THE CHARTERED INSTITUTE OF TAXATION

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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PAPER I

PRINCIPLES OF INTERNATIONAL TAXATION

Answers

Question 1:

This question is based on the premise that bilateral double taxation conventions may be dispensed with. In other words, that such conventions are not necessary in order to resolve the international tax problems that normally fall within their remit. However, this premise works on the assumption that it is possible to ascertain why such conventions exist and what they are intended to do. Therefore, it is expected that, initially, answers to this question will focus on the following purposes that, usually, double taxation conventions are stated, expressly, to serve:

- to eliminate double taxation
- to allocate the jurisdiction to tax between the contracting states
- to facilitate international trade and investment
- to counteract tax avoidance and tax evasion

Each of these purposes requires detailed examination with emphasis placed in each instance (bearing in mind the thrust of the question) on the various ways in which these purposes may or may not be achieved. This aspect of the question will provide some latitude for the candidates, but any discussion should be not overly descriptive and be conducted in a manner that provides a foundation for the latter part of the question that requires consideration of viable alternatives to bilateral double taxation conventions.

Such alternatives might include the following:

- the grant of unilateral relief (where appropriate)
- multilateral tax conventions
- dealing with taxation through multilateral trade and investment treaties
- the harmonisation of tax laws
- the introduction of a universal model tax law.

In the context of alternatives, credit may also be given to candidates who may regard bilateral double taxation conventions as essential and suggest means by which they may be improved in order to fulfil their purposes.

Question 2:

This question requires commentary upon the OECD 's approach to harmful tax competition/harmful tax practices since the publication of its report entitled "Harmful Tax Competition - An Emerging Global Issue" in 1998. The starting point must, therefore, be to identify and examine the major themes of this report, and then to trace important subsequent developments. In this latter respect, particular attention should be given to the series of later reports, namely, "Towards Global Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices" (2000), "The OECD's Project on Harmful Tax Practices: The 2001 Report", and "The OECD's Project on Harmful Tax Practices: The 2004 Report" (with emphasis, perhaps, on the latter which contains the OECD's most recent pronouncement on the progress that, in its opinion, has been made). Thereafter, an assessment may be made as to whether the OECD in developing its approach to harmful tax competition/harmful tax practices has succeeded (as stated in the quotation) in encouraging an environment in which fair competition can take place and where there is `a level playing field among all countries and jurisdictions'.

It is anticipated, therefore, that answers will normally comprise three sections - the 1998 Report, important subsequent developments and the assessment of whether the OECD has achieved the above objectives. These sections might include the following:

(a) The 1998 Report

- the reason(s) for the initiative
- the distinction between tax havens and harmful preferential tax regimes, and the factors used to identify each of them
- the recommendations made in the Report with a view to counteracting harmful tax competition and harmful tax practices
- the proposal to set up a Forum on Harmful Tax Practices.

(b) Important subsequent developments

- the work of the Forum on Harmful Tax Practices
- publication of a list of jurisdictions characterised as tax havens
- advance and scheduled commitments by jurisdictions
- the Model Agreement on Exchange of Information on Tax Matters
- the establishment of the Joint Ad Hoc Group on Accounts
- the identification of possible defensive measures and their co-ordination

(c) Achievement of objectives

- increased dialogue and co-operation between jurisdictions
- implementation of "rollback" and "standstill" provisions
- greater transparency and effective exchange of information, see the Model Agreement
- recognition of the efficacy of co-ordinated defensive measures.

Note: candidates are not expected to consider parallel developments in the EU, but credit may be given where this has been done.

Question 3:

This question requires examination of the circumstances in which it may be possible for a state to tax the profits of an enterprise engaged in cross-border e-commerce transactions on the basis that through such activities it has established a permanent establishment in that state within the meaning of Article 5 of the OECD Model Tax Convention on Income and Capital.

Initial and in-depth consideration should be given to the ways in which a permanent establishment may be established under Article 5 i.e. through satisfaction of either the "business activity" test (paragraphs 1-4) or the creation of an agency permanent establishment (paragraphs 5-7). Thereafter, the propensity of all or any of the following to constitute a permanent establishment should be examined:

- a web site
- a server
- an independent service provider

Such examination should be conducted in the light of relevant literature. Particular reference should be made to the views expressed in recent years by the OECD about the taxation of the profits of e-commerce. In this regard, attention might be given to the Technical Advisory Group Discussion paper entitled "Are the current Treaty rules for taxing business profits appropriate for e-commerce" (2003), and the amendment to the wording of the Commentary to Article 5.

Credit may also be given to candidates who refer to the position adopted by states in relation to the taxation of profits derived from e-commerce e.g. the USA.

Question 4:

Initial consideration may be given to the circumstances in which double taxation may arise. Thereafter, the question requires a critical analysis of the three specified methods by which double taxation relief may be provided and the respective shortcomings of those methods.

(a) Deduction method

- residents taxed on worldwide income and allowed a deduction for foreign taxes paid
- foreign taxes are thereby treated as an expense of doing business or earning income in another jurisdiction
- usually used in circumstances where credit not available for foreign tax
- not sanctioned by OECD Model Tax Convention on Income and on Capital or by the UN Model Treaty
- can lead to unequal treatment of residents
- not neutral in relation to allocation of resources between states.

(b) Exemption method

- residents taxed on domestic income but exempt from domestic tax on foreign income
- jurisdiction to tax lies with state of source
- usually limited to certain types of income e.g. business income
- operation of "exemption with progression"
- sanctioned by OECD and the UN (Article 23A of the Model Treaties)
- in its pure form, simple to administer and effective
- objectionable on grounds of fairness and economic efficiency
- encourages investment in states with low tax rates
- deficiencies may be countered by partial exemption.

(c) Credit method

- foreign taxes paid by resident on foreign income reduce domestic tax payable by amount of foreign tax
- limitations imposed to counter inappropriate use of foreign tax credits
- sanctioned by OECD and UN (Article 23B of the Model Treaties)
- residents treated equally from perspective of the total domestic and foreign tax burden
- neutral as to decision to invest domestically or in another jurisdiction
- tax credit system may be complex with associated administrative and compliance burdens
- "indirect" foreign tax credits.

Credit may be given where reference is made to the use of these methods by states.

Question 5:

1) Zodiac Ltd. should be advised that the arm's length principle will govern any adjustments that may be made, and that this principle is set out in Article 9 paragraph 1 of the double taxation conventions between the respective states. It requires that the result of the transactions between the members of the groups should be similar to the result of transactions that would have taken place between unrelated parties in similar circumstances. Consideration should also be given to:

   - the meaning and operation of Article 9 paragraph 2
   - pertinent aspects of the OECD Transfer Pricing Guidelines
   - the possibility of economic double taxation.

2) Zodiac Ltd. should be informed that the methods used to give effect to the arm's length principle are transaction-based and profit-based. The OECD has expressed a preference for the former (see the Transfer Pricing Guidelines), which comprise the comparable uncontrolled price, resale price and cost plus methods (each should be considered and explained). The "approved" profit-based methods i.e. the profit-split and transactional net margin methods should also be examined and explained. Reference may also be made to the comparable profit method, and to the differentiation between the profit-based methods and a division of profits based on formula apportionment.

3) Zodiac Ltd should be advised as to the possible tax consequences of any adjustment i.e. economic double taxation, and should be referred to the mutual agreement procedure in Article 25 of the double taxation conventions. An explanation of this procedure should be provided and attention drawn to its shortcomings e.g. it only involves the contracting states (so no taxpayer participation), no independent/impartial involvement and no time limit for resolution. Further, on the assumption that the states are members of the EU, consideration should be given to the possibility of invoking the EU Arbitration Convention.

Question 6:

Principally, this question requires a candidate to exhibit an awareness and understanding of the increasing significance attached by states to the provision of mutual assistance in relation to the assessment and/or recovery of taxes and the important role that the exchange of information plays in these contexts. In relation to the exchange of information between states, detailed consideration should be given to the following fundamental issues:

- the legal authority for the exchange of information
- the nature of the information that may be disclosed
- the manner in which such information may be disclosed
- the purpose(s) for which the information may be used
- restrictions on the disclosure of information.

It is expected that most candidates will concentrate on the exchange of information provisions contained in Article 26 of the OECD Model Tax Convention on Income and on Capital. If this is so, any discussion of this Article should encompass consideration of the amendments made in 2004 to the text of this Article and the Commentary thereon. Reference should also be made in relation to EU member states to the Directive on Mutual Assistance (for the Exchange of information), and to the OECD's Model Agreement on Exchange of Information on Tax Matters (2002). Unilateral provision of information should also be discussed.

Credit will also be given to candidates who examine the pertinence of the exchange of information to the process by which states lend assistance to each other in the recovery of taxes under Article 27 of the OECD Model Tax Convention on Income and on Capital or under the EU Mutual Assistance for the Recovery of Tax Claims Directive.

Question 7:

This question requires an initial examination of the dual nature of double taxation conventions, which includes consideration of the legal status of double taxation conventions as a matter of international law, of the obligations to which they give rise, and of the methods by which they may be incorporated into domestic law. Thereafter, attention should be given to the following issues:

- the meaning of interpretation
- the reasons for the apparent dichotomy between the rules of interpretation for treaties/conventions and the approaches applied to the interpretation of domestic (fiscal) legislation
- the meaning and application of Articles 31-33 of the Vienna Convention on the Law of Treaties
- the role of the Commentaries to the OECD Model Convention as an aid to interpretation
- the approach of different jurisdictions (especially the UK) to the interpretation of double taxation conventions.

Answers should contain an assessment of how courts might (should?) proceed with regard to the interpretation of double taxation conventions.

Marking Schedule

10% will be allocated for presentation, clarity and coherence, writing style.

70% will be allocated for coverage of the main substantive issues.

20% will be allocated for originality and perception, the overall quality of the answer, any additional issues covered, demonstration of understanding of the subject and awareness of current trends and developments.

In order to pass, a candidate should exhibit the following:

- Identification and appreciation of the main issues in the question
- reasonable understanding and knowledge of those issues
- knowledge of current trends and developments
- Clear presentation of the issues raised by the question
- Appropriate advice where this is required by the question
- Answers to four questions

It is essential that a degree of flexibility is built into the marking schedule bearing in mind that candidates may adopt varying approaches in answering the same question. Such diversity of approach may be particularly evident in those questions that prompt a discursive approach and encourage debate e.g. the question concerned with the OECD and harmful tax competition/harmful tax practices. Markers must be given sufficient discretion to determine whether in any given case the approach adopted and/or the content of an answer provided by a candidate is or is not appropriate.

Time management by candidates is important. However markers should not be precluded, where it would appear that a candidate has been hampered by time constraints, from marking answers presented in note form.