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RESOLUTION OF DUAL RESIDENCE INSTANCES IN THE CASE OF COMPANIES

The application of double taxation treaties presupposes that the potential cases of dual residence have been previously resolved. For this purpose, the major model-conventions on the basis of which double taxation treaties around the globe are negotiated contain the so-called tie-breaker rule. In the wake of the recent revision of the international tax system resulting from the OECD's Base Erosion and Profit Shifting Action Plan, the existing tie-breaker rule for companies has been thoroughly amended. Instead of determining companies' residence based on the place of the effective management criterion, the new approach stipulates that such cases will be decided through the application of the Mutual Agreement Procedure, between the competent authorities of the relevant contracting states. After outlining the historical development of the said mechanism in the context of dual residence resolution, this article purports to critically assess its desirability, with a special focus on its implementation in Serbia.

Key words: *Fiscal Residence. – Dual Residence. – Tie-breaker rule. – Mutual Agreement Procedure. – Place of Effective Management.*

1. THE CONCEPT OF FISCAL RESIDENCE AND ITS RELEVANCE FOR THE APPLICATION OF TAX TREATIES

The concept of fiscal residence lies at the very core of the international tax system. It is by far the most commonly utilised personal connecting factor, the purpose of which is to signalize the fiscal attachment

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of a taxpayer to a specific taxing jurisdiction (Knechtle 1979, 35–36; Popović 2017, 246). It is not only crucial for the application of national tax laws, but also for the functioning of international tax conventions (tax treaties).[1] Namely, in order for a tax treaty to be applicable in a specific case, the interested taxpayer needs to fall under the personal scope of the tax treaty in question, which is determined by having recourse to its articles 1 – *Persons covered* and 4 – *Resident* (Berglund, Cejie 2018, 55).

In line with Art. 1 of the OECD Model Convention, a tax treaty is applicable to a person who is a resident of one or both of the contracting states. The term 'person' shall be understood to include an individual, a company, or any other body of persons.[2] Pursuant to Art. 4 of the OECD Model Convention the term 'resident of a contracting state' means any person who, under the laws of that state, is liable to tax therein by reason of their domicile, residence, place of management or any other criterion of a similar nature.[3] Accordingly, it may be concluded that no specific definition of a resident for tax treaty purposes exists (Živković 2017, 18). The term is defined by referencing the contracting states' domestic tax laws and is, therefore, reliant on the residence criteria used therein. Consequently, tax liability under the national tax law of one of the contracting states is a necessary precondition for treaty residence. The provision stipulates *exempli causa* several commonly used residence criteria, therefore leaving it open for any other similar criterion to also be taken into account. The crucial characteristic of the enumerated as well as any other potentially utilised criteria is that they generate comprehensive tax liability for the taxpayer—liability regarding the taxpayer's worldwide income.[4]

Jurisdictions are completely free to deem residence using whatever criterion they find appropriate (Obuoforibo 2018, 7). Depending on the criteria that they apply in determining the fiscal residence of companies, jurisdictions can be divided into three groups. The first group consists of

[1] Currently there are approximately 3,000 tax treaties concluded between various tax jurisdictions around the world. They are predominantly based on the two main model conventions, which serve as guiding templates in the course of treaty negotiations. They are published by the Organisation for Economic Cooperation and Development (hereinafter: OECD Model Convention) and the United Nations (hereinafter: UN Model Convention). Although the provisions cited in this paper refer to the OECD Model Convention, they do not differentiate significantly from those contained in the UN Model Convention. In addition, the existing discrepancies are not relevant from the point of view of the topic of this paper.

[2] Article 3(1)(a) Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing, 2017.

[3] The term also includes the contracting state and any political subdivision or local authority thereof as well as a recognised pension fund of the state in question.

[4] Para. 8, Commentary on Article 4 of the 2017 OECD Model Convention.

jurisdictions applying a formal criterion, such as the place of incorporation or the place of registered seat. The second group encompasses countries prescribing a subjective criterion that presupposes that residence is determined on a case-by-case basis by considering all relevant facts and circumstances. Examples of such criteria are the place of management, the place of effective management, and the place of central management and control. The last and the largest group of jurisdictions applies both formal and subjective criterion, alternatively. Serbia belongs to the latter group.

2. RESOLUTION OF DUAL RESIDENCE AS A PREREQUISITE FOR TAX TREATY APPLICATION

Due to the fact that residence for the purpose of tax treaty application is dependent on the definition of a resident as stipulated by the national tax laws of the contracting states in question, it is possible for a taxpayer to be considered a resident of both of the contracting states concurrently. The described circumstance is referred to as a case of *dual residence*. With respect to corporate taxpayers, dual residence may arise in the following situations (Živković 2017, 25). Firstly, it can follow from the contracting states applying different criteria for the determination of residence under their national tax laws. More specifically, if one jurisdiction applies a criterion of a formal nature, whereas the other applies a criterion of a factual nature, concurrent application of those two criteria may easily lead to each of the contracting states considering the taxpayer to be their resident and, consequently, a dual resident in terms of the treaty. Secondly, dual residence may result if both contracting states apply the same factual criterion for the determination of residence in their national tax laws, but interpret that criterion differently. This could cause a taxpayer to be deemed, for the purpose of national law application, a resident of each of the states in question, and accordingly, a dual resident for the purpose of treaty application.

However, the nature of the majority of tax treaty provisions is such that they are applicable only if the taxpayer is a resident of exclusively one of the contracting states for the purpose of tax treaty application (Lang 2013, 83). Therefore, in order for the treaty distributive rules[5] as well as the methods article[6] to be applicable, the potential case of dual residence must be resolved beforehand.[7] For this purpose, a separate

[5] Tax treaty provisions modelled upon articles 6–22 of the OECD Model Convention.

[6] Tax treaty provisions drafted on the basis of article 23A and 23B of the OECD Model Convention.

[7] This is because each of these provisions refers to one of the contracting states as being the residence state and the other contracting state as being the source state.

provision directed at the resolution of dual residence cases of companies—the so-called *tie breaker rule*—is provided in Art. 4, para. 3 of the OECD Model Convention. The application of a tie-breaker rule has as a result that a person who qualified as a resident of both of the contracting states in line with treaty provision patterned after Art. 4, para. 1 of the OECD Model Convention, will be regarded, for treaty purposes, as a resident of exclusively one of the states in question. Nevertheless, the said provision does not in itself affect the residence status of that person for the purpose of national tax law (Sasseville 2006, 45).[8]

3. THE EVOLUTION OF THE TIE-BREAKER RULE

3.1. The Development of the Factual Criterion

Throughout much of its existence, the OECD Model Convention remained unchanged with respect to the tie-breaker rule for companies. According to the 1963 OECD Draft Model Convention, Art. 4 para. 3 stipulated that '*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 of the Contracting State in which its place of effective management is situated'*.[9] The provision was adopted in virtually identical form in the 1977 OECD Model Convention and, apart from one minuscule amendment in 1995, remained intact until 2017.

The idea of a factual criterion as a tie-breaker rule in the case of companies precedes the work of the OECD.[10] It can be traced back to the so-called London Draft Model,[11] published by the League of Nations in

[8] There are, however, jurisdictions whose national tax laws specifically presuppose, with the aim of limiting opportunities for abusive practices, that a taxpayer which was deemed to be their non-resident, for the purpose of treaty application on the basis of a tie-breaker rule, ceases to be their resident for the purpose of national tax law as well. It is interesting that Serbian tax authorities follow this approach in practice, although nothing in the Serbian tax legislation requires them to do so, causing a significant level of legal uncertainty (Popović, Kostić 2009, 71).

[9] Although the provision refers to dual residence of persons other than individuals, it is the cases of dual residence of companies that are the most numerous and, in an economic sense, the most relevant. It is for this reason that the author will use the phrases 'dual residence of persons other than individuals' and 'dual residence of companies' interchangeably.

[10] During the previous half a century, the OECD established itself as the dominant body outlining international tax policy and the design of double tax treaties. However, work on this matter was first initiated by the League of Nations during the 1920s. It was not until the late 1950s that the predecessor of the OECD, the Organisation for European Economic Co-operation (OEEC), took over the work on the development of a model tax treaty. Initially consisting of 18 European countries, the OEEC transformed into the OECD in 1961, following the accession of the United States and Canada.

[11] The London Draft Model and the Mexico Draft Model resulted from the work of the League of Nations Fiscal Committee, undertaken from 1940 to 1946, on the matter

1946, which presupposed in its Art. II, para. 4 that '*The fiscal domicile of a partnership, company and any other legal entity or de facto body shall be the State in which its real centre of management is situated*'.[12] However, the cited model provision was not endorsed by a considerable number of jurisdictions in the course of subsequent treaty negotiations. For this reason, the OEEC later decided to base its future model tie-breaker rule on a criterion that was better represented in treaty practice. As a result, in its 1957 Report the OEEC Fiscal Committee suggested substituting the real centre of management criterion with the place of company's management and control criterion. Although it had its origin in the United Kingdom's national tax law,[13] the suggested criterion was also widely accepted among continental European countries in their treaties with the UK (OEEC Fiscal Committee 1957b, 6). The choice of a more frequently used criterion should be understood in the context of the objective of the new model convention, which was to establish uniform and widely accepted principles, definitions, rules, and methods on which the future double tax treaties would be based (Holmes 2014, 61).

The switch to the place of effective management (POEM) criterion ensued the following year, with the intention of harmonising the terms used in various parts of the future model convention (OEEC Fiscal Committee 1958, 6). Namely, the POEM criterion was already present in the provision allocating taxing rights in the case of profits from shipping, inland waterways transport, and air transport (OEEC Fiscal Committee 1958, 6). Last but not least, the UK delegate to the Fiscal Committee confirmed that in this regard the place where the business is managed and controlled basically means the POEM of the enterprise (OEEC Fiscal Committee 1957a, 11).

The prevailing assumption at that time was that, unlike in the case of individuals, instances of dual residence of companies are fairly rare,[14] for which reason the tie-breaker rule was thought to have little practical importance. Consequently, the definition of the POEM criterion was not provided in the Draft Model nor in any of the subsequent versions of the Model Convention. So as to be able to apply the said criterion, tax practitioners relied heavily on the interpretation of similar criteria

of juridical double taxation. They are commonly referred to as the predecessors of the OECD Model Convention and UN Model Convention, respectively.

[12] Protocol of the Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property (London Draft). *https://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-15.xml;chunk.id=item-15;toc.depth=1;toc.id=item-15;database=;collection=;brand=default* (last visited: 1 November, 2020).

[13] For an elaborate analysis of the evolution of and the case law on the central management and control criterion see: Couzin 2002, 55–102.

[14] OECD. 2019. *Model Tax Convention on Income and on Capital 2017 (Full Version)* Paris: OECD Publishing, C(4)-23.

contained in the respective national tax laws (Burgers 2007, 378). Therefore, during four decades of POEM test application, numerous uncertainties appeared regarding its interpretation, rendering it one of the most controversial aspects of the model conventions and, consequently, the double tax treaties patterned upon them. In an attempt to introduce some clarity into its meaning, the OECD repeatedly amended the Commentary on Art. 4 of the Model Convention (Jones 2009, 186).

The 1992 amendment removed the reference to the UK's treaty practice, as well as the clarification that the POEM has the same meaning as the initially advocated common law criterion—the place of management and control. The said removal voided the referencing of the settled case law on the interpretation of the latter criterion for the purpose of defining the POEM, leaving its meaning completely vague. It is for this reason that in 2000 the Commentary on Art. 4 of the OECD Model Convention was supplemented with certain guidelines on the interpretation of the tie-breaker rule for companies. It was specified that the POEM refers to a place where key management and commercial decisions necessary for the conducting of the entity's business are in substance made. It was identified that this will ordinarily be the place where the most senior person or group of persons (e.g. board of directors) make their decisions, or the place where actions to be taken by the entity as a whole are determined. Therefore, it seemed that the OECD supported the idea that the place of the top management of the company is crucial. The Commentary further underlined that all relevant facts and circumstances need to be evaluated in each specific case in order to determine the POEM. This statement was intended to reinforce the substance over form principle as the basis of the said provision (Burgstaller, Haslinger 2004, 387). Finally, it asserted that although an entity may have more than one place of management, it can only have one POEM at any given point in time.[15]

At the turn of the 21st century, it became apparent that the development of information technology, global transportation systems, and the ever-growing complexity of the organisational structures of companies would deprive the POEM of its potency as a tie-breaker rule (Burgstaller, Haslinger 2004, 377). All too often this criterion was not able to resolve cases of dual residence, as it became quite common for a company to have POEM in more than one jurisdiction at the same time. This is why in 2003 the OECD Technical Advisory Group issued a discussion draft suggesting two alternative solutions to the existing problem (OECD TAG 2003). The first proposal was intended to refine the POEM test by expanding the Commentary explanations on how this concept should be interpreted, while the second presupposed replacing

[15] OECD. 2019. *Model Tax Convention on Income and on Capital 2017 (Full Version)*, Paris: OECD Publishing, C(4)-26.

the existing tie-breaker rule with a hierarchy of tests, similarly to the approach followed in the case of dual residence of individuals.[16]

Due to the opposition by the majority of the OECD member states, none of the specific solutions suggested in the discussion draft were adopted. However, additional clarifications were added to the Commentary in 2008. Surprisingly, the sentence specifying that the POEM ordinarily means a place where the most senior person or group of persons (e.g. board of directors) makes its decisions was removed (OECD 2008, 7). The question was therefore raised whether the said amendment represents a new stance of the OECD, that the POEM does not relate to the place where the company's top management makes decisions, but rather to the place from which actual day-to-day management is carried out. If the latter were to be true, the POEM could be interpreted in line with the continental European approach, based on which focus is placed on the location from which everyday management of the company is conducted, instead of the location where top strategic decisions are made, on which the Anglo-American approach is based (Burgers 2007, 385).

The evolutionary path of the POEM concept shows that its introduction to the Model Convention was not thoroughly though out. Although the rationale of a tie-breaker rule implied using a criterion that is autonomous and, as such, independent of influences from tax laws of various contracting states, this was not possible to achieve due to the absence of precise guidelines for its interpretation. Relying on the fact that dual residence of companies rarely occurred at the time of the inception of the tie-breaker rule, its creators imprudently linked the meaning of the POEM criterion to a similar but not identical concept already present in certain national tax systems. Moreover, the inconsistency and contradictions between what were supposed to be clarifications of the concept, brought about by subsequent amendments of the Commentary, considerably contributed to the confusion. To this day, the problem in interpreting the POEM test boils down to the fact that contracting states tend to identify its meaning with the meaning of similar criteria present in their national laws (e.g. the place of management and control in common law jurisdictions or the place of management in continental European jurisdictions).[17] The described problem has only been exacerbated by the technological advancement of the business environment (OECD TAG 2001, 8).

[16] Compare to Article 4(2) of the OECD Model Convention.

[17] For an overview of different approaches to the interpretation of POEM, see: Sasseville 2009, 297–299.

3.2. The Shift towards the Mutual Agreement Procedure

The financial crisis of 2008 and its consequences substantially affected the international tax landscape. The ensuing budgetary constraints in countries around the world urged the launching of an international action plan by the G20 and the OECD, directed at combating tax planning structures used by multinational enterprises for the purpose of minimising their tax liabilities. The resulting Base Erosion and Profit Shifting Plan (BEPS Action Plan) encompassed 15 actions, each of which set forth various recommendations presupposing the amendment of national tax laws, or of the existing double tax treaty network, intended to prevent or at least limit the opportunities for aggressive tax planning and tax avoidance (OECD/G20 2015a, 5). The BEPS Action 6 contained, among others, recommendations regarding the tie-breaker rule for persons other than individuals (OECD/G20 2015b, 72–75).

The stance on dual residence of companies taken by the OECD in the BEPS Action Plan differs substantially from the one advocated during the several preceding decades. While maintaining the view that cases of dual residence of companies are relatively rare, the OECD emphasised that these often involve abusive practices, which call for the introduction of a specific anti-abuse measure aimed at preventing them (OECD/G20 2015b, 69, 72). The solution was found in addressing cases of dual residence on a case-by-case basis by the competent authorities of the contracting states.[18] In order to include the recommendations put forward by the BEPS Action Plan, the OECD Model Convention was revised in 2017. Subsequently Art. 4, para. 3 reads 'Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.'

The idea of dual residence cases being resolved through mutual agreement of the contracting states' competent authorities is far from new; with respect to dual residence of individuals, it has been a part of the OECD Model Convention since the very beginning.[19] However, in respect of dual residence of companies, its inclusion into the text of the Model Convention was not as straight-forward.

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[18] Para. 23, Commentary on Art. 4 of the 2017 OECD Model Convention.

[19] See: art. 4(2)(d) of the 1963 OECD Draft Model Convention.

Already in 1957, the OEEC Fiscal Committee voiced concerns about the potential inefficiency of the factual tie-breaker rule (OEEC Fiscal Committee 1957b, 2). It suggested that the cases of dual residence that cannot be resolved through the application of a factual tie-breaker rule—at that time the place of management and control—should be settled by mutual agreement of the competent authorities (OEEC Fiscal Committee 1957b, 2). In substance, the recommendation presupposed the supplementary application of the two mentioned mechanisms. Surprisingly, the Fiscal Committee quickly changed its approach. It decided to omit the provision referring the case to the competent authorities, stating without any further explanation that 'it will hardly ever be required' (OEEC Fiscal Committee 1957c, 10). The said change in approach coincided with the substitution of the place of management and control criterion with the POEM criterion. The reasoning behind the omission of the supplementary mechanism is even harder to grasp if we take into account that at the same time the Fiscal Committee observed that the two factual criteria have, in substance, the same meaning (Jones, 2009: 185).

More than four decades later, the OECD reconsidered the idea of mutual agreement as a tool for the resolution of dual residence instances in the case of companies. The reason was an indication by a number of its member states that they had already began adopting bilaterally a different approach compared to the long-standing POEM test: handing over the decision on dual residence of companies to their respective competent authorities.[20] Consequently, in 2008 mutual agreement was included in the Commentary on Art. 4 of the OECD Model Convention as an alternative provision to the factual tie-breaker rule. Contracting states were, therefore, given the option of introducing the Mutual Agreement Procedure (MAP) into their treaties instead of the default tie-breaker rule at the time—the POEM test—which remained part of the OECD Model Convention. In comparison to the earlier OEEC suggestion regarding the MAP, the newly-proposed provision was not supposed to serve as a last resort, i.e. in the case of unsuccessful application of the factual criterion, but instead of it. The alternative provision added to the Commentary was identical to the current Art. 4, para. 3 of the OECD Model Convention.

4. CASE-BY-CASE DECISION OF THE COMPETENT AUTHORITIES INSTEAD OF A TIE-BREAKER RULE

It is evident from the current wording of Art. 4, para. 3 that the OECD Model Convention no longer provides a tool capable of definitely resolving potential cases of dual residence of companies (Bräumann,

[20] OECD Centre for Tax Policy and Administration, *Draft Contents of the 2008 Update to the Model Tax Convention*, 21 April to 31 May 2008, 8.

Tumpel 2016, 306). As such, it cannot be regarded as a tie-breaker rule in the true sense of the word because, in substance, it does not actually 'break a tie'. The provision does not impose a duty on the competent authorities to reach an agreement on the resolution of dual residence, but requires them only to *endeavour* to agree on the issue. As a result, the application of this provision may easily leave a case of dual residence unresolved. Moreover, the provision does not lay down any deadline for the competent authorities to finalize the MAP (even if the case of dual residence is to remain unresolved). It is interesting to note that in the case of individuals, the OECD Model Convention does not leave room for a case of dual residence to remain unsettled. Art. 4, para. 2 explicitly requires the competent authorities to settle the issue by mutual agreement (Bräumann, Tumpel 2016, 317 n. 54). It is far from clear what could justify such considerably less favourable tax treatment of companies compared to individual taxpayers. After all, one of the overarching principles of tax policy—the principle of tax neutrality—presupposes that tax law should not interfere with the taxpayer's economic choices (Kahn 1990, 11), one of which is the choice of form in which they will conduct their business activity.

The Commentary clarifies that the mutual agreement referred to in this provision should be initiated following the rules of the MAP stipulated under Art. 25, para. 1 of the OECD Model Convention. Consequently, the settlement of a case of dual residence must be initiated by the dual resident taxpayer. The request may be made as soon as it becomes probable that the taxpayer will be considered a resident of each of the contracting states pursuant to Art. 4, para. 1 of the OECD Model Convention.[21] If, however, the taxpayer fails to submit a request within the deadline generally prescribed for the initiation of a MAP, the competent authorities will not address such a case. In other words, the competent authorities are not obliged to address cases of dual residence *ex officio*, regardless of the fact that they might be aware of them.

Once the procedure has been initiated, the competent authorities should take into consideration certain factors when determining the single state of residence. These include the place of effective management, the place of incorporation, the place where the company is constituted, as well as other relevant factors. The manner in which the provision is drafted implies that none of the cited criteria is given priority. As the list is non-exhaustive, the competent authorities are free to consider any other criteria they deem relevant. In the same vein, the Commentary lists additional suitable criteria that the competent authorities may take into account. Bearing in mind that the Commentary does not provide any

[21] Para. 24.2 of the Commentary on Art. 4 of the 2017 OECD Model Convention.

further guidance on the hierarchy[22] or on the interpretation of the stated criteria—among which is the long-disputed POEM—it might be reasonable to question the future efficiency and consistency of the decisions reached by the competent authorities. Their diverging views on the relevance and interpretation of the various criteria, combined with the inherent interest in attaching the residence of a taxpayer to their own jurisdiction (Nenadić 2016, 140)[23] could easily render the resolution of dual residence cases unfeasible. On the other hand, the fact that taxpayers cannot anticipate which criteria may be considered by the competent authorities nor how they might be interpreted means that it will be difficult, if not even impossible, for them to roughly predict their future tax burden (Bräumann, Tumpel 2016, 313).

Yet the change of utmost importance lies in the last sentence of the new Art. 4, para. 3, which stipulates that, until the mutual agreement is reached, the taxpayer is not entitled to 'any relief or exemption from tax provided by the respective treaty, except when and to the extent that competent authorities agree otherwise. This essentially means that, subject to the contrary decision of the competent authorities, dual residence companies remain outside the scope of the treaty in question. While waiting for the mutual agreement to be reached, the taxpayer will have to endure a period of time in which it will be subjected to unlimited tax liability in each of the contracting states concurrently. In practice, this implies double tax filing, double tax consultancy and double tax payments (Bräumann, Tumpel 2016, 314). The simple instruction included in the Commentary—that the competent authorities should address taxpayers' requests expeditiously—cannot be expected to contribute much to the resolving of issues inherent in the MAP. On the other hand, even if the case is successfully resolved, a possible change of the facts that are basis on which the competent authorities reached their decision would require *de novo* negotiation between them.

Having in mind the above outlined deficiencies of the new Art. 4, para. 3 of the OECD Model Convention, it is no surprise that almost all public commentators criticised its proposal as a part of the BEPS Action Plan (OECD 2015d). The fact that the OECD did not give up on it may have to do with the insistences of several of its member states who already abandoned the POEM criterion in their treaties in favour of the mutual

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[22] For an elaboration on the absence of the order of importance of the stated factors and their relevance, see: Maisto, Austry, Jones, *et al*. 2018.

[23] As a rule, the state of taxpayer's residence is able to tax taxpayer's worldwide income, i.e. not only income sourced within its territory, but also income sourced anywhere else in the world. Moreover, the distributive rules contained in the OECD Model Convention are tailored in such a way that they predominantly allocate to the residence state the jurisdiction to tax different types of income.

agreement mechanism, among which the most notable advocate was the US (Bräumann, Tumpel 2016, 319). As an illustration, the latest US Model Convention does not even stipulate a mechanism supposed to resolve dual residence of companies. It simply presupposes that a dual resident company shall not be treated as a resident of either of the contracting states for the purpose of treaty application.[24] For dual residence companies this means double taxation, or at best, reliance on unilateral measures for relief from double taxation (Sanghavi 2016, 522).

5. ACCEPTANCE OF THE NEW MECHANISM FOR THE RESOLUTION OF DUAL RESIDENCE IN TREATY PRACTICE

In order to facilitate the inclusion of the amendments related to double tax treaties recommended by the BEPS Action Plan, the OECD formulated the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Instrument, MLI). It was signed on 7 June 2017, in Paris, by 68 jurisdictions, one of which was Serbia. To date, the total number of signatories has reached 94, with four more jurisdictions expressing their commitment to sign the MLI in the near future.[25]

5.1. General Overview

Art. 4, para. 1 of the MLI reproduces the provision of Art. 4, para 3 of the OECD Model Convention. This provision was not designated as the so-called minimum standard, for which reason signatories were allowed to opt-out of it.[26] Analysing the official positions of the jurisdictions that signed the MLI, we may conclude that only 35.1% of them agreed to modify their treaties by substituting the POEM with the mutual agreement mechanism.[27] Taking a look at the EU Member States exclusively, that number is even lower—22.2%. Additionally, the MLI provides the signatories with the option of introducing into their treaties an even stricter provision, under which the competent authorities would not have the authority to agree to permit the granting of certain treaty benefits to the

[24] Art. 4(4) of the US Model Convention. 2016.

[25] Signatories and Parties to the MLI. *https://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf* (last visited 25 July, 2020).

[26] For a detailed elaboration on the minimum standard concept and its relevance in the context of the BEPS Action Plan, see: Langer 2018.

[27] The following tax jurisdictions: Argentine, Armenia, Australia, China, Colombia, Costa Rica, Egypt, Fiji, India, Indonesia, Ireland, Israel, Jamaica, Japan, Kazakhstan, Kenya, Mexico, the Netherlands, New Zealand, Norway, Oman, Papua New Guinea, Peru, Poland, Romania, Russia, Senegal, Serbia, Slovakia, Slovenia, South Africa, the United Kingdom, and Uruguay. Status as of 22 July 2020.

taxpayer whose dual residence could not be settled previously.[28] Only a minor number of jurisdictions opted for this provision.[29]

5.2. Serbia's Approach

Serbia accepted to amend all its double tax treaties to include the mutual agreement mechanism in place of the previously predominantly used POEM criterion. Leaving aside the generally keen attitude of the Serbian policymakers regarding the modifications introduced by the MLI (Popović, Ilić-Popov, Živković, 2020a), this approach could have been anticipated, bearing in mind that already in 2005, in its position regarding the OECD Model Convention,[30] Serbia reserved the right to replace the POEM test in its tax treaties with a provision referring to the MAP.[31] Thereafter, a number of Serbian treaties presupposed the MAP as a mechanism for resolving dual residence of non-individuals.[32] Nevertheless, only a few of them stipulated that, in the absence of an agreement of the competent authorities, dual resident taxpayer would be denied treaty benefits.[33] Interestingly, several treaties presupposed the application of the MAP as an alternative only, for cases in which the application of the POEM criterion is unsuccessful.[34]

Since a treaty may be modified by the MLI only to the extent that both of its contracting parties agree to the modification in question, the reach of Serbian policy choice regarding the mechanism for the resolution of dual residence of companies is expected to be limited. Namely, after matching Serbia's position on Art. 4 of the MLI to those of its contracting parties, it follows that only 15 treaties will be modified accordingly. These are the treaties with Armenia, China, Egypt, India, Indonesia, Ireland, Kazakhstan, the Netherlands, Norway, Poland, Romania, Russia, Slovakia, Slovenia, and the UK. Nonetheless, it appears that the described change in treaty practice is here to stay. This may be inferred from the fact that even the treaties that Serbia negotiated after signing the MLI (with San Marino and Israel) follow Art. 4, para. 3 of the 2017 OECD Model Convention.

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[28] Art. 4(3)(e) of the MLI.

[29] Australia, Fiji, Indonesia, Japan, Papua New Guinea, and Peru.

[30] As a non-OECD member, Serbia is only allowed to place a position and not a reservation or observation to the OECD Model Convention.

[31] OECD. 2019. *Model Tax Convention on Income and Capital 2017 (Full Version)*, Paris: OECD Publishing, P(4)-7.

[32] Treaties with: Armenia, Azerbaijan, Bulgaria, Canada, Estonia, Latvia, Lithuania, Norway, and Turkey.

[33] Treaties with: Azerbaijan, Latvia, Norway, and Turkey.

[34] Treaties with: China and India.

5.3. Future Relevance of the POEM Criterion

Although the POEM will not serve as the decisive criterion under the OECD Model Convention,[35] it will still remain relevant, for several reasons. Firstly, a majority of existing treaties will not be modified by the MLI in this respect, for which reason the POEM will continue to be the predominantly used tie-breaker rule. Secondly, even for the modified treaties, the POEM will be one of the factors that the competent authorities may take into account when deciding on dual residence of non-individuals. Lastly, amendments added to the Commentary in 2017 presuppose that that negotiating parties may still opt for the POEM test as a tie-breaker rule, provided that they agree on the manner in which this criterion will be interpreted, and are of the view that it may be interpreted in such a way that prevents it from being abused.[36] To what extent this opportunity will be chosen by the contracting parties is yet to be seen.

6. CONCLUDING REMARKS

The manner in which the new Art. 4, para. 3 of the OECD Model Convention is drafted seems to imply an irrebuttable presumption that, when it comes to companies, dual residence is a result of aggressive tax planning. Numerous authors, however, agree that dual residence of companies may fairly often, if not in a majority of cases, be motivated by non-tax reasons (Bräumann, Tumpel 2016, 310; Sanghavi 2016, 523; Maisto *et. al* 2018, 44). This is why the presupposed denial of treaty benefits in the case of unsettled dual residence seems rather excessive.

However, the core issue with the new mechanism for the resolution of dual residence of companies stems from the fact that the MAP, on whose functionality this mechanism is entirely dependent, is plagued with deficiencies. The absence of the obligation for the competent authorities to reach an agreement, the omission of time constraints for the competent authorities to end the procedure even if unsuccessfully, the complete absence of taxpayer’s participation, and the utter lack of transparency make this mechanism an unfortunate choice for the resolution of dual residence. Being a matter of such fundamental value, on which treaty application is dependent, the resolution of dual residence deserves a carefully considered tailor-made mechanism, appropriate for today’s rapidly changing world. The above presented arguments show that the MAP could considerably jeopardize legal certainty and block taxpayers’

[35] In addition to being abolished as the deciding tie-breaker criterion, it was removed from Art. 8, which allocates taxing rights with respect to profits from shipping, inland waterways transport, and air transport.

[36] Para. 24.5 of the Commentary on Art. 4 of the 2017 OECD Model Convention.

access to treaty benefits even in *bona fide* situations, i.e. situations that do not involve aggressive tax planning.

Granted, the OECD Model Convention does contain an additional tool intended to increase the efficacy of the MAP and protect the rights of taxpayers—the so-called mandatory binding arbitration, stipulated under Art. 25(5). As a result, if a resolution of a case of dual residence takes more than two years, the taxpayer may initiate the arbitration process. This means that, theoretically speaking, under a treaty entirely corresponding to the OECD Model Convention, the chances of unresolved dual residence are virtually non-existent. However, the situation in practice is very different. Only a small portion of tax treaties concluded around the world actually contain mandatory binding arbitration. And even those that do, often explicitly exclude cases of dual residence of non-individuals from their scope.[37]

On a final note, it may be concluded that the POEM criterion indeed deserved to be removed from the model conventions. However, it is clear that, under the circumstances in which the OECD faced an extremely short deadline for formulating BEPS measures,[38] the MAP was only a ‘quick fix’ to the problem. It was an already developed solution that was familiar to many of the OECD members, the introduction of which did not necessitate thorough deliberation. The core issue with the described choice is that the matter of treaty residence is a preliminary question for the application of treaty provisions, and as such it predetermines the role in which contracting states will find themselves in the course of their application. Specifically, it designates one of them as the residence state, leaving the other acting in the capacity of the source state. Leaving such a fundamental question to be addressed by a mechanism that is overly unreliable shakes the very foundations of tax treaties.

Just as it was in the case of other amendments to the treaty network that were introduced through the MLI, Serbia’s choice to substitute the MAP for the POEM was not subject to public discussion, nor was any assessment carried out regarding its expected impact on the tax administration and the MAP caseload (Popović, Ilić-Popov, Živković

[37] See for example: Italy’s position regarding Art. 28(2)(a) of the MLI. *https://www.oecd.org/tax/treaties/beps-mli-position-italy.pdf* (last visited 1 August, 2020); Art. 23(7) of the treaty between the United Kingdom and Canada; Art. 25(6) of the treaty between United Kingdom and Albania; Art. 24(6) of the treaty between the United Kingdom and Lichtenstein; Art. 25(6) of the treaty between the United Kingdom and Japan. *https://www.gov.uk/government/collections/tax-treaties* (last visited 1 August, 2020).

[38] The Final Report on the BEPS Action Plan was published in 2015, only two years after the project was initiated.

2020a, 703). In general, the experience of the Serbian competent authorities in conducting MAP is as yet rather sparse, so the decisiveness with which the policy makers embraced this tool might seem surprising. Though, as previously mentioned, a handful of Serbian tax treaties already provided for the MAP as a tool for resolving cases of dual residence of companies, the Serbian competent authorities have never had the opportunity to negotiate this matter in practice. Another difficulty lies in the fact that Serbia resolutely opposes the inclusion of mandatory binding arbitration to its tax treaties. It not only refuses to include a provision patterned upon Art. 25(5) of the OECD Model Convention, but it abstains from agreeing to tailor-made arbitration clauses as well (Popović, Ilić-Popov, Živković 2020, 707). Although BEPS Action 14 proposes measures intended to mitigate legal uncertainty and undesirable double taxation by improving various features of the MAP (OECD/G20 2015c), Serbia has only recently undertaken the very first steps in this direction. There is a long way to go, which has been confirmed by the OECD in its MAP Peer Review Report for Serbia, published in early 2020 (OECD 2020, 53–56). Taxpayers are left with the hope that the procedural framework, as well as resources made available to the competent authorities for the conduct of MAP, will be improved before the caseload starts increasing.

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