Solving The Dilemma of Dual Residence

By Athul Aravind, June 18, 2019

This paper aims at analysing the tie-breaker test in determining residence in the OECD as prescribed under Article 4(3) and how it is evolved. It analyses the 2017 update to the OECD which prescribes the Mutual Agreement Procedure (MAP). The paper finally provides a method of properly implementing MAP and how it can be effectively done so through arbitration by choosing the correct method.

THE DILEMMA OF RESIDENCE IN INTERNATIONAL TAXATION

Before 2017, Article 4(3) of the OECD MC provided the tie-breaker clause in the case of dual-residence, which states: “Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.”

Paragraph 24 of the OECD MC Commentary construes place of effective of management (POEM) to be “the place where the key management and key commercial decisions that are necessary for the conduct of the business a whole are in substance made.”

However due to domestic interpretations of POEM being different among many jurisdictions, it has created confusion as to how it should be interpreted as many countries use the ‘control and management’ test used in the De Boor’s case. However, the OECD brought a new interpretation of POEM in its 2008 commentary and defined it as where the corporation is ‘actually managed’. \[1\] In other words, The place where the senior day-to-day management of the company is, in fact, carried on is an important factor to determine the POEM of an enterprise.

Claims to treaty benefits by subsidiary companies, in particular companies established in tax havens or benefiting from harmful preferential regimes, may be refused where careful consideration of the facts and circumstances of a case shows that the place of effective management of a subsidiary does not lie in its alleged state of residence but, rather, lies in the state of residence of the parent company so as to make it a resident of that latter state for domestic law and treaty purposes. \[2\] This was done to prevent foreign parents from abusing treaty provisions by using the head and brain test to hold board meetings abroad but carry on most of the core business functions in the state of the subsidiary. This offers a more source-based method of taxation, as it helps tax authorities in the state of the subsidiary to tax where the activities are occurring.

Some jurisdictions like the Netherlands holds that the residence of parent and subsidiary must be determined independently, and courts have deferred from inferring residence of a subsidiary at the place of residence of the parent entity and vice versa. \[3\] However, jurisdictions like Belgium adopt the head and brain test and hold that the ‘seat of management’ will determine residence. It further gave factors to identify the seat of management by stating “that the meetings of the board of directors and the general
meetings of shareholders were always held at the registered office of the company, in France. It disposed of administrative and commercial organization in France. Thirdly, the taxpayer had exercised a significant part of his activities in France. According to the court, the mere fact that the taxpayer had carried out certain activities of day-to-day management in Belgium was not sufficient to conclude that the company was effectively managed in Belgium.”

The dilemma between the control and management test and the day-to-day management test is reason for most of the clashes in the interpretation in international taxation and the OECD proposed the ‘Mutual Agreement Procedure’ (MAP) as a solution to this dilemma in its 2017 update to the commentary.

MUTUAL AGREEMENT PROCEDURE- THE NEW TIE BREAKER TEST?

An alternative version of Art. 4(3) or the tie breaker test was introduced according to which “the competent authorities of the Contracting States shall, having regard to a number of relevant factors, endeavor to determine by mutual agreement the State of which the person is a resident for the purpose of the Convention. When that alternative was discussed, the view of many countries was that cases where a company is a dual-resident often involve tax avoidance arrangements. For that reason, it is proposed that the current rule found in Art. 4(3) be replaced by the alternative found in the Commentary, which allows a case-by-case solution of these cases.”[4]

Under this method, the issue of residence is done through mutual agreement by the competent authorities, having regard to the company’s place of effective management, place of incorporation and several other factors. However, the clause reads that the authorities ‘shall’ reach an agreement, which means that it the wording of the law is allowing it for there to be a disagreement between the competent authorities of both states. This may merely add more hurdles in determining residence as it is unlikely that the competent authorities will choose a position that is drastically different to its domestic law, which would mean that the same problem may extend into this procedure as well if domestic interpretation of these competent authorities are at a binary and this method may not present the answer.

A NEW METHOD OF RESOLUTION

The solution to this dilemma is through the method of ‘baseball’ arbitration. If the Mutual Agreement Procedure is followed up by a ‘compulsory arbitration as enshrined in Article 25(5) of the OECD Model Convention. This would offer a more amicable solution to the problem.

The competent authorities can write down their interpretation of the case, and if they cannot agree then it will go the arbitrator, who will then pick between both the recordings of the authorities and pick the most suitable recording that it thinks will do justice to the case. It offers a quick and efficient solution to the prolonged dilemma of determining residence through POEM.

WHAT IS BASEBALL ARBITRATION?

The baseball arbitration process was initially developed as a compromise between baseball owners and the players association as an alternative to free agency to resolve issues regarding salaries and other monetary issues. This also proved to be an efficient form of resolving disputes between trade unions and its employers.
Baseball arbitration is an efficient form of settling disputes, as it is relatively quicker than most other alternatives to resolve tax disputes. In this method, the arbitrator can only evaluate the reasonableness of both the proposals, however he can only choose between the two proposals and not give his own alternative proposal. This would limit the arbitrator's job to merely picking the best figure that is proposed by the parties.

This can be used in resolving tax disputes, especially niche areas in taxation like transfer pricing disagreements. The Mutual Agreement Procedure (MAP) can be incorporated with the compulsory arbitration clause with this method of arbitration.

The competent authorities of each contracting state, when in disagreement will draft their proposal and send it to the arbitrator to pick the most suitable proposal.

One of the biggest advantages in this method of resolution is that parties will try and be as reasonable as possible, as they will be cautious of the arbitrator. They cannot make take aggressive positions as adopted in conventional arbitration to sway the arbitrator in their favour, as the arbitrator will eliminate any proposal that is even slightly unreasonable. This will push the parties to bargain in good faith and moving towards the middle to reach a settlement.

CRITICISM OF BASEBALL ARBITRATION

It is relevant to note that the competent authorities in most countries are members of the executive. For example, in India it is the Chief Commissioner or the Director-General of Tax, who are both members of the executive and may be interpreting the case in a way that may not have be in the interest of justice to both parties, and may be open to the influence of political will.

Another drawback is if both offers are completely unreasonable and unlawful, then this method is inflexible as the arbitrator will be forced to choose between two bad proposals

One may argue that it is against the spirit of separation of powers, which is a basic principle of law. However, in the international realm this principle does not hold much relevance in international law as there are many organs in that sphere, and it cannot be strictly demarcated into three core organs without taking away authority from other supranational organs. So this can be easily resolved.

Baseball arbitration can be used to determine most of the tax disputes as they involve a figure that it would add up to, and the arbitrator can pick whichever figure he finds most reasonable. However, the main problem in the case of residence is that is there is no figure involved and that would be problematic for the arbitrator to pick between two reports with legal reasoning as it changes the nature of the arbitrators role in the process, and it should ideally be legally analysed before passing the order. In these cases, ‘night baseball’ arbitration should be invoked, which is another form of baseball arbitration.

NIGHT BASEBALL ARBITRATION – THE SOLUTION

To determine residence factors like place of incorporation, place where board meetings take place, day-to-day management, etc will be relevant. This cannot be equated to a value, which would mean that a method of ‘night baseball’ arbitration is the most efficient method of resolving this dispute.

In night baseball arbitration, the arbitrator will write an independent decision on the facts of the case, without hearing the pleadings of the party. On writing the decision, the arbitrator will then review both of the pleadings and choose whichever pleading
resembles his decision the most. This would mean that the judgement is still passed by a judicial member, and he picks the narrative that ‘fits’ within his own decision.

This method of resolution is the most efficient way to implement the MAP as prescribed under Article 4(3) of the OECD. Baseball arbitration for disputes involving values and Night Baseball arbitrations to determine substantive issues like residence.


[3] Netherlands – Case 10/05383


*(Author is 5th year student in Jindal Global Law School, NCR)*