THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2022

MODULE 1

SUGGESTED SOLUTIONS

PART A

Question 1

Although the phrase "liable to tax" is found in Article 4, mention can also be made of Article 4's inter-relationship with Article 1 (Persons Covered) and Article 29 OECD MTC (Limitation of Benefits). The question requires candidates to consider whether the "liable to tax" criterion will be satisfied where no tax is paid. At a very general level it can be said that in order to gain access to a DTA, a person must be a resident of a CS (Article 1 OECD MTC) and in order to be a classified as a resident of a CS the person must be, inter alia, "liable to tax" in that CS.

Being classified as a resident can have positive or negative consequences for the taxpayer depending on the situation at hand and the particular DTA (Ismer and Blank, 2022). Accordingly, it is important to be able to readily determine whether a person is a resident of a CS for the purposes of a DTA and part of this inquiry involves confirming that they are "liable to tax" in the relevant CS. A clear understanding of the meaning of "liable to tax" will, therefore, not only be necessary to establish when a person is prima facie "resident" per Article 4(1) (and so prima facie able to access DTA benefits) but is also necessary to answer the question raised.

Candidates may also note that notwithstanding a person being resident under Article 4, they may nevertheless be denied access to DTA benefits where, depending on the precise wording of the provision adopted by the CSs, their circumstances are found to fall within the remit of Article 29(9) or Article 29(1)-(7) or a combination of both (footnote to Article 29). Accordingly, Article 29 can be briefly referenced also.

The following considers Article 1; Article 4(1); and Article 29. Article 4(1) is explored in more detail relative to the other aforementioned provisions.

Article 1 is focussed on persons covered by the OECD MTC i.e. persons who are residents of one or both CSs. It also provides a specific rule pertaining to fiscally transparent entities in Article 1(2) whereby income derived by a (wholly/partly) transparent entity will be treated as income of a resident to the extent that it is treated as income of a resident of that CS, which may impact "who" is treated as being "liable to tax" under Article 4(1). As mentioned above, Article 4(1) provides the definition of a resident for the purposes of the OECD MTC.

Article 29 was introduced in OECD MTC 2017 and operates as a limitation of benefit provision. It is not necessary to discuss this provision in depth but it can be referenced in the context of Article 4(1) – and in particular the requirement the person be "liable to tax" to be a resident and so prima facie have access to DTA benefits – as there is a view that the liable to tax aspect of Article 4(1) has been relied upon to attempt to avoid instances of DTA shopping and that this task is better carried out by articles such as Article 1(3) and Article 29.

Article 4 is focused upon the definition of "resident" and is considered to be of importance in the following three situations: (a) determining the personal scope of application of the OECD MTC; (b) solving cases of double taxation in relation to double residence; and (iii) solving cases where double taxation arises as consequence of taxation in the state of residence and in the state of source or situs. (Commentary on Article 4, [1]).

Article 4(1)

For the purposes of this question, only Article 4(1) needs to be considered – as opposed to Article 4(2) and Article 4(3). Article 4(1) provides that the term "resident of a CS" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature [....] This term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein." Article 4(1) can be analysed on a sentence-by-sentence basis (Ismer and Blank, 2022) and such an approach separates out the first sentence of Article 4(1) and the second sentence.

First sentence of Article 4(1)

"[T]he term "resident of a CS" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature [...]"

It appears that this covers persons who are defined as residents under domestic law but are not subject to tax on their worldwide income (Vann, 2009). The first sentence of Article 4 requires that a person be "liable to tax", without specifying what type of tax. The Article then goes on to refer to a tax on income and this combined with Article 2 suggests that the liability must be to income tax (Wheeler, 2012). The very general wording of the first sentence can nevertheless create some perhaps unintended consequences e.g. in an Indian case it was held a partnership was entitled to the dividend WHT rate in the DTA even though the partnership was not liable to income tax and was only liable to trade tax (Wheeler, 2012). The case was ITAT, 30 September 2010, Chiron Bering GmbH & Co KG, ITA No. 3860/Mum/08.

A further question is whether there is a need for the liability to tax to apply to a specific item of income (or more generally). This would appear to be a concern of CSs as it has knock-on effects for granting DTA benefits. This concern is demonstrated by the inclusion of subject-to-tax conditions; remittance-based clauses and switchover clauses by CSs in their DTAs (Wheeler, 2012).

R v Crown Forest Industries Ltd. and the Government of the USA established that a person must be linked to a CS by a generally recognised connecting factor before that person is recognised as a resident of a CS. The DTA in the case did not include the second sentence of Article 4(1).

Second sentence of Article 4(1)

"This term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein."

This second sentence provides an exception to the first sentence in Article 4(1) such that where a person who is a resident under domestic law but only subject to tax on (i) income from sources within that state or (ii) from capital situated in that state not falling within the first sentence in Article 4(1). An example is foreign diplomatic and consular staff (Ismer and Blank, 2022). The second sentence would also appear to exclude certain companies or other persons that are not subject to comprehensive tax liability such as conduit companies that are exempted from tax on foreign source income as part of a targeted incentive regime (Commentary on Article 4, [8.2]).

The second sentence in Article 4(1) does not however exclude residents of territorial systems. Such an interpretation is due to the need to interpret the second sentence in light of the context and object of Article 4, which is to exclude persons that are not subject to full liability to tax. As residents of territorial systems will be, prima facie, fully liable as per the relevant territorial system, residents of territorial systems cannot be excluded as a general rule from being considered resident for DTA purposes. To exclude residents of territorial systems in such a way is not considered to have been intended.

An example of a non-OECD member state that reserves its right to modify the definition of resident due to it not being a sovereign state and also taxing on a territorial basis is Hong Kong, (Non-OECD Members' Positions on Article 4, [3]). Examples of the second sentence of Article 4(1) in practice include DTAs that: (i) exclude the alternative of "or capital situated therein" (e.g. Austria / Nepal DTA (2000); Switzerland / Mexico DTA (1993); Canada / Chile DTA (1998)) and (ii) that do not provide any exemption for source taxation (e.g. Austria / Kuwait (2002)); Switzerland / Armenia DTA (2006)). See also the Malaysia and Singapore, Non-OECD Members' Positions on Article 4, [3.1]).

Payment of Tax

The following provides an overview of some of the issues that could be explored in relation to whether payment of tax is needed to satisfy the “liable to tax” criterion. It should be noted that just focusing on the meaning of “liable” is not sufficient and it is anticipated that candidates will consider how the requirement that the person be liable to tax impacts their ability to satisfy the residence definition. Furthermore, whilst there are some instances of payment being a requirement (e.g. Cyril Eugene Pereira ([1999] 239 ITR 650 (AAR)), there is considerable support for the proposition that payment is not required.

Owing the Tax

In terms of being “liable to tax” it is the person who owes the tax who is liable to tax such that where a paying agent simply withholds tax that paying agent will not be “liable to tax” due to their compliance with a legal requirement to withhold tax (Ismer and Blank, 2022). This may point away from the notion that payment is the decisive aspect of “liability”.

There is a question around who is liable to tax. Sometimes this will be addressed in the relevant DTA (e.g. Article 1(2) OECD MTC 2017) or sometimes it will be necessary to consider extraneous materials to determine who is liable to tax in a given case. Examples of DTAs that explicitly address who is “liable to tax” include Netherlands / Luxembourg DTA (1968), which references “diplomats”; Netherlands / Belarus DTA (1996), which references “partnerships”; and Germany / Belgium DTA (1996), which has a special provision for individuals living aboard ships).

- Tax Exempt Entities: A particular DTA may address a specific instance where a person will be explicitly included within the DTA even if exempt from tax in the relevant CS e.g. pension funds. Commentary on Article 4, [8.9] provides that CSs should negotiate this point and include a provision to clarify the position. An example of a country that considers pension funds not to be residents is Chile (Observation on the Commentary on Article 4, [25]). This would appear to be similar to the view of France (Observation on the Commentary on Article 4, [30]).

- Sovereign wealth funds (special purpose investment funds for State / political subdivision for macroeconomic purposes) are often viewed as forming part of a State and therefore there is a need to ensure that the customary international law principle of sovereign immunity is not compromised when considering the position of such funds. Issues may arise as to their classification as “resident” and it is possible that CSs will negotiate their treatment especially in relation to their qualification as “persons” and being “liable to tax”.

- Partnerships: Article 1(2) OECD MTC 2017 provides that where income is derived wholly or partly through a fiscally transparent entity under the tax law of either CS it shall be considered to be income of a resident of a CS to the extent that the income is treated for the purposes of taxation of that CS as the income of a resident of that CS. In a classificatory mismatch scenario where one country treats a partnership as opaque and the other treats it as transparent it is open to the latter state to treat the person that is both resident under its domestic law and also treated as deriving the relevant income, as a person that is covered by the DTA. Clearly in such a scenario, the resident person (e.g. a partner of partnership in the CS that treats partnerships as transparent) will be the person that is “liable to tax” and accordingly would also be expected to be the person who is paying the tax on the appropriate portion of the partnership’s income.

Remittance Based Tax Systems

These are systems where residents are taxed only on all or specified foreign source income that is remitted to their country (Vann, 2009). It never seems to have been doubted that residents of country subject to remittance-based taxation are entitled to DTA benefits whether or not such income is remitted. The Commentary on Article 1, [26.1] provides that DTA benefits will be allowed when the income is remitted.

Difference between Liable and Subject to Tax

“Subject to tax” and “liable to tax” are not synonymous (Ward, 1996) or put another way, a distinction can be made between “subject to tax” (interpreted as requiring effective tax liability or actual taxation) and “liable to tax” (interpreted as including a person who is entitled to an objective or subjective exemption from tax or “potential” taxation) which may assist in the application of the “liable to tax” criterion Article 4 (de Graaf and Potgens, 2011, Ismer and Blank, 2022). The OECD recognises that the words “liable to tax” should not require that persons are actually subject to tax to obtain DTA benefits as otherwise large numbers of taxpayers - such as charities - would be unable to access DTAs (Vann, 2009).

Conclusion

Candidates should conclude by stating whether they consider that payment of tax is needed to satisfy the liability to tax criterion and summarise the reasons for their conclusion. It would appear the consensus view is that a person does not have to actually pay tax to be ‘liable to tax, otherwise a person who had deductible losses or allowances, which reduced his tax bill to zero would find himself unable to enjoy the benefits of the Convention (Baker, 2002). Candidates could also note that “liable to tax” is mentioned in the context of Article 4 and its inclusion results in entity classification being intertwined with attribution of income” (Butani et al., 2021).

There is also a fairly widely held view that over time Article 4(1) has been relied upon to limit access to DTA benefits in a way that is perhaps better suited to other DTA provisions (such as Article 29 OECD MTC 2017 and inclusion of subject-to-tax clauses etc.). Candidates could also reference the fact that it is open to countries to include a domestic definition of “liable to tax: in their domestic law e.g. recently, India introduced the following domestic “liable to tax” definition in 2021: “in relation to a person, means that there is a liability of tax on such person under any law for the time being in force in any country, and shall include a case where subsequent to imposition of tax liability, an exemption has been provided.”

Question 2

This question requires candidates to be up to date (October 2021) with the peer review process as it pertains to Action 13. Given that the Compilation Report was published in mid-October 2021, candidates should be in a position to discuss the various stages of review and the general findings. The findings should be considered from the perspective of: transparency; exchange of information and base erosion / profit shifting. There is no requirement that candidates provide multiple examples from domestic law, although inclusion of country practice is welcome. Candidates should note that the peer review process is distinct from the wider review of Action 13, which will consider whether any changes are required to be made to the contents and requirements contained in Action 13. The next peer review is scheduled for the last quarter of 2022. Candidates should consider the following:

BEPS Action 13

BEPS Action 13 anticipated the development of rules that would enhance transparency through improved and standardised transfer pricing documentation and effective exchange of said information, which would, in turn, enable countries to monitor transfer pricing issues, the global allocation of income and have an indication of the level of tax being paid by any relevant entities in other countries. More specifically BEPS Action 13 provides for tax documentation to contain a master file, local file and country by country report.

Whilst all three documents are highly important, it is the CbCR report that relates most directly to the quote in the question as the information to be contained within the report includes at a general level: (i) information about the global allocation of income: (i) global information about taxes paid; and (iii) information about the economic activity of the relevant entity.

BEPS Action 13 Minimum Standard

Country-by country reporting under Action 13 is one of the four minimum standards of the BEPS project and so is subject to peer review. (BEPS Action 13 on Country by Country Reporting, Peer Review Documents (2017)). Country by country reporting involves a framework under which the ultimate parent entity of a large MNE group will prepare and file its country-by-country report (CbCR) with the tax authority in its tax jurisdiction of residence and then that tax authority will automatically share the CbCR with the relevant tax authority in the other jurisdictions in which the MNE has a constituent entity for tax purposes (Kofler and Wittendorf, 2022).

OECD Multilateral Competent Authority Agreement on Exchange of CbCR (CbC MCAA): The OECD prepared this (along with some other CbCR guidance documents e.g. OECD Guidance on the Implementation of CbCR: BEPS Action 13 (2016 – 2019) and Guidance on the Appropriate Use of Information Contained within Country-by-Country Reports, 2017) in order to assist countries with the exchange of country-by-country reports. Specifically, Article 6 of the Convention on Mutual Administrative Assistance in Tax Matters (Convention), requires the competent authorities of the parties to the Convention to mutually agree on the scope of automatic exchange of information and the procedure to be complied with. The CbC MCAA is based on these requirements and two further model competent authority agreements have been developed for the exchange of CbC Reports (one for exchanges under DTAs and the other for exchanges under tax Information Exchange Agreements).

BEPS Action 13 Peer Review and Stages of Review

The focus of the peer review is to monitor the implementation and operation of CbCR by the jurisdictions to address recommendations that have been made (OECD, 2021).

The peer review process is a staged approach, which is intended to allow for the early detection of inconsistencies with the minimum standard as well as to provide the opportunity to take action to address inconsistencies. Each phase of the peer review focuses on different key aspects of jurisdictions' implementation. (EY, 2021)

(i) Phase one: Domestic Legal and Administrative Framework.

(ii) Phase Two: Exchange of Information framework and appropriate use.

(iii) Phase Three: Confidentiality and appropriate use of the CbCR reports.

(iv) Phase Four: Compilation: this covers the peer review of over 132 participating jurisdictions participating in the Inclusive Framework (IF). The Phase Four Report was published on 18/10/2021, and was stated to reflect the status of CbCR implementation as of 31 March 2021 (apart from Exchange of Information (EOI), which was stated to reflect the status as of 31 December 2020).

Finding of Phase Four – Compilation

The Compilation Report of October 2021 highlights the "significant progress made with respect to implementation of CbCR requirements around the world and the sharing of tax and financial data across financial authorities (OECD, 2021). As the name suggests, the Phase Four Report complies data on the subject matter of Phases One – Three. Each phase may be discussed briefly in turn:

(i) Domestic Legal and Administrative Framework – according to the Compilation Report, over 100 countries have a domestic legal framework in place, covering most MNE groups that have consolidated group revenue above 750 million Euros. A handful of countries have legislation that is in its final stages.

Overall, implementation of Action 13 has been consistent with the minimum standard. In terms of country specific feedback arising from the peer review process: (i) 33 of the 132 jurisdictions received a general recommendation to action their domestic legal and administrative frameworks; (ii) 43 jurisdictions received at least one recommendation to improve specific areas of their frameworks (such as amending definition in line with the minimum standard; amending the relevant group revenue threshold; and limiting requirement for local filing of reports).

(ii) Exchange of Information framework and appropriate use – as well as considering to what extent countries have EOI agreements in place that provide for CbCR, the Compilation Report also reviewed to what extent recommendations made from the first annual peer review have been addressed by the relevant country. Some of the more significant findings include: 83 countries have multilateral or bilateral competent authority agreements; as of 12 August 2021, 91 have signed the CbC Multilateral Competent Authority Agreement (CbCMCAA), which has resulted in over 3,000 bilateral exchange relationships being activated under the CbCMCAA, the EU Council Directive 2016/881/EU as well as being signatories to bilateral agreements for EOI under DTAs or Tax Information Exchange Agreements.

In terms of conformity with the terms of reference: 57 countries are reported to have met the terms of reference in relation to EOI with the remaining 75 countries receiving at least one recommendation to improve a specific area such as taking steps to conclude qualifying competent authority agreements that meet the confidentiality, consistent and appropriate use conditions.

As at 31 January 2022 there were 92 signatories to the CbC MCAA (OECD, 2022). Many countries have "activated" their exchange relationships e.g. the USA and Czech Republic signed on 28 September 2017 with an effective date of 25 October 2017 and Australia and Hong Kong activated their exchange relationship for tax periods starting on or after 1 January 2019.

(iii) Confidentiality and appropriate use of the CbCR reports: according to the Compilation Report, 84 countries provided detailed information to ensure that the appropriateness of use could be assessed (not included within this aspect are fifteen countries that have committed to send CbC reports to their relevant exchange partners but who will not receive CbC reports and will not apply local filing). In terms of confidentiality, reference was made to the work of the Global Forum. 89 countries were assessed by the Global forum with no recommendations being made whilst a further 10 countries were working on an Action Plan issued by the Global Forum. It should be noted that CbCR information may also be used for the purposes of economic and statistical analysis where this is consistent with the relevant DTA or TIEA. (Guidance on the Appropriate Use of Information Contained within Country-by-Country Reports, 2017).

At a general level, stated protections include: compliance teams documenting the specific actions they take with respect to taxpayers in large groups; tax authorities incorporating the “appropriate use” condition in their review mechanisms; and having a person who is independent of the compliance function to check that the CbCR information is being used by appropriately trained staff, whether controls are effective and to ensure the outcome of audits is fully documented and evidenced. See Guidance on the Appropriate Use of Information Contained within Country-by-Country Reports, 2017.

Effectiveness: in terms of effectiveness of BEPS Action 13 there are numerous points that could be made, including:

- BEPS Action 13 has resulted in the Chapter V, Transfer Pricing Guidelines (2017) – hereafter TPG - being completely revised. The TPG sets out a three-tiered approach to TP documentation as well as guidance in relation to TP audits, compliance issues and implementation. Given the supreme importance of TPG in relation to TP practice and the extent to which there appears to be buy-in across many countries in relation to implementing Action 13 (as per the various peer reviews), it appears to have had a considerable impact on the manner in which tax and financial information relevant to tax assessments is filed and shared across jurisdictions. Candidates may note that the TPG 2022 were released in January 2022.

- The CbC reports are reported to be central to a number of related projects (e.g. OECD / G20 2.0 project; the International Compliance Assurance Programme; and the EU project on effective tax rates), which have been stated to “highlight the increased importance of the peer review reports to ensure compliance with the minimum standard under BEPS Action 13.” (OECD, 2021). In the European context, Member States are required to ensure that resident parent companies prepare CbCR and that these reports are exchanged automatically under the Mutual Assistance Directive (Council Directive, 77/799/EC, [2011], O.J., 1).

- CbCR has been described as “the only dataset available to depict the entirety of MNE activities.” (Bratta, 2021). The CbCR dataset is considered unique due to: (i) its extensive geographic coverage; the fact it combines financial and tax information in one single source; and (iii) its ability to connect the activities of entities in different jurisdictions with the MNE Group to which they belong. This in turn enables tax authorities to cross-cross check CbCR information against other information they may have available such as tax payments and the TP master and local files (Bratta, 2021).

- The results of a recent study find that the concentration of profit shifting in a few, small low tax jurisdictions may suggest that international tax reforms aimed at guaranteeing a minimum level of tax may be an efficient way to reduce profit shifting (Bratta et. al, 2021).

- A recent South African study that tracked the average consolidated effective tax rate (ETR) before and after the CbCR obligation, found that when comparing the average consolidated ETR of MNE groups with a filing obligation was significantly higher than the average ETR of MNE groups without such an obligation (Tlhart, 2020). Whilst not conclusive, this could suggest that increased revenue is being collected as a consequence of increased reporting requirements.

<u>Conclusion</u>

Candidates should summarise the key points on the effectiveness of BEPS Action 13 in reducing tax avoidance and / profit shifting. It is perhaps difficult to quantify the effectiveness of

Action 13 in relation to reducing tax avoidance and profit shifting, although it appears there is at least some support for the view that it is helpful. At the least, it can be stated that Action 13 has created a foundation upon which other initiatives can be built e.g. the threshold for the GloBE rules is determined under the CbCR rules under Action 13 (OECD, 2021). Furthermore, the extent of up-take in relation to Action 13 and the revision of Chapter V TPG 2017 – and the significant impact that the TPG has on TP practice generally - could be described as further supporting the contention that continued reliance on Action 13 outputs is likely to continue to assist tax authorities exchange relevant data, cross-reference the various items of data they have access to and make more effective tax assessments.

The peer reviews have revealed the considerable support for Action 13 across various countries, which has been witnessed by “significant progress” being made with regards the implementation of CbCR requirements (EY, 2021). However, a number of concerns remain including the compliance burden (for both qualifying MNE groups and under-resourced tax authorities) and that the appropriate use of CbCR protections may still be lacking in some country regimes (EY, 2021). On balance, candidates could conclude by tracking the progress made in the quest for greater tax transparency and could conclude that the “push for greater tax transparency is likely past the tipping point.” (O’Brien and Johnson, 2021).

Question 3

This question requires candidates to focus upon a particular aspect of the mutual agreement procedure (MAP), namely the extent to which both competent authorities and taxpayers can expect MAP to result in a final solution. The focus of the question is on Article 25 but candidates may also refer to BEPS Action 14, which provides that securing progress on dispute resolution and resolving matters in a timely manner is a minimum standard.

MAP definition

"A special procedure outside domestic law aimed at resolving the dispute on an amicable basis, i.e. by the agreement between the competent authorities of the contracting states, in cases where tax has been charged, or is going to be charged, in disregard of the provisions of a tax treaty, with a view to securing the uniform application and interpretation of the tax convention in both countries'" (Lombardo, 2008).

MAP

Can be relied upon by tax authorities and taxpayers alike (however, it appears that competent authorities dominate the MAP, (Burnett, 2007). In the case of tax authorities, there are various instances in which Article 4(3) requires MAP to be used throughout the OECD MTC, e.g. where either it proves impossible to determine the residence of an individual under Article 4(2)(a)-(c) and of a person other than an individual in Article 4(3). A further example is the reliance on MAP to settle the mode of application of the source state and limits the rate of tax applied therein in relation to Articles 10 and 11 OECD MTC. Article 25, provides a mechanism by which taxpayers can invoke the MAP.

The Commentary lists the other cases as commonly arising under MAP: questions related to the attribution of profits to a PE; taxation in the state of the payer (such as Article 11). MAP permits the authorities to communicate with each other directly without going through diplomatic channels. Information exchanged is subject to Article 26 and therefore the information should be treated as confidential (Commentary on Article 25, [4]).

Article 25 (MAP and Arbitration)

This article constitutes "special provision" in the OECD MTC and 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 endeavour to resolve the dispute through bilateral negotiation.

Article 25(1) 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. Article 25(2) provides that where the competent authority considers the taxpayer's objection to be justified and where it cannot itself resolve the issue within two years from the date when all the information required by the competent authorities in order to address the case has been provided to the competent authorities, then the unresolved issue can be resolved via mutual agreement with the other state. Relevantly, no domestic time limits are to be imposed on the MAP process under Article 25.

A time limit is however, may be imposed under Article 25(5) for the competent authorities to submit any unresolved issues to arbitration where the taxpayer requests this in writing (two years as described above). However, there is no recourse to arbitration where a decision has been reached by a tribunal or court of either state. Where a decision is reached by way of arbitration, it is binding unless the relevant taxpayer does not accept the mutual agreement that implements the decision (unless the wording in Article 25(5) third sentence is amended e.g. along the lines outlined in the conclusion). Arbitration is described as an "integral part of MAP" and "does not constitute an alternative route to resolving disputes concerning the application of the DTA." (Commentary on Article 25, [5]).

Time limits

These are referred to above and referenced in the text of Article 25. However, the Commentary also elaborates on these e.g. the MAP can be set in motion by a taxpayer without waiting until the taxation considered to be "not in accordance with the DTA has been charged or notified to him." Rather the taxpayer may set MAP in motion under Article 25 when there is a probable (as opposed to possible) risk that taxation not in accordance with the DTA will be imposed (See Commentary on Article 25, [14] and [15]). This allows the MAP to be made available as widely and with as much flexibility as possible (Commentary on Article 25, [17]. However, the three-year time limit for the taxpayer to submit the issue to MAP is included in order to "protect administrations against late objections" (Commentary on Article 25, [20]).

In terms of the starting of the "three-year period", the Commentary on Article 25, [21] makes clear that the relevant event ("first notification of the action resulting in taxation not in accordance with the provisions of the DTA") should be interpreted in the way most favourable to the taxpayer. Countries interpret the nature of the relevant act differently e.g. Chile takes the view that the three year period starts from the time of filing of the amended return and Hungary does not accept MAP can operate outside of the prescribed period provided for under its domestic law (See Observations on Article 25, [95.1], and Reservations, [101]).

These comments highlight the tension that exists between providing a mechanism for both taxpayers and competent authorities to obtain a resolution as soon as practicable and considering their circumstances. Given the interplay between domestic time limits and those within Article 25, the Commentary considers varied approaches to the wording of Article 25 when included in countries' DTAs (See Commentary on Article 25, [25]).

Review and Reporting Requirements

The OECD has released data that compares the statistical reporting framework for MAP between 2006 (the year in which the OECD began to compile annual statistics on MAP caseloads) and 2015 (the first period) and the new reporting period from 1 January 2016 onwards, which is when reporting jurisdictions committed to implement Action 14 minimum standard. According to the OECD, during the first period the average time cycle for MAP cases was two years. However, the validity of this data has been queried due to the fact a great number of countries failed to supply data re: time cycles and some countries failed to include any data at all and the consequent averaging also has been said to hide some very lengthy delays in MAP. (e.g. Belgium completed eight cases with non-OECD economies but these took an average of 116 months, OECD, MAP Program Statistics for the 2015 Reporting Period and Cai and Zhang, 2018).

The new reporting requirements (post 2015) add some additional data e.g. as well as calculating the average cycle time for the entire MAP, the MAP is broken into stages and there is a need to record the time spent on each of the three main stages ((i) date of receipt of the taxpayer's MAP request as the starting point (ii) the stage when the first authority prepares its position paper and (iii) the stage when the authorities negotiate with each other) (Cai and Zhang, 2018). The new requirements also specify the number of cases closed (including denied MAP access), objections not justified, and withdrawn by the taxpayer). Cai and Zhang also consider that the agency problem is one of the major sources of delay (competent authorities are viewed as agents of the taxpayers under this view and whilst the competent authorities are expected to protect the interest of the taxpayer, they may care more about revenue collection).

Finality of decision-making

The extent to which MAP decision-making is final, may often depend upon the interaction between domestic legal remedies and MAP, e.g. a taxpayer may choose not to accept the agreement arising out of the MAP e.g. where the MAP is first pursued and a mutual agreement has been reached, the taxpayer and other persons directly affected by the case are offered the possibility to reject the agreement (this is considered to occur quire rarely, UN Committee of Experts, 2019) and pursue the domestic remedies that had been suspended; conversely, if these persons prefer to have the agreement apply, they will have to renounce the exercise of domestic legal remedies as regards the issues covered by the agreement (Commentary on Article 25, [76]).

In relation to an agreement that implements an arbitration decision the default position is that the decision is binding unless the taxpayer directly affected by the case does not accept the agreement (See Article 25(5) and Commentary, [81]). A further qualification as to the binding nature of an arbitration decision is where the decision is found to be unenforceable by the courts of one of the contracting states because of a violation of Article 25(5) or any procedural rule. In such a case the decision will not be binding. Commentary, [81].

The Commentary on Article 25 UN MTC, [51] provides that "in most countries a mutual agreement cannot be finalised before the taxpayer has given agreement and renounced legal remedies." Markham has referred to the requirement that representatives are required to attempt to reach a resolution as opposed to being compelled to achieve a final agreement (Markham, 2018).

The Multilateral Instrument 2016 (MLI) specifically provides for arbitration and more specifically that: "the arbitration decision with respect to the issues submitted to arbitration shall be implemented through the MAP concerning the case [....t]he arbitration decision shall be final." This feature of the MLI could be said to support a view of MAP as increasing the incidence of final solutions. However, the decision is not binding on both CSs in three situations: (i) where a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision; (ii) where a final court decision of one of the CSs holds that the arbitration decision is invalid; or (iii) a person directly affected by the case pursues litigation on the issues that were resolved in the mutual agreement that implemented the arbitration decision in a court or administrative tribunal (Markham, 2018).

<u>Lack of Finality</u>

Unresolved MAPs may result in double taxation for the taxpayer involved. Some statistics point to 85% of MAP cases being resolved (OECD, 2017) but other features of the MAP process may compromise the financial position of the taxpayer even where there is an eventual solution e.g. the length it takes for MAP cases to be resolved, whilst a focus of BEPS Action 14, can also extend a case to many years in certain instances and the longer the period over which the taxpayer may be required to pay tax. Whilst it is acknowledged that this amount may be refunded when the issue is eventually resolved, there are opportunity costs associated with the taxpayer utilising their resource in this way (Markham, 2018).

<u>Conclusion</u>

Candidates should conclude by confirming whether they consider that the MAP provides final solutions for tax authorities and affected taxpayers. It could also be mentioned that in order for continued co-ordination of tax rules, countries and taxpayers require dispute resolution mechanisms that are effective. Providing a final solution can be seen as an aspect of the MAP's effectiveness. Accordingly, the finality of MAP is likely to continue to be something to strive for as it will provide certainty and the ability for impacted parties to move on. MAP processes and time limits impact the effectiveness of MAP and this is supported by peer review and monitoring. There have been reports that judicial review of MAP may also increase both the length of time at a given stage of the MAP and thus the finality of the decision may be affected (Cai and Zhang, 2018).

Furthermore, the fact there is scope for countries to amend aspects of Article 25 may restrict the finality of the MAP process and thus its decision-making e.g. it is possible for states to allow the competent authorities to agree on a solution that is different to the arbitration decision in certain circumstances (i.e. where the competent authorities agree on a different solution that would settle all outstanding issues that were not resolved under the MAP, they can agree to amend Article 25(5), third sentence, by including the italicised wording: "[u]nless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision or the competent authorities agree on a different resolution of all unresolved issues arising from the case within three months after the decision has been communicated to them, the arbitration decision shall be binding on both States and shall be implemented notwithstanding any time limits in the domestic law of these States.") (Ismer and Piotrowski, 2022).

There are also various reservations on Article 25 that need to be considered before assessing the extent to which MAP can provide a final solution (e.g. Australia reserves the right to exclude cases presented under MAP from the scope of Article 25(5) where unresolved issues pertain to its anti-avoidance rules in both Part IVA A, Income Tax Assessment Act 1997 and section 67, Fringe Benefits Tax Assessment Act 1986) (Reservations on Article 25, OECD MTC 2017, [103]). Various other countries reserve the right not to include Article 25(5) e.g. Denmark, Mexico and Turkey [97].

In sum, it would appear that the MAP has some way to go before providing final solutions (and within a timely manner) across all cases but the MLI is likely to play a key role in "enhancing certainty, predictability, and enforceability in relation to unresolved MAP disputes" (Markham, 2018). Whether this statement can be said to apply equally to all taxpayers is not as clear. Concerns pertaining to taxpayer rights through the MAP have been raised, especially with regards the need for taxpayer involvement at all stages of the MAP (typically this includes submitting the MAP request and ensuring all information required is provided; offering or responding to requests for engagement with each competent authority and accepting, rejecting the proposed mutual agreement) and protecting confidentiality where possible (Baker and Pistone, 2015/16).

Claims have also been made that few taxpayers reject MAP decisions ((UN Committee of Experts on International Cooperation in Tax Matters Eighteenth Session (Subcommittee on Dispute Avoidance and Resolution), April 2019) and that only 3% of reported MAP cases have involved non-OECD countries that have joined the Inclusive Framework (other than India or China) (OECD, Mutual Agreement Statistics, 2017), which can be viewed as an indication that whilst MAP is moving in the right direction it still has some way to go before it provides finality of decision-making in a DTA context. Whilst the MAP may continue it should not be forgotten that dependence on MAP will continue until such time that rules pertaining to areas such as transfer pricing - that constitute a significant proportion of the MAP's workload - are "made clearer and easier to apply" (Picciotto, 2016).

Question 4

The question requires candidates to demonstrate their knowledge of the manner in which Article 10 in both MTCs operates and also to consider the allocation of taxing rights between the source and residence states. Candidates should also consider the extent to which no, limited or full source state taxation on dividend income is desirable and may include references to DTAs that converge with or diverge from the OECD/UN MTC approaches. Answers should also reference the rules pertaining to double taxation relief in the OECD / UN MTC and how these apply to dividends taxed under Article 10.

The following will consider: the nature of dividends; a brief historical overview of DTA allocation of dividend income taxing rights; the operation of Article 10; the rules around double taxation relief; the WHT rates applied in different circumstances; and the consequences for developing countries of adopting the relevant articles in the form they are in the MTCs.

Dividends

Dividends can be considered as a form of passive income where the recipient does not participate in the activity that gives rise to the income (OECD Glossary of Tax Terms) or where they constitute cash flow obtained without continuous time involvement (Kopeland, 2003). Passive income is often used to describe investment income when there is a lack of control or involvement over the source that actually generates the income such as interest, royalties and dividends. Whilst the CS applying the DTA will refer to its domestic law when considering whether a relevant amount falls within Article 10 as a dividend, the OECD / UN MTC also provide details of core elements of "dividends" in Article 10(3) for the purposes of Article 10 e.g. "corporate rights".

History of Allocation

The League of Nations' Report of 1927, Article 4 recommended unlimited source taxation for income from shares (based on the real centre of management) and a refund of such taxation was apparently considered as an addition (Haslehner, 2022). The Mexico Draft 1943, Article IX rejected the refund idea but retained the notion of unlimited taxation at source (based on where such capital is invested). This approach was ultimately replaced (see below, "shared taxing rights")

The London Draft 1946, Article VIII introduced exclusive residence taxation for inter-company dividends in cases of "dominant participation" and the prohibition of extraterritorial taxation. The OECD MTC 1963 was strongly influenced by the above three proposals and the practice of the then OEEC membership, with the first report of the Fiscal Committee's Working Party 12 contained a provision very similar to the current Article 10 OECD MTC. The approach adopted by the OECD MTC consists of "shared taxing rights" with the source state retaining the ability to tax dividends up to a maximum.

Article 10(1) "Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State." The payer and recipient of the dividend are determined by referencing domestic law and the term payment is to be given a very wide meaning (Commentary on Article 10, [7]). Notwithstanding the reliance on domestic law, the OECD MTC and UN MTC, Article 10(3) each provide a number of core elements that are effectively essential characteristics of a dividend (e.g. corporate rights etc.). Article 10(1) does however operate to ensure that the company paying the dividends is a resident of one of the two CSs.

The extent to which Article 10(2) limits the source state's taxation is dependent upon: (i) the legal status of the beneficial owner and (ii) size of the relevant shareholding (with a lower rate for inter-company dividends and a higher rate for non-corporate recipients). The residence state's taxing rights are also affected but only by way of Article 23(A), which requires that it provide a credit for tax withheld in the source state.

Article 10(2)

Provides that the source state may also levy a tax on dividends paid by a company that is resident of that state but the rate must not exceed where (i) the recipient is a beneficial owner and the dividend is an intercompany direct investment (5% WHT); and (ii) the recipient is a beneficial owner and the dividend is not an intercompany direct investment (15%). The effect of Article 10(2) OECD MTC is that it provides a fixed limit on the source state taxing rights in a situation where the recipient is a beneficial owner or a beneficial owner paid an inter-company dividend.

This contrasts with Article 10(2) UN MTC, which provides: (i) the opportunity for CSs to negotiate the maximum WHT rates – this is because the OECD MTC rates are not considered appropriate maximum rates as they may result in too much lost revenue (Commentary on Article 10 UN MTC, [7]); (ii) a lower threshold for a holding to qualify as a direct investment (10% per the UNMTC), which could reduce the levels of revenue collected in the source state; and (iii) that the scope of Article 10(2) is restricted by Article 10(1) (referencing "such dividends") such that all the conditions in Article 10(1) are to be applied to Article 10(2), which means that a situation where an intermediary in a third state is interposed between the payer and beneficial owner of the dividends does not fall within Article 10(2) (cf. the connection of Article 10(2) with Article 10(1) was severed in 2014 in the OECD MTC).

Article 10(4)

Applies where Article 10(1) and (2) OECD MTC do not i.e. where the dividends are paid in respect of a holding that is effectively connected with a PE. The UN MTC extends this to a "fixed base". In such a situation, the OECD MTC provides that the relevant dividends will be taxed as "business profits" under Article 7 and the UN MTC provides that in the case of a fixed base, the dividends will be taxed under Article 14. Although a rare occurrence, some DTAs provide a subject to tax clause when the source state does not tax the dividends as business profits (e.g. France / Thailand DTA, 1974). The subject to tax clause has the effect of enabling dividends falling within the Article 10(4) scenario to be subject to Article 10(1), which permits the residence state to tax such dividends under the relevant DTA.

Article 10(5)

This provision prohibits extra-territorial taxation and subjects non-resident companies to special taxes on undistributed profits. Extra-territorial taxation here applies to a situation whereby a state taxes dividends distributed by a non-resident company solely because the corporate profits from which the distributions are made originated in their territory. (Commentary on Article 10(5), [35]). Extra-territorial taxation does not apply to a situation where either the corporate profits are paid to a shareholder who is a resident of that state or to a PE in that state. The prohibition of special taxation of the undistributed profits of non-resident companies in the country of source. Article 10(5) does not impact taxation in the residence state (including such measures as CFC rules).

WHT Rates under the OECD MTC and UN MTC

The OECD includes 5% and 15% but as noted above the UN MTC does not include any rates (this is true of the US MTC also). DTAs in practice contain a wide range of rates. For developing country DTAs the range of WHT rates has been reported to be 5-15% for intercompany dividends and 15-25% for portfolio investment (Commentary on Article 10 UNMTC, [10]).

Double Taxation Relief Method selected by the Contracting States

The method of DTR applied to dividends (and other passive income) has been considered to be critical to CSs that have entered into DTAs where the economic positions of the CSs are not symmetrical. There is a view that the exemption method is preferable in such an asymmetrical scenario because all income arising in the source state will be exempted from tax by the residence state (as opposed to being neutralised for the investor by a credit being made available in the investor's residence state) and thus the source state can more freely determine at what level it taxes the dividend income (e.g. it may choose to provide an incentive) (Garfias von Furstenberg, 2021). In terms of the OECD MTC 2017 its Commentary on Article 10, [5] provides that "[t]axation of dividends exclusively in the state of source is not acceptable as a general rule [...]" nor is "[t]axation of dividends exclusively in the state of the beneficiary's residence [...] feasible as a general rule.". As noted above, what is noted above is a form of shared right to tax.

In terms of DTR, the Commentary acknowledges that the residence state may choose to exempt or credit tax in the source state. For a CS that uses the exemption method and that wishes to tax the dividend income, the Commentary on Article 23B, [58] notes that "[t]he ordinary credit method is intended to apply also for a state which follows the exemption method but has to give credit, under paragraph 2 of Article 23 A, for the tax levied at limited rates in the other state on dividends and interest.". Accordingly, even where a country operates the exemption method it is possible for it to tax the dividends of its residents and provide them with an ordinary credit. The Commentary to Article 23 UN MTC 2017, [31] where a combination of DTR methods may be included in circumstances as those outlined in the OECD MTC 2017's Commentary, [58]. Furthermore, Commentary on Article 23B, UN MTC 2017, [47]-[48] contemplates exemption countries applying the (ordinary) credit method to certain items of income as

Whilst double taxation in a DTA context typically refers to juridical double taxation (JDT), there is some limited acknowledgement of the need to reduce economic double taxation (EDT). The general position is that EDT generally persists with regards dividends as Article 10 is not designed with the relief of EDT in mind (Haslehner, 2022). However, it is acknowledged that there is some level of elimination of EDT on qualified holdings (Tischbirek and Specker, 2015) but this does not translate into making a significant difference in practice, mainly due to many countries eliminating taxation on inter-company dividends (Haslehner, 2022).

Both the MTCs state that in their Commentaries that Articles 23A and 23B deal with JDT which is to be distinguished from EDT (Commentary on Article 23A and 23B OECD MTC 2017, [1]-[2] and Commentary on UN MTC 2017, A. 1 - 2).

<u>Allocation – other ways</u>

<u>Exclusive source taxation</u>

The Andean Model 1971, Article 11 provides the state of the enterprise paying the dividends or share of profit (i.e. the source state) with the exclusive right to tax those dividends and shares of profit.

<u>No source taxation</u>

Although a relatively rare occurrence, some DTAs provide exclusive residence taxation at the general level e.g. Egypt / France DTA 1980/1999 and Finland / UK DTA 1969/1996. Where a DTA provides for exclusive residence taxation of dividends it will also include an explicit beneficial ownership requirement (Haslehner, 2022).

For an example of a specific exemption, the OECD has suggested in its Commentary that pension funds and similar institutions are exempt from taxation in the source state to mirror the tax treatment they receive in the residence state (i.e. exempt). (Commentary on Article 10, [13.1] and on Article 18, [69]. This can be seen in some DTAs (e.g. UK / Hungary DTA 2011, Article 2(b)(ii)).

<u>DTR – other ways</u>

Tax sparing (or matching) credits provide a credit in the residence state that covers any relevant tax incentives offered by the source state. Although the prevailing view of OECD members is that tax sparing credits or not effective nor efficient and that only a select few types of tax sparing credit that are limited in time should be permitted. Some CSs have included these in their DTAs with developing countries (Kemmeren and Streicher, 2022). However, other CSs (such as the USA) do not include tax sparing credits.

In practice, a handful of DTAs include rules to prevent EDT by requiring the exemption of dividends in the residence state if comparable dividends are exempted e.g. Finland / France DTA 1970 (Haslehner, 2022)

WHT Rates – other ways

Some DTAs have a 0% rate for inter-company dividend rates provided that the company profits have borne the "normal rate of company tax". (e.g. France / Australia DTA 2006, Article 10(2)(a)). Several DTAs provide for uniform treatment of dividends in terms of WHT rate (i.e. no special rate for inter-company dividends) e.g. Australia / China DTA 1988 and Australia / India DTA 1992. It is possible that this approach will change in the future as more CSs include such a distinction in their DTAs. Candidates could also note that whilst most favoured nation (MFN) clauses are not recommended by the OECD, where a DTA has a MFN clause this may have the effect of increasing the WHT rates where these have been agreed upon at higher levels in other DTAs e.g. South Africa / Netherlands DTA 2005/2008, Article 10(10).

Developing Countries

When considering Article 10 as applied to developing countries, of primary importance is whether the CSs entering the DTA are in a symmetrical relationship as regards their stages of economic development. The provision, as with many provisions within the OECD MTC, is based upon reciprocity. For reciprocity to be effective it must necessarily involve two parties that are capable of providing and forsaking broadly the same level of resources. DTAs entered into between capital importing and capital exporting countries may not always meet this threshold criterion. As the possibility that an imbalance - as regards the allocation of taxing rights to passive investment between developing and developed countries - has not formed a formal focus within the BEPS Actions, it has been suggested that the issue is implicitly contained within the matters addressed in the BEPS Reports (Brauner 2014)

Notwithstanding, its implicit place within the more recent international tax dialogue, it has been further suggested the interests of capital importing countries have not been sufficiently considered in the more recent changes (Garfias von Furstenberg, 2021). Suggestions for reform include leaving the decision of how to tax dividends to the domestic law of the source countries (by not entering a DTA and relying on domestic provisions alone to determine source and double tax relief) or where entering a DTA having the residence state exempt the foreign dividend income, which again has the effect of leaving the source state to freely tax the income or not as it sees fit.

Conclusion

Candidates could conclude by summarising their discussion of taxing rights and dividends under Article 10. As evident from the above, unless the dividends are effectively connected with a PE that the investor has in the other CS under Article 10(4), the right to tax dividends sits with the resident state in the main. In terms of restrictions on tax sovereignty Article 10 restricts the source state's ability to tax the dividends and requires the residence state to relieve any juridical double taxation by way of a credit. This approach involves a "shared allocation" of taxing rights. Tracing the history of the provision this could be described as a compromise allocation.

The combined restriction on residence and source tax sovereignty has recently been considered from a developing country perspective. The view formed is that the requirement for a credit to be granted by the resident state - whilst neutralising the overall position for the resident investor - necessarily curtails the ability of the source state to set its own tax rates, including incentivised rates (Kemmeren and Streicher, 2022). This is considered to have a negative knock-on effect on development and raises the question as to why developing countries would enter into DTAs with provisions such as those in Article 10 (Garfias von Furstenberg, 2021) when they are able to provide unilateral relief from double taxation under their domestic law.

As referred to above, either not including Article 10 as currently worded and relying on upon its domestic law is one option for a developing country or, alternatively, including Article 10 but removing the requirement that double taxation relief be provided by way of credit are two ways that have been suggested as a possible improvement (Garfias von Furstenberg, 2021).

Question 5

This question requires candidates to demonstrate their understanding of Article 21 OECD MTC and to formulate a view as to whether they agree with the statement or not, providing reasons for their (dis)agreement. The wording in the question is based on wording contained within A. Bosman's book on Article 21 where he states that "[i]n one school of thought, the article serves as a catch-all clause – an article of last resort – over which other distributive rules take precedence [...i]n this view, Article 21 is of relatively minor importance....". See A. Bosman, "Other Income under Tax Treaties: An Analysis of Article 21 Other Income of the OECD Model Tax Convention", 2015.

The following provides an overview of one way to approach the question.

Introduction

The statement in the question requires candidates to consider the role that is played by Article 21 OECD MTC and its relativity to the other distributive rules contained therein. Accordingly, reference will need to be made, inter alia, to: its scope; its positioning within the MTC, and its Commentary. Additional knowledge that candidates may have surrounding the history of the provision can also be included but this is not essential. This is also the case for country practice.

Article 21 (1) OECD MTC provides that the residence State has the exclusive right to tax income that is not dealt with in the previous articles (i.e. Article 6-8 and 10-20) and this applies wherever the income arises.

Broadly, Article 21 may apply where: (i) a type of income is not covered by the previous distributive articles; and (ii) a distributive rule in the MTC (Article 6-20) only deals with the relevant type of income when it arises in the other CS. In other words, where the relevant distributive rule does not deal with income that arises in the residence state or in a third state, the income is not considered to have been dealt with by the relevant article and is therefore caught by Article 21 (Rust, 2022).

Examples from case law of income falling within Article 21 include: a prize won by a UK resident at Disneyland (US Letter Ruling 87-14-55) and deductions that were denied in computing profits of a French company (in respect of maintenance of a building for entertaining clients of the company) which were treated as distributions to the US parent and fell within the "other income article", Conseil D'Etat, March 5, 1999, SA "Domain Clarence Dillon" reported in Revue de Droit Fiscal, 2000, No. 8 comm. 125 (Baker, 2002).

Furthermore, the rule applies: (i) irrespective of whether the residence state exercises the right to tax (Commentary on Article 21(1), [3]); and (ii) when income arises in a third state and the recipient of the "other" income is treated as being resident of a CS then the other CS may not impose any tax even where the resident CS does not impose tax (Commentary on Article 21(1), [3]). These features leave open the potential for double non-taxation and therefore it is left open to CSs to modify Article 21(1) during negotiations. Some DTAs include a "subject to tax "clause to ensure that the "other income" is not excluded from the normal tax treatment in the other CS (e.g. Morocco / Germany DTA 1972, Protocol).

Article 21(2) OECD MTC provides an exception to (and so limits the scope of Article 21(1). The exceptions are where:

(i) the income is from immovable property as this income is always subject to tax in the source state; and

(ii) in a similar vein to paragraph (4) of the passive income Articles 10-12, where the income is derived by a resident of a CS who carries on business in the other CS through a PE situated therein and the right or property in respect of which the income is paid is effectively connected with such PE, Article 7 will apply.

Article 21(2) is not always included in DTAs as many DTAs are still based on the 1963 MTC (Rust, 2022). The effect of inclusion of Article 21(2) in a CS's DTAs is that it covers certain income, namely, that from immovable property, dividends, interest and royalties, in the residence state or a third state that are attributable to a PE in the other CS.

Candidates may note that UNMTC has an additional paragraph in Article 21, namely Article 21(3). This additional paragraph provides that "notwithstanding the provision of Article 21(1) and (2), items of income of a resident of a CS not dealt with in the foregoing Articles of this Convention and arising in the other CS may also be taxed in that other State". The Commentary to Article 21(3) UNMTC,[5] provides that Article 21(3) will apply where the domestic law of the CS in which the other income arises provides for taxation in its state, whilst the residence state will still have the right to tax the other income under Article 21(1). Article 23A and 23B are to be applied to any juridical double taxation that may arise under circumstances where both CSs apply Article 21.

The Commentary also notes that it is possible that CSs will include a reduced rate of tax in the source state under Article 21(3) in lieu of unlimited source state taxation. Commentary on Article 21(3) UNMTC, [9]. In many cases, Singapore includes a provision equivalent to Article 21(3) UNMTC and does so in order to adhere to the principle of territoriality. Notable exceptions include: Bulgaria, and Germany, whilst the Singapore's DTA with Sri Lanka and Taiwan does not include Article 21 at all (Hwa See, 2017).

Commentary, Reservations and Observation – The Commentary on Article 21 OECD MTC is fairly brief Commentary (just over three pages) relative to many of the other distributive rules. It states that Article 21 provides a "general rule relating to income not dealt with in the foregoing Article". (Commentary on Article 21, OECD MTC, [1]). The UN MTC Commentary describes Article 21 in similar but not identical words and spans a little over six pages. Numerous OECD countries have filed reservations on Article 21 e.g. Australia, Canada and Mexico have reserved the right to tax income arising from sources in their own country as do various non-OECD members such as Argentina and Singapore. There are no Observations on Article 21 OECD MTC.

History: The first inclusion of an "other income" dates back to 1869 (Prussia/Saxony DTA). The article was considered by some as a "fundamental rule and was placed at the beginning of the convention" in some DTAs (e.g. Prussia/ Saxony DTA 1869) and placed at the end in other DTAs (e.g. German Reich and the Swiss Confederation, 1934) ((Rust, 2022). The OECD MTC 1963 included an article entitled "income not expressly mentioned" (Article 21) that assigned the right to tax to such income to the residence state. The Commentary described it as forming a general rule relating to items of income not expressly mentioned in the preceding Articles of the Convention.

The OECD MTC 1977 added a reference to "wherever arising" such that income arising in third states could be caught and replaced "not expressly mentioned" with "not dealt with". A further consequence was that income from all sources (and so not just from sources not expressly mentioned) was caught by Article 21 (Commentary on Article 21(1), [1]).

A second paragraph was also introduced and this referred to: (i) PEs (aimed at dealing with dividends paid by a company resident in a CS to a PE in the other CS that belonged to a resident in the first-mentioned state but also applied to income from third States) and (ii) an exception for immovable property as agreed to in 1975 as the source state has the primary right to tax such amounts (even where the immovable property forms part of the business property of a PE of an enterprise of that State situated in the other Contracting State shall be taxable only in the first mentioned State in which the property is situated and in which the recipient of the income is a resident) in line with Article 13 and 22 (Bosman, 2015). Various countries made reservations on the article stating they wished to maintain their right to tax income arising from their own country e.g. Australia, New Zealand and the Spain. Article 21(2) was apparently introduced in order to avoid a situation where Article 7 was viewed as not covering investment income earned in the course of carrying on a business.

Until the introduction of Article 21(2), investment income that was effectively connected with a PE was not caught by Article 7 (because a DTA partner did not view investment income as forming part of income derived from carrying on a business), and it would then be caught by Article 21(1), which would mean that the resident state would tax the income (and the source state could not). (Avery Jones, 2021 and van Raad, 2021). This outcome was considered undesirable and thus Article 21(2) was introduced.

There was an amendment in the OECD MTC 2000 update that impacted the wording of Article 21 such that any references to Article 14 and “fixed base” were removed from the Commentary and then in 2017 the Commentary on Article 21, as amended, it was made clear that (i) in a situation where no other Article applies and (a) where a beneficiary and the payer of income are both residents of the same contracting state and (b) the income is attributed to a PE that the beneficiary has in the other CS, the CS in which the PE is situated will have the right to tax the income, with the resident state providing relief where double taxation arises and (ii) Article 29(9) would deny the benefits of tax exemption where an enterprise of a contracting state attaches shares, bonds or patents to a PE situated in the other CS in order to obtain more favourable tax treatment. (Commentary on Article 21, [5] and [6]).

<u>Supporting Arguments</u>

There are a number of possible arguments for supporting the statement that the role of Article 21 is of minor importance within the role of the OECD MTC framework, which include (this is not an exhaustive list):

- Article 21 does not extend the scope of the OECD MTC or UNMTC, as Article 21 is restricted by Article 2 (taxes covered by the DTA) (Rust, 2022).

- The scope of Article 21 can only be defined by exclusion (Rust, 2022), which may point to the rule playing a lesser role than the other distributive rules.

- There is also a view that Article 21 should not be applied if the taxpayer cannot convincingly prove how they acquired certain income (Rust, 2022).

- The types of income to which it may apply could be described as being of less consequence - or at least less frequently occurring than the types of income covered by the other distributive articles e.g. social security retirement payments that are not covered by Article 18 (Schwarz, 2018); certain damages i.e. those that do not represent a loss of income covered by an Article in the OECD MTC (Wassermeyer and Kaeser, 1992).

- All that is needed for one of the other distributive rules to apply is a causal link (Wassermeyer and Kaeser, 1992), which could lend weight to an argument that in a typical case, a causal link will be established with more typical forms of income and as such Article 21 will often not come into play.

- There is also the fact there is a need to consider the interaction of the other distributive rules with each other, which may itself result in Article 21 not being enlivened e.g. Article 8 (where profits do not fall within Article 8 they will fall within Article 7) and Article 13 (capital gains that are not caught by Article 13(1) – (4) are caught by Article 13(5) and therefore Article 21 cannot apply).

- The placing of Article 21 as the final provision of Chapter III could lend weight to an argument that it occupies a less significant position than the other distributive articles with the OECD MTC.

<u>Counter-arguments</u>

There are a number of possible counter-arguments against the statement that the role of Article 21 is of minor importance within the role of the OECD MTC framework, which include (this is not an exhaustive list):

- Article 21 embodies the main principle underlying the OECD MTC i.e. allocation of the right to tax income to the state of residence of the recipient of the income, which ensures that no income falls outside the scope of the OECD MTC (Bosman, 2015).

- The Commentary on Article 21, [1] refers to Article 21 as a general rule (Commentary on Article 21, [1]).

- The view of Article 21 having a broad application may be supported by some case law where income with an undeterminable source was considered to be covered by the "Other Income Article" of the France / Iran DTA, 1993 (French Conseil d'Etat of 28 April 1993, req. n. 73.105).

- Article 21 can be viewed as having a "wide net" in that it applies to income "wherever arising" (and so applies to income arising in third states). Whilst it is acknowledged that some Articles already cover income arising in a third state (e.g. Article 15), Article 21 expands the scope of the DTA in this way as certain Articles only apply to income arising in the other CS e.g. Articles 6, 10 – 12 (Rust, 2022).

- A DTA that does not contain Article 21(2) "remains a residual provision that cannot derogate from the application of Article 7 (Rust, 2022). Implicit in this statement is the view that the inclusion of Article 21(2) dilutes the residual nature of Article 21.

- The residual nature of the provision, also referred to as a "catch-all provision", enables types of income that were not envisaged at the time a particular DTA is concluded to be covered by the previously entered DTA (Rust, 2022) This is, however, subject to Article 2, Taxes Covered.

- Article 21 has been described as a "fundamental provision" (Avery Jones, 2021).

<u>Conclusion</u>

Candidates should conclude by forming a view as to whether they consider the statement is broadly (in)correct and summarise their key arguments. There is also scope to explore some of the reasons why the precise role of Article 21 has been considered unclear at times e.g. (i) it has been noted it is not clear whether the OECD MTC 1963 was merely trying to eliminate double taxation of other income in cases in which it actually arose (on which credit and exemption states have different approaches) or whether Article 21 was trying to establish taxing rights more generally (Avery Jones, 2021)); and (ii) the precise scope of Article 21 is somewhat dependent upon the demarcation between Article 21 and other distributive rules such that it will often be closely related to the interpretation of the terms used in the relevant DTA (Bosman, 2015), which may lead to Article 21 coming into play in different circumstances at different times.

Notwithstanding these, and other, views as to its scope, it appears that the Article is "of major importance" (and this is in spite of its "innocuous" title) (Baker, 2002) and that this is also supported by the fact that some countries have typically avoided including a version of Article 21 that mirrors the OECD focus on residence taxation (e.g. Australia (Taylor, 2011) and Singapore (Hwa See, 2017).

PART B

Question 6

There are numerous ways in which this question could be answered and the below provides one possible schematic. Some factors for candidates to include are:

- Identifying tax issues pertaining to the inter-company loan and the releavnt interest rate;
- Referencing relevant parts of Article 11 OECD MTC 2017;
- Referencing relevant parts of the OECD MTC 2017 and the Transfer Pricing Guidelines 2022 (with a focus on Chapter X, which was released in 2020);
- Acknowledging that the Country B Revenue Authority (BRA) will seek to recover what it considers to be an appropriate level of tax on the profits of EnerSub Ltd.;
- Whether any part of the loan can be recharacterized as an equity contribution;
- Whether the interest rate represents an arm's length price in the circumstances such that an adjustment to the level of interest is permitted; and
- The resolution of any issues pertaining to any adjustment by Country B and any secondary adjustment by Country A by way of Article 25(3).

Tax Issues – Inter-Company Loan

At a general level the key concern for BRA is likely to be whether the deductions for interest claimed by EnerSub Ltd. on a loan entered into with its parent company (Energio Ltd.) in their Country B tax return are appropriate in the circumstances. BRA will wish to ensure no more interest than is permissible and no more than is reflective of the interest payable by independent parties operating at arm's length is deductible against any profits that EnerSub Ltd. may have derived in the current year or that it may be able to carry forward as a loss against future years' profits.

Accordingly, the BRA will wish to know whether its domestic law and its DTA with Country A may:

(i) limit the deductibility of interest that may be considered excessive in a given case and specifically in relation to EnerSub Ltd.'s loan; and / or

(ii) recharacterize all or part of the relevant loan where it considers EnerSub Ltd.'s levels of debt relative to equity to be excessive;

(iii) require Country B to apply the reduced rate of withholding in Article 11 OECD MTC 2017 to the full amount of interest payable by EnerSub.

Given the breadth of issues, the limited amount of information in the fact pattern (e.g. whether the cost of the construction of the generator matched the loan amount) and in particular the fact that no information is provided about Country B's domestic tax laws (transfer pricing rules in line with Chapter X Transfer Pricing Guidelines and/or interest deductibility rules in lines with BEPS Action 4) it is anticipated that the approach to answering to this question will be varied. For the purposes of this suggested solution, it is anticipated that Country B has both transfer pricing and interest deductibility rules that are consistent with the TPG and BEPS Action 4 respectively. However, candidates who do not make this assumption may advise Country B to implement such domestic rules.

A further issue that may distinguish answers relates to the manner in which the relationship between Article 9 and Article 11 OECD MTC 2017 is viewed when considering a situation where the relevant parties may qualify as both being in a "special relationship" under Article 11(6) and also qualify as "associated enterprises" and there is a concern that the relevant transaction was not at arm's length. There appear to at least three views as to the application of these provisions in these circumstances (including that the provisions complement each other as they have different functions; Article 11 takes precedence over Article 9; and that Article 9 does not apply to interest (nor royalties) (for a summary of the various views, see Kofler and Wittendorff, 2022).

Given the diversity of views and the fact the OECD has included financial transactions in the most recent TPG 2022 (Chapter X), the "complementary approach" is adopted here with the result that both Article 11(6) and, to a greater extent, Article 9 and the relevant parts of TPG are considered. This "complementary approach" views Article 11(6) and Article 9 as having different functions: (i) Article 9 enables an arm's length adjustment to be made to the profits of the payer (here EnerSub) whereas (ii) Article 11(6) is concerned with whether there is an obligation on Country B to reduce the withholding tax rate applied to the relevant amount of interest where there is a special relationship and the interest is excessive (referred to as a treaty qualification issue).

The OECD Commentary on Article 11(6) also notes that it is possible for the payer (EnerSub) to be affected by its operation in that it is possible that Country B has domestic law provisions that may deny deductions for the excessive portion. (Commentary on Article 11(6), [35] (note there is no reference to such domestic law measures in the fact pattern)

Article 11: In terms of the fact pattern, it is clear that Article 11 is relevant as it deals with interest payments and Article 11(6) may be cited as EnerSub and Energio would be classified as having a "special relationship". Article 11(6) provides that the excess portion is not subject to limited source taxation under Article 11, rather it is for the domestic law to apply its own legislation (e.g. this may involve Country B subjecting the excessive portion to tax at the its' prevailing withholding tax rates as opposed to the reduced rate in Article 11 (Commentary on Article 11(6), [32])). The excessive portion is arrived at by determining the arm's length amount of the interest based on Article 9 and the TPG. Relevantly, the nature of the loan cannot be re-characterised under Article 11(6), which concerns itself just with interest payments (Commentary on Article 11(6), [35]). Where contracting states wish to achieve this purpose it has been open to them to amend the wording of Article 11, (6) (see Commentary on Article 11(6), [35]).

As noted above, it is also possible that Country B may have (or may be advised to introduce) domestic rules denying a deduction to EnerSub for the excessive portion under Article 11(6). The process of excluding the excess portion from Article 11 (by perhaps treating it as a dividend under Article 10) has been described as "secondary adjustment". (Bullen, 2011).

Article 9

Whilst EnerSub and Energio are in a "special relationship" per Article 11(6) they also qualify as "associated enterprises" under Article 9 (special relationship is considered to be a wider term than associated enterprises (Commentary on Article 11, [33]). Accordingly, Article 9 and the relevant parts of the Transfer Pricing Guidelines (TPG) 2022 are also considered in the following (Chapter X, Financial Transactions, which provides guidance on both the delineation of the loan and the adjusted interest rate).

Given that Country B is assumed to have relevant domestic rules (or has been advised to implement these if not already in existence), Article 9 ensures that the relevant adjustment taken under domestic law is consistent with the arm's length principle (ALP) or put another way that no adjustments are made that are not in line with ALP. (Kofler and Wittendorff, 2022). There is also a view that Article 9 creates an independent right to adjust profits not in line with the ALP but this Is not explored here.

ALP

There is a need to determine whether Article 9 MTC applies to the relevant transaction. Article 9 contains the "arm's length principle" (ALP), which provides that "where conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would be made between independent enterprises, then any profits which would but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly." The essence of the ALP is that members of an MNE group are treated as separate entities and attention is focused on the nature of the transactions between those members and on whether the conditions differ from the conditions that would be obtained in comparable uncontrolled transactions (CUP). [TP Guidelines, B.1 [1.6]). At the heart of the investigation into the extent to which a transactions is "controlled" or "uncontrolled" is a "comparability analysis" to establish an "ALP".

The DTA will contain Article 9 and because Energio Ltd. and EnerSub. Ltd. are "associated enterprises" (EnerSub Ltd. is a wholly-owned subsidiary of Energio Ltd.) Article 9 may apply to the transaction in the question with the consequence that BRA may be able to adjust the amount of interest claimed as a deduction under Article 9(1) and it may be also possible that Country A makes a corresponding adjustment in relation to Energio Ltd.'s income where not do so would result in economic double taxation (Article 9(3)). However, it is first necessary to consider the scope of Article 9 and its application in the circumstances.

Scope of Article 9: as the DTA mirrors the MTC, it will contain a savings clause that lists Article 9 amongst its exceptions. This means that the savings clause in the DTA does not apply to Article 9 and consequently where the BRA relies upon domestic transfer pricing rules to adjust the amount of interest on the relevant transaction, the BRA will need to ensure that it does so in a manner that is in accordance with Article 9 i.e. in line with an ALP. Whilst not a universally held view, it appears that Article 9 is not considered to create any independent legal basis for amending taxpayers' tax returns. Rather for those Contracting States (CSs) that have DTAs that mirror the MTC (by excluding Article 9 from the savings clause), Article 9 only restricts a country's domestic law to the extent that the country at issue adjusts profits between associated enterprises beyond those that are permissible under the ALP (Kofler and Wittendorff, 2022).

As applied to the facts in the question, Country B will be able to apply its domestic TP rules to adjust the interest payments provided such an adjustment is consistent with the ALP under Article 9. There is therefore a need to consider whether the interest payments were made at an arm's length price.

Application of Article 9: An application of Article 9 to the facts requires a consideration of:

(i) whether the balance of debt and equity in EnerSub Ltd. differs from that which would exist if EnerSub Ltd. were an independent entity operating under the same or similar circumstances, (TPG, Chapter X, B.1 [10.4]); and

(ii) whether the rate of interest provided for in a loan contract is an arm's length rate (TPG, Chapter X, B.1 [10.5]).

The Commentary on Article 9(1) [3(b)] supports this dual approach noting that Article 9 is relevant "not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital." Accordingly, and as applied to the facts: (i) the loan, or a part thereof, may be recharacterized as an equity contribution, which has the effect of reducing the size of the loan (to become the "delineated loan") and (ii) the interest claimed by EnerSub Ltd. may be adjusted following an investigation into the contract terms, business environment etc. The TPG provide guidance as to the determination of both amounts.

<u>TPG</u>

The TPG contain a new Chapter X on Financial Transactions and this provides guidance as to the determination of (i) the delineated loan and (ii) an adjusted interest rate. Some aspects of the guidance that may be relevant to the case at issue are outlined below.

<u>Delineated Loan</u>

Whilst the TPG acknowledges that approaches other than “accurate delineation” may be taken to address the issue of the balance of debt and equity funding of an entity under domestic legislation before pricing the interest on the dent so determined, it appears to be implicit that where other approaches are adopted this can lead to different views on the classification of said amounts (TPG 2022, [10.10]). The following provides an overview of some of the guidance in relation to determining the balance of debt and equity in advance of pricing the relevant interest on the relevant amount of debt where the accurate delineation approach is used (TPG, 200s, [10.8]).

The TPG require that certain economically relevant characteristics are considered in order to determine what part of the loan can be classified as a loan or an alternative advancement of funds such as an equity contribution. As applied to the facts in the question, certain characteristics are relevant and may point towards the transaction being classified as a loan e.g. the inclusion of repayment dates; the apparent obligation to pay interest; the loaned funds appear to have been used to acquire a capital asset for use in the business; and the fact that the funds were repaid, albeit it at the revised due date (TPG, Chapter X, [10.12].

However, some factors could potentially reduce the likelihood that the full amount of the transaction will be treated as a loan e.g. there is no reference to the consequences of EnerSub Ltd. not paying back the principal or interest; there are no details as to the status of Energio Ltd. relative to commercial lenders; there are no financial covenants or guarantees mentioned; there is no indication as to the source of the amounts EnerSub Ltd. is paying as interest; EnerSub Ltd. was unsuccessful in organising a loan with a number of commercial lenders; whilst the loaned funds appear to have been used to acquire a capital asset for use in the business it is not clear how much the capital asset cost is relative to the size of the loan; and the loan amount and repayment dates changed significantly (TPG, Chapter X, [10.12].

Furthermore, the financial and commercial relations of Energio Ltd. and EnerSub Ltd. would need to be evaluated. This would include a consideration of their respective positions vis-à-vis the loan. A particular focus of this aspect would be an assessment of the risks that each party assumed (risks related to: repayment, alternative uses of the amount transferred etc.) See TPG, Chapter X, [10.52]). More specifically, Energio Ltd. would need to show it had carried out a full credit assessment of the borrower (EnerSub Ltd.) (TPG, Chapter X, [10.54]- [10.55]. EnerSub Ltd. would also need to demonstrate how feasible it was for it to assume the risk associated with economic conditions changing such as an increase in the inter-bank lending rate. (TPG, Chapter X, [10.54]- [10.55]. Other factors are also outlined in the TPG.

Another factor to be considered is the credit rating of the borrower (EnerSub Ltd.). The credit rating of the borrower as a stand-alone entity is preferable but it is recognised that this does not always yield a reliable result. As applied to the facts in the case, there is no reference to EnerSub Ltd.’s credit rating. Accordingly, reference may be made to the MNE’s group credit rating where the borrower’s stand-alone rating is not reliable (TPG, Chapter X, [10.81]-[10.82]). Implicit support, the level of which is considered to depend on the relative status of the entity within the group (KPMG, 2022), could be mentioned here as an aspect of determining the credit rating (TPG 2022, C.1.1.3).

It is also noted that the existence of financial covenants and guarantees may be relevant but, as noted above, there is no mention of either in the facts. The TPG provide that where there is no covenant in any written agreement, there would be a need to consider whether there is a maintenance covenant in practice (i.e. any financial indicators that may provide an early warning sign that EnerSub Ltd. may be having difficulty repaying the loan) Chapter X, [10.85]).

The BRA would be advised to seek additional information in order to make a more informed decision as to the identification of the delineated loan but is possible that a reduction in the loan amount may be made under the Chapter X approach on the basis of the information available.

Arm's Length Interest Rate

Having established that it is possible that the BRA may be able to reduce the size of the loan (under Article 9 by an application of Chapter X TPG where there are relevant domestic laws), the next task is to ascertain whether it is also possible for the BRA to adjust the interest rate on the delineated loan.

Chapter X TPG also provides specific guidance on this aspect of the process. Chapter X provides a number of approaches to determining an arm's length interest rate on a delineated loan. Unsurprisingly, the preferred approach is the "comparable uncontrolled price" method (CUP). CUP considers various factors including: the length of the maturity date; the absence of a security; EnerSub Ltd.'s credit rating; benchmarking against publicly available data, which is considered an easier task in relation to transactions such as loans; the potential return on alternative investments entered into by Energio Ltd.; and any data pertaining to other Energio Ltd.'s intra-group loans

The TPG specifically references the risk-free rate of return, which is viewed as a hypothetical return that can be expected to arise on an investment with no risk or loss (e.g. a government security or inter-bank lending rate) and the risk-adjusted rate of return, which includes a risk-free component and a risk premium (TPG, D.1.22.1). With the exception of the maturity date bring relatively short, the other criteria mentioned in the question cannot be assessed without further information. On the basis of the information available, it would appear difficult for the BRA to arrive at a CUP and so an alternative method may need to be used.

Where there is no CUP, the TPG provides that the cost of funds approach (COFA) can be used in certain circumstances. Included in COFA from Energio Ltd.'s perspective are: borrowing costs incurred to raise the funds to be lent as well as any expenses for arranging or servicing the loan; a risk premium; and a profit margin (TPG, Chapter X, [10.97]). The facts do not reveal how Energio Ltd. sourced the funds lent to EnerSub Ltd. and thus without further information COFA cannot yield a reliable result. The BRA should request further information from Energio Ltd.

The BRA may also be advised that where neither the CUP nor COFA are available, it is possible that certain other approaches to determine an arm's length interest rate may be relied upon. However, it should be noted that these other approaches are to be used in the absence of information pertaining to the underlying asset that could be used as a comparable transaction. This leaves open the possibility of relying on a credit default swap approach or where reliable comparable uncontrolled transactions cannot be identified, an economic model approach. Notwithstanding, the possibility that approaches other than CUP and COFA may be relevant, the TPG notes that "bankability opinions" – stating what interest rate an independent bank would apply were it to make a comparable loan to a particular enterprise – are not generally regarded as providing evidence of arm's length price and conditions. (TPG, Chapter X, [10.101] - [10.108]). Accordingly, Energio Ltd.'s submission of an opinion from a local Country A bank as to the interest rate it would charge on the relevant loan is unlikely to be relied upon by the BRA.

Dispute Resolution

It is acknowledged that where Country B makes an adjustment, it is open to Country A to make a corresponding adjustment. Whilst this may result in complete elimination of economic double taxation for Energio Ltd. and EnerSub Ltd., it is also possible that some economic double taxation remains following these adjustments. Article 25 MTC provides a mechanism for the competent authorities to resolve any aspect of a transfer pricing assessment by way of the mutual agreement procedure (MAP) and where appropriate arbitration proceedings (TPG, Preface, [17]). BEPS Action 14 has also addressed the effectiveness of dispute resolution mechanisms in cases of transfer pricing adjustments by: (i) making access to the mutual agreement procedure a "minimum standard" even where the relevant DTA does not include Article 9(2) MTC and (ii) making the inclusion of Article 9(2) best practice in that corresponding adjustments can be made unilaterally where the objection of the taxpayer is justified (BEPS Action 14, [43] and Multilateral Instrument, Article 17).

Where Article 9(2) is applied (i.e. corresponding adjustments) then there is an onus on the State that has been requested to make the corresponding adjustment to make the corresponding adjustment if it considers that the adjusted figure correctly reflects what the profits would have been if the transaction was at arm's length (TPG, Preface, [17]). The result is that the State that has proposed the primary adjustment (i.e. Country B) bears the burden of demonstrating to the other State (Country A) that the adjustment is justified in principle and as regards the amount.

Article 9 and 11(6)

As noted above these provisions can be considered as complementing each other (Article 9 only authorises an arm's length adjustment of profits of the payee (EnerSub Ltd.) under the residence state's law (Country B) whereas Article 11(6) addresses the treaty qualification of the recipient's income (i.e. Energio Ltd.'s interest income)). Article 11(6) focuses on whether the state of source (Country B) is required to withhold tax on the interest income paid (i.e. outbound interest) at a lower rate as per Article 11 and enables the source state (Country B) to disregard Article 11 and treat the payment as a non-interest amount e.g. under Article 10 to the excessive portion of the payment that was initially considered to be an interest payment. The treatment of the excess interest under Article 11(6) has been referred to as a "secondary adjustment" (Bullen, 2011).

Article 24

Article 24(4) MTC provides that interest paid to residents of the other CSs (i.e. to Energio Ltd.) shall be deductible under the same conditions as if it had been paid to a resident of enterprise's residence state (i.e. a resident of Country B). It would appear that: (i) domestic law provisions that comply with Article 9(1) are not in violation of the Article 24(4) such that if the BRA adjusts the interest payable to Energio Ltd. in line with an ALP then there is no non-discrimination and (ii) non-discrimination will occur where (a) the deductibility of interest payments is denied on the basis of an adjustment that is not in line with an ALP and the adjustment only applies to non-resident creditors. As applied to the case, and on this basis, provided the BRA adjusts the interest payments made by EnerSub Ltd. in a manner that is consistent with Article 9(1) there will be no discrimination under Article 24(5) (See, Commentary on Article 24, [74]).

Article 24(5) prohibits discrimination against an enterprise of one CS (e.g. EnerSub Ltd.) that is controlled by a resident of the other CS (e.g. Energio Ltd.) compared with enterprises that are controlled by residents of the first mentioned state (another enterprise that is resident in Country B). Where, however, Article 9(1) is viewed as being part of the context in which Article 24(5) must be read then, and as with Article 24(4), where an adjustment is made by the BRA in relation to the interest payments made to Energio Ltd. then provided the adjustment is made in line with the ALP it will not breach Article 24(5) (See, Commentary on Article 24(5), [80], De Broe, 2008 and Helminen, 2010).

Conclusion

Candidates may conclude by summarising the approach to determining an ALP and use the results of their analysis to determine whether the BRA would be justified in adjusting the EnerSub Ltd.'s interest payment. On balance, it is likely that the BRA will be justified in adjusting the interest payment in line with an ALP determination and where it does it is open to Country A to make a corresponding adjustment. However, the BRA would be advised to first request additional information from both Energio Ltd. and EnerSub Ltd. such that it can attempt to carry out a comparability analysis in line with the CUP before moving on to any other method of determining the ALP. Where Country B is able to arrive at an ALP then it is unlikely that there will be any claim brought against it under Article 24 even where its domestic law treats interest payments paid to non-residents differently than those paid to residents.

Candidates can also raise the possibility that Country A and B may need to rely upon the mutual agreement procedure under Article 25 to resolve any adjustment related issues.

Question 7

The following provides an overview of one approach to answering the question and it is anticipated that answers will adopt a variety of approaches. However, the key issues in the question should be addressed in a logical fashion such that the reader is made aware of the respective tax positions of Mykola in Country U and Country X. It is open to candidates to cite cases specific to their particular jurisdiction and the following provides references to a number of cases that candidates may have included in their answers.

Mykola

In order to establish whether the Country U / X DTA has any application to Mykola's situation, the first consideration is whether he is a tax resident of either or both contracting states (CS) under domestic law. Where he is tax resident in both CSs, reference is made to Article 4(2) OECD MTC 2017 to determine his tax residence for DTA purposes.

Domestic Tax Residence

Mykola is tax resident according to the domestic law of both CSs either for most or all of Year One and thus will be dual resident during at least the majority of the calendar year (Year One):

(i) Mykola is tax resident in Country U immediately before his arrival in Country X on 1 January Year One. He also continues to be tax resident in Country U during the period of 1 January to 31 August and becomes resident again on 5 September when he arrives back in Country U (on this view he is non-resident for a few days). It is also possible to view Mykola as being resident in Country U throughout the calendar year where his return to Country U within five years of departure is treated as re-igniting his original residence status; and

(ii) he will satisfy the Country X tax resident test at the end of June Year One (and this is backdated to 1 January Year One) as he has been present in Country X for 183-days and does not satisfy the non-resident test as at 31 December Year One because he has not been absent from Country X for 365 days.

DTA Residence

Candidates may include some general observations about Article 4(2) before considering its application to Mykola's situation:

(i) Article 4(2) provides a tie-breaker test for instances, such as Mykola's, where an individual is resident in two CSs.

(ii) The tie-breaker tests (permanent home (PH); centre of vital interests (CV); habitual abode (HA); nationality and mutual agreement operate as a hierarchy where the first test is not satisfied (or is satisfied in both CSs) there is a need to move through to the next test and so on.

(iii) The tie-breaker tests in Article 4(2)(a) and 4(2)(b) i.e. PH); CVI); and HA are considered to provide an example of when the context requires interpretation other than by way of their domestic meaning (Ismer and Reimer, 2015). In other words, the three tests are to be interpreted as autonomous treaty terms. Such an approach to their interpretation enables the terms to function as tie-breaker tests (Ismer and Reimer, 2015). There is no scope for interpreting these terms in accordance with domestic law as to adopt such an approach may result in different countries having interpretations in dual resident cases, which would defeat the purpose of the tie-breaker (Baker, 2010) and thus it is logical for something other than domestic law to be used to resolve the disagreement (Da Silva, 2008).

(iv) The PH, CVI and to a lesser extent HA tests involve a "high level of factual analysis" (Long, 2005) to determine whether a given CS is the state to which Mykola has the greater "financial allegiance in economic and social terms" (Tax Court of Canada of 28 September 2007, 2006-2458 (IT)I: DTC Canada/USA). The Commentary on Article 4(2), [10] provides that "the preference criterion must be of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the right to tax devolves upon that particular State.

(v) The OECD MTC 2017 does not refer to a tax period (as do many domestic law residence tests), however, it has been suggested that once residence for the purposes of the DTA has been determined then it sticks until the taxpayer's circumstances change (Ismer and Reimer, 2015).

(vi) Related to (v) is the fact the tests operate on an inter-period basis because facts both before and after (as well as during) the relevant domestic law residence overlap periods may be considered in determining whether a tie-breaker test has been satisfied.

(vii) A further point related to temporal aspects of residence, is that DTA residence must be determined each time it becomes relevant i.e. each time the individual derives income or holds capital that falls within the relevant DTA (Sasseville, 2010).

Mykola's Residence under the DTA

Whilst a "high level of factual analysis" is required, the question does not provide full facts and inferences will need to be made to determine which CS is more likely to be classified as the residence state for DTA purposes. The following lists some of the facts taken from the question that may be included when applying Article 4(2):

Connections with Country U

He appears to have lived there for at least fifteen years and is a tax resident before the relevant period (Year One); is employed in Country U by a tax resident of Country U; lives with his partner and children in Country U in a home he and his partner own; immediately returns to Country U when the project is finished; and it is unclear whether he is a national but his long period of residence in Country U may indicate he is likely to be.

Connections with Country X

Spends a total of 8 months in Country X in the relevant period but initially only planned to stay for three months and only extends his stay when his employment requires an extension; has spent time in Country X in the past (unclear how much time but appears to be for short periods); has some relatives in Country X (but again the nature of their relationship us unclear); owns an apartment that is rented out for the majority of the time; stays in his apartment when it is unexpectedly untenanted (in Year One). It is unclear whether he is a national of Country X.

Application of Tie-Breaker Tests

The tests should be applied in order such that there is a need to determine first whether Mykola can be found to have a PH in either Country U or X. If he is found to have a PH in neither CS or in both CSs then reference will be made to the next test: CVI.

PH

The following must be present in order to satisfy the PH test in one CS (Commentary on Article 4(2), [11]).

(i) own or possess a home, which can be any form of home; and

(ii) the home must be permanent such that Mykola has arranged it and retained it for his permanent use (as opposed to staying at a particular place under such conditions that it is evident the stay is intended to be of short duration or, put another way, permanence

> is exhibited by the dwelling being available at all times continuously and not occasionally for the purpose of the stay, which owing to the reasons for it is necessarily of short duration.

As applied to Mykola, whilst he clearly has a home (and that appears to be continuously available to him) in Country U it is unclear whether the fact that he does not actually spend any time in Country U in the relevant period impacts the PH test.

In terms of Country X, it would appear that both the short-stay accommodation and Country X apartment satisfy the requirement that they constitute "any form of home". However, neither property is continuously available nor do they appear to have been arranged and retained for Mykola's permanent use. Rather they are used for temporary short term stays due to Mykola's employment, which points away from Mykola having a PH in Country U. The fact that Mykola does not own the short-stay accommodation that he stays in during part of the period is irrelevant (as legal title is not a relevant criterion (Ismer and Blank, 2022)). Neither is it relevant that he owns the Country X apartment he also ends up staying in. Furthermore, it does not appear to be relevant that Mykola has a family home (i.e. another home) available for use (Sasseville, 2010).

In order for the properties in Country X to constitute a PH, it would need to be demonstrated that the intensity of his use of the properties was of such quality that it had a place in his "everyday life". Personal interests may be relevant such as those that come into play when considering the CVI test e.g. where his family lived, where the centre of his personal interests were etc. It is not clear that either or both of the Country X properties satisfy the "home" aspect of the PH test, although his Country U family home may be viewed as a significant focus of a "CVI" inquiry.

Notwithstanding this conclusion, it is advisable to briefly consider whether either of the Country X properties could be considered to satisfy the permanence criterion. As the HA test involves a day-counting component, the frequency of use of the Country X properties should not be considered in isolation when considering the permanence criterion of "PH". However, frequency of use can be considered alongside other factors e.g. a stay of six months or more may be considered to surpass the temporary threshold. As Mykola stays in Country X for more than 6 months - albeit in different properties during a continuous period of presence in Country X – he may satisfy the permanence aspect. However, it is still arguable that the home aspect is not satisfied.

The PH must be available to him. Accordingly, a property that is owned by an individual that is rented out to unrelated parties such that the individual no longer has possession of the house nor the possibility to stay there will not satisfy this criterion (Commentary on Article 4(2), [13]). As applied to his Country X apartment: this property was not available to him continuously and he inhabited it only whilst he was unable to secure tenants. In sum, it is not clear that the availability criterion is met.

The short-stay accommodation leased by Ultrine Ltd may have been available to him (although he may have had to move from one apartment to another) throughout his time in Country X but the fact that he only used the short-stay accommodation for business purposes (as opposed to retaining it for his permanent use) may point away from the permanence of the short-stay accommodation (Commentary on Article 4(2), [13]). The same could be said of the apartment he owns in Country X as he only appears to have the ability to use it as a result of the tenants leaving early.

On balance, it is not clear that Mykola has a PH in either CS as although, (i) his family home in Country U is continuously available and (ii) his use of the family home is of a quality that typically involves a sufficient level of intensity, such that he would be expected to use the property as his PH outside of the periods of absence, Mykola spends a minimal amount of time in the family home (under 3 months) in the relevant period i.e Year One. Furthermore, he only lives in the Country X properties due to the (temporary) requirements of his employment and although he stays in Country X for more than six months - and so may satisfy the permanence criterion - it is possible he may fail the home and availability criteria.

Given the level of uncertainty relating to the PH test, there is a need to consider the CVI test. The CVI test is another facts and circumstances test that requires an investigation into which of the two CS Mykola has the closer personal and economic relations. These relations have the potential to encompass a large number of facts and thus any investigation involving the CVI test produces a significant workload and also may create lack of legal certainty for the taxpayer (Ismer and Blank, 2022). It is not possible to have a CVI in both CSs, rather Mykola can be found to have a CVI in either or neither CS. The Commentary on Article 4(2), [15] provides that regard will be had to Mykola's family and social relations, his occupations, political, cultural or other activities, his place of business etc. This is a non-exhaustive list that courts have expanded on to include factors such as: family home; passport; other family members; temporal dislocation; relocation support; bank accounts; employer (e.g. relocation support was considered in Norweigan Borgarting lagmannsrett, 29 September 1997, 1780/96: Sweden/Norway DTA). It may be the case that different courts afford different weight to different factors and thus it may be preferable to focus on a narrower group of factors. One approach is to read PH and CVI together and thus interpret "vital interests" as being "characterized by a certain permanence" (Ismer and Blank, 2022). The approach suggested would consider the ease with which a factor can readily be altered and where the change can be effected quickly (e.g. driving licence, bank account). These factors may be disregarded from a CVI inquiry. By the same token, factors that are not so easily changed (such as family home, a partner, employment etc.) may be afforded weight (Ismer and Blank, 2022). As applied to Mykola, and whilst acknowledging that Mykola has relatives and owns a property in Country X, it would appear that in the main his "vital interests" are located in Country U.

From a MTC perspective, the Commentary on Article 4(2), [15] provides:

(i) that personal acts of the individual must receive special attention;

(ii) a scenario that is broadly similar to the one in the question would result in Mykola being likely to be found to have a CVI in Country U. The scenario involves an individual setting up a home in one CS (Country U) and then setting up another in the other CS (Country X) such that where Mykola retains the first home in an environment where he has worked and where he has his family and possessions may contribute towards Country U being treated as his CVI.

In terms of (i), the OECD's view that personal acts must receive special attention is not accepted as the only interpretation of the CVI test. An alternative view is that "personal and economic" must be read together and there is no "hierarchy" in terms of Mykola's personal / economic relations (e.g. Baker, 2010, Pittman, 2009 and Italian Corte Suprema di Cassazione, decision no. 6501 of 31 March 2015 re: DTA Italy / Switzerland).

As applied to Mykola's situation, and whichever approach is adopted, it would appear that Country U may still be considered his CVI.

In terms of (ii), further support for the contention that Country U is likely to constitute his CVI is found in case law e.g. Mykola's transfer to Country X may be considered as temporary as after moving to Country X Mykola is aware that he will return to Country U within a short period of time (the Administrative Court of Luxembourg, 2 March 2017, no. 38088C (Hong Kong / Luxembourg DTA). Country U may even continue to constitute his CVI where Mykola is absent from Country U for a significantly longer time than in the question provided he only has minimal economic relations in Country X and maintains his family home etc. in Country U. Mykola's circumstances could be said to fall within these circumstances.

<u>HA</u>

As it is possible that Country U will be considered to be Mykola's CVI, it is not strictly necessary to consider whether he has an HA In either CS. However, candidates may consider the HA test i.e. they may consider frequency, duration and regularity of stays are part of a settled routine and more than transient. Where his stays are considered to be more than transient it is possible that he would be found to have an HA in Country X. The length of time in Country X factor is very important but is not the only factor to be considered under the HA test (however, see Hungary's Observation on the Commentary on Article 4(2), [19] and Observation, [27] where it is stated that Hungary considers that priority should be given to the number of days of presence). In terms of time, it is clear that Mykola spent more time in Country X than in Country U in the relevant period and whilst the time factor is not the only relevant factor, the focus of the HA test should not be on qualitative use as otherwise the HA test starts to operate in a similar fashion to the facts and circumstances tie-breaker tests considered above and so becomes a redundant test.

Accordingly, where neither the PH nor the CVI test are satisfied or where Mykola is found to have a PH or CVI in both CSs, the HA may be applied to determine that he is more likely to be found to have a HA in Country X. Having said this, it is possible that the fact that Mykola is only in Country X for a specified purpose (i.e his employment) means that he may be able to present evidence that suggests that whilst he is physically present in Country X for a significantly longer period in Year One than in Country U (eight months relative to four months), it is at least possible that his period of presence in Country X may not be considered to be "habitual" (or as part of a "settled routine", Commentary on Article 4(2), [19.1]) as he was only there to oversee the completion of a project that was expected to complete after a three month period but was unexpectedly extended. Therefore, it may be possible to look to periods outside the relevant period (i.e. outside Year One) in order to determine the frequency, duration and regularity of stays that were part of his settled routine (Commentary on Article 4(2), [19.1].

Such an approach to interpreting "HA" may be more consistent with the CS in which Mykola "normally lives", which has been suggested as an alternative to the "archaic and ambiguous" term "HA" (Arnold, 2011). Where an HA is not found due to the individual having spent a similar amount of time in each CS residence for DTA purposes sits with the CS of nationality.

<u>Nationality</u>

There is no direct evidence that Mykola is a national of either CS. He may be more likely to be a national of Country U but again there is nothing to clearly support such a contention. As such, it is quite possible that the issue of Mykola's residence may need to be resolved by way of MAP.

<u>MAP</u>

Should Country U and Country X be unable to agree on the applicability of the tests, they are required by Article 4(2)(d) ("shall settle") to resolve the issue under Article 25 (mutual agreement) and as the DTA mirrors the OECD MTC 2017, it is possible that Article 25(5) may require arbitration where: the issue is not resolved within two years under Article 25(2), which requires CSs to endeavour to resolve the relevant issue, and the person who presented the case requests this in writing. For the requirement that domestic remedies are either not pursued or have been exhausted before requesting arbitration under Article 25 see answer to Question 3 on MAP above.

<u>Conclusion</u>

It is anticipated that candidates will summarise their findings as to the CS in respect of which Mykola is resident for the purposes of the DTA. Given the relative paucity of facts in the question and the fact that there is some uncertainty as to the precise manner in which certain aspects of the tie-breaker tests will be interpreted, it is possible that candidates will consider all the tie-breaker tests to determine whether Mykola is tax resident therein and, ultimately, suggest that further information is required and that, if it is not forthcoming, the matter be referred to the MAP for resolution.