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A Future for the "Place of Effective Management"?

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Tax treaty rules to resolve the dual residence of persons other than individuals have been consistent since the 1963 OECD draft convention. Such dual residence in resolved by Article 4(3) of the OECD and UN Model Treaties in favour of the place of effective management. Only a very few states have noted reservations on this rule which is found in the vast majority of treaties.

Public Discussion Draft OECD BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances 14 March 2014 asserts that the view of "many countries" was that cases where a company is a dual-resident "often involve tax avoidance arrangements" (at para 52). On the strength of this single unsubstantiated assertion, it is proposed that the POEM be abandoned. In its place, it is proposed that entities that are dual resident will be denied treaty benefits "except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States" (para 38).

Public Discussion Draft BEPS ACTION 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues) 19 March 201 casts no further light on why this radical proposal, which will apply to every case of dual residence, not just cases of abuse is put forward.

Leaving aside the obvious subversion of the rule of law by replacing a legal rule with administrative discretion, this proposal is a recipe for increased and inevitable double taxation where agreement is not reached, or not reached on a timely basis. Even the OECD recognises that there is trouble ahead if this path is chosen. The Public Discussion Draft Follow Up Work on BEPS Action 6: Preventing Treaty Abuse 21 November 2014 suggest that their proposal might not apply to the tax treatment of persons other than the entity itself. Its only solution is to urge competent authorities to deal with such issues quickly. Everyone knows that even simple MAP cases take years to resolve in the real world.

Emerging economies show the way forward

While the OECD thrashes around with a problem of its own making, leading emerging economies offer sensible answers to the dual residence question:

South Africa, on the recommendation of the Katz Commission on modernisation its tax system post-apartheid, adopted the POEM as its domestic rule for corporate residence. This was done explicitly to bring its domestic law in line with recognised international norms.

Most recently, India, has proposed in the 2015 Budget that the POEM be introduced to determine

the residence of companies under domestic law. This will replace the "central management and control" test that has applied throughout the Commonwealth since the beginning of the 20th Century. The motivation is identical to that of South Africa: The explanatory memorandum to Finance Bill states that "including the concept of effective management would align the provisions of the Act with the Double Taxation Avoidance Agreements (DTAAs) entered into by India with other countries and would also be in line with international standards."

South Africa too has again been active on this subject. The South African Revenue Service (SARS) published on 14 April 2015 a draft revised practice note on its interpretation of the meaning of POEM.

The SARS draft revised practice note observes that "experience has shown that the application of these principles does not present serious problems in the majority of cases." POEM resolves dual residence because, the POEM can only be in one state. It is thus an improvement on the traditional common law "central management and control" test which inherently contemplates dual or multiple residence where management is divided or distributed among various states. Thus states that adopt the POEM as their domestic law, will automatically resolve dual residence without recourse to treaties (except in incorporation v POEM conflicts). SARS realistically accepts that not all states understand POEM in the same way. Despite this, The OECD Commentary on article 4(3) has remained consistent for many years, suggesting stability in international practice.

Technological development and management practice

SARS has also attempted to address some of the important changes in corporate management both as a result of the telecommunications and information technology revolution as well as new corporate management models and modern business practices. The OECD last addressed this in 2001 The Impact of the Communications Revolution on the Application of "Place of Effective Management" as a Tie Breaker Rule. Much has happened in these fields since 2001 and a re-examination of the consequences of technology on management models and practices is certainly due.

POEM addresses BEPS concerns

POEM is apt to address BEPS concerns. The SARS draft revised practice note concludes that the POEM test is one of substance over form. Management trumps the formality of incorporation. It is thus in line with other BEPS proposals. In India, The explanatory memorandum to finance bill 2015 observes that the introduction of POEM into domestic law is also an anti-abuse measure to deal with the creation of shell companies outside India but managed from India.

The international tax community would be well served by a proposal that states adopt POEM as a domestic law test and retain it in Article 3(2). The effect of this would be that where incorporation and POEM are in different states, the state of management would win the tie-breaker. This is entirely consistent with the BEPS agenda of aligning taxing rights with economic substance.

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