Answer-to-Question- 1

The arm's length principle is the standard used by all OECD parties in setting and testing prices between related parties. It aims to assess the level of profits which would have been assigned to each party were they independent of each other i.e. it looks at how two unrelated parties would have priced the transaction. The arm's length principle has been preferred by the OECD as it seeks to treat members of a multinational group and independent enterprises in the same way. This means that multinational groups should not be disadvantaged in anyway for being part of a group and at the same time, should not have access to tax advantages that are not available to independent enterprises. Overall, the OECD considers that the arm's length principle promotes cross-border trade and investment.

Companies are becoming more international and integrated globally. At the same time national economies and markets have become integrated and are impacted more and more by what other governments are doing. This means that the arm's length standard has become even more critical as it is instrumental in allocating profits between territories and therefore, determining the level of taxation which a local government can collect. If companies were all purely domestic there would be no need for international tax rules and no need for the arm's length principle but as companies are increasingly not focused on domestic markets, these principles will continue to grow in importance and be open to critique.

The key challenge for multinationals in applying the arm's length standard is the level of subjectivity required. Companies are required to "adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances". This requires multinationals to not only understand their own business and transactions, but also to have access to data relating to independent enterprises such that they can compare their results with these independent enterprises.

There are transactions which are simpler to price, and these transactions relate to transactions where independent data is readily available. An example is pricing the sale of a commodity like gold. Gold is publicly traded globally and the information on daily prices are readily available. Therefore, a multinational group selling gold between two related parties will easily be able to refer to conditions applied between unrelated parties and ensure these same conditions are met.

On the other hand, where a group develops increasingly integrated products, especially those utilising intangibles, finding comparable transactions and data would be more difficult, time consuming and ultimately costly. It is these complex transactions which cause the most difficulties for a multinational, they have to first invest significantly in pricing the transactions and then a tax authority may take a different view leading them to a costly audit. Additionally, Article 9 of the MTC allows for one tax authority to make adjustments to the profits of an enterprise in its state if it believes the arm's length standard has not been met. This could give rise to double taxation for the multinational. Though there is a mechanism within paragraph six for a corresponding adjustment, many companies end up with the case being taken to the Mutual Agreement Procedure as the tax authorities dispute what the correct arm's length result should be. The number of transfer pricing case currently in MAP is an indication of how difficult and open to interpretation the arm's length standard is.

Though the OECD still argues that the arm's length standard is effective in the majority of cases there has been a recent shift away from it. In BEPS Action 4, a recommendation was made on a formula approach for the calculation of interest which should be deductible. This is move away from the arm's length standard which historically tested by looking at what would a third party be willing to lend to the company and at what rate, and could that company actually source that debt externally. This approach placed multinationals groups on an equal footing with independent enterprises. With the introduction of the formulaic approach which looks at the level of net interest of the group to the groups EBITDA, the OECD is no longer saying that the results of a group entity should be the same as an unrelated entity.

The approach of the OECD on Action 4 is part of a increasing call by certain tax authorities and tax payers to move away from the arm's length standard to a more formulaic approach with the use of safe harbours. This is increasingly seen in domestic legislation. Many countries utilise safe harbours for thin capitalisation requirements. Countries, such as Singapore and the US, have safe harbour rules on the mark-up which should be applied to low value add intergroup services. The benefit of these safe harbours, is they reduce compliance costs for taxpayers on simpler transactions and free up time of the tax authorities to look at more substantial cases.

A step further from the use of safe harbours is the idea of a global formulaic apportionment whereby the profit to be taxed in each of the jurisdictions of a multinational will be determined by a set of formulas rather than by assessing individuals transactions with relation to third party data. Many of the United Nation countries, which predominantly rely on source income, are arguing for this approach as they believe it will better align profits with where functions are actually performed. They would like to see capital and labour being key components of the formula as this would allocate greater income to these labour and capital intensive countries and allow less profit to be shifted to low tax jurisdictions due to financing transactions of intangible property ownership.

The benefit of global formulaic apportionment is that it would provide a reduction in compliance costs for the taxpayer and would give certainty in tax treatment. There would be a significant reduction in double tax and international tax disputes. However, it is also not without its challenges the greatest of these being getting countries to agree to one formula. Individual countries would have an incentive to push for a formula which would reward the characteristics of its economy. Secondly, multinationals could still engage in tax planning by shifting labour and capital to low tax jurisdictions and therefore still eroding the tax base of many countries. The formulaic approach treats all companies the same and ignores market conditions and differences between industries. It may not reduce compliance costs as companies would need to gather significant global data and account for differences such as accounting treatments and exchange rate movement.

Conclusion

In conclusion, the arm's length principle is a critical aspect of international tax as it is responsible for allocating the profits, and therefore determining the tax revenues, to individual countries. It is not without its flaws, it is arguable complex and costly to administer and can be manipulated by multinational companies. It often leads to tax disputes and double taxation. The alternative approach is greater use of safe havens and a shift towards formulaic apportionment. Though arguable easier to administer and should result in less tax disputes, it would require all countries globally to sign up to one set of rules and put the international field ahead of their own country interests. This is unlikely to be an easy task and would be timely to implement.

As such, I believe that the arm's length principle is the correct approach and will continue to be significant for a number of years to come.

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Answer-to-Question- 2

Domestic anti-avoidance rules are important to avoid companies artificially shifting profits to low tax jurisdictions. They can take many forms including the following:

1. Controlled Foreign Company rules: Seek to correct tax deferral which gives overseas investor a benefit above domestic companies. The CFC rules can apply on an entity basis or to specific income streams. They apply where the domestic company has a significant ownership over another company i.e. the company is "controlled". Many countries use them to target specific factors such as: companies in low tax jurisdictions, passive income (such as royalties or investment income) and financing.

2. General Anti-Avoidance Rules: GAAR rules broadly try to capture any transaction which is deemed to be abusive. An abusive transaction is one where the economical outcome of the transaction is not inline with the outcome anticipated when the policy was designed. These transactions have as their main, or one of their main, purpose to avoid tax. GAAR rules apply penalties to transactions which are caught under the scope.

3. Diverted Profits Tax: Recently introduced in the UK and Australia, DPT seeks to penalise companies who enter into artificial arrangements with the objective of shifting profits out of the resident territory. They apply where a transaction lacks substance and has the purpose of tax avoidance or where a company has artificially structure in a way to as not create a permanent establishment and therefore a taxable presence in a country.

4. Anti-hybrid rules: Seek to avoid hybrid mismatches such as double non-taxation, or deduction / no taxation. They correct the mismatch through adjustments or the application of tax. For example the could deny a deduction in the P&L in the income is not taxed in the overseas jurisdiction. Or apply a withholding tax to a royalty of interest payment which is not taxable in the hands of the recipient.

5. Thin capitalisation rules: Seek to deny a deduction for interest where a company is thinly capitalise i.e. has greater levels of debt than equity. Generally, companies can achieve a tax advantage through using debt over equity as with debt, they are allowed a deduction for the interest paid. The interest is often paid to a company in a jurisdiction which does not impose a

tax on interest.

Domestic anti-avoidance rules can interact, and arguable go against international tax rules as they often seek to tax the profits of a non-resident transaction or apply a tax to a transaction with an overseas resident. These rules could conflict with the terms of the double tax convention in place between the two jurisdictions.

Interaction with Article 7

Article 7 states that "profits of an enterprise of a contracting state shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment". In other words, under the terms of the DTC the UK, for example, could only tax profits in France if the UK company had created a permanent establishment in France.

CFC rules, disallow deferral and tax profits arising in overseas controlled companies as soon as they are generated. This goes against the principle in Article 7 which states that those profits should only be taxed in the overseas jurisdiction and should not be taxed in the resident jurisdiction.

However, the commentary to the OECD MTC states that, paragraph one of Article 7 does not limit the right of a country to tax its residents through CFC rules. This is argued to be because the CFC rules do not reduce the profit of the overseas company and therefore do not conflict with the rules of taxation.

Interaction with Article 10

Article 10 limits the amount of tax which the state where the dividend is paid from can levy. The tax (a withholding tax) is limited to 5% if paid the a beneficial owner and 15% in all other cases. In many signed Double Tax Agreements this amount has been reduced to zero.

Under domestic anti-avoidance rules, certain tax authorities, such as Switzerland, will deem a dividend as being paid if a situation which is not arm's length has been imposed between two parties. For example assume that Switzerland has a royalty agreement in place with Malaysia and under the terms of the royalty agreement, Malaysia is to pay Switzerland a 10% royalty. Malaysia may choose not to pay that royalty as it does not want to incur the cash tax from withholding taxes on royalties applicable under the double tax agreement. In this case, Switzerland would consider the profit of Switzerland to be that which is would have been had th royalty been paid. It may then assume that this profit would be distributed to its shareholders, and would therefore charge a deemed dividend on the Swiss entity with the applicable withholding tax of 30% (under the domestic law).

The question is whether such a deemed dividend would be classified as a dividend under Article 10 or whether it would be classified as other income under Article 21. And whether the classification under either Article would give rise to an additional tax and whether this would be in keeping with the terms of the agreement. The commentary to the OECD MTC states that even if a deemed dividend was considered a dividend under Article 10 the convention is not intended to stop the source country from taxing that dividend in this case.

Therefore, the anti-abuse rules should not conflict with article 10.

International Tax more broadly and the MTC purpose

More broadly, there has been a shift in recent times of the purpose of a double tax agreement. historically, the purpose was to foster international growth through the elimination of double tax and the provision of certainty on tax matters. Nowadays, the purpose has shifted such that the treaty should not only eliminate double tax but also play a role in the elimination of double non-taxation. For example in the latest MTC there is a suggestion to include within the preamble that one of the purposes is to prevent fiscal evasion. This is also the purpose of all domestic anti-avoidance rules so in this case the two are very much aligned and should be seen as complimentary rather than conflicting.

The OECD is also going further in terms of including anti-avoidance rules within the treaty, and therefore international tax law. There is a move to stop companies from benefiting from treaties when their purpose is to avoid tax. This is reflecting in the changes to the beneficial owners rules which circumvents a company inserting an extra party into a transaction such that it may benefit from the treaty provisions. There is also a recommendation from the OECD that all treaties should include a limitation of benefits clause to ensure that there is substance behind the treaty claims.

Conclusion

As such, though at face value domestic anti-avoidance rules may conflict with international tax law and provisions within double tax agreements, in practise they work alongside the modern double tax agreements as they both have a key aim of reducing tax abuse and limiting fiscal erosion.

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Answer-to-Question- 3

In 2013 the OECD released a report detailing the issues of Base Erosion and Profit Shifting. From that report, they identified a 15-point Action plan which was needed to address BEPS and bring the international tax rules inline with changes to how companies operate and the structure of the global markets. The BEPS project was born from an increasing political pressure globally to target and correct for companies which had historically been able to circumvent the international tax rules and were considered to not be paying their fair share of tax. The BEPS project, though driven by the OECD and G20 in France, addressed issues which impacted all countries. It is often considered that developing countries suffer most from large companies ability to tax plan, as these countries do not have the resource of knowledge to combat and fight the tax evasion.

In 2015, the majority of the reports where finalised and work began on how countries would implement these into their domestic rules and laws. There was concern from the outset that the voices of the non-OECD countries would not be heard and that a new set of international tax rules would be developed that would continue to favour capital exporting countries at the determent of those countries that rely on source income. The OECD addressed these concerns by ensuring that developing countries were engaged throughout. There are many countries that are not OECD which have been very active in meetings and discussions for example, China was an early supporter and adopter of BEPS measures.

The BEPS working groups created many groups to ensure the developing voices were heard. These included the African Tax Administration Forum and the InterAmericano group.

Additionally, many developing countries chose to represent themselves through NGOs who were active (and vocal) in the BEPS discussion papers often disputing the arm's length standard and pushing harder for formulaic apportionment. Developing countries often have different issues when it comes to BEPS than developed countries. Many of their issues stem from a lack of technical resource within their tax authorities and limited access to data which could help them assess where BEPS is being undertaken.

On the other hand, developed countries have vast amounts of knowledge and access to data but need international tax laws to help support them in their fights against BEPS.

Not all of the BEPS measure will help developing countries to combat BEPS. Therefore, in this response I have considered the areas of the BEPS project which I believe could have a positive impact on developing countries in their fight to target Base Erosion and Profit Shifting.

Action 13: Country-by-Country Reporting (CbCR)

The CbCR rules were introduced under Action 13 and apply to groups with global consolidated revenue of Euro 750 million i.e. only very large groups. The rules impose a new reporting requirement on these countries to not only produce and file more detailed transfer pricing documentation, but also to produce a CbCR report outlining functions and financial data at a jurisdictional level.

Within the CbCR report companies are required to report the following on a consolidated basis for each jurisdiction:

- Revenues broken into related and unrelated
- Profit / loss before tax
- Income tax paid (on a cash basis)
- Stated capital
- Accumulated earnings
- Number of employees
- Tangible assets
- For each entity the main business purpose

This data will be filed in the location of the top company and shared automatically between tax authorities through the automatic exchange mechanisms.

The data will put more power in the hands of all tax authorities including those of developing countries. Developing countries often do not have their own multinational companies and instead are capital importing countries for multinationals of more developed nations. They are often used as outsourcing countries for manufacturing and services being low cost. These economies have suffered from profit shifting as they did not have the visibility to the activities undertaken by the multinationals operating in their territories outside of that territory. They saw only a small window on the operations and were therefore, unable to assess whether they were being attributed a fair share of the profits.

The CbCR reports along with the Master File will allow developing countries a better visibility of what multinationals are doing on a global basis. They will be able to compare the results of their territory with other territories in which the multinational operates and where two territories perform the same key activity, they will be able to see more clearly whether they are being attributed a fair profit.

There are now over 100 countries which have implemented or stated they will implement the CbCR rules including developing nations such as Chile, Mexico and China.

Action 7: Creation of a Permanent Establishment and Profit Attribution

Action 7 'Artificial Avoidance of a Permanent Establishment' will benefit developing countries potentially more than developed countries. This is because developing countries are capital importing countries rather than exporting countries. They have access to large consumer base which multinationals want access to and because of this, multinationals will be attracted to these jurisdictions.

However, many multinationals have developed their structures such that they can sell in these countries in a way which does not generate a taxable presence in that country and therefore, does not create a requirement to file tax returns or pay corporate tax. When comparing the OECD MTC and the UN MTC the permanent establishment rules under Article 5 are very different. The UN Article five is broader than the OECD definition including within it the furnishing of services as well as construction projects for a period of six months (rather than the OECDs 12 months). The UN model also does not allow for the delivery of goods in storage which the OECD does.

Hence under the UN model, a warehousing function could create a permanent establishment.

Under the BEPS project, the threshold for creating a permanent establishment under the OECD MTC has been lowered. This means that where the developing countries are entering into tax conventions with developed countries under the OECD model, they will have a greater likelihood of being able to tax companies under Article 7 of the treaty. The threshold has been lowered in two ways. Firstly, to remove the ability of a company to have a commissionaire structure without creating a taxable presence. Secondly, by removing the requirement for the contract to be concluded to create an agency PE, requiring now only that significant aspects of the contract were negotiated in that country.

Arguably, the lowering of the permanent establishment threshold will see the creation of more permanent establishments which could help developing countries to increase their tax base.

Action 2: Hybrid Mismatches

The hybrid mismatches rules seek to stop circumstances where companies can achieve double non taxation or a deduction in one entity with no corresponding increase in taxable profits of another entity.

The hybrid mismatch rules are complicated but they may see companies unwinding structures, particularly relating to financing, which again are detrimental to developing countries.

Action 4: interest restrictions

The action 4 rules are based on a global formula / safe harbour approach and are therefore easy for tax administrators to implement. The rules seek to restrict the amount of interest a company can claim in one jurisdiction by reference to its ratio of global net interest to global EBITDA. If a local country has a significant amount of interest expense some of this may be denied a deduction and would therefore increase the taxable base in that jurisdiction.

As financing costs are easily portable, these are often pushed down to high-tax jurisdictions which developing countries often are. These countries should therefore be able to benefit from these rules, if applied in their country, to deny deductions and therefore increase their taxable base.

Multilateral instruments

Multi-lateral instrument signing took place last week. A week or so prior, multiple countries had engaged in MLI "speed dating" whereby various sets of tax administrators representing different countries met together to discuss which of the OECD recommended changes they would support and incorporate into their treaties. They also outlined and discussed their reservations.

Countries which have signed up to the MLI have to agree to implement the minimum standards which include exchange of information and treaty abuse. Both of these rules will benefit developing countries.

Conclusion

In conclusion developing countries are often disproportionately impacted by BEPS as they do not have the resources, knowledge or data to fight tax evasion. Some of the BEPS initiatives were aimed more at problems impacting developed countries but some should also benefit developing countries especially where the benefits give them greater visibility of data.

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Answer-to-Question- 6

Part 1)

Dear OI

I have included below a report based on your structure and the advise you have provided in relation to the believed upcoming audit from ALRA. At this time we understand the ALRA are looking to target the license agreement based on disputing your four-year useful life and consider both agreements in their entirety as being an effective sale of overseas business to the foreign counterpart.

In relation to both contracts, the onus is on the taxpayer to evidence that the transactions have been conducted at arm's length. With this in mind, my first recommendation for the strategy is to ensure that you have transfer pricing documentation in place which supports these transactions. The transfer pricing documentation should focus specifically on the following:

- Evidence of the four-year life-span with reference either to third party data or internal data
- Method and data to support the buy-in payments of OIBL
- Reasons why the internal Comparable Uncontrolled Method is not reliable i.e. you are required to identify why the software agreements between OI and third parties could not be used to support the transaction by reference uncomparable features. Additionally, you need to evidence why these cannot be reliably adjusted for.
- Identify how each party benefits from the agreements

The following should help you structure your arguments.

1. Cost-contribution agreement

Document the parties to the cost-contribution agreement and why these are the only relevant parties.

Identify the total benefits expected to be generated from the arrangements and determine how these benefits are dividend between the parties.

Identify how you have measured the contribution of each party by the value which that party brings to the arrangement. This could be looked at with reference to third party agreements.

Consider whether balancing payments are required to match the expected value with the value realised.

2. Technology license

First consider your internal license agreements. If you are disregarding these are comparable you need to document why.

In relation to the length of the IP, this should again be set in reference to internal or external data. If possible if would be useful to have documented how you got to four years and any external resources you refereed to.

Finally, it may be possible to consider a secondary method to test either the profits of OI or OIBL to ensure they are arm's length.

As well as the above, which should form your transfer pricing documentation, you will also need to have your intercompany agreements which should set-out what each party contributes and gains from the transaction and the transfer pricing policy.

I trust the above is useful. Please reach out again once you have received the initial information request from ALRA.

Kind regards,

Part 2)

The issue with cost-contribution arrangements and buy-in payments was addressed in part by BEPS Action 8-10. The issue is how to price these given that they relate to intangibles which may not be present in the open market and therefore, comparable data may not be available. In general for the CCA to adhere to the arm's length principle, the value of each participants contributions must be consistent with what a comparable independent enterprise would have agreed to contribute. But the question is, do independent enterprises enter into CCAs? If not, then this poses the issue to the tax payer in terms of how to price and prove that the conditions are the same as an independent enterprise.

The second issue stems from the fact that the expected benefit is not always the same as the actual benefit received when the CCA is looked at retrospectively. The OECD only calls for a "reasonable expectation" that it will benefit. What is required is for there to be a condition that tax authorities cannot use hindsight to dispute this reasonable expectation because in hindsight the benefit did not materialise.

The tax payer is then required to value the contributions by reference to value or cost. This then ties in with the difficulty and cost of valuing intangibles. In Action 8-10 the OECD identifies that these are hard to value but does not go far in offering tax payers solutions to deal with these difficulties. The most robust method is still to conduct an independent valuation of the fair market value but this is a very timely and costly exercise, the costs of which may exceed the benefit to the company of entering into the CCA.

The OECD developed the DEMPE criteria to help with this. The DEMPE functions are:

Development
Enhancement
Maintenance
Protection
Exploitation

DEMPE provides a framework for companies and taxa authorities to assess which parties are contributing to the value of the intangible and should therefore be entitled to some of the profit generated from that intangible. It focuses not on the legal owner of the IP but on the company(ies) which are focused on the operational aspects of creating, defending and ultimately creating profit from the IP.

Overall, there are many difficulties in valuing the contributions and buy-in payments of a CCA. The OECD is focused on ensuring that these arrangements do not create BEPS opportunities by ensuring that the valuation methods are robust and that each party has the appropriate resource to manage and control the risks.