4 OECD (2013) Secretary General Report to the G20 Leaders, available at http://www.oecd.org/tax/SG-report-G20-Leaders-StPetersburg.pdf.

CROSS-BORDER ENFORCEMENT OF TAXES

2.9 The general principle in international law is that a country will not assist in the collection of taxes charged by another country. Quite why this principle, sometimes referred to as the Revenue Rule, should be so entrenched is not known but Baker (2002), writing with reference to the position in the US, puts forward the opinion that perhaps it is because the collection of tax is an act of sovereignty and no sovereign state allows another state to exercise its sovereignty on its territory. This is the view taken by the UN Group of Experts[1].

Considering other possibilities, Baker concludes that the principle definitely exists even if we are not sure why. All tax treaties are based on the principle. Therefore, to deviate from the principle would undermine the basis upon which the whole framework for international taxation is currently built. In the UK, the matter was considered in *Government of India v Taylor*[2]:

> 'The trouble about a rule of law which everyone has taken for granted is that no one goes into its origin or the reason why it was first established. The basis is lost sight of and the application becomes wider and wider. The origin is the dictum of Lord Mansfield CJ in *Holman v Johnson* and *Planché v Fletcher*, but there was no question there of foreign taxation. The courts were only concerned with the principle of not enforcing performance of a contract which is illegal in the place of performance. …There are no adequate reasons for the imposition of the alleged rule. It has been suggested that it would be derogatory to the sovereignty of foreign States to allow such suits and that it might cause political embarrassment. But that cannot be right, because our courts have never refused to enforce other foreign laws. It would be far more likely to cause political embarrassment if it were refused to enforce revenue laws. It was also suggested that it would be contrary to public policy to enforce such laws, but no reason has been given for this, and if the laws are not confiscatory it cannot be so. There is nothing contrary to public policy in enforcing laws similar to our own. If a tax is the sort of tax which is recognised in this country it is not penal. Further, it has been suggested that the investigation of foreign tax law would be too difficult a task, but our courts have never refused to investigate foreign law on such a ground as that. All foreign law is a question of fact.' (pp 495 and 496)

The case concerned the effective nationalisation of the Delhi tramway system and the subsequent liquidation of the English company which had previously operated it and which went into liquidation owing Indian tax. The liquidators refused to pay Indian taxes on the capital gains on liquidation. The House of Lords rejected the claim by the Indian Government, mainly on the grounds that they would not enforce Indian tax law, although there were some doubts too as to the technicalities of the claim. The judgment provides an in-depth

consideration of the Revenue Rule. Amongst other sources, their Lordships referred to the standard legal text by Dicey and Morris: *The Conflict of Laws*[3] which states as Rule 3:

> 'English courts have no jurisdiction to entertain an action: (1) for the enforcement, either directly or indirectly, of a penal, revenue or other public law of a foreign state; or (2) founded upon an act of state.'

However, co-operation in the collection of taxes of other countries is now widespread, if limited, via:

- Provisions in the thousands of bilateral double tax treaties which exist. Most double tax treaties contain provisions on the exchange of information for tax purposes and a few contain provisions for assistance in the collection of the tax revenues of the other contracting state.
- Agreements which are essentially one-sided whereby one country agrees to provide information to another country to enable that country to enforce its taxes. Why a country should give such assistance on a unilateral basis is an interesting question: the countries concerned are usually low-tax countries which have been put under pressure to do so by the OECD. This is discussed further in Chapter 14.
- The EU Mutual Assistance for the Recovery of Tax Claims Directive[4] and the Directive on Administrative Cooperation in the Field of Taxation[5].
- The 1988 Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters[6].

The EU and OECD multilateral measures generally include:

- The requirement to exchange information, automatically (eg lists of interest payments by banks), spontaneously, where one state passes information to the other state which it thinks would be of interest to it without being asked and upon request.
- The right to permit tax officials from one country to visit the other country to carry out investigations.
- Recovery of tax claims: where one state actually collects the tax due to the other state and then hands it over. This is the most problematic form of assistance as one state may not understand or agree with the taxes which it is being asked to collect and there may be issues concerning the human rights of the taxpayer.
- Measures of conservancy, such as freezing the assets of the taxpayer or even seizing them, to ensure that the tax claims of the other state can actually be met.

1 See Report of the Tenth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, Geneva, 10–14 September 2001. UN ST/SG/AC,8/2001/L.2, available at http://unpan1.un.org/intradoc/groups/public/documents/UN/UNPAN001659.pdf.

2 *Government of India, Ministry of Finance (Revenue Division) Appellant; and Taylor and Another Respondents* [1955] AC 491.

3 (2008) 14th ed, London, Sweet & Maxwell.

that time under British rule. However, if the company was found to be tax resident in the UK as opposed to India, its Indian income would have been taxable in the UK under the *residence* principle. The company had a director in India who ostensibly exercised control of the company but the Board of Directors held their meetings in London and:

> '… from that office would issue all the orders to the managing director in Calcutta. No doubt, until he received orders to the contrary, he would have full power and discretion to do what he liked in Calcutta; but at any moment from this Head Office, they might have revoked his authority, or altered any arrangement which he had made connected with the working of the company.'

In other words, for all his powers the director was still just a delegate. The decision was that the company was tax resident in the UK. Delegated authority was insufficient to constitute central management and control.

1 (1876) 1 TC 83.

The De Beers case

4.4 *De Beers Consolidated Mines Limited v Howe*[1], a case dating from 1905 is still considered by many to be the leading case on central management and control. The company was fabulously wealthy, being the world's major diamond miners and brokers and the case concerned disputed tax assessments of around £3 million, in 1905 money. The company was registered in the Colony of the Cape of Good Hope (now part of South Africa). Directors' meetings were held both in Kimberley (South Africa) and in London and under the company's constitution at least four of the directors had to reside in London. There were 19 directors altogether. Eleven of these were resident in the UK, two were itinerant between London and Kimberley (a considerable undertaking in the days before air travel), four, plus the chairman, Cecil Rhodes[2], were resident in South Africa and the other had a home in both countries. The directors' meetings held in London were attended by more directors than those held in Kimberley.

However, the courts examined not just the frequency and composition of directors' meetings but, importantly, the nature of the decisions taken in each location. The company's residence would be determined by looking at the relative strategic importance to the company of decisions taken in each place. Decisions concerning the raising of capital (£3.5 million of debentures was issued in 1888), and decisions designed to control the global market for diamonds and hence the price were taken in London. Decisions concerning the mining activities themselves were generally taken in Kimberley. The courts also heard that the Kimberley directors were to some extent answerable to the London directors but not vice versa. The decisions taken by the London directors were those which most amounted to central management and control:[3]

> '… the Directors' Meetings in London are the meetings where the real control is always exercised in practically all the important business of

> the Company except the mining operations. London has always controlled the negotiation of the contracts with the Diamond Syndicates, has determined policy in the disposal of diamonds and other assets, the working and development of mines, the application of profits and the appointment of directors.'

The company was held to be UK tax resident.

1 5 TC 198.
2 Who went on to found Rhodesia, now Zimbabwe.
3 5 TC at p 213.

Bullock v Unit Construction: company residence as fact

4.5 The question of company residence is one of fact. This was illustrated in the case of *Bullock v Unit Construction Co Ltd*[1] Lord Radcliffe's summary of the case:

> '… a company is resident where its central management and control abide … where its real business is carried on.'

Rather unusually, in this particular case the taxpayer was arguing that companies *were* resident in the UK. The case concerned a UK-resident subsidiary of Alfred Booth & Co Ltd, a UK-resident parent company. This subsidiary made certain payments to three fellow subsidiaries in Kenya and claimed these as allowable business expenses in arriving at its UK taxable profits. However, these payments would only have been allowed for tax purposes if the three subsidiaries to which they were made were resident in the UK, not Kenya. They were incorporated in Kenya and their Articles of Association expressly stated that management and control rested with the directors and also required directors' meetings to be held outside the UK. Presumably this had been done with the intention of protecting the company from any future accusation of residence outside Kenya.

It was found as a fact that due to trading difficulties at the material times the boards of directors of the Kenyan subsidiaries were standing aside in all matters of importance and also many matters of minor importance affecting the central management and control and that real control of them was being exercised by the Board of Alfred Booth & Co Ltd in London. Hence all the subsidiaries physically located in Kenya were in fact UK tax resident.

1 (1959) 38 TC 712.

The role of the shareholders in determining central management and control

4.6 The central management and control test is a dual test: control by itself is insufficient. The case of *The Gramophone and Typewriter Ltd v Stanley*[1] confirmed that a controlling interest does not amount to central management and control:

systems based mainly on the credit method whilst 8 reported mainly the use of the exemption method. The remaining 13 countries reported a hybrid approach. The reports generally put forward a view that the credit method was less likely to facilitate tax avoidance. However, the administrative burden was significant compared with the exemption method, yet the credit method was thought unlikely to yield higher tax revenues.

VARIATIONS ON THE CREDIT METHOD

6.3 Credit methods in practice are much more complicated than was depicted in Chapter 5. Countries which use the credit method each have particular rules within their domestic law as to:

- How the foreign tax credit is to be calculated.
- Whether there are any limits on the amount of foreign tax credit in relation to the amount of domestic taxation.
- Whether credit is given merely for foreign withholding taxes, or whether it extends to relief for foreign corporation taxes on the profits used to pay dividends.
- Whether tax credits from lower tier companies can be recognised: for instance, where Company 1 in Country A owns Company 2 in Country B, which in turn owns Company 3 in Country C. If no tax is payable in Country B, and so no double tax relief is claimable there, can the tax credit arising from the tax paid in Country C be set against the tax liability in Country A?
- Whether unused foreign tax credits can be used in previous or future tax years or whether they can be used by other companies in the same corporate group as the recipient.
- Whether tax credits may be set against domestic tax liabilities on foreign income other than that which gave rise to the foreign tax credit. This is known as pooling and there are two main types. With 'onshore pooling', high foreign tax credits on some sources of overseas income can be offset against residual home country taxation on other foreign sources of income. This is the most favourable system of ordinary or normal credit for the taxpayer. Under a system of 'offshore pooling' a multinational group may route its dividends from overseas subsidiaries through an intermediate holding company, which then pays a single dividend to the ultimate parent company. If the parent country tax authority does not permit onshore pooling, this strategy achieves pooling offshore. The lack of any facility for onshore pooling can be circumvented by the parent company only having one immediate source of foreign income: a dividend from the offshore intermediate holding company. Provided the tax authority in the parent company's country recognises the tax credits attaching to the dividends from each of the subsidiaries further down the shareholding chain, the dividend from the intermediate holding company is paid carrying a tax credit representing the average rate of tax suffered on the dividends paid by lower tier companies to the intermediate holding company. Note that to avoid additional tax liabilities the intermediate holding company would be located in a country such as the Netherlands, which operates a double tax system of exemption with participation.
- Which foreign taxes may be credited at all.

The UK has traditionally operated a series of complex versions of the credit method for corporation tax, but since 2009 it has used an exemption (territorial) system for two important classes of foreign income earned by UK corporations (foreign dividends and branch profits). Other foreign income of UK companies and other types of UK taxpayers are still granted double tax relief under the credit method.

Before considering the exemption system in more detail, we first consider some examples of credit systems in operation. Now that Japan and the UK have largely moved to an exemption system, only six OECD countries operate credit systems (Chile, Ireland, Korea, Mexico and Poland and the US). There is considerable ongoing discussion in the US as to whether a system of double tax relief by exemption for foreign dividends should be adopted.

Credit relief in the US

6.4 The US is one of the very few countries that has stuck to a credit system of double tax relief. Citizens, resident aliens and domestic corporations of the US may credit against US income tax any 'qualified' foreign taxes paid or accrued to a foreign country. Taxpayers may choose each year between taking a credit against US tax or a deduction against US taxable income for the foreign income taxes.

For tax years beginning after 2006, for the purposes of the rule which limits the foreign tax credit to the taxpayer's US tax liability, an individual's US tax is reduced by the sum of non-refundable personal credits (other than the adoption credit, the child tax credit and the credit for elective deferrals and Individual Retirement Arrangement contributions) allowable for the year.

The foreign tax credit is computed separately for two different categories of income. This is known as the 'separate baskets' system:

- the passive income basket: interest, dividends, rents and other items of investment income;
- the general basket: everything else.

The rationale for separating out income in this way is that it is easier for a US firm to position the assets giving rise to investment income in a low tax country, because passive investment assets tend to be financial assets and are therefore mobile. On the other hand, income from foreign direct investment, such as dividends from manufacturing subsidiaries and branches, is likely to be positioned in the country best suited to the investment by reference to more general (non-tax) commercial factors. It is therefore likely to have suffered substantial amounts of foreign tax. Without the separate baskets, the total foreign income

might issue, if indeed a company issues shares at all. Identifying a non-preferential ordinary share in a UK company might be easy but identifying this type of share in a foreign company might not be. In practice, it is going to be essential correctly to characterise the types of shareholdings in respect of which dividends are paid to a UK corporate shareholder. HMRC mention the example of a Delaware limited liability company which would not issue share capital, but rather would issue certificates of interest in the company. Such certificates, depending on their terms, might be considered analogous to ordinary shares. Other common types of company without share capital are the German GmbH and the Italian SRL which have quotas rather than shares. Because of the practical difficulty UK companies are likely to face in determining whether their investments in foreign companies may be treated as if they are ordinary shares, HMRC have agreed to offer advice, under the terms of HMRC Code of Practice 10. Under this Code of Practice, they have agreed, inter alia, to advise on the interpretation of legislation passed in the last four Finance Acts[3].

1 CTA 2009, s 931F.
2 CTA 2009, s 931U.
3 HMRC has also indicated that Customs Business Brief 54/07 may be used to determine whether or not the entity paying a dividend has ordinary share capital.

Distributions in respect of portfolio holdings (holdings of less than 10%)

6.24 In accordance with the decision of the ECJ in the *FII GLO* case, that it is not in accordance with the TFEU that dividends paid by UK companies to other UK companies should be exempt from tax whilst those from companies within the EEA were not, the dividend exemption extends to dividends paid in respect of shareholdings irrespective of size. The exemption in respect of portfolio dividends extends to dividends paid not just on ordinary shares but on any type of share. The main requirement is that the UK shareholding holds less than 10% of the share capital of the same class as the shares in respect of which the distribution is made.

It is perfectly possible for a UK company to own both ordinary shares and preference shares in an overseas company. A UK company owning 40% of the ordinary share capital and, say, 6% of its preference share capital would be entitled to exemption on dividends from both shareholdings. The 10% threshold is measured only by reference to the class of shares out of which the dividend is paid, so for the purpose of this leg of the exemption, the 40% holding in the ordinary share capital does not matter: the preference dividend would be exempt because less than 10% of the preference shares are owned.

Dividends derived from transactions not designed to reduce tax[1]

6.25 This is another very wide class of exempt dividends, into which most foreign dividends (dividends only, not other types of distribution) will fall: so long as the profits out of which the dividend was paid do not arise due to transactions designed to avoid tax in the UK, they will be exempt.

To be exempt under this heading, a dividend must be paid in respect of 'relevant profits'. These are defined as any profits available for distribution at the time that the dividend is paid, other than profits that reflect the results of a transaction(s) which achieved a reduction in UK tax and this was the purpose (or one of the main purposes) of the transaction(s). To interpret this class of exempt dividends, we need to be able to interpret this 'purpose' test. The wording makes it clear that it is only reductions in UK tax, as opposed to foreign taxes, which are important. The 'purpose' test is similar to the motive already in use for determining whether or not a UK company should be exempt from an apportionment of the profits of a controlled foreign company, where none of the other available exemptions apply[2]. Applying that test would indicate that the 'purpose' test would be failed even if the company receiving the dividend did not itself enjoy a reduction in UK tax. Neither is it necessary that the reduction in taxes be enjoyed in the same period as that in which the dividend is paid.

Example 6.1

UK Plc sells assets liable to capital gains tax at an arm's-length price to a foreign subsidiary and makes a gain, which is covered by capital losses brought forward. The foreign subsidiary, resident in a territory which would not tax the gain, sells the property to another group company, which obtains a tax deduction for the expenditure. The gain is then paid to the UK in the form of a dividend.

1 CTA 2009, s 931H.
2 CTA 2010, s 1064.

Dividends in respect of shares accounted for as liabilities[1]

6.26 This last head of exemption briefly states that a dividend will be exempt if paid in respect of a share which would normally be treated as a loan, but is not so treated merely because the investing company does not hold the share for a so-called 'unallowable purpose'. 'Unallowable purpose' is just one of six conditions, all of which must be met for a share to be treated as a loan. In practical terms, this exemption will apply to shareholdings which are accounted for under GAAP as a loan, and on which the return is not reclassified for tax purposes as disguised interest only by virtue of the fact that it was not set up for an unallowable purpose (ie to obtain a tax advantage). An example would be a redeemable preference share, which is a type of security commonly issued for its commercial rather than for its tax advantages.

1 CTA 2009, s 931I.

The anti-avoidance rules for the dividend exemption

6.27 Even if a dividend falls under one of more of these five heads of exemption, it will still not enjoy the exemption if it falls foul of the set of eight

1 See Baker (2002) at para F.04 for some examples.
2 Report on Tax Treaty Override, OECD Committee on Fiscal Affairs, 1989.
3 *Padmore v Inland Revenue Commissioners* [1989] STC 493 and *Padmore v Inland Revenue Commissioners (No 2)* [2001] STC 280.

The relationship between tax treaties and EU law

7.5 Perhaps because until fairly recently EU law relating to taxation was concerned mostly with VAT and duties, relatively little work has been done on the relationship between treaty law (ie the provisions of double tax treaties which are effective in a state's domestic law) and EU law. VAT and duties are not covered by double tax treaties except for provisions concerning non-discrimination against non-residents and provisions for the exchange of information between states. Within the EU there is a network of more than 300 bilateral double tax treaties which exist alongside EU law. It is worth stating that EU law for tax purposes normally takes the form of Directives and the decisions of the Court of Justice of the European Union (CJEU). The relationship between this EU law and the domestic laws of the Member States is complex but in general, Member States are required to incorporate the provisions of the Directives into their domestic laws and to follow the decisions of the CJEU. The lack of co-ordination between treaty law within the EU and EU law itself is not surprising as they have different objectives: the former is to allocate taxing rights between a pair of states, and the latter is to help to establish the EU Single Market.

What is established beyond all doubt is that Member States of the EU are at liberty to develop and enforce their own rules in the sphere of direct taxation. In *Gilly*[1], the CJEU stated:

> 'The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation – by means inter alia, of international agreements – and have concluded many bilateral conventions based, in particular, on the Model Tax Conventions on income and wealth tax drawn up by the OECD.'[2]

In the case of *Saint Gobain*[3] the principle was established that it is up to the individual EU Member States to determine the connecting factors (residence etc) for the purposes of allocating powers of taxation. However, the rights afforded to taxpayers under the Treaty on the Functioning of the European Union (TFEU), and in particular under Article 49, the freedom to establish anywhere in the EU without hindrance (ie without suffering less favourable tax treatment than if the person had remained taxable purely in the State where resident) cannot be subordinated to the provisions of a double tax treaty. Where there is a conflict between EU law and the provisions of a double tax treaty, the EU law will prevail. This was made explicit by the ECJ in the famous *Avoir Fiscal*[4] case in which it was stated:

> 'the rights conferred by Article 43 of the Treaty are unconditional and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State.'[5]

In the *Avoir Fiscal* case, the taxpayer was resident in another Member State and under the terms of the double tax treaty, received tax treatment which was more onerous than that received by taxpayers who were French residents. There is a distinction to be made between the allocation of powers of taxation and the exercise of those powers. The first is a matter for the individual Member States, but in the second, the principles set down in the Treaty on the Functioning of the EU (TFEU) must be followed. In other words, Member States are free to decide *who* has the right to tax, but not *how* to tax if this results, broadly, in discrimination against the foreign taxpayer if that taxpayer is a resident of a fellow EU Member State.

1 Case C-336/96 *Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin* [1998] All ER (EC) 826.
2 Above at para 24.
3 Case C-307/97 *Compagnie de Saint-Gobain SA, branch Germany* [2000] STC 854.
4 Case C-270/83 *Commission v France* [1986] ECR 273. The Article number refers to an earlier version of the Treaty.
5 Above at para 5.

The relationship between tax treaties and EU law in practice

7.6 There is no direct relationship as such, but the Parent/Subsidiary Directive[1] and the Interest and Royalties Directive[2] in particular contain provisions regarding withholding taxes on dividends, interest and royalties which must be enacted in the domestic law of all EU Member States unless a Member State specifically obtains permission to omit or vary them. The effect of this is that it is now frequently the case that the domestic law of an EU Member State will provide for withholding tax rates on certain types of dividend, interest and royalty payments which are lower than those provided for in its double tax treaties with other Member States. Even where domestic law has not been amended in line with a Directive, taxpayers, in some circumstances, have the right to rely on the Directive rather than on the corresponding domestic law. Thus an EU Member State might charge a 20% withholding tax rate on interest in its domestic law which would apply to payments of interest to non-EU resident recipients, or EU-resident recipients not covered by the Interest and Royalties Directive. Then there could well be a double tax treaty with a fellow EU Member State providing for a maximum withholding tax rate of 10%. Finally, domestic law for certain EU recipients qualifying under the Interest and Royalties Directive would exempt certain interest payments from withholding tax altogether. Hence great care is needed when determining the correct rate of withholding tax on payments made between EU enterprises.

1 90/435/EC, updated by 2003/123/EC.
2 2003/49/EC.

Treaties with developing states – tax sparing

7.40 Double tax treaties with developing states which are based on the UN Model often contain 'tax sparing' provisions. This means that State A will give credit for tax in State B (the developing state), even where no tax has actually been paid in State B. This preserves the usefulness to an investor in State A of any tax incentives offered to it by State B. In the absence of tax-sparing provisions, the only result of a reduction in tax in State B would be an increase in tax in State A due to a lower or non-existent State B tax credit. Tax-sparing provisions can be worded so that they refer to tax exemptions given under particular statutes (usually to do with encouraging foreign inward investment). This is typical of Indian treaties. Alternatively, the provisions might state that, in our example, State A will allow a certain percentage of gross dividend, interest or royalty income as a credit, even if no withholding tax has been charged by State B. This is common in Chinese tax treaties, many of which date from the early 1980s and are still based on the UN Model. Sometimes a time limit is placed on the provisions, typically 10 years from the date of the treaty, and in other cases the provision is open-ended.

US treaties – the complicating effect of the 'saving clause' on the double tax relief mechanism

7.41 US treaties have a unique problem to deal with in the double tax relief article – because the US reserves the right, through the 'saving clause' (Article 1, para 4 of the US model), to charge full US taxes on its residents and on individuals who are, or have been, US citizens. A US citizen tax resident outside the US in State X may find that they have been subject to full residence-based taxation in both the US and in State X. The US wishes to achieve the effect that the individual pays the same amount of tax worldwide as if he were merely resident in the US. State X is normally in the position of giving a credit to its residents for tax suffered overseas, but does not see why it should concede a very large tax credit just because the US has insisted on taxing the individual as if he were still resident in the US. Therefore State X will usually only agree to grant the tax credit up to the amount of tax that would be paid if the US did not impose extra tax charges on the grounds of the individual's US citizenship, in other words, the normal amount of tax the US would charge to a non-resident who was *not* a US citizen. At this point the individual is suffering a high combined tax liability – full US residence-based tax plus residual tax (after the tax credit for 'normal' US tax) in State X. The solution usually adopted is for the US to reduce the tax it charges to the non-resident on the basis of citizenship by granting, in turn, a credit for the tax suffered State X. The amount of the credit will be limited to the amount needed to bring the US citizen's global tax bill back down to what it would have been had the individual been both a US citizen and a US tax resident. The problem with this solution is that it involves treating income arising in State X as if it had arisen in the US and so lengthy provisions are needed to ensure that the income can be treated as arising out of a source in the technically correct state: so called 're-sourcing' rules.

Article 24: Non-discrimination

7.42 The purpose of this article is to prevent discrimination against foreign taxpayers. State A may not subject a national of State B to any taxation or connected procedures which are in addition to, or more burdensome than those to which, in the same circumstances, it subjects its own nationals. Note that the article is expressed in terms of 'nationals' rather than residents, which arguably is a wider concept. This means that all nationals of each contracting state are entitled to invoke the non-discrimination article against the other contracting state even if they do not fall within the definition of resident for tax purposes (ie they could even be a tax resident of a third state). Thus, states are permitted to discriminate on grounds of residence but not nationality. However, where residence status has no bearing on the treatment in question, states are not permitted to discriminate on the grounds of residence alone. The Commentary gives several examples illustrating these principles.

This article is the one that generates the greatest number of international tax law disputes and the most contentious phrase is 'in the same circumstances'.

There is nothing to stop a state from negotiating exceptions from the principle of non-discrimination. For instance, India commonly insists upon the right to discriminate against the permanent establishments of foreign enterprises by subjecting their profits to a higher rate of tax than that applied to the profits of Indian enterprises. Poland, in some of its treaties, reserves the right to discriminate in favour of its formerly state-owned enterprises. More commonly, states which operate a branch profits tax usually reserve the right to charge this tax in the non-discrimination article.

Many treaties extend the principle of non-discrimination to all taxes, not just those specifically covered by the treaty.

Article 25: Mutual agreement procedure

7.43 Article 25 of the OECD Model is designed to provide a procedure for resolving difficulties in the application of the treaty. It provides that the competent authorities of each state must attempt to resolve the situation of a taxpayer who is taxed other than in accordance with the provisions of the treaty, for example in relation to the attribution of profits to a permanent establishment, or where the treaty has been misapplied, perhaps in the determination of residence. Instances of double taxation not eliminated by any specific article in the treaty can also be dealt with using the mutual agreement procedure. The mutual agreement procedure is for the protection of the taxpayer and is initiated by the taxpayer.

The procedure is available to taxpayers without interfering with any other remedies available to them under domestic laws. There does not need to be any double taxation in order to invoke the procedure, the only requirement is that the taxation in dispute has been imposed in contravention of the treaty. For example, State A may tax a particular class of income that the Convention allocates rights to tax to State B, although State B may not in fact tax it, for

control over his premises. The only business carried out at the premises of the CCA was therefore that of the CCA, not AIL.

The PGAs fulfilled more operational functions. Other agents reported up to them through the hierarchy, each level of superiority conferring powers of management and supervision with respect to those agents in the lower tiers. The PGA was responsible for determining commission levels, recruitment and training of agents providing the other agents with sales leads. The PGA worked solely for AIL and these functions were performed at the PGAs' own premises. There was an AIL sign at reception and the telephone number was listed under AIL. The PGAs' business cards named AIL as the insurer but made it clear that they were merely agents. The PGA was not allowed to use AIL's name on any leases, equipment purchases or to incur any expenditure in AIL's name. In considering whether the PGAs' premises constituted a fixed place of business from which the business of AIL was carried on, the court noted:

- AIL had no interest in the PGAs' premises; there was no designated space for AIL employees;
- AIL had no legal control over the premises;
- the PGAs' premises were used entirely in the PGAs' operations;
- AIL did not meet any expenses relating to the premises;
- all equipment at the premises was owned or leased by the PGAs;
- no AIL employees worked there;
- AIL did not assume any risk on behalf of the PGAs;
- no detailed instructions for how the PGAs' operations were to be conducted was issued by AIL: the PGA was 'left to his/her own devices';
- the PGAs hired their own staff; and
- the training of lower-tier agents which took place at the PGAs' premises was ultimately for the purpose of increasing the profits of the PGAs and all training expenses were borne by the PGAs.

The judge in *American Income* admitted the evidence of expert witnesses which was given in the *Knights of Columbus* case. Here are a couple of extracts from the *Knights of Columbus* case report:

> 'Mr Vann confirms this reliance on the concept of premises being at the disposal of the enterprise. In his opinion he states:
>
> "The clear separation between the two types of permanent establishments that now exists in the OECD and UN Models requires the drawing of a distinction between a fixed place of business of the enterprise and a fixed place of business of a dependent agent of the enterprise. When the separation occurred, this distinction was drawn in terms of whether the place of business was 'at the disposal' of the

> enterprise .... What is clear is that the fixed place of business has to be that of the enterprise, not that of an agent or an associated enterprise."
>
> Further, in his opinion, after quoting the OECD commentary, Mr Vann clarifies the position as follows:
>
> "From these extracts it is clear that a place of business of a representative of an enterprise cannot be a place of business of the enterprise unless the enterprise itself or through other representatives has access to the fixed place of business in its own right and not simply because it is the place of business of the representative."'[3]

These Canadian decisions can be contrasted with the case of *Norway – Universal Furniture Ind AB v Government of Norway*[4].

In this case, a Swedish company employed a Norwegian sales person. The salesman operated one day per week from his home and spent the rest of the week on the road soliciting orders. The taxpayer company had no ownership rights over the salesman's home and neither did it pay him any expenses for use of his home as an office. The salesman used his home office for planning his itinerary of customer visits, making telephone calls and discussing business issues with his employer. These activities were held to constitute core activities of the taxpayer company (as opposed to being merely preparatory or auxiliary, as discussed below) and the home office was deemed to be a PE of the taxpayer company. The result was that profits arising from the contracts made as a result of the salesman's activities were taxable in Sweden.

The key distinction between this case and the Canadian cases is that the salesman was an employee rather than an agent.

In its October 2011 report the OECD gave further guidance of when the use of home as office might constitute a fixed place of business. Where employees work from home, the OECD considers it unlikely that the employee's home could be considered a fixed place of business through which the business of the employer is partly carried on unless no office accommodation is provided for that employee at the employer's premises in circumstances where the employee could not fulfil his/her role without office facilities. In many cases, the activities carried out from the employees home would be merely auxiliary or preparatory and thus excluded from the definition of a PE (see para **8.7** below).

1 2008 TCC 306 Tax Court of Canada, reported at 11 ITLR 52.
2 2008 TCC 307 Tax Court of Canada, Ottawa, reported at 10 ITLR 827.
3 Above at p 854.
4 Case No 99-00421A Stavanger County Court 19 November 1999.

Fixed place of business – is it 'at the disposal' of the foreign enterprise?

8.8 It is not necessary for the foreign enterprise to legally own or lease the foreign premise. It is quite possible that a fixed place of business for a foreign enterprise could be the premises of a resident enterprise. Once it has

- a dependent agent authorised to conclude contracts on behalf of the firm. Such an agent may or may not be an employee.

Certain activities are specifically excluded from the definition of PE. These include keeping a stock of goods in another state and facilities for the display of goods and any other activities which can be characterised as preparatory or auxiliary. Short-term construction sites (generally less than 12 months) are also excluded. The UN Model extends the definition of a PE beyond that found in the OECD Model. This extension, to the provision of services, is discussed at length in Chapter 9.

The dependent agency PE definition may encompass so-called 'commissionaires': these are often group companies located in relatively high tax states, from which many profit-making functions have been stripped. This is done so that the group can justify the commissionaire making low taxable profits.

Deciding whether a fixed place of business exists is sometimes difficult, as the rules were formulated in an era when most foreign trading activities consisted of having factories or sales outlet abroad. The OECD does not give any definite rule on how long a foreign enterprise must be present for a PE to arise, although most states use a period of six months. The advent of e-commerce and associated digital technologies, have raised concerns about the ability of traditional PE rules and procedures to cope with new technological developments. Much effort has been devoted to deciding if and how the concept of PE should be altered to accommodate e-commerce, the consensus being that traditional rules can be adapted and there is no need for a radical reform.

The OECD now recommends the use of quite sophisticated techniques to establish the allocation of profits to the PE. The profits attributable to the PE should be computed as if it was a separate and economically independent enterprise. This means that 'interest' payments between head office and branch can be calculated in respect of branch capital and that the head office can make charges to the branch for head office common services. More generally, the principles of arm's-length transfer pricing should be adhered to, along with full documentation of intra-enterprise pricing policies. There are many practical problems in adhering to the fiction of the PE as a separate enterprise and the OECD approach is not adopted in the UN Model.

There is a danger that a MNC may find that a host state asserts the presence of a PE where none was intended. This leads to uncertainty for MNCs and even more problems in attributing profits, as no internal records attributing profits to the PE will exist.

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using the UN Model will have a better chance of taxing at least some income from services provided by residents of the treaty partner state: even if the treaty partner will not agree to a services PE provision in Article 5, then because the UN Model retains Article 14, the developing state may be able to put forward a stronger case for having that article included in the new treaty than if its provisions had been subsumed into Article 5 of the UN Model.

Article 14 applies to 'a resident of a Contracting State' and this has caused difficulties in interpretation. Some treaties specify that Article 14 applies to individuals only, or to partnerships as well. In others, the term 'resident' is used and this can be interpreted applying to a partnership or even a company as well as to individuals. Different states have interpreted the Article differently. These kinds of arguments contributed to the OECD's decision to scrap Article 14.

The first test applied in Article 14 is whether or not the non-resident has a 'fixed base' in the other State. The concept of a 'fixed base' is not defined either by the OECD or the UN but is generally accepted as being equivalent to a fixed place of business. Some commentators think that the term denotes a more casual relationship between the service provider and the source state than the idea of a fixed place of business.

It seems likely that states which use the UN Model in their treaty negotiations will continue either to keep Article 14 in their treaties or to incorporate its contents into Article 5.

1 Commentary on Article 5, para 9.

The OECD Model Tax Convention

9.11 The text of the OECD Model has never included any provision for a services PE and, as noted above, Article 14 was deleted in the year 2000. The Commentary to the 2008 version of the OECD Model introduced new discussion of services, including wording for a services PE. This development is thought to have been controversial within the OECD, with some members keen to have such a provision within the Model itself and others firmly opposed. Canada, stung by the decision in *Dudley,* is known to have been in favour of its inclusion[1]. In addition, some countries with strong dependencies in their domestic tax laws and treaty practices on services PEs have accepted observer status on the Committee on Fiscal Affairs within the OECD, which deals with tax treaty matters. In the period leading up to the 2008 update, Chile, India, China, Russia and South Africa had such status. India attained this status in 2006. These observer countries, in practice, are able to exert considerable pressure on the OECD.

The optional Article 5 provision provided by the OECD reads:

> 'Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State:

> (a) through an individual who is present in that other state for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50% of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other state through that individual, or for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other state
>
> (b) the activities carried on in that other state in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other state, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.'[2]

The two tests set out in the Article are sometimes known as the 'key worker' and the 'large project' tests. Besides these tests which limit the right of the source state to assert the existence of a PE, the basic principles embodied in the provision are that:

1 For the source state to assert taxing rights, the services must be performed in that state; it is not enough that an enterprise happens to have a deemed services PE in that state. The location of the customer is irrelevant, such that even if the customer is in the state which wishes to assert the existence of a services PE, that state can only do so if the services are performed within its jurisdiction[3].

2 By deeming a PE to exist, the source state is only permitted to tax the profits arising under Article 7 and hence on the net basis. Thus, final withholding taxes on payments for services will not be permitted where a treaty between the states includes the services PE provision. If withholding taxes are used, they must be refundable to the extent that they exceed the tax due under Article 7 principles. Failure to refund would give the service provider the right to invoke the non-discrimination article.

The two tests broadly equate to the provisions for the source state taxation of enterprise services contained in the UN Model.

Where a PE arises due to a 'key worker', the individual concerned may be regarded as liable to taxation on his employment income in the source state under the employment article in the relevant treaty if present there for more than 183 days. The employer would be taxed on the net profits from the

The PepsiCo Puerto Rico case

10.28 In *PepsiCo Puerto Rico Inc*[1] hybrid instruments referred to as 'advance arrangements' were entered into between a Dutch subsidiary and a US group company, with the intention that they should be treated as debt in the Netherlands and as equity in the US, which would give rise to a tax advantage for the group. Whilst the facts are complex, the case is notable because the Court considered 13 separate indicia in its attempt to determine whether, for US tax purposes, the instruments were debt or equity. These are summarised below. The material in italics did not form part of the case report but is intended to give a general idea of which way the various factors might point:

- the name given to the instruments;
- the presence or otherwise of a fixed maturity date and the term of the instrument *(short term with a fixed maturity date indicates debt)*;
- the source of the payments: were they out of profits or out of cash flow? *(if only out of cash flow, ie when funds available, suggests equity)*;
- the extent and nature of rights to enforce payments, the creditor safeguards and subordination of repayments *(extensive rights, safeguards and lack of subordination indicates debt)*;
- the participation in the management of the issuing company *(participation indicates equity)*;
- was the 'lender' under any obligation to ensure that the issuing company could fulfil its obligations to its regular corporate creditors? *(such obligation indicates debt)*;
- the intentions of the parties as to the characterisation of the instruments in each of the countries;
- were the amounts 'lent' by the shareholders in proportion to their shareholdings? *('lending' in proportion to existing shareholdings indicates equity)*;
- the debt/equity ratio of the issuing company *(a very high debt to equity ratio would indicate equity)*;
- would a third party lender have loaned funds in the same amounts on the same terms as the instruments in question? *(if no, indicates equity)*;
- the use to which the funds were put *(if funds not spent on capital investment, may indicate debt)*;
- the consequences of failure to repay *(if legal consequences ensue, indicates debt)*;
- the acceptance of risk by the 'lender' *(acceptance of risk indicates equity)*.

1 *PepsiCo Puerto Rico Inc v Commissioner of Internal Revenue* (2012) 15 ITLR 264.

Tax arbitrage using hybrid entities

10.29 There are many types of hybrid entity, including:

- Silent partnerships: a silent partner does not participate in the activities of the partnership but merely provides capital. They are popular in Germany, where they are known as 'Stille Gesellschaften'. The income is treated as investment income rather than trading income. The return is often treated as akin to interest rather than a share in the trading profits of the partnership.
- Limited partnerships, where the partner has no responsibility for the debts of the partnership beyond his investment. This differs from the normal joint and several nature of partnership liabilities. Again, common in Germany where it is known as the 'Kommanditgesellschaft'.
- Atypical silent partnerships: these have features of both the typical silent partnership and the limited partnership, but the partner is involved in the management of the enterprise and often commands a premium rate of return on his investment.

Examples of arbitrage using hybrid entities

Double deduction for tax losses

10.30 These schemes often revolve around the double use of a deduction for interest which has generated a tax loss. They take advantage of the fact that most countries permit companies within their country which are in the same corporate group to pool tax profits and tax losses.

Before arbitrage activity (see Figure 10.5):

Company A, resident in Inistania owns all the share capital of Company B, resident in Ruritania. There are other, profitable, group companies in both Ruritania and Inistania. Company B has a requirement for an injection of capital. Without any tax planning, this could be achieved by Company B borrowing from a local bank, or by Company A either making a loan or subscribing for additional share capital. However, the group forms a hybrid entity, Entity X. Entity X could take many forms, but in this example, we

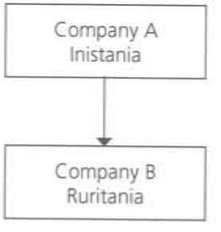

Figure 10.5

- all or substantially all of the activities that those companies undertake throughout a period of account consist of treasury activities undertaken for the worldwide group of which they form part; and
- all or substantially all of the assets and liabilities of the companies relate to such activities.

The treasury company may elect for exemption under s 316(2). The result is that its transactions are excluded from the group's total of tested expense and tested income amounts, although they are still taken in to account for the gateway test and if the treasury company has external borrowings, these will be included in the worldwide group's 'available amount'. If there is more than one UK group treasury company, they must each pass this or none of them can be exempt[2].

Treasury activities are specially defined for debt cap purposes in s 316(9) as:

- managing deposits of surplus cash or overdrafts;
- making or receiving deposits of money;
- lending money;
- subscribing for/holding shares in another company which is a UK group company and a group treasury company;
- investing in debt securities (per the FSA Handbook);
- hedging assets, liabilities, income or expenses.

Whether or not the exemption is attractive depends on the trade-off between the amount of tested income that could be taken out of tax via the debt cap (because most treasury companies are set up so as to make a profit, made up essentially of an excess of finance income over finance expenses) and the costs involved in complying with the debt cap rules. If a treasury company applies for exemption it cannot benefit from the exemption for net financial income.

If there is more than one treasury company, any election must cover all of them, otherwise none of them can be exempt. Election is to be made within three years of the end of the relevant period. The Finance Act 2012 removed the requirement that each treasury company in the group must give its consent to the election.

1 Finance Act 2013, s 44.
2 Per June 2010 Budget Announcement. Under FA 2009, the 90% applied to the total income of any company carrying out treasury facilities, however minor, so that hardly any treasury companies would have qualified for exemption.

Short-term finance – TIOPA 2010, ss 319–321

10.59 The exemption applies to short-term internal financing and is subject to a number of conditions.

Both parties to the transaction must elect for exemption (so that if the expense is allowed, the related income is definitely taxable). The time limit is the usual

36 months from the end of the worldwide group's period of account. There are two conditions to be met:

- Both parties to the loan relationship in question are members of the same worldwide group.
- The financing arrangement must be a short-term loan relationship within the worldwide group. Short term is defined as a money debt or other loan relationship that either contractually exists for less than 12 months or in actual fact is in existence for no more than 12 months. Regulations[1] are in force which seek to prevent long-term financing arrangements being dressed up as short term – the exemption will not apply where the finance arrangement can be settled either using borrowings (rather than cash), or if it is settled on a temporary basis only by using funds which are available to the debtor of only a limited time. There is an anti-avoidance provision to prevent a long-term financing arrangement being dressed up as a series of short-term ones. Such long-term aggregated finance arrangements are not exempt.

1 The Corporation Tax (Exclusion from Short-Term Loan Relationship) Regulations. 2009 (SI 2009/3313).

Exemption from taxation on finance income from EEA group companies

10.60 To ensure compliance with the EU Treaty, the debt cap provisions provide that certain amounts of income received from a group company resident in an EEA country are not taxable. The payment must be received from a company which is a member of the same worldwide group from a payer who is the parent, or a 75% subsidiary, or a fellow 75% subsidiary of the same parent as the recipient. The payer must be liable to tax in the EEA country of residence on profit, income or gains. This is loosely defined; it appears that local taxation or property taxes could suffice. Finally, the payer must not be able to obtain tax relief for the amount paid either in the current, past or future periods. Importantly, the payer must have taken all possible steps to try to obtain relief.

The types of income covered are those covered by the debt cap provisions.

Stranded deficits in non-trading loan relationships

10.61 Where funds are borrowed in order to finance, say, a foreign subsidiary, those funds have not been borrowed to finance the trade of the borrower. They are thus termed 'non-trading'. If there is sufficient income and gains in the year the interest is paid (from any source) then the interest can be offset. However, if there is insufficient income and gains, then the excess interest can be carried back for a limited period or carried forward without time limit. Excess interest carried forward in this way is known as a non-trading deficit on loan relationships. It can only be offset in future periods against a surplus on loan relationships, in simple terms when there is an excess of interest receivable over interest payable.

Whether Konganga will grant a reciprocal reduction of $2,400,000 in profits to be taxed there depends on the wording of any double tax treaty between the two countries. This is discussed further later in the chapter.

A VERY BRIEF HISTORY OF TRANSFER PRICING LEGISLATION

12.5 In 1928 the US Congress granted the Internal Revenue Service (IRS) the power to adjust the accounts of related companies. Here is a famous quote from that time:

> 'subsidiary corporations, particularly foreign subsidiaries are employed to "milk" the parent corporation or otherwise improperly manipulate the financial accounts of the parent company'[1].

There was no requirement for consolidated accounts, but the IRS was given the power to adjust the accounts of individual companies. The League of Nations (the predecessor of the OECD) introduced in its 1935 Model Tax Treaty a requirement for the arm's-length method. As a fallback where arm's-length profits were difficult to determine, permitted profits were to be determined within groups of companies on the 'percentage of turnover' method. This alternative method forms the basis of *unitary taxation*, which is the major alternative to the arm's-length principle. This method is widely used in the US and Canada to allocate the taxable profits of a company or group of companies for the purposes of state/provincial (local) taxation. This method is also referred to as global formulary apportionment. For an interesting history of the development of the arm's-length principle in the US, see Avi Yonah (1995).

In the UK temporary provisions were introduced during the First World War to prevent the avoidance of high wartime taxes by foreign companies trading in the UK. The problem was not properly addressed until in 1945 the League of Nations' Model Treaty was adopted as the basis for the agreement of bilateral treaties. To deal with enforcement of Article 9, the UK introduced transfer pricing provisions in the Finance Act 1951. These were updated in the Finance Act 1999[2] to more closely reflect the provisions of Article 9 and to take account of the growing variety and sophistication of transactions taking place within multinational groups. The UK also wanted its domestic legislation to follow Article 9 more closely as this makes it easier to resolve disputes. See the 'Further study' section at the end of this Chapter for more detail about the UK transfer pricing provisions.

In the 1950s and 1960s the growth of the international tax-planning industry led to the introduction in the US of the s 482 Regulations in 1968.

> '*Section 482: Allocation of income and deductions among taxpayers*
>
> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that

> such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.'

The primary pricing test adopted was the Comparable Uncontrolled Price (CUP, see below). Relevant circumstances accounting for differences between actual prices and open market prices may be taken into account. The legislation contains the 'safe harbour' concept: for loans, services and leasing. This means that if firms stay within set limits, they can expect their policies to escape attack under s 482. Like most US legislation, s 482 is accompanied by copious detailed regulations[3], which were substantially updated in 1994 to cover the transfer pricing of intangibles and the sharing of costs.

1 Report 350 67th Congress 1st Session p 14, cited in Picciotto (1992), p 174.
2 Taxation (International and Other Provisions) Act 2010, s 147.
3 Available at http://www.irs.gov/pub/irs-apa/482_regs.pdf.

THE ROLE OF THE OECD

12.6 In 1979, the OECD issued a landmark report 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'. The OECD firmly rejected global methods of profit allocation or the use of predetermined formulae to allocate the profits of multinationals between the various host countries in which they operate.

In 1994 the OECD Guidelines were reissued, reconfirming opposition to global formulary methods: 'the global formulary apportionment approach would not be acceptable in theory, implementation or practice'. New chapters were added dealing with transfer pricing of intangibles and cost-sharing agreements (see below). A further revised set of guidelines was issued on 22 July 2010.

However, it should be noted that some commentators continue to prefer the US legislation to the OECD Guidelines, believing it to be superior in terms of the certainty that it affords to multinational groups. The US has always taken responsibility for developing its own rules rather than relying on the OECD Guidelines and the regulations accompanying s 482 of the Internal Revenue Code are a good deal more detailed than the OECD material. This higher level of detail is often preferred by taxpayers and tax administrations alike as it allegedly provides a higher level of certainty. A common criticism of the OECD materials is that they are too general.

RECOMMENDATIONS IN THE OECD GUIDELINES

12.7 The OECD has historically recommended the use of transactions-based methods, rather than any method of allocating the profits of multinational groups to different countries. The methods recommended by the OECD are:

> the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.'

Few double tax treaties deal with the position regarding 'secondary adjustments'. If one state makes an upwards adjustment of taxable profits and the other makes an exactly equal corresponding downwards adjustment, then the tax revenues of the two states might still be different to what they would have been had arm's-length pricing been applied in the first place. This is because higher profits in the state where the upwards adjustment took place might well have given rise to higher dividends or interest payments, on which withholding taxes might have been chargeable. So even though the state making the upwards adjustment has retrieved the tax deficit on the enterprise resident there, it has still not retrieved any deficit in withholding taxes. Whether it makes a secondary upwards adjustment to make good this deficit in withholding tax receipts depends on whether this is provided for in domestic law. If it does so, then double taxation will result which will not necessarily be relieved by the normal treaty article on elimination of double taxation and it may be necessary to invoke the mutual agreement procedure.

The XYZ Group can use two main tools to try to have the Inistanian and Ruritanian tax authorities reach an agreement as to the amount of the adjustment:

- the Mutual Agreement Article of the double tax treaty; or
- assuming Inistania and Ruritania were Member States of the EU, the EU Arbitration Convention.

These will now be considered in turn below.

The Mutual Agreement Procedure (MAP)

12.39 Article 25 of the OECD Model Tax Treaty reads:

> 'Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.'

Using our example, the fact that Company A is being taxed by Inistania on $1 million of profits that are also still being taxed by Ruritania (on Company B) means that there is double taxation of profits. That is not in accordance with the provisions of the treaty (the Convention). Assuming that the Inistania–Ruritania double tax treaty has a provision similar to Article 25 of the OECD Model, Company A can present its case to the Inistanian tax authority and require it to try to reach a mutual agreement with the Inistanian tax authority as to what represents an arm's-length price and therefore have a reciprocal downwards adjustment by Inistania which properly reflects the upwards adjustment made by Inistania.

Company A has three years to present its case. The three years would normally run from the date that a 'reasonably prudent person' would have realised he was being subjected to double taxation. In this case, it would probably be the date when it became apparent that Ruritania was not prepared to make a downwards adjustment as large as the upwards adjustment required by Inistania. It would not matter if time limits for appealing the relevant tax assessment under Inistanian law had already passed. Once Company A has invoked the mutual agreement procedure, the Inistanian tax authority has to contact the Ruritanian tax authority with a view to coming to an agreement as to the proper arm's-length price.

Weaknesses of the mutual agreement procedure

12.40 The tax authorities do not have to involve the taxpayer in their deliberations. In a transfer pricing dispute, the primary source of information on pricing policies and decisions will be the company itself. The company's knowledge of its markets and products will naturally be far more in-depth than that of the tax authorities. By not including the taxpayer in the MAP, the quality of decisions reached may be poor, as decisions may be based on incomplete information or inadequate understanding. When requesting a MAP, the taxpayer needs to co-operate fully with the tax authorities and make available all pertinent information, even though this may assist the tax authorities in future attacks on transfer pricing, either of the firm requesting the MAP or of its competitors. Although, in theory, information supplied to the tax authorities in the course of a MAP is confidential, in practice it would be unwise to assume that the tax authority will not make use of the information at some time in the future.

The MAP provision in the Inistania–Ruritania double tax treaty may simply require that the two tax authorities 'shall endeavour to resolve' the problem. If they cannot come to an agreement, then the double taxation may remain. Since 2008, the OECD Model Tax Treaty introduced a taxpayer's right to demand binding arbitration, should the two tax authorities not be able to reach satisfactory agreement. Depending on its age and the positions taken by the two countries on the subject, the Inistania–Ruritania treaty may well not include this provision for arbitration. The introduction of a provision for the two contracting states to submit to binding arbitration in the 2008 update to the OECD Model Tax Treaty was intended to speed up the time taken to get a result under

RATIONALE FOR THE USE OF TAX HAVENS

14.2 A multinational company (MNC) setting up abroad using a 100% owned subsidiary has considerable influence over the amount of profits declared by that subsidiary: transfer prices, royalties and interest charged, and management charges can all be manipulated to some extent without causing the subsidiary to be considered tax resident in the parent company's country.

Generally, an MNC will aim to minimise the worldwide tax burden of the group by:

- seeking to minimise taxable income arising in high-tax jurisdictions;
- preventing or delaying earnings and/or investment income from entering high-tax jurisdictions by 'parking' them in a very low-tax country until needed elsewhere within the group; and
- siting operations (especially financial operations) in low-tax countries wherever possible to reduce the MNC's average tax rate on its worldwide profits.

The result is that the 'foreign tax credit' mechanism is no longer efficient as a means of ensuring equity between the taxation of earnings abroad and at home. If profits are now repatriated from low-tax countries then MNCs have a tax advantage over firms operating solely in the domestic market. Put another way, firms may bear low tax rates abroad, but never bring the money back to their home (and high tax) countries. The result is that overseas investment is financed mainly out of retained earnings or foreign borrowings as the MNC recycles the foreign profits outside its home country.

Tax havens are used mainly to shelter portfolio income and gains as opposed to profits and gains from foreign direct investment. This is mainly because portfolio income is more mobile and because most tax havens do not have the infrastructure to support or attract foreign direct investment such as manufacturing plants. The factors influencing the location decisions of firms were briefly considered in Chapter 2.

What is a tax haven?

14.3 When asked to identify tax havens, most people automatically think of small islands, possibly in the Caribbean. However, whilst many Caribbean islands do operate to some extent as tax havens, we must examine the properties of tax havens to make a more considered judgement. We should note that by acting as a tax haven, in whatever shape or form, a country is competing for business. Countries use their tax systems to attract business and particularly to attract mobile capital. In some cases tax havens charge hardly any tax, in others they charge a rate which they judge to be lower than that charged by competitor countries.

Countries generally recognised as tax havens often prefer to be described as offshore financial centres. The term 'offshore' has a particular meaning in this

context and usually means any shifting of funds out of the country of taxpayer residence for tax planning or tax evasion purposes. The distinction between a tax haven and an offshore financial centre can be difficult but it is probably true to say that whilst all tax havens are offshore financial centres, not all offshore financial centres are tax havens. For instance, London is an important offshore financial centre but one would not normally think of the UK as a tax haven. Offshore financial centres are jurisdictions in which transactions with non-residents far outweigh transactions related to the domestic economy (Dixon 2001). They have some or all of the following attractions: favourable tax regime, favourable legal environment, and a favourable regulatory system. Although the tax system will inevitably play some part in their popularity, those offshore financial centres which are not primarily tax havens use these other attractions to bring in business. For instance, a favourable legal environment may permit MNCs to adopt new financial products quickly and flexibly.

The Gordon Report, prepared for the US Treasury in 1981, listed certain characteristics of a tax haven:

- Low or nil tax on some or all types of income and capital.
- Secrecy: banking and/or commercial. This provides opportunities not only for tax avoidance but for tax evasion.
- Absence of exchange controls.
- Provision of offshore banking facilities.
- Good communication facilities.
- Political stability: offshore investors in Panama had a nasty shock in 1988 where there was a crisis involving the president being indicted of narcotics offences. This prompted sanctions by the US government and, eventually, invasion.
- Opportunity for multilateral tax planning.
- Favourable disposition to foreign capital.
- Availability of professional advisers.
- Handy location, decent climate for communications and to attract staff. (Hence the traditional attraction of the Caribbean for US taxpayers.)

In addition, freedom from excessive regulation is an important factor, particularly for the offshore insurance sector. Jersey is well known for this type of business. On a general definition, Gordon had this to say:

> 'The term "tax haven" has been loosely defined to include any country having a low or zero rate of tax on all or certain categories of income, and offering a certain level of banking or commercial secrecy … The term "tax haven" may also be defined by a "smell" or reputation test: a country is a tax haven if it looks like one and if it is considered to be one by those who care.'

A recent study (Dharmapala and Hines 2009) indicates that tax havens actually tend to have stronger governance institutions than comparable non-haven coun-

US with details of accounts held with them by US residents. If the financial intermediaries fail to supply the right information at the right time, in the right format and n the right amount of detail, they face a heavy penalty. This penalty is that the US will impose a 30% withholding tax on any payments made to the foreign financial intermediary from the US, whether income, or the proceeds of sales of US securities. If the withholding tax were to be used, this could put the financial intermediaries out of business, damaging the economies of the countries in which they are resident.

So concerned are governments of countries where the financial intermediaries are resident there, that they have negotiated with the US to agree upon how their financial intermediaries will comply with FATCA. France, Germany, Italy, Spain and the UK have negotiated with the US to produce so-called 'inter-governmental agreements' (IGAs) under which the financial institutions will report their FATCA information to their own tax authorities, who in turn will relay it to the US. These are known as 'Model 1 IGAs'. Japan and Switzerland have negotiated slightly different arrangements, under which their financial institutions would report directly to the US: Model 2 IGAs. Many more countries are expected to negotiate IGAs with the US. There are reciprocal and non-reciprocal versions of Model 1, meaning that, in theory, a country such as the UK, could place equivalent demands on US financial intermediaries as the US is placing on UK financial intermediaries. Rather than present the signing of the IGA with the US as capitulating to US extra-territorial tax practices, HMRC has presented it as a groundbreaking move, forming part of a new standard in international tax transparency (HMRC 2013).

In brief, the main type of information to be provided to the US tax authority, starting in January 2014, is:

- the name, address and tax identification number of the account holder;
- the account number;
- the account balance or value;
- payments made during the year with respect to the account. This includes the aggregate gross amount paid or credited to the account with respect to:
  - dividends;
  - interest;
  - the sale or redemption of property;
- transfers and closings of deposit, custodial, insurance, annuity financial accounts.

If foreign intermediaries operated in a corporate group, all group members who are financial intermediaries must register under FATCA[1].

As well as reporting to the US on specific customer accounts, financial intermediaries are expected to carry out due diligence procedures to find out which of their customers might be US taxpayers. Technically, they are required to determine whether an account holder has 'US indicia'. Such indicia would be

a US place of birth, per the person's passport, or a US mailing address or US telephone number. There might be a standing instruction to transfer funds to a US account. If the signs are that an account holder has a US connection, then the financial intermediary must take further steps to check this. If it turns out that the account holder probably is a US tax resident, then the account holder must be formally asked for his US tax identification number (TIN) and for a waiver of the account holder's rights under any financial secrecy laws which might otherwise apply. If the account holder refuses, then the financial intermediary must report the account holder as a recalcitrant account holder. In this case, the financial intermediary will be expected to apply 30% withholding on payments to the account holder on behalf of the US.

Several commentators have expressed concern over the potentially significant compliance costs associated with FATCA[2]. Christians (2013) has expressed concern about the legal efficacy of IGAs, which raises questions about enforcement. The big question is whether or not other countries will follow the lead of the US and also adopt their own FATCA-style legislation. For instance, the UK is planning to impose similar rules on the Isle of Man, Jersey and Guernsey.

1 See de Clermont-Tonnerre, J and Ruchelman, S (2013) 'A Layman's Guide to FATCA Due Diligence and Reporting Obligations', 42 Tax Management International Journal 75, available at http://www.ruchelaw.com/pdfs/A%20Laymans%20Guide%20to%20FATCA%20Due%20Diligence%20and%20Reporting%20Obligations.pdf

2 See for example Coder (2013).

The push towards automatic exchange of information

16.16 FATCA represents a unilaterally imposed system of automatic supply of information for tax purposes, although not necessarily an exchange. It is a far more powerful system than anything devised to date by the OECD, because it is coercive rather than voluntary. The penalty for non-compliance with FATCA is clear: the 30% withholding tax. In addition, it is clear exactly which taxpayers will suffer the penalty: the non-compliant financial intermediary. In contrast, it is not clear exactly what 'bad things' might happen to a country which does not get around to complying with the OECD's initiatives, eg by not responding to criticisms made in a Peer Review or by signing the Mutual Assistance Convention but not getting around to ratifying it. Penalties for non-compliance with the OECD initiatives are indirect, in that a country's reputation may be damaged which might, in turn, lead to a decline in the business prospects for some of its residents.

The drawbacks of the current agreements for information exchange, be they in the form of double tax treaties containing a full Article 26 (Exchange of Information) or a TIEA, are that these methods of information exchange depend on requests being made. As we have just seen, requests can only be made when the requesting country has already established grounds to suspect one of its residents of tax evasion. Along with the G20 Finance Ministers, the OECD is now pursuing the implementation of a standardised model of Automatic exchange of information. Under this system, rather than waiting