THE TAXATION INSTITUTE OF HONG KONG

CTA QUALIFYING EXAMINATION PILOT PAPER

PAPER 3 – INTERNATIONAL TAX

NOTE

This Examination paper will contain SIX questions and candidates are expected to answers any FOUR of them. This represents a change from what appears in the Syllabus contained in the Handbook "Certified Tax Adviser (CTA) Qualifying Examination", which requires candidates to answer five out of seven questions.

QUESTIONS

This examination paper contains SIX questions and candidates are expected to answer any FOUR of these questions. Each question answered (up to the maximum of four) carries 25 marks. The maximum score for this paper is 100 marks.

Question 1 (25 marks)

A Hong Kong resident construction company, BuildCo, has been engaged to undertake two construction projects in Thailand. The first project will run from 1 October 2010 until 28 February 2011 (i.e. 5 months). The second project will run from 1 April 2011 until 31 July 2011 (4 months). These are the only projects undertaken by BuildCo in Thailand and BuildCo maintains no presence in Thailand other than offices located on site at the projects.

(a) Analyse and conclude whether, and if so to what extent, Thailand will be permitted to impose tax on the profits of BuildCo pursuant to the Double Taxation Agreement entered into between Hong Kong and Thailand. Advise whether there may be any other factual matters which would impact your conclusions.

(b) Would your conclusion in (a) above be different if the second project ran from 28 February 2011 until 30 June 2011? Explain your answer.

(c) Assuming the original facts, would your conclusion in (a) above be any different if BuildCo maintained a small office in Thailand to undertake market research, seek further business opportunities and supervise the projects being undertaken? Explain your answer.

Question 2 (25 marks)

Acme Paper Company Limited (APC) is a resident of Country A where it manufactures and distributes a range of specialised stationery products.

APC employs a senior marketing person, Mrs. J, in Country B. Mrs. J rents warehouse space where she maintains a small stock of goods. She markets the products to customers in Country B and occasionally fulfils orders from her small stock. If she receives non-urgent or large orders, she emails the order to APC in Country A which will then arrange for the filling and shipment of orders.

Assume that there was a current Double Taxation Agreement (DTA) in place between Country A and Country B which followed the OECD Model DTA.

(a) Would APC likely be considered to have a permanent establishment in Country B? Explain your reasoning and any assumptions you have made.

(b) Would it make any difference if Mrs. J rented the warehouse in her own name or in the name of APC? Explain.

(c) Would it make a difference if, when processing customers' orders, Mrs. J formally accepted them, or alternatively passed them to APC in Country A for formal acceptance? Explain.

(d) If Mrs. J was not an employee of APC, but was engaged as an independent contractor, would your conclusions in (a) above change? Explain fully the reasoning for your conclusion and any assumptions you have made.

Question 3 (25 marks)

(a) Describe the concept of "tax sparing" as sometimes included in Double Taxation Agreements. Include a definition of the term together with an explanation of how it operates in practice and the rationale for the concept.

(b) Have any tax sparing clauses been included in Double Taxation Agreements concluded by Hong Kong? Comment on whether this was expected.

Question 4 (25 marks)

The credit method of double taxation relief is common in both unilateral and bilateral double taxation relief systems. Under this method, a tax credit is typically provided against tax payable in the residence country in respect of foreign tax paid in the country of source of an item of income. Although conceptually very simple, there are a number of practical issues which commonly arise, and are required to be dealt with, under the credit method. Give examples of such difficulties and how they might be resolved.

Question 5 (25 marks)

(a) Describe what is meant by the term "transfer pricing" and explain why it is a major issue in international taxation.

(b) Give two examples of how a transfer pricing arrangement might work.

(c) Do you agree with the statement that "*the principal means of countering transfer pricing arrangements is through the entering into of double taxation agreements based on the OECD Model Agreement*"? Explain your answer.

Question 6 (25 marks)

(a) Explain why some jurisdictions consider it appropriate to enact "thin capitalisation" provisions or publish administrative guidance to address the issue of "thin capitalisation".

(b) Give examples of different means by which "thin capitalisation" provisions or guidance might determine the amount of excessive interest expenses.

(c) Some "thin capitalisation" provisions are concerned only with limiting the deductibility of interest on debt between related parties. Is such a limitation logical, particularly when applied in the circumstances of a corporate group carrying on substantial business activities in a large number of jurisdictions? Explain your answer.

– END OF QUESTION PAPER –

SUGGESTED ANSWERS

Question 1

(a) Pursuant to Article 7 of the Double Taxation Agreement concluded between Hong Kong and Thailand ("the DTA"), Thailand only has the right to impose tax on the profits of BuildCo if it has a permanent establishment (PE) in Thailand. If BuildCo does have a PE (which is defined in Article 5 of the DTA) in Thailand, Thailand will have the right to impose tax on the profits attributable to such PE. In essence, the profits attributable to a PE are to be determined by looking to what the PE could have been expected to earn if it were a distinct and separate enterprise engaged in providing services independently to the enterprise of which it is a PE.

The key issue in analysing Thailand's right to tax BuildCo is whether BuildCo has a PE in Thailand. Article 5 of the DTA contains the definition of PE and in paragraph 1 defines the term as a fixed place of business through which the business of an enterprise is wholly or partly carried on. Article 5(2) of the DTA includes in the definition of PE a place of management, a branch, an office, a factory, a workshop, a place of extraction of natural resources and, in certain circumstances, a warehouse. Article 5(3) of the DTA further provides that the term PE also encompasses "*a building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six* months".

In BuildCo's case, there are two projects which it is assumed are unrelated. Neither of these projects individually lasts for more than six months. Accordingly, neither project should constitute a PE in Thailand and, as such, Thailand will have no right to impose tax on the profits of BuildCo.

The main factual matter which could impact this conclusion relates to the assumption that the projects are unrelated. In particular, the OECD Commentary on Article 5(3) notes that the six month test is to be applied to each individual site or project and that "*a building site should be regarded as a single unit even if based on several contracts, provided that it forms a coherent whole commercially and geographically*". Accordingly, if the two projects in the present case were in fact merely separate contracts in relation to a single overall construction project in Thailand, even if those contracts concerned different parts of the single project, the above analysis would be different. In particular, as the total time period covered by the activities exceeds six months, it is necessary to consider whether a PE may exist. Nonetheless, as the two projects are neither concurrent nor consecutive (i.e. there is a break between them), it is necessary to consider whether the six month test is still satisfied. In this regard, the OECD Commentary on Article 5 suggests that the time period should be measured from the commencement of work until the completion of the project, and that temporary discontinuations of work should be ignored for this purpose. Although open to interpretation, if BuildCo's two projects had the necessary commercial and geographic coherence to be considered as a single building site or construction project, it is likely that the one month period between the work would be ignored. In such circumstances, BuildCo's activities in Thailand would be considered to exceed six months, thereby constituting a PE and rendering it subject to Thai tax on the profits attributable to that PE.

(b) If the two projects were to run consecutively, the conclusions and reasoning as set out in (a) above would remain valid. In particular, the issue of liability to Thai tax would essentially still come down to the question of whether a PE existed.

If BuildCo's two projects were unrelated commercially and geographically, the fact that they ran consecutively and spread over a total period of ten months would not mean that a PE existed as the total period must be measured in respect of each individual project, not the total time period over which consecutive (or partly concurrent) projects run.

If BuildCo's two projects did have commercial and geographic coherence sufficient to treat them as a single project, a PE would exist. As noted above, however, it is likely that the same conclusion would be reached even if there was a one month period during which BuildCo was not rendering services in Thailand.

(c) The maintenance of a permanent office in Thailand may change the analysis of BuildCo's liability to Thai tax. In particular, the analysis in (a) above focused solely on Article 5(3) of the DTA because on the basis of the stated facts it was not necessary to consider whether a PE existed under the general definition in Article 5(1). Where, however, an office is maintained on a more permanent basis, it will generally be considered a fixed place of business through which the enterprise's business is partly carried on, in which case a PE will exist unless it is deemed not to be a PE by another part of the definition.

With regard to the latter point, Article 5(4) of the DTA deems a fixed place of business not to constitute a PE where the activities undertaken by it are limited as specified. There are a number of activities specifically mentioned in Article 5(4) as being permitted without constituting a PE, the most relevant of which to BuildCo is collecting information (e.g. market research). More generally, a PE will not be considered to exist if the activities undertaken can be considered to be of a preparatory or auxiliary character. The terms “preparatory” and “auxiliary” are not defined but the OECD Commentary suggests that they refer to activities which although linked to the business of the enterprise, are so remote from the realisation of any profit that it is difficult to allocate any profit to the place of business through which those activities are undertaken. It is important to also note that all of the activities of the place of business must fall into the activities specified in Article 5(4) if a PE is to be deemed not to exist.

In the facts presented in this question, it is clear that the market research activities would be covered by the exemption in Article 5(4) of the DTA. The activities involved in looking for new business opportunities would not fall under any specific category in Article5(4) and it is not clear whether it could be successfully argued that they are of a preparatory or auxiliary nature. However, it is unlikely that the activities involved in supervision of projects would qualify as preparatory or auxiliary in nature and, accordingly, the maintenance of an office as described would likely result in a PE of BuildCo being considered to exist in Thailand. As a result, Thailand would have the right to impose tax on BuildCo’s profits attributable to such PE. It is, however, important to note that it is only the proposed office which would constitute a PE (assuming that the projects themselves do not constitute a PE) and therefore only any profits attributable to that office which would be taxable in Thailand and not the profits of the projects themselves.

Question 2

(a) The starting point for determining whether APC has a permanent establishment (PE) in country B is to ascertain whether it meets the general criteria of having a fixed place of business in country B through which the business of APC is wholly or partly carried on.

On the basis of the OECD Model DTA and the Commentary thereto, the fact that APC rents warehouse space in country B would likely mean that it was considered to have a fixed place of business in country B. Further, the fact that there is an employee in that country is likely to mean that APC’s business is considered to be partly carried on in that jurisdiction. Together, these factors would point to a PE existing under the general provisions of the DTA.

Nonetheless, particularly given the limited scope of the operations, it is pertinent to consider whether the exclusions from the definition of PE as contained in Article 5(4) of the OECD Model DTA may apply to deem a PE not to exist. In this regard, paragraphs (a) and (b) of Article 5(4) may be relevant. Paragraph (a) provides that the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise shall not constitute a PE. Similarly, paragraph (b) provides that the stock of goods itself shall not constitute a PE in similar circumstances.

On the basis of the above, it would appear that the maintaining of the stock of goods in the warehouse would not constitute a PE. It is important to note, however, that this exclusion from the definition of PE applies only if the maintaining of the stock of goods in the warehouse for the purpose of storage, display or delivery is the only activity undertaken by APC in country B. It is clear, however, that Mrs. J's activities includes marketing of products and it would appear that she concludes orders which she then fills from her stock of goods. It is likely that this activity would go beyond the mere storage of goods and, therefore, it is seems that the exclusion from the definition of PE in Article 5(4) would not apply. In other words, APC would be considered to have a PE in country B and country B would have the right to impose tax on the profits attributable to that PE.

(b) The above conclusions would not be effected by whether the warehouse was rented in Mrs. J's name or directly in the name of APC. This is because for the purpose of determining whether an enterprise has a place of business in a jurisdiction the Commentary to the OECD Model DTA explains that the test is simply whether the enterprise has use of the premises. There is no need for the enterprise to be the owner or lessee of the premises; it merely needs to have space at its disposal for the purpose of carrying on the business.

(c) For the reasons explained above, APC would likely be considered to have a PE in country B. This conclusion has been reached on the basis that it has a fixed place of business through which APC's business is partly carried on. The conclusion was also based on the fact that the activities were not so limited as to qualify for exclusion from the definition of PE under Article 5(4). The question of the extent of Mrs. J's involvement in sale transaction is not critical to the above conclusions. This assumes, however, that Mrs. J is an employee of APC. If, in fact, Mrs. J was an independent contractor, the answer may be different as explained below. In particular, the extent of a person's authority to conclude contracts on behalf of a principal may be relevant in determining whether that person constitutes a PE of the principal under Article 5(5) of the OECD Model DTA whereby a person (other than an independent agent) acting on behalf of an enterprise may constitute a PE of that enterprise if they habitually exercise a general authority to conclude contracts in the name of the enterprise. Nonetheless, the fact that an <u>employee</u> in a jurisdiction does not have, or does not regularly exercise, a authority to conclude contracts will not prevent a finding that a PE exists in that jurisdiction.

(d) If Mrs. J was an independent contractor the analysis of whether APC has a PE in country B would change. In particular, under Article 5(6) of the OECD Model DTA, an enterprise is deemed not to have a PE in a jurisdiction merely because it carries on business in that jurisdiction through a broker, general commission agent or other agent of independent status acting in the ordinary course of their business.

Accordingly, if Mrs. J was an independent agent providing services to APC, those activities would not constitute a PE of APC. In this regard, “independent” refers to legal and economic independence. Whether Mrs. J is legally independent of APC is a question of the extent of the legal obligations between her and APC and the extent of the control exercised by APC over Mrs. J’s activities. Mrs. J would not necessarily be legally dependent simply because she had an ownership interest in APC. Economic independence is a question of fact to be determined by various factors including the degree of control exercised over Mrs. J’s activities by APC, the entrepreneurial risks assumed by Mrs. J and the extent to which Mrs. J acts for other enterprises.

If, on the other hand, Mrs. J was held to be a dependent agent, she would constitute a PE of APC if she has and habitually exercises in country B a general authority to conclude contracts in the name of APC. On the facts provided, it appears that Mrs. J concludes contracts in respect of items delivered from her stock of goods. This would indicate Mrs. J has a general authority to enter into contracts on behalf of APC and if this occurred regularly it would amount to a PE. We also know that for large or non-urgent orders she emails the head office which arranges filling and shipment of orders. It is not clear whether, in these cases, Mrs. J is formally negotiating and concluding the orders, or simply relaying the requests to the head office for consideration. Under the OECD Commentary, however, the fact that Mrs. J did not formally approve the orders would not prevent her being considered to regularly exercise a general authority to conclude contracts if, in practice, she solicited and received orders notwithstanding that she referred them abroad where they were routinely accepted, filled and shipped.

Question 3

(a) Tax sparing relates to the practice provided for in some DTAs where one country agrees to grant a credit for tax which was not actually paid in the other country, but would normally have been payable under the general tax provisions. It can broadly be defined as the practice of granting foreign tax credits in respect of notional tax.

Tax sparing is usually only found in DTAs between developed economies and emerging economies. The rationale for the practice is that many developed economies tax their residents on a worldwide basis and allow double tax relief by means of the credit method. At the same time, many emerging economies grant non-residents tax concessions in an effort to encourage foreign direct investment. Where, however, an emerging economy grants a foreign investor who is taxed on worldwide income a tax concession, the tax foregone in the investee country typically becomes payable in the jurisdiction of the investor as a result of the reduced tax credit available. The effect of this is to eliminate the benefit of the tax concession offered by the investee country and to shift tax revenues from an emerging economy to a developed economy.

Accordingly, tax sparing was introduced as a means of countering these problems and preserving the benefit of tax concessions offered by emerging countries. It works by deeming, in the country of residence of the investor, tax to have been paid in the investee country at normal corporate tax rates notwithstanding that because of a tax concession no tax was actually paid.

(b) Tax sparing clauses have been included in Hong Kong's DTAs with Vietnam, Brunei and Thailand.

The reason for this can only be speculated upon as neither the IRD nor the Hong Kong Government have published a policy with regard to tax sparing. Nonetheless, tax sparing is generally finding less favour these days than in the past. One reason for this is that there is a history of perceived abuse of tax sparing provisions in DTAs. i.e. conduit entities have been established in treaty countries in order to benefit from tax sparing arrangements. Indeed, the OECD looked at the issue in 1998 and recommended that tax sparing not be implemented as widely as it had been. International attitudes towards tax incentives have also changed over the years such that taking action to encourage or perpetuate concessions (such as through the adoption of tax sparing clauses) is less common.

On the other hand, because Hong Kong operates a territorial taxation system, any profits of a foreign PE will generally not be taxable in Hong Kong and credits for foreign tax (including tax sparing credits) will generally not be available in respect of such income. Accordingly, the tax sparing clauses included in Hong Kong's DTAs would generally have little practical effect.

Question 4

There are various practical difficulties with the credit method of double taxation relief which are generally required to be dealt with under clearly defined rules. Examples include:

- How to deal with the position where the tax is assessed in respect of different accounting periods in the residence and source jurisdictions.
- Where income is derived in multiple source jurisdictions, should foreign income and foreign tax be aggregated, or dealt with on an income by income basis? Should there be total aggregation of foreign income and tax, or should such aggregation be on the basis of territory, type of income, etc.
- How to deal with the position where foreign tax is imposed on a gross basis (i.e. interest withholding tax) in the source jurisdiction, but on a net of expenses basis in the residence jurisdiction. In these circumstances there may be excess foreign tax credits (foreign tax which cannot be relieved) due to the fact that the residence country recognises a much small amount of foreign income than was used to impose tax in the source country.
- How to deal with the position where there is an overall loss in the residence jurisdiction but tax is still payable in the source jurisdiction.
- How to deal with the position where several sources of income are derived in a single source country, but they are taxed at different rates or some items are exempt. i.e. should all of the source country income and tax be aggregated for the purpose of calculating the maximum credit allowable in the residence country, or should each item of income be dealt with separately?

Question 5

(a) Transfer pricing usually refer to the setting the terms of transactions between related parties on a non-arm's length basis in order to move income, profits or expenses between group companies which suffer different tax rates so as to reduce the overall tax burden of a corporate group. The types of transactions which may be subject to transfer pricing arrangements include the sale of goods, the provision of services, the sharing of expenses, the apportionment of profits between jurisdictions and interest on loans and advances. A transfer pricing arrangement may also involve the interposition of a company in a zero tax jurisdiction between two other group companies in order to derive a portion of the overall profit from a transaction in a manner whereby no tax is suffered.

If there were no limits on transfer pricing, corporate groups acting rationally would shift all profits away from high tax jurisdictions to low or nil tax jurisdictions.

(b) There are numerous examples of how a transfer pricing arrangement may work including the following:

- a Sale of goods from a high taxed company to a low taxed company at an artificially reduced price.
- b Loaning money from a high taxed company to a low taxed company at an artificially low interest rate.
- c Provision of management services by a low-taxed company to a high taxed company at an artificially high price.

(c) Disagree. The principal means of countering transfer pricing is through domestic tax law provisions addressing the issue. Nonetheless, because transfer pricing is fundamentally a cross-border issue, the OECD has taken an interest in the issue. In particular, the OECD has published guidelines for determining arm's-length prices in an effort to encourage all countries to adopt a consistent approach to the question and, therefore, minimise double taxation which may otherwise arise where countries adopt different bases for determining such prices. The OECD has also worked to ensure that the OECD Model DTA does not prevent the application of domestic transfer pricing provisions, but also that where justified transfer pricing adjustments are made by one jurisdiction, the other jurisdiction will make corresponding adjustments to the taxation of the related party.

Accordingly, although the OECD promotes the adoption of fair transfer pricing rules and the inclusion of associated provisions in DTAs, these measures are not the primary means of countering transfer pricing. Rather, domestic tax legislation is the principal means by which transfer pricing is countered.

Question 6

(a) "Thin capitalisation" generally refers to the situation where a company is financed excessively with debt as opposed to equity. Thin capitalisation provisions seek to counter such practice by deeming interest on some debt to be non-deductible, essentially on the basis that such debt is to be treated as equity.

Some countries believe that thin capitalisation provisions are appropriate because of the relative tax advantages of financing an operation in their country by debt rather than equity. Typically, the advantages of debt financing compared to equity financing are as follows:

- Interest on debt is typically deductible, whereby dividends paid on equity are non-deductible. Accordingly, the use of debt funding tends to reduce the tax collected by the country in which an investment is located.
- Withholding tax rates on interest are often lower than the rates on dividends. This leads to a further erosion of tax collections in the jurisdiction of an investment when that investment is financed predominantly by way of debt.
- Although not relevant in the jurisdiction of the investment, the benefits of debt financing may be offset by the fact that interest will typically be assessable in the hands of the recipient, whereas dividends often qualify for concessional treatment. Nonetheless, it is sometimes possible to provide the debt through a group finance company in a low tax jurisdiction, or through the use of a hybrid entity whereby the interest is treated as a dividend to the recipient.

(b) The key to "thin capitalisation" provisions is establishing the amount of debt the interest on which will be allowed as a deduction, or alternatively the amount of allowable interest expenses. There are a number of ways of doing this. In particular:

- Traditionally, in many jurisdictions the amount of debt on which interest is an allowable deduction has been determined by specifying a maximum debt equity ratio for the company. For example, the provisions might specify that interest on debt of no more than three times the equity will be allowed to be deducted. This requires a careful definition of the terms “debt” (whether all debt, related party, foreign lenders, etc.) and “equity” (whether retained earnings, provisions, convertible debt, etc. is included).

- An alternative approach is to adopt rules similar to the US earnings-stripping provisions where interest deductions are limited to a percentage of the net profit before interest.
- Finally, a more modern approach to determining the acceptable level of debt funding (or gearing) which recognises that different groups and industries have different approaches to finance, is to allow a debt:equity ratio in a jurisdiction based on the group’s overall debt:equity ratio. So if, for example, a multi-national group has an overall debt:equity ratio of 7:1, this could be the starting point for determining an acceptable ratio in a particular jurisdiction.

(c) If a jurisdiction is concerned that inbound investment is being funded excessively by debt and that not enough of the group’s equity is being allocated to the jurisdiction, it is not logical to apply restrictions only to related party debt. To do so implicitly treats the problem as one of narrow tax planning by the group.

In particular, the benefits of debt funding to a taxpayer in a jurisdiction apply irrespective of whether the debt is from a related party. Indeed, bank debt in many cases provides for greater benefits than related party debt because it sometimes attracts lower rates of withholding tax. From the perspective of a multi-national group which has significant overall borrowings, financing an investment in a foreign jurisdiction with a high level of borrowings is simply a matter of allocating a disproportionate share of the aggregate borrowings to that jurisdiction. Put another way, a group financed with a mixture of debt and equity can, in the absence of relevant thin capitalisation rules, choose to allocate its total equity and total debt between jurisdictions in a tax efficient manner. Accordingly, focussing solely on related party debt does not properly address the issue of thin capitalisation. For this reason, some jurisdictions now look to all debt when applying thin capitalisation restrictions and seek to measure the gearing ratio in the jurisdiction to the groups global gearing ratio.

A further reason why looking only to related party debt is not logical is that in the absence of effective anti-avoidance provisions (either general or specific to the thin capitalisation provisions), circumventing the restrictions by interposing an unrelated party (such as a bank) in the transaction would appear to be relatively straightforward.

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