ADIT

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Excellence in Taxation

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MODULE 1

SUGGESTED SOLUTIONS

PART A

Question 1

Article 26 is intended to serve the national revenue interest whilst assisting (i) with the appropriate allocation of taxing rights and (ii) in dispute resolution regarding source of income and taxpayer residence (Dourado, 2015).

- 26(1) provides that the competent authorities of the contracting states (CSs) shall exchange such information as is "foreseeably relevant" for carrying out the provisions of the DTA or of the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the CSs, or their political sub-divisions or local authorities, insofar as the taxation thereunder is not contrary to the DTA.

- 26(2) provides for exceptions in relation to secrecy requirements and outlines under what circumstances certain information can be disclosed.

- 26(3) provides for the general scope of the information to be exchanged.

- 26(4) deals with the obligation to deliver information.

- 26(4) deals with bank secrecy.

Types of information request: (i) on request (EOIR); (ii) automatically (AEOI) and (iii) spontaneously (SEOI). These are the three main types of EOI. However (i) they can operate in combination and (ii) this not an exhaustive list of types of exchange of information (EOI) (e.g. simultaneous examinations, tax examinations abroad and industry wide EOI, are all valid types of exchange (Commentary on art.26, [9.1]).

Scope of Information: not limited to information regarding residents/taxes covered by the relevant DTA. Article 26 is considered to be a "major information clause" in that states exchange information that is "foreseeably relevant" (see below) for the application of domestic law (as well as the DTA) even if it is only relevant for the purposes of domestic law (Oberson, 2018). This contrasts with a "minor information clause" which is necessary only for carrying out the DTA such that, for example, requests about persons not covered by the DTA are not permitted and many of the requests will involve the supply of information that relates to persons who claim benefits from a DTA (often in the form of reduced tax at source). EOI related to customs duties will generally be subject to other legal instruments and, so, the provisions in those other specialised instruments will generally prevail (Commentary on art.26, [5.5]). The specificity of the request falls under art.26(3) and art.26(4) also ensures that bank secrecy is not used as a justification for non-delivery of information.

Article 26(3): limitations to the rule in art.26(1) in favour of the requested state (i.e. the supplier of information). The three paragraphs: (a) administrative measures at variance with the laws and administrative practice of that of the other contracting state (b) supply the information which is not obtainable under the laws or in the normal course of the administration of that of the other state, and (c) supply of information that that would disclose any trade business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy. Para.(c) derives from the right of a state under public international law to refuse a request (art.60 VCLT) where there are reasons to believe that the secrecy of the information as required or the information will be misused (Dourado, 2015). Internal provisions regarding tax secrecy are not considered to be an obstacle to EOI (Commentary on art.26(3), [14.1]). Article 26(3)(a)&(b) both limit the scope of art.1 but also contain a principle of "equivalence". Whilst encompassing the reasons by which states can refuse an EOI request, (a) and (b) are also described as providing a justification where the one state would take advantage of the information system of the other CS if it is wider than its own system. However, candidates could mention that not all DTAs incorporate the principle of reciprocity (e.g. Germany/Ireland and Israel/France DTAs require the requested state to carry out administrative measures at variance with the laws and administrative practice of the requesting state provided it is in accordance with a domestic procedural law (Dourado, 2015)).

"Foreseeably relevant (FR)": This features in art.26(1) and, according the Commentary on art.26, [5], the standard of FR is intended to provide for EOI in tax matters to the widest possible extent and at the same time to clarify that fishing expeditions are not permitted or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer.

The change from "as is necessary" to "foreseeably relevant" in 2005 and the insertion of the words "to the administration or enforcement" were made to achieve consistency with the Model Agreement on Exchange of Information on Tax Matters and were not intended to alter the effect of the provision."

"Foreseeably relevant" information includes ownership, accounting, and banking information but must not amount to a fishing expedition. The type of information that falls within the "foreseeably relevant" condition and the extent to which a request directed towards a taxpayer may also include information about third parties has been the subject of court cases (e.g. Swiss cases involving requests for information pertaining to being granted). FR requires that at the time a request is made, there is a reasonable possibility that the requested information will be relevant. Once the requesting state has supplied an explanation of FR information, the requested state may not decline or withhold requested information because it believes that the information lacks relevance to the underlying investigation or examination.

The Swiss Supreme Court (24 September 2015, 2C_1174/2014) has held that all information the state needs to impose tax on its taxpayers is relevant and that Switzerland could not reject an EOIR solely on the basis that the relevant person was subject to tax in Switzerland (Bernasconi and Beusch, 2015). More specifically, "foreseeable relevant" has two distinct meanings for information requests: (i) substantive and (ii) formal. In relation to (i), the request should contain the facts of the case and explain the purpose of the request with regards to the scope of the DTA, which is the application of the DTA itself or the securing of taxation in the requesting state. In relation to (ii), the requesting state has to define sufficiently the objects of the request and its intended purpose in order to enable the requested state to verify that the documents are likely to serve the mentioned fiscal purpose.

Fishing Expeditions (FE): are described in the Commentary on art.26, [5], and the Manual on EOI as "being speculative requests that have no apparent nexus to an open inquiry or investigation". According to the Commentary, a request will not constitute a FE where:

- it does not provide the name and address (or both) of the taxpayer under examination/investigation (however, information sufficient to identify the taxpayer is required), names are spelt differently or information on names and addresses is presented using a different format, and the names and address of the person believed to have the relevant information [5.1];

- the administration or enforcement of the requesting state's domestic tax laws is served by requesting the information [5.2]; and

- a state can point to an ongoing investigation into a particular taxpayer [5.2]

The Commentary, [8.1], also provides examples of information requests where the requested state is not obliged to provide the information and so these may be viewed as falling within the FE category where:

- State A requests information from State B about State A residents who have bank accounts in Bank B in State B. The request states that Bank B is known to have a large group of foreign account holders but does not contain any additional information.

- State A requests the names of any State A residents who have shares in a State B company from State B on the basis that the State B company has significant activity in State A. It is therefore likely that State A residents will be shareholders and it is well known that taxpayers often fail to disclose foreign source income or assets.

Conclusion

FE and FR can be viewed as sitting at opposite ends of a spectrum. Many requests will clearly fall at one end or the other. The Commentary provides some guidance as outlined above. The standard of foreseeable relevance is intended to provide for EOI in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to engage in "fishing expeditions" or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer. In the context of EOIR, the standard requires that at the time a request is made there is a reasonable possibility that the requested information will be relevant; whether the information, once provided, actually proves to be relevant is immaterial (Commentary on art.26, [5]).

Candidates could provide of examples of DTAs that converge/diverge with art.26 (e.g. France/Switzerland 1966 was amended by Protocol in 2009, which had the effect of extending the scope of the information that could be collected, to include information re: evasion and any other case where the requested information was foreseeably relevant). Previously in Switzerland, certain information was protected by secrecy laws (e.g. banking information) and the information needed to relate to the taxes that were the object of the relevant DTA). However, due to political pressure, Switzerland removed these restrictions and this had a knock-on effect for many of its DTAs. Some Protocols to DTAs contain provisions detailing what types of information request amount to a FE (e.g. Additional Protocol to Austria/Slovenia 1997, as amended by the Protocol of 2006, provides that a random request for State B bank account information of residents of State A and a request made by State A to State B relating to a specific taxpayer where no transaction/indication of possible transactions has been identified as involving a nexus with State B.

The question could also be addressed through the taxpayer protection lens in that it appears that taxpayers are frequently uninformed about the sharing of their information. Pistone and Baker 2016 suggest requiring taxpayers to be notified that information is being collected such that they are in a position to have "effective international legal remedies available for an ex ante protection of their rights". This would allow taxpayers to have access to the relevant tax information held by tax authorities and to be promptly informed of any action connected with tax collection concerning them. In this sense, the collection of reasonably foreseeable information can also be assessed as such by the relevant taxpayer and they themselves can put forward a case why such information may not be relevant and so potentially query the validity of the relevant information request.

Recent Developments:

The following could be mentioned:

1. (i) Common Reporting Standard 2014 (ii) BEPS Action 13 as it relates to country by country reporting for MNE groups with over 750m turnover; and (iii) 2019 AEOI Implementation Report: update on the Standard for AEOI, which reported that a very large majority of countries have adopted AEOI and that the Global Fourm is working with countries to ensure they are all on track to be AEOI compliant.

2. The Global Forum on Transparency and Exchange of Information for Tax Purposes: formed in the early 2000s to address risks to tax compliance posed by non-co-operative jurisdictions. It now has over 160 members. Peer review is a fundamental aspect of their work. There are two rounds of review with the first round starting in 2010 (review of the legal framework) and a second round (review of EOIR in practice) commencing in 2016. Countries with "low rating" are supported by a technical assistance scheme to make amendments, for example, in July 2019 it was reported that the Secretariat was helping Morocco prepare for its second round of peer review) aimed at assessing its compliance with the international standard of EOI on request. Samoa, Panama, Malaysia, and The Netherlands completed second round peer review reports in 2019.

3. The International Compliance Assurance Programme launched in March 2019. This is tasked with, inter alia, supporting policy makers in the development of new standardised

reporting requirements to facilitate international EOI on those selling goods and services through the sharing and gig economy and to pursue collective work on the effective use of vast data on offshore accounts currently being exchanged under the OECD G20 Reporting Standard. The OECD is also seeking input on its recently published Public Consultation Document: Model Rules for Reporting by Platform Operators with Respect to Sellers in the Sharing and Gig Economy." (February – March 2020). This draft model includes rules and commentary that can be adopted by countries at the domestic level on a uniform basis to collect information on transactions and income realised by platform sellers, which will, in turn, facilitate automatic exchange of information.

4. The new substantial activities standard for no or only nominal tax jurisdictions, requires such jurisdictions to spontaneously exchange information on the activities of certain resident entities with their jurisdiction(s) in which the immediate parent, the ultimate parent and/or the beneficial owners are resident. This information will allow the tax authorities of these jurisdictions to assess the substance and the activities of the entities resident in no or only nominal tax jurisdictions. Guidance was released by the OECD in October 2019: See, "Substantial Activities in No or Only Nominal Tax Jurisdictions: Guidance for the Spontaneous Exchange of Information".

<u>Question 2</u>

Allocation of Taxing Rights: art.12 within the OECD MTC and the UN MTC contains a special allocation norm for a category of passive income (royalty income). There is a boundary issue in that these special rules override the general rules and so entrepreneurial income will be trumped by the special rules unless the income is effectively connected with a PE or in the case of UN MTC with art.14 (Valta, 2015).

The OECD MTC 2017 provides that royalties arising in a Contracting State (CS) and beneficially owned by a resident of the other CS shall be taxable only in that other State (art.12(1)). Accordingly, the primary rule provides for exclusive taxation in the resident state of the beneficial owner (BO). Article 12(1) is subject to the exception in art.12(3) where the BO is resident of a state and carries on business through a PE in the other state and the right/property in respect of which the royalties are paid is effectively connected with such PE. Where art.12(3) applies, the relevant income will be subject to art.7 and not art.12. A further qualification to art.12(1) is provided by art.12(4), which provides that where the amount of the royalties exceeds the amount that parties that were not in a special relationship would have paid then the excess amount is subject to the tax laws of the relevant states and only that part which is consistent with the pricing of unrelated parties is subject to art.12. The primary allocation to the residence state of the beneficial owner is consistent with that of the US MTC, in effect but not wording. The Commentary [20] provides that there is no force of attraction principle of the PE and this is stated in reference to the application of art.12(3).

The UN MTC does not eliminate the possibility of withholding tax on royalty payments. Rather art.12(1) provides a right for the resident state of the payee to tax the royalty payment and does not include a BO requirement (this is a non-exclusive right). Article 12(2) provides an exception where the payee is a resident of the other state when the state of the payer may withhold tax at a rate of not more than a negotiated amount. Article 12(4) UN MTC provides the equivalent of art.12(3). However, given that the UN MTC still includes art.14 Independent Services, there is a reference to both art.7 and art.14 in art.12(4) UN MTC. Article 12(5) provides source rules, where the source state is deemed to be the residence state of the payer or the PE state in which the payment obligation was incurred/borne (Valta, 2015). Article 12(6) provides for treatment for royalty payments in the context of special relationships similar to art.12(4). Accordingly, arts.12(2) and (15) are unique to the UN MTC. However, UN MTC 2017 introduced art.12A, which deals with fees for technical services arising in a state and paid to a resident state that may be taxed in that other state. Article 12A gives primary taxing rights to the state where the service was provided (where the fees arose) and secondary rights to the state of residence. Distinctive to other articles, the imposition of tax does not require a physical nexus like a fixed base or a permanent establishment, bestowing a potential solution for evasion relating to the digital service economy. Prior to the introduction of art. 12A, the rules relating to technical services were considered to be more restrictive and to erode the tax base for countries that could not tax such fees under the UN MTC, Commentary on Art. 12A, [7]. Notwithstanding this introduction, some members of the Committee did not agree with the policy justification for including in the tax base payments for technical services that are not provided in the payer's State (Commentary on Art. 12A, [16]).

Potential boundary issues: Article 6 (immovable property)/business profits (art.7); operation of ships and aircraft (art.8); associated enterprises (article 9); capital gains (art.13); income from employment (art.15); entertainer sand sportspersons (art.17); other income (art.21) and non-discrimination (art.24(4)).

Generally, certain payments for the provision of the following services are not considered to be payments for the provisoin of know-how and so would not fall within Article 12 (see OECD MTC 2017, Commentary on Article 12(2), [11.4]): after sales services; services rendered under a warranty; pure technical assistance; an opinion provided by a accountant; advocate; engineer. A contract may involve both technical assistance and know-how and there is a need to break down the whole amount according to the various parts of what is being supplied under the contract. Where, however, know-how constitutes the largest part and the principal purpose of the contract then Article 12 can be applied to the whole amount (and vice versa). OECD MTC 2017 Commentary on Article 12(2), [11.6]. The Commentary to the UN MTC 2017 also refers to know-how in similar terms (See Commentary on Article 12(30, [11.4]). The Commentary UN MTC on Article 12(2), [14] does note that some countries tend to regard the provision of "brain-work and technical services" as the "provision of information concerning industrial, commercial or scientific experience" and to regard these as royalties.

Payments (whether variable or fixed) for the working of mineral deposits, sources or other natural resources that are governed by Article 6 do not fall within Article 12 (Commentary on Article 12(2), [19]), OECD MTC 2017.

Transactions that permit the customer to electronically download digital products for their own use may constitute amounts that cannot be properly classified as royalties and so may be subject to tax under Article 7 or 13; a relevant factor will be the extent to which whether the creation of a copy is considered a use of copyright by the provided as opposed to the customer (OECD MTC 2017 Commentary on Article 12(2), [17.3]. A similar result is achieved under the UN MTC (see Commentary on Article 12(3), [17.3] – [17.4]), however, the Commentary notes that some members of the Group of Experts would view these amounts as payments of royalty. The UN MTC Commentary, Article 12, [10] notes that income from film rentals should be dealt with in the context of royalties (as opposed to industrial and commercial profits).

A further example is that of fees for musical performances by artists where it is combined with a simultaneous radio broadcast may well fall within OECD MTC 2017 Article 17 (as opposed to Article 12), however, where the musician requires that they be remunerated by way of royalties on the public playing of records then such amounts are likely to fall within OECD MTC 2017 Article 12. (Commentary on Article 12(2), [18]).

Third State Scenarios: Article 12 OECD MTC 2017 only deals with royalties arising in a state and beneficially owned by a resident of the other state (art.12, (Commentary, [5]) so does not apply to royalties arising in a third state as well as to royalties arising in a state that are attributable to a PE which an enterprise has in the other state.

Art. 12A UN MTC 2017 does not apply to fees arising in a third state. However, art. 12A does apply where the fees for technical services are paid by a resident of a CS or a third state that are born by a PE or fixed base that the resident has in a CS. Commentary on Art. 12A, [41].

Article 29(8) deals with potential abuses arising from situations where royalties that arise in a state are attributable to a PE which an enterprise of the other state has in a third state. Commentary on art.12 [5].

OECD MTC 2017 Commentary on art.1, [82] – [100] contain potential provisions that states wishing to deny benefits of art.12 to royalties that enjoy a preferential treatment in the state of residence can include in their DTAs. UN MTC Commentary on art. 1, [28] discusses beneficial ownership; mixed contracts [107]; conversions of royalties into capital gains [109]; and [117] special regimes involving royalties.

Single Tax Principle: OECD Commentary on Art. 12(1), [6] provides that whether or not the exemption in the State of source should be conditional upon the royalties being subject to tax in the State of residence is to be settled by bilateral negotiations. There is no equivalent wording in the Commentary to the UN MTC. However, both MTCs consider the issue of DTA benefits arising in triangular cases.

Commentary on UN MTC 2017 Art. 1, [77] – [80] considers triangular cases whereby royalties or technical services that are derived from S by a resident of R, which is an exemption country and where said income is attributable to a PE established in a low tax jurisdiction (P) may constitute an improper use of a tax treaty with the result that DTA benefits may be denied. OECD MTC 2017 also provides that where transfers of rights or property to PEs set up solely for that purpose in countries that either do not tax (or have preferential tax treatment) for the income generated, then where the state of residence exempts the profits attributable to PEs in third states, the state of source should not be expected to extend DTA benefits. Exceptions are listed in the OECD MTC Commentary. See Commentary on art. 29(8), [161].

Non-Discrimination and Net Basis: under OECD MTC 2017 art.24(3) UN MTC a state is prohibited from taxing a PE of a resident of the other State less favourably than it taxes its own resident enterprises carrying on similar activities. Thus, if resident enterprises are taxable on their profits on a net basis, non-residents carrying on business through a PE must be similarly taxable on a net basis and must be allowed to deduct royalty expenses in the same manner as resident enterprises. It is important to note in this regard that, although art.7(3) deals with the attribution of expenses to PEs and leaves the deductibility of expenses to domestic law, art.24(3) covers the deductibility of expenses in computing the profits of a PE. Commentary on art. 24(4) UN MTC 2017 provides that PEs must be accorded the same rights as resident enterprises to deduct trading expenses that are, in general, authorised by the taxation law to be deductible from taxable profits.

Reservations: A number of countries have reservations on art.12, OECD MTC 2017 including the USA which reserves its right to tax in accordance with its domestic law, royalties paid by an expatriated entity to a connected person for up to a period of ten years, [32]. Latvia reserves the right to tax royalties at source if the recipient of the income is an individual who is resident of the other Contracting State [32.1]. Greece does not accept a provision which would preclude it, in bilateral conventions for the avoidance of double taxation, from stipulating a clause conferring on it the right to tax royalties at a rate of up to 10 per cent [33]. 36. Australia, Chile, Korea, Mexico, New Zealand, Poland, Portugal, the Slovak Republic, Slovenia and Turkey reserve the right to tax royalties at source [36].

Developments in relation to the International Taxation of Royalty Payments: In this part of the question candidates should consider the extent to which the allocation rules relating to royalty payments may be impacted by developments in the international tax space. These could include: country practice; policy approaches; proposals at the internationally/domestic level etc. The Inter-American Centre for Tax Administrations, 2019 following a survey has listed the transactions that most erode the tax base and 60% of respondents indicated that base erosion is caused in large part by the rules relating to royalty and service fees and in particular due to the wording of art.12(1) OECD MTC 2017 (Calderoni, 2019). The UK brought in changes to its domestic withholding tax regime which brought all royalties within the definition of royalties as per the definition in the OECD MTC and also introduced a source rule that is broadly similar to the source rule in art.12(3) (Greenbank, 2017).

China has introduced (under Article Bulletin 6) a special tax adjustment on the royalties' received or paid as a result of intangibles licensing transactions in certain circumstances. It also introduced a matching rule such that the economic benefits generated by an intangible matches the royalty paid or received. Where there is a mismatch between the royalty and the economic benefit (by reducing gross taxable income or taxable income) tax authorities may initiate a special adjustment – known as the "principle of benefit commensurate with royalty rate" (Avi Yonah and Xu, 2018). This rule and others are described as following the substance requirements of BEPS Actions 8-10.

The revised nexus rules project of the OECD, (OECD Secretary General Tax Report to G20 Leaders, Japan, June 2019) has led to three proposals (user participation, marketing intangibles, and significant economic presence proposals) each of which have different objectives and have varied impact on the re-allocation of taxing rights. They also share some similarities in that they have common policy features (nexus in place of physical presence, using total profit of a business, simplifying conventions to reduce compliance costs and disputes and would operate alongside current profit allocation rules (Chapter II, Pillar One). Also, included in this work is the need to explore the interaction between new taxing rights and existing taxing rights and royalties, as a form of payment that is withholding tax, may well form part of the 'reallocated income" as per one of the proposals.

A further proposal relevant to royalty payments is the exploration of a global anti-base erosion proposal (GLOBE) that would leave countries free to determine their own tax system whilst simultaneously permitting other countries to apply rules to income that is effectively taxed below a minimum rate (Chapter III, Pillar Two). This proposal is furthered by two inter-related complementary rules: (i) an income inclusion rule (inclusion rule and switch over rule) and (ii) a tax on base eroding payments rule (an undertaxed payments rule and a subject to tax rule). In relation to royalties, the subject to tax rule would explore the possibility of limiting benefits or subjecting to withholding tax certain items of income (such as royalties) where the payment is not subject to a minimum rate of tax.

Candidates could also mention the possible extension of art.12 to allow for digital services to be taxed in a similar way to royalties (proposal for new art.12B in UN MTC, (see Committee of Experts on International Cooperation in Tax Matters, April 2019 and refer to the potential for overlap between such a provision and art.12 (e.g. in the area of music downloads).

The UN MTC 207 Commentary to Art. 12, [8] – [9] provides various factors that should be taken into account when negotiating the withholding rates of royalties, including developing countries need to earn revenue and conserve foreign exchange; the fact that royalty payments flow almost entirely from developing countries to developed countries; the extent of assistance that developed countries should extend to developing countries; the special importance of royalty payments, etc.

Question 3

Definition: An offshore indirect transfer (OITs) involves the sale of an entity located in one country that owns an "immovable" asset located in another country, by a non-resident of the country where the asset is located. An "indirect transfer is defined as the disposition of an indirect ownership interest in an asset, in whole, or part" and "an offshore indirect transfer" is an indirect transfer in which the transferor of the indirect interest is resident in a country that is different from the country in which the asset is located." Furthermore, for the transfer to qualify as offshore, the transferor will not have a PE in the state in which the asset is located.

Developing countries were particularly concerned that OITs might be used to avoid, inappropriately, capital gains taxation in the country where the underlying assets are located. One example is provided by "round-tripping", where an affiliate is from the same country as the ultimate owners whilst the direct owner is foreign (or put another way, the parent invests domestically though a foreign intermediate subsidiary). At a general level, round-tripping is associated with a certain group of jurisdictions (most notably Hong Kong, China, Bermuda, UK, Cayman Island, BVI, USA and Germany are listed as the countries that have the highest number of direct or ultimate owners), often to smaller multinational enterprises, involves a nationality mismatch and impacts tax, illicit financial flows, national security, industrial and competition policies, see Alabrese and Casella, UNCTAD, 2020.

More specifically the issue of OTIs of particular significance in the extractive industries; for the view that developing countries are particularly vulnerable to profit-shifting in the oil and gas industries Beer and Loeprick, 2017. Developing countries may be missing out on revenue from OTIs by not including provisions in their DTAs when originally entered into or because they may view such provisions as interfering with their attempts to attract foreign direct investment. The revenue issues have been described as being "complex" and "case-specific." and may often involve issues of timing that result in significant revenue losses over time.

A well-known example is that of the DTA between India / Mauritius under which gains realised by a Mauritius entity on transfers of Indian entities were only taxed by Mauritius and thus effectively escaped tax. The India / Mauritius DTA was amended such that India imposed capital gains tax at initially lower rates and then at full rates from 1 April 2019.

Taxation under OECD MTC and UN MTC Article 13 (1) of each Model provides that capital gains derived by a resident of a state from the alienation of immovable property that is situated in the other state may be taxed in that other state. Article 13(4) provides that the gains derived by a resident of a state from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other state, if at any time during the 365 days preceding the alienation these shares or immovable interests derived more than 50% of their value directly or indirectly from immovable property, as defined in art.6, situated in that other state.

Article 13(5) UN MTC provides for gains other than those to which art.13(4) applies, derived by a resident of a state from the alienation of shares of a company, or comparable interest, such as interests in a partnership or trust, which is a resident of the other state may be taxed in that other state if the alienator at any time during 365 days preceding such alienation held indirectly or directly at least _ % (to be bilaterally negotiated) of the capital of that company or entity. This effectively expands the instances in which the state in which a company or other entity is resident (state B) may have the right to tax gains derived by a resident of the other state (state A).

Whilst both OECD MTC and UN MTC 2017 contain an identical provision, there is no equivalent in OECD MTC 2017 to art. 13(5) UN MTC. The OECD Commentary does not specifically address why there is no art 13(5) UN MTC equivalent in the OECD MTC, rather it is suggested that (i) the OECD may consider the exception in art. 13(4) OECD wide enough as it is or put another it already sufficiently narrows resident state taxing rights, the OECD notes in its Commentary on Art. 13(5), [30] that apart from art. 13(4) Article 13 does not contain any "special rules for gains from the alienation of shares or other interests".

Commentary on UN MTC 2017 provides that whilst some countries consider that a CS (B) should be able to tax a gain on the alienation of share of a company resident in that state (B) irrespective of whether the alienation occurs within or outside that State (B), the UN MTC 2018 7 acknowledges there are administrative reasons for limiting state (B)'s taxing rights. The focus on art. 13(5) UN MTC is on substantial holding as well as the 12-month holding period. The UN Commentary also notes that developing countries may wish to exclude shares in frequently traded shares listed on a recognised exchange as taxing gains on such shares can be costly Commentary on Article 13, UN MTC 2017. [13] The UN Commentary on Art. 13950, [15] also notes that some countries may wish to omit art. 13(5) UN MTC in its entity as they may be concerned that the provision may cause economic double taxation, a priori for countries that apply a participation exemption to both dividends and capital gains made on shares in relation to substantial shareholdings. The aforementioned concerns may provide a reason for the variance between the UN MTC and OECD MTC in relation to Art. 13(5) UN MTC.

Problem: According to the Platform for Collaboration on Tax (PFCT) only 35% of DTAs contain art.13(4) and the likelihood of art.13(4) being found in a DTA reduces further where one of the states is a low-income resource rich country. The PFCT also notes that the Multilateral Convention for the Implementation of BEPS Related Measures has had a positive impact on the number of DTAs that effectively include art.13(4). Notwithstanding this occurrence, there is still a need for domestic law to play a role by clarifying what types of asset will fall within art.13(4). Article 13(4) is said to be more likely to feature in a DTA the greater the difference between the rates at which capital gains are taxed by the DTA partners. Whilst it is noted that some resident states will be impacted, this is primarily an issue for source states.

Considerations re: Allocation of Taxing Rights. Candidates could mention here inter-nation equity/efficiency/political economy concerns. In particular, there is a need to consider the following options:

- Inter-nation equity

    1. The state in which the asset is located has the taxing rights at least to the extent that the asset has not been "improved" by persons based overseas.

    2. The state in which the asset is located has taxing rights over income streams such as dividends and so this could be extended to capital gains.

    3. Whether movable and immovable property should be treated differently for tax purposes. Justifications for treating immovable property differently include: benefit theory; pragmatically, the asset can be seized for non-payment; and the value of the asset reflects its location to a certain extent.

- Efficiency: Not generally considered to be very helpful in this context as the idea here is that the tax rule should not distort an investor's decision. Neutrality could also require that both in/direct transfers are taxed in a similar fashion, although this is, of itself, does not necessarily lend weight to source state taxing rights.

- Political Economy: where the state in which the asset is located is unable to tax indirect transfers this can have harmful effects e.g. negative impacts on building up a tax paying culture, large sums can be at stake and dissatisfaction with the tax regime at the domestic level can become widespread, which, in turn, can lead to unilateral responses (as opposed to co-ordinated responses)such as countries introducing domestic laws to bring into tax offshore transfers related to all assets (as opposed to just those deriving value from immovable property located therein)., see for example the Peruvian case below.

<u>Examples</u>

There are various examples of countries foregoing large amounts of revenue where assets were transferred by businesses that derived value from government concessions in the country in which the underlying asset was located; often the country in which the underlying asset is located loses in court sometimes due to the insufficiency of its domestic rules or where there is a treaty override.

A pertinent example involves Petrotech and Peru. In 2009, Ecopetrol Colombia and Korea National Oil Corp purchased a Houston-based company (Offshore International Group Inc.) whose main asset was Petrotech Peruana (the license-holder), a company incorporated and resident in Peru and the third largest oil producer there, for approximately US$900 million, from Petrotech International, a Delaware incorporated company. Since Peru's income tax law at the time did not have a specific provision taxing offshore indirect sales, the transaction was untaxed there. The potential foregone tax revenue for Peru was estimated at US$482 million. Petrotech international, a resident of the U.S.A., would be taxed in the U.S. on the corresponding capital gain. The case triggered a Congressional investigation in Peru that eventually led to a change in the law. Currently, all offshore indirect sales of resident companies are taxed in Peru, regardless of the proportion that immovable property belonging to the Peruvian subsidiary may represent in the total value of the parent company, although some limitations apply, for example, the portion of the parent company subject to sale must derive its value at least 50 percent from Peruvian assets, and at least 20 percent of the Peruvian assets must be transferred in order for the transaction to be taxable in Peru.

<u>Response</u>

The PFCT – a joint initiative of the International Monetary Fund (IMF), OECD, United Nations and World Bank Group – has indicated that further adoption of art.13(4) as it is currently worded will assist low income resource rich countries to access revenue from OITs. However, there is also a need for these countries' domestic regimes to be amended so that there is clarity around the types of asset to which art.13(4) will apply. The PFCT has two recommendations but considers the first to be preferable: (i) a deemed disposal of the underlying asset and (ii) treat the transfer as being made by the seller, offshore, but provide that the gain has a source in the location country, thereby enabling the location country to tax the gain.

<u>Conclusion</u>

According to the PFCT this issue was not addressed in the BEPS Actions and there is no unifying principle on how to treat such transactions. However, the UN has considered OITs in relation to the extractive industry and the PFCT has been working in the general OIT space since 2017 (see, its above recommendations). More recently, the UN has considered whether a specific provision for OITs is needed that grants the state of source taxing rights and has expressed the view that this suggestion is in line with developing countries position on the issue. The reasoning behind this suggestion is that countries often choose to tax OITs under their domestic law, by treating these as tax avoidance or base erosion devices and relying on anti-abuse rules to counter the non-payment of source state tax (Committee of Experts on International Cooperation in Tax Matters Eighteenth session New York, "Modification to Article 13 (Capital gains) of the UN Model ", 23-26 April 2019, April 2019).

Question 4

Evolution of International Trade: GATT was signed in 1947 and provided the rules for much of the world's trade (mainly in goods). GATT was not a treaty and several countries joined GATT under its Protocol of Provisional application i.e. GATT's provisions applied to the extent they were not inconsistent with domestic provisions. The WTO was created in 1995 to cover, inter alia, trade in services, subsidies, food safety, and intellectual property. The agreement included a dispute resolution mechanism (see below). The WTO's objective is to provide a level playing field for international trade. Fundamental features of the WTO framework are that it is a multilateral initiative, Most Favoured Nation (MFN) is a key principle (although tax measures that depart from MFN are permitted to the extent that they feature in a DTA or similar international agreement), it does not have direct effect, it has a binding arbitration mechanism, retaliatory sanctions are permitted in specified cases and it is considered to be relevant to indirect taxes (with direct taxation also sometimes falling within its remit) (Daly, 2016).

Evolution of International taxation: in 1869, Prussia and Saxony entered into an agreement to regulate the position of Prussian citizens who owned land in Saxony where they resided more or less continuously. They were simultaneously subjected to tax in both Prussia and Saxony. The need to regulate this situation arose from the fact that this double taxation was claimed to interfere with citizens' right to establish themselves freely and so not to be discriminated against by virtue of the concept of common citizenship that was introduced by the Constitution of the North German Federation. The League of Nations (LON) was established in 1920, in accordance with the Treaty of Versailles. The LON's mission was to: 'promote international cooperation and to achieve international peace and security'. In the same year, and so also shortly after the end of the First World War, the International Chamber of Commerce put the issue of double taxation on the political agenda and considered it to be an impediment to international trade.

By 1927 a group of experts 'published its first Draft Model Convention and Commentary for the avoidance of double taxation. This first Draft favoured allocation to the state in which the relevant person was resident. This draft was not considered to be sufficiently wide in scope and therefore the LON established its own fiscal committee to review the appropriate approach to the drafting of the MTC. The fiscal committee's work from that point on culminated in the Mexico draft treaty (1943) and the London draft taxation convention (1946), which, in turn, and further to significant amendments resulted in the publication of the OECD MTC and, thereafter, the UN MTC. Salient features of the regime include: the extent of the bilaterally negotiated tax treaties many of which are based on the OECD's model treaty; multilateralism in international taxation is growing; dispute resolution mechanisms increasingly include arbitration but retaliatory sanctions are permitted. The principle of reciprocity guides international tax treaties and the focus is on direct as opposed to indirect taxation. The treaties provide tax authorities and taxpayers with rights to ensure the relevant treaty is being complied with.

Extent to which they have evolved separately: candidates should consider the extent to which the rules regulating international trade and international tax has evolved in tandem or separately. Candidates would be expected to focus on a number of topics and contrast their treatment under each legal regime. Some possible topics are outlined below and dependent on the topics selected it is open to candidates to consider to what extent certain areas of each regime are converging:

- MFN. This principle is contained within the first article of the GATT and is also a priority in art.2, GATS and TRIPS, art.4. MFN has some exceptions e.g. countries are free to set up a free trade area and give developing countries special access to their markets. The general position is that if a concession is provided to one member then all members are entitled to that concession. By contrast, due to the reciprocal nature of DTAs, MFN provisions in DTAs are generally not considered appropriate. Notwithstanding this fact some countries include MFN provisions in DTAs and not only does such inclusion bring the international tax regime closer to that of international trade, but such inclusion has also been said to make DTAs functionally multilateral (Avi Yonah and Xu, 2018]), which is again another feature of the international trade regime (see below).

- Multilateral Nature. The WTO is a multilateral trading system that consists of a number of agreements negotiated and signed by the vast majority of the world's major trading economies. By contrast, the international tax regime still consists, predominantly, of thousands of bilateral agreements. However, certain inroads into the level of bilateralism have been witnessed in more recent years. There have been multilateral efforts in the areas of international tax co-operation (e.g. in relation to exchange of information) as well as the Multilateral Convention to Implement Tax Treaty Measures to Prevent BEPS, 2016.

- Dispute Settlement. The binding nature of dispute settlement under the World Trade Organisation's (WTO) Dispute Settlement Understanding (DSU) – under which any member state can file a complaint with the WTO if it believes another state has violated its obligations under the treaty – can be contrasted with the dispute resolution mechanisms open to taxpayers/competent authorities under DTAs. Following a complaint, the WTO organises an ad hoc Dispute Settlement Body (DSB) consisting of three experts from a list of experts. The parties may then submit briefs and facts to the DSB, which then takes them into consideration in determining whether a member state has violated its obligations. There may be time allocated for the member state to remedy the situation. If the remedy is deemed satisfactory then the matter is closed. If not, the DSB issues a ruling of non-compliance. There is an appeal process for interpretative and legal obligations under the relevant treaty. Where the appeal is unsuccessful the complaining member state is authorised to impose retaliatory tariffs without being in violation of the WTO.

DTAs are considered to be relevant to direct (as opposed to indirect) taxes, but there have been some cases where the WTO DSB has ruled that direct tax rules fall within the remit of the WTO, a priori in relation to subsidies and border tax adjustments (Daly, 2005).

A number of areas are still relatively separate in the two regimes.

- It has generally been considered that direct taxation has effectively been excluded from GATS disciplines where there is a DTA (Daly, 2016).

- WTO's reach in tax matters is severely curtailed by the absence of direct effect and the inability of persons to access the WTO dispute settlement procedure – this, to a large extent, insulates a Member state's national tax sovereignty from the outside threat of international trade rules (Farrell, 2013).

- The dispute resolution mechanisms in international tax appear to have been influenced by the mechanisms of the WTO but there are significant differences such as the binding nature of the decision, the existence of the appellate body and the retaliatory nature of the permitted sanctions where a member state refuses to remedy a situation decided to be in breach of the member state's obligations under the WTO.

- The ability of individual taxpayers to invoke provisions of the relevant DTA as opposed to the lack of direct effect of the WTO.

- The bilateral nature of DTAs relative to the multilateral nature of the WTO (however, candidates should mention the multilateral tax treaties that are in existence including the MLI).

<u>Further considerations</u>

A number of commentators have stated that a turnover tax, such as the destination-based cash flow tax is likely to breach WTO rules as it would be likely to be deemed to be an unlawful subsidy on domestic goods, an export subsidy or a de facto tariff on imports (Brady, 2016). The proposed French Digital tax (that would apply to digital activities such as selling online advertising on the basis of user data) has been described as potentially falling foul of GATS rules in relation to discriminatory measures levied on certain companies (Gottlieb, 2019).

The DSU described above is not considered to be appropriate for international tax because of their distinct foci: for international trade the focus is said to be on increasing economic growth by lowering barriers to trade between countries whereas in international tax the focus is on raising revenue, which involves public goods (as opposed to private goods in international trade) (Rozenweig, 2012). The public/private goods dichotomy is used as a basis for not utilising a DSU style approach to dispute resolution in international tax as it is considered that retaliatory measures such as enforcement measures do "not make as much sense for international tax as it does for international trade."

Further support for not extending the DSU to international tax is said to be based upon the difference between the "agreed baseline" rules. Whereas the DSU is aimed at resolving issues relating to disputes over the application of already agreed base line rules, this is not true of tax treaties (Rozenweig, 2012).

Question 5

Candidates should consider the extent to which the long-standing criticisms of the mutual agreement procedure (MAP) are (i) valid, (especially with respect to the duration of the MAP and finality of decision-making) and (ii) if valid, whether any developments in the area are likely to improve MAP's effectiveness.

MAP: can be relied upon by tax authorities and taxpayer alike. However, it appears that competent authorities dominate (Burnett 2007). In the case of tax authorities, there are various instances in which art.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 art.4(2)(a)-(c) or of a person other than an individual under art.4(3). A further example is the reliance on MAP to settle the mode of application of a source state and limits the rate of tax applied therein in relation to arts.10&11. Article 25 provides a mechanism by which taxpayers can invoke MAP. The Commentary lists the other cases as commonly arising under MAP: questions related to the attribution of profits to a PE and taxation in the state of the payer (such as art.11). MAP permits the authorities to communicate with each other directly without going through diplomatic channels. Information exchanged is subject to art.25 and therefore the information should be treated as confidential (Commentary on art.25, [4]).

Article 25 (MAP and Arbitration): this article constitutes a "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 contracting state. Relevantly, no domestic time limits are to be imposed on the MAP process under art.25. A time limit is however, may be imposed under art.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 contracting 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. 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 art.25, [5]).

Time limits: these are referred to above and referenced in the text of art.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 art.15 when there is a probable (as opposed to possible) risk that taxation not in accordance with the DTA will be imposed (see Commentary on art.25, [14]&[15]). This is such that the MAP can be made available as widely and with as much flexibility as possible. Commentary on art.25, [17]. However, the 3-year time limit for the taxpayer to submit the issue to MAP is included in order to "protect administrations against late objections" (see, Commentary on art.25, [20]). In terms of the starting of the "three year period", the Commentary on art.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 3-year period starts from the time of filing of the amended return and Hungary does not agree to agreeing to MAP outside of the prescribed period provided for under its domestic law (see, Observations on art.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 taking into account their particular circumstances. Given the interplay between domestic time limits and those within art.25, the Commentary considers varied approaches to the wording of art.25 when included in countries' DTAs (see, Commentary on art.25, [25]).

New Reporting Requirements: The OECD has released data that compares the statistical reporting framework for MAP between 2006-15 and the new framework from 2015 onwards. According to the OECD, initially 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 about time cycles and some countries failed to include any data at all. In addition, the average also hides some very lengthy delays (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 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 (e.g. 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), objection not justified, case withdrawn by taxpayer. Cai and Zhang, 2018 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 be more focused on 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 to 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 (see, Commentary on art.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, art.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 art.25(5) or any procedural rule. In such a case the decision will not be binding. Commentary, [81]. The Commentary on art.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."

<u>Conclusion</u>

Most international tax disputes have been finalized through the MAP mechanism (Burnett, 2007). It is recognised that in order for continued co-ordination of tax rules, countries and taxpayers require dispute resolution mechanisms that are effective. As noted above, the OECD MTC includes various time limits and offers guidance on when these periods should begin and end. The MAP has been streamlined but there is a careful balance to be struck between making the process accessible to taxpayers and also enabling the authorities to deal with issues in a timely manner. As noted above, new MAP reporting requirements provide more detailed information about the extent to which countries are complying with the time limits in OECD MTC 2017 and details surrounding the stages during which MAP may be held up. Peer review and monitoring reflects a new attempt to strengthen MAP (Nias, 2016), which, in turn, may assist a more effective MAP. Interesting cases relating to the finality of the decision-making of MAP could also be mentioned here e.g. the Italian case involving a transfer pricing adjustment (see Cassazione Civile, SS.UU, ordinanze 19/06/2015 n. 12759 and 12760) in which the court asserted that jurisdiction over an aspect (i.e. the assessment of the validity of the request) of the MAP fell within domestic law and so the jurisdiction of the court. It is therefore quite possible that the new reporting requirements and the more detailed information they require, may result in further judicial review of MAP (Cai and Zhang, 2018), albeit that certain stages of the process may, in turn, impact both the length of time at a given stage of the MAP and ultimately the finality of the decision. In terms of the finality of the decision, there is a need to consider both the rights of taxpayers to reject decisions as well as the claim 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).

PART B

Question 6

This is one possible schematic. However, candidates should set out their answers in the following format per the instructions in this question. In all cases, candidates should introduce the legal issue(s) and then apply the relevant provisions of the OECD MTC 2017 to the relevant facts in the scenario (or in the case of the second part the relevant provision of the Leonia/Zantra DTA in the question).

Salaries, dividends and stock-options

Salaries: in the present case, there is little detail about the type of employment but the combination of the reference to a sales function and the fact there is a private sector employer means it is fairly unlikely that anything other than art.15 would apply. There is also no need to consider whether there is a PE. Salaries, etc, derived by A and B (as residents of Zantra) should only be taxed in Zantra because the vast majority of A and B's time in employment appears to be spent in Zantra (they attend four sales meetings a year in Leonia). Employment is considered to be exercised in the state in which the relevant employee is personally present, and it is clear A and B are physically present in Zantra. Therefore, it appears that the salaries of both A and B are subject to tax in Zantra (see also Commentary on art.15(2), [1]). It is unlikely that the salaries paid by Finesse Ltd. would fall within the exception in art.15(2).

Whilst there is no mention of Covid-19 in the fact pattern, it is open to candidates to mention that (i) several governments have announced that any residence tests that take into account physical presence in their territory may not necessarily include periods of physical presence spent in a territory due to Covid-19 restrictions and (ii) the OECD Secretariat has also considered the impact of Covid-19 more generally in relation to cross-border workers, noting that where governments have stepped in to subsidise workers and these workers are:: (a) kept on the payroll and (b) not in the state they usually carry out the work they do then these payments "most closely resemble termination payments" and thus according to the Commentary on Article 15, [2.6] are attributable to the place where the employee would otherwise have worked. Generally, this will be the place where the person worked before the Covid-19 crisis. The OECD also references the potential for countries to lose taxing rights as a consequence of cross-border workers changing the place where they exercise their employment rights due to periods of time spent in another country and the knock-on effect such a change could have on, for example, compliance issues where an employer has withholding obligations but taxing rights are "no longer underpinned by a substantive taxing right." see OECD Secretariat, Analysis of Tax Treaties and the Impact of the Covid-19 Crisis, April 2020, [21]-[27]).

Dividends: art.10(1) provides that dividends paid by a resident of one state (i.e. Leralo Ltd. which is resident in Leonia) to a resident of another state (i.e. A and B) may be taxed in the other state (i.e. Zantra, as the resident state of the recipient). Article 10(2) provides that Leonia may also tax the Leralo Ltd. dividends in certain circumstances: where A and B are the beneficial owners the maximum withholding rate is 15% per Article 10(2)(b). There is no reason to query A and B's beneficial ownership of the Leralo Ltd. shares and so prima facie the dividends will be subject to 15% withholding tax in Leonia, which is the standard Leonian rate of 15% withholding tax. As Leonia applies the 15% rate as a matter of course, there is no need to consider art.29, as there does not appear to be any benefit being granted to A and B in terms of reduced withholding rates under the DTA (Commentary on art.10, [12.5]). The separate issue of the availability of the FTC, which is clearly a benefit relative to the current domestic position in Zantra, will however need to be considered (see below).

Stock Options: stock options create tax issues because they are often taxed at a time that is different from the time when the employment services are rendered (Commentary on art.15, [12]); Commentary on Article 15 , [12.1] notes that Article 15 provides that the source state (State B) may tax the part of the stock-option that constitutes remuneration from employment exercised in State B if the tax is levied at a later time when the employee is no longer employed in State B. This is not the issue here as the relevant employment is not exercised in Leonia.

The Commentary to OECD MTC 2017 makes clear that any benefits derived from the exercise of stock-options is subject to art.13 whereas art.15 deals with the stock options in terms of any benefit that may be derived from the stock-options (pre-exercise/sale/disposal) (Commentary on art.15, [12.2]). Accordingly, A and B should be advised that until such time, the stock-options will be dealt with by art.15 and its Commentary. They should also be advised that the state of source (in this case Leonia) is permitted to subject the stock-options to tax but this right is limited to any amount that is attributable to the option itself and this does not extend to any amount attributable to any subsequent holding of shares acquired following the exercise of the option.

A and B should also be advised that neither art.21 (other income) nor art.18 (pensions and similar remuneration) apply. The fact that art.18 does not apply even where the option is exercised after termination of employment/retirement is relevant to both A and B. In other words, both A and B are within the remit of art.15 to the extent they do not exercise the option in the relevant tax year and subject to art.13 to the extent that they do exercise the stock-option. In the case of both A and B, there is a need to consider whether the option is derived from employment exercised in the source state. Whilst stock-options are often granted to induce employees to stay on, it appears from the facts that Finesse Ltd. is aware that A is leaving but is not aware that B is leaving. Candidates could mention this fact.

<u>Availability of FTC in Zantra</u>

Candidates should note that the FTC provision has been separately negotiated between Zantra and Leonia but that all other provisions in the DTA between Leonia and Zantra mirror those in the OECD MTC 2017. Whilst it is not necessary for candidates to reference the case mentioned below (Supreme Court (SC), 16 June 2017, AR F.15.012.N re: French/Belgian 1964) it does provide a recent example of similar facts and therefore affords insight into some of the issues that candidates could be expected to include in their answers. In this case, an FTC was awarded in spite of the change in the domestic law. Candidates should note the following in relation to the interpretative issues surrounding the availability of the FTC under the DTA where the domestic law of the state applying the DTA has been amended after the signing of the DTA. There is a need to focus in on the issue of interpretation of DTA terms, specifically where a provision of a DTA entered into pre-1995 references a domestic law that is no longer in existence in the domestic regime of the country applying the DTA (i.e. the change to Zantra's rules relating to the availability of FTCs on overseas dividends). Candidates should then consider the treaty rules and, more specifically, DTA interpretation including those contained within the OECD MTC itself, as well as its Commentary.

Any discussion on DTA interpretation should include a reference to the rules contained within the Vienna Convention on the Law of Treaties and in particular Articles 31-33. There is no need for candidates to use up time fleshing out these provisions. Rather candidates should reconcile the various approaches to DTA interpretation (VCLT/OECD MTC) to determine whether it is reasonable to expect that a court would require a FTC to be granted to A and B under the DTA. Issues that could be considered include:

1. The fact that the rules of interpretation only apply to the terms used in the DTA as opposed to general reliance on domestic law interpretations of domestic tax policy or as a mechanism that uses domestic tax rules to close loopholes with DTAs (Rust, 2015 and Vogel and Prokisch, 1993) (it is not the case that there is a loophole in the DTA that Zantra's law must fill rather the issue is regarding the primacy of the right to a FTC afforded under a DTA as opposed to the non-availability under domestic law amended post the signature of the DTA granting the FTC). See following point.

2. There is a need to consider the interaction between rights under DTAs and domestic law. The extent to which an international treaty is supreme with respect to domestic law is a contentious issue with some commentators suggesting that DTAs are supreme and others stating that DTAs are afforded their (limited) "supremacy" by domestic law and as such are necessarily subordinated to domestic law level (this is relevant here as the amendment to the domestic law that removes the ability to claim an FTC conflicts with the right to a FTC, albeit in certain circumstances, under the DTA.)

3. DTA terms are not considered to be general terms that are then to be fleshed out by domestic law (Wassermeyer, 1990). (This may be relevant to the extent that the Zantra revenue authority should not rely on the details of the domestic law alone to determine further details relating to the availability of a FTC.)

4. Tax law meanings prevail over non-tax law meanings (there is no suggestion here that a non-tax interpretation is being proposed). (There does not appear to be any suggestion that non-tax law meanings are being advanced in the fact pattern).

5. The object and purpose of the Zantra/Leonia DTA should be addressed. A good place to start is art.1 or the DTA's Preamble (both based on OECD MTC 2017), which provides for prevention of juridical double taxation and double non-taxation. (It could therefore be mentioned that without the grant of the FTC, it is possible that juridical double taxation may occur and there does not appear to be any evidence that double non-taxation is an issue.) This latter point is addressed in an academic comment on the French/Belgian case mentioned above (Van de Vijver, 2018) and would point towards an interpretation that supported the grant of the FTC to A and B.

6. Commentary on art.3(2), [11] makes clear that, when considering the interpretation of terms not defined by the convention, these will be interpreted in line with the legislation at the time the DTA is being applied and that this resulted in a change to the OECD MTC wording in 1995 ((“at any time” and “that it has at that time”).

7. Whilst an FTC may be awarded, it is possible that the Zantran government may amend its domestic law to accommodate a judicial pronouncement or alternatively re-negotiate this aspect of the DTA. The former occurred following the decision in the case mentioned above (France/Belgium DTA).

Question 7

Residence: Before considering the tax treatment of Karl's pension payments, bank interest and director's fees, it is necessary to establish Karl's state of residence under the G/H DTA. It is clear that Karl is a citizen of G but lives in H and has acquired permanent resident status there for immigration purposes. From the facts, it would appear that Karl is tax resident in H on the basis that he has lived in H for fifteen years and it appears to be his home now. However, it is also possible that G would consider him to be resident for tax purposes on the basis that he maintains connections with G (bank account, directorship, derives a pension and spends every summer with family in a house he owns and seems to have done so for a period of at least fifteen years). It is not clear whether Karl has access to the home outside of the summer season but given that it is rented out to writers as a retreat it is possible that these could be short-term rentals and that he does indeed have access to the home whenever it is vacant. Given that he could be treated as being resident in both G and H, candidates should briefly consider his residence under the G/H DTA.

Article 4(2) provides that the first tie-breaker is the permanent home (PH) test: on this basis it would appear that the property in G is not "continuously available …" and may not be considered to be a PH as it is "rented out and effectively handed over to an unrelated party so that the individual no longer has the possession of the house and the possibility to stay there." Whilst it is probable that Karl has a PH in H, it is also possible that he may be found to also have a PH in G, as the object of art.4 is to ensure "as far as possible... There can be no question but that the person concerned will satisfy it in one State only" (Commentary on art.4, [10]). Where an individual has a PH in both countries, there is a need to move to the next test: centre of vital interests (COVI). Again, as he owns property, maintains connections (social and financial) and spends time in G on a regular basis it may be necessary to look to the "habitual abode" (HA) test to acquire more certainty about his resident status. The HA test looks to the frequency, duration and regularity of the stays that are part of a settled routine of an individual's lives that are more than transient. On this basis, it is more likely that K will have an HA in H (Commentary on art.4, [19]). This schematic proceeds on the basis that Karl is resident in H for the purposes of the G/H DTA.

Candidates may choose to note that several governments have announced that it may be possible to disregard periods of physical presence for the purposes of certain residence tests that include a physical presence component where the period of physical presence arises as a result of the Covid-19 crisis (e.g. Greece Circular No. E 2113/2020 and in the UK, HMRC have published RDRM11005, which is to be read alongside existing guidance in RDRM13200 – note there is a need to carefully consider the guidance in order to determine whether presence within the relevant country constitutes relevant presence for tax residence purposes or whether it can be disregarded in the circumstances). Furthermore, the OECD has stated that due to countries dealing with individual residence at the national level, it does not envisage issues arising at the tax treaty level (OECD Secretariat, April 2020). Accordingly, it is open to candidates to reference the potential impact of Covid-19 restrictions and domestic changes to tax residence rules in this regard.

Rental Income: Article 6(1) provides that the state of source (i.e. Gelia) has the right to tax any rental income derived by Karl in Gelia. This follows on from the determination in the "residence" section above that Karl is a tax resident of H per the G/H DTA.

Bank Interest: Interest of 10% of $20,000 is withheld in Gelia (i.e. $2,000 p.a.). Taxing rights under art.11 on interest are shared between G and H: where Karl derives interest income this will be included in his H tax return and G will have the right to withhold tax up to a maximum of 10%. The result is that Karl will have tax withheld in G at a rate of 10% and will need to claim a tax credit from H on any amounts of tax paid in respect of the withholding tax in G. This follows on from the determination in the "residence" section above that Karl is a tax resident of H per the G/H DTA.

Pension payments: There is a need to consider whether the payment should be treated as forming part of Karl's remuneration (and is therefore is subject to art.15) or whether the amount falls within art.18/19. Given that Karl is 70 years old and retired 15 years ago, it would be reasonable to presume that the payments he receives constitute payments for services previously rendered and furthermore, the fact pattern refers to these as "pension payments".

Article 18 governs the taxation of income from pension payments and art.19 contains a special provision for services rendered to a state with respect to income from both current and former activities (Ismer, 2018). Therefore, there is a need to be clear that the relevant income is not employment income (which is subject to art.15) and as a form of pension whether it relates to services rendered to a state or to a private sector employer and if to a state employer then whether the payment falls within art.19(2). Where the services were rendered to a state employer and do not fall within art. 19(2), they will nevertheless fall within art.18. Article 18 provides that subject to art.19(2) pension payments made to a resident of a state shall be taxable only in that state. Accordingly, there is a need to determine first whether Karl's pension payments fall within the "special allocation rule for pensions … paid in respect of a former government employment" as his ex-employer is a government department. (Ismer and Blank, 2015).

Moving on to art.19(2)(a) pensions are taxable only in the state to which the services were rendered. Accordingly, unless art.19(2)(b) applies, which would result in the payments being taxable only in H, Karl's pension payments will be subject to tax in G under art.19(2)(a). It does not appear that art.19(2)(b) applies because, whilst Karl is a resident of H, he is not a national of H (he is only a permanent resident). The result appears to be that the payments are taxable only in G. As art.19(2) trumps art.18 (see Commentary on art.18, [3], where it states that art.18 also applies to pensions in respect of services rendered to a state … which are not covered by the provisions of Paragraph 2 of art.19). Accordingly, Karl's pension payments are subject to tax in G and not H. Had Article19(2) not applied, reference would have been made to art.18, which would have resulted in a different outcome: Karl's pension payments would have been subject to tax in H as the payments are made in prospect of services rendered to G but to a resident of H.

Should Karl move his pension out of the public fund into the private fund, it is possible that art.19(2) will no longer apply and therefore by default, art.18 will allocate the taxing rights over his pension. There is a difference of view as to whether the fact of the transfer will result in Karl's payments being treated as falling outside the scope of art.19(2)(a) – and so by extension falling within article 18 – or whether some form of apportionment of taxing rights would result (see Observation of the Netherlands on the Commentary on art.19, [5.4], [5.6] & [7]). The view of the Commentary, [5.4], is that such a transfer would result in a full application of art.18 as the payments "would not meet the technical requirement of subparagraph 2a". However, the OECD also acknowledges the possibility of apportionment in such circumstances and suggests alternative wording for art.19(2)(a). In the fact pattern, the wording is as per the OECD MTC 2017 and so it would appear that art.18 would apply as previously explained.

Directors' Fees: Article 16 treats services of a director as being performed in the state of residence of the company (Commentary on art.16, [1]). Under art.16, Karl's fees "may be taxed" in G, as well as in H. Karl will therefore be required to pay tax at source in G where this is imposed and can claim a tax credit from H. Candidates could note that not all DTAs adopt the precise wording of the OECD MTC, with some making explicit distinctions between directors who are involved in the day to day management of the relevant company and those who are not. Examples of cases that could be mentioned include: Liege Court of Appeals, 15 January 2014 (case Nr. 2012/RG/749) considering the French/Belgian DTA, where the relevant provision diverged from the OECD MTC. A distinction was drawn between directors who are employed by the company and are in charge of day to day management of the company and "general directors" who are general members of a board or equivalent organ. In the former scenario, directors would be subject to the art.15 equivalent of the OECD MTC and, under the latter scenario, they would be subject to art.16. In the present case, and notwithstanding that the relevant provisions to apply are those within the OECD MTC, Karl is a non-executive director and would fall within the latter scenario. See also the Commentary on Article 16, [2]. Candidates could also note that Estonia and Latvia reserve the right to tax any remuneration of a member of a board of directors or any other similar organ or resident of a company. Reservations, on art.16, [4]. It is also open to candidates to mention that the OECD has considered the impact that director presence in a country may have on the tax residence status of a company and cites Ireland as an example of a country that may disregard the presence of a director (or other individual) for corporate residence purposes (effective management) where their presence arises as a result of Covid-19 travel restrictions. See OECD Secretariat, April 2020, [14]-[16].