dispute resolution mechanisms. A good attempt at answering the question will include the following:

- Introduction – identification of the MS.
- Brief description of each MS, including key focus areas, where applicable.
- Analysis, evaluating the impact/effectiveness of the MS – requires a discussion of the changes introduced to tax laws/regimes (including the MLI) because of the adoption/implementation of the minimum standards and how those changes have helped to the aforementioned objectives.
- Conclusion – summary of key points and a consideration of any recommendations for improvements (noting that reference to possible improvements does not form part of the required).

One possible solution is as follows:

Introduction

The BEPS package consists of a final report adopted for each of the 15 BEPS actions, with four of the actions providing for a minimum standard (MS). All members of the OECD/G20 Inclusive Framework on BEPS (IF) have agreed to implement the minimum standards (MS), which were agreed, to tackle avoidance in cases where no action would have created negative spill overs (including adverse impacts of competitiveness) on other countries (OECD/G20 BEPS Project: BEPS Project Explanatory Statement, Final Reports 2015, para. 11 (OECD, 2015) and OECD, Tax Challenges Arising from Digitalisation – Interim Report 2018, Foreword and Chapter 3).

The BEPS MS are contained within Actions 5, 6, 13 and 14; each of which is outlined below. Each MS is subject to peer review (or "targeted monitoring", OECD 2015) to ensure timely and accurate implementation and thus safeguard the level playing field. All IF members commit to implementing the MS and participating in regular peer reviews to assess the extent to which the relevant MS has been implemented across countries (e.g. OECD, Country by Country Reporting – Compilation of 2022 Peer Review Reports).
Given the focus of the question is on, broadly, substance, transparency and certainty/predictability there are a number of different ways candidates' answers could be structured. The following provides one possible schematic.

BEPS Minimum Standards

Action 5 – Countering harmful tax practices more effectively, taking into account transparency and substance – focuses on three broad areas:

- Preferential tax regimes (assessing such regimes to identify features that can facilitate BEPS);
- Transparency (developing a framework for the compulsory spontaneous exchange of relevant information); and the
- Substantial activities requirement (requiring that the taxation of profits is broadly aligned with substantial activity)

Action 6 – Preventing the granting of treaty benefits in inappropriate circumstances - is focussed on providing minimum standards and safeguards for tax treaty (DTA) abuse. Action 6 recommends a three-tiered approach to dealing with treaty shopping (DTA shopping) and other treaty abuse strategies: inclusion of a clear statement of intention in relevant tax treaties (DTAs) to eliminate double taxation without creating opportunities for non-taxation or reduced taxation by way of tax evasion / avoidance / treaty shopping; and the inclusion of an anti-abuse rules within relevant DTAs by way of either:

- a combined limitation of benefit (LOB) and principal purpose test (PPT);
- the PPT rule alone; or
- the LOB rule supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in DTAs.

Action 13 – Guidance on transfer pricing documentation and Country by Country Reporting (CbCR) - requires the development of rules regarding transfer pricing (TP) documentation to enhance transparency for tax administrations while considering compliance costs for businesses. It seeks to develop a framework and common template for multinational enterprises (MNEs) to provide relevant governments with information on their global allocation of income, economic activity, and tax paid in the countries in which they operate. Action 13 recommends a three-tiered standardised approach to transfer pricing documentation consisting of: a Master File, a Local File, and a Country-by-Country Report.

Action 14 – Making dispute resolution mechanisms more effective – aims to make dispute resolution mechanisms more effective by developing solutions and measures to address issues that prevent countries from resolving DTA-related disputes under the mutual agreement procedures (MAPs). Action 14 focuses on four key areas: preventing disputes, the availability and access to MAP; resolution of MAP cases and implementation of MAP agreements.

Assessing the impact of the BEPS Minimum Standards

When considering the extent to which implementation of the MS has achieved: alignment of taxation with substance requirements; and increased transparency, certainty and predictability some points that could feature in candidates' answers include:

Aligning taxation with substance

Action 5: If member countries have been taking steps to ensure that the harmful aspects of harmful or preferential regimes that may contribute to BEPS are addressed. Since the start of the BEPS project, the OECD Forum on Harmful Tax Practices has reviewed 319 regimes. Certain Intellectual property (IP) regimes which examples of harmful or preferential tax regimes, are now being abolished or amended because of Action 5. The nexus approach under Action 5 requires that tax benefits be provided to income derived from IP assets only to the extent that the related, underlying research and development (R&D) activities are undertaken primarily by the taxpayer itself or in the tax jurisdiction providing the benefits. To this end, jurisdictions such as France (reduced corporation tax rate on IP income), Belgium (deduction for innovation income) and the Netherlands (innovation box) have amended their IP regimes to include the nexus approach (with either no grandfathering or grandfathering that ended in 2021).

A further example is Luxembourg which has abolished its partial exemption for income/gains derived from certain IP rights regime (OECD, Updated Conclusions on the Review of Preferential Tax Regimes, 2023). According to the OECD, "all IP regimes are, with one exception, now either abolished or amended to comply with the nexus approach. These changes mean that it is no longer possible to shift income from IP assets into a preferential regime without having undertaken the underlying R&D activity to create that IP…" (OECD, Harmful Tax Practices – 2018 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5, 2019,). Whilst Albania's software production and development incentive continues to be harmful due to the fact that it does not have any substantial activities requirements and has been described by the OECD as being a "potentially harmful" preferential regime (OECD, Harmful Tax Practices – Peer Review Reports, 2023) on balance significant progress has been achieved in relation to preferential regimes.

More generally, Action 5 has been instrumental in curbing the hitherto widespread practice of establishing entities without economic substance in low or nominal tax jurisdictions, by elevating the substantial activity requirement to a key factor in assessing the harmfulness of preferential tax regimes and setting out a MS based on an agreed methodology to assess whether there is substantial activity in a preferential regime. As a result, there has been an increase in the introduction of new domestic legislation or amendments to existing legislation aimed at curbing BEPS and aligning substance with value creation. This includes proposed legislation such as the European Commission's Directive on Preventing Shell Companies from Misusing their Structure for Tax Purposes ("EU Unshell Directive"). A combination of Action 5 and the European Union's list of non-Cooperative Jurisdictions have also led jurisdictions traditionally classified as "low or no tax jurisdictions" to introduce domestic economic substance regulations (e.g., Cayman Islands (International Tax Co-operation (Economic Substance) Act (2021 Revision), British Virgin Islands (Economic Substance (Companies and Limited Partnerships) Act, 2018 and the United Arab Emirates (Cabinet of Ministers Resolution No. 57 of 2020, Concerning Economic Substance Requirements). It could also be said that significant progress has been achieved in relation to "low or no tax jurisdictions".

Action 6: Whilst the 2018 and 2019 peer reviews revealed that there were very few reported DTAs that met the MS, the 2021 peer review notes that the MLI (the main tool used to implement the MS) started to have a "significant effect" with "important differences in the progress made on the implementation of the [MS]" between countries "that have ratified the MLI and those that have not"(OECD, 2021). According to the OECD, there has been such widespread implementation of the Action 6 MS that countries have implemented necessary DTA changes either through their signature and ratification of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI) or by updating their DTAs through bilateral negotiations. (OECD, Tax Challenges Arising from Digitalisation – Interim Report 2018, Chapter 3: Implementation and impact of the BEPS package).

To date, 100 jurisdictions have joined the BEPS MLI, out of which 81 jurisdictions have ratified, accepted or approved the BEPS MLI. (OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS). As at May 2021, over 710 bilateral agreements (over 975 in May 2022) between members of the IF and an additional 60 (76 in May 2022) agreements between members of the IF and non-members complied with the Action 6 MS. (OECD (2022), Prevention of Tax Treaty Abuse – Fourth Peer Review Report on Treaty Shopping: Inclusive Framework on BEPS: Action 6 & OECD (2023), Prevention of Tax Treaty Abuse – Fifth Peer Review Report on Treaty Shopping: Inclusive Framework on BEPS: Action 6 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS).

In the majority of covered tax agreements (CTAs), both the preamble statement and the PPT were implemented to meet the minimum standard, with over 40 of the DTAs, including the LOB to supplement the PPT (with CTAs all incorporating the Preamble statement and the relevant DTA anti abuse rule). Whilst this would suggest that the anti-abuse rules in DTAs will support alignment of taxation with substance requirements it is perhaps too early to consider the extent to which these DTA amendments are achieving such an objective. Whilst it is the case that most countries have adopted the PPT as their preferred anti-abuse test, not all countries have adopted the PPT test (notably the USA).

Improving tax transparency

The adoption of the Action 13 MS on TP documentation (including CbC reporting by MNEs and automatic exchange of CbC reports by MNEs), makes it possible for tax authorities across multiple jurisdictions to have access to qualitative and quantitative information about the global tax and economic activities of MNE groups. Tax administrations can now more readily identify whether MNEs have engaged in activity (such as TP) that results in the artificial shifting of substantial amounts of income to tax-advantaged jurisdictions. This in turn enables tax authorities to make comprehensive tax and TP risk assessments, exchange relevant information and make decisions on the allocation of scarce resources for audits. It would appear that the implementation of this aspect of Action 13 has increased tax transparency.

A similar result could be said to be achieved with the automatic exchange of certain tax rulings under Action 5. BEPS Action 5 MS on the compulsory spontaneous exchange of information on tax rulings (also known as the "transparency framework") provides tax administrations with timely information on rulings that have been granted to a foreign related party of their resident taxpayer or a permanent establishment, which can be used in conducting risk assessments and which, in the absence of exchange could give rise to BEPS concerns. IF members invest significant resources to identify, prepare and begin exchanging information on rulings in line with the agreed framework. In some cases, jurisdictions have had to enact specific legislative and regulatory changes to allow spontaneous exchange of tax rulings (for instance, the EU adopted the Directive on Administrative Cooperation in Direct Taxation between the Competent Authorities of the EU Member States in 2015).

In its sixth annual peer review of the transparency framework released in December 2022, the OECD found that jurisdictions under review had issued over 23,000 in-scope tax rulings as at 31 December 2021. As at the same date, almost 50,000 exchanges of information had taken place between tax administrations around the world, providing authorities with useful information about potential risks to their own tax base (OECD (2022), Harmful Tax Practices – 2021 Peer Review Reports on the Exchange of Information on Tax Rulings: Inclusive Framework on BEPS: Action 5). It would appear that the implementation of this aspect of Action 5 has increased tax transparency.

Whilst the implementation of Action 14 MS could be said to increase transparency through its MAP Statistics Reporting Framework, there are also transparency concerns regarding MAP e.g., MAP decisions are not generally made public and this lack of transparency has been criticised (Mills and Spencer, 2015). It has also been noted that unless MAP arbitration decisions are "reasoned and published, they will not influence the interpretation or application of the 'DTA' by national courts" (Noonan and Plekhanova, 2023), which then may in turn dilute the benefits of improved MAP processes but would reduce transparency.

Ensuring greater certainty and predictability (possibly all four BEPS MS)

It could be stated that at a general level, the commitment of IF member countries to a consistent implementation of the MS combined with their widespread adoption serves to provide taxpayers (and administrations) with a degree of certainty as to how tax positions will be determined across multiple jurisdictions e.g. widespread ratification of the Multilateral Instrument (MLI) has introduced an element of consistency into DTAs that adds to the existing similarity in structure of DTAs more generally. Having said this, not all MLI provisions have found their way into all DTAs at a general level and there are still a number of countries that have not ratified the MLI (the USA being a case in point).

The process of determining a tax position may now additionally involve confirming whether the DTA is a covered tax agreement and then carefully considering to what extent, if any, the relevant provision has been modified by the MLI, which adds complexity to an already complex area of taxation. Where additional complexity is viewed as counter to certainty then it could be stated that a given tax position may be less certain as a result of the complexity involved in applying provisions with covered tax agreements. However, bringing the discussion back to MS, it can be said that in relation to Action 6, and as noted above, there has been widespread adoption of the Preamble of the MLI and also of the PPT such that this supports a finding of increased certainty and predictability at least as regards this specific MS.

It could be said that the MS contained within Action 14 MS on dispute resolution has also increased certainty and predictability. According to the OECD, Action 14 MS has had an impact on MAP and tax certainty and many countries are working to address deficiencies identified in their respective processes. For instance, an increasing number of jurisdictions have introduced or updated comprehensive MAP guidance to provide taxpayers with clear rules and guidelines on MAP, there has been a significant increase in the number of closed cases in almost all jurisdictions reviewed as part of the initial peer review process for the Action 14 MS and the number of IF MAP profiles continues to increase and now covers over 100 jurisdictions.

The Stage 2 Peer Review evaluated the progress of countries such as Brunei Darussalam, Guernsey and Monaco (following recommendations made in the Stage 1 Peer Review) and reported that these countries ensure that their MAP agreements are always implemented notwithstanding domestic time limits; arguably commitments such as this increase certainty and predictability. From 2023 onwards there will be a "continued monitoring process" with a simplified process for countries that do not have “meaningful MAP experience” (based on, inter alia, MAP caseload) with further reviews taking place. (OECD, BEPS Action 14 on Effective Dispute Resolution Mechanism, Peer Review Documents (Updated December 2022), 2023). Whilst these continued peer reviews support the view that greater certainty and predictability are being witnessed across the board, there is arguably still work to do in this space. For example, on the basis that it is accepted that mandatory binding arbitration (MAB) provides a high degree of certainty, reports that only 30 MLI signatories have opted into Articles 18 to 26 MLI (on mandatory binding arbitration) (Noonan and Plekhanova, 2023) may then signify that the level of certainty in the MAP area is still somewhat lacking. Further support for such a view can be found in the “transparency” section in that the lack of publication of MAP decisions may also lead to a lack of certainty and predictability in relation to the likely outcome of a given MAP case.

Action 13 can be said to provide some level of standardisation of data that both taxpayers and tax administrations alike can expect to respectively prepare or review and so could be said to have enhanced certainty and predictability. However, the business community, interested stakeholders, governments and commentators more generally are likely to continue to identify ways in which these objectives can be further realised. Some of the work to be done to better achieve these objectives has been noted in the above discussion.

Conclusion

On balance it would appear that the MS have contributed to increased: alignment of taxation with substance requirements, transparency and certainty. Whilst there is clearly more work to do to better achieve these objectives, when viewed collectively the MS have made in-roads into achieving the objectives in the question statement (one example of the synergies that arise as a result of viewing the MS collectively stems from the interaction between the MS e.g. it has been reported that it is becoming increasingly difficult to establish conduit companies and/or special purpose holding companies in low-tax jurisdictions with the aim of avoiding withholding taxes on passive income, especially since any tax rulings or similar arrangements granted by tax authorities reducing the effective taxation of taxpayers now have to be disclosed in line with Action 5 (OECD, Tax Challenges Arising from Digitalisation – Interim Report 2018, Chapter 3: Implementation and impact of the BEPS package).

Question 2

This question requires candidates to demonstrate knowledge of the arm's length principle (ALP) and global formulary apportionment (GFA) as methods for the determination and allocation of profits in transactions between associated enterprises.

Candidates should discuss (i) the key pillars of each method and (ii) the relative effectiveness of each method as a means of preventing profit shifting between associated enterprises.

Content to cover could include:

- An introduction to the two methods of profit allocation and the issue they both seek to address whether directly or indirectly.
- Overview of the mechanics of the ALP and GFA.
- Advantages and disadvantages of using the ALP and GFA.
- A consideration of which method is more effective at preventing profit shifting between associated enterprises.
- A brief conclusion.

One possible solution is as follows:

Introduction

The arm's length principle (ALP) and global formulary apportionment (GFA) are methods for determining and allocating profits across countries that arise from transactions involving associated enterprises (AE). Both have advantages and disadvantages as (i) allocators of business profits and (ii) preventers of profit shifting.

ALP

Article 9 OECD MTC 2017 works in conjunction with Article 7 in relation to business profits of AEs. Article 9 relies upon the ALP, which has been agreed upon by the OECD membership. Broadly, the ALP requires conditions of commercial and financial relations between AEs to be determined by market forces in the same way as transactions between independent enterprises. To correct possible tax distortions arising from transactions between AEs, the ALP adjusts the profits of AEs to bring them in line with market reality and results that would have been achieved had a transaction comparable to that undertaken by the AEs been effected in comparable conditions. Article 9(1) permits a contracting state (CS) to make a primary adjustment to reflect the ALP and Article 9(2) permits the other CS to make a corresponding adjustment to avoid economic double taxation.

The ALP can be described as comprising of the separate entity principle – in seeking to adjust profits by reference to comparable uncontrolled transactions, the ALP treats members of an MNE group (i.e., AEs) as operating as separate entities and a comparability analysis – focuses on both the nature of the transactions between AEs and whether those conditions differ from the conditions that would have existed in comparable uncontrolled transactions. Such an analysis of the controlled and uncontrolled transactions is referred to as a "comparability analysis" and is at the heart of the application of the ALP.

GFA

The GFA views an MNE group as a consolidated unit (as opposed to a collection of separate entities), determines MNE profits on a worldwide basis and allocates or apportions an MNE's global profit across its jurisdictions of operations. The allocation relies upon a predetermined formula, that could include factors such as costs, assets, payroll, and sales. Although the GFA has not yet been applied internationally between jurisdictions, some jurisdictions (e.g., the US (state corporate income taxes), Canada (provincial corporate income tax), Germany (municipal trade tax) and Japan (prefectures and municipalities levy, corporate inhabitant tax and enterprise tax)) have applied it domestically.

Advantages and Disadvantages of the ALP

Advantages of the ALP include:

- The ALP is enshrined in Article 9 OECD MTC 2017 and maintained and developed in the TPG 2022 (Koffler 2022 citing Langbein, 1986). It is also employed, inter alia, in Article 9 UNMTC, Article 9 US MTC. There is an argument that the ALP has the status of customary international law (Thomas 1996).
- The ALP provides opportunities for equal tax treatment for AEs and independent enterprises, thereby preventing the creation of advantages or disadvantages that would otherwise distort the relative competitive positions of each type of entity (Paragraph 1.8, Chapter I, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 (TPG 2022))
- The ALP is applicable across a variety of transactions for which independent comparable transactions can readily be found. There are also many cases where a relevant comparison of transactions can be made based on financial indicators such as mark-up on costs, gross margin, or net profit indicators (TPG 2022). Chapter I, Paragraph 1.9,
- The ALP has been claimed to avoid overlapping tax bases and double taxation of profits with a relatively low level of international cooperation (and correspondingly low-tax administration costs) ((Greil, Larden, Schreiber and Simons, 2020).
- The OECD has worked on many TP issues over the years (e.g., business restructuring and advance pricing arrangements) some of these forming part of the BEPS project (e.g., intangibles and country by country reporting). This could lend support to arguments that there is extensive guidance for both administrations and AEs alike to ensure compliance with the ALP.
- The TPG 2022 provide guidance on the ALP and have been agreed to by all member countries; this agreement has been described as creating a "soft obligation" on member countries to adhere to the TPG 2022 (Calderon, 2007) and have been described as having almost as much weight as the Commentary on the OECD MTC (Lahodny-Karner, 1994). This could be described as creating a level of certainty at an international level.

Disadvantages of the ALP include:

- Ignoring the economies of scale and interrelation of diverse activities created by integrated businesses, which may arise directly as a result of AEs internalising and centralising transactions within the group. Often AEs benefit from such "integration" as a result of implementing a business policies that are not driven by tax considerations. (Paragraph 1.10, Chapter I, TPG 2022)
- The ALP's reliance on comparability assumes access to relevant comparable market data. Such data is not always readily available and thus the application of the ALP may be difficult in the absence of comparable independent transactions to benchmark transactions between associated enterprises. (Paragraph 1.11, Chapter I, TPG 2022, Avi-Yonah, 2010[1]). This is perhaps particularly true in the current globalised, high-tech environment (Koffler, 2022
- The ALP is often viewed as complex, arbitrary and as creating a compliance burden for tax administrations and impacted taxpayers alike. (Paragraph 1.12 – 1.13, Chapter I, TPG 2022, De Moojj, Liu & Prihardini, 2019[2]).
- The reliance of the ALP on an arm's length range (with measures ranging from "any in the range" to the central tendency being relied upon in some circumstances by some countries) has arguably supported claims that the ALP is not an "exact science". It has also been described as creating uncertainties, which may only be partially mitigated by advance pricing arrangements (Baistrocchi, 2006).

[1] Reuven S. Avi-Yonah, "*Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation."* World Tax J. 2, no. 1 *(*2010): 3 – 18 and available at https://reporitory.law.umich.edu/articles/1181

[2] Ruud De Mooij, Li Liu and Dinar Prihardini, *An Assessment of Global Formula Apportionment,* International Monetray Fund Working Paper WP/19/213, published 2019 and available at: https://www.imf.org/en/Publications/WP/Issues/2019/10/11/An-Assessment-of-Global-Formula-Apportionment-48718

Advantages and disadvantages of the GFA include:

Advantages of the GFA include:

- GFA has been described as relatively easy to apply (De Moojj, Liu & Prihandini, 2019) in that it would provide more administrative convenience and certainty for taxpayers; viewing the MNE group on a consolidated basis will likely reduce compliance costs as, in principle, only one set of accounts would be prepared for the Group for domestic tax purposes. (Paragraph 1.19, Chapter I, TPG)
- GFA is more in line with economic realities as an MNE group must be considered on a group-wide or consolidated basis to reflect the business realities of the relationships among the AEs in the group, especially for highly integrated groups where it is difficult to determine what contribution each AE makes to the overall profit of the MNE group. (TPG 2022 Paragraph 1.19, Chapter I,).
- GFA may lead to an actual alignment of profits with value creation and discourage profit shifting to low tax jurisdictions, since profits will be allocated across jurisdictions based on actual economic activities performed in each jurisdiction and tax liabilities will follow such apportionments (Tax Policy Center, 2020).[3]

Disadvantages of GFA include:

- To avoid double taxation and ensure single taxation, the GFA would require an international consensus to adopt the approach, how to allocate corporate profits among jurisdictions as well as a consensus on the use of a common accounting system, on the factors to be used, and how to measure and weight those factors (TPG 2022, Chapter Paragraph 1.22). As negotiation and agreement on Pillar 1 has demonstrated, it can be extremely difficult to obtain international consensus on taxing rights and their allocation (Tax Policy Center, 2020).
- There is a view that a predetermined formula will be arbitrary and necessarily disregards the particulars at issue (market conditions, individual circumstances, and management's own allocation of resources, thus producing an allocation of profits that may bear no relationship to the facts of the transaction etc.) (TPG 2022, Paragraph 1.25, Chapter I. See also Tax Policy Center, 2020.[4])
- Implementation of the GFA may increase compliance costs and data requirements because information would have to be gathered about the entire MNE group and presented in each jurisdiction based on the currency and the book and tax accounting rules of that jurisdiction (TPG 2022, Paragraph 1.27, Chapter I).
- Whilst formulary apportionment may be considered to better "achieve full tax goals", it may nevertheless require "fiscal fail-safes" (linking tax treatment countries, specify conditions under which tax treatment in one state triggers a response in the other; special tax treatment that deviates from ordinary treatment; and aims to achieve full taxation or otherwise curb avoidance) e.g. a revenue share could be allocated to a state that has productive factors, but that lacks jurisdiction to tax the income (Mason, 2020).

Assessing the effectiveness of the ALP or GFA in preventing profit shifting

A comparison between the ALP and GFA as regards their ability to successfully prevent profit shifting necessarily involves considering these methods at a theoretical level and then also factoring in the reality that the GFA has never been implemented at the international level. Whilst some domestic level evidence exists as to how the GFA might operate at the international level (e.g. the USA), it is simply not possible to assess GFA in the same way as the ALP, for which there is ample data.

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[3] Tax Policy Center, *Tax Policy Center Briefing Book – Taxes and Multinational Corporations (How would formulary apportionment work?),* available online at https://www.taxpolicycenter.org/sites/default/files/briefing-book/3.18.5_0.pdf
[4] Tax Policy Center, *Tax Policy Center Briefing Book – Taxes and Multinational Corporations (How would formulary apportionment work?),* available online at https://www.taxpolicycenter.org/sites/default/files/briefing-book/3.18.5_0.pdf

However, some points can be made in conclusion: the ALP has been criticised as been too porous, thereby incentivising MNEs to locate profits in low-tax countries, both by locating real economic activities in such countries and by shifting profits for tax purposes towards low-tax locations (Avi-Yonah & Benshalom, 2011).[5] According to De Mooij, Liu and Prihandini (2019) MNEs currently use tax planning techniques to shift taxable income between enterprises to minimise their overall CIT liability e.g. abusive transfer pricing, which may arise because of stretching, violating, or exploiting weaknesses in the ALP.[6] The BEPS Project highlighted the significance of TP in the quest to address BEPS concerns. Several BEPS Actions e.g., Action 8 (Intangibles); Action 9 (Risk and Capital); Action 10 (Other High-Risk Transactions) and Action 13 (Transparency). The BEPS focus has led to a significant amount of work on these various areas, including additions to the TPG 2022 for high-risk transactions, updating guidance on cost contribution arrangements and financial transactions).

While the GFA has the potential to eliminate the form of profit shifting prevalent under the ALP approach (as there is a perception that MNEs are less likely to reduce sales in a jurisdiction, simply to reduce tax liability (e.g. it has been reported over the years that the US states have shifted – in inconsistent ways – away from traditional three-factor apportionment towards sales-only apportionment factors gain a competitive advantage in attracting tangible investment and jobs (Hellerstein, 2018)), it may enable other forms of profit shifting. It has been posited that allocating profits on the basis of a formula may provide incentives to shift profits between MNEs and independently owned (unrelated) firms. (e.g. where physical assets help determine the location of MNE profits, a firm might have an incentive to contract its low-margin manufacturing activities in high-tax jurisdictions to independently owned (unrelated) firms instead of establishing a manufacturing subsidiary to reduce its share of capital assets allocated to high-tax countries (Tax Policy Center, 2020 and De Mooij, Liu & Prihandini, 2019).[7]

Sales-based allocations may also facilitate MNEs avoiding tax on the profits from their intangible assets by selling their products to independent distributors in low-tax countries, who would then resell them throughout the world (Tax Policy Center, 2020).[8] Accordingly and as noted above, even formulary apportionment might require fiscal fail-safes e.g. a revenue share could be allocated to a state that has productive factors, but that lacks jurisdiction to tax the income. In such cases, fiscal fail safes could provide rules for reallocating the untaxed share to the other taxing states, as in the “throw-around rules” found at the U.S.-state level (Mason, 2020).

Conclusion

The concern with the allocation of profits of MNEs across countries is a very live issue with recent evidence of the move away from a focus on ring-fencing the digital economy to a focus on more generalised concerns with the allocation of profits that has culminated with the two Pillars (Grinberg, 2020). Th extent to which the ALP or GFA is best suited to providing a comprehensive solution to the persistent problem of the optimal method of allocating profits and preventing artificial profit shifting by MNEs is at best unclear. Both methods have strengths and weaknesses and both may incentivise profit shifting, albeit in different forms.

Furthermore, whilst BEPS 2.0 incorporates “formulary apportionment” (in that it allocates business profits that are subject to tax and allocate these jurisdictions according to a formula) under Pillar One, it appears that it may be some time before the GFA replaces the ALP (see for example reports that the United States resisted country-by-country reporting because its officials feared the information in the reports would be used to allocate income according to factor presence, rather than arm’s-length transfer pricing, (Mason 2020). In conclusion, whilst the the approach of the IF and UN Subcommittee has been described as signalling the onset of the demise of, inter alia, separate entity taxation and arm’s length pricing (Cooper, 2021), support for the ALP remains with its proponents calling for it to be further developed to reduce

[5] Reuven S. Avi-Yonah and Ilan Benshalom, “*Formulary Apportionment: Myths and Prospects – Promoting Better International Policy and Utilising the Misunderstood and Under-Theorised Formulary Alternative”.* World Tax J. 3, no. 3 (2011): 37 1 – 98. Available online at https://repository.law.umich.edu/articles/1180
[6] De Mooij, et.al., page 10
[7] Tax Policy Center, see footnote 6. See also De Mooij, et. al., *Ibid.*
[8] *Ibid.*

complexity and increase certainty (including improving APAs and conflict resolution mechanisms, safe haven rules based on accounting figures) rather than replacing it with GFA (Greil, Larden, Schreiber and Simons, 2020).

Question 3

This question is designed to provide candidates with an opportunity to demonstrate their knowledge of DTA override. discuss why overriding domestic legislation may be perceived as problematic and consider whether DTA override is justifiable. A good attempt at answering this question will cover the following:

- Overview of the importance of DTAs.
- Binding nature of DTAs based on Articles 26 and 27 of the Vienna Convention on Law of Treaties (VCLT).
- Definition of treaty override, what it entails, approaches to the relationship between domestic and international law (monist vs. dualist) and why treaty overrides pose a problem.
- Evaluation of arguments in favour of and against DTA override and conclusion.

One possible solution is as follows:

Introduction

DTAs are legally binding on the relevant contracting states (CSs) as they are international treaties; CSs mutually undertake to respect and apply the DTA provisions (the principle of “pacta sunt servanda”, enshrined in Article 26 Vienna Convention on the Law of Treaties (VCLT)). The principle of pact sunt servanda embodies two elements (i) agreements must be kept (meaning that CSs enter a mutual obligation to respect and apply the DTA provisions) and (ii) agreement must be kept in good faith (suggesting that CSs take the necessary steps to comply with the object and purpose of the DTA). These elements are reinforced by Article 27 VCLT, which makes it clear that a CS may not invoke restrictions imposed by domestic law as a good reason for not complying with treaty obligations.

Whilst the principle of “pacta sunt servanda”, can be thought of as being sacrosanct this is not always the case. DTAs are instruments of public international law negotiated between sovereign states, whereas domestic law is the source for rights and obligations of individuals (such as taxpayers) and operatives (such as tax administrations) within any individual state.

DTA Override

DTA override implies that a CS by legislative action gives preference to domestic law over international law, and thus refuses to fulfill certain obligations arising out of the contractual nexus on grounds that the DTA obligations conflict with its domestic law. DTA override may happen unintentionally such as where:

1) A CS legislates to reverse the effect of a court decision that deviates from the common interpretation, explicitly expected by the treaty partners, of a provision based on the text of the treaty.
2) A CS’s newly adopted domestic legislation is incompatible with a DTA provision, without the competent organs intending, or even being aware of, such an effect.

DTA override may also occur intentionally e.g., where the legislature enacts domestic legislation intended to have effects in clear contradiction to its DTA obligations. DTA override under domestic law can be automatically avoided if, under a state’s constitution, a higher value is attributed to a DTA obligation than to domestic law or if a state regards treaty law as “lex specialis” to which priority is to be given in domestic law. On the other hand, if DTA obligations are considered as having – at most – the same rank as that of domestic law, they may, within some national legal systems be subject to the rule “lex posterior derogat legi priori” (i.e., later law overrides prior law).

While jurisdictions that treat international law as lex specialis are generally considered monist (viewing both international and domestic law as intrinsically part of the same legal system), jurisdictions with the lex posterior derogat legi specialis approach are considered dualist (i.e., view international and domestic law as separate regimes of law. In monist jurisdictions (e.g., some European countries like France and the Netherlands), a DTA that is validly executed in the international legal sense automatically takes full legal effect. In contrast, for dualist jurisdictions (e.g., the US, the UK, and many common law jurisdictions), the application of international law only occurs when it is expressly incorporated into domestic law. Accordingly, the manner in which a DTA is adopted into domestic law may determine whether that DTA can be overridden by subsequent domestic tax legislation. In dualist jurisdictions, there is, seemingly no domestic constitutional limitation that prevents DTA override.

The OECD, Recommendation of the Council concerning Tax Treaty Override OECD/Legal/0253. Adopted by the OECD Council on 2 October 1989 (OECD, 1989) notes that DTA override depends to a large extent on each state's legal system, how, and at what level, international law treaties, customary law, and general principles is placed at the domestic level. Accordingly, the level attributed to DTA obligations, as incorporated in domestic law, may determine whether derogations therefrom are unconstitutional or not (OECD, 1989, paragraph 14). A CS's ability to use its own domestic law to override a DTA obligation depends both on its domestic constitutional law and on the degree to which, under its constitution, the legislature is involved in the negotiation, conclusion and implementation of its DTAs (Ellife (2022),[9]

As well as the introduction of legislation that is perceived to run counter to a DTA provision or provisions, "other" types of DTA override have been recognised e.g. a more difficult" [override] is where a court gives effect to domestic tax legislation in a way that overrides the terms of the DTA whereby "judicial override may arise because a court is suspicious that provisions of the [DTA] may have a "disruptive' effect on the domestic tax system. (Roxan, 1997). This may also arise, because the relevant courts are "less familiar with the interpretation of [DTAs] than with the interpretation of domestic tax legislation." (Roxan, 1997). Others consider DTA override to "cover a multitude of occasions" ranging from a unilateral DTA modification by domestic law that was acceptable to the other CS but not in fact negotiated to a clear DTA breach" (Bartlett, 1991). Such a view of DTA override may provide a justification for certain types of DTA override.

Accordingly, it is at least possible that when there is a discussion involving DTA override there is a need to identify the specific acts that are claimed to constitute DTA override in a given case as these may inform subsequent arguments surrounding the possible justification or otherwise of the relevant type of DTA override. It should be noted however that the view that not all types of DTA override are unjustified is not universally shared e.g., there is a view that DTA override is a violation of international law (Vogel, 1997) and as such would be difficult if not impossible to justify.

Other matters that add to the difficulty in identifying DTA override in some cases may include the fact that there appears to be disagreement about when DTA override occurs e.g., when, for example, a domestic law is passed (OECD, 1989) or when that law is applied (Wouters and Vidal, 2006).

Evaluation of whether DTA override, as defined, can be justified

The following considers some of the arguments that candidates could include in their answers to either support / disagree with the contention that DTA override is justified:

DTAs as special types of international treaty and interpretative override

DTAs have been described a special category of treaties, distinct from other types of treaties – in both implementation and modification, as can be seen from the separation in the approaches taken by international tax lawyers and general international lawyers when applying the VCLT in practice (Ellife, 2022).[10] An example of a difference in the provisions of a typical DTA and other international treaties, is the inclusion of Article 3(2) of the OECD MTC in many DTAs. Article 3(2) is not commonly found in non-tax treaties. Article 3(2) is considered by some to be

[9] Craig Ellife, *Preventing Unacceptable Tax Treaty Overrides",* British Tax Review, Number 1, 2022, pp. 38 – 63 at page 42. See also paragraphs 13 – 17 of the OECD, *Recommendation of the Council concerning Tax Treaty* Override OECD/Legal/0253. Adopted by the OECD Council on 2 October 1989
[10] Craig Ellife, *Preventing Unacceptable Tax Treaty Overrides",* British Tax Review, Number 1, 2022, pp. 38 – 63 at page 47

a vivid treaty-based reminder of the connection between the DTA and the two contracting states' domestic legal systems, which allows the DTA to link into the relevant CS's taxing rights that are established in its domestic legislation.

The actual wording, of Article 3(2) is an ambulatory interpretation of the domestic law, which requires the meaning of the term to be determined at the time of application of the DTA as opposed to applying the meaning at the time the DTA was signed (implying a lex posterior derogat legi priori approach). Ellife (2022) citing John Avery Jones et.al., writes that the advantage of the DTA meaning of undefined terms following domestic tax law is that the taxing provisions of internal law and the relieving provisions of the DTA will then have the same scope.[11] This could then lend weight to the fact that a CS's interpretation of the domestic law at the time may not necessarily result in DTA override. This feature of DTAs has been described as meaning that "situations of technical override are expressly contemplated and "baked into [DTAs]" albeit "unless the context otherwise requires" (Eliffe, 2022). Such situations may be considered to constitute a form of "justified" DTA override or may be viewed as not constituting a form of DTA override at all to the extent they are anticipated. Notwithstanding such an interpretation, it is possible that an interpretation of a DTA term that is based on a domestic law meaning may go beyond the context of the DTA and as such the meaning would need to be considered in light of the relevant DTA's purposes (i.e., the DTA itself might curtail domestic law meaning where it goes beyond the context of the relevant DTA).

Preventing DTA abuse

There is an argument that domestic measures that seek to counter tax avoidance may constitute DTA override (Baker, 2013 referring to specific anti-avoidance rules to prevent the enjoyment of the tax advantage that would otherwise be given by the DTA) but by the same token such measures may be considered to constitute a legitimate objective for the use of overriding legislation (OECD 1989, [34]).[12] Justifications for DTA overriding on this ground include: (i) one of the purposes of DTAs is to prevent tax avoidance and evasion (ii) domestic general anti abuse rules often override DTA provisions and (iii) international law obligations of good faith do not sanction an abuse of rights. It could be noted that in recent years there have been discussions about the introduction of countries unilateral measures and whether these may be inconsistent with DTAs. An example of a unilateral measure that could potentially be considered to be inconsistent with DTAs is controlled foreign company (CFCs) rules.

The OECD has stated that CFC rules are not contrary to the provisions of the OECD MTC not only because CFC rules involve countries taxing their own residents (which does not conflict with the OECD MTC), but also because when the relevant provisions are read in their "context" the CFCs rules are not found to be contrary to the OECD MTC (OECD Commentary on Article 1, [81]). This lends support to the view that unilateral measures that seek to achieve DTA purposes (which previously included prevention of tax avoidance and evasion and now may also include anti-abuse as a central purpose) provide scope for certain unilateral measures to be introduced where these might be otherwise be considered to be "DTA override".

Notwithstanding this position there have been relatively recent instances where the introduction of unilateral measures has led to discussions as to whether said measures are inconsistent with DTA e.g. (i) the UK's revenue authority (HMRC) has stated that the Diverted Profits Tax was not a "covered tax" for the purposes of its DTA network (rather it was a "separate and distinct tax" and so sat outside DTAs, (HMRC, 2016)) and (ii) India's introduction of an Equalisation Levy (EL), which was introduced in 2016 and extended in 2020 and has been described by some commentators as "an alternative income tax" (that contravenes the permanent establishment concept in DTAs (Vasudevan and Sawana, International Bar Association, 2021).

The EL was introduced by legislation (Finance Act, 2016) other than the main income tax legislation and perhaps unsurprisingly questions have been asked as to whether the EL is a

[11] *Ibid.,* at page 49
[12] OECD, *Recommendation of the Council concerning Tax Treaty* Override OECD/Legal/0253. Adopted by the OECD Council on 2 October 1989, paragraph 34

"covered tax" for DTA purposes and more specifically whether it is an "identical or substantially similar tax" for the purposes of Article 2 (Rajgopalan, 2020).

Whilst there is support for the view that prevention of DTA abuse at the domestic level does not conflict with DTAs at the general and so does not constitute DTA override or alternatively may constitute a form of justifiable DTA override, any justification of unilateral breaches of contractual obligations imposed by DTAs that have been duly and validly executed by CSs, undermines the co-ordination efforts of international tax community in more recent years, which have made significant progress in addressing DTA abuse in a coordinated (as opposed to unilateral) manner.

Alternative options

DTA override is not the only route open to CSs who need to implement domestic measures that may conflict or be perceived as conflicting with DTAs into which they have entered. Rather there are alternative options open to CSs, for example, to engage the other CS in bilateral consultations to address problems connected with DTAs provision. The individual CS's desire to implement domestic measures that may conflict with a DTA could also be addressed at the multilateral level, a priori where many countries have the same concern e.g., the work of the Inclusive Framework can be described as supporting the view that when significant cooperation between states occurs, it is possible to achieve fundamental, consensus-driven change." (Ellife (2022)).

Prevalence

There is a view that the problem of DTA override may not be as serious as it seems because it rarely happens (Avi-Yonah, 2006).[13] This may be because CSs realise that they have an obligation under a validly executed DTA, which is sacrosanct and requires them to act in good faith and so they are unlikely to deliberately override DTAs, except in extreme cases and as a last resort, where circumstances may justify such an override. At the time of the OECD Report (1989), DTA override was almost exclusively deployed by the United States (US), however, there have been some cases of DTA override by other jurisdictions in more recent times. An example is the Lamesa case (1997)[14] in Australia, which involved the interpretation of Article 13 of the Australia-Netherlands DTA.

Lack of uniformity

Derogations from CS obligations under DTAs may be allowed under dualist jurisdictions (with the effect that the CS's organs and taxpayers can rely on the relevant derogation), such derogations do not alter the CS's obligation under international law. However, such an override could be said to constitute a breach of the DTA itself (as between the CSs) and is contrary to international law. The relationship between these international obligations and domestic law is therefore both inconsistent between different CSs and unresolved in the sense that some states can breach their international obligations by enacting new domestic law.[15] This then results in DTA override undermining the certainty that DTAs seek to provide taxpayers which in turn affects economic relations, cross-border commerce and investments.

Conclusion

Whilst it has been claimed that more countries have resorted to DTA override in more recent times (Avi-Yonah (2022), there are also numerous instances of cases of domestic measures that may be claimed to conflict with a DTA override being justified on the basis that (i) the putative DTA override actually involves the giving effect to the relevant DTA (e.g. and as noted above, CFC rules generally) and (ii) the disputed measure falls outside the scope of the DTA (e.g. UK's DPT and India's Equalisation Levy).

[13] Avi-Yonah, Reuven S. "Tax Treaty Overrides: A Qualified Defense of U.S. Practice." In *Tax Treaties and Domestic Law,* edited by G. Maisto, 65-80. EC and International Tax Law Series, vol. 2. Amsterdam: IBFD Publications, 2006
[14] (1997) 36 ATR 589 (Burchett, Hill, and Emmett JJ).
[15] *Ibid.,* at page 47

As a common reason for introducing these more recent domestic measures has been the prevention of DTA abuse the precise scope of the domestic anti-abuse measures should be carefully considered so as to distinguish between abusive arrangements and those that are consistent with the purposes for which the DTA was concluded (Baker, 2013). Whilst the introduction of the MLI's Preamble into many covered tax agreements and the expected introduction of the two Pillar solution may reduce the need for domestic anti-abuse measures, the issue of DTA override is unlikely to disappear from the discourse e.g. DTA compatibility with Pillar Two has been recently highlighted as an area of potential concern (the argument being that the distributive rules for business profits in the DTA networks of countries across the globe may be at odds with Pillar Two? allocation rules and has been described as "extra-territorial "(Maarten de Wilde, 2022).

Question 4

This question requires candidates to demonstrate an understanding of the fundamental principles of both the mutual agreement procedure (MAP) and advance pricing arrangements (APA). Candidates may make reference to other forms of dispute prevention and/or resolution, such as correlative relief, the International Compliance Assurance Programme (ICAP), joint audits, or the work on tax certainty within the OECD two pillar solution. Candidates should provide a view on whether or not they consider that preventing double taxation in the first instance is favourable to dispute resolution after double taxation has already been suffered. Candidates should form their answers from the perspective of the tax administration.

One possible solution is as follows:

Introduction

When considering how best to manage the risk of double taxation, tax administrations have several options but limited resources. As such, the decision of how best to allocate resources to address double taxation is an important one. Consideration must be given as to whether it is preferable to focus on dispute prevention (i.e. mitigating the risk of double taxation in advance of it occurring, e.g. by way of an advance pricing arrangement (APA)) or dispute resolution (i.e. resolving double taxation disputes after they have already occurred, e.g. through the mutual agreement procedure (MAP) or correlative relief). Only one method of dispute prevention and one method of resolution needs to be assessed, as well as a determination as to which is a more effective use of scarce resources.

Dispute Prevention (DP): refers to the practice of preventing instances of double taxation arising in the first instance, i.e. prospectively. The main method is using an APA, but double taxation may also be avoided through the use of the International Compliance Assurance Programme (ICAP), or even by way of adjustments agreed as part of a joint audit. Although a joint audit is not explicitly a form of DP, nor is it voluntary for taxpayers, it does result in a better use of tax administration resources and can achieve a greater level of certainty than a traditional bilateral or unilateral audit, which simultaneously ensuring the case does not progress to MAP. Both MAP and ICAP are considered below, however candidates are only required to consider one method of DP.

APAs

The OECD defines an APA as an agreement between a taxpayer, one or more associated enterprises, and one or more tax administrations, which determines in advance an appropriate set of criteria for a transaction that all parties agree can be used to determine an arm’s length price for the duration of the agreement (OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, [4.134] (TPG 2022)).

APAs can be unilateral (i.e. between the taxpayer and one jurisdiction), bilateral (two jurisdictions), or multilateral (more than two jurisdictions). As a result of BEPS Action 14, the TPG 2022, [4.141] now state that a bilateral APA is considered best practice, as unilateral APAs still carry the risk of double taxation as they are one-sided. Multilateral working between tax administrations is still in its early stages, but in the future, multilateral APAs will play a bigger role, in an effort to use limited tax administration resources more effectively and efficiently. (OECD Bilateral Advance Pricing Arrangement Manual 2022 (BAPM 2022)).

APAs can require significant financial investment from taxpayers, and significant time investment from both taxpayers and tax administrations, but the benefits provided will often outweigh the costs. APAs provide legal certainty to taxpayers and allow tax administrations to focus their resources on more high-risk taxpayers, as the transactions under the APA should not require further intervention once the critical assumptions remain unchanged. Taxpayers can therefore be comfortable that these transactions should not be subject to an audit. As APAs are prospective, they can cover a number of future years, and it should also be possible to roll-forward the APA. APAs are generally used for the most complex transactions/those with the highest risk of double taxation, so they are a good use of tax administration resources and should subsequently have the effect of reducing future MAP case numbers. In recognition of the importance of APAs and the role they will likely continue to play in the future, the OECD recently released a manual on best practices for bilateral APAs (referred to here as BAPA) (OECD, Bilateral Advance pricing Arrangement Manual 2020), which is intended as a guide for streamlining the BAPA process and should continue to aid the use of APAs as a method to prevent double taxation from arising.

<u>ICAP</u>

ICAP is a voluntary risk assessment and assurance programme involving 22 jurisdictions, all of which are members of the Forum on Tax Administration (FTA). ICAP began in 2018 with two pilot programmes before becoming a full FTA programme. ICAP is completely voluntary and is multilateral - meaning a minimum of three countries must participate in order for an ICAP assessment to take place. As ICAP does not provide legal certainty (rather, it provides comfort that a tax administration does not anticipate allocating audit resources to the covered low risk transactions for a period of two years following the end of the assessment), it can be concluded much quicker than other compliance interventions such as MAP and APAs, (an average ICAP assessment is likely to be completed in under a year). These ambitious timeframes allow tax administrations to more efficiently and effectively complete a risk assessment of lower risk taxpayers.

Another advantage of ICAP is that the documentation required from taxpayers is standardised, with all tax administrations working from the same documentation pack. ICAP allows less experienced tax administrations to learn from those who have more advanced risk assessment capabilities and can allow discussions to happen before country positions on certain matters become entrenched and create a precedent. ICAP is therefore more adaptable mechanism. An ICAP assessment that results in a low-risk outcome provides taxpayers with comfort that the covered tax administrations do not anticipate allocating resources to those transactions in the covered periods nor in the following two years.

As ICAP focuses on low/medium risk transactions, which are quicker to resolve, more resources are made available for higher risk taxpayers. ICAP may also provide a steppingstone for transactions that were thought to below risk but have been reclassified as higher risk. The work undertaken in ICAP can be leveraged to progress such higher risk transactions to, for example, APAs or MAP.

<u>Dispute Resolution (DR)</u>

This refers to mechanisms that can be undertaken after a taxpayer has already suffered double taxation, i.e. retrospectively. The main form of DR available to taxpayers is entering into a MAP, or alternatively requesting correlative relief.

<u>MAP</u>

The OECD defines MAP as a well-established means which enables tax administrations to consult to resolve disputes regarding the application of double tax treaties, which can be used to eliminate double taxation arising from transfer pricing disputes (TPG 2022, paragraph 4.29). Article 25 of the OECD MTC 2017 provides for a mechanism whereby a taxpayer who believes that the actions of one or both tax authorities of the contracting states would result in double taxation or taxation not in accordance with the provisions of the DTA may submit the case to the competent authority of either contracting state. If that competent authority is unable to resolve the case unilaterally, it then approaches the other competent authority, and the two parties are to endeavor to resolve the dispute through bilateral negotiation. Article 25(1), OECD MTC 2017 includes a time limit of three years from the date of the first notification of the action resulting in taxation not in accordance with the DTA.

MAP permits the tax administrations in both jurisdictions to communicate with each other directly without going through diplomatic channels. While MAP is commonly used to address double taxation arising as a result of transfer pricing adjustments, it can also be used to resolve double taxation arising from permanent establishment, residency, withholding tax, and other

DTA issues, such as the determination of residence for a non-individual, characterisation of certain types of income, and exchange of information and administrative assistance between tax administrations.

The benefits of MAP are numerous - MAP can allow double taxation to be avoided efficiently, and is also considered to be a generally effective process, with statistics from the OECD showing that MAP relieves double taxation in most cases. Finally, the resolution reached in a MAP case can sometimes be rolled forward into an APA to cover future periods.

However, MAP also has a number of drawbacks, most notably, the amount of time it can take tax administrations to resolve a MAP case. MAP is captured as part of Action 14 of the OECD BEPS project, and is a Minimum Standard, meaning all OECD Inclusive Framework jurisdictions commit to its implementation. Action 14 calls for competent authorities to endeavour to close new MAP cases involving transfer pricing issues within an average timeframe of two years or less. However, this two-year target only sets the standard for average completion times and generally does not require individual cases to be completed within any particular time frame. This means individual cases continue to be completed in varying timeframes. The OECD MAP statistics show that sometimes taxpayers choose to withdraw from MAP without resolution; their withdrawal may be due to the cost/time investment involved in taking part in the MAP. MAP also generally focuses on a specific transaction or set of transactions, where double tax has already been levied. This means the scope of MAP is typically much more limited than a DP mechanism, such as an APA or ICAP.

<u>Correlative Relief</u>

Article 9 of the OECD MTC 2017 provides the basis for corresponding adjustments (correlative relief) where economic double taxation has occurred. A claim for correlative relief arises where a taxpayer has accepted a transfer pricing adjustment from a foreign tax administration unilaterally and is now Article 9 of the OECD MTC 2017 provides the basis for corresponding adjustments (correlative relief) where economic double taxation has occurred seeking relief for the double taxation that occurred from the jurisdiction on the other side of the transaction, i.e. it is a request for unilateral relief that it does not require negotiation or agreement between the relevant tax administrations. Tax administrations are under no obligation to relieve the double taxation which the taxpayer unilaterally agreed. Accordingly, a claim may be wholly or partly accepted, or it may be wholly refused. If the claim for correlative relief is unsuccessful, and where the relevant time limits have not been exceeded, a taxpayer may then request MAP.

Correlative relief provides few benefits for a tax administration; it is time intensive, utilises scarce resources and as it is wholly unilateral, the tax administration does not get to negotiate its position with the other tax administration. The fact that a taxpayer may seek to move into MAP proceedings means resources will need to continue to be allocated to the case, and this is in addition to cost and time involved with correlative relief process.

Tax administrations that decide to focus resources on DR may be advised to enter into MAP cases immediately rather than pursuing correlative relief claims.

<u>Conclusion</u>

Candidates should conclude by confirming whether they consider DP to be a more effective use of tax administration resources than DR in managing the risk of double taxation.

As the tax landscape continues to evolve, the risk of double taxation remains a live issue and so tax administrations need to ensure they are allocating resources in the most effective and efficient way across the various compliance interventions available. This means making a decision between whether to allocate resources to DP or DR. While there will always be a need for both, it is arguable that the best way to resolve double taxation is to ensure that it does not occur in the first place. Tax administrations should therefore use any excess resources available to improve DP mechanisms. While there are many advantages for each compliance intervention, there are a number of clear benefits in focusing on DP over DR where possible.

Firstly, dispute prevention focuses on the facts and circumstances of a given transaction, and aims to conclude on methodology, rather than a specific monetary amount. Conversely, dispute resolution focuses largely on the monetary amount of double taxation that has already been levied, as any subsequent adjustment will result in a real cost to the relieving jurisdiction. Therefore, relying on DP can shift focus from what the correct pricing of the transaction should be and turn instead to the monetary amount in the MAP claim. Furthermore, DP activities that occur before double tax is levied could also be a form of capacity building, where experienced and less experienced tax administrations work together e.g. In an ICAP assessment that involves both an experienced and a less experienced tax administration, the less experienced jurisdiction may have exposure to the risk assessment processes of the more experienced jurisdiction.

While both DP and DR interventions can be expensive and time consuming, there is evidence that MAP suffers from a number of additional issues including that (i) a number of taxpayers withdraw from the MAP process and (ii) the MAP case load grows each year. (OECD MAP Statistics, 2021). Some of the reasons why taxpayers may choose to withdraw a MAP case include a negative experience with one or more tax administrations (such as excessive documentation requests, or requests for unrelated information which the MNE may view as a “fishing expedition”), the time it takes to resolve the MAP case, and/or the financial cost of participating in MAP (either the cost of in-house employees or tax advisor fees) may be too large relative to the double taxation which is to be relieved. In comparison, DP such as an APA will only be accepted by tax administrations if they are interested in pursuing the APA, the documentation required is usually more standardised, and while the time taken to complete DP can also be long, the benefit is in the roll forward periods, and the assumption that the same transactions will not end up in MAP as a result of the APA.

The MAP case load grows each year as a result of an increasingly complex international tax environment and under resourced tax administrations. With DP, such as an APA, the prospective nature of the APA will help to relieve the burden on MAP case numbers, will provide certainty regarding complex transactions, and will allow tax administrations to better manage resources, as they decide which APAs to get involved in.

Where resources are focused on DP mechanisms, these are often easier to roll forward ad infinitum, where facts and circumstances remain unchanged. For example, with an APA, once the initial APA is concluded, tax administrations will often provide taxpayers with a roll forward period that involves standardised updates for a set period of time, and should the taxpayer wish to roll forward the APA for even longer, the work required to undertake this subsequent APA will be much quicker as it can rely on the work already completed. This is not always the case for MAP, where it may not be practicable to roll forward the conclusion as it relates to a specific transaction which has been subject to double taxation. Work undertaken in MAP to resolve this double taxation will be unlikely to be sufficient to continue to provide certainty on the transaction into the future.

Whilst it is the case that tax administrations are unlikely to ever be able to prevent all instances of double taxation even when they have the benefit of adequately resourced DP teams, which means that there is a role for DR, it would appear that DP provides the most beneficial use of scarce tax administration resources. DP mechanisms - such as ICAP quickly “clear” low risk transactions and identify higher risk transactions that can then be speedily moved into APA programmes – enable tax administrations to reduce the number of new MAP cases each year, which then enables MAP teams to focus on clearing the open MAP inventory as efficiently as possible.

Question 5

This question requires candidates to demonstrate (i) an up to date (December 2022) knowledge of the ongoing work by the OECD in relation to the Pillar Two GloBE rules and (ii) the manner in which the OECD had incorporated the results of public consultations in developing the administrative details of the GlobE rules. More specifically, candidates should identify and outline the operation of transitional safe harbour and the permanent safe harbour, Candidates should note that both are based on data from the Country-by-Country Report and evaluate (i) the usefulness of Country-by-Country Reporting (CbCR) data (e.g. data quality, availability, etc.) in calculating the GloBE safe harbours and (ii) impact that safe harbours have on the administrative burden for MNEs both in relation to the two GloBE safe harbours and how safe harbours reduce the compliance burden of MNEs.

One possible solution is as follows:

Overview of the GloBE Rules and 2022 Public Consultation

The OECD's Pillar Two GloBE rules: (i) impose top-up taxes where the effective rate of tax of an MNE in a jurisdiction is below the global minimum corporate tax rate (15%) and (ii) apply to MNE groups with revenue of at least €750m in at least two out of the last four years, and the group must operate in two or more jurisdictions – through two Constituent Entities (CEs) or through a main entity and a permanent establishment.

Jurisdictions

Jurisdictions are not required to adopt the GloBE rules, but if they do, they agree to implement them consistently (OECD (2022), Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), First Edition: Inclusive Framework on BEPS) and (ii) adopt the GloBE rules will apply an effective tax rate test using a common tax base and definition of covered taxes to determine whether a qualifying MNE pays tax at an effective tax rate below the agreed minimum rate in jurisdictions in which it operates.

Calculation of GloBE Rules

The tax imposed under the GloBE Rules is a "top-up tax" calculated and applied at a jurisdictional level. The GloBE rules use a standardised base and definition of covered taxes to identify those jurisdictions where an MNE is subject to an effective tax rate below 15%. It then imposes a coordinated tax charge that brings the MNE's effective tax rate on that income up to the minimum rate (after taking into account a substance-based carve-out). Taxpayers in scope of the rules calculate their effective tax rate for each jurisdiction where they operate and pay top-up tax for the difference between their effective tax rate per jurisdiction and the 15% minimum rate. Any resulting top-up tax is generally charged in the jurisdiction of the ultimate parent of the MNE.

The GloBE rules are administratively burdensome, hence the need for safe harbours which would relieve MNEs from performing full GloBE calculations for low-risk jurisdictions during an initial period.

Public Consultation and Safe Harbours

A public consultation on the safe harbours was held during March-April 2022 (OECD, Tax challenges of digitalisation: OECD invites public input on the Implementation Framework of the global minimum tax). Stakeholders were invited to comment on the development of simplifications and safe harbours. The outcome of the consultation suggested that the GloBE rules could impose a disproportionate compliance burden on certain MNEs in respect of operations in high-tax/low-risk jurisdictions. As such, there was a request to develop safe harbours, which would relieve MNEs from performing full GloBE calculations for low-risk jurisdictions during an initial period. Stakeholders noted that safe harbours would play an important role in reducing compliance and administration costs and improving tax certainty for MNEs. As such, the Inclusive Framework agreed a transitional safe harbour and a regulatory framework for developing a potential permanent safe harbour, using CbCR data for calculation. In December 2022 the OECD published relevant guidance on both the transitional and permanent safe harbours: Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two) December 2022, (Guidance 2022).

The operation and complexity of the Transitional Safe Harbour

The transitional safe harbour (TSH) is a temporary measure that would exclude an MNE's operations from the scope of GloBE for an initial period where those operations are conducted in certain lower-risk jurisdictions and in certain circumstances. (Guidance 2022, [9.1]). More specifically, the TSH would allow an MNE to avoid undertaking detailed GloBE calculations in respect of a jurisdiction in circumstances where it can demonstrate that it satisfies certain tests (outlined below).

The TSH uses revenue and profit (loss) before income tax from an MNE's CbC Report and income tax expense from an MNE's financial accounts (after eliminating taxes that are not covered taxes and uncertain tax positions) to determine whether the MNE's operations in a jurisdiction meet one of these tests. In practice, the TSH would apply to jurisdictions in which CEs of the MNE are located ("Tested Jurisdiction"). Although the TSH is based on CbC data, it can only be applied where the MNE uses Qualified Financial Statements (QFS) to prepare the CbC Report. QFS means accounts used to prepare the consolidated financial statements (CFS), or separate financial statements of each CE prepared in accordance with an acceptable/Authorised financial accounting standard, or for CEs not included in the CFS due to sise/materiality, the financial accounts of that entity used for the CbC report.

TSH tests

1) The de minimis test, i.e. where average GloBE revenue of the MNE group in a jurisdiction is less than EUR 10 million and the average GloBE Income is less than EUR 1 million (or the MNE group in that jurisdiction has an average GloBE loss);The MNE Group's Total Revenue and Profit (Loss) before Income Tax for each jurisdiction is extracted directly from the Qualified CbC Report (i.e. one prepared and filed using QFS). If a Tested Jurisdiction produces revenue and income that meet the de minimis test, then the Tested Jurisdiction qualifies for the safe harbour.
2) The ETR test, i.e. its ETR equals or exceeds an agreed transition rate, which starts at 15% for fiscal years beginning in 2023 and increases annually for each year the TSH is available. The ETR is calculated using Profit (Loss) before Income Tax data from the CbCR and the income tax expense reflected in the Qualified Financial Statements. The income tax expense used for the ETR test therefore includes deferred items and does not require any adjustments under GloBE (such as the allocation of CFC or Main Entity taxes), other than the removal of taxes which are not covered taxes and uncertain tax positions.
3) The routine profits test, i.e. comparing the Substance-Based Income Exclusion (SBIE) amount of an MNE in a jurisdiction to that jurisdiction's Profit (Loss) before Income Tax as reported in the MNE's Qualified CbC Report. If a jurisdiction's SBIE amount equals or exceeds its Profit (Loss) before Income Tax, it means that it is likely that little (or no) excess profits arise in such jurisdiction, and the MNE would qualify for the TSH in that jurisdiction. The SBIE provides that the GloBE Income (taxable base) is reduced by a percentage of payroll costs and the carrying value of tangible assets. The percentage of payroll costs starts at 10% and is gradually reduced each year until 2033. The SBIE amount computed for purposes of the routine profit test does not take into account the payroll and tangible assets of Entities that are not CEs under the CbCR (e.g., Entities held for Sale) or under GloBE (e.g., Excluded Entities)

Temporary nature

The TSH is limited to an initial period that applies to fiscal years beginning on or before 31/12/2026 but this does not extend to a fiscal year that ends after 30/6/2028. After this initial period, the TSH expires. Furthermore, if an MNE has not applied the TSH in a year in which the MNE group is subject to the GloBE rules, it cannot qualify for the TSH in future years.

The TSH is only available for a set period of time (as opposed to being available for a set number of years after which an MNE is subject to GloBE rules), which facilitates the common approach but limits usefulness for MNEs that become subject to GloBE after the initial application date.

An MNE that qualifies for the TSH on a jurisdictional basis is still subject to the GloBE Rules as a whole, as the safe harbour does not discharge the MNE Group from complying with group-wide GloBE requirement such as preparing and filing a GloBE Information Return (GIR), including the information concerning the application of the TSH in a jurisdiction where applicable, i.e. the TSH is not applied group-wide. The fact an MNE still has to ensure they comply with various GloBE related requirements (e.g. carrying out various complex calculations) even where it can apply the TSH could be said to diminish the reduction in administration burden intended from having a TSH.

<u>The operation and complexity of the Permanent Safe Harbour</u>

The OECD (Guidance 2022, para. 75.2) notes that where an MNE does not meet the requirements of a TSH, it may still access the permanent safe harbour (PSH), i.e. an MNE that did not qualify for the TSH may still qualify for the PSH. An MNE that can access the PSH, like the TSH, qualifies on a jurisdictional basis with the result that the MNE is still required to comply with group-wide GloBE requirements (e.g. filing a GIR). The PSH consists of a simplified calculations safe harbour, (SCSH) that simplifies compliance with the GloBE rules by reducing the number and complexity of calculations MNEs are required to make. As the name suggests the PSH is not limited in time.
The Top-up Tax for a jurisdiction shall be deemed to be zero for a fiscal year when the Tested Jurisdiction has met the requirements of one of:

a) the Routine Profits Test;
b) the De Minimis Test; or
c) the Effective Tax Rate Test.

A CE may use a simplified income calculation, revenue calculation, or tax calculation to determine whether any one of these tests are met in the Fiscal Year, i.e. although the tests remain unchanged, the calculations required to apply the tests are simplified, thereby reducing the burden on MNEs.

A jurisdiction in which the MNE has CEs can access the PSH (and the simplified calculations it contains) where it satisfies any one of the following tests:

- Satisfies the Routine Profits Test where its GloBE Income as determined under the simplified income calculation is equal or less than the amount that results from computing the SBIE in that jurisdiction.
- Satisfies the De Minimis Test where the Average GloBE Revenue of the jurisdiction income as determined under the simplified income calculation is less than EUR 10 million, and the Average GloBE Income of that jurisdiction is less than EUR 1 million or where it suffers a GloBE loss.
- Satisfies the Effective Tax Rate Test where its effective tax rate of the jurisdiction as determined under the simplified income and tax calculation, is at least 15%.

The above simplified calculations are alternatives to those required under the GloBE Rules. In other words the simplified calculations allow MNEs to avoid making complex GloBE calculations where simplification is available without altering the MNE's GloBE outcomes or undermining the integrity of the GloBE Rules, i.e. the safe harbours will not compromise the effectiveness and purpose of the GloBE rules. This approach would appear to increase the usefulness of the PSH for relevant MNEs and achieves the aim of reducing complex calculations.

The simplified calculations are not yet fully developed and will form part of future agreed administrative guidance. MNEs subject to the PSH would then be able to rely on the PSH when filing its GIR and calculating its ETR on a jurisdictional basis. To access the benefit of the PSH, the MNE Group would need to comply with the filing requirements that are agreed as part of any future Agreed Administrative Guidance for that Safe Harbour. Basing the safe harbour on these simplifications protects the integrity of the GloBE rules by ensuring that they are applied consistently, using the same simplified calculations each time.

Impact on the compliance burden for MNEs

As noted above the purpose of the TSH and PSH is to allow a simpler method of determining that liability, in a situation where certain conditions are met. As work on the GloBE rules continues, it is clear that the GloBE are complex and could create uncertainty for taxpayers (e.g. the calculations needed may require data that is not readily or easily available). The TSH may help to reduce the administrative burden for MNEs in the initial period as MNEs get up to speed with applying the rules (the TSH) whilst the PSH may reduce MNE's compliance burden by excluding certain GloBE requirements, albeit in specified circumstances.

The TSH and PSH remove some of the immediate compliance difficulties that MNEs will face in building systems to collect the data needed by allowing for the use of readily available data in undertaking simplified calculations, such as the data in the CbC report and an MNE's financial statements. Given that (i) the threshold for CbC and GloBE is broadly the same (i.e. €750m, in the previous year for CbC and in at least 2 out of 4 previous years for GloBE) and (ii) MNEs are likely to be required by law to have their consolidated financial statements audited, the data needed to apply the TSH and PSH already exists. This latter feature may result in a reduced upfront reliance on new systems and new data. It could be said that the reliance on existing constitutes a trade-off in that the ability of MNEs to use readily available and verifiable data may result in a lower degree of precision but provides a practical workaround the heavy compliance burden the GloBE rules have introduced.

There are protections around the quality of the data from both CbCR and financial statements that is to be used in the TSH and PSH (Guidance, 2022, [18]). This raises an interesting issue for MNEs and their existing policies around data collected for CbCR purposes. Those MNEs that have, to date, collected "low quality" data may need to revisit those policies; tax administrations have commented on the low quality of CbCR data.[16] Reliance on low quality may now find that their access to the TSH / PSH is restricted. On the other hand, for MNEs that have complied with the data collection requirements and can now rely on their existing systems of data collection, access to the TS or PSH is not at issue.

Conclusion

While the TSH and PSH may well result in a reduction in the compliance and administrative burden for MNEs, (i) the TSH is temporary and (ii) the PSH is still in development. Both the TSH and PSH are applicable on a jurisdictional basis, meaning qualifying for either does not exempt the MNE Group from complying with group-wide GloBE requirements such as filing the GIR. These caveats mean that it continues to be crucial for MNEs to evaluate the potential impact of the GloBE rules on their tax positions as well as their data and compliance processes and systems.

[16] Anonymised and aggregated Country-by-Country reporting data FAQs: Corporate Tax Statistics (oecd.org)

PART B

Question 6

The question requires candidates to determine which country has taxing rights over Mr Ky's salary and bonus in year 2. There is a need to ensure that Article 15 OECD MTC 2017 applies, which refers to the need to clarify that these amounts fall within Article 15 as employment income and not under, for examples, Articles 16-19 or under Article 7. On the basis that the amounts fall within Article 15 there is a need to analyze the facts and determine which country has the right to tax the amounts. Where amounts do not fall within Article 15 they may fall under Article 21.

One possible solution might be as follows:

Taxing rights over Mr KY's income (salary and bonus)

The question on taxing rights over Mr Ky's (a resident of Home Country for the purposes of the DTA) salary and bonus prima facie falls within Article 15 (often referred to as the "dependent personal services" article) of the OECD MTC 2017. The first point to note is that Mr Ky appears to be an employee as opposed to having a different status (e.g., independent contractor), which requires a consideration of whether there is an employment relationship (see below). Furthermore, there is nothing to indicate that this scenario could fall within another specific distributive rule (such as under Articles 16-19, noting that Article 17 may just apply to relevant "business activity" in some DTAs). Therefore, answers should focus upon whether the amounts fall within the scope of Article 15 (where they do not then there would typically need to be considered under Article 21). A further point is that the point of contention in the question is the amounts of salary and / or bonus that are derived from employment exercised in Country A and taxing rights over these amounts (as opposed to taxing rights over amounts derived through employment in Home Country). However, the question asks for a consideration of taxing rights over the salary and bonus then the position of Home Country and Country A must form the focus of the conclusion.

Operation of Article 15 OECD MTC 2017

According to Article 15 OECD MTC, "income from employment" is generally taxable in the employee's state of residence. A limitation to this rule may be found in the place-of-work-principle (Schoueri, 1993) in the latter part of Article 15(1), which requires that income derived from employment should be taxed in the state where the services are rendered, i.e., the state of employment. Whilst it is possible for the employee's state of residence and state of employment to be the same, this is not always the case (e.g., where an employee is on a temporary secondment). Where an individual is resident in one CS and exercises their employment in another CS then the latter CS (in which the employment is exercised) has the right to tax the non-resident's income from the employment (Commentary on Article 15, [1]). This would prima face appear to be relevant to Mr Ky's scenario.

However, Article 15(2) contains an exception to the general rule in Article 15(1). Article 15(2) excludes the application of the place-of-work principle in cases of "short term activity", such that income from employment is only taxable in the employee's state of residence (to the exclusion of a second state where employment is exercised) if the three conditions prescribed in Article 15(2) are satisfied. These conditions are broadly: (i) the employee is present in the other state for a period or periods not exceeding 183 days in any 12 months period commencing or ending in the fiscal year concerned; (ii) the employer paying the remuneration is not a resident of the state in which the employment is exercised; and (iii) if the employer has a permanent establishment (PE) in the state in which the employment is exercised, the remuneration is not borne by that PE. Article 15(2) operates so as to reduce the administrative burden where either the individual or the employer have a limited nexus with the state in which the employment is exercised (where individual is only in the other state for a short period and where the employer is not tax resident of nor has a PE in the state in which the employment is exercised). It is therefore necessary to consider whether Mr Ky's situation falls within Article 15(2).

Article 15(3) provides an exception to Articles 15(1) and (2) where the remuneration is in respect of an employee who is a member of the "regular complement of a ship or aircraft". Mr Ky is a senior procurement specialist for Dynacorp and therefore Article 15(3) is not further considered here.

Application of Articles 15(1) and (2)

Are the salary and bonus earned by Mr Ky "income from employment"?

As noted above there is a need to first consider whether the income derived by Mr Ky could fall within a different (more specific distributive) DTA provision (e.g., under Articles 16-19 as "lex especialis). Given My Ky's role and the nature of the amounts of salary and bonus it is unlikely that these amounts would fall within Article 16-19. Prima facie, these amounts prima facie fall within Article 15 where the individual is an employee, which requires there to be an employment relationship. It should also be noted that amounts may fall within Article 15 as being "income from employment" notwithstanding the terminology used to describe the relevant income amounts (see Commentary on Article 15(1), [2.1]-[2.4], which notes that "member countries have generally understood benefits in kind received in respect of employment to be included in "salaries, wages or other remuneration" provided the amount was derived as a result of the exercise of current, ongoing employment or after the termination of employment, for work done before the employment was terminated"). Therefore, the provision of benefits in kind like stock-options, the use of a residence or automobile, health or life insurance coverage, and club memberships are likely to fall within the scope of Article 15. Accordingly, both Mr Ky's salary and bonus are likely to fall within Article 15 as income from employment and furthermore. Candidates could also note that there is nothing to indicate that Mr Ky's employment (with Dynacorp) has been terminated.

Other points that could be made include that where amounts do not fall within Article 15 these may fall within Article 21 as "other income" (De Broe, 2022). Amounts under Article 21 are subject to tax in the state of residence only.

In which Contracting State is Mr Ky resident for the purposes of the DTA?

As noted in the facts, Mr Ky is a resident of Home Country for the purposes of Home Country / Country DTA and therefore there is no need to consider whether he is resident in Country A for the purposes of the DTA.

Which entity was Mr Ky's employer at the time he rendered services in Country A?

Identifying the employer may not be straightforward in a cross-border scenario. Whilst there has been debate around whether the term "employment" ("employment relationship" has been the focus in the identification of the "employer" since 2010) is ascribed a common international meaning or a domestic tax law meaning, it would appear that "unless the context otherwise requires" the domestic tax law meaning should be relied upon (De Broe, 2022). Furthermore, it is the domestic tax law of the CS (Country A) that applies the DTA that is prima facie relevant here (noting that in some circumstances there may be some exceptions to a CS's domestic tax law taking priority e.g., where the resident state (Home Country) disagrees with the domestic tax law definition of the other CS, a MAP case could be brought). As there are no details about the domestic law in the question, and as there is support for the view that a "common international meaning" should be ascribed to the term "employment relationship" candidates may determine whether an employment relationship exists based on the limited information available in the facts and on the basis of the position of the OECD. (Commentary on Article 15(2), [8.7] and [8.11.1]).

The Commentary on Article 15(1) prescribes a "substance over form" approach whereby the whole context of the employment should be reviewed to determine which entity is the "economic employer" i.e., the existence of an employment relationship (PwC, 2013 and Commentary on Article 15(2), [8.14]). Central to this approach is the identification of which entity bears the responsibility or risk for the results produced by the individual's work. Where the risk and responsibility does not lie with the formal employer, additional factors may be relevant to determine which entity will qualify as the employee's "economic employer". These additional factors include authority to instruct the employee on the way the work must be performed, control and responsibility for the place at which the work is performed, and who bears responsibility for the employee's remuneration, among others. One point of note is that the OECD considers that although not necessarily conclusive, the direct charging of the various payments (that are made to an individual by the formal employer) to another enterprise for services provided by that individual to the other enterprises is relevant when considering whether an employment relationship exists as between the individual and other enterprise (Commentary on Article 15(2), [8.15]]

The approach of the OECD could be thought of as requiring the satisfaction of two tests:

1) Nature of services – with a focus on integration and level of entrepreneurial risk assumed
2) Control – who has the authority to instruct the individual; who controls or has responsibility for the place at which the work is performed; whether the remuneration is directly charged by the formal employer to the enterprise to which the services are provided; who puts tools and materials necessary for the individual's work at their disposal; who determines the number and qualifications of individuals performing the work; who has the right to select the individual who will perform the work and to terminate the contractual arrangements entered into with that individual; who has the right to impose disciplinary sanctions related to the work of the individual; and who determines the holidays and work schedule of the individual.

Although the facts provide that there is an employment contract between Dynacorp and Mr Ky, the circumstances under which Mr Ky renders services in Country A in relation to AlphaCorp projects are not clear. For example, it is not clear whether in rendering those services, Mr Ky is subject to the control, direction and or supervision of AlphaCorp. It could be argued that as Mr Ky heads the procurement team at Dyna Corp, there may be no other senior employees with more technical knowledge on procurement matters in AlphaCorp who may direct or control the way Mr Ky renders his services. Related to this is that the facts do not reveal the nature of AlphaCorp's business and so determining the extent to which My Ky is integrated in AlphaCorp's business is unclear. It could therefore be argued that Mr Ky is integrated in DynaCorp's business notwithstanding that he is outside Home Country when performing some services whilst exercising his employment in Country A. The fact that a defect in materials supplied for one of AlphaCorp's projects, led to an extended stay for Mr Ky could support a conclusion that AlphaCorp does have a controlling or supervisory authority over Mr Ky. A further point that could be addressed is that My Ky is "required" as part of his" employment responsibilities" to make three trips to Country A. This requirement points towards DynaCorp having instructed Mr Ky to work in Country A and where this is the case, this would support a conclusion that DynaCorp has the requisite control over the provision of Mr Ky's services and is his employer.

Candidates could cite Example 3 and 6 in Commentary on Article 15(2), [8.21] and [8.26] that consider "secondments in group of companies" and "manager in group of companies". Although neither example is identical to that in the fact pattern, both examples refer to the connection between the function that the individual performs in the overseas country and the extent to which that function is an integral feature of the home or overseas jurisdiction entity. Candidates may then also consider whether Mr Ky's function in Country A is more integral to either Dyna Corp's or Alpha Corp's business and if it then an employment relationship with that business may be more likely to be found.

It could also be noted that Article 15 may leave open the possibility of an individual having two employers (due to the use of "an employer" and not "the employer") However, there is also a view that only one employer is envisaged as the Commentary refers to "single" employers in its examples (e.g., Commentary on Article 15, Example 3) but this view could be described as being inconsistent with use of "an employer" and the economic reality that an individual can have more than one employer. Furthermore, it has been argued that whilst an individual can have more than one employer, Article 15(2)'s reference to "an employer" requires a consideration of each functionally separate part of the employment relationship and that therefore there will be only one employer when applying Article 15(2) notwithstanding that the individual may have two employers in reality (Dziurdź, 2013).

Candidates may also note that there is no mention of DynaCorp charging AlphaCorp for either the salary or bonus (or any other amount) but that the OECD considers that such charging arrangements may be a relevant consideration in establishing an employment relationship (Commentary on Article 15(2,[8.15].

What are the resident states of Alpha Corp and Dynacorp for the purposes of the DTA?

Dynacorp is resident in Home Country and Alpha Corp is resident in Country A for the purposes of the DTA.

Application of Article 15(1)

As Mr Ky is a resident of Home Country for the purposes of the DTA, and can be described as deriving employment income he is prima facie taxable under Article 15(1) on that salary and bonus in Home Country (365,000 and 70,00) but as he also exercises that employment in the other CS (i.e. Country A) then Country A may also be able to tax his salary. It would appear that in respect of the salary that both Home Country (365,000) and Country A (140,000 pro rated on a day count basis) may tax his salary. On the basis of Article 15(1) alone, Home Country would then need to provide a tax credit or exempt the relevant employment income subject to tax in Country A.

In terms of the bonus, this has been derived for employment exercised in Country A. Accordingly, the 70,000 bonus is prima facie subject to tax in Country A.

Notwithstanding the above possible outcome, there is a need to consider Article 15(2) as this may modify the Article 15(1) outcome.

Application of Article 15(2)

Broadly, Article 15(2) provides an exception to the place-of-work principle: where Mr Ky (resident of Home Country) derives remuneration in respect of an employment exercised in Couhtry A (i.e. the 140,000 and the 70,000 bonus) then that remuneration shall be taxable only in Home Country if all three of the conditions below are satisfied. Where, however, any one of the three conditions is not satisfied then state in which the employment is exercised has the right to tax the relevant income (here Country A). Note the focus of Article 15(2) is only remuneration derived in respect of income derived by Mr Ky in respect of employment exercised in Country A (not Home Country). Accordingly, to apply Article 15(2) it is necessary to ascertain the remuneration that arises from employment in Country A, which necessarily involves questions of source and quantum. It is assumed that 140,000 of his total salary and the full bonus of 70,00 have a source in Country A.

The three aforementioned conditions are:

1) The employee is present in the other state for a period or periods not exceeding an aggregate of 83 days in any 12 months period commencing or ending in the fiscal year concerned.

   During calendar year 2, Mr Ky was only present in Country A for 140 days (two trips of 35 days and one trip of 70 days), which falls short of the 183-days referred to in Article 15(2)(a). Candidates may note this includes the Mr KY day trips when he drove down to Country B for hikes, as part days count towards his days of presence in Country A (Commentary on Article 15(1), [5]). The facts state that the calendar year corresponds with the fiscal years of both countries and only refer to the fact that Mr Ky is in Country A during year 2 as such the 12-month period condition is satisfied.

   This first condition is satisfied.

2) The remuneration was paid by or on behalf of an employer who is not a resident of the state in which the employment is exercised.

   This condition seeks to grant a right to tax to the CS that recognises the cost of the remuneration as a deduction from taxable profits (Commentary on Article 15(2), para. 6.2). There is a need to:

   - Identify an employer or rather a person with whom Mr Ky has an employment relationship in respect of the salary and bonus. As noted above, Dynacorp is taken to be his employer in respect of employment exercised in Country A.
   - Identify whether the employer (Dynacorp) is resident of the other CS (Country A). The facts provide that DynaCorp is resident for the purposes of the DTA in Home Country. Accordingly, DynCorp is not a resident of the other CS (Country A).
   - Identify whether the remuneration was paid by DynaCorp or on its behalf. The facts provide that DynaCorp paid the bonus and the salary.

   Accordingly, the second condition appears to have been satisfied as DynCorp is not a resident of Country A and has paid the salary and bonus.

3) The third condition is that the remuneration is not borne by a permanent establishment (PE) that the employer has in the other CS.

   The question states that neither Alpha Corp nor Dyna Corp have a PE in the other CS so this condition would appear to be satisfied in respect of both the salary and the bonus.

All three conditions of Article 15(2) have been satisfied.

<u>Conclusion</u>

On the basis that (i) DynaCorp is My Ky's employer in respect of the salary of 365,000 and the bonus of 70,000 and (ii) the three conditions in Article 15(2) are satisfied, Home Country will have the exclusive right to tax the salary and bonus under Article 15(2)). The application of Article 15(2) has therefore modified the outcome under Article 15(1), which when applied had initially resulted in Country A also having taxing rights over the amounts derived from employment exercised in Country A.

Question 7

Part 1 requires candidates to demonstrate their knowledge of Article 17 of the OECD MTC and advise on how the performers at the annual musical festival should be taxed on their income earned from performing in Azuria.

Part 2 provides candidates with an opportunity to consider the manner and extent to which States can assist each other in the recovery of tax by way of exchange of information (Article 26) where they have entered into a DTA that mirrors the OECD MTC 2017.

One possible solution might be as follows:

Part 1

Article 17 OECD MTC 2017 provides that where a resident of a jurisdiction (e.g. Resident State) derives income from a relevant performance activity that is exercised in another jurisdiction (e.g. Azuria) then the state in which the activity is performed may tax the income (e.g. taxable in Azuria). Article 17 overrides Articles 7(4) and 15 (2), i.e. income arising from a business or employment activity where the income falls within the scope of Article 17. This provision makes it possible to avoid the practical difficulties that may arise in taxing entertainers or performers when they perform abroad as otherwise the taxation of international entertainers may impede cultural exchanges.

The annual musical festival that takes place in Azuria involves non-resident and Azurian resident performers, and so Article 17 is directly applicable. However, the question is only focused on the taxation of non-resident performers (for the purposes of the relevant DTA).

The Commentary on Article 17, (paragraph 3) notes that it is not possible to give a full list of what constitutes an "entertainer," but that stage performers are clearly included. The non-resident performers at the Azurian festival are likely to be included in this definition as they provide entertainment, and so Article 17 is relevant for the taxation of their income. Azuria prima facie has the right to tax the income related to performances that physically take place in Azuria.

Where the performer is not a resident of Azuria, the ATA has the right to tax the income derived from those performances taking place in Azuria. Based on the information provided, it appears that Azuria has very basic income tax rules that apply to non-resident performers and these are not effectively enforced. Azuria could, under the terms of Article 17 (OECD MTC 2017), apply a withholding tax on the gross income earned by the international performer to ensure that tax is levied on the income derived. Further ways to enforce these tax liabilities are considered below. Once the music festival moves to a new jurisdiction (i.e. once it leaves Azuria), the ATA is not entitled to tax non-resident performers on any income earned as part of those performances held outside Azuria.

The non-resident performers receive two sources of income, the fee from their performance at the music festival (paid directly to the performer) and a fee for a television performance following the festival (paid to the performers agent). The income from the performance at the music festival can clearly be considered to be derived directly from that performance in Azuria, and so the ATA has the right to tax that income related to the performance. As the fee is paid directly to the performers in respect of their performance, there is no need to consider apportionment of the remuneration, as it relates solely to the performance in Azuria (Commentary on art.17 [8]). The payment is being made to the performers by the Azurian festival organisers. The provisions of Article 17 apply regardless of who actually pays the income, i.e. it does not matter whether the payment is made to the performers by the Azurian government, or as is the case in the question, by the festival organisers.

The provisions of Article 17 would still appear to apply to the income (Commentary on art.17 [8.1]). There is no reference to the filming / broadcasting of the festival and as such there is no requirement to consider whether any part of the payment may be subject to other provisions (such as art. 12). Note the references to Commentary below.

The Income from the television performance (which takes place immediately after the relevant performer's performance), would also appear to fall within Article 17 where it is considered to be "closely connected" to the performance at the music festival. A close connection may exist where it cannot reasonably be considered that the income would have been derived in the absence of the performance at the music festival (Commentary on art.17, [9]). There is nothing in the facts to suggest that the performance would have taken place had the relevant performer(s) not been performing at the festival. The payment for the television performance is made to the agent of each non-resident performer, i.e. not to the non-resident performer themselves. Article 17 would appear to apply to this income, irrespective of the fact that the income was derived indirectly (i.e. through their agent) (Commentary on art.17, [8]). As such, the ATA is likely to have the right to tax the income earned by the non-resident performers as a result of the television performance.

There is no mention of the sale of any broadcasting rights in the television performance, nor the circumstances in which the televised performance is broadcast (e.g. whether it is a simultaneous broadcast/subsequent broadcast etc.) in the given facts. However, it would appear that in spite of the fact that the payment is made to the agent, it is made for the benefit of the relevant non-resident performer. Although not required, candidates may consider art 12, and the OECD's Commentary in relation to the application of arts. 12 and 17 in relation to the broadcasting of televised performances broadcasting (e.g. Commentary on art 17, [9.4] and art 12, [18]).

Based on the facts and circumstances, along with the provisions of Article 17 of the OECD MTC 2017, it is likely that the ATA would be entitled to tax both the income from performance at the concert and the income derived from the television performance. Should it come to light that the non-resident performers earn other forms of income that are "closely connected" to their performance, the ATA may also be entitled to tax such income. However, there is no requirement to consider payments not specified in the fact pattern.

Part 2

The facts presented in the question suggest that non-resident performers at the music festival have not been paying their Azurian tax liabilities. Given the implementation of a network of DTAs that mirror the OECD MTC 2017, the ATA will now be able to request assistance from other jurisdictions in respect of this issue in the form of exchange of information (EOI) requests (Article 26, OECD MTC 2017), which is considered a special provision under the OECD MTC (2017), i.e. provisions that are included in the OECD MTC to address particular situations or circumstances that may arise in the application of the MTC.

Article 26 (OECD MTC 2017) provides a framework for the EOI between tax authorities of different countries. The article is designed to help prevent tax evasion and avoidance, and to promote transparency and cooperation between countries. Article 26 embodies the rules under which information may be exchanged to the widest possible extent, and in particular the text of the Article makes clear that it is not restricted by Articles 1 and 2, such that information may include particulars about non-residents and may relate to the administrative enforcement of taxes not referred to in Article 2 (Commentary on art.26, [2]).

The key provisions of Article 26 are as follows:

- 26(1) provides that the competent authorities of the contracting states (CSs) shall exchange such information as is "foreseeably relevant" for carrying out the provisions of the DTA or of the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the CSs, or their political sub-divisions or local authorities, insofar as the taxation thereunder is not contrary to the DTA.
- 26(2) provides for exceptions in relation to secrecy requirements and outlines under what circumstances certain information can be disclosed.
- 26(3) contains certain limitations in favour of the requested state, such that a CS is not bound to go beyond its own internal laws and administrative practice in providing information to another CS.
- 26(4) incorporates into the text of the Article the general understanding previously

expressed in the Commentary. It deals explicitly with the obligation to exchange information in situations where the requested information is not needed be the requested State for domestic tax purposes.
- 26(5) imposes a positive obligation on a CS to exchange all types of information, i.e. to ensure that the limitations in paragraph 3 cannot be used to withhold the exchange of banking or other such information.

On the basis that Azuria has implemented a network of DTAs that mirror the OECD MTC 2017, they will be able to use the provisions of Article 26 of these DTAs to request information from other CS's in which the non-resident performers who owe taxes in Azuria are resident for tax purposes. There are three ways in which Azuria can request information under Article 26: (i) on request (EOIR); (ii) automatically (AEOI) and (iii) spontaneously (SEOI). These are the three main types of EOI. However (i) they can operate in combination and (ii) this not an exhaustive list of types of exchange of information (EOI) (e.g. simultaneous examinations, tax examinations abroad and industry wide EOI, are all valid types of exchange (Commentary on art.26, [9.1]).

The Azurian Tax Authority (ATA), as the requesting state, will be able to make a request to another CS (the requested state) for information that is considered "foreseeably relevant" by the ATA to the administration/enforcement of Azuria's domestic tax law. The concept of "foreseeable relevance" (Article 26 [1]) has a dual purpose (Commentary on art.26, [5]) - to provide for exchange of information in the widest sense, and also to ensure jurisdictions do not engage in "fishing expeditions" that are irrelevant to the affairs of a given taxpayer. There must also be a reasonable possibility, at the time the request is made, that the information requested will be relevant.

Any information received by the requesting state shall be treated as secret in the same manner as information obtained under its domestic legislation and disclosed only to persons/authorities concerned with the assessment/collection of taxes. Information received can only be used by the requesting state for the purposes for which it was requested, or for other purposes only where the laws of Azuria (the requesting state) and the requested state both permit. While certain limitations on the imposition on the requested state exist, these limitations cannot be used to decline the EOI request purely because the requested state has no use for the information being requested by the requesting state.

If the ATA suspects an non-resident performer has not discharged their tax liability in Azuria, the ATA could make a request for information under the provisions of Article 26 (EOIR). This would involve the ATA preparing a formal request, which should include specific details about the information requested (i.e. information on the tax affairs of the international performers) and a reasonable basis for believing that the requested information is relevant and necessary for tax purposes, i.e. the ATA should be able to demonstrate why it believes these taxpayers have not been discharging their tax liabilities in Azuria. An EOIR request should be sent from the Competent Authority of Azuria to the Competent Authority of the requested state, likely through diplomatic channels. Once received by the requested state, they will review and ensure the request meets the requirements of Article 26 of the DTA, and if deemed valid, the requested state will obtain the relevant information and transmit it to Azuria, maintaining strict confidentiality throughout.

Nothing in the OECD MTC 2017 prevents the application of Article 26 to the EOI that existed prior to the entry into force of the convention, as long as the assistance is provided after the convention has entered into force and the provisions of the Article have become effective (Commentary art.26 [10.3]). This means the ATA can request information on the international performers that have historically failed to pay tax in Azuria in relation to tax years from before the relevant DTA between Azuria and the requested state came into force, as long as the requested state only provides such assistance after the date the DTA enters into force. This particular provision is particularly relevant to the ATA as it will allow for the collection of historic tax liabilities from the international performers, and also enable them to better enforce tax liabilities going forward.