

YIN Moot Court: Blossom Online Dating

Friday 20th April 2017
09:00 to 10:30



Introduction

Sanjay Iyer (Hong Kong/Singapore)
Young IFA Global Committee Chair

What is YIN?

YIN = Young IFA Network

Setup over 10 years ago to encourage the participation of younger members in IFA

40 years old or less

54 of the 70 IFA Branches have YIN Reps

YIN Reps – organise local events (e.g. Talks, Moot Courts, Article competitions, Discussion groups etc.)

YIN Committee – organises YIN events at the Annual Congress and the Regional Conferences (e.g. Asia Pacific, LATAM, Russia etc.)

Moot Court: Blossom Online Dating

A POEM, PE and Abuse Case

Participants

Acting for the Taxpayer:

- Jacques Desroches, EY Hong Kong

Acting for the Tax authority:

- Martin Yuan-Chun Lan, Chinese Culture University

Acting Judge:

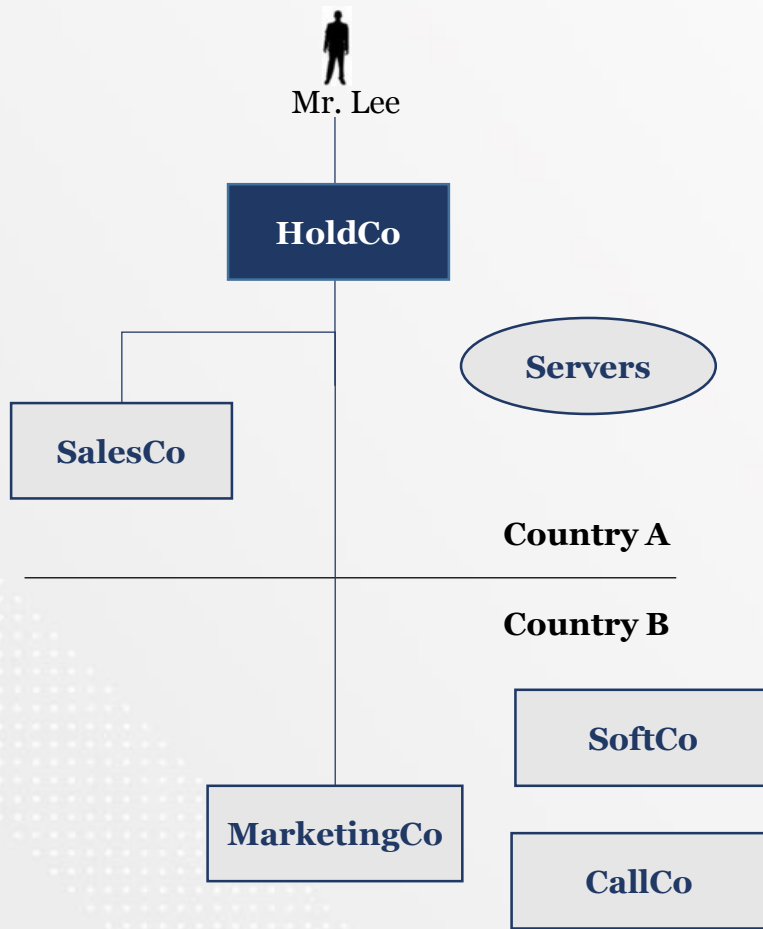
- Prof. Wei Cui, University of British Columbia

Moot Court: Facts

Prof. Wei Cui (Canada/USA)

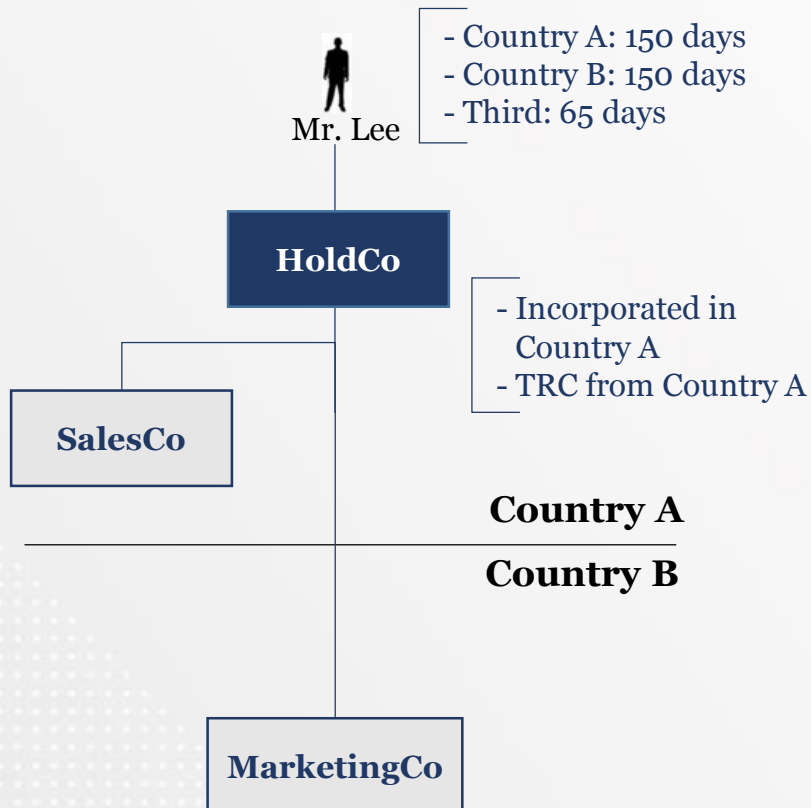
Acting Judge

Overview of facts



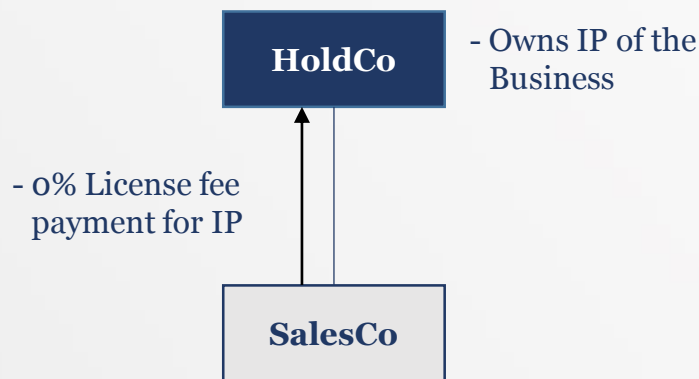
- Blossom earns revenue from selling user data to third parties in exchange for a fee or selling advertising space to third party advertisers.
- Web/Mobile app to users in Country A (Low Tax Country) (10% users) and Country B (High Tax Country) (90% users)
- Third Party: SoftCo develops web/mobile app in Country B and CallCo provides user support
- Server for all data is located in Country A
- Mr. Lee founded the Group and owns the Group through HoldCo located in Country A.
- HoldCo owns 2 entities: SalesCo (Country A) and MarketingCo (Country B)

Overview of facts (cont'd)



- Mr. Lee is a national of Country B. He moved to Country A shortly before founding Blossom.
- He is the sole director of all 3 related entities
- HoldCo and SalesCo hold valid TRCs from Country A.

HoldCo's License fee payment from SalesCo

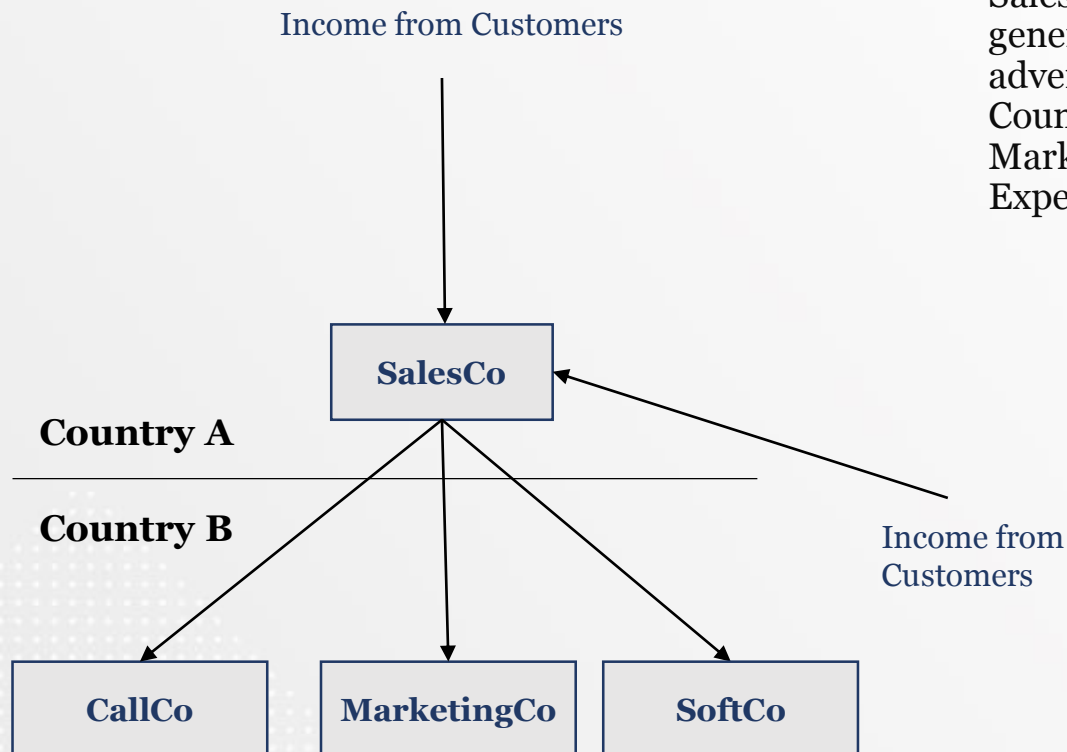


Country A

Country B

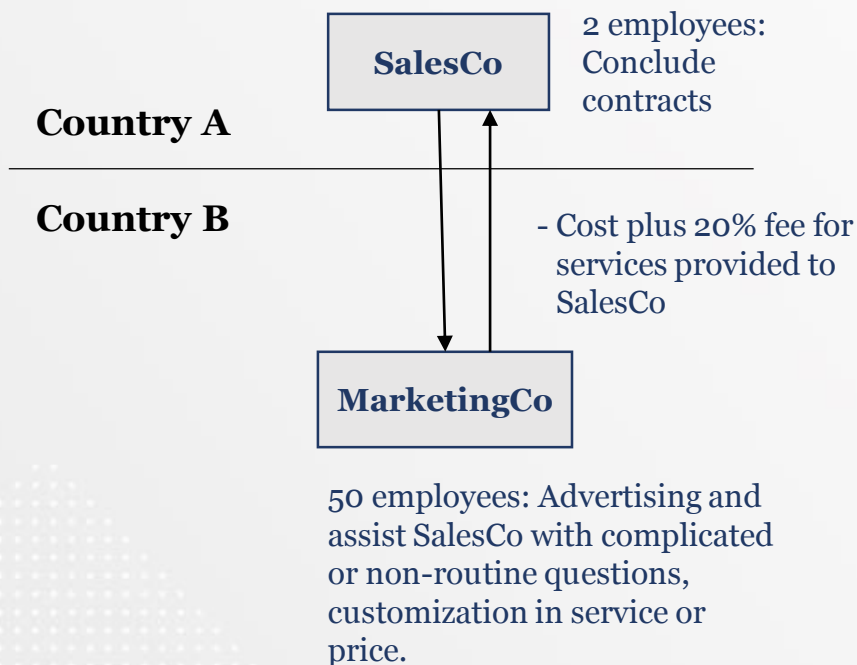
- HoldCo owns the intellectual property of the business and licenses the use of such IP where appropriate to SalesCo.
- HoldCo earns a 0% license fee for its license of IP to SalesCo

SalesCo's income from the sale of data and advertising



- SalesCo earns 100% of the revenue generated from the sale of data and advertising to customers in Country A and Country B less fees paid to CallCo, MarketingCo and SoftCo and Operating Expenses in Country A.

SalesCo's Operating Model



- SalesCo has two employees (who are located in Country A) who manage the sales process.
- MarketingCo has 50 employees (who are located in Country B). They advertise and market Blossom's data and advertising space to customers.
- For more complicated or non-routine questions, or for the customisation of the service or price, SalesCo employees pass customers to the more experienced MarketingCo employees based in Country B. Once their queries are resolved, MarketingCo employees direct them back to SalesCo to finalise the sales process.

Assumptions

- Country A's tax rate is 8.25% and it does not impose withholding taxes.
- Country B's tax rate is 25%. Country B imposes a 25% withholding tax on all payments made to non-resident persons.
- Country A determines tax residence of companies based on the location of the residence of the directors.
- Country B determines tax residence of companies based on the location of the place of effective management of the company.
- The A-B double tax treaty is identical to the OECD Model Convention 2014.
- Country A and Country B have all signed the Multilateral Convention on BEPS ("MLI"). Country A has reserved on Article 4.

Resources

- OECD Model and Commentary (2014 edition)
- International Case Law regarding place of effective management, abuse and agency PE
- MLI and accompanying Explanatory Statement:
 - Article 4 (Dual Resident Entities) (nb. Country A reserved)
 - Article 6.1 (Purpose of a Covered Tax Agreement)
 - Article 7.1, 7.2 (Prevention of Treaty Abuse) (reserved on Limitation of Benefits)
 - Article 12.1 (Artificial Avoidance of Permanent Establishment Status)
- OECD TP Guidelines
- Related BEPS Action Reports

The Dispute

- HoldCo:
 - Country B assessed it as a resident
- SalesCo:
 - Country B assessed it as a resident
 - Where SalesCo is a non-resident, SalesCo has a PE in Country B (using Article 12 of the MLI through the activities of MarketingCo and CallCo).
- MarketingCo:
 - If the above arguments all fail, MarketingCo should earn 100% of the total Blossom Group Sales Revenue less expenses of the Group. In substance all of the activities of The Blossom Group are carried out in Country B.

The Issues

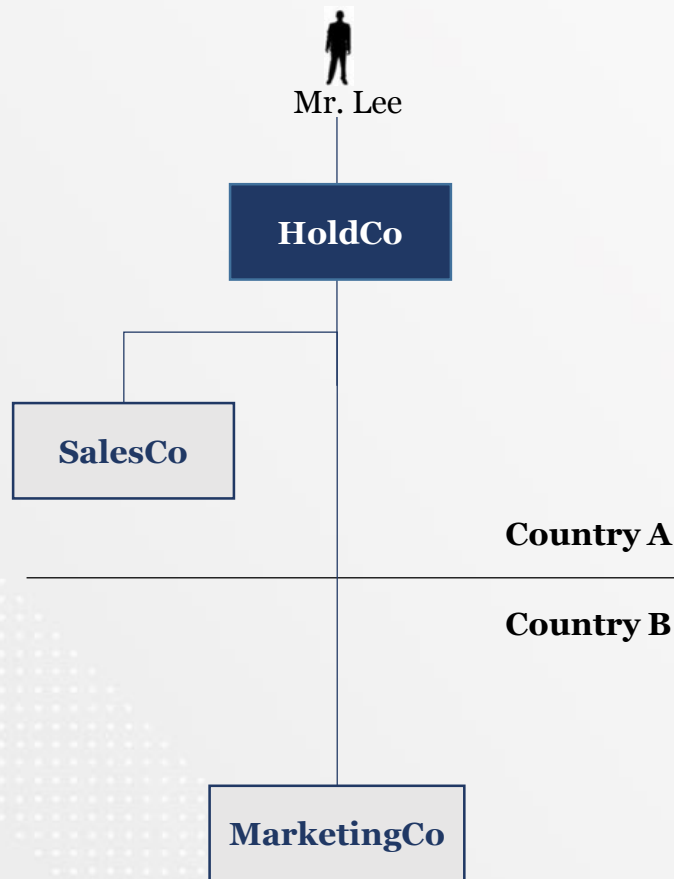
No.	Issue
1	Where is HoldCo's Place of Effective Management Located?
2	Where is SalesCo's Place of Effective Management Located?
3	Where SalesCo is non-resident, does it have a PE in Country B?
4	Where SalesCo has a PE in Country B, can SalesCo be considered to have paid a royalty to HoldCo?
5	Does MarketingCo earn an arm's length remuneration for its services rendered?

Arguments for the Taxpayer

Jacques Desroches (Hong Kong/Canada)

Counsel for taxpayer

Overview of facts

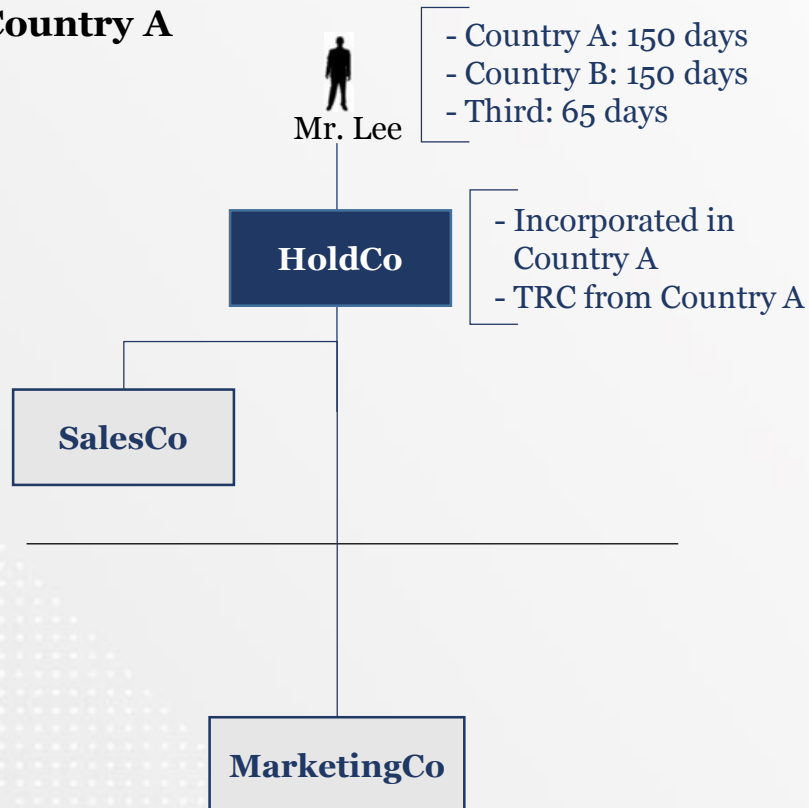


- Mr. Lee is a successful entrepreneur / engineer that developed a highly effective algorithm for data collection & analysis
- Two years ago, Mr. Lee decided to market his algorithm through the management of an online dating website (Blossom Online Dating)
- Mr. Lee established Blossom Group in Country A because of socio-economic incentives such as –
 - ✓ Lower operating costs
 - ✓ Skilled labour
 - ✓ Lower domestic tax
- Blossom Group is well known and respected for its integrity regarding the use made of the user data collected – intensive customer background checks
- Even if Blossom Group has grown considerably since its inception, Mr. Lee remains significantly involved in every facets of its activities

Issue 1: Where is HoldCo's Place of Effective Management Located?

HoldCo – Tax Residency

Country A

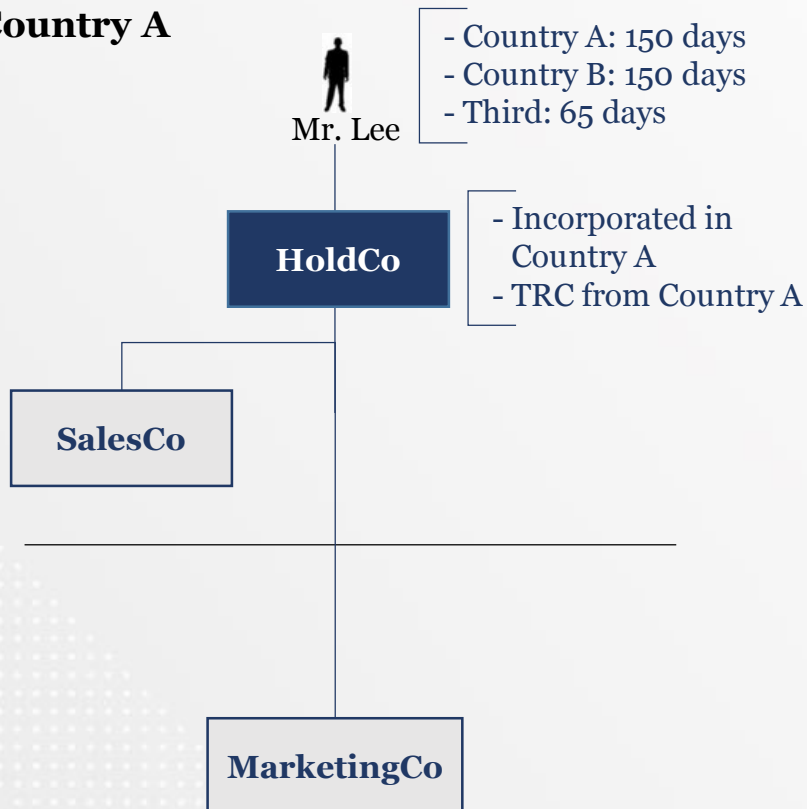


Country B

- HoldCo – key management and commercial decisions made in Country A:
 - ✓ Financing
 - ✓ Investments in subsidiaries
 - ✓ IP management
 - ✓ Servers
- ⇒ **Key contracts are signed in Country A**
- Articles of Association give blanket authority to Mr. Lee
 - ✓ BoD meetings unnecessary given Mr. Lee's powers
 - ✓ No abrogation of Mr. Lee's authority / no puppet

HoldCo – Tax Residency (cont'd)

Country A



Country B

- If dual residency, tie-breaker rule under A-B tax treaty is POEM (Country A reserved on Article 4 MLI)
- Para. 24 of Comm. to Article 4 OECD MTC:
“The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made.”
- Exchange of notes – BEPS Action 6
 - Location of BoD meetings
 - Location where CEO / senior executives carry their activities
 - Location where day-to-day senior management is carried
 - Location of headquarter
 - Place of incorporation
 - Location of accounting records
 - Whether residency would carry the risk of improper use of treaty provisions
 - Etc.

Issue 2: Where is SalesCo's Place of Effective Management Located?

SalesCo – Tax residency



Relevant facts (SalesCo)

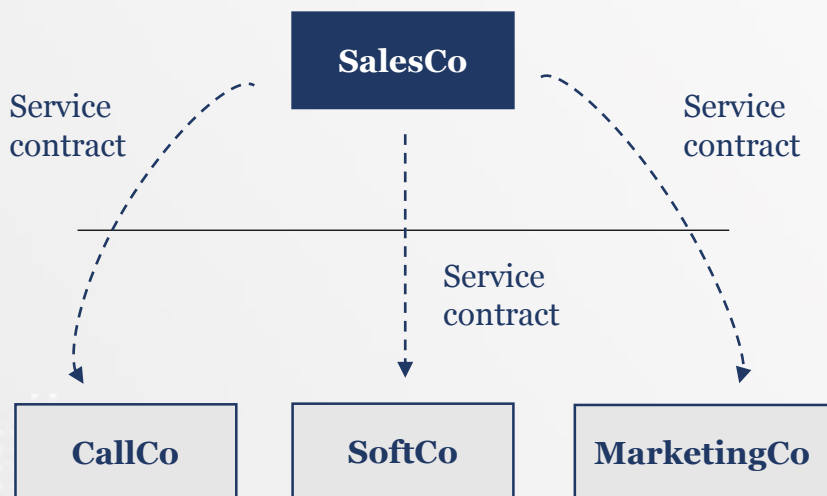
- Incorporated in Country A
- TRC from Country A
- Mr. Lee is sole director
- 2 full-time employees
- Active business income

- SalesCo – key management and commercial decisions made in Country A:
 - ✓ Sales strategy (incl. customer policy)
 - ✓ Marketing strategy
 - ✓ Contract relationship
- ⇒ **Key contracts / communications when Mr. Lee is in Country A**
- Articles of Association give blanket authority to Mr. Lee
 - ✓ BoD meetings unnecessary given Mr. Lee's powers
 - ✓ No abrogation of Mr. Lee's authority / no puppet
- If dual residency, deciding in favor of Country A would not carry the risk of facilitating an improper use of the provisions of the A-B tax treaty

Issue 3: Where SalesCo is non-resident, does it have a PE in Country B?

SalesCo – Permanent establishment

Country A

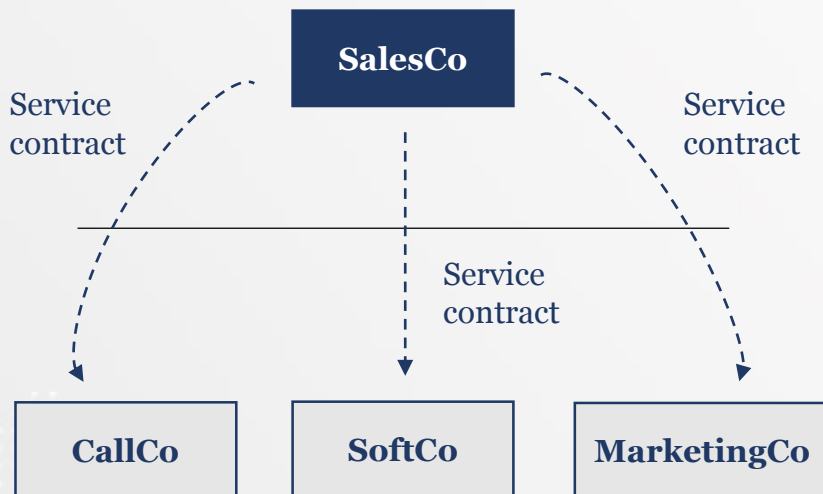


Country B

- No fixed place PE
 - No agency PE
- (1) CallCo / SoftCo are third-party contractors providing technical services
 - ✓ No agency relationship
 - ✓ No detailed instructions / bears own entrepreneurial risk / not closely related to SalesCo / multiple clients
 - ✓ No interaction with buyers of data/advertising space
 - (2) MarketingCo organizes marketing / promotional events for users / customers
 - ✓ Preparatory or auxiliary activities
 - ✓ Anti-fragmentation rule does not apply – CallCo and MarketingCo are not closely related

SalesCo – Permanent establishment (cont'd)

Country A



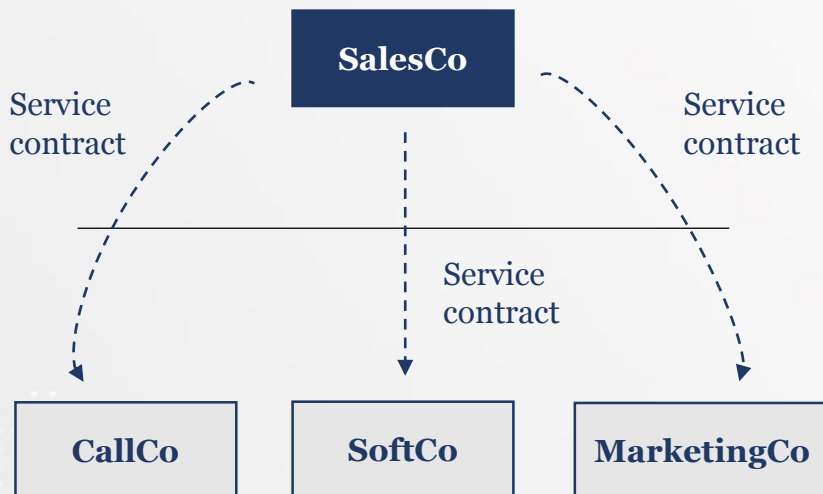
Country B

- Application of revised Article 5(5) & BEPS Action 7
- Final Report on BEPS Action 7 –

“The principal role leading to the conclusion of the contract will ... typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise. The phrase ... applies where, for example, a person solicits and receives (but does not formally finalise) orders ... **It does not apply, however, where a person merely promotes and markets goods or services** of an enterprise **in a way that does not directly result** in the conclusion of contracts ... **even though the sales ... may significantly increase** as a result of that marketing activity.” (p. 19)
- MarketingCo does not solicit / receive orders
- No routine approval of customers discussing with MarketingCo – background checks (ethical issues, creditworthiness, etc.)

SalesCo – Permanent establishment (cont'd)

Country A



Country B

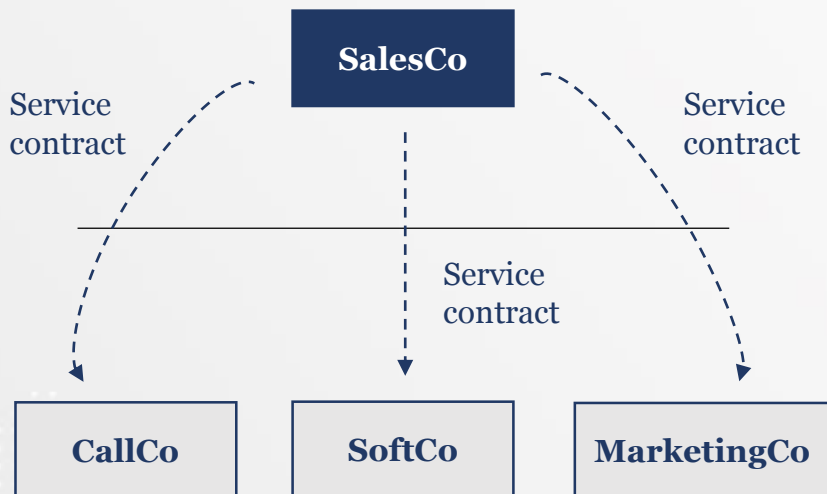
- If SalesCo does not have a PE, PPT does not apply to deem a PE

Principal purpose of transaction(s) –

- *Service agreements* – commercially necessary for SalesCo
- *Establishment of SalesCo* –
 - Purposes of establishment in Country A:
 - ✓ Lower operating costs
 - ✓ Skilled labour
 - ✓ Proximity with customers
 - ✓ Lower domestic tax regime
 - ✓ Country A's growing economy
 - ✓ Proximity with Country B
 - ✓ SalesCo not a conduit / not fictitious
 - ✓ Article 5(5) not in existence at time of transactions

SalesCo – Permanent establishment (cont'd)

Country A



Country B

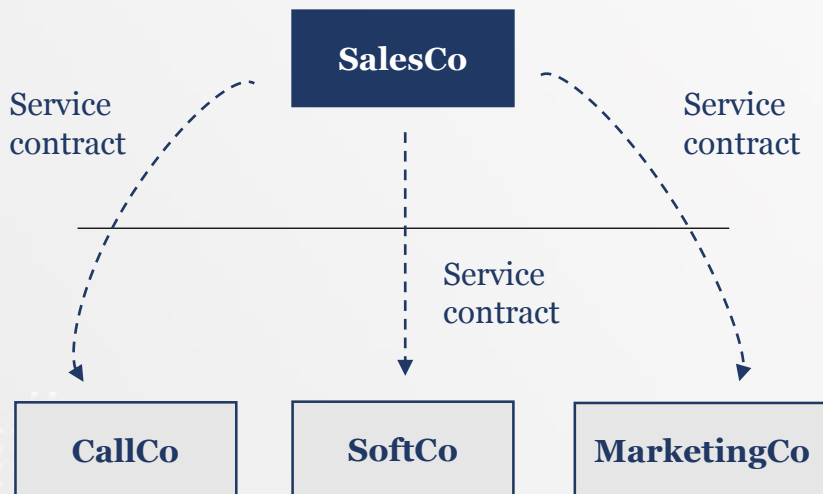
- **If SalesCo does not have a PE, PPT does not apply to deem a PE (cont'd)**

Object & purpose of Article 5 –

- Article 5 provides detailed guidance, i.e. does not apply if PE conditions not met
- PPT Example E (BEPS Action 6) –
 - ✓ PPT does not apply to an increase of equity participation from 24% to 25% shortly before dividend payment (lower DWHT)
- Preamble on economic relationship –
 - ✓ Businesses of Country A and B need certainty on an issue as fundamental as PE protection

SalesCo – Permanent establishment (cont'd)

Country A



Country B

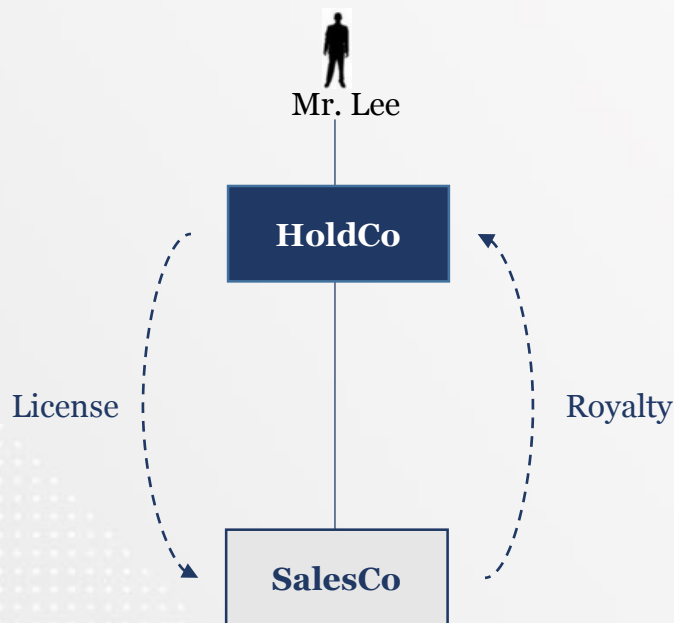
- Attribution of profits to PE – zero profit PE
- BEPS Action 7 – “Additional Guidance on the Attribution of Profits to Permanent Establishment” (March 2018)

“[W]hen both Article 7 and Article 9 are applicable [...] and the functions performed by the intermediary can qualify as significant people functions for the attribution of a specific risk to the PE and as risk control functions for the allocation of a risk under Article 9, **it is important to ensure that the risk to which those functions relate is not simultaneously allocated to the intermediary [...] and attributed to the PE** (under Article 7). Accordingly, where a risk is found to be assumed by the intermediary under the guidance in Section D.1.2 of Chapter I [Transfer Pricing Guidelines], **such risk cannot be considered to be assumed by the non-resident enterprise or the PE for the purposes of Article 7. Otherwise, double taxation could occur in the source country** through taxation of the profits related to the assumption of that risk twice, i.e. in the hands of both the PE and the intermediary.” (para. 40)

Issue 4: Where SalesCo has a PE in Country B, can SalesCo be considered to have paid a royalty to HoldCo?

HoldCo as non-resident – Deemed royalty payment

Country A



Country B wants to impose 25% WHT

- Income recognition – royalty from SalesCo to HoldCo
- WHT tax exemption available under Article 12 of A-B tax treaty

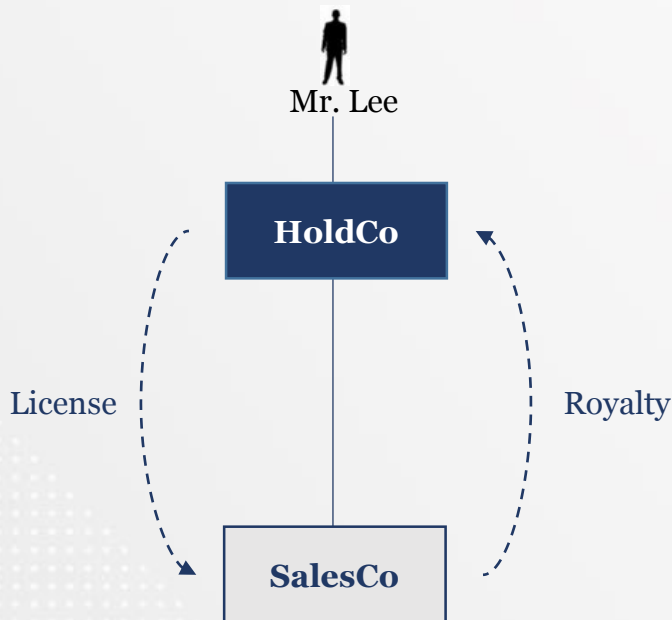
=> Principal Purpose Test (PPT) does not apply

Principal purpose of transaction(s) –

- *License agreement* – commercially necessary for SalesCo
- *Establishment of HoldCo* –
 - ✓ Lower operating costs
 - ✓ Lower domestic tax regime
 - ✓ Proximity with customers
 - ✓ Country A's growing economy
 - ✓ Skilled labour
 - ✓ Proximity with Country B
 - ✓ HoldCo not a conduit / not fictitious

HoldCo as non-resident – Deemed royalty payment (cont'd)

Country A



Country B wants to impose 25% WHT

=> Principal Purpose Test (PPT) does not apply (cont'd)

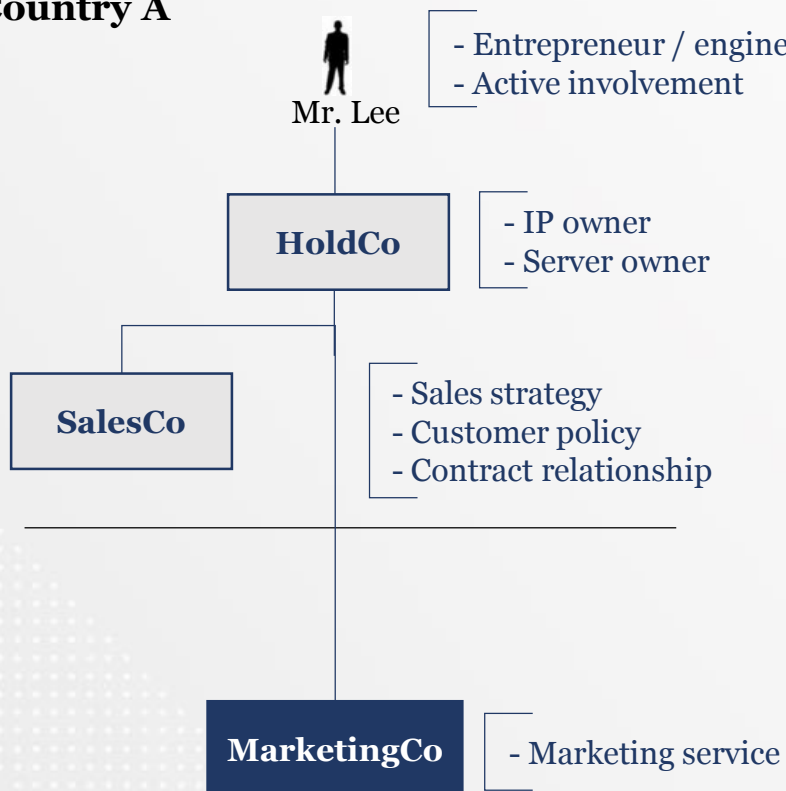
Object & purpose of Article 12 –

- Preamble to the A-B treaty indicates a desire by Country A and B to further develop their economic relationship through the treaty
- No double non taxation / treaty shopping
- PPT Example C (BEPS Action 6) –
 - ✓ PPT does not apply to establishment of a manufacturing plant in another country because tax treaty encourages cross-border investment
- WHT exemption results in more efficient allocation of resources
 - ✓ Reduced prices for customers and website users

Issue 5: Does MarketingCo earn an arm's length remuneration for its services rendered?

MarketingCo – Deemed 25% tax on net group profits (cont'd)

Country A



Country B

- Algorithm / source codes vs user data
- BEPS Action 1 – “Tax Challenges Arising from Digitalisation –Interim Report 2018” (March 2018)

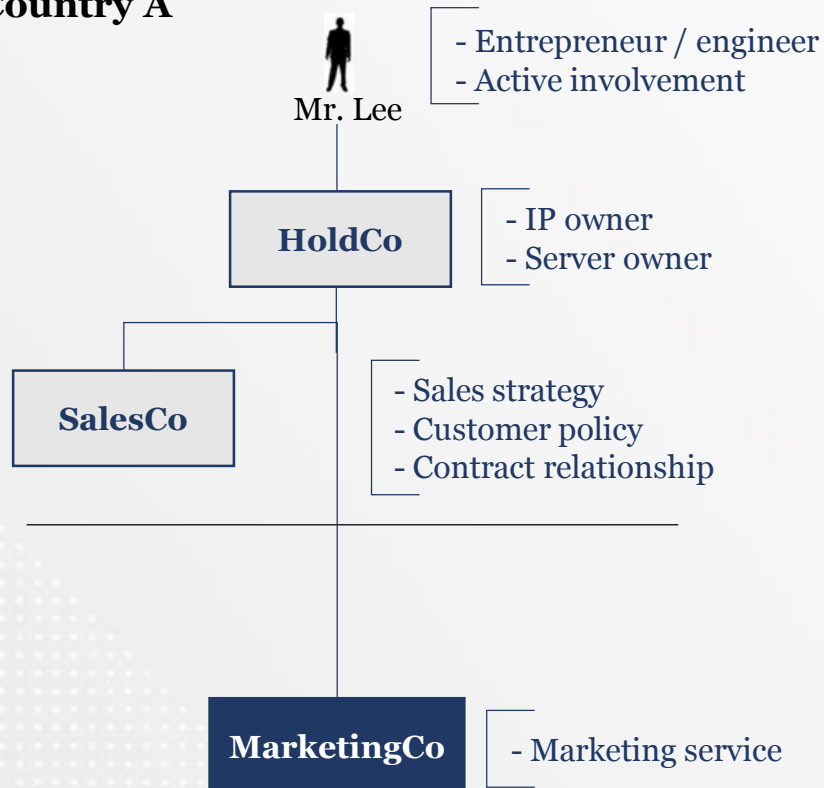
“For many digitalised enterprises, **the intense use of IP assets such as software and algorithms** supporting their platforms, websites and many other crucial functions **are central to their business models.**” (para. 34)

“Data collection processes lead to increasing volumes of digital data being stored by private as well as public entities. **However, without further manipulation and analysis by businesses, the economic value of this type of big data is typically limited.**” (pp. 53-54)

“**Processing, interpretation and analysis of the data is necessary in order to generate economic value.** [...] Data analysis related to a specific jurisdiction can be carried out, for example, by highly skilled data scientists in another jurisdiction, **generally the headquarters, or it can be automated by an algorithm.**” (p. 54)

MarketingCo – Deemed 25% tax on net group profits

Country A



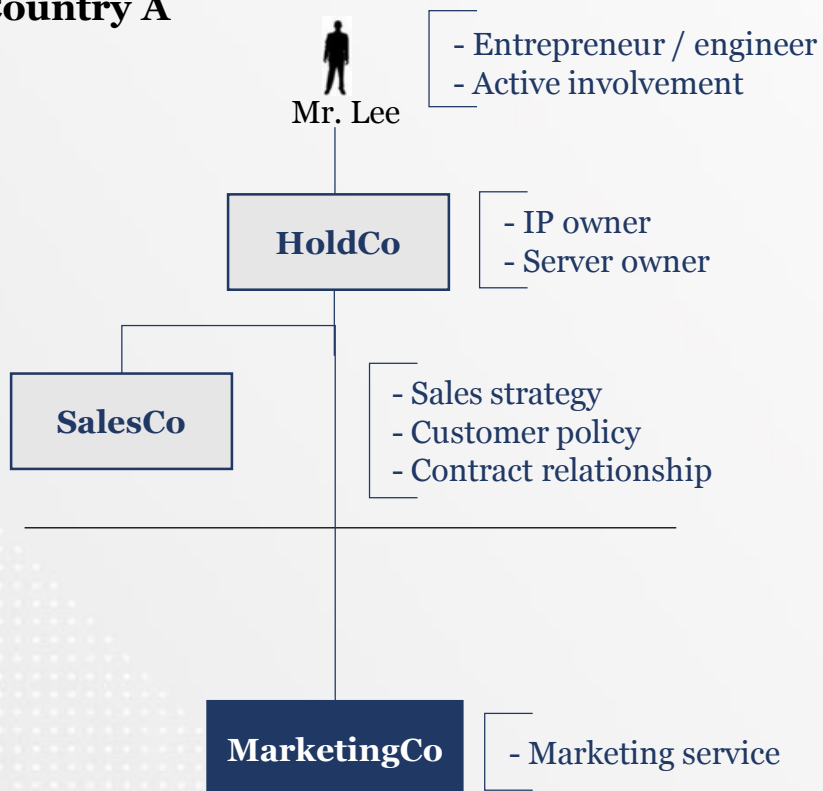
Country B

- Control and management of IP
- Final Report on BEPS Actions 8-10 –
“It is not essential that the legal owner physically performs all of the functions related to the development, enhancement, maintenance, protection and exploitation of an intangible through its own personnel in order to be entitled ultimately to retain or be attributed a portion of the return derived by the MNE group from exploitation of the intangibles. In transactions between independent enterprises, certain functions are sometimes outsourced to other entities.” (para. 6.51)

In outsourcing transactions between independent enterprises, it is usually the case that an entity performing functions on behalf of the legal owner of the intangible that relate to the development, enhancement, maintenance, protection, and exploitation of the intangible **will operate under the control of such legal owner** [...]” (para. 6.53)

MarketingCo – Deemed 25% tax on net group profits (cont'd)

Country A



- MarketingCo – functional analysis
 - MarketingCo organizes user / customer events
 - Needs 50 employees because of need for “boots on the group” (market penetration)
 - MarketingCo’s activities do not create local marketing intangibles (such as trademark, customer lists, etc.)
 - Complicated / non routine issues – realm of exploratory discussions, not negotiation of contracts (no assumption of sales function)
 - MarketingCo bears only the operational risk associated with performance failure
 - MarketingCo has limited assets (desk, chairs, computers, etc.)
- **Appropriate remuneration: routine marketing service provider (cost+ 20% per benchmarking)**

Country B

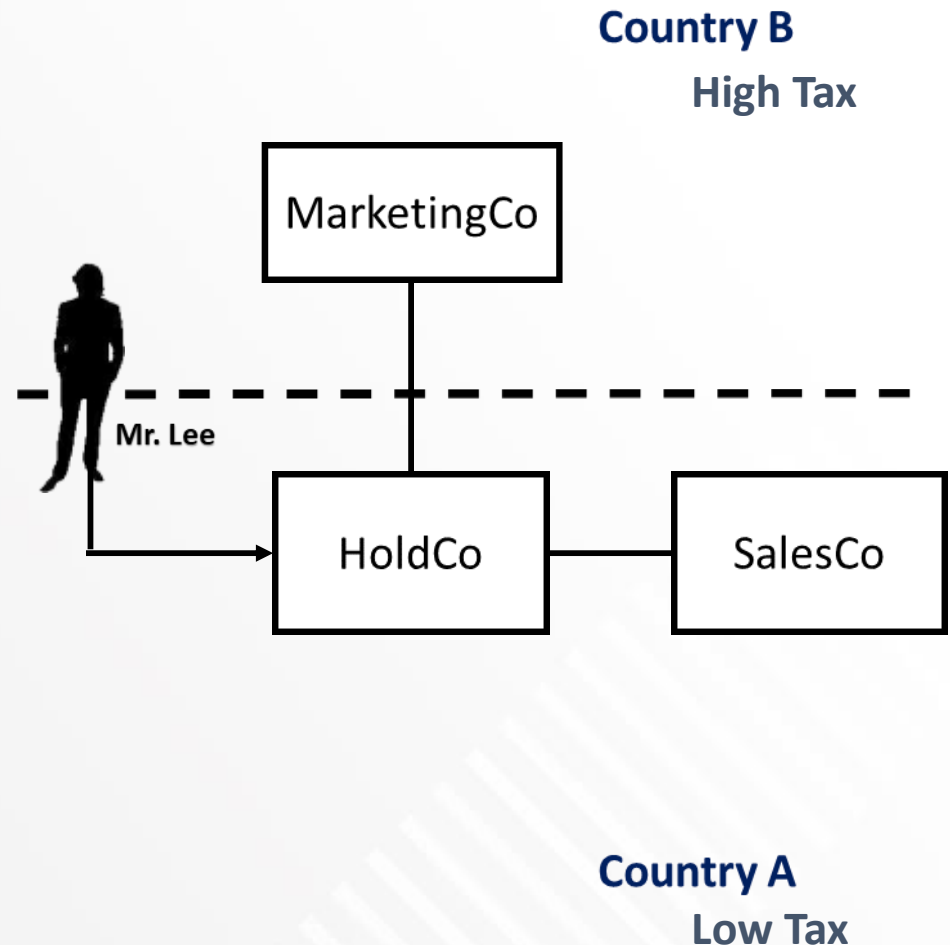
Arguments for the Tax authority

Martin Yuan-Chun Lan (Host)

Counsel for tax authority

Overview of facts

- Mr. Lee is a successful entrepreneur. As the sole director, he controls 3 companies, located at Country A and Country B.
- Mr. Lee is a national of Country B. He was born and raised up in Country B. But he moved to Country A shortly before founding Blossom.
- Country B is a developed country, highly cooperative of international anti-tax avoidance.
- Country A is a low tax country. It has signed the MLI on BEPS but reserved on Article 4 of dual resident Entities.



The Issues

No.	Issue
1	Where is HoldCo's Place of Effective Management Located?
2	Where is SalesCo's Place of Effective Management Located?
3	Where SalesCo is non-resident, does it have a PE in Country B?
4	Where SalesCo has a PE in Country B, can SalesCo be considered to have paid a royalty to HoldCo?
5	Does MarketingCo earn an arm's length remuneration for its services rendered?

Issue 1: Where is HoldCo's Place of Effective Management Located?

HoldCo – Tax Residency

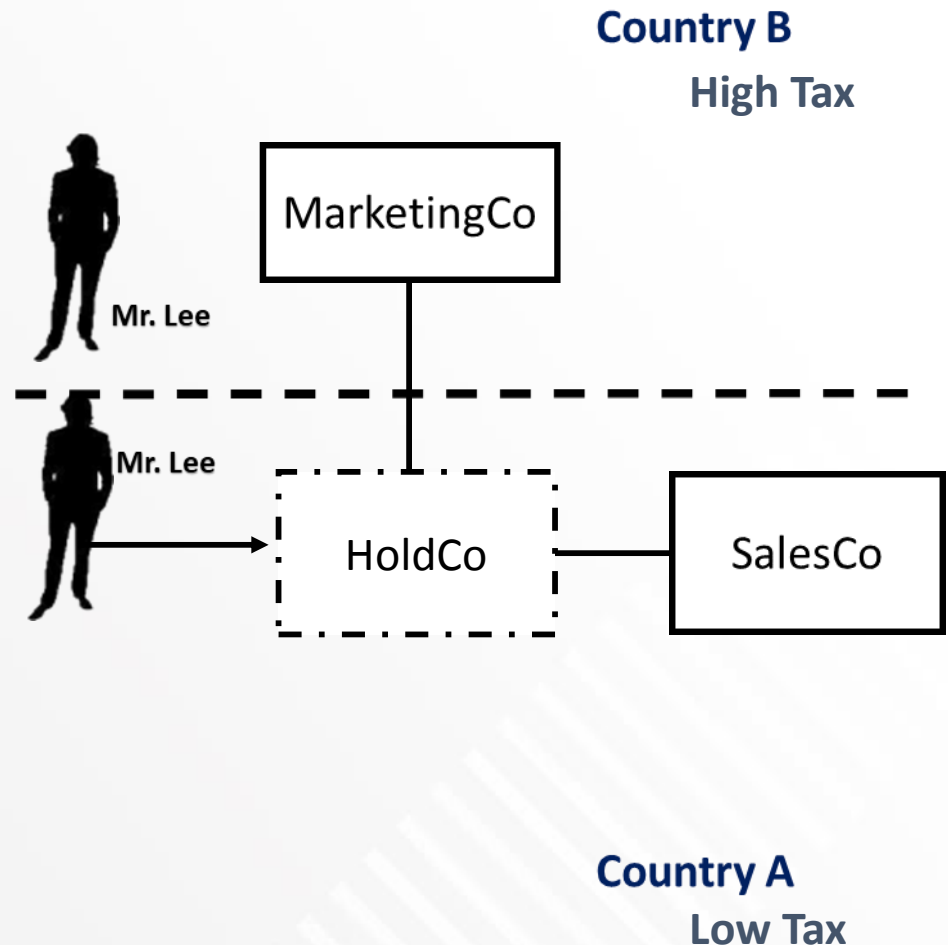
- Residence

- Art. 4 (3), A-B DTA

“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.”

Place where

1. Significant decision maker resides;
2. Financial statements, records of accounting books, minutes of meetings of the Board of Directors, etc. are prepared or stored.
3. Major business activities carried out.

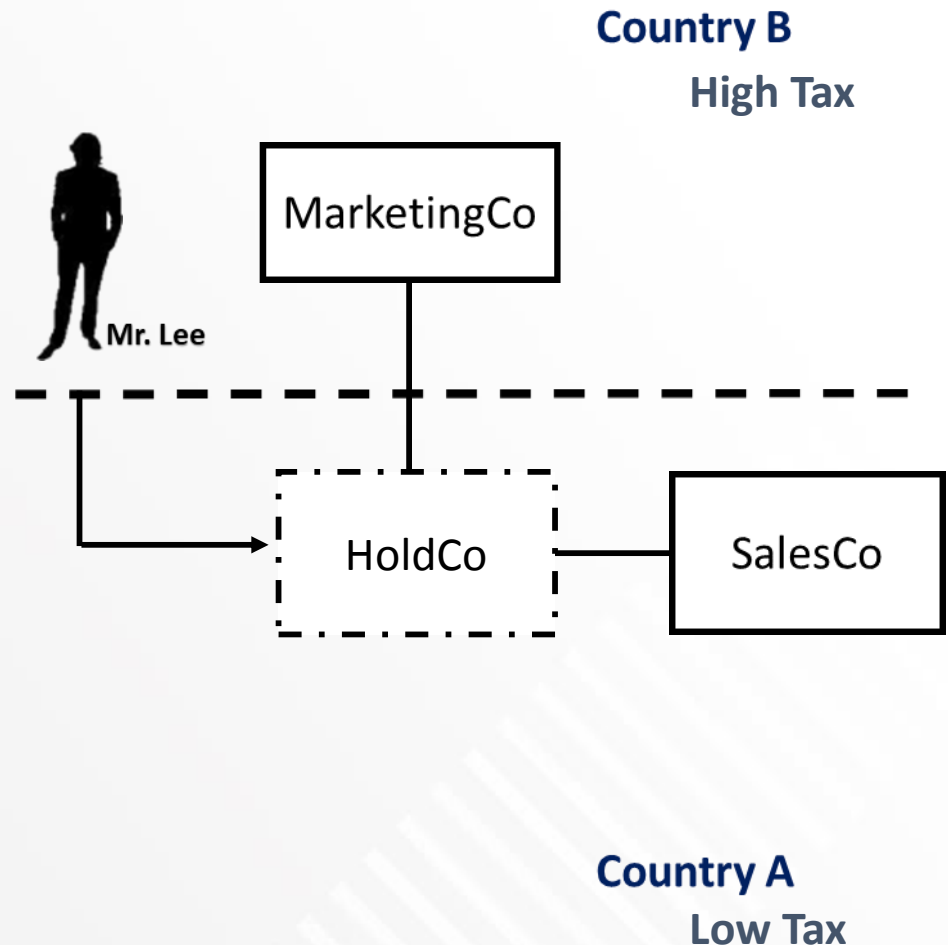


HoldCo – Tax Residency (cont'd)

Major Business Activities carried out

- ✓ Main business activities within the Country other than place of incorporation
- ✓ Affiliate or invested entity shall not be considered in the determination of the major business activities
- Most functions of the group are performed in Country B, not practical for Mr. Lee to make important decision elsewhere.

→→Thus, POEM in Country B

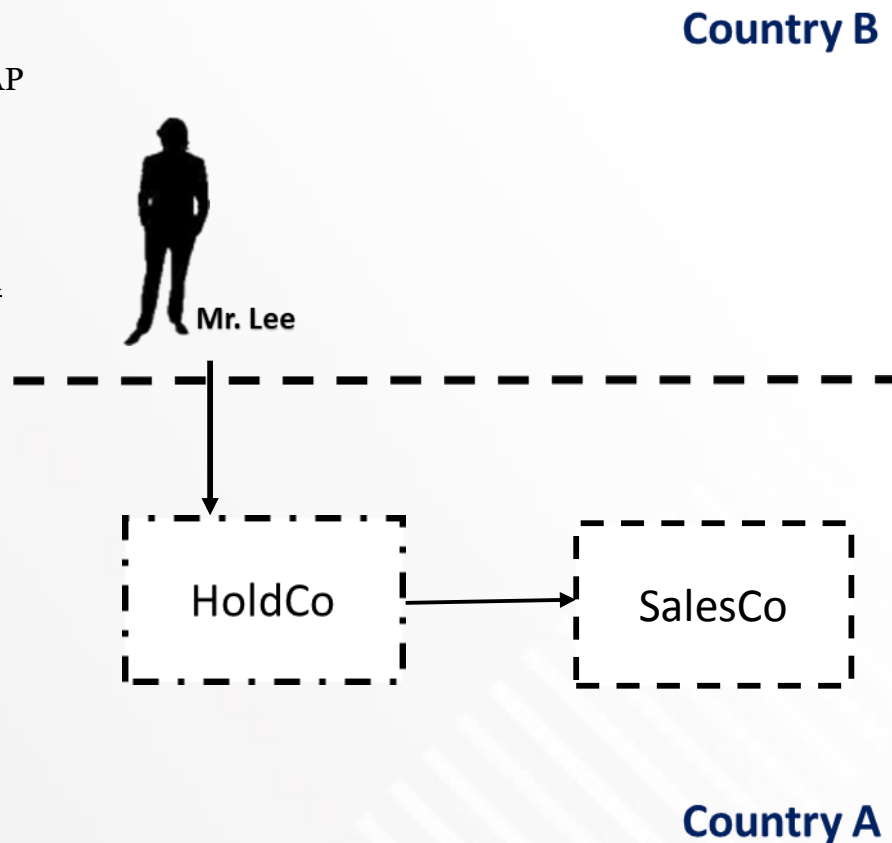


Issue 2: Where is SalesCo's Place of Effective Management Located?

SalesCo – Tax residency

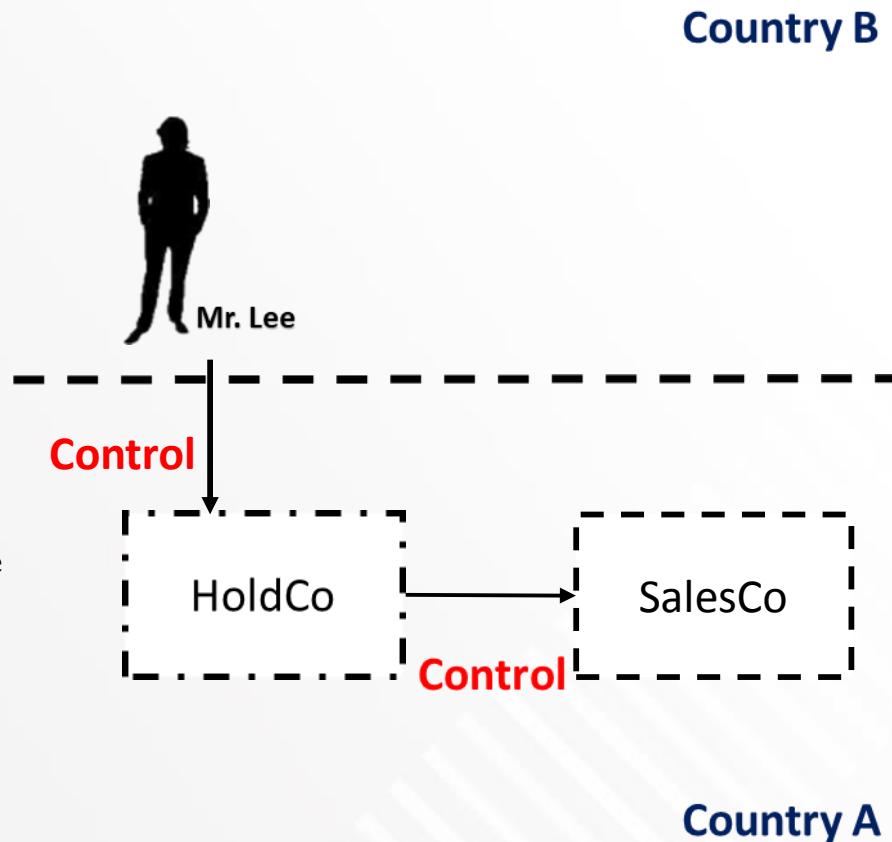
- POEM in Country B
 - Art. 4.3. of A-B DTA adopts POEM
 - Inapplicability of Art. 4 of MLI for MAP due to reservation from Country A
 - Para 24 of Comm. OECD MTC, 2014

“The place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made.”



SalesCo – Tax residency

- HoldCo controls SalesCo
 - Para 23 of Comm. OECD MTC, 2014
 - POEM, not necessarily place of management, nor fiscal domicile of operator
 - place of incorporation of HoldCo and SalesCo is irrelevant
 - movement of Mr. Lee is irrelevant
 - holding employment visa in Country A is irrelevant.
 - Key management lies in the Control of Mr. Lee through HoldCo
 - POEM in Country B, as discussed above on the case of HoldCo
- Thus, SalesCo is a tax resident of Country B



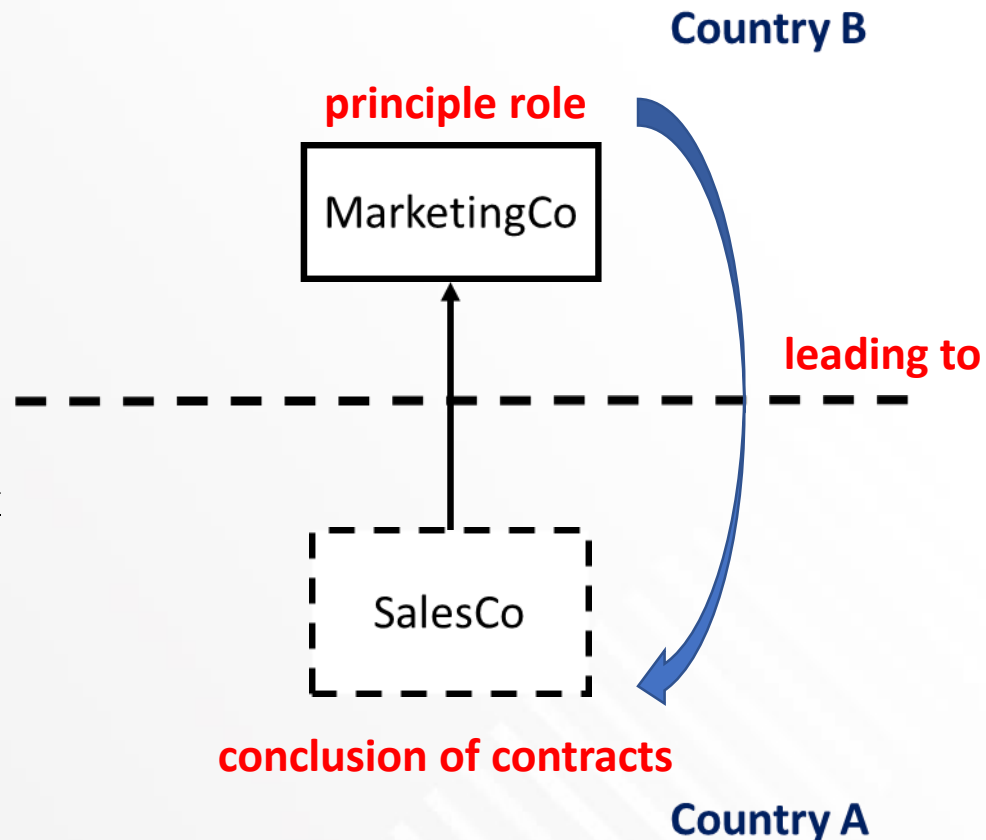
Issue 3: Where SalesCo is non-resident, does it have a PE in Country B?

SalesCo – Permanent establishment

- MarketingCo deemed as PE in Country B
 - Art. 5 (5) A-B DTA

“...a person...acting on behalf of an enterprise and has, and habitually exercises...an authority to conclude contracts in the name of the enterprise ...shall be deemed to have a PE in that Country...”
 - Modification by Art. 12 (1) MLI

“...habitually concludes contracts or habitually plays the principle role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise...”
- Profits attributable to MarketingCo as PE
 - Art. 9 of A-B DTA **TP**
- Thus, SalesCo, being non-resident, has PE in Country B



Issue 4: Where SalesCo has a PE in Country B, can SalesCo be considered to have paid a royalty to HoldCo?

HoldCo as non-resident – WHT on royalty payment

- No licensing fee paid – cannot be deemed
- Taxpayer cannot invoke “substance over form”

HoldCo as non-resident – WHT on royalty payment

- Art. 12 (1) A-B DTA be modified by Art. 7.1 MLI (PPT)

- Principle Purpose Test

“...having regard to all relevant facts and circumstances, obtaining that benefit was one of the principle purposes of any arrangement or transaction that resulted directly and indirectly in that benefit...”

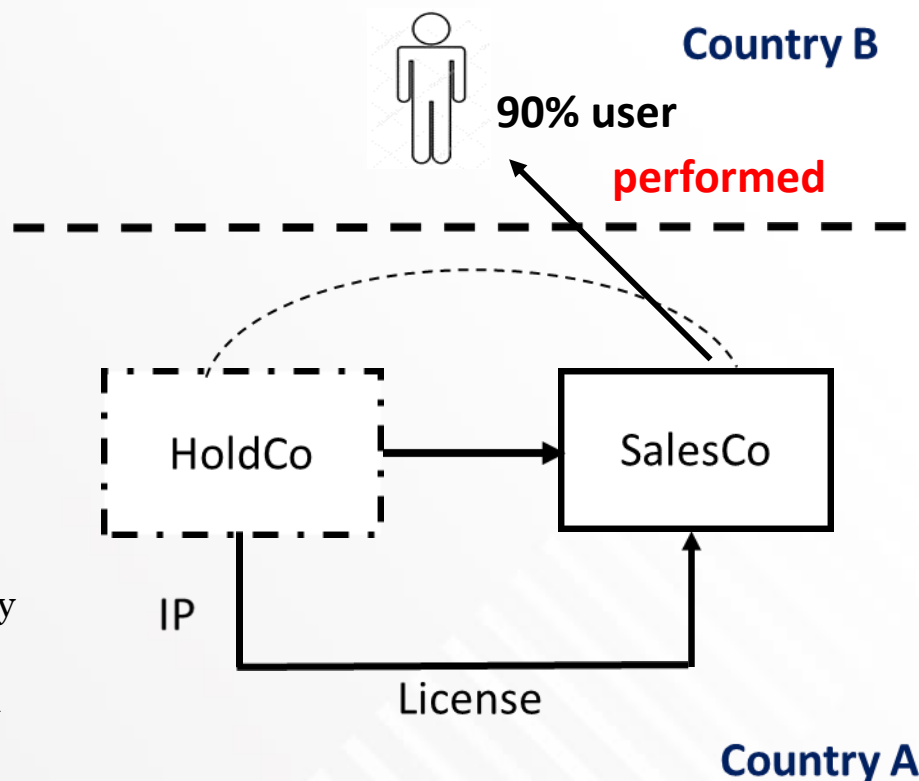
→ Benefits otherwise provided under A-B DTA shall be denied. (Art. 7.2 MLI)

“...benefit...shall not be granted...if it is reasonable to conclude...that obtaining that benefit was one of the principle purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.”

Cannot just move out of Country B to Country A to obtain these benefits.

Roundtripping

No activities in Country A in substance



Issue 5: Does MarketingCo earn an arm's length remuneration for its services rendered?

Comparison of SalesCo and MarketingCo

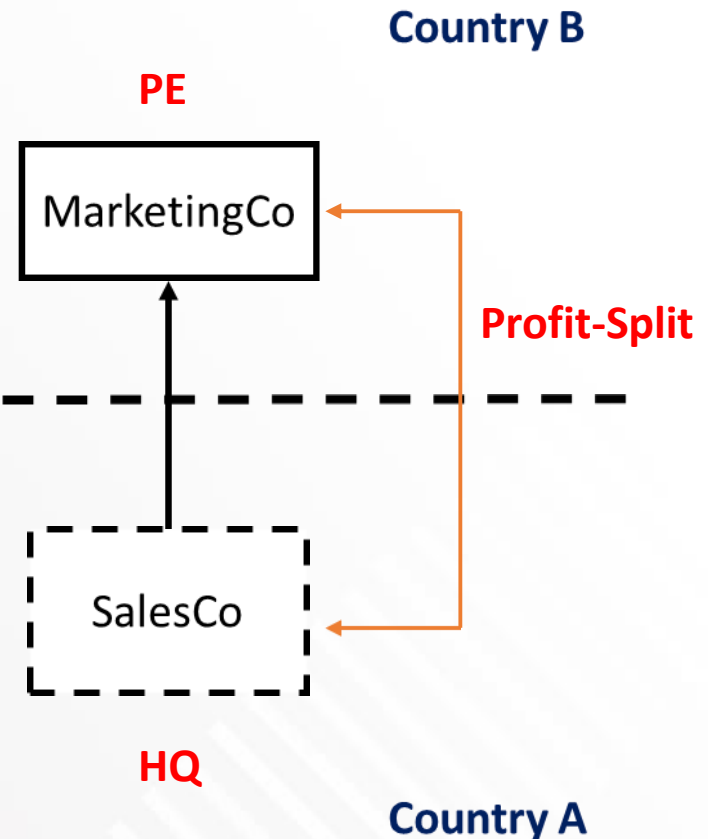
-restatement of facts

	SalesCo	MarketingCo
Place of incorporation	Country A	Country B
Number of employees	2	50 (more experienced)
Functions	Sales process; Assist with contract concluding; Information of terms of pricing; Concluding contracts	Advertisements; Customization of service, Customization of price
Risk	Routine	Non-routine and complicated questions
Allocation of profits	80% +	Cost plus 20% from SalesCo for services rendered in Country B

Arguments for MarketingCo

- Substance over form
 - activities of group exercised (value created)
 - User participation represents contribution to value creation in digital economies.
- Methods for adjustment ALM
 - Inappropriateness of CPM
 - Traditional method for brand (incommensurate with income)
 - Weak line between functions of production and sale
 - Allocation of average profits from routine activities does not fit but dividing entrepreneurial profits from the exploitation of valuable intangible property
 - Possibility of Profit-Split Method
 - Profit sharing element
 - Risk-adjusted return
 - Risk-free return

→ Thus, MarketingCo's marketing activities are key value derives from, thus taxable by Country B according to its contribution.



Taxpayer's rebuttal

Jacques Desroches (Hong Kong/Canada)

Counsel for taxpayer

Tax authority's rebuttal

Martin Yuan-Chun Lan (Host)

Counsel for tax authority

Judgement by Acting Judge

Prof. Wei Cui (Canada/USA)

Acting Judge