UNIVERSITÀ POLITECNICA DELLE MARCHE
FACOLTÀ DI ECONOMIA "GIORGIO FUÀ"

Corso di Laurea Magistrale o Specialistica in
INTERNATIONAL BUSINESS AND ECONOMICS

THE ARTICLE FOUR AND ITS EVOLUTION: THE STARBUCKS' CASE

Relatore: Chiar.mo
Prof. Samperna Simone

Tesi di Laurea di: Maria Vittoria Ballirano

Anno Accademico 2018 – 2019

THESIS INDEX:

1. INTRODUCTION

Taxes are often considered with the treatment of debt financing that is affected by interest payments as deductible expenses, the treatment of capital losses or gains and the valuation with Adjusted Present Value (tax shields). The first thing that needs to be done is a clear distinction between returns to debt and returns to equity: in the first case we have tax deductibility of interest payments; concerning the second case we have the treatment of foreign exchange gains and losses. Corporate income tax is designed as a tax on the returns to equity only. Equity returns are taxed in the host country, then may be taxed in the home country (possibly with different timing): the host government acts first and then the home government determines policies vis-à-vis with the host government.

The Host government determines tax rates on corporate profits first and then sets withholding taxes that are taxes imposed on capital paid to the parent as they are taken out of the country. In the Home government the tax policies are more complicated because they establish policies relative to previously determined host country's policies. Two factors have to be considered by the policies :

1. The treatment of foreign income and foreign taxes paid
2. Timing of taxation (there are two different types of timing of taxation: the first one occurs when the home country may choose to tax foreign equity returns during fiscal year in which they are earned (contemporaneous taxation). In the second case the timing of taxation occurs when profits are repatriated as dividends (tax deferral).

The goal of the international tax management is to increase corporation-wide profits by reducing the total amount of taxes paid. However there are some relevant issues that have to be taken into account concerning management: the allocation of profits and the allocation of costs and the Branch vs. the Subsidiary.

There are three principles of the international tax management:

1. PRINCIPLE I: if there are no excess tax credits, cost allocation decisions do not matter for branches. If there are excess tax credits, show branch profits in the lowest-tax jurisdictions, without making negative profits.

2. PRINCIPLE II: if there are no excess tax credits, transfer pricing decisions do not matter for branches. If there are tax credits, show branch profits in the lowest-tax jurisdictions by following a simple rule: if one branch is sold to a foreign branch, set the transfer price as high as possible when $T^*>T$ without making profits negative, and as low as possible when $T^*<T$ without making profits negative.
   T is the tax rate on profits earned by the branch
   T^* is the tax rate on profit earned by the foreign branch.
3. PRINCIPLE III: if there are no excess tax credits, use the lowest possible transfer price between branches in the presence of important tariffs. If there are excess tax credits, minimize branch taxes paid in the presence of import tariffs by comparing T^* to $[T+ Td^*(1-T^*)]$.
   Use the high transfer price if $T^*>[T+ Td^*(1-T^*)]$ without making profits negative and use the low transfer price if $T^*<[T+ Td^* (1-T^*)]$ without making profits negative.

Countries around the world are under pressure in order to limit the deficit on the public finances this has resulted in governments seeking new ways to generate profit, without taxing the voters directly, one of the means in order to achieve this objective is to increase the focus on multinational companies and transfer pricing. Even though transfer pricing and awareness of it has been around for the past 100 years, the first draft of OECD guidelines was not issued until 1995. In addition, it is only within the past 10-15 years, that transfer pricing has generated as much awareness as it has today.
With the changing business environment leaning towards larger organizations, the number of transactions in the world has increased. The share of transaction which are between related parties, are by some estimated to be between 60% and 80% of all transactions. These changes reflect on international trade, as multinationals have a greater effect on the local tax base than even before. Furthermore, the transactions increasingly involve more complicated products and services which can be difficult to price. These transactions go from transferring simple goods, over to today's intercompany transactions which can involve anything from specific knowledge, IP, financial instruments, management services and so on.

With national tax authorities under heavy political pressure, more transfer pricing adjustments are made in order to test the local legislations and ensure the companies are not using transfer pricing as a mean to avoid tax. One of the areas which are experiencing an increased focus in transfer pricing related to financial transaction are intercompany financing. Not only are tax authorities challenging the pricing of these transactions, they are also testing the economic rationale behind the transactions, in order to secure the local tax base. This has put the principles in the OECD guidelines to the test, and some cases have been taken to the highest courts around the world.

2. OECD GIUDELINES AND THE ARM'S LENGTH PRINCIPLE

The Organization for Economic Co-operation and Development (OECD) is a forum where governments can seek solutions to common economic, environmental and social challenges. It consists of 34 different countries and was formed in 1948 to administer the Marshal Aid provided from the USA and Canada after the Second World War. Today the OECD strives to improve policies and implement soft law. Soft law is a non-binding law, Which eventually can lead to international treaties or support interpretation of local law and trough that becomes binding law (OECD, 2011).

One of the areas where the OECD strives to create international common policies and legal framework is in international tax, and this has led to the model tax convention, which serves as a template for bilateral negotiations regarding tax coordination and cooperation. The aim of the model for tax convention is to establish principles which shall minimize the risk of double taxation for multinational companies.

The Arm's length principle described in the OECD Guidelines is the center of motion when handing transfer pricing issues. The Arm's length principle is the final argument used between tax authorities and multinationals, arguing that intercompany transactions have been conducted on market conditions, thus no profit has been allocated to jurisdictions, which were not entitled to tax. The Arm's length principle does not stand alone, as it is supported by a range of tools, which can be applied in order to establish a reliable foundation for the dispositions taken by the multinational company. Eventually supports the company in convincing the tax authorities, that the tax base follows the activities performed by each entity in the group and by that avoids double taxation.

The Arm's length principle is the international standard, which the countries that are members of the OECD have agreed upon. The principle states that transactions that are taking place between companies that are related should be priced as if the companies where unrelated parties- at market price. By following this principle, the general idea is that every part of the value chain in a multinational company, is allocated with profit accordingly to the value, which is being created. Ultimately leading to each country getting a tax base that is equivalent to the actual value created in the country. If companies do not follow the Arm's length principle, they will be able to shift profits between countries in order to have low margins in high tax jurisdictions and higher margins in low tax jurisdictions. (Hansen and Andersen, 2008).

When evaluating an Arm's length priciple, the circumstances under which the transaction takes place as well as the price of the transaction have to be taken into consideration. The initial point is to identify the characteristics of the transaction, the functions performed, the risks assumed, and assets employed, and based on that, determine the market price. It can be necessary to change the characteristics of the transaction if these are evaluated to be so far from what any unrelated parties would agree on, and then re-evaluate the price. According to the OECD guidelines, a tax administration's examination of a controlled transaction should ordinarily be based on the transaction actually undertaken by the associated enterprises, as it has been structured by them, using the methods applied in so far these are consistent with the transfer pricing methods described by OECD. Only in exceptional cases should the tax administration deviate from the actual transaction or substitute other transactions for them. As stated above, establishing the Arm's length price is a comparison of the terms and conditions under which the controlled transaction takes place versus similar transactions between independent unrelated parties. This means, that none of the characteristics in the tested transactions must deviate significantly from those transactions used as comparable. This is only relevant towards characteristics that have an impact on the price and/or margin, or if an accurate adjustment here to can't be done. The reasoning behind the comparability analysis is the considerations that independent unrelated enterprises would have before entering into a commercial relationship. Independent unrelated enterprises will consider the different options available and in comparing one option to another, differences that would affect their value would be taken into consideration. So, when establishing the basis for the justification of

an Arm's length price between related parties, OECD lists 5 comparability factors, which are seen as the most important when determining comparability. The 5 factors in the OECD Guidelines are characteristics of the property or service transferred, the functions performed by the parties (taking into account the assets applied and risks assumed), the contractual terms, the economic circumstances and the business strategies pursued by the parties. It should be noted, that this should neither be seen as a complete list, nor as a minimum of comparability factors, as this may change from transaction to transaction. (Bundgaard & Wittendorff, 2001). The comparability analysis is not only used to compare single transactions or goods, it can also be used to determine the characteristics of a group company, in order to determine an Arm's length profit level; more on the different transfer pricing methods below.

2.1 Functional analysis

The functional analysis, as defined in the OECD Guidelines, is a framework established to identify the functions that each involved entity performs and ultimately identify the level of compensation for a given good or service. The OECD Guidelines state:

"This functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken, assets used, and risks assumed by the parties to the transaction"

The term "economically significant" is important as it state which functions, assets and risks are to be considered. Firstly, it states a minimum requirement for what has to be analysed. Intra-group transactions of lesser economically significance have not to be considered. Secondly the analysis should only focus on the value creating activities in the group. Meaning administrative functions and routine activities are less important, if they are not seen as a direct value creating activity.

Based on the functional analysis a full picture of the functions, assets and risks adding value to each transaction should be clarified, eventually mapping the full or parts of the company value chain.

FUNCTIONS

It is as such not the transferred commodity itself, which is being evaluated; it is the functions that are creating the added value to the traded commodity.

The challenge for the company is to determine whether a function is seen as economically significant. Especially when valuating intra-group services, that are not in themselves seen as central for the overall business but rather seen as support functions. In some cases, it may not be possible to identify a function, since also processes related to a transaction, may be seen as value adding, depending on the transfer pricing method. If a group company undertakes manufacturing, special processes related to the manufacturing which significantly lowers the cost base, then special considerations towards the transfer pricing method should be made. If the transfer pricing method is based on a price per unit, it will not affect the result of the company negatively, as any improvement made in the manufacturing processes are allocated to the manufacturing company.

ASSETS

Here should all assets used to, create, or in any other way support the transaction be listed. Anything that has a significant economically value adding function. The OECD Guidelines mentions plant and equipment, the use of valuable intangibles, financial assets etc., and the nature of the assets used, such as the age, market value, location, property right protections available.

Usually a distinction is made between trade intangibles and marketing intangibles. Trade intangibles are often created through research and development, which usually is connected to a risk and significant costs during their development. Companies owning trade intangibles should be compensated for the expenses related to their development either through a royalty or increased transfer prices. Marketing intangibles are the same, these are usually connected to a significant risk and cost in their development and an increased compensation should be given here to.

RISKS

Assumed risk is derived from the above analysis of assets and functions. The higher risk one party may assume the higher the compensation should be; thus, the level of risk is an important factor when determining the price. The OECD Guidelines explicit mentions that controlled and uncontrolled transactions are not comparable if there are significant differences in the assumed risk for which appropriate adjustments cannot be made. The underlying assumption is that from an economical perspective any risk connected to a

potential loss will, if the transaction is between third parties, result in an expected higher return. When determining the compensations that should follow an increased risk related to the tested transaction all additional cost here to has to be considered. This include price of capital tied in the transaction, future costs caused by the risk, that is loss on debtors, fluctuations in currency rates etc. OECD Guidelines also list various risks that have to be considered, these include but are not limited to market risks, such as raw materials and finished goods price fluctuations, risks of losses associated with the investment in and use of property, plant and equipment, risk of the success or failure of investment in research and development, financial risk caused by interest rate variability, credit risk and so forth. The analysis of assumed risks by either party is closely linked to the section below about contractual terms, as that often support or clarifies whether the distribution of risks has been done correct. It should also be considered if the allocation of risk between the parties is done in such a way, that it resembles the control the parties can excise over that risk. In an arm's length transactions, it generally makes more sense for parties to carry a greater share of those risks, over which they have relatively more control. When evaluating to which extend a party to a transaction bears the financial risk related to for example, currency or interest rate risk, it will usually be necessary to determine whether the multinational have specific business strategies in place dealing with such. Strategies dealing with the management or minimization of such could be used as an indicator to which party that has undertaken the risk. These arrangements could be the usage of hedging arrangements, forward contracts, put and call options, swaps etc. If associated enterprises use these instruments with other group companies or third party enterprises, this could be used as an indicator to whether they have assumed a significant risk related to the tested transaction. By identifying these business strategies, it can help to identify the allocation of risks between the parties. If parties have used a hedging arrangement this indicates, that it also carries the hedged risk in the transaction.

CONTRACTUAL TERMS

The contractual terms between unrelated independent parties, generally define explicitly or implicitly how the responsibilities, risks and benefits are divided between them. It is common in transactions between related parties, that local tax authorities require a list of intercompany agreements, in order to use these in the functional analysis.

Another important factor that an analysis of the contractual terms can highlight is terms that can affect the price, this could be volume of the transaction, and a fixed high number of units bought that could affect the price downward compared to an open contract without a predefined order. Term for the contract, is it a long term or short-term contract. Terms of delivery; when is the risk handed over to the buyer etc. Service and guarantee condition. Terms of payment, how long is the credit offered, interest on delayed payments, etc.

In some cases, adjustments can be made, usually on discounts based on volume a simple linear regression can be made to adjust for differences. Whereas delivery terms and credit terms are more difficult to adjust for, as pricing of those is complicated to determine.

2.2 Economic circumstances

An Arm's length price on the same commodity traded across various markets may vary because of differences in market and industry factors. Therefore, economic circumstances where the commodity is traded have to be included in the comparability analysis. By identifying these differences in the market, appropriate adjustments can be made to make up for differences, ensuring that the Arm's length principle is complied with.

This means, that any country (or smaller geographic areas) can have economically circumstances that greatly affect the pricing of a service or good. For instance, when determining interest rates, the local price on money could be an important factor, here pricing of government bonds could be used as an indicator to whether an adjustment has to be made. But also, other financial factors such as inflation and local finance and budgetary politics could play an important role when evaluating a loan or investment policy in a subsidiary.

2.3 Business strategies

Business strategies can be used as a comparability factor, just as independent enterprises can act and price products based on a business strategy, related parties can have the same objectives. That could be when entering new markets; a lower price may be needed in order to penetrate the market. But depending on transfer pricing method other factors may be relevant, that could be innovation and new product development, degree of

diversification, risk aversion, assessment of political changes, input of existing and planned labor laws, duration of arrangement.

When businesses use special business strategies, it is essential that these can be documented and that they are followed, e.g. when a manufacturer sells goods below market price to a distributor, this has to lead to lower prices when reselling the good on the market. It also has to be evaluated if the additional costs incurred by following the business strategy, can be covered by the expected return from that strategy. Considerations towards which entity should carry the cost also needs to be evaluated, if the local entity is a limited risk distributor or an agent, with limited risk in regard to future sales and earnings, the costs should be considered to be carried by the parent or another beneficiary of the business strategy. In the US it is a requirement, in order for a business strategy to be recognized, to demonstrate that independent enterprises use comparable strategies, under the same circumstances and in comparable time periods. Furthermore, the company has to document that the costs related to the strategy is carried by the company who will be the beneficiary of future revenues generated from the strategy; and that the strategy was only in place for a period which is typical for the industry, so as the strategy, the costs, the expected return and agreement on the cost sharing were in place before the strategy was initiated.

In general it is recognised that a business strategy can fail, and a failure in itself does not as such allow the strategy to be ignored for transfer pricing purposes. However, when a strategy fails, it should be evaluated whether an independent party would continue to follow the strategy, and if so, how long does it seems plausible – the economic rationale behind the decision has to be defendable in terms of expected outcome.

2.4 Evaluating the Arm's length price/transfer pricing method

In order to determine whether the conditions imposed in the commercial and financial relations between the associated enterprises are consistent with the arm's length principle, the OECD Guidelines lists, different transfer pricing methods have to be considered. These transfer pricing methods are divided into two groups the "traditional transfer pricing methods" and the "transactional profit methods". Where the traditional methods are comparable uncontrolled price method ("CUP"), Resale minus method, and the cost

plus method and the transactional profit methods are the transactional net margin method and the transactional profit split method.

When determining the transfer pricing method, the consideration should always be which one is the most suitable one, in light of the tested transaction. The appropriateness of the selected method is based on which comparable are available, the nature of the transaction, including risks and functions, the availability of reliable information and the comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments, which may be needed to eliminate material differences between them. Thus, the methods are not ranked to start from, only if several methods can be applied on an equal manner. If this is the case, then the traditional transactions are preferred over the transactional profit methods. This is to ensure, if possible, that the commercial and financial relations are linked directly to the good or service sold, and thereby not relying on any other financial positions in the companies involved in the transaction. Companies are recommended but not limited to the five above mentioned transfer pricing methods, if another method is considered more relevant then that can be an option. This is however, more an exemption than the general rule, and if another transfer pricing method is used, it is usually good to describe why the by OECD recommended transactions have been deselected.

Traditional transfer pricing methods

The transfer pricing methods covered in this part are the traditional transfer pricing methods. These methods are seen as the most appropriate, if the necessary comparability between the related and unrelated transitions can be done. These methods are related directly to the transferred good or service, so, as mentioned above, any other activity in the involved companies does not affect the pricing of the transaction.

Comparable uncontrolled price method ("CUP")

The CUP method is regarded as the most direct transfer pricing method, as it compares the price on a transaction between two unrelated parties, with that which has been entered between related parties under similar circumstances. Consequently, when reliable and relevant information is available, the CUP method is preferred over all other methods.

Following the principles stated in the OECD, an uncontrolled transaction is comparable to a controlled transaction, when applying the CUP method, if one of two conditions is met:

None of the differences between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market,

If so, reasonable adjustments should be possible to make, in order to eliminate any material effects of the differences.

When considering if controlled and uncontrolled transactions are comparable not only the characteristics of the transferred right (goods or service) should be reviewed, also the broader business functions of the individual parties, which can have an effect on the price, should be taken into account.

When evaluating if the CUP method is applicable a review of existing internal comparison should be made, as these may have a more direct and closer relationship to the transaction under review.

Given that the OECD Guidelines continue to stress the importance to consider the applicability of CUPs, when possible, and given that there are a number of potential internal CUPs available for the purpose of the analysis, this methodology is considered to be the most appropriate method.

By collecting various different prices on comparable transaction an arm's length range can be established. This range is often calculated as being between the first and fourth quartile (25-75), where the median is considered the most appropriate price.

Resale price method

The method uses the resale price to an unrelated independent third party in a series of transactions in order to determine the sale price between two related parties, by subtracting a "service fee" or a margin from the resale price. This method is generally used with activities related to sale, marketing and distribution. The method is mostly used when the remuneration is related to a relatively simple function, for example as a broker fee. In this, the value of the functions, risks and assets is the value driver of the transaction eventually determining the level of the margin. The product itself is not as important as in the CUP method, as the main function performed can be compared to a service

company. Although comparability has to be in place between the products transferred, the product differences can have an effect on the profit level.

Cost plus method

This pricing method uses the cost base as the price indicator in a controlled transaction; the transfer price will then consist of the cost base plus a margin. Whilst precise accounting standards and terms may vary, the costs can be divided into three broad categories. Firstly, there are direct costs of production; secondly indirect production costs and thirdly there are operating expenses. Which costs are included in the cost base may depend on the available comparable, that can be identified. The profit margin is determined on basis of what comparable independent unrelated enterprises would earn on similar services or good. This method is more dependent on the actual functions performed in the related entity, than the characteristics of the commodity or service itself. Again as mentioned above, the characteristics of the transferred commodity has to be somewhat comparable, as differences in valuable intangibles or difficulties in handling the commodity can have an effect on the profit margin.

Often the issue with this method is the comparability of cost base. It is important to determine which costs are included, but also the nature of the costs, whether it is budgeted costs, marginal costs or actual variable costs. If marginal costs are used, the company could be challenged on who should carry the costs of excess capacity in for example in a production facility. One more thing is which part of the cost base the mark-up should be added to. Some discussion is on whether the mark up should be added to the full costs base or only costs relating to value adding activities.

Even though this method seems straight forward, there are many factors that can result in wrong transfer prices. Differences in efficiency could be seen, if the company used, is in comparisons more efficient and thereby having lower costs per produced unit, then using the margin could lead to too high transfer prices between related parties. Such differences have to be taken into account. Also, the nature of assets employed, if the production equipment is leased or whether it is owned by the manufacturer could result in differences in cost base.

OECD mentions that the general rule is, "there is no general rule" when determining the cost base. It has to be evaluated from case to case and is highly depending on which comparables, can be identified in order to support the selected margin to add to the costs.

Transactional profit methods

The transactional profit methods examine the profits arising from a particular transaction between related parties. Profit generated on transactions between related parties can be used as an indicator of whether the transaction was affected by conditions that differ from what would be seen between independent unrelated parties, i.e. the arm's length price.

Transactional net margin method ("TNMM")

TNMM examines the net profit relative to an appropriate basis the tax payer realises from a controlled transaction. The basis used could be revenues, costs, or assets. This method is the most used of all the transfer pricing methods. TNMM should only be used when one of the parties involved in the transaction makes valuable, unique contributions, as this is a one-sided method.

The strength of this particular method is that only one of the parties has to be tested, under the essential condition which only one part is contributing with valuable unique functions – or if appropriate adjustments can be made. One other strength of this method is that comparables can have some differences in their functional profile, as these will be reflected in the operating expenses. Thus, the tested margin (gross profit indicators) will reflect these differences. Consequently, this may return a wide range of gross profit margins, which are still broadly similar to the levels of operating profit indicators.

If comparables are used, which are not considered close comparables appropriate adjustments have to be made, as mentioned above. A weakness in the TNMM is however, it can prove difficult to make such an adjustment, as it can be difficult to determine an actual transfer price on the traded good, as the target is a profit level indicator and not a resale price.

Transactional profit split method

In this transfer pricing method the accumulated profit generated from an intercompany transaction is identified and based on a functional and risk analysis, the profit is split

between the involved parties. The approach of splitting the profit between the involved parties is a contrast to the other transfer pricing methods, as the price or profit generated from the transaction itself is not compared to external sources. When evaluating the relative value of the related parties' contribution an economic approach is used, thus the functions each party contributes with, is the essential factor when performing the profit split, this analysis is called a contribution analysis (Hansen & Andersen, 2008).

The strength of this method is, it can be used for operations which are highly integrated, where one of the one-sided methods would not be considered appropriate, or in cases where both parties to the transaction make unique and valuable contributions

The weakness of this method is, it can be difficult to implement. Not because the method itself is complicated, but identifying the allocation key can prove difficult. It has to be well supported by strong arguments, in order for tax authorities on both sides to accept. Furthermore, it can be difficult to assess the correct costs carried by each involved part as well as the actual profit generated from the transaction.

So even though this method is considered flexible, and it is very unlikely that one party involved in the transaction will get an extreme and improbable profit result, as all parties involved are assessed. The difficulty in assessing the right distribution key and the level of information needed in order to establish a reliable profit split makes the method less prevalent.

2.5 Summarizing the comparability analysis and transfer pricing methods

As described above, the single most important thing when evaluating an intra-group transaction is it characteristics, the kind of risk carried by each party, assets invested and functions undertaken. If a similar transaction is undertaken by third parties this can be used to determine the most appropriate arm's length price. If this is not the case – i.e. there are differences in e.g. the risks assumed – an adjustment compensating for the differences has to be made. But also, in light of the financial crisis, the economic circumstances in a country could mean greater adjustments, especially if comparable that are between one and five years old are used. When selecting the transfer pricing method, the most appropriate method in each given situation should be used, in order to determine the correct arm's length price. One method is not preferred to the other, and each situation

calls for an evaluation of which method to apply. Thus, it is important to know the characteristics of the transactions, as well as what comparable data is available.

3. THE OECD AND THE ARTICLE 4

Two States that consider entering into a tax treaty should evaluate the extent to which the risk of double taxation actually exists in cross-border situations involving their residents. A large number of cases of residence-source juridical double taxation can be eliminated through domestic provisions for the relief of double taxation (ordinarily in the form of either the exemption or credit method) which operate without the need for tax treaties. Whilist these domestic provisions will likely address most forms of residence-source juridical double taxation, they will not cover all cases of double taxation, especially if there are significant differences in the source rules of the two States or if the domestic law of these States does not allow for unilateral relief of economic double taxation (e.g. in the case of a transfer pricing adjustment made in another State). Entering into a tax treaty includes the various features of tax treaties that encourage and foster economic ties between countries. The ability and willingness of a State to provide assistance in the collection of taxes would also be a relevant factor to take into account. It should be noted, however, that in the absence of any actual risk of double taxation, these administrative provisions would not, by themselves, provide a sufficient tax policy basis for the existence of a tax treaty because such administrative assistance could be secured through more targeted alternative agreements, such as the conclusion of a tax information exchange agreement or the participation in the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

The Convention applies to all persons who are residents of one or both of the Contracting States (Art. 1). It deals with taxes on income and on capital, which are described in a general way in Article2. In the case of a number of items of income and capital, an exclusive right to tax is conferred on one of the Contracting States. The other Contracting

State is thereby prevented from taxing those items and double taxation is avoided. As a rule, this exclusive right to tax is conferred on the State of residence. In te case of other items of income and capital, the right to tax is not an exclusive one. As regards two classes of income (dividends and interest), although both States are given the right to tax, the amount of tax that may be imposed in the State of source is limited. Second, insofar as these provisions confer on the State of source or situs a full or limited right to tax , the State of residence must allow relief so as to avoid double taxation; this is the purpose of Articles 23 A and 23 B. The Convention leaves it to the Contracting States to choose between two methods of relief, i.e. the exemption method and the credit method.

Other items of income and capital may not be taxed in the State of source or situs; as a rule, they are taxable only in the State of residence of the taxpayer. This applies, for examples, to royalties, gains from the alienation of shares or securities, remuneration in respect of an employment exercised aboard a ship or aircraft operated in international traffic, private sector pensions payments received by a student for the purposes of his education or training, and capital represented by shares or securities.

Where a resident of a Contracting State receives income from sources in the other Contracting State, or owns capital situated therein, that in accordance with the Convention is taxable only in the State of residence, no problem of double taxation arises, since the State of source or situs must refrain from taxing that income or capital. The State of residence has the obligation to eliminate double taxation and this can be accomplished by one of the following two methods:

1. EXEMPTION METHOD: income or capital that is taxable in the State of source or situs is exempted in the State of residence, but it may be taken into account in determining the rate of tax applicable to the taxpayer's remaining income or capital
2. CREDIT METHOD: income or capital that is taxable in the State of source or situs is subject to tax in the State of residence, but the tax levied in the State of source or situs is credited against the tax levied by the State of residence on such income or capital.

Although all member countries are in agreement with the aims and the main provisions of the Model Convention, nearly all have entered reservations on some provisions, which are recorded in the Commentaries on the Articles concerned. When drafting the 1977

Model convention, the Committee on Fiscal Affairs examined the problems of conflicts of interpretation that might arise as a result of changes in the Articles and Commentaries of the 1963 Draft Convention. The Committee believes that the changes to the Articles of the Model Convention and the Commentaries that have been made since 1977 should be similarly interpreted. Other changes or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD member countries as to the proper interpretation of existing provisions and their application to specific situations. Also relevant is the Convention on Mutual Administrative Assistance in Tax Matters, which was drawn up within the council of Europe on the basis of a first draft prepared by the Committee on Fiscal Affairs. The Committee considers that bilateral conventions are still a more appropriate way to ensure the elimination of double taxation at the international level.

Issues related to the improper use of tax conventions and international tax avoidance and evasion have been a constant preoccupation of the Committee on Fiscal Affairs since the publication of the 1963 Draft Convention. Over the years, a number of provisions (such as Art. 29 that was added in 2017) have been added to the Model Convention, or have been modified, in order to address various forms of tax avoidance and evasion. The Committee on Fiscal Affairs will continue to monitor the application of tax treaties in order to ensure that, as stated in the preamble of the Convention, the provisions of the Convention are not used for the purposes of tax avoidance or evasion.

4. ARTICLE 4 OF THE CONVENTION- RESIDENT

1. For the purposes of this 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 his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as recognized pension fund of that State. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then this status shall be determined as follows:
   a) He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
   b) If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
   c) If he has an habitual abode in both States or neither of them, he shall be deemed to be a resident only of the State of which he is a national;
   d) If he is a national of both States or of neither of them, the competent authotities of the Contracting States shall settle the question by mutual agreement
3. Where by reason of the provisions of paragraph 1 a person other that an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavor 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 the competent authorities of the Contracting States.

4.1 *Commentary on article 4*

4.1.1 Preliminary remarks

The concept of "resident of a Contracting State" has various functions ans is of importance in three cases:

a) In determining a convention's personal scope of application
b) In solving cases where double taxation arises in consequence of double residence

c) In solving cases where double taxation arises as a consequence of taxation in the State of residence and in the State of source or situs.

The Article is intended to define the meaning of the term "resident of a Contracting State" and to solve cases of double residence. To clarify the scope of the Article two cases have to be taken into account: conflict between two residences and between residence and source or situs. In both cases the conflict arises because, under their domestic laws, one or both Contracting Sates claim that the person concerned is resident in their territory. Generally, the domestic laws of the various States impose a comprehensive liability to tax (full tax liability) based on the taxpayers' personal attachment to the State concerned (the "State of residence"). This liability to tax is not imposed only on persons who are "domiciled" in a State in the sense in which "domicile" is usually taken in the legislations (private law). The cases of full liability to tax are extended to comprise also, for instance, persons who stay continually, or maybe only for a certain period, in the territory of the State. Some legislations impose full liability to tax on individuals who perform services on board ships which have their home harbor in the State. Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as "resident" and, consequently, is fully liable to tax in that State. They do not lay down standards which the provisions of the domestic laws on "residence" have to fulfil in order that claims for full tax liability can be accepted between the Contracting States. In this respect the States take their stand entirely on the domestic laws.

This manifests itself quite clearly in the cases where there is no conflict at all between two residences, but where the conflict exists only between residence and source or situs. But the same view applies in conflicts between two residences. The special point in these cases is only that no solution of the conflict can be arrived at by reference to the concept of residence adopted in the domestic laws of the States concerned. In these cases, special provisions must be established in the Convention to determine which of the two concepts of residence is to be given preference. An example will elucidate the case. An individual has his permanent home in State A, where his wife and children live. He has had a stay of more than six months in State B and according to the legislation of the latter State he is, in consequence of the length of the stay, taxed as being a resident of that State. Thus, both States claim that he is fully liable to tax. This conflict has to be solved by the

Convention. In this particular case the Article (under paragraph 2) gives preference to the claim of State A. This does not, however, imply that the Article lays down special rules on "residence" and that the domestic laws of State B are ignored because they are incompatible with such rules. The fact is quite simply that in the case of such a conflict a choice must necessarily be made between the two claims, and it is on this point that the Article proposes special rules.

4.1.2 Commentary on the provisions of the Article

Paragraph 1

Paragraph1 provides a definition of the expression "resident of a Contracting State" for the purposes of the Convention. The definition refers to the concept of residence adopted in the domestic laws. As criteria for the taxation as a resident the definition mentions: domicile, residence, place of management or any other criterion of a similar nature. As far as individuals are concerned, the definition aims at covering the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax). It also covers cases where a person is deemed, according to the taxation laws of a State, to be a resident of that State and on account thereof is fully liable to tax therein (e.g. diplomats or other persons in government service). In accordance with the provisions of the second sentence of paragraph 1, however, a person is not to be considered a "resident of a Contracting State" in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State. That situation exists in some States in relation to individuals, e.g. in the case of foreign diplomatic and consular staff serving in their territory. According to its wording and spirit the second sentence also excludes from the definition of a resident of a Contracting State foreign held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies. It also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States. The exclusion of certain companies or other persons from

the definition would not of course prevent Contracting States from exchanging information about their activities. Indeed States may feel it appropriate to develop spontaneous exchanges of information about persons who seek to obtain unintended treaty benefits. The application of the second sentence, however, has inherent difficulties and limitations. It has to be interpreted in the light of its object and purpose, which is to exclude persons who are not subjected to comprehensive taxation (full liability to tax) in a State, because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended. It has been the general understanding of most member countries that the government of each State, as well as any political subdivision or local authority thereof, is a resident of that State for purposes of the Convention. Before 1995, the Model did not explicitly state this; in 1995, Article 4 was amended to conform the text of the Model to this understanding. This raises the issue of the application of paragraph 1 to sovereign wealth funds, which are special purpose investment funds or arrangements created by a State or a political subdivision for macroeconomic purposes. These funds hold, manage or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. They are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses or receipts resulting from commodity exports. Whether a sovereign wealth fund qualifies as a "resident of a Contracting State" depends on the facts and circumstances of each case. For example, when a sovereign wealth fund is an integral part of the State, it will likely fall within the scope of the expression "the State and any political subdivision or local authority thereof" in Article 4. States may want to address the issue in the course of bilateral negotiations, particularly in relation to whether a sovereign wealth fund qualifies as a "person" and is "liable to tax" for purposes of the relevant tax treaty. Paragraph 1 also refers expressly to a "recognised pension fund". Most member countries have long considered that a pension fund established in a Contracting State is a resident of that State regardless of the fact that it may benefit from a limited or complete exemption from taxation in that State. Until 2017, that view was reflected in the previous version of paragraph 8.6, which referred to "pension funds, charities and other organisations" as entities that most States viewed as residents. Paragraph 1 of the Article was modified in 2017 to remove any doubt about the fact that

a pension fund that meets the definition of "recognised pension fund" in paragraph 1 of Article 3 constitutes a resident of the Contracting State in which it is established. This definition is drawn from: International Working Group of Sovereign Wealth Funds, *Sovereign Wealth Funds — Generally Accepted Principles and Practices — "Santiago Principles"*, October 2008, Annex 1. The effect of the definition of "recognised pension fund" and of the reference to that term in paragraph 1 of the Article will depend to a large extent on the domestic law and on the legal characteristics of the pension funds established in each Contracting State. The type of fund established within a legal entity that is described in paragraph 10.5 of the Commentary on Article 3 would not be covered by the definition of "recognised pension fund", which applies to an entity or arrangement that constitutes a separate person, but since the income of these funds is attributed to the legal entity of which it is part, the provisions of the Convention will apply to that income to the extent that the legal entity itself qualifies as a resident of a Contracting State under paragraph 1 of the Article. Where, however, a fund constitutes a "person" which is distinct from any other person by whom, or for the benefit of whom, it has been established and is operated, the definition of "recognised pension fund" will be relevant and, to the extent that the conditions of that definition are met, the fund will itself constitute a "resident of a Contracting State". This will be the case in many countries because it is "liable to tax therein" by reason of the criteria mentioned in the first sentence of paragraph 1, as this sentence is interpreted by the Contracting States or, if that is not the case, because of the specific inclusion of the term "recognised pension fund" in paragraph 1. Contracting States are of course free to omit the reference to "recognised pension funds" in paragraph 1 if they conclude that the income of the pension arrangements established in both States is derived by persons that otherwise qualify as residents of the Contracting States, although they might prefer to keep that reference in the paragraph simply to remove any uncertainty.

Given the diversity of arrangements through which retirement benefits are provided, it will therefore often be useful for the Contracting States to review the main types of pension arrangements used in each State and to clarify whether or not the definition of "recognised pension fund" applies to each type of arrangement and, more generally, how the provisions of the tax convention between these States apply to these arrangements.

This could be done at the time of the negotiation of that convention or subsequently through the mutual agreement procedure.

Paragraph 1 refers to persons who are "liable to tax" in a Contracting State under its laws by reason of various criteria. In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, charities and other organisations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, thus, subject to the tax laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax. Most States would view such entities as residents for purposes of the Convention. In some States, however, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws. These States may not regard such entities as residents for purposes of a convention unless these entities are expressly covered by the convention. Contracting States taking this view are free to address the issue in their bilateral negotiations.

Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In that case, however, paragraph 2 of Article 1 clarifies that the Convention will apply to the partnership's income to the extent that the income is treated, for purposes of taxation by that State, as the income of a partner who is a resident of that State. The same treatment will apply to income of other entities or arrangements that are treated as fiscally transparent under the tax law of a Contracting State (see paragraphs 2 to 16 of the Commentary on Article 1).

Paragraph 2

This paragraph relates to the case where, under the provisions of paragraph 1, an individual is a resident of both Contracting States.

To solve this conflict special rules must be established which give the attachment to one State a preference over the attachment to the other State. As far as possible, the preference criterion must be of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the right to tax devolves upon that particular

State. The facts to which the special rules will apply are those existing during the period when the residence of the taxpayer affects tax liability, which may be less than an entire taxable period. For example, in one calendar year an individual is a resident of State A under that State's tax laws from 1 January to 31 March, then moves to State B. Because the individual resides in State B for more than 183 days, the individual is treated by the tax laws of State B as a State B resident for the entire year. Applying the special rules to the period 1 January to 31 March, the individual was a resident of State A. Therefore, both State A and State B should treat the individual as a State A resident for that period, and as a State B resident from 1 April to 31 December.

The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, e.g. where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.

Subparagraph *a)* means, therefore, that in the application of the Convention (that is, where there is a conflict between the laws of the two States) it is considered that the residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration. As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.). For instance, a house owned by an individual cannot be considered to be available to that individual during a period when the house has been rented out and effectively handed over to an unrelated party so that the individual no longer has the possession of the house and the possibility to stay there. If the individual has a permanent home in both Contracting States, paragraph 2 gives preference to the State with which the personal and economic relations of the individual are closer, this being understood as the centre of vital interests. In the cases where the residence cannot be determined by reference to this rule,

paragraph 2 provides as subsidiary criteria, first, habitual abode, and then nationality. If the individual is a national of both States or of neither of them, the question shall be solved by mutual agreement between the States concerned according to the procedure laid down in Article 25. If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.

Subparagraph *b)* establishes a secondary criterion for two quite distinct and different situations:

1. the case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;

2. the case where the individual has a permanent home available to him in neither Contracting State.

Preference is given to the Contracting State where the individual has an habitual abode.

In the first situation, the case where the individual has a permanent home available to him in both States, the fact of having an habitual abode in one State but not in the other appears therefore as the circumstance which, in case of doubt as to where the individual has his centre of vital interests, tips the balance towards the State where he stays more frequently. For this purpose regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State.

The second situation is the case of an individual who has a permanent home available to him in neither Contracting State, as for example, a person going from one hotel to another. In this case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them.

The application of the criterion provided for in subparagraph *b*) requires a determination of whether the individual lived habitually, in the sense of being customarily or usually present, in one of the two States but not in the other during a given period; the test will not be satisfied by simply determining in which of the two Contracting States the individual has spent more days during that period. The phrase "*séjourne de façon habituelle*", which is used in the French version of subparagraph *b*), provides a useful insight as to the meaning of "habitual abode", a notion that refers to the frequency, duration and regularity of stays that are part of the settled routine of an individual's life and are therefore more than transient. As recognised in subparagraph *c*), it is possible for an individual to have an habitual abode in the two States, which would be the case if the individual was customarily or usually present in each State during the relevant period, regardless of the fact that he spent more days in one State than in the other. Assume, for instance, that over a period of five years, an individual owns a house in both States A and B but the facts do not allow the determination of the State in which the individual's centre of vital interests is situated. The individual works in State A where he habitually lives but returns to State B two days a month and once a year for a three-week holiday. In that case, the individual will have an habitual abode in State A but not in State B. Assume, however, that over the same period of five years, the individual works short periods of time in State A, where he returns 15 times a year for stays of two weeks each time, but is present in State B the rest of the time (assume also that the facts of the case do not allow the determination of the State in which the individual's centre of vital interests is situated). In that case, the individual will have an habitual abode in both State A and State B.

19.1 Subparagraph *b*) does not specify over what length of time the determination of whether an individual has an habitual abode in one or both States must be made. The determination must cover a sufficient length of time for it to be possible to ascertain the frequency, duration and regularity of stays that are part of the settled routine of the individual's life. Care should be taken, however, to consider a period of time during which there were no major changes of personal circumstances that would clearly affect the determination (such as a separation or divorce). The relevant period for purposes of the determination of whether an individual has an habitual abode in one or both States will not always correspond to the period of dual-residence, especially where the period of dual-residence is very short. This is illustrated by the following example. Assume that an

individual resident of State C moves to State D to work at different locations for a period of 190 days. During that 190-day period, he is considered a resident of both States C and D under their respective domestic tax laws. The individual lived in State C for many years before moving to State D, remains in State D for the entire period of his employment there and returns to State C to live there permanently at the end of the 190-day period. During the period of his employment in State D, the individual does not have a permanent home available to him in either State C or State D. In this example, the determination of whether the individual has an habitual abode in one or both States would appropriately consider a period of time longer than the 190-day period of dual-residence in order to ascertain the frequency, duration and regularity of stays that were part of the settled routine of the individual's life. Where, in the two situations referred to in subparagraph *b)* the individual has an habitual abode in both Contracting States or in neither, preference is given to the State of which he is a national. If, in these cases still, the individual is a national of both Contracting States or of neither of them, subparagraph *d)* assigns to the competent authorities the duty of resolving the difficulty by mutual agreement according to the procedure established in Article 25.

Paragraph 3

This paragraph concerns companies and other bodies of persons, irrespective of whether they are or not legal persons. It may be rare in practice for a company, etc. to be subject to tax as a resident in more than one State, but it is, of course, possible if, for instance, one State attaches importance to the registration and the other State to the place of effective management. So, in the case of companies, also, special rules as to the preference must be established.

When paragraph 3 was first drafted, it was considered that it would not be an adequate solution to attach importance to a purely formal criterion like registration and preference was given to a rule based on the place of effective management, which was intended to be based on the place where the company, etc. was actually managed.

In 2017, however, the Committee on Fiscal Affairs recognised that although situations of double residence of entities other than individuals were relatively rare, there had been a number of tax-avoidance cases involving dual resident companies. It therefore concluded

that a better solution to the issue of dual residence of entities other than individuals was to deal with such situations on a case-by-case basis.

As a result of these considerations, the current version of paragraph 3 provides that the competent authorities of the Contracting States shall endeavor to resolve by mutual agreement cases of dual residence of a person other than an individual. Competent authorities having to apply paragraph 3 would be expected to take account of various factors, such as where the meetings of the person's board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc. Countries that consider that the competent authorities should not be given the discretion to solve such cases of dual residence without an indication of the factors to be used for that purpose may want to supplement the provision to refer to these or other factors that they consider relevant. A determination under paragraph 3 will normally be requested by the person concerned through the mechanism provided for under paragraph 1 of Article 25. Such a request may be made as soon as it is probable that the person will be considered a resident of each Contracting State under paragraph 1. Due to the notification requirement in paragraph 1 of Article 25, it should in any event be made within three years from the first notification to that person of taxation measures taken by one or both States that indicate that reliefs or exemptions have been denied to that person because of its dual-residence status without the competent authorities having previously endeavored to determine a single State of residence under paragraph 3. The competent authorities to which a request for determination of residence is made under paragraph 3 should deal with it expeditiously and should communicate their response to the taxpayer as soon as possible. Since the facts on which a decision will be based may change over time, the competent authorities that reach a decision under that provision should clarify which period of time is covered by that decision. The last sentence of paragraph 3 provides that in the absence of a determination by the competent authorities, the dual-resident person shall not be entitled to any relief or exemption under the

Convention except to the extent and in such manner as may be agreed upon by the competent authorities. This will not, however, prevent the taxpayer from being considered a resident of each Contracting State for purposes other than granting treaty reliefs or exemptions to that person. This will mean, for example, that the condition in subparagraph *b*) of paragraph 2 of Article 15 will not be met with respect to an employee of that person who is a resident of either Contracting State exercising employment activities in the other State. Similarly, if the person is a company, it will be considered to be a resident of each State for the purposes of the application of Article 10 to dividends that it will pay.

Some States, however, consider that it is preferable to deal with cases of dual residence of entities through the rule based on the "place of effective management" that was included in the Convention before 2017. These States also consider that this rule can be interpreted in a way that prevents it from being abused. States that share that view and that agree on how the concept of "place of effective management" should be interpreted are free to include in their bilateral treaty the following version of paragraph 3:

Whereby 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.

4.2 Observations on the Commentary

- *Chile* wishes to clarify that, with respect to paragraph 8.12, entities that are not regarded as residents may also include pension funds unless expressly covered by the convention.
- *Spain*, due to the fact that according to its internal law the fiscal year coincides with the calendar year and there is no possibility of concluding the fiscal period by reason of the taxpayer's change of residence, will not be able to proceed in accordance with paragraph 10 of the Commentary on Article 4. In this case, a mutual agreement procedure will be needed to ascertain the date from which the taxpayer will be deemed to be a resident of one of the Contracting States.
- *Hungary* cannot fully share the interpretation in paragraph 19 of the Commentary regarding the term "habitual abode". Hungary considers that during the examination of a person's habitual abode priority should be given to the

comparison of the number of days of presence in each State over a given period of time.

4.3 Reservations on the Article

- *Japan* and *Korea* reserve their position on the provisions in this and other Articles in the Model Tax Convention which refer directly or indirectly to the place of effective management. Instead of the term "place of effective management", these countries wish to use in their conventions the term "head or main office".
- *France* does not agree with the general principle according to which if tax owed by a partnership is determined on the basis of the personal characteristics of the partners, these partners are entitled to the benefits of tax conventions entered into by the States of which they are residents as regards income that "flows through" that partnership. For this reason, France reserves the right to amend the Article in its tax conventions in order to specify that French partnerships must be considered as residents of France in view of their legal and tax characteristics and to indicate in which situations and under which conditions flow-through partnerships located in the other Contracting State or in a third State will be entitled to benefit from the recognition by France of their flow- through nature. *France* reserves the right not to include the reference to "recognised pension funds" in paragraph 1 and thus to treat pension funds like other entities that do not meet the requirements relative to residence.
- The *United States* reserves the right to use a place of incorporation test for determining the residence of a corporation, and, failing that, to deny dual resident companies certain benefits under the Convention.
- *Portugal* and *Sweden* reserve the right not to include the words "as well as a recognised pension fund of that State" in paragraph 1 and to treat pension funds in accordance with the general definition of "resident" or with bilaterally agreed special provisions.
- *Israel* reserves the right to include a separate provision regarding a trust that is a resident of both Contracting States.
- *Estonia* and *Latvia* reserve the right to include the place of incorporation or similar criterion in paragraph 1.

- *Japan* reserves the right to omit the phrase "except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States" in paragraph 3.

5. THE STARBUCKS' CASE

5.1 Abstract

The aim of this study is to understand the Transfer Pricing system and its difficult interpretation. I wanted to emphasize the difficulty in interpreting the subject, which acts in a context of uncertainty, in fact on the one hand it manages to give the possibility to multinationals (not just Starbucks) to abuse the practice of transfer pricing to obtain advantages in the context of taxation, while on the other side it puts the multinationals in front of the difficult cohabitation with the apparatus that govern the correct use of these practices, as the multinationals find then difficulty in justifying their own tax strategies.
To demonstrate what transfer pricing consists of, I therefore focused my attention on the Starbucks case, which like many multinationals has taken advantage of the lack of specific and universal rules, particularly in the Netherlands but also in the UK and other national entities, to build a fiscal strategy which had as its objective to pay less taxes.
The analysis I did of this case will therefore follow this order: Initially, a historical analysis of the company will be presented, and then the analysis of the three European branches that have been involved. Subsequently, the methodology used by this multinational will be analyzed, which ended with the achievement of the objective of reducing taxation in the low countries and beyond. Although the case moves in full compliance with the law, I have concluded our work by suggesting some modalities, with which the tax control authorities in this case the Europeans, can succeed in reinforcing the discipline of this matter. Given the study of the Starbucks case and the analysis of the current position of the multinational, I have therefore concluded this work by recommending a discipline of transfer pricing practice using the block-chain technology.

5.2 Pills of history

Starbucks is an American coffee chain founded in 1971. Part of it is the largest chain of its kind in the world, with 28 720 stores in 78 countries, of which 12,000 in the United States.

Starbucks stores sell only their own brand of coffee (ground or grain), tea, drinks, pastries, utensils and coffee machines, but the company's main goal is to "provide the consumer with an experience" , ie to offer its customers a unique service that will not find in the cafes of another brand.

The first Starbucks store was opened on March 31, 1971 in Seattle, by three students who attended the University of San Francisco: Jerry Baldwin, an English teacher, Zev Siegl, a history teacher, and Gordon Bowker, a writer. The breakthrough came from an idea of Howard Schultz, the historic managing director, now recognized as the true founder of the famous chain.

As of March 2012, Starbucks also arrived in Europe and there were 19,435 Starbucks worldwide, of which 12 781 in the mother country. Currently, Starbucks is present in 67 countries. In Europe, Starbucks coffee shops are very popular, especially in large cities such as Paris, Madrid, Berlin or London, as well as in many smaller centers.

As of September 6, 2018, Starbucks is located on 6 continents and in 76 countries and territories. The last countries Starbucks has arrived in 2018 are Italy and Uruguay. Starbucks is listed on the US NASDAQ stock exchange.

5.3 Starbucks structure in Europe

As previously mentioned, Starbucks has been the company responsible for providing and roasting the finest coffee in the world since 1971, and Starbucks is also the first coffee roaster and coffee retailer in the world.

Following our case study, we decided to analyze the three important branches for us, specifically in the Netherlands, Switzerland and the United Kingdom.

Starbucks Coffee Switzerland opened 10 years ago. It had two characteristics, it was the first Starbucks coffee present in Switzerland, but it was also the first Shop built in Continental Europe.

A feature present in all Starbucks in the world are the coffee machines, they are in fact identical in every shop and are all produced by the same Swiss company the Thermoplan. However, the most important feature for our case study and that we want to highlight is that Starbucks has chosen Switzerland as a hub for the purchase of coffee beans, this for particular reasons of taxation that we will see later.

Located in Lausanne, Starbucks Coffee Trading Company is responsible for purchasing all the coffee served in Starbucks worldwide. Starbucks Coffee Switzerland currently manages 46 coffees.

In the Netherlands, Starbucks Manufacturing EMEA B.V. is the company responsible for coffee roasting but not only it, in fact, sells and distributes the coffee and all the products they treat to all the shops under the ownership of Starbucks.

The company was founded in 2001 and is based in Amsterdam. The Amsterdam office is a central office that deals with receiving, roasting and shipping coffee to retail stores in the area dubbed EMEA (Europe, Middle East and Africa). The roasting office based in Amsterdam is the only one in Europe and the only one outside the United States. The company has relationships with over 1200 retail stores and guarantees employment of around 150 employees.

To conclude, the last company we analyzed is the Alki Limited Partnership. In fact, Starbucks has registered its intellectual property, such as its brand and its logo in this company that operates as a subsidiary of Starbucks Coffee International. Today this subsidiary no longer exists as it has dissolved. From the information obtained we can say that it was a subsidiary of an even larger Starbucks subsidiary called Emerald City and its function was to collect copyrights. Unfortunately, knowing the geographical position of this subsidiary is very difficult due to the lack of information received, but there are several subsidiaries with placement in tax havens that are registered under the name Emerald City, but also the US headquarters in Seattle.

We summarize below the relationships between the branches that are important for our case study:

1- The Starbucks office in the Netherlands buys coffee beans from the responsible branch in Switzerland.
2- The Starbucks site in the Netherlands uses coffee beans from Switzerland to roast, pack and ship coffee in the EMEA area.
3- The Starbucks production of the Netherlands is however related to Alki, the company that owns the intellectual property, with royalties for roasting, blending formulas, brand and copyright.

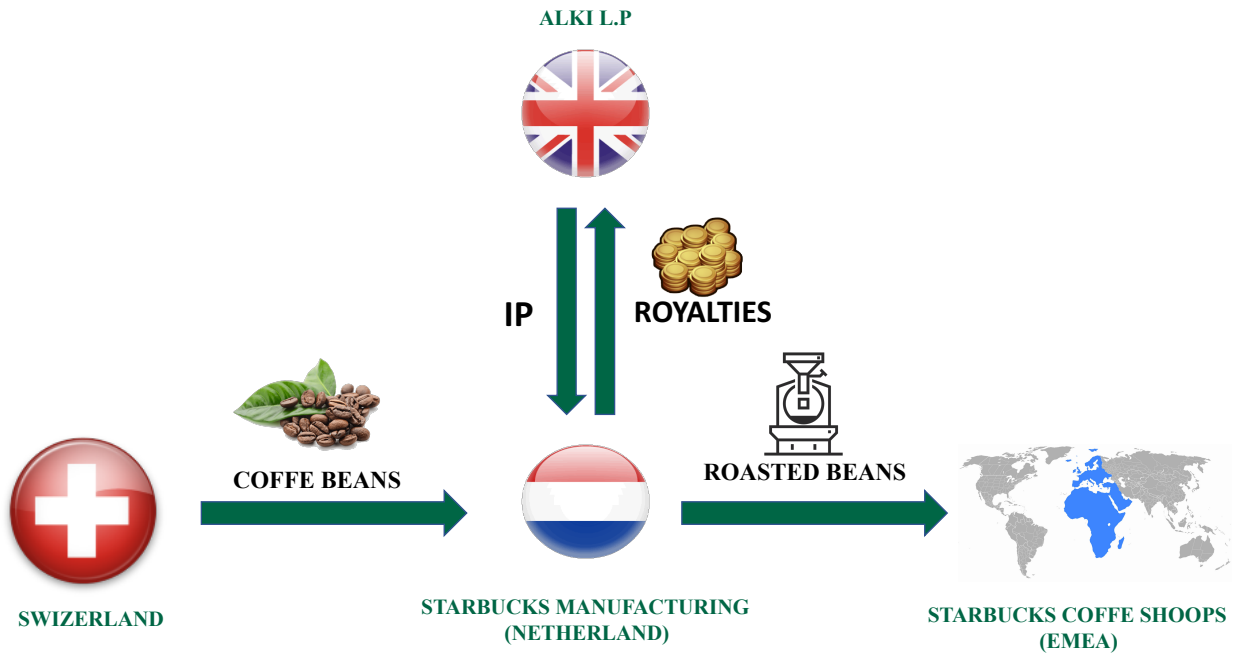


Figura 1 *STARBUCKS EUROPEAN STRUCTURE*

5.4 Transfer pricing and European dilemma

As we can see from the definition that we fully quote from the European community: "Transfer pricing is defined as the price charged between related parties for goods, services, or use of property".

Considering that transactions within the same company represent the majority of international transactions, it is obvious to understand why it represents one of the rising topics of this last period and one of the major problems with which the global finance government has challenged.

The main problem with this modality concerns the fact that prices are set by the same associated parties, who can then decide to model prices so as to make the group profit, rather than thinking of acting as a single identity.

It is in fact difficult for the bodies responsible for control to be able to investigate because the organization of the companies in question is structured in a complex and flexible manner.

Thanks to this structure the Multinationals could be tempted to abuse the transfer pricing practice in order to move their profits in the most convenient contexts.

Considering what has just been said, it is very important to specify how the transfer pricing system is a legal practice, so it is important not to link transfer prices directly with tax fraud issues, even if this practice has often been incorrectly applied. and thus becoming illegal, as a means to achieve such illegal purposes.

To prevent this misbehavior from happening, the OECD (Organization for Economic Co-operation and Development) has published a document entitled "OECD Transfer Price Guidelines for Multinational Enterprises and Tax Administrations" in which it analyzes the modalities with which can be avoided if these behaviors occur.

These guidelines establish the fundamental "principle of free competition" which is the standard for the evaluation of prices of intra-group transactions.

Analyzing the guidelines it is easy to understand how in the practical application of these principles requires a comparison between the price resulting from the transaction carried out by the related parties and the price deriving from exchanges between independent parties: in particular, considering the associated parties as if they were independent , taking into account the other companies that are effectively independent and manage comparable transactions, in a context of comparable circumstances, the tax authorities should be able to find a match between these two prices, all this may be possible obviously if no manipulation occurs (omissions or errors). This type of analysis is called a comparability analysis and constitutes the largest part of the application of the principle of free competition.

However, it is very difficult to apply free competition in complex cases, a clear example being the difficulty of carrying out comparability analyzes when the related companies produce highly specialized products or services or services or non-material goods.
A further problem concerns the difficulty in obtaining the information from the tax authorities, often these are in fact incomplete or not available for highly confidential data. All this makes the work of the authorities even more difficult.
Finally, bearing in mind that transfer pricing "is not an exact science but requires the exercise of judgment by both tax administration and taxpayers", one should take into account a certain degree of uncertainty, given the different interpretations of imposed authority of the EU members and associated companies involved. That said, it is understandable that even an attempt to carry out a comparative analysis can find difficulties. Considering what we said previously, we believe that the standard used for transfer pricing assessment is difficult to implement both by nations and businesses. We also want to highlight how we need to build a single legislative framework that reduces uncertainty, thus improving the proper functioning of the European market.

5.5 Starbucks' fiscal strategy and monetary authority supervision

With the 2015 ruling, the European Commission stated that the Netherlands has granted tax benefits to the multinational Starbucks. With this ruling, the commission has therefore forced the low countries to recover a figure between twenty and thirty million from society so as to re-establish competitiveness on the market.
The commission, textually, reports:
"Tax rulings that artificially reduce a company's tax burden are not in line with EU state aid rules, they are illegal and I hope that with today's decisions, this message will be heard by the governments of the Member States and companies. small, multinational or not, should pay their fair share of taxes".
This decision will be very important in the future, in fact, although the amount requested by Starbucks barely reaches 0.1% of profit in the fiscal year 2015, it has introduced a new principle that will be used for the next few years and which will report the commission statement he claims:

"Tax rulings cannot use methodologies, no matter how complex, to set transfer prices without economic justification and unduly shift profits to reduce taxes paid by companies."

In order to understand this last point, it is important to analyze and understand the commission method defined as "artificial and complex" used by Starbucks to reduce taxable taxation in the Netherlands.

The companies involved in the process, as mentioned above are:

- Starbucks Coffee Trading Company Sàrl (a Swiss company).
- Manufacturing Starbucks EMEA B.V (Dutch private limited liability responsibility)
- High Limited Partnership (A UK Limited Partnership).

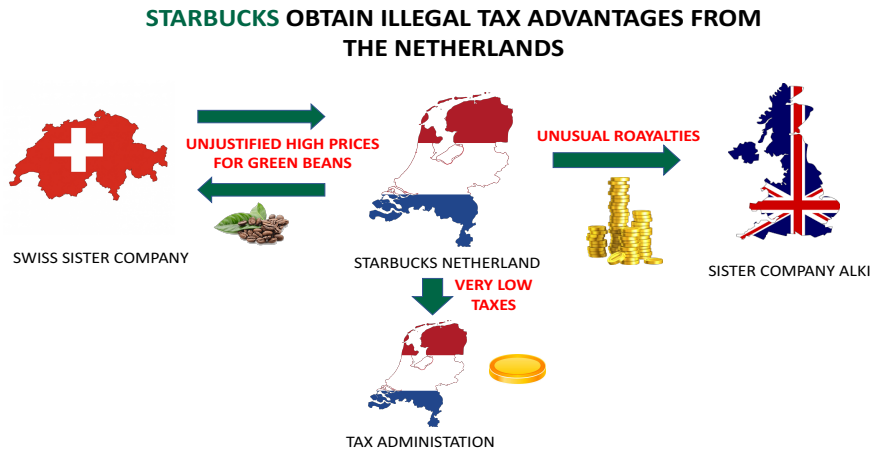


Figura 2.2 *STARBUCKS OBTAIN ILLEGAL TAX ADVANTAGES NETHERLANDS*

Starbucks Manufacturing SMBV based in Amsterdam, is the only roasting company of the Starbucks group present in Europe. It sells, packages and distributes the roasted coffee and the products that are processed by them to all the stores under Starbucks or Starbucks brand in Europe, the Middle East and Africa. The UK-based company, the so-called Alki, is the owner of the IP or the so-called "know how" for the universal roasting process for all Starbucks companies. The last but not least is the SCTC-based company that has the task of buying or buying coffee beans from the international market and then selling it within the Starbucks group and to all those who have a Starbucks license.

The story is now easy to understand, as reported in Figure 2, the SMBV company buys green beans from SCTC at a price almost tripled, according to the commission completely unjustified, since profits related to international trade in raw materials or raw materials such as coffee are taxed at 5 percent in Switzerland, while if this had happened in the Netherlands it would have been taxed at 25%. It should be noted that more than 80 percent of the company's annual entrances in Amsterdam were paid up to 2015 to buy coffee beans, making two accounts easy to understand how the profit transferred to Switzerland is very substantial.

At the same time, SMBV pays very high royalties to Alki UK for the use of its intellectual property, thus shifting profits to the United Kingdom where the tax rate is about 24% higher. But analyzing the profits ended in the UK do not stay here long, in the period 2013-2015, Starbucks has not registered any kind of profit in the United Kingdom and has therefore paid no income tax, this affects a figure of more than 1.2 billion pounds. Still analyzing the situation in the UK, we remain appalled to note that the average loss of the company in the fiscal years 2008-2010 was on average 37 million pounds despite the sales continued to grow. However, finding an answer to this dilemma is simple, they have circumvented the tax authorities through the use of instruments such as royalties and loans within the company. In fact, looking for information on the Internet cannot find information on where these royalties are shot from the UK, but it remains clear that Alki is a subsidiary of Starbucks international, named Emerald City, now if this was in turn a member Starbucks International based on a tax haven would then be even more advantageous, since once it arrived on a tax haven the income is untraceable by the IRS (Internal Revenue Service) because Emerald City is an unlimited liability company. Under UK law, unlimited liability

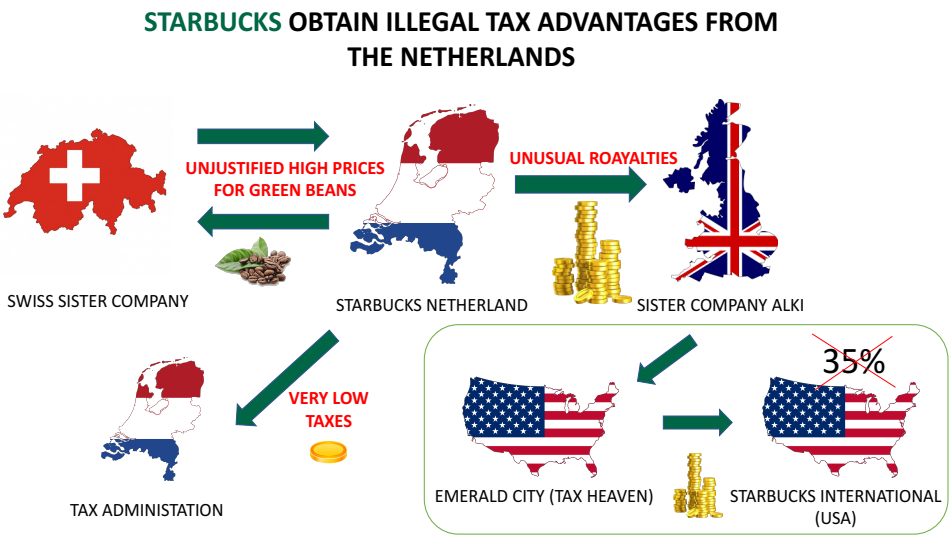


Figura 1.3 WITH TAX HEAVEN COUNTRY

companies are not required to release certain financial information. This foreign income could be taxed if it is funnels back into the United States. Corporate tax is 35% in USA.

This is not all, the Dutch authorities impose the payment of taxes for the activity carried out in their territory by Starbucks, however, again here on an average annual turnover of 154 million euro, the average profit of the Dutch tax authorities was about 1.6 millions of euros, close to 1% of the total. This was possible thanks to a price agreement (APA) signed in 2001 between SMBV and the Dutch tax authority.

An early price agreement (APA) is an early agreement between a tax payer and a tax authority on an appropriate transfer pricing method (TPM) for certain series of transactions in question over a given period of time (calls "Covered transactions"). It can be unilateral, bilateral or multilateral:

• Unilateral APA: an APA involving only the tax payer and the tax authority of the country in which the tax payer is located.

• Bilateral APA (BAPA): an APA involving the tax payer, the tax-payer associated company (AE) in the foreign country, the tax authority of the country in which the taxpayer is located and the foreign tax authority.

• Multilateral APA (MAPA): an APA involving the tax payer, two or more taxpayer AEs in various foreign countries, the tax authority of the tax payer's country and the tax authorities of the EAs. This is what Google has experienced in its particular situation.

The purpose of an APA is to eliminate potential disputes over transfer pricing in a cooperative way, but Google has abused it legally for great financial benefits.

The APA in question regards the determination of the arm’s length remuneration for SMBV for its functions performed of roasting and distribution, and thanks to that, the determination of the royalty payment to Alki for the use of intangibles such as process and distribution know how.

The Dutch tax system has a law on which the rule is based on which profits are taxed wherever value is created, exploiting this law to its own advantage, Starbucks because intellectual property rights are not found in the Netherlands, fees for 'use of these cannot be taxed in the Netherlands.

The method agreed with the authorities to assess the performance of SMBV and thus to discover the value of the royalties is the so-called "net margin-net margin" method (TNMM).

According to the OECD guidelines, the TNMM analyzes the net profit of the transitions within the group performed, calculated through the use of a percentage at an appropriate basis. The net profit indicator should therefore be established by referring to the profit indicator that the same contributor gains in comparable transactions with independent companies or the margin that would have earned an independent company in comparable transactions.

However, to be able to determine if the transactions are comparable with each other, it is necessary to independently analyze all the intragroup transactions and the independent ones without an initial comparison.

According to the European Commission this method is what led to overestimate the monetary value of the canons.

The commission in fact criticizes Starbucks several things, the main and most important are the following:

- The OECD guidelines stated: *"The part subjected to testing in general would be the least complex part of the controlled transaction and should be the part in relation to which the most reliable data for comparability is available"*. In this case the tested part was SMBV, but the commission claims that SMBV only carries out routine tasks. On the other hand, Alki's activities are very limited: it has no employees and operates with limited capacity. The latter should have been the tested part.
- Starbucks has selected the cost pool for applying the TNMM, considering only those for which SMBV plays a value-added role. The European Commission has contested the exclusion of costs that would not affect value-added activities since it does not exist in the OECD guidelines and has the sole effect of increasing the value of the fees.
- If Starbucks had used the CUP method and compared it to other coffee roasters worldwide, SMBV would not have paid any royalties for know-how. Furthermore, copyrights cannot be regulated on the basis of the principle that SMBV does not seem to obtain any commercial advantage from the use of intellectual property. Because of the high cost of coffee roasting, Starbucks coffee roasting activities would not generate

sufficient profits to pay for Alki's toasted coffee rights.

Finally, the commission did not accept Starbucks' justification for the increase in the costs of green beans paid to SCTC, considering that the margin on beans has more than tripled since 2011. This decision shows, and in a certain way imposes, uncertainty legal framework surrounding the Transfer Pricing discipline, calling into question the interpretation of the OECD guidelines on transfer prices of the tax authorities of the Member States. In fact, it seems clear that Starbucks has moved legally within the tax system of different countries taking advantage of the lack of clarity and laws that regulate this discipline and that has also shown how the tax authorities have had to use a force in many respects not justified to be able to limit losses also gigantic because of a lack of regulation.

Although Starbucks and the Dutch firm in general have demonstrated compliance with all OECD rules and guidelines, it was still possible for the committee to discuss the specific method used. The TNMM method can be used to establish remuneration at market conditions for production activities, such as those of the Dutch coffee roaster Starbucks Manufacturing BV, to the extent that it is covered by the OECD guidelines, and is widely used at the level international.

The problems of regulation between states and between states and multinationals have done nothing but bring out a situation in which there is an absolute lack of regulation in which everyone is free to move in a field where there are no universal laws and adaptable to everyone and in moreover, a problem has arisen that will be difficult to regulate the lack of specific laws to assess the market value of non-tangible goods and also the correct monetary value for copyrights.

5.6 Recommendations

The Starbucks case is the demonstration of the fact that current rules must be improved. The lack of a common regulation governing agreements between countries has, indeed, created many problems. If Europe wants to combat these harmful tax practices, each country should start to ensure transparency, particularly with regard to their tax rulings.

About that, OECD and G20 countries have taken joint action to address the weaknesses within the international tax system that create opportunities for base erosion and Profit

Shifting (BEPS). Working with other countries, they have developed a comprehensive package of measures to tackle BEPS: the BEPS package. The OECD Committee on Fiscal Affairs (CFA) – had been opened to interested countries and jurisdictions in order to put in place an Inclusive Framework on BEPS. Members of the framework work on an equal footing to tackle tax avoidance, to improve the coherence of international tax rules, and to ensure a more transparent tax environment. Effective and consistent implementation of the BEPS package requires an inclusive implementation process. First, the implementation of the BEPS package into different tax systems should not result in conflicts between domestic systems. Furthermore, the interpretation of the new standards should not lead to increased disputes. The BEPS package consist on 15 actions and we have found out that some of that are strictly related with the Starbuck case. We are talking about these in our recommendations because we think that, if all the suggestions contained in the 15 actions were legally binding for countries involved (and not just suggestions and analysis), maybe protect the taxable bases of countries involved could be possible and simpler. We have focused our attention to some of these action in particular: action2, action3, action4, and action8.

Action 2 develops model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effects of hybrid instruments and entities. Indeed, as in the Starbucks case, rules that allow taxpayers to choose the tax treatment of certain domestic and foreign entities could facilitate hybrid mismatches. In the case of Starbucks the situation was that: firstly, there was a confidential tax ruling between Netherlands government and Starbucks so that the tax rate for royalties was very low; secondly, based on the tax treaty between UK and Netherland, UK government does not charge withholding tax on royalties that company gave to Netherland subsidiary, but, under UK accounting rules, royalties can deduct the taxable amount. The final result is a reduction of the global tax bill as a consequence of this hybrid mismatch arrangements.

Action 3 sets out recommendations to strengthen the rules for the taxation of controlled foreign corporations (CFC). Indeed, taxpayers could have no incentive to shift profits into a third, low-tax jurisdiction. In this regard, the Starbucks subsidiary in Switzerland was created to be a coffee bean distributor, buying and sell coffee bean to all Starbucks manufacturing, but the coffee bean never physically goes to Switzerland. The small activity made by Switzerland subsidiary cannot be compared to the activities in UK Yet,

Switzerland subsidiary earned much more earnings and pay more tax than UK subsidiary. It is not surprising that income tax in Switzerland are much lower than ones in UK. Even though the mark-up price charged by Switzerland subsidiary has been consistent with the arm's length principle, the fact that it caused a loss in another subsidiary was not fair and efficient and that is the reason why we think that the implementation of this action is very relevant.

Action 4 outlines a common approach based on best practices for preventing base erosion through the use of interest expense. Even in this field the connection with the Starbucks case is immediate. Indeed, we know that the Starbucks company in UK had reported losses for more than 1 years but had survived thanks to debt, it means thanks to inter-company loans (loan from US parent company). The unusual thing is that Starbucks US charge its UK unit at Libor +4%, while KFC charges its subsidiary at Libor+2%, and McDonald charges its subsidiary at below of Libor rate. Based on this, we think that limitation regarding deductible interest from the taxable income should be more effective.

Action 8 contains transfer pricing guidance to assure that transfer pricing outcomes are in line with value creation in relation to intangibles.

In the meaning of International Accounting Standards (IAS 38 "Intangible assets") intangible assets are defined as identifiable non-monetary asset, without physical substance.

The problem in valuing intangibles is that you can't give them a specific "price" and you can't clearly evaluate the future economic benefits that it can bring an intangible asset arising from the sale of products or services, the use or lease of assets or to reduce production costs.

There are several methods to try to do it, but the one we suggest and prefer is the income approach.

The income approach is based on the income and expense data relating to the intangibles, is analytical and prospective and allows to realize how patents and other intangible assets create value.

In order to better understand the development of this case we have researched a lot of information, taking also example from other analyzed case studies such as American fiscal policies and develop short and long term reflection with a final research on the Blockchain technology. We have thought of some suggestions that can contribute to the

construction of more transparent conditions to the multinationals and simplify the discipline of this practice regarding the European tax authority.

One of the problems we faced with was the lack of specific conditions on the provision of supporting documents related to transfer pricing practices, as each country treats this practice differently. It is clear that the lack of discipline is dictated by the fact that each country acts for its own interest.

Basically, the problem that emerges and that wants to be resolved is how to succeed in sharing the global profits among different tax jurisdictions.

The answer could be an utopian suggestion (since it is difficult to realize) and it would be that the European Union should adopt a fiscal union. If most decisions about taxes remain at the national level, there will be a less fair market because each country will act for its own convenience. Since there is already an economic and monetary union (EMU), it will be functional also having a unitary fiscal approach. In this way (like in the United States) multinationals would be consider as a single entity. This suggestion is for the long- term for its difficulty to be realized and for a matter of priority since today the OECD cares more attention on other aspects.

This approach is used already, and with positive results especially in the American market.

A short-term solution that we believe will help the tax authority to achieve greater transparency and avoid misunderstanding between states is about giving the possibility to the tax authority to recalculate the taxable income of the multinational company which do not produce clear and transparent documents about the reliability of their prices. This would be another step after that the OECD has adopted the principle in Article 9 of Model Tax Convention in 2017, to ensure that transfer prices are established on a market value basis following the arm's length principle.

Belonging to what we have already seen, it is obvious that the lack of common agreements among countries has created several problems, also the lack of appropriate regulation, not to mention a system of fiscal authority based on antiquated practices that don't do nothing but make themselves ineffective in their task of control and leaving full freedom of action to multinational companies. For this reason we strongly advice the implementation of the blockchain solution. This is a choice that will take the whole system to a higher level,

eliminating the shortcomings of a now obsolete system and guaranteeing a suitable and performing system.

How does Blockchain work?

In general terms, a Blockchain is a ledger of information that is replicated across computers that are joined in a Peer-to-Peer network. The communication inside the network uses cryptography to provide secure identification of who sends the information and who receives it. When a peer wants to add a piece of data to the ledger, other peers must confirm the correctness of the information, which in turn is added to a block. Each block contains a unique hash (acting as a digital fingerprint) of the previous block, linking them together to create a chain of blocks. The technology eliminates the need of centralization through an intermediary, allowing parties to share information and transact directly with each other in a secure manner. Moreover, using Blockchain technology allows for complete immutability of the ledger, as altering the information stored on a block is not possible without altering its hash. The following points will give you a better explanation.

Key carachteristics of Blockchain:

a. Based on consensus Information can be added onto a Blockchain only if all, or a defined number of participants in the network agree on the correctness of information.

b. Sealed with cryptography The created Blocks are cryptographically locked into the chain, meaning that the Blockchain record is immutable – it is impossible to delete or alter the information stored in the block. Furthermore, Blockchain eliminates the single point of failure: If a part of the network fails, Blockchain continues to function.

c. Chronological and time-stamped

Blockchain is a chain of blocks, each one storing data on a wide range of information. Each one is linked to the previous block, forming a chronological chain of the data uploaded onto the Blockchain.

d. Digital

Every information stored on Blockchains is digital, eliminating the need for paper documentation

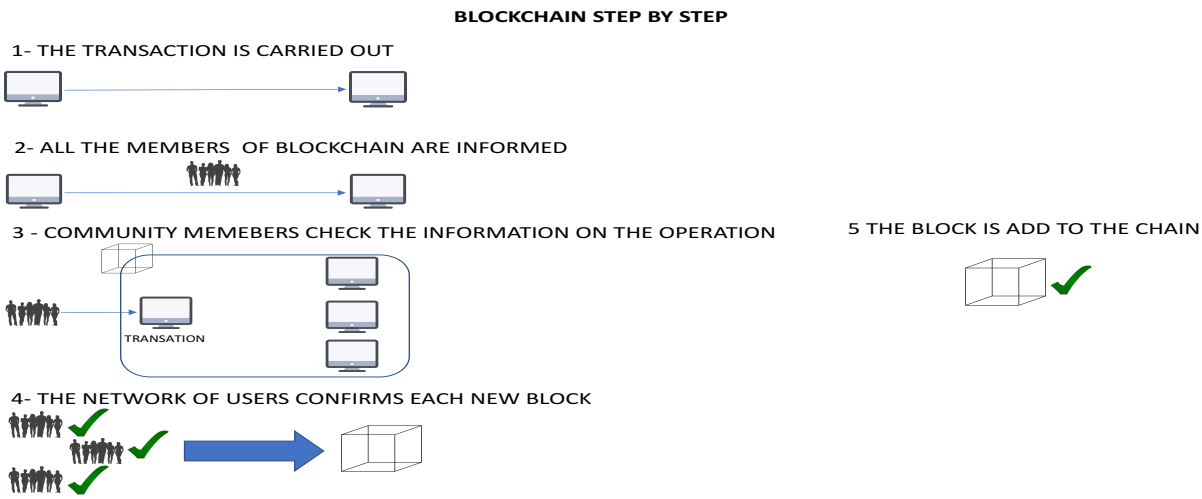


Figura 3 *Blockchain Step by Step*

It is important now to explain how they can reach consensus, and the answer is easy, with the use of a consensus solution is referred to as Proof of Stake (PoS).

This works similarly to a joint-stock company, where each shareholder holds a certain stake (a number of shares in the company). In this method, every participant places a bet on its block. The participants that hold the correct block (containing no fraudulent transactions) get their block added to the chain and get rewarded, but the participants whose block turns out to be fraudulent get punished and the amount of bet that they had put get reduced from their balance. The shareholders with a bigger share in the network have a higher chance of being selected. This is a two way street: on one hand there is risk related to the scope of share a participant possesses in the network, but on the other they have a higher interest in securing the stability of the network. However, it is worth noting that these are not the only consensus algorithms available. As Blockchain technology is still new and undeveloped, the process of creating new algorithms, suitable for many types of Blockchains, is an ongoing process.

To better understand imagine the TripAdvisor platform where there are many restaurant but everyone with a different valutation from the customers is more or less the same with the only differences that the bad recension is given by the fact that their transaction weren't correct.

Before arrive to the end is also important to give you a little explanation about how smart contract works.

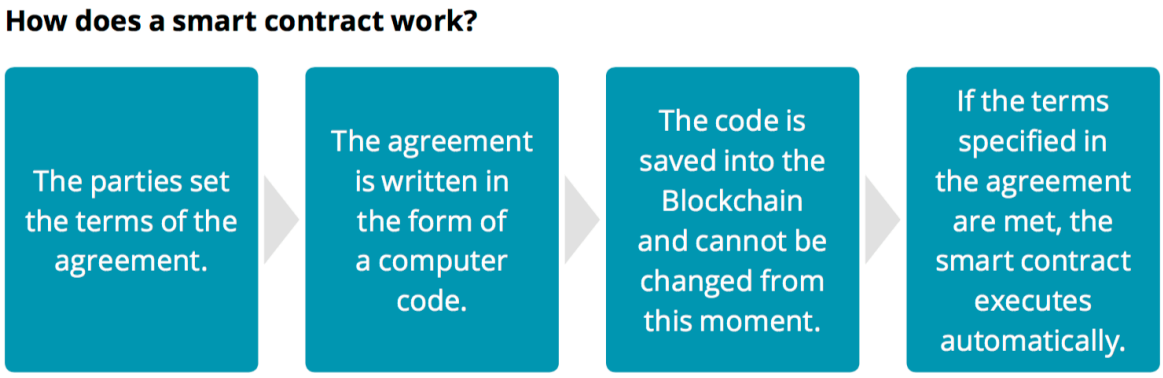


Figura 3.1 *How does a smart contract work*

Block chain has the power to disrupt and strongly reorganize accounting and the way tax payments are processed. As the technology is still in its infancy, introducing Blockchain to the tax authorities would require a revolution in both governmental databases and network systems. The effective implementation of Blockchain for taxes is not only limited to this area and requires considering every area of governmental activity. Asides from integrating IT systems on many levels, it is clear that implementing Blockchain would also require far reaching changes to the legal system, reforming laws on databases, intellectual property and legal identity. However, the benefits of Blockchain technology on a governmental level are hard to overlook. In the long run, Blockchain can be a driving factor in implementing real-time, automated tax processes for both small and large enterprises. After this short picture of the blockchain we can go more in deep about the effect of blockchain in the transfer pricing method, as we said before according to United Nations data, intrafirm trade makes up around 30% of global trade altogether. The laws regulating transfer pricing are different for each country, requiring that cross border transactions between related parties comply with arm's length price. Simply put, this price should mirror the proposed or applied price between non-related parties
in an open market.

How could Blockchain benefit transfer pricing regimes?

Traditional transfer pricing	Blockchain based transfer pricing
Heavily reliant on intra-firm documents and correspondence to define the role of each involved party.	A Blockchain distributed ledger that makes it easy to track the flow of transactions and identity of all involved parties.
The intra-firm agreements are executed manually.	The agreements are written into a self-executing smart contract.
High risk of falsification of transaction documents.	All movements on the Blockchain are time-stamped and cryptographically sealed, eliminating the possibility of tampering.
The entire system is heavily reliant on paper documents and data stored on many servers to track the supply chain.	Each information is stored on the Blockchain and visible to parties that have access to the Blockchain.
Tracking of payments is ERP- based.	The payments are executed by a smart-contract if they meet the specified conditions.

Figura 3.2 *How could Blockchain benefit transfer pricing regimes?*

Looking at the table above it is easy to say how blockchain technology in long term can help tax discipline in all its areas. In this case, talking about transfer pricing, we note that 'implementation of this technology can bring better regulation. the better understanding of techniques such as that of the arms lenhgt principle and furthermore can lead to the elimination from the global panorama of tax authorities as intermediay, as following the blockchain dicipline the regulation will be given automatically by the markets.

5.7 Conclusion of the case

Following what I have analyzed and said in these brief studies on transfer pricing and on the specific case on the Starbucks, I can repeat as previously mentioned that transfer pricing is not an exact science and that a small level of uncertainty is normal; in fact the goal of the international tax management is to increase corporation-wide profits by reducing the total amount of taxes paid. The tax structure is based on a worldwide tax principle: gross foreign branch income is taxed and a full credit is given for foreign taxes paid up to the amount of the US tax liability. Taxes are shifted from foreign countries to domestic country, but total taxes remain the same. By using the credit method, domestic

country taxes total branch income regardless of where the income is earned or where the taxes are paid. A description of the various aspects of determining credit risk associated with loan arrangements were used to identify the main value drives behind pricing of loans. This was done in order to identify major differences between a loan provided between two related parties and two unrelated parties.

However, the study I carried out made it clear that the system in place today is far from the perfection it would need. Belonging to what we have already seen, it is obvious that current international tax rules in Europe need to be improved. The lack of common agreements among countries has created several problems as it is possible to see from the Starbucks case. If Europe wants to prevent harmful tax practices, each country should be transparent to each other especially about their tax ruling and domestic taxed rules.

The lack of reference points, specific rules and regulations, with the chaotic definition of some principles give the possibility to multinational companies to skip the rules as they want, shifting their profits to countries that can guarantee the best possible taxation for their profits. First, it is evident from the case that the very first problem is the Royalty, and specifically the determination of its value. In the specific case, Starbucks charges too high royalties to the related parties. This problem could be driven by the uncertainty of the rules regarding how intangible assets should be valued (and which standards should a company use). In this case, it is helpful to develop some standards in valuing the intangibles and strengthen regulations regarding royalties and interest charged by any multinational company. Another issue is linked to the lack of specific and clear conditions on giving supportive documents related to transfer pricing practices, which are dealt differently by each country. A less fair market will be built because each country is supposed to act by own convenience (like the MNEs do of course). A possible solution taken from the American market is adopting a unitary fiscal approach that treats multinationals as a "single entity", assessing their taxable profits at the global level. But, for the OECD, the main issue still is the way of ensuring fair market prices ("arm's length" prices) so that intra-group transactions are not used to shift profits and cause distortion between countries, and countries will manage to take their status quo and revenues under control. This is an odd solution also for MNEs, since they are more efficient than separate entities trading at arm's length from one another.

The crucial question might be: how to apportion global profits between taxing jurisdictions? The answer, basing on the consensus view that profits should be aligned with economic activity, countries and multinational companies should focus on finding a formula reflecting each jurisdiction's share of activity. This approach is seen to be in surprisingly common use already, and with broadly positive results especially in the American market. While gathering supportive info another issue may occur: there is not enough data that prove a genuine arm's length principle in the inter-company transactions. One solution might be that the taxpayer is supposed to document all steps and supporting them in their activity in terms of comparable analysis proving so, the genuine of the arm's length principle. Additionally, to obtain reliable and transparent solutions, tax administrator must require the tax payer supportive documents as evidence of their transfer pricing. On the other hand, companies must anticipate scrutiny from tax authorities and comply with documentation requirements. If Starbucks cannot provide the supportive documents or the reported income is understated and/or reported expense is overstated, tax authorities should recalculate the taxable income according to the state if there is no special relationship or it was a transaction between independent enterprises.

What about short-term solution? It is advisable to focus on giving a more genuine arm's length principle. It is evident that many transfer pricing issues are linked to this principle because mispricing is the consequence of the difficulty on making market comparison and implementing arm's length. Europe should make fixed conditions and guidelines for a "European way" that helps companies to build an appropriate arm's length principle guaranteeing transparency among countries fiscal

I have noted the difficulties that the European Union is experiencing but given the power that the community has in economic terms, it is not possible that a Community fiscal policy is still so weak. The timing for the change is now ripe and a decision must now be implemented. However, change will take time to come, and this work is completed with advice that could help the Commission to clarify and ensure more coherence in the transfer pricing world.

APPENDIX

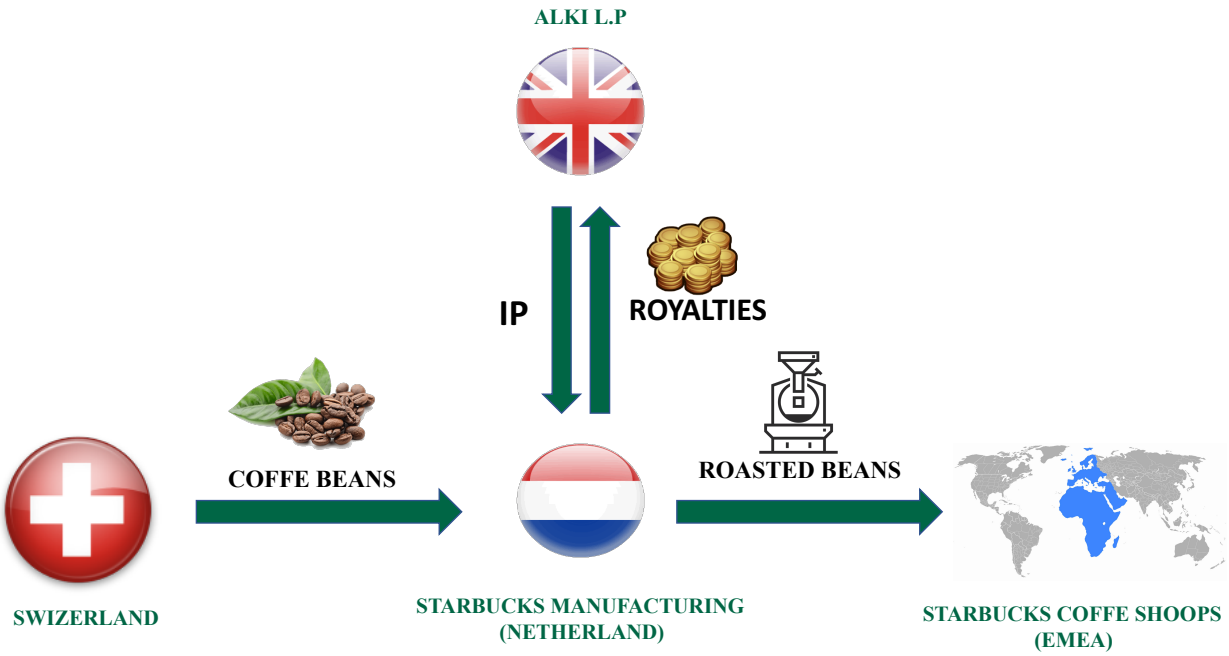
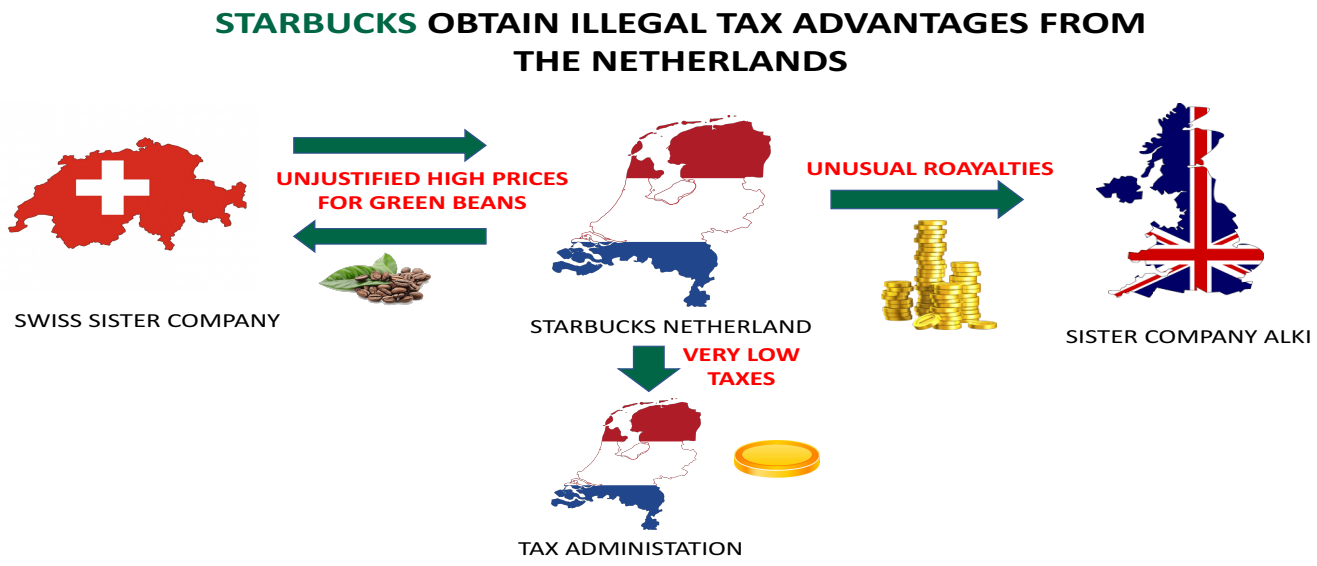


Figura 4 STARBUCKS EUROPEAN STRUCTURE

Figura 5.2 STARBUCKS OBTAIN ILLEGAL TAX ADVANTAGES



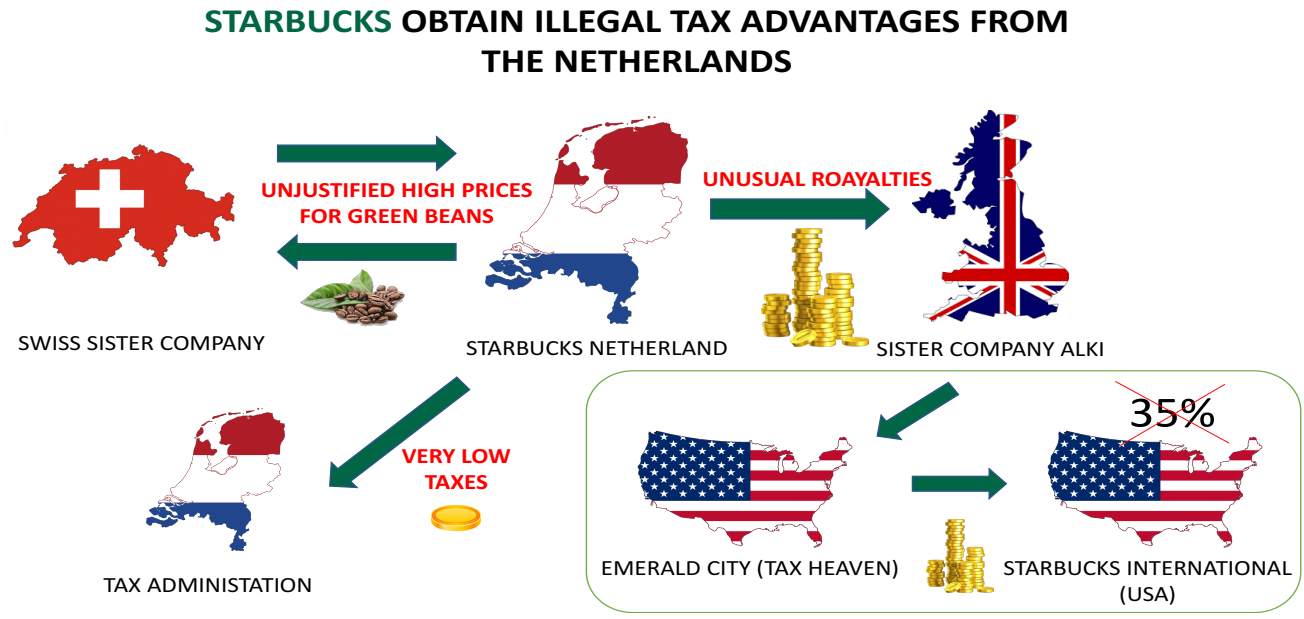


Figura 1.3 WITH TAX HEAVEN COUNTRY

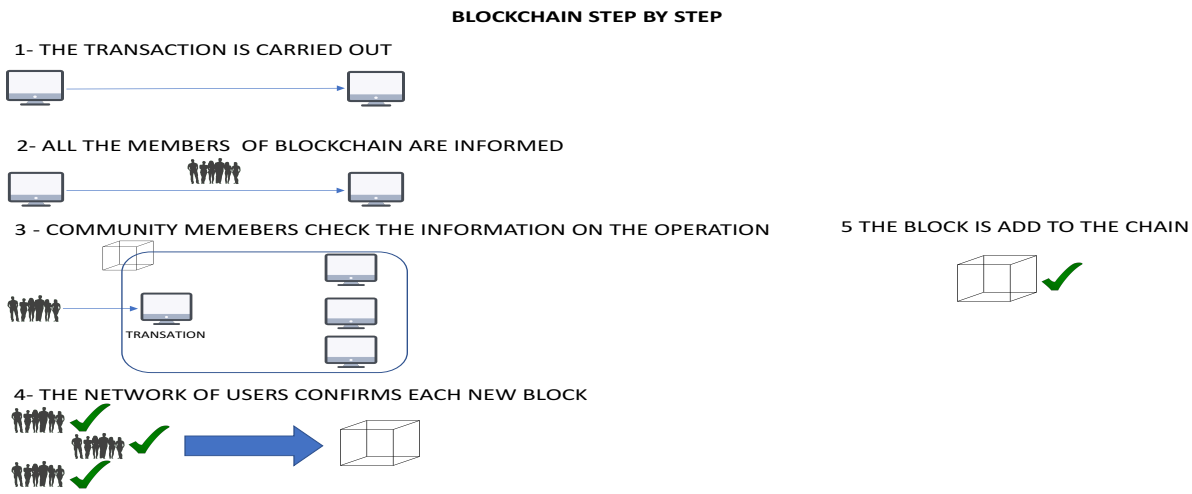


Figura 3 *Blockchain Step by Step*

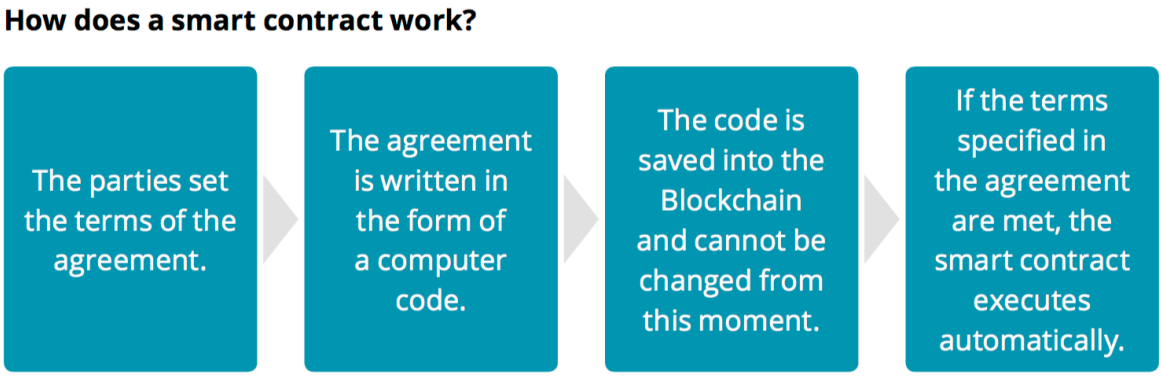


Figura 3.1 *How does a smart contract work*

How could Blockchain benefit transfer pricing regimes?

Traditional transfer pricing	Blockchain based transfer pricing
Heavily reliant on intra-firm documents and correspondence to define the role of each involved party.	A Blockchain distributed ledger that makes it easy to track the flow of transactions and identity of all involved parties.
The intra-firm agreements are executed manually.	The agreements are written into a self-executing smart contract.
High risk of falsification of transaction documents.	All movements on the Blockchain are time-stamped and cryptographically sealed, eliminating the possibility of tampering.
The entire system is heavily reliant on paper documents and data stored on many servers to track the supply chain.	Each information is stored on the Blockchain and visible to parties that have access to the Blockchain.
Tracking of payments is ERP- based.	The payments are executed by a smart-contract if they meet the specified conditions.

Figura 3.2 *How could Blockchain benefit transfer pricing regimes?*

CORPORATE INCOME TAX RATES AMONG COUNTRIES	
JAPAN	39.5%
UNITED STATE	39.2%
FRANCE	34.4%
BELGIUM	34.0%
GERMANY	30.2%
AUSTRALIA	30.0%
MEXICO	30.0%
SPAIN	30%
NEW ZELAND	28.0%
NORWAY	28.0%
CANADA	27.6%
ITALY	27.5%
PORTUGAL	26.5%
SWEDEN	26.3%
FINLAND	26.0%
AVERAGE OF ALL OECD COUNTRIES	**25.0%**
UNITED KINGDOM	25.0%
AUSTRIA	25.0%
CHINA	25.0%
DENMARK	25.0%
NETHERLANDS	25.0%
SWITZERLAND	21.2%
GREECE	20.0%
POLAND	19.0%
IRELAND	12.5%

Figura 4 *Corportate income tax rates among countries*

REFERENCES

http://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf

https://www.senato.it/service/PDF/PDFServer/BGT/00941275.pdf

https://www2.deloitte.com/content/dam/Deloitte/id/Documents/tax/id-tax-transfer-pricing-update-seminar-per-29.pdf

https://www2.deloitte.com/content/dam/Deloitte/pl/Documents/Reports/pl_Blockchain-technology-and-its-potential-in-taxes-2017-EN.PDF

https://en.wikipedia.org/wiki/Unlimited_company

http://europa.eu/rapid/press-release_MEMO-14-394_en.htm

https://www.ilsole24ore.com/pdf2010/SoleOnLine5/_Oggetti_Correlati/Documenti/Norme%20e%20Tributi/2011/02/istruzioni-uso-societa-perdite-fiscali/ocse-linee-guida-2010-prezzi-trasferimento.pdf

http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf

https://www.facebook.com/financialtimes/videos/10153627660565750/

http://europa.eu/rapid/press-release_IP-15-5880_en.htm

https://www.linkedin.com/pulse/starbucks-eu-commission-comments-transfer-pricing-william/

https://mlexmarketinsight.com/insights-center/editors-picks/antitrust/europe/starbucks-ruling-by-eu-raises-questions-about-profit-shifting

https://uk.reuters.com/article/us-britain-starbucks-tax/special-report-how-starbucks-avoids-uk-taxes-idUKBRE89E0EX20121015

http://kluwertaxblog.com/2016/07/13/application-tnmm-starbucks-roasting-operation-seeking-comparables-understanding-market/

https://www.taxjustice.net/topics/corporate-tax/transfer-pricing/

https://www.globalresearch.ca/the-growing-abuse-of-transfer-pricing-by-transnational-corporations/5860

https://doc.morningstar.com/Document/029b97dbe8e679448909465c94f62fed.msdoc/original?clientid=globaldocuments&key=52dbc583e1012395

https://www.linkedin.com/pulse/transfer-pricing-meaning-examples-risks-benefits-shivangi-agarwal

https://www.heerlaw.com/determining-value-intellectual-property

https://unctad.org/en/PublicationChapters/wir2015ch5_Annex_III_en.pdf

https://www.fiscomania.com/2018/02/lussemburgo-tasse-professionisti-imprese/

http://www.finanze.it/export/sites/finanze/it/.content/Documenti/Varie/TPG_Italian.pdf

https://www2.deloitte.com/content/dam/Deloitte/id/Documents/tax/id-tax-transfer-pricing-update-seminar-per-29.pdf

http://brandfinance.com/images/upload/ip_valuation_royalty_rates.pdf

Gary R. Trugman, *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses, Third Edition, 2011.*

https://www.cgma.org/content/dam/cgma/resources/tools/downloadabledocuments/valuing-intangible-assets.pdf

Baeten, N. Borgers, C. Ford, J. *Commission's tax ruling cases: Fiat and Starbucks decided,* Linklaters, ottobre 2015.
https://www.google.com/search?client=safari&rls=en&ei=WzLTW_GwOMegad-hv-AK&q=Commission%27s+tax+ruling+cases%3A+Fiat+and+Starbucks+decided%2C+Linklaters%2C+ottobre+2015&oq=Commission%27s+tax+ruling+cases%3A+Fiat+and+Starbucks+decided%2C+Linklaters%2C+ottobre+2015&gs_l=psy-ab.3...3115.3115.0.3801.1.1.0.0.0.0.142.142.0j1.1.0....0...1c.1.64.psy-ab..0.0.0....0.97_I-ISgj4w#

Sari1, N. Hunar, R.S. *Analysis Method of Transfer Pricing Used by Multinational Companies Related to Tax Avoidance and its Consistency to the Arm's Length principle*, BINUS University.
analysis method of transfer pricing used by multinational companies ...journal.binus.ac.id/index.php/JBSE/article/download/.../1508