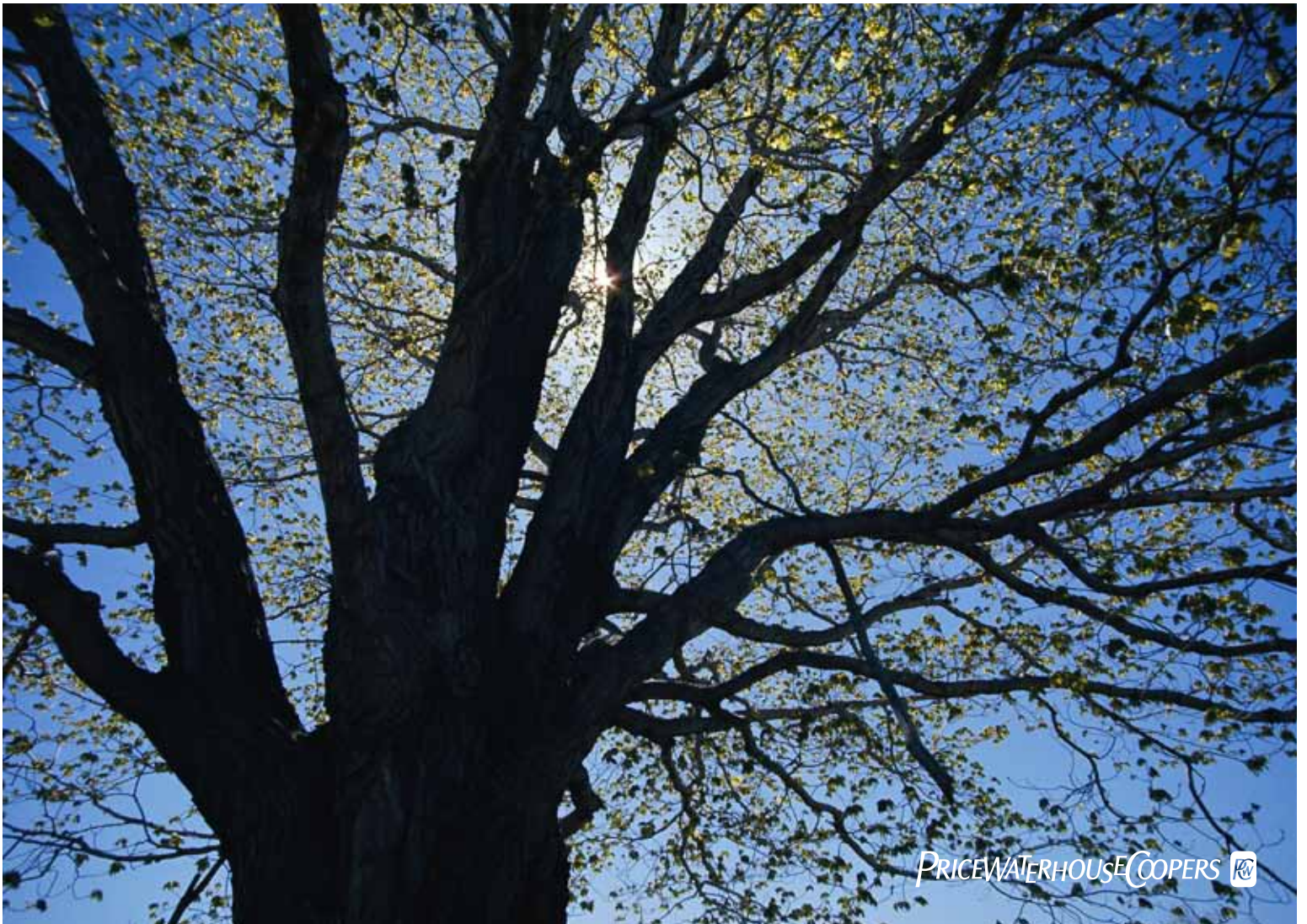


Transfer pricing

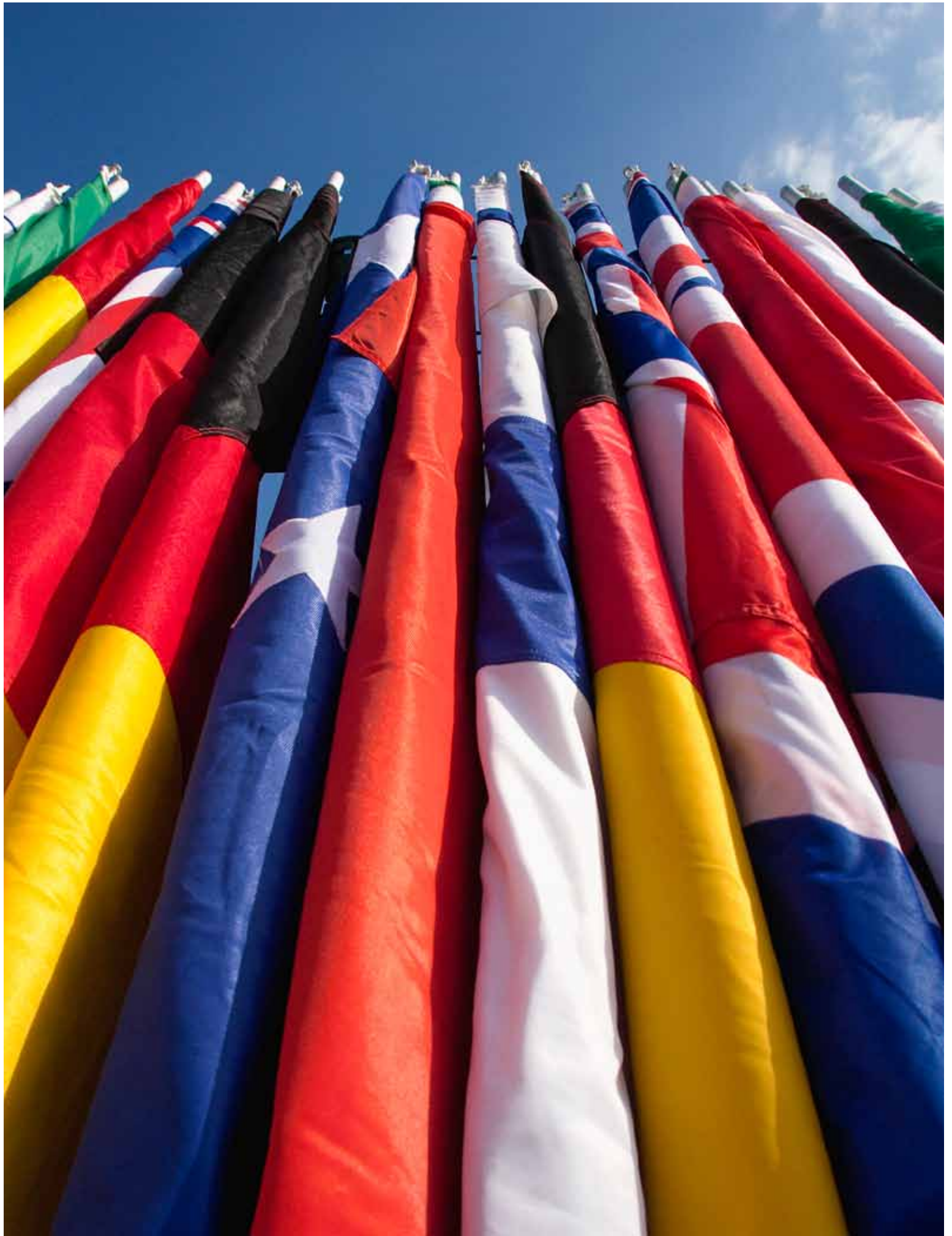
# Transfer pricing perspectives

Re:solutions  
moving towards certainty



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## Foreword

As we look forward to welcoming our transfer pricing advisors and clients from around the globe to the 9th PricewaterhouseCoopers<sup>1</sup> Global Transfer Pricing Conference in Lisbon, we take a look at some still relevant topics from last year's conference before looking forward. What follows are articles originating from last year's sessions in Vancouver, outlining new developments as well as other articles, which will provide greater insights and strategies in meeting the increased transfer pricing challenges during these recessionary times.

As we all know, transfer pricing results in uncertain tax positions. Our clients face the challenge of meeting the competing demands of increasingly combative tax authorities and stakeholders who seek certainty. The present economic situation has also heightened the challenges that multi-nationals face.

This edition highlights recent developments involving:

- the taxation of permanent establishments
- business restructuring
- implications of IFRS on cost sharing arrangements

as well as providing insights from India, China, Latin America and Eastern Europe perspectives.

We trust that this new edition of Perspectives will give you greater insights into how your business can better manage the risks and opportunities arising from transfer pricing in these difficult times.



Garry Stone  
Global transfer pricing network leader  
PricewaterhouseCoopers (US)

<sup>1</sup> 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity

## OECD holds public consultation on business restructuring discussion draft

While the Discussion Draft reflected consensus among OECD member countries across many issues, it also suggested quite openly the existence of differences of opinion between governments on some critical issues—a lack of consensus which the OECD now seeks to narrow or resolve through its continuing deliberations.

*By Joseph Andrus (PwC US) and Isabel Verlinden (PwC Belgium)*

On June 9 and 10, 2009, the OECD held a Public Consultation on its Discussion Draft on Transfer Pricing Aspects of Business Restructurings (the “Discussion Draft”). The two-day Public Consultation brought together representatives of more than 30 national tax agencies, the OECD Tax Policy Directorate, and representatives of the business community including company tax directors and advisory firm representatives to discuss points of disagreement arising from the Discussion Draft.

The Discussion Draft was published by the OECD in September 2008. It addresses in four lengthy issues and notes several important transfer pricing aspects of the taxation of internal business restructurings. Among those issues are the treatment of allocation and transfer of risk among related parties, the question of whether and when internal business restructuring transactions require arm’s length compensation and/or indemnification, the question of how transfer pricing rules should be applied to the parties to a business restructuring transaction following the restructuring, and the question of whether and when governments have the ability to disregard a taxpayer’s restructuring transaction for purposes of applying transfer pricing rules. While the Discussion Draft reflected consensus among OECD member countries across many issues, it also suggested quite openly the existence of differences of opinion between governments on some critical issues—a lack of consensus which the OECD now seeks to narrow or resolve through its continuing deliberations.

The Discussion Draft generated tremendous interest in the business community as evidenced by more than 400 pages of written comments provided to the OECD on its work. While the written comments were generally complimentary of the OECD work on business restructurings, they also reflect significant disquiet in the business community over some key issues addressed in the Discussion Draft. Continuing intense interest in the topic was indicated by the attendance of more than 150 representatives at the Paris Public Consultation. The Public Consultation provided an opportunity for a face to face exchange of views between governments and the business community. While it was not expected to result in a full meeting of the minds, it provided a useful airing of the critical issues addressed in the Discussion Draft.

This article summarises the key discussion topics from the Public Consultation. It should be recognised that the discussions by design focused far more attention on areas of actual and possible disagreement between business and governments than on the broad areas of consensus reflected in the Discussion Draft.

## **Disregard or recharacterisation of taxpayer restructuring transactions**

The single Discussion Draft issue causing greatest concern in the business community is clearly the analysis in Issue Note 4 regarding the circumstances under which governments can disregard or recharacterise business transactions. This section of the Discussion Draft primarily seeks to interpret paragraph 1.36 of the OECD Transfer Pricing Guidelines suggesting that tax authorities may disregard transactions that both lack “commercial rationality” and where the nature of the transaction makes it impossible to determine an arm’s length price for the transactions undertaken.

In introducing this topic at the Public Consultation, the representative from Australia stated that in Issue Note 4, the country delegates were focusing principally on “shell company” structures that were lacking in business substance. He also indicated that it was intended that where restructuring transactions could be dealt with on a transfer pricing basis, that would be done—asserting that Australia had addressed numerous restructuring cases in Advance Pricing Agreements (APAs) and audits and in the vast majority of cases had found transfer pricing resolutions to the issues.

The Discussion Draft itself suggests that the circumstances when a transaction would be disregarded are exceptional. The business commentators, however, expressed concern that the descriptions of the term “commercially rational” in the Discussion Draft were sufficiently vague that there was serious exposure to recharacterisation based on naked assertions that “unrelated parties would not have undertaken the transaction in the same way” or that the transaction is not “arm’s length.” This concern is exacerbated by suggestions at various points in the Discussion Draft that commercial rationality must be tested both at the group level and at the individual entity level.

Representatives from the PricewaterhouseCoopers network of member firms, in providing the initial business response to this topic, suggested that the discussion of commercial rationality in the Discussion Draft should be expanded to indicate that any transaction which has a bona fide non-tax business purpose at the group level, and where the taxpayer actually carried out the described transactions and dealings in a manner consistent with its agreements, should be deemed to be commercially rational. This led to a lively discussion of the scope of serious government concerns regarding transfers of assets and income to principal companies having no or limited functions. In particular the Dutch representative raised the difficult question of how a transaction having a valid but limited business purpose should be treated. An example put forward was a situation involving the centralisation of back office functions in a low-tax jurisdiction with a transfer of high value intangibles to the low-tax entity appended to the transaction.

An issue closely related to the potential disregard of business restructuring transactions involves the treatment of taxpayer allocations of risk for transfer pricing purposes. This issue is addressed in detail in Issue Note 1 in the Discussion Draft.

Certain business commentators expressed the view that the only requirement for commercial rationality should be whether the entity receiving assets has the financial wherewithal to bear risks associated with such assets. Functions, it was asserted, could be “outsourced” because unrelated parties routinely engage in outsourcing transactions. There was clear government scepticism regarding this view. Other commentators suggested that it could be appropriate for governments to insist on some alignment of functions and risks.

The government commentators made it clear that there was a difference of opinion among governments as to how business restructurings involving transfers of high value intangibles should be treated. Some governments continue to express the view that even where there are valid business purposes for such transfers at the group level, governments should be able to disregard such transfers since they would never be commercially rational from the point of view of the transferor entity. Governments taking this view suggest that such intangibles simply are not transferred in arm’s length dealings between unrelated parties. Business representatives uniformly suggested that this should be a question of valuation of the transferred intangibles, not a question of disregarding the transaction. The differences in view are crystallised in the first example at the end of Issue Note 4 in the Discussion Draft.

Government representatives noted that they would continue to work to narrow their differences and determine if consensus examples could be published in a final version of their work. They also noted that the broader issue of valuation of intangibles is likely to be the topic of a separate OECD project to be undertaken in the relatively near future.

### **Taxpayer allocations of risk**

An issue closely related to the potential disregard of business restructuring transactions involves the treatment of taxpayer allocations of risk for transfer pricing purposes. This issue is addressed in detail in Issue Note 1 in the Discussion Draft. The US representative introducing this topic at the consultation summarised the Discussion Draft analysis of the issue. He indicated that the Discussion Draft was clear in suggesting that the analysis of risk should begin with an examination of the taxpayer’s contracts. Those contracts are generally to be respected if they reflect an allocation of risk that is consistent with that observed in unrelated party dealings. In situations where comparable transactions cannot be observed, it was noted that the Discussion Draft provides that taxpayer contractual assignments of risk should nevertheless be respected in many instances.

The US representative noted that the Discussion Draft points to financial ability to bear risk and “control” of risk as factors to be considered in determining whether risk allocations should be respected. He emphasised, however, that neither of these was intended to be a mandatory factor and that other considerations could come into play.

Business commentators generally took issue with two features of the Discussion Draft treatment of risk allocation. The first was whether paragraph 1.27 of the Transfer Pricing Guidelines provides an independent basis for disregarding taxpayer contractual undertakings regarding the allocation of risk. It was observed that paragraph 1.27 of the Guidelines is contained in a section on comparability, not in the section of the Guidelines addressing disregard of transactions. They expressed concern that the Discussion Draft was creating from whole cloth an independent basis for disregarding taxpayer contractual undertakings based on absence of control over risk.

The other widely articulated business concern was that the notion of control over risk was unrealistic in view of normal operations of multinational enterprises. Commentators noted that there were strong trends toward diffused, global management structures which made it unlikely that ultimate control of risks in the sense described in the Discussion Draft would or could be centralised in a single legal entity. Some suggested that the control standard be eliminated and that reliance be placed only on taxpayer contracts and financial ability to bear risks.

The government representatives were very clear that they uniformly interpreted paragraph 1.27 of the Transfer Pricing Guidelines to give governments authority to reallocate risk in appropriate circumstances. They acknowledged some lack of clarity in the Discussion Draft over the circumstances in which risks could be reallocated and indicated that they would continue to work to clarify this area. There was no indication at all, however, of a willingness to retreat from the proposition that governments could effectively reassign risks in related party transactions in appropriate circumstances or from the view that some alignment of functions and risks is an important consideration.

It should be noted that this issue has potential application to transfer pricing matters going far beyond the restructuring context, a fact acknowledged by the government representatives.

### **Transfers of “profit potential”**

The Discussion Draft suggests that a transfer of “profit potential” pursuant to an internal business restructuring does not necessarily give rise to a need for compensation. However, it also suggests that transfers of assets should be compensated at arm’s length and further implies that, for this purpose, the notion of asset should be broadly defined. In particular, several paragraphs in the Discussion Draft suggest that intangible assets should broadly include transfers of goodwill and going concern value.

In the Public Consultation, several business commentators expressed misgivings regarding the broad definition of assets and suggested that the effect might be to tax every shift of profit potential. It was suggested by some that taxable transfers should be limited to transfers of legally protected intangible property rights and that goodwill and going concern value, which legally cannot be transferred separate and apart from the business to which they relate, should not routinely be compensable.

The Discussion Draft refers at several points to the necessity of considering the “reasonably available alternatives” to restructuring transactions in determining how transfer pricing rules should be applied to those transactions.

The Canadian representative indicated her view that the Discussion Draft had intended to cast a broad definition of intangible property and that transfers of valuable goodwill and going concern value were intended to be treated as assets in defining when a transfer might be taxable. Other country representatives were equally forthright in suggesting that they intended a definition that was broader than legally protectable intangibles. It was further suggested that while profit potential itself was not an asset, that the profit potential carried by transferred assets should be taken into account in valuing the assets transferred in a restructuring transaction. It was suggested that it would usually not be appropriate to value assets transferred in a business restructuring on a break-up or liquidation value basis, but that the value of such assets in a going business should generally be considered.

Business representatives suggested that governments sometimes had a misguided notion that the future profits of a business, and its profit potential, could be viewed as an annuity for valuation purposes. It was suggested that future earnings of a transferred business are attributable, at least in part, to the risks borne and activities undertaken by the transferee following the business restructuring and that proper valuation should take that fact into account.

#### **Role of “reasonably available alternatives”**

The Discussion Draft refers at several points to the necessity of considering the “reasonably available alternatives” to restructuring transactions in determining how transfer pricing rules should be applied to those transactions. The government representatives suggested that the “reasonably available alternatives” notion should be considered primarily for pricing purposes rather than for purposes of respecting transactions or assignments of risk. They also suggested fairly strongly that this concept had its most important application at the individual entity level and that the alternatives theoretically available to each party to a business restructuring transaction should be taken into account in determining appropriate levels of compensation to be paid in connection with such a transaction.

Business commentators suggested that it was unrealistic to consider alternatives available to one member of a controlled group since key operational decisions for such entities were generally made by group management. Thus, individual legal entity members of a multinational enterprise likely have little discretion as to whether to participate in a business restructuring.

The comments of government participants in the consultation made it seem unlikely that the Discussion Draft reliance on reasonably available alternatives will be abandoned. The clarification that the concept had primary application in pricing decisions, however, was a useful point of understanding and likely portends some modification of the Discussion Draft language.

## **Local country anti-abuse rules**

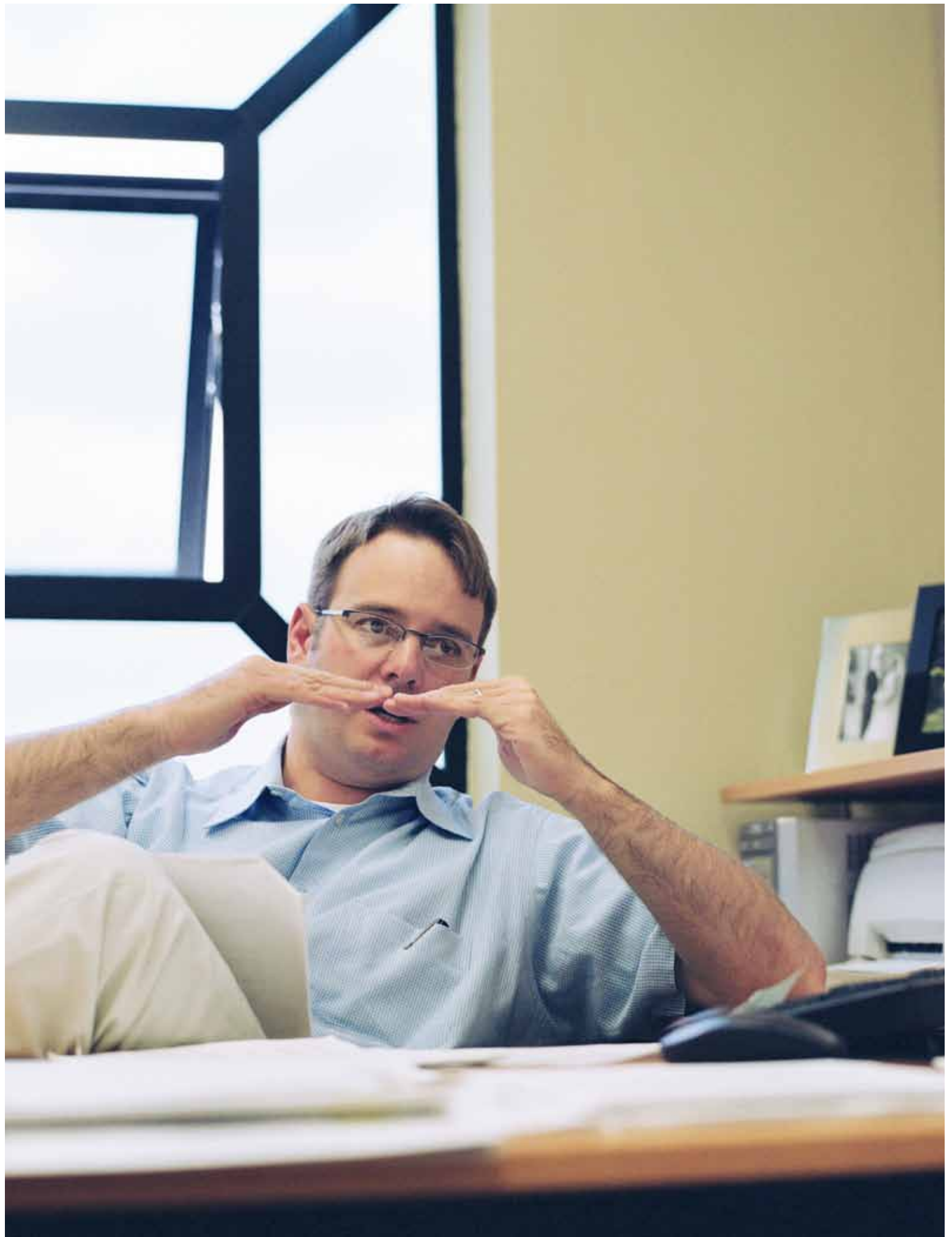
There was a brief discussion of the application of local country anti-abuse rules in a business restructuring context. The Discussion Draft indicates that its provisions do not cover domestic law anti-abuse rules. Business commentators requested clarification of the scope of this exception, in particular requesting clarification as to whether domestic statutes such as the recently adopted German rules on business restructurings were thought of as domestic anti-abuse rules or as rules governed by the treaty interpretations set out in the Discussion Draft. Government representatives suggested very strongly that consideration of domestic law anti-abuse rules was outside the scope of the Business Restructuring project. They further seemed reluctant to try and clarify what types of rules either do or do not fall within the domestic law anti-abuse rubric.

## **The way forward**

The governments indicated that they were continuing to work to define the timing and manner of finalising the Business Restructuring project. They suggested that possibilities included converting the Discussion Draft into a new chapter of the Transfer Pricing Guidelines, or merely issuing the Discussion Draft with clarifying revisions as a final report. They also suggested that OECD Working Party 6 operating rules made it important to seek to achieve consensus and that continuing difficulties in doing so on certain issues may require some modification to the Discussion Draft. There was little clarity on timing for next steps, a topic the Working Group hopes to clarify in its continuing discussions later this week.

## **Conclusion**

The business restructuring issue will clearly continue to be one of intense interest to both governments and taxpayers. The OECD will continue its efforts to improve and finalise the Discussion Draft in a balanced manner. The Chair mentioned the need to make some parts less subjective and less ambiguous so as to accommodate business' valid concerns to lessen the risk of double taxation. It will also seek to forge consensus on critical issues. Taxpayers cannot expect, however, that the governments will pull back significantly on their demands that such transactions have functional substance and business motivation if they are to be respected. Some critical issues in the Discussion Draft are likely to be clarified further but its basic outlines are likely to remain fairly stable and quite influential. Forging consensus on issues surrounding transfers of high value intangibles is likely to continue to be very challenging.



# Achieving transfer pricing and customs nirvana: Is it possible?

*By Henry An (PwC Korea), Domenick Gambardella (PwC US), and Zara Ritchie (PwC Australia)*

## **One of the most difficult challenges multinationals face is concurrently managing transfer pricing and customs risks.**

Because transfer pricing and customs are governed by different rules and often enforced by different authorities, situations can arise where a taxpayer receives a transfer pricing adjustment and also incurs additional customs duties on the same set of import transactions. This form of “double taxation” can be especially frustrating for taxpayers because it arises from seemingly contradictory positions taken by the tax and customs authorities.

Oftentimes, tax directors will focus their attention on demonstrating transfer pricing compliance, erroneously assuming that meeting the arm’s length standard for tax purposes will also demonstrate customs compliance. In fact, certain countries including the United States have issued official positions confirming that a transfer pricing study, in and of itself, is insufficient for satisfying customs requirements.

This article examines how instances of double taxation arise, reviews common transfer pricing pitfalls that can create customs exposure, and provides recommendations on how to mitigate double taxation risk.

## **The whipsaw**

To begin understanding the potential for double taxation, it is necessary to become familiar with the transfer pricing and customs regulatory regimes.

Global transfer pricing standards are set forth in the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). The OECD Guidelines are intended to prevent taxable income from being shifted indiscriminately and provide guidance on transfer pricing methods that can be applied to test or demonstrate the arm’s length nature of prices.

Customs valuation rules are not “harmonised” in the same fashion but are part of international agreements. Currently, more than 150 countries are signatories to the World Trade Organization (WTO) Customs Valuation Agreement (WTO Agreement), formerly known as the GATT Valuation Code. Jointly administered by the WTO and World Customs Organization (WCO), the WTO Agreement requires signatories to adhere to a largely uniform system of appraisal for the assessment of customs duties and fees on imported goods.

Unfortunately, this basically means that for taxpayers importing products sourced from affiliates, the same set of import transactions will be subject to two sets of regulations intended to serve different purposes. This duality problem is exacerbated by the fact that the transfer pricing regulations are often enforced by different agencies with very limited interaction and coordination. Based on this inherent conflict, joint WCO-OECD task force meetings have been held to discuss these issues, identify the areas of concern, and attempt to develop a common approach. These meetings have included the WCO, OECD, WTO, customs administrations, tax administrations, and the private sector. Although they have reached agreement on the areas of concern and common problems, no concrete “solutions” have been developed to date. Interestingly, one outgrowth of these meetings has been knowledge sharing among customs administrations on common audit issues, resulting in a convergence in customs audits across multiple jurisdictions.

The potential for conflict becomes even more apparent when examining differences in how compliance with transfer pricing and customs is enforced through tax and customs audits, respectively. Tax auditors approach audits from a corporate income tax frame of reference, which means that they generally are concerned about identifying instances of above-arm’s length transfer prices and are predisposed to reduce transfer prices so as to increase taxable income. Customs auditors, on the other hand, generally focus on identifying instances of below-arm’s length transfer prices (for example, where customs declaration value was underestimated) and are predisposed to increase transfer prices to increase customs duties. The regulatory frameworks for tax and customs auditors also drive their differences in approach when they issue assessments.

At a fundamental level, the inconsistency between the transfer pricing and customs realms derives from the fact that, pursuant to the OECD Guidelines, the direct tax discipline focuses on the aggregation of results over a prescribed period, combined with a recognition that individual performance should be benchmarked against that of other entities undertaking comparable functions, regardless of incompatibility in other areas. In stark contrast, the prevailing customs valuation framework is founded on a transaction-by-transaction approach and requires a product-by-product compatibility for benchmarking of functionally comparable entities.

When reviewing transfer prices during a tax audit, auditors evaluate their arm’s length nature pursuant to the relevant transfer pricing regulations. The auditors request and analyse transfer pricing documentation (including transfer pricing study, copies of intercompany agreements, etc.) to determine whether the application of the most reasonable pricing method supports that the transfer prices paid by the taxpayer are consistent with the arm’s length concept. In most cases, the most reasonable transfer pricing method on import transactions is either the resale price method or the transactional net margin method.

Taxpayers and tax auditors derive an arm's length range of results based on a sample of comparable companies typically identified through Standard Industrial Classification code screening with consideration of functions performed, risks incurred, and assets employed.

It is important to note that even when the tax auditors agree with the taxpayer's transfer pricing method, they may disagree about the specific application of the method, particularly with regard to the selection of comparables. Taxpayers and tax auditors derive an arm's length range of results based on a sample of comparable companies typically identified through Standard Industrial Classification code screening with consideration of functions performed, risks incurred, and assets employed. The transfer pricing methods generally are applied to a taxpayer's aggregate import transactions during the year, and a transfer pricing adjustment is made if the profitability results on the taxpayer's import transactions fall below the arm's length range.

In contrast, customs authorities typically apply added scrutiny to related party transactions to confirm that the price between the related parties meets the customs requirements for valuation purposes, because the appraisal forms the basis for duty assessment and ultimately customs revenue. In countries that adhere to the principles of the WTO Agreement, customs authorities require that upon entry (importation), imported merchandise be appraised and the customs value declared. The valuation framework set forth in the WTO Agreement provides a hierarchy of methods that must be applied sequentially.

The preferred method of appraisal is known as "transaction value," the price actually paid or payable for the goods when sold for export, with certain adjustments. Although this method is available in related party transactions, customs authorities can question the transaction value if they are concerned that the relationship between the parties has affected the transfer price. The authorities generally analyse the "circumstances of the sale" to determine whether the transaction was conducted in an arm's length manner: whether the price was settled in a manner consistent with either the normal pricing practices in the industry or the way the seller prices goods for unrelated buyers; whether the price is adequate to recover all costs plus a profit equivalent to the company's overall profit realised over a representative period in sales of merchandise of the same class or kind; etc.

In some jurisdictions, such as the United States and many European Union countries, the customs authorities consistently apply a straightforward interpretation of the aforementioned criteria in determining whether the transactions under review are undertaken at arm's length. When the taxpayer can support the arm's length nature of its transfer prices under any of the referenced alternative criteria, those prices generally are accepted as the basis of customs transaction value. If the transfer price declared by the importer is rejected by the local customs authority, the importer is required to apply the sequence of alternative valuation methods, which are generally more complex and impose a heavy documentary burden, until the authorities are satisfied that the customs value of the merchandise is appropriately reflected.

However, even in these jurisdictions with somewhat uniform practices, significant discretion exists in the manner in which the prescribed criteria can be met. For example, in many EU countries, customs authorities often accept and defer to transfer pricing studies as compelling and decisive support for the arm's length nature of prices determined as transaction values. In the United States, however, customs authorities have specifically noted that traditional transfer pricing studies alone are insufficient to support satisfaction of the arm's length criteria from a customs perspective.

In further contrast, customs authorities in other jurisdictions (including several Pan-Asian countries) are likely to compare the taxpayer's results to those of similar importers by using an internal database of customs declarations. If the customs authorities determine that the relationship of the parties affected the transfer prices, transaction value would be denied and an appropriate arm's length value for the transaction would be needed. The customs auditors typically apply either the deductive value method, which "backs into" the import value by focusing on the profit and general expense (P&GE) ratio achieved by the taxpayer on its import transactions, or the computed value, which focuses on the P&GE of the manufacturer selling the goods to the importer. Moreover, in deriving an arm's length P&GE ratio for deductive value, customs auditors screen for comparable transactions according to Harmonized System codes, with an emphasis on similarity of product as opposed to industry or functional similarity.

It is important to note that although customs auditors may make a request for a taxpayer's transfer pricing study or information on transfer pricing policies during their review, this information generally has limited usefulness because it tends to focus on supporting the arm's length nature of transfer prices from a corporate tax perspective rather than a customs perspective.

Given the differences in the tax and customs regimes, it is easy to see the potential for a taxpayer to get whipsawed between the tax and customs authorities. In certain respects, customs auditors may be viewed as applying a more stringent arm's length standard than tax auditors. Moreover, the relatively narrow approach taken by the customs auditors does not appear to easily accommodate taxpayers with unique fact patterns or business circumstances.

Taxpayers should understand the global pricing policies and be prepared to respond to inquiries based on the relevant regulations. The WTO Agreement provides various requirements for the import prices to be accepted as transaction values, and careful planning, in many cases, can avoid unnecessary scrutiny.

### Common pitfalls

Given the increased focus on transfer pricing by tax administrations around the world and the rise in transfer pricing disputes, some taxpayers are so focused on demonstrating compliance that they take actions without considering the potential negative repercussions. In other cases, taxpayers simply overlook potential customs issues that are closely related to transfer pricing; this may be regrettable because awareness and careful planning could prevent customs issues from arising or escalating. Common pitfalls include the following:

#### *Local adoption of global transfer pricing policies or price lists*

Many multinationals manage transfer prices by developing corporate transfer pricing policies that they consistently apply to intercompany transactions on a global basis. In other cases, a multinational may use a global price list that is consistently applied to transactions with affiliates. During tax audits, it is common for taxpayers to try to defend the arm's length nature of transfer prices by citing their consistent global application of transfer pricing policies or price lists—particularly when these policies have been successfully defended in tax audits in other jurisdictions or when the taxpayer has negotiated an advance pricing agreement (APA) based on the policies.

However, overemphasising the adoption of global transfer pricing policies or price lists can highlight the significant differences presented by the arm's length requirements of tax and customs and, from a customs perspective, suggest that the pricing is artificially set based on aggregate sales. In fact, for customs purposes, new prices often serve to call into question the legitimacy of old prices, and reduced pricing does not usually permit the importer any duty refund.

To help mitigate this risk, taxpayers should understand the global pricing policies and be prepared to respond to inquiries based on the relevant regulations. The WTO Agreement provides various requirements for the import prices to be accepted as transaction values, and careful planning, in many cases, can avoid unnecessary scrutiny. Although customs valuation methods may not exactly match transfer pricing methods, certain aspects in the customs regulations can be applied to the specific fact patterns at hand. As with most tax issues, preparation is key.

### *Taxpayer-initiated transfer pricing adjustments or changes in transfer prices*

Taxpayers that apply transfer pricing policies by targeting a specific arm's length margin will often find it necessary to make transfer pricing adjustments when actual financial results diverge from projected results. Transfer pricing adjustments are made periodically during the year or at the end of the year. An alternative to making a transfer pricing adjustment is simply to adjust or change the transfer price during the year. Although these transfer pricing adjustments are generally intended to demonstrate pricing compliance and mitigate pricing risk, they can have the unintended effect of creating significant risk from a customs perspective.

Initiating a transfer pricing adjustment or changing transfer prices can indicate that the customs transaction value was subject to influence because of a special relationship. It can also raise doubts about whether the customs transaction value originally declared was representative of a fair value. Taxpayers can also face a classic "heads, we win; tails, you lose" scenario where an upward transfer pricing adjustment will result in additional duty liability, whereas a downward adjustment in price will not automatically result in a refund of duty payments. Fluctuations in import prices will generally attract the attention of the customs authorities. Moreover, given the customs authorities' propensity to apply the deductive value method based on a specific P&GE ratio, significant fluctuations in import prices can result in significant duty assessments.

Another concern/risk relates to the method of declaring the adjustment to the customs authorities. While some countries have voluntary "disclosure" concepts for companies to declare the adjustment and avoid the threat of penalties, many countries have no method to correct the customs declarations without penalty risk, and other countries may not have any mechanism to correct the declarations. This can be particularly troublesome in jurisdictions with foreign exchange control rules, and if the customs value cannot be changed for the goods, the only method to effect payment would be to attribute the payment to services, which creates tax and value-added tax concerns.

To mitigate customs risks associated with adjusting transfer pricing or changing transfer prices, taxpayers should carefully monitor variance between actual and budgeted performance. This can reduce the need to make large transfer pricing adjustments or significant changes in transfer prices.

### *Royalty payments, cost contribution arrangements, and management service fees*

Tax auditors closely scrutinise royalty payments, cost contribution agreements, and management service fees. To help establish the deductibility of these expenses, taxpayers generally exert significant time and effort preparing detailed documentation that supports

To manage the risk of double taxation, taxpayers are encouraged to engage in careful planning that considers tax and customs ramifications from the outset when structuring related party transactions. This will reduce the likelihood of getting whipsawed between the tax and customs authorities.

their arm's length nature. Despite the intense focus on these charges from a tax perspective, many taxpayers are oblivious to their potential customs implications.

Customs auditors also generally focus on reviewing these charges, and if they are deemed to be related to the imported goods and exist as a condition of sale, the charges may be dutiable (added to the transaction value). In some instances, only a portion of such payments should be added to the transaction value, especially when the importer is engaged in multiple business activities, such as distribution, manufacturing, and provision of services. Directly linking "add back" items to the specific imported goods may present a challenge to many companies.

#### *Advance pricing agreements (APAs)*

APAs, in which the local tax authorities in either one (unilateral) or both (bilateral) of the jurisdictions involved in the transaction affirm the arm's length nature of a taxpayer's transfer prices, are generally seen by taxpayers as the ultimate achievement of certainty around the acceptability of their transfer prices. All too often, however, the process of securing an APA does not include any analysis of the customs implications of what is being proposed to the tax authorities. Nor is any attempt generally made to advise or include the customs authorities in the APA negotiations. Accordingly, it is common for taxpayers to find themselves committed in a binding APA arrangement to transfer pricing methods that can have deleterious effects on the customs valuation of imported merchandise.

Whenever possible, companies should seriously consider jointly approaching both the tax authorities and the customs authorities in any APA negotiations involving the cross-border movement of goods.

#### **Achieving nirvana**

In a perfect world, a taxpayer would be able to apply a single arm's length price that would satisfy both the tax and customs authorities. Unfortunately, we don't live in a perfect world. Moreover, the increased attention and friction between transfer pricing and customs valuation have created the need for an integrated, coordinated approach to transfer pricing and customs compliance.

Although differences between the tax and customs regulatory regimes make achieving this state of nirvana difficult, it is not impossible. To manage the risk of double taxation, taxpayers are encouraged to engage in careful planning that considers tax and customs ramifications from the outset when structuring related party transactions. This will reduce the likelihood of getting whipsawed between the tax and customs authorities.

# Blockbuster or Block-bust? Practical transfer pricing solutions in the world of high risk product investment decisions<sup>1</sup>

By Horacio Peña (PwC US), Diego Muro (PwC US), Jeremy Capes-Baldwin (PwC Australia), Yanna Wu (PwC US), Yongli Zhang (PwC US), and Fabian Chiang (PwC US)

**Abstract:** Set in the context of current and emerging transfer pricing disputes, this article discusses the manner in which economic conditions, business opportunities, services, risks, and intangibles interact during the lifecycle of products (development, commercialisation, and end of product life); the transfer pricing implications of this interaction and best practices with emphasis on intangible property (IP) valuation; profit split analyses and new techniques for IP analysis; and migrations.

## Introduction

Major transfer pricing disputes often arise from conflicts or confusion of the prevailing concepts and analysis involving economic conditions, business opportunities, services, risks, and intangibles. By some measures, more than 50% of the US federal transfer pricing cases decided to date specifically deal with one or more of the above factors, which all interact during the lifecycle of products.<sup>2</sup>

**Figure 1: The Puzzle**



<sup>1</sup> This article is summarised based on the presentation prepared for the PwC 2008 Transfer Pricing Global Conference Technical Session held in Vancouver, Canada.

<sup>2</sup> Transfer Pricing Case Summary: Simplifying Complexity, PwC Internal Publication, 2008.

## **Economic conditions**

Although the important role that “economic conditions” play in transfer pricing analysis is acknowledged explicitly in US regulations, the guidelines set by the Organisation for Economic Co-operation and Development, and transfer pricing legislation, it is ignored or simplified in practice.

At any given time, intercompany transactions could take place under a wide range of conditions from perfect competition to pure monopoly.

Perfect competition usually is characterised by many buyers and sellers with equally small market share, perfect information, identical products sold in the market, and the absence of barriers to entry or exit in the long run. These firms may adopt a variety of market share strategies. In this environment, however, the precondition to create and sustain economic rent generally is low.

In a near perfect competition market (e.g., an oligopoly), there are usually only a limited number of sellers with significant and varying market shares and uneven access to resources. This situation may be associated with imperfect information and barriers to entry. Firms may differentiate their products through innovation, marketing, and advertising. In this environment, the precondition to create and sustain economic rent generally is moderate. Firms may achieve it by: lobbying for market regulations; preserving economic conditions; creating brand loyalty; maintaining/increasing innovation and information asymmetry; creating or extending barriers to entry and exclusive relationships; and increasing economies of scope, scale, and efficiencies.

In a market with a pure monopoly, only one seller holds complete market share and absolute access to resources. There is imperfect information and high or absolute barriers to entry. All these characteristics provide the monopoly firm with a high precondition to create and sustain long-term economic rents.

The economic conditions surrounding the intercompany transactions under analysis may lead to the creation of economic rent and thus influence the ability to gain access to business opportunities. Therefore, it is important to analyse the prevalent economic conditions of the taxpayer, which will provide critical information and economic evidence in a transfer pricing dispute.

## **Business opportunities**

Tax authorities have a keen interest in transfers of “business opportunity,” also known as profit potential. The desire to require compensation for the loss of business opportunity may or may not be consistent with prior advance pricing agreements, rulings, tax law, and transfer pricing practices in many jurisdictions, however.

For instance, in the United States, business opportunity is a concept of corporate law developed to impose a fiduciary duty on directors not taking for him or herself an opportunity to generate income. Instead, that income should be reported and given to the company. While current IRS positions on intangibles may not always be aligned, the seminal court decision on this issue in US tax law explicitly states that business opportunity is not a transferable intangible (Hospital Corporation of America case).<sup>3</sup>

In contrast, “lost business opportunity” is a long-standing concept in German civil code and is more established there. New transfer pricing rules in Germany stipulate a potential payment for a lost business opportunity.<sup>4</sup> Furthermore, an OECD working group on Business Restructurings is currently studying the issue.

## **Services**

Historically, tax authorities have taken a simplistic approach to evaluate routine/low-value and non-routine/high-value services. For example, tax authorities have deemed services to be non-routine whenever a service provider makes non-routine contributions. This has sometimes led tax authorities to believe that these services cannot be benchmarked and therefore the profit split method has to be applied. In reality, however, these high-value services can be measured. An example may be to compare some of these “high-value” services with asset management or investment advisory services (IAS). Those who work in IAS obtain capital from clients and invest it where appropriate. Furthermore, its employees earn salaries and bonuses but do not keep the returns on the capital they manage. In some instances, IAS may provide useful benchmarks. A number of PwC databases provide data on IAS fees that may be useful when analysing these types of intercompany transactions.

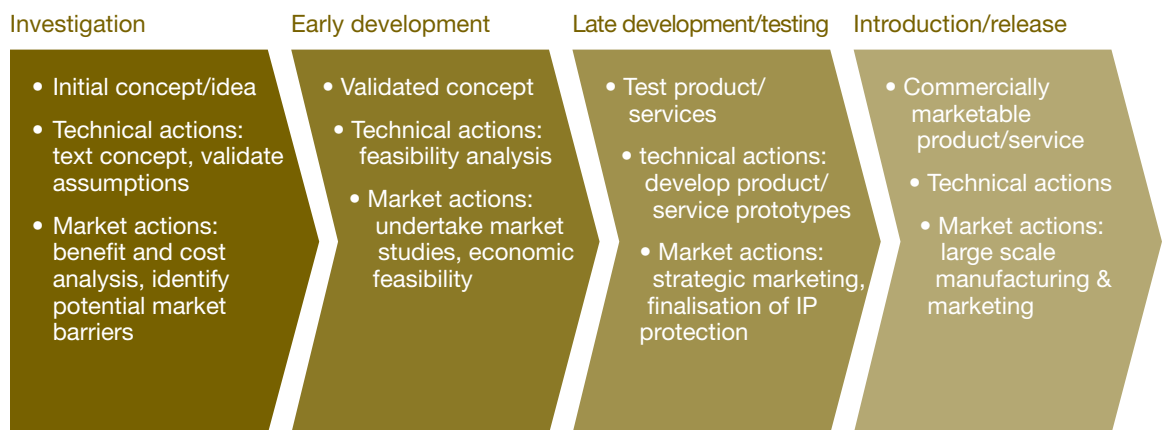
<sup>3</sup> Cost Segregation Audit Techniques Guide, Chapter 2, IRS, [www.irs.gov](http://www.irs.gov).

<sup>4</sup> Tax Reference Library No .35; Transfer Pricing (9th edition), International Tax Review.

## Risks

The concepts of economic conditions, business opportunities, and services should not be interpreted alone without considering the associated risks to which they are exposed under each phase of product development. To identify risks, each phase of product development has to be clearly specified and understood first. The classification of each phase varies from industry to industry. For example, in the pharmaceutical industry, there are preclinical trial phases and clinical testing phases, the latter of which can be further divided into Phase I, Phase II, and Phase III.<sup>5</sup> Meanwhile, product development for computer software typically is divided into five phases: analysis, design, coding, testing, and closing.<sup>6</sup> However, the various classifications could be generalised into one analytical framework, as shown in the figure below.

**Figure 2: General Analytical Framework for Product Development**



Traditional product development is managed in a closed, internally focused manner. Recent trends in product development point toward an open system with a far greater external focus. The all-inclusive traditional internal research and development (R&D) has become hard to justify in a world of dispersed ideas, abundant capital, and a mobile workforce.<sup>7</sup> Increasingly, companies are transforming their R&D groups into knowledge scouts and brokers.

Taxpayers are still free to arrange global affairs how they see fit. However, revenue authorities increasingly want to understand business rationale for development decisions and whether third parties might also follow open innovation strategies.

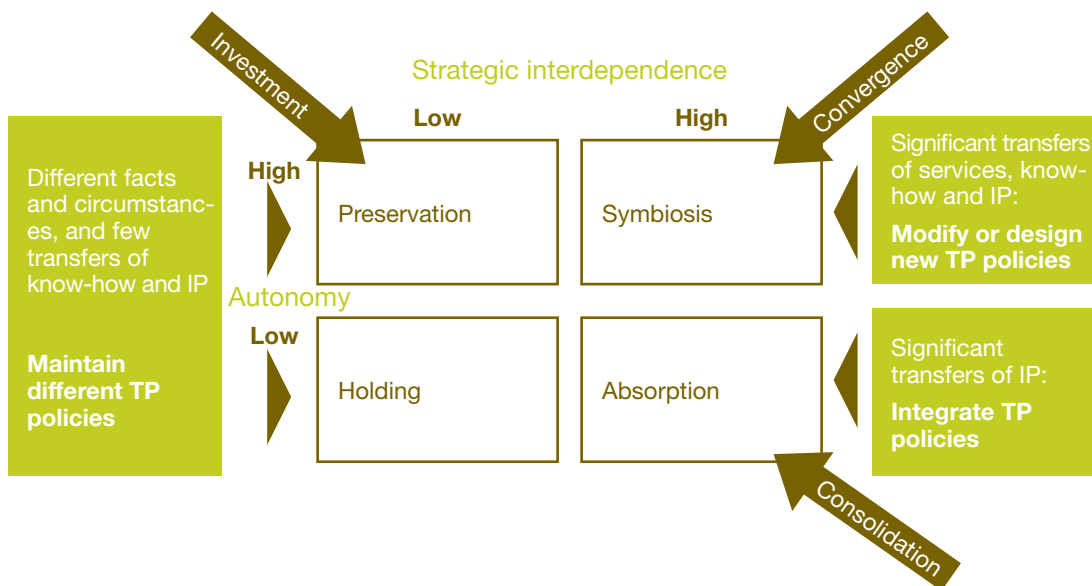
Investment strategies and firm interactions are driven by the various approaches to product development. Accordingly, transfer pricing models are influenced by the type of open innovation strategy adopted, as shown in Figure 3.

<sup>5</sup> DiMasi, J. A., R. W. Hansen, H.G. Grabowski, and L. Lasagna, (1991), "Cost of Innovation in the Pharmaceutical Industry," *Journal of Health Economics*, 10: 107-142.

<sup>6</sup> D. Kelly, "Software Test Automation and the Product Life Cycle," *MacTech*, Vol.13,1997.

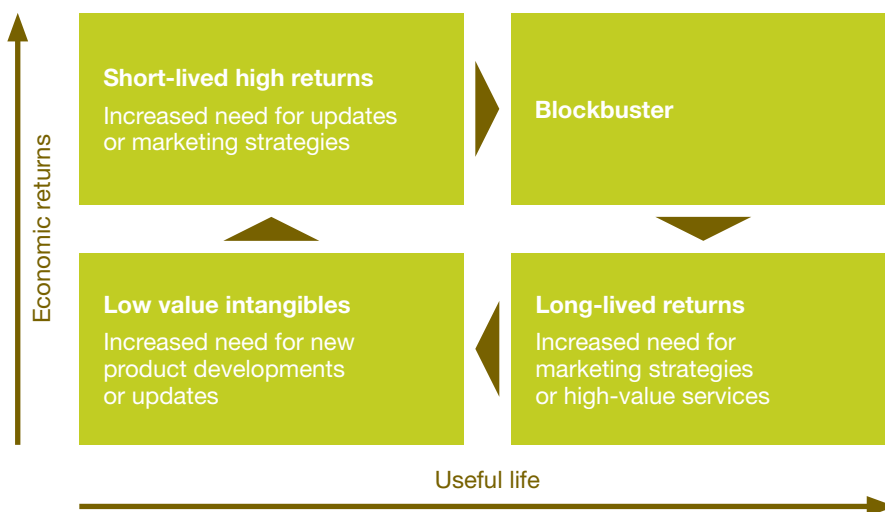
<sup>7</sup> H. Chesbrough, "Open Innovation," HBS Press 2003.

**Figure 3: Product development under open innovation:  
Different implications for transfer pricing analysis**



The results of the product development efforts depend on the length of useful life and economic returns of new products. As illustrated in Figure 4, if the economic returns are low and useful life is short, then the product development efforts may produce only low value intangibles, for which there is an increased need for new product development or updates to maintain the economic rent. If the economic returns are high but the useful life is short, then there are only short-lived high returns on the new products, for which there is an increased need for updates or marketing strategies. If the economic returns are low but the useful life is long, then there are long-lived returns on the new products, for which there is increased need for marketing strategies or high-value services. If the economic returns are high and useful life is long, then the product development has produced the ideal product: a blockbuster.

**Figure 4: Product development and useful life**



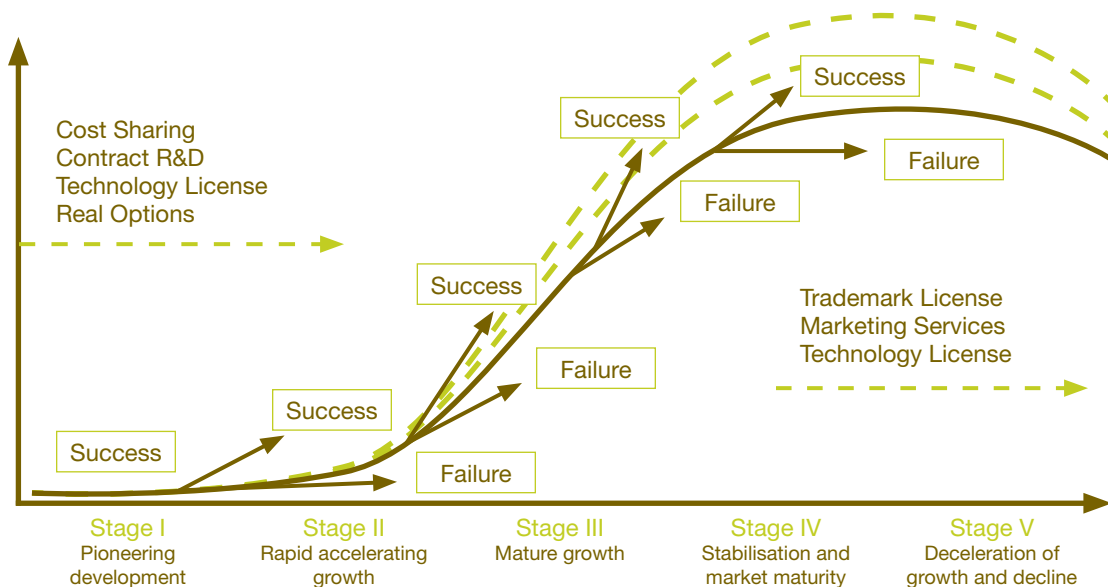
### Intangibles

There are alternative approaches to valuing intangible assets based on the degree of sophistication. Transfer pricing models may range from: a cost approach that estimates the value by determining the cost to build or replace the asset; income approach estimates value in terms of future cash flows to which the owner of the asset is entitled; market approach estimates the value by analysing the characteristics of recent sales of similar assets; flexibility approach couples discounted cash flows with decision tree analysis methods to increase flexibility; real options approach estimates value in light of changing market and economic conditions; or a combination of the above mentioned models for complex situations.

An integral component in the valuation of intangible assets is an estimation of their useful lives. Life analysis is the study of the placements of (or investing in) similar assets—and their subsequent retirements—in order to develop their life characteristics. Based upon an evaluation of these life characteristics, the remaining useful life of the surviving assets can be estimated.<sup>8</sup>

<sup>8</sup> R. Reilly and R. Schweihs, "Valuing Intangible Assets," 2007, McGraw-Hill.

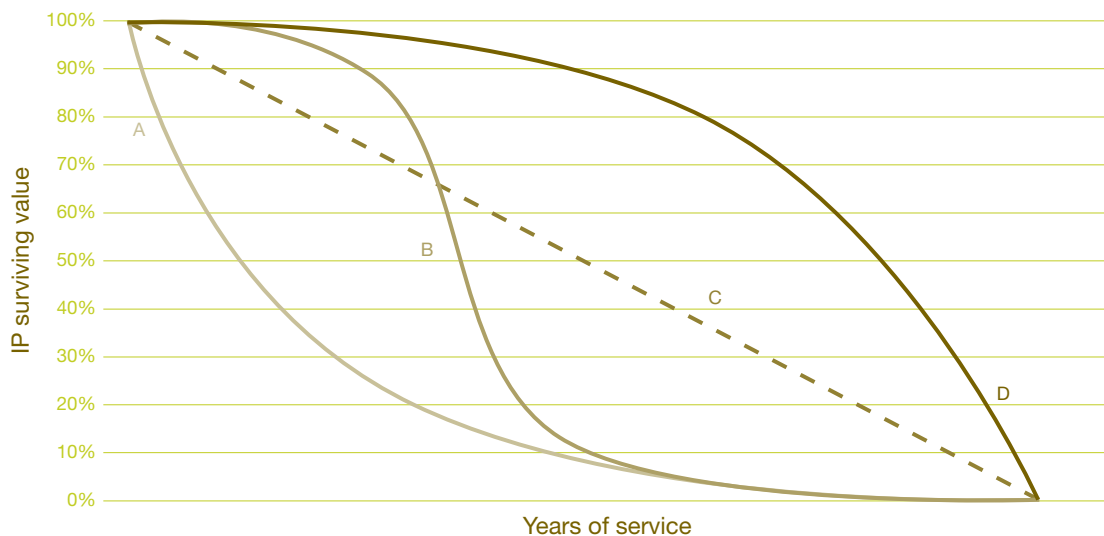
**Figure 5: Life cycles and valuation models**



There are eight determinants of the useful life of an intangible asset: legal life (or statutory life), contractual life, judicial life, physical life, technological life, functional life, economic life, and analytical life. Survivor curves are used to predict the average life and the remaining useful life of intangible assets. As time passes, the percentage of the intangible surviving value decreases. This creates a downward sloping survivor curve. A survivor curve can be any mathematical function of age that accurately depicts the intangible asset's decay.

Figure 6 illustrates four potential shapes of survivor curves. Statistical analysis may be used to determine the shape of the survivor curve most applicable to each type of product. These results vary by industry and can have a significant impact on the outcome of transfer pricing models (e.g., cost sharing, buy-ins, IP migration).

**Figure 6: Survivor curves potential shapes**



Often times, various types of intangibles are combined, and they play an important role in the generation of economic rents and excess profitability. This is especially the case with blockbuster products. Any modelling exercise must be based on a deep understanding of the facts, prevalent economic conditions, and value drivers. Certain factors have a significant effect on the outcome of any valuation exercise, including timing of migration, profit potential, risks, and useful life.

## Conclusions

Major transfer pricing disputes often arise from a misunderstanding or oversimplification of the interdependence of economic conditions, business opportunities, services, risks, and intangibles. The number and magnitude of disputes are growing exponentially and the complexities of these issues are causing some tax authorities to consider new transfer pricing legislation. At the same time, more and more companies are changing their business models to deal with rapidly evolving economic conditions and new business opportunities. To date, planning structures have tended to focus on isolated transactions and factors rather than adopting a holistic approach that takes into account high-value services, auxiliary or third party IP, changes in profit-potential, and other relevant economic conditions.

In an age of increased disputes, it is more important than ever to understand and analyse economic conditions, business opportunities, services, risks, and intangibles in order to establish compelling legal and economic evidence to support transfer pricing positions.



# Transfer pricing and IFRS: Implications of IFRS on cost sharing arrangements

*By Vu Tran, Partner (PwC US) and Alexander Gurevich, Director (PwC US)*

Cost sharing arrangements (CSAs), one of the most complex areas associated with international transfer pricing, serve as a popular financial and tax planning tool for many organisations. Financial accounting is often at the heart of these arrangements. In particular, US GAAP has historically been the financial accounting standard most often relied upon for measuring many of the elements within a CSA. As US-based multi-national organisations continue to evaluate their potential move from US GAAP to International Financial Reporting Standards (IFRS), through either continued convergence or ultimate conversion, they will need to consider how changing accounting policies may potentially impact their existing and future CSAs. Specifically, this article analyses how IFRS may impact the following key elements of CSAs:

- Reasonably anticipated benefits (RABs)
- The commensurate-with-income standard
- Intangible development costs (IDCs)

## **Cost sharing agreements—an overview**

A CSA is an arrangement in which two or more parties agree to share the costs to develop intangible property (IP) in exchange for an ownership interest in the newly generated IP. IP may include legally protected assets, such as patents and trademarks, and non-legally protected assets, such as know-how and confidential trade secrets.

The sharing of costs within these arrangements are typically based on RABs (i.e., projections of economic benefits that a party anticipates deriving from the newly developed IP). There are various manners in which RABs are measured. Two common methods include:

- Measuring revenue
- Utilising a profitability measurement (e.g., operating profit)

If revenue or a profitability measurement is selected, those methods typically rely on financial accounting to determine the amounts. As noted above, for many US multinational corporations (US MNCs), the financial accounting standard relied upon, historically, has been US GAAP. As companies continue to assess the ongoing convergence between IFRS and US GAAP, as well as the potential ultimate adoption of IFRS in the US, they will need to consider how any changes in accounting policies, most notably those related to revenue and expense recognition, may impact how costs are shared in a CSA and, therefore, how ownership interests are allocated among the CSA participants.

## Revenue and expense recognition—US GAAP vs. IFRS

Differences exist between US GAAP and IFRS with respect to both revenue and expense recognition. In regards to revenue recognition, the guidance in US GAAP is extensive and highly detailed. The guidance for revenue recognition under IFRS consists of more broad principles. As a result, differences often arise between the two standards in several areas, including multiple element arrangements, sales of services, and software revenue recognition.<sup>9</sup>

With respect to expense recognition, there are also several areas of difference between US GAAP and IFRS. Two common examples include expenses associated with internally generated intangible assets and share-based compensation. Please see the PwC IFRS publication, *IFRS and US GAAP, similarities and differences*,<sup>10</sup> for more detailed information on the similarities and differences between IFRS and US GAAP with respect to revenue and expense recognition, as well as other significant areas of pretax accounting.

A simple illustration of the impact that a change in revenue recognition, for example, may have on CSAs is as follows: Assume two parties entered into a CSA to develop a new pharmaceutical product. The cost sharing and ownership interest in the newly developed pharmaceutical product was based on the revenue related to the CSA under US GAAP. Based on this agreement, Party 1 projected its revenue to be \$50. Party 2 also anticipated its revenue to be \$50, thus Party 1 and Party 2 shared the costs associated with this CSA equally. Upon the adoption of IFRS, Party 1's projected revenue changed to \$60 and Party 2's projected revenue changed to \$40. As a result, the RABs from the CSA for Party 1 and Party 2 would be 60% and 40%, respectively, thereby potentially causing the timing associated with and/or the amount of cost sharing to change among the two parties.

## Commensurate with income

<sup>9</sup> In December 2008, the Financial Accounting Standards Board and the International Accounting Standards Board jointly issued the discussion paper, "Preliminary Views on Revenue Recognition in Contracts with Customers." This discussion paper proposes changes to both US GAAP and IFRS that, if ultimately included in a new standard, would have potentially significant ramifications to revenue recognition.

<sup>10</sup> [http://www.pwc.com/en\\_US/us/issues/ifrs-reporting/assets/ifrs\\_usgaapsep09.pdf](http://www.pwc.com/en_US/us/issues/ifrs-reporting/assets/ifrs_usgaapsep09.pdf)

Very often in CSAs, one party in the arrangement contributes pre-existing IP (i.e., IP in existence at the establishment of the CSA). In turn, it must be compensated for this contribution through a platform contribution transaction, commonly known as a buy-in payment. Under the US tax law, in cases where pre-existing IP is contributed to a CSA, the commensurate-with-income standard applies.

The commensurate-with-income standard requires related parties to price IP consistent with the expectation that the income associated with the transfer is commensurate with the relative risks and economic activity the parties undertake. Further, under the commensurate-with-income standard, if any IP is transferred or licensed, the income with respect to the transfer or license should be commensurate with the income attributable to the IP. An adjustment may be required if actual financial results differ materially from the expected financial results at the time the transfer was made.

For example, assume Party A and Party B enter into a CSA. Party A, a US corporation, possesses a portfolio of IP that it wishes to license to Party B, the related party located in another jurisdiction. At the time the transaction was consummated, the parties agreed to a royalty rate of 10% based on income projections anticipated to be derived from the exploitation of the aforementioned transferred IP. The commensurate-with-income rules provide US taxpayers a 20% margin of error on its projections used to establish the IP price (e.g., the royalty rate). If the actual financial result from the exploitation of the transferred IP is within 20% of the original projection, then no adjustments are required. However, if the actual financial result varies from the original projections by greater than 20%, the transaction must be adjusted to reflect the actual result. Assume the same facts as above, except now assume that it is three years after the consummation of the license arrangement between Party A and Party B. Based on the actual financial result of the income derived from the licensed IP, it is determined that the price (royalty) that should have been charged by Party A to Party B is 33%. Party A and Party B will be required to adjust the royalty rate upwards to 33% as required by the commensurate-with-income rules.

In the context of a CSA, if the initial financial projections used to establish the platform contribution transaction price were determined under US GAAP, and later actual results were calculated under IFRS, differences in the revenue and expense recognition standards between US GAAP and IFRS may lead the company to erroneously conclude that the original transaction price should be adjusted. Companies may come to this erroneous conclusion simply because the financial projections and actual results were measured under two different accounting standards. To confirm whether the pre-existing IP pricing structure falls within the allowable margin of error, companies should ensure they are applying an apples-to-apples comparison when evaluating expected results to actual results. As such, companies with platform contribution transactions should evaluate and consider the impacts that IFRS adoption will have on their commensurate-with-income analysis.

### **Intangible development costs**

Intangible development costs (IDCs) are the pool of costs that are required to be shared between the participants of a CSA based on each party's RABs. IDCs consist of items such as operating expenses, the charge for tangible property made available to the CSA, expenses associated with internally generated intangible assets, and share-based compensation.

Currently, the rules within the US tax law state the following with respect to which costs should be considered IDCs:

“Reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not be conclusive regarding inclusion of costs in IDCs.”

Based on the excerpt, the starting point to determine which costs are to be considered as IDCs under the current US tax law may be based on financial accounting. Although many organisations today use US GAAP as their starting point to determine IDCs, the current US tax law leaves the door open for companies to utilise another financial accounting standard, such as IFRS, as long as the standard is applied consistently.

The question then arises, will utilising IFRS to determine an organisation's IDCs produce different cost sharing results compared to US GAAP? The answer is potentially yes.<sup>11</sup> Differences currently exist between US GAAP and IFRS with respect to various expense recognition items, which could potentially lead to differences in the calculation of the IDCs.

To help illustrate how changing accounting standards (e.g., changing from US GAAP to IFRS) may impact the calculation of IDCs, consider the following: Assume there are two parties within a CSA. Party 1 incurs expenses related to share-based compensation and Party 2 does not. Assume all expenses in the IDC pool, other than share-based compensation, are treated similarly under US GAAP and IFRS. See Exhibit 1 below.

As illustrated in Exhibit 1, the expenses related to share-based compensation for Party 1 are \$100,000 under US GAAP versus \$150,000 under IFRS. As a result, the IDC percentages within this CSA would be altered upon the adoption to IFRS, which would ultimately result in a potentially different RAB share. As shown in Exhibit 1, since the total IDCs for Party 1 and Party 2 under IFRS equal \$450,000, and the costs are required to be shared equally under the CSA in this example, each party would be required to contribute \$225,000. Since Party 2 contributed only \$200,000 to the total IDCs upon the adoption of IFRS, Party 2 would be required to make a payment of \$25,000 to Party 1, so that the costs for Party 1 and Party 2 would be equal (i.e., \$225,000 each).

#### Exhibit 1

	US GAAP		IFRS	
	Party 1	Party 2	Party 1	Party 2
Share-based compensation	\$100,000		\$150,000	
Other IDCs	\$100,000	\$200,000	\$100,000	\$200,000
<b>Total IDCs</b>	<b>\$200,000</b>	<b>\$200,000</b>	<b>\$250,000</b>	<b>\$200,000</b>
IDC percentages	50%	50%	56%	44%

<sup>11</sup> In 2008, the US Treasury released temporary and proposed regulations that may impact the treatment of IDCs. Companies should monitor these regulations to understand the potential impact on their IDCs.

## Other considerations

Transactions involving the sale or license of IP can have a significant impact on CSAs. When a transaction is structured as a sale, both US GAAP and IFRS eliminate, in consolidation, any gain realised from the sale. However, US GAAP and IFRS currently differ on how the tax-related impacts of an intercompany sale are recorded in the consolidated financial statements.

In March 2009, the International Accounting Standards Board (IASB) released an Exposure Draft on Income Taxes,<sup>12</sup> which has the potential to affect US GAAP. If the Exposure Draft is finalised in its current state, and is adopted by US filers, the tax accounting associated with intercompany transactions will be impacted. Specifically, under the Exposure Draft, which is consistent with current IFRS, on an intercompany sale or transfer of assets, the selling company will be required to recognise the current tax expense associated with the profit on the sale or transfer immediately (i.e., in the period that the sale or transfer takes place). In addition, the buying company will be required to recognise deferred taxes upon the intercompany sale or transfer. This tax accounting model, which differs significantly compared to current US GAAP, may create a significant impact on an organisation's effective tax rate in the period of the sale or transfer.

## What this means for your company

Adopting new IFRS accounting policies may have a significant impact on an organisation's transfer pricing, including its CSAs. Differences between US GAAP and IFRS related to revenue and expense recognition, in particular, may have significant impacts to several key elements of CSAs, including the calculation of reasonably anticipated benefits, the application of the commensurate-with-income standard, and the determination of intangible development costs.

As companies continue to evaluate their accounting policies in connection with efforts to converge with, or convert to IFRS, it is critical that they understand the potential implications that IFRS may have on their overall financial and tax planning, including the potential impacts to their transfer pricing and CSAs. The status of IFRS reporting requirements vary significantly across many jurisdictions around the globe. US MNCs that participate in CSAs should therefore proactively plan for and manage the IFRS impacts on these arrangements to avoid surprises and maximise planning opportunities.

<sup>12</sup> For more information please see [http://www.pwc.com/en\\_US/us/ifrs-tax-issues/assets/income\\_tax\\_iasb\\_exposure\\_draft.pdf](http://www.pwc.com/en_US/us/ifrs-tax-issues/assets/income_tax_iasb_exposure_draft.pdf)

# Rebalancing the functional analysis: Functions, assets and risks

By Annie Devoy(PwC UK) and Alan Ross(PwC Canada)

In order to establish price according to the arm's length principle, the Organisation for Economic Co-operation and Development (OECD) and the tax authorities most active in transfer pricing are increasing focus on the 'functions' element of the functional analysis that traditionally evaluates an entity's assets and risks involved in its inter-company transactions. It is clear that part of the reason for this focus is an assumption by tax authorities that, whilst risk, capital and assets may be relatively easily moved by taxpayers who wish to manage their effective tax rate, it may be much harder to move key staff, either because they need to be close to the market or they would not have access to a suitable workforce and/or personal commitments make such moves unattractive. Clearly, at arm's length, the price that can be commanded is not a result simply of what an organisation does (functions), but the assets it owns and the risks it takes. Therefore, arguably, if the tax authorities favour one of these elements unduly, the arm's length principle is compromised. However, tax authorities and the OECD have also continued to confirm vigorously that the arm's length principle should be at the heart of appropriate transfer pricing regimes. In this article we look at how this position has developed and some of the issues it raises.

## **The OECD Guidelines<sup>13</sup> state the following with regard to the arm's length principle:**

*"It may also be relevant and useful in identifying and comparing the functions performed to consider the assets that are employed or to be employed. This analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, etc., and the nature of the assets used, such as age, market value, location, property right protections available, etc.*

*"It may also be relevant and useful in comparing the functions performed to consider the risk assumed by the respective parties. In the open market, the assumption of increased risk will also be compensated by an increase in the expected return.*

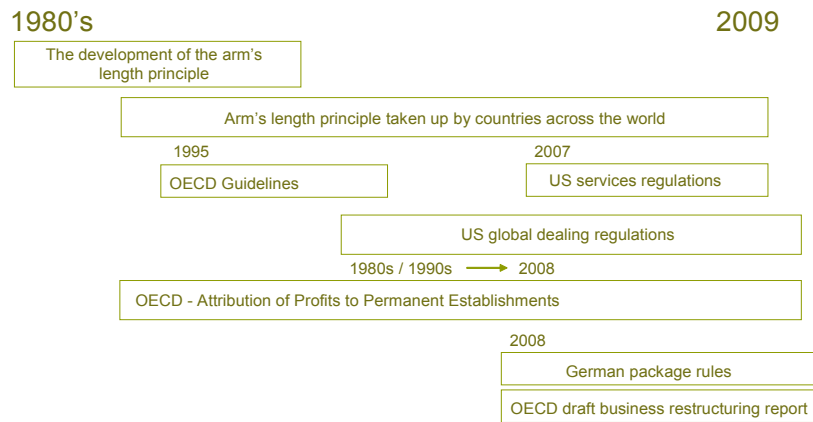
*"Functional analysis is incomplete unless the material risks assumed by each party have been considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises".*

## **OECD Guidelines—Chapter I, paragraphs 1.22 – 1.23**

The Guidelines clearly indicate that assets and risks must be taken into account in establishing appropriate arm's length pricing. However, if one looks at what has happened in the transfer pricing arena over the past 30 years, one sees a subtle, yet inexorable increased emphasis on the functions and less placed on the assets and risks.

<sup>13</sup> Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

## Re:solutions—moving towards certainty\*



During the 80s and 90s, the arm's length principle was adopted by a great many developed and undeveloped countries alike. When the OECD Guidelines were first issued in 1995, they presented a balanced view on the importance of functions, assets and risks. The work of the OECD on the Attribution of Profits to Permanent Establishments,<sup>14</sup> evolved over a long period of time. However, in the few years preceding the publication of the four papers in 2008, there was an increased emphasis placed on what are known as, in relation to the financial services sector, Key Entrepreneurial Risk Takers (KERTs) or, for the non-financial services sectors, Significant People Functions (SPFs). The OECD made it clear in relation to its work on the attribution of profits to permanent establishments (PEs) that, where a PE existed and KERTs and/or SPF's were based in that PE, it was likely they would attract assets, capital and risk in accordance with their functionality in the PE. Within an intra-entity fact pattern (e.g., head office to branch) an asset/capital attraction that was based on people functionality made sense. Different technical considerations apply however, where an inter-entity factor pattern exists (e.g., corporate to corporate).

As an example, though, the approach to capital articulated in the draft of the US global dealing regulations state that the return to capital may be "routine". However, it is a widely held view that it is not intuitive to suggest that the return to capital can be "routine", as the return to capital must, at arm's length, be commensurate with the risk at which such capital is placed. Some believe that it is important in these circumstances to distinguish the meaning of the word routine, as it is sometimes used in transfer pricing, to mean "low value", compared simply with meaning possible to be benchmarked to a market price. However, if capital is placed at risk in circumstances where that risk is clearly subject to significant uncertainty and potential volatility, then it is likely to be difficult to fix the return by reference to the market. Therefore the routine return to capital is likely to be very much the exception rather than the rule. The revised dealing regulations remain under wraps and Jeffery Dorfman's comments on the matter are telling:

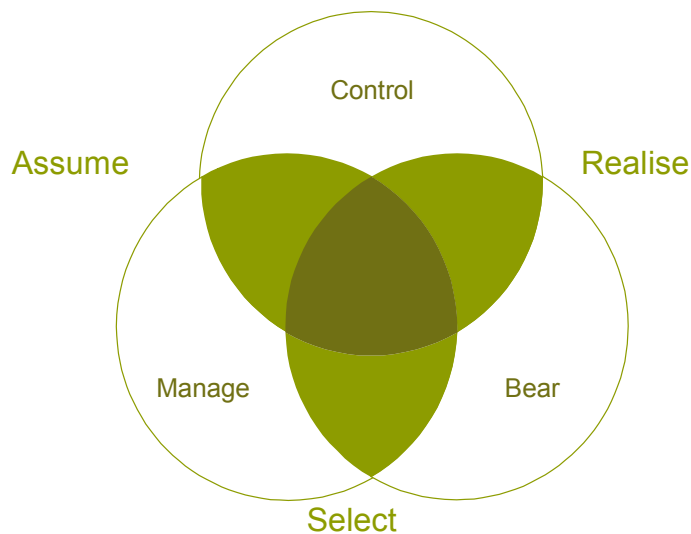
<sup>14</sup> OECD papers I-IV Permanent Establishment 2008.

*“The view of the OECD in Part III of the Attribution of Profits to Permanent Establishments Report ‘is basically that capital is routine and the trader function is non-routine. Some of the investment banks view it as just the opposite—that the trader function is routine and capital is non-routine. So there’s a spectrum of positions as to the way the profit split could work... We’re trying to gather as much information as we can before we make these decisions.”*

...Jeffery Dorfman, Chief, Branch 5, Associate Chief Counsel (International)

The new German rules on businesses moving out of Germany and the OECD’s draft paper on business restructuring both encapsulate elements which do not clearly allow for a market-based division of risk between two separate entities. The German tax rules work off the assumption that the decision to move risk from a German company to a non-German company carries with it, prima facie at least, an assumption that any profit associated with that risk should be capitalised and paid to the German company. However, this is something that may not happen at arm’s length where entities regularly reconsider and rearrange their risk profile without any capital payments.

The problem with risk is that it is capable of complex analysis in many commercial settings. Often elements of risk taking and management are shared across two or more entities and it may be a third entity which ultimately bears the risk. In covering the credit crunch, journalists have been known to search for more words to describe what banks do with risk. They could do worse than to look to the OECD’s paper on Business Restructuring which contains many references to what businesses do with risk, but remains unclear with regards to the consequences.



The draft Business Restructuring paper is unclear about what happens when risk is assumed or managed in one entity and borne in the P&L/balance sheet of another. The implication is that a tax authority might try to shift the risk into the entity with more functionality; but would this happen if, for instance, the functional entity did not have the financial capacity to bear the risk?

It is also important to note that risk taking and asset ownership are often closely associated. If an entity invests in developing or buying an asset, it takes risk, and if the asset turns out to be commercially valuable, then the risk element explains, in part, why the market allows the asset owner to derive a certain level of return.

We know from experience that the process by which tax authorities within the OECD reach consensus on transfer pricing matters is tortuous. It is therefore of some concern that over the next few years we can expect a great deal of deliberation on how risk, capital and assets fit into pricing models where functionality resides in other entities. In the meantime, PE risk management and robust pricing of risk and asset related transactions will be necessary.

# Equity for all? Challenges and controversies with equity-based compensation

Businesses have used equity-based compensation, including stock options, the granting of restricted stock, phantom stock plans, and other employee stock plans, to motivate employees and align employee goals with the goals of the shareholders in maximising shareholder value.

*By Marios Karayannis (PwC US) and Carl Herbert (PwC US)*

## Introduction

Equity-based compensation is a mainstay in many businesses' incentive plans. Over time, it has become a hot issue in transfer pricing on a global basis. Guidance and consistency in how equity-based compensation should be treated internationally are lacking, creating significant controversy between taxpayers and taxing authorities as well as among taxing authorities.

## Background

Businesses have used equity-based compensation, including stock options, the granting of restricted stock, phantom stock plans, and other employee stock plans, to motivate employees and align employee goals with the goals of the shareholders in maximising shareholder value. Equity-based compensations in the form of stock options have become prevalent, largely because they benefit employees only when the stock price of a company increases. From a shareholder perspective, there is only a dilution of share value and not an actual cash cost on the exercise of stock options by employees. There is also no out-of-pocket cash cost to the company issuing the stock options, although arguably there is an opportunity cost to the extent that these options are issued at a significant discount over market prices. The use of options peaked in 2001 for Standard and Poor's 500 companies with options granted, representing approximately 2.5% of outstanding shares. Since then, the burst of the dot.com bubble, the change in accounting standards, and public perceptions of large option gains of upper management have resulted in a 16% annual decrease in the granting of stock options among S&P 500 companies to 0.8% of outstanding shares in 2007.

Although there is no cash outlay, International Financial Reporting Standards have adopted the expensing of all equity-based compensation on financial statements in 2005, and US generally accepted accounting principles (US GAAP) adopted expensing equity-based compensation in 2006. These accounting standards require that the fair market value (FMV) of the options be determined at the time of grant and expensed based upon the amortisation of this equity-based compensation over the period for which the option vests for the employee. The expense generally is included with the relevant cost centres to which they relate. These accounting guidelines are flexible on how FMV is established; however, most companies apply the Black-Scholes option pricing model to determine their option expenses for financial statements.

Conversely, for income tax deductions, the United States and most other countries that allow any deduction for options use the spread at exercise as the basis for the expense as opposed to grant date valuations. The spread at exercise requires that the stock price increase and the option be exercised for a tax deduction to be recognised. As such, the tax deduction can diverge significantly from the FMV in both the amount and timing of the expense.

## **Transfer pricing guidance**

Although the use of equity-based compensation and the accounting for such compensation have evolved in business, guidance is limited on how options impact transfer pricing. The US cost sharing, services, and comparable profit method sections of the transfer pricing regulations provide specific rules and guidance, but the Organisation for Economic Co-operation and Development (OECD) has issued broad guidance that leaves a lot to interpretation. Many tax authorities are developing their interpretation of the OECD guidance, which is likely to lead to inconsistent positions and double taxation. For example, the US regulations contain a number of inconsistent positions.

## **US transfer pricing regulations**

The US regulations have adopted the view that equity-based compensation is a cost for transfer pricing purposes. These regulations followed the IRS field and Tax Court positions that equity-based compensation should be a cost for purposes of determining costs to be shared under a cost sharing arrangement (CSA). This treatment of equity-based compensation as a cost was introduced in the United States as part of the cost sharing regulations and comparable profits method (CPM) regulations in 2004. Under these regulations, the default position is that the spread at exercise is the cost that should be included in the cost pool for intangible development activities within the scope of a CSA. Taxpayers can, however, elect to use the accounting expense when the equity-based compensation is in a regularly traded stock on a US securities market and under US GAAP or consistent with US GAAP.

The US temporary regulations for services clarified the IRS intent that total services costs should include stock-based compensation for cost-based services methods (e.g., cost of services plus method, services cost method, and CPM). Unlike the cost sharing regulations, the temporary services regulations indicate a preference on the part of the IRS to use a grant-date valuation methodology. Again, this is an inherent divergence, in both timing and value, in how costs should be treated from the cost sharing transactions for which a taxpayer has not made an election or is not able to make an election, to the service regulations where an option to elect how equity-based compensation expense should be measured is not explicitly offered.

In relation to tangible and intangible property transactions, the US regulations for the application of the CPM also address equity-based compensation. Although not as definitive as the cost sharing or services regulations, the CPM regulations state that “it may be appropriate” to make comparability adjustments for material differences in utilisation or accounting for stock-based compensation between the tested party and the comparables. This essentially requires that equity-based compensation be included, excluded, or adjusted in both the tested party and the comparables’ financial data for the purposes of applying the CPM. Although not specifically addressed by the US regulations, the consistency in accounting provisions of the resale price method and the cost plus methods also would require that equity-based compensation be considered.

Unlike the US regulations, however, the OECD introduces certain caveats on the inclusion of the equity-based compensation in intercompany transactions.

### OECD guidance

The OECD published “Employee Stock Option Plans: Impact on Transfer Pricing” on September, 3, 2004, which addresses equity-based compensation. The paper starts with the premise that options are an element of employee remuneration and a cost to the employer issuing the option, not an equity interest or a dilution of interest of the shareholders of the company. It concludes that it is a cost for transfer pricing purposes for the application of the cost plus method, profit split method, and transactional net margin method (TNMM) as well as in cost contribution arrangements (CCAs). The OECD paper specifically reviews the following three situations:

1. The provision of options by a parent to subsidiaries’ employees: The paper concludes that this is a cost, and the FMV should be used for a dilutive share option or the actual cost (spread at exercise or cost to purchase the option) where the parent actually purchases the shares or option in a third-party transaction.
2. The inclusion of options in service, intangible, and tangible good transactions: The paper concludes that these options are a cost and need to be considered for the application of the cost plus, profit split, and TNMM. For consistency in accounting, the FMV generally would be used to determine the cost. However, the resulting price would need to be reflective of an arm’s length price.
3. The inclusion of options in CCAs: The OECD paper concludes that these options are costs that should be included in CCAs, even though there is no direct evidence of parties at arm’s length including these as costs. The OECD believes that the lack of evidence of arm’s length relationships of sharing options costs is a result of prior accounting standards, the overall economics of the arrangements, and natural setoffs between parties in joint venture arrangements. In the conclusion, the paper discusses a hypothesis on what arm’s length parties would do. This is a deviation on the OECD’s traditional reliance on actual evidence of arm’s length transactions in applying the arm’s length principle.

Unlike the US regulations, however, the OECD introduces certain caveats on the inclusion of the equity-based compensation in intercompany transactions. It concludes that the costs must be reasonable and, when included, reflect the arm’s length price for the property or service under examination. This would indicate, for example, that in situations where significant options expenses are incurred by the controlled entity but not by an uncontrolled entity, and other aspects of underlying compensation are the same as the general market, comparability adjustments would need to be made to include only a portion of this equity-based compensation or that cost-based methods are not as reliable as other methods.

## Other guidance

Other countries have provided limited guidance on how options should be treated. In Canada, the Canadian Revenue Authorities (CRA) have indicated in informal public statements that option expenses included in service charges and CCAs may be nondeductible. The CRA has also informally noted that the underlying costs become a service fee and that you should not look through to the underlying costs any more than you would look at the underlying costs when you receive a bill from arm's length parties. However, one must examine the value of the service rather than the underlying costs. In these circumstances, the CRA may limit the quantum of stock option costs included in a service fee to an amount it considers reasonable based on the benefit provided.

The Australian Tax Office (ATO) recognises a connection between the cost or value of employee stock incentives and the cost or value of the employee services remunerated by the incentives. However, no specific guidance is provided, and deductibility of the service charge clearly will depend on the benefit received from the services provided and whether the cost allocation is appropriate.

Similar positions have been adopted informally by other countries. Several countries do not allow a deduction for equity-based compensation or do not recognise equity-based compensation as a cost that arm's length parties would pay. Furthermore, they may challenge the amount of the cost for equity-based compensation as they may consider that the accounting treatment estimate or spread at exercise is unreliable in determining actual costs or the market value of the employees' services.

## Impact on taxpayers

For cost-based methods, the guidance outside of the United States leaves open the question whether, and to what extent, equity-based compensation would be included in arm's length arrangements. In the Xilinx US Tax Court case, the taxpayer provided a volume of evidence that parties at arm's length would not share in the equity-based compensation in joint ventures and cost-based service arrangements. This evidence included service contracts with the US government under federal acquisition regulations that did not allow any expense related to equity-based compensation to be included in cost-based contracts. The Tax Court held that the government had not established, through evidence, that parties acting at arm's length would include equity-based compensation and could not accept the hypothesis that it would be based upon economics. This decision further calls into question the OECD paper's conclusion in respect of CCAs, which relies on the hypothesis that parties acting at arm's length would share such costs. The OECD only provided reasons why direct evidence that arm's length parties share equity-based compensation costs may not have been available as opposed to evidence of arm's length parties actually do share such costs.

In applying the CPM/TNMM for all transactions, taxpayers will need to account for options for comparability purposes and make reliable adjustments for equity-based compensation. The following table demonstrates the impact that equity-based compensation may have in a situation where both parties have the same operating margin after an expense for equity-based compensation has been accounted for but significantly different operating margins before equity-based compensation.

	Operating margin before ESOP expense	Operating margin after ESOP expense
Tested party subsidiary distributor	5%	3%
Median of comparables sample	3.5%	3%

This example raises a number of questions when undertaking a CPM/TNMM analysis:

- Does the disparity in equity-based compensation levels mean that the CPM/TNMM is not reliable? At which point does the inclusion of equity-based compensation in order to increase comparability reflect a true divergence in functions and risks that would render the comparison less reliable?
- Are options attributable to function being tested? For example, the value of equity-based compensation granted to employees of the distribution arm of an integrated multinational would not reflect solely the contribution of their efforts to the equity value of the company. By contrast, the same employees at an independent distribution company would receive equity-based compensation that reflects solely on the performance of the distribution operation.
- Will this divert the underlying transfer price from the arm's length standard?
- Are the underlying compensation expenses excluding equity-based compensation comparable for the functions performed? For example, if equity-based compensation is properly viewed as a substitute for other forms of compensation, then one would expect to find that employees of the comparable companies are receiving less in salaries than employees of the tested party for performing the same function.

In the example above, the tested party's taxable income increases to 5% of sales if equity-based compensation expense is nondeductible. Even if equity-based compensation expense is deductible, depending on the timing and amount that can be deducted, this adjustment may result in a significant divergence and uncertainty between income subject

to tax and operating income under the CPM/TNMM analysis. Similar results would occur in service transactions for which there is a question on deductibility or a divergence in the amount and timing of the deduction. In such cases, taxpayers need to consider how the parent company should structure the equity-based compensation recharges to offset additional tax. Also, taxpayers will need to consider the character, timing, and actual amount that should be charged to optimise their global tax position.

Given the limited and contradictory guidance and evidence on the treatment of equity-based compensation, taxpayers may be well advised to develop a methodology for deriving an actual cost of equity-based compensation rather than an estimate or change in the way that transfer pricing is determined. This would be the case where significant equity-based compensation is involved to ensure intercompany transactions are fully deductible and the underlying transaction value is consistent with the arm's length standard. Companies should also further examine their intercompany agreements and revise them, if necessary, to reflect the actual policies they adopt and ensure that references to accounting standards for determining costs are consistent with how they treat equity-based compensation.

The potential is high for tax disputes and double taxation surrounding the impact of equity-based compensation, given the uncertain treatment by multiple tax authorities. Accordingly, taxpayers should consider the impact of their tax reserves and available avenues to resolve dispute. Bilateral advanced pricing agreements are one way to achieve some certainty in this respect and reach agreement between tax authorities. Carefully established positions, including when and how much of the equity-based compensations should be included in intercompany transactions, together with clear and concise documentation and consistent treatment of equity-based compensation across all transactions, also will assist in taxpayers being able to defend their positions on a global basis.

## **Conclusion**

The inconsistent treatment of equity-based compensation regarding transfer pricing and tax deductibility raises significant challenges for taxpayers in managing their global transfer pricing and global taxes. The evolution of guidance on equity-based compensation means that these challenges need to be addressed proactively to optimise a taxpayer's tax position and manage exposures. In developing their strategies, taxpayers should examine their provision of equity-based compensation to employees to align the deductibility of such compensation with the potential income from intercompany transactions. Taxpayers also should ensure that their intercompany agreements are consistent with actual policies adopted to ensure that a cohesive strategy to deal with this uncertainty is developed. Furthermore, as the impact and guidance on the impact of equity-based compensation evolves, controversy in this area will increase, and taxpayers will need to continually review, manage, and take advantage of global controversy avenues available to them.



## Transfer pricing and the green agenda

*By Garry Stone (PwC US), David Cheney (PwC US), Yvonne Cypher (PwC UK), and Duncan Nott (PwC UK)*

Climate change and soaring energy costs are driving alternative approaches to doing business. Especially in North America and Europe, customers want companies to show environmental responsibility at each point along their supply chains—from product source and production to delivery as well as at the point of consumption. National and local commitments to address environmental challenges and risks compound the situation.

As the public and the market increasingly mandate corporate responsibility as a prominent branding feature, sustainability will touch nearly every action taken by a multinational company. Thus, multinationals are spending, and making commitments to spend, significant sums on projects that in some way help them meet the environmental and sustainability goals of the green agenda.

This green agenda gives rise to expansive transfer pricing issues that require companies to consider new along with more traditional concepts. Transfer pricing issues arising include:

- major new product costs or savings;
- development of new products and processes;
- creation or enhancement of intellectual property assets;
- changes to the supply chain and operating models;
- participation in new regulatory or trading regimes; and
- profit changes that reflect new environmental costs and benefits and new products.

In addressing these issues, multinational companies need to rethink how they factor in these changes to their business models and reflect them in their transfer prices. Those responsible for transfer pricing must engage across their organisations to ensure they are positioned to influence decision making, address challenges, and take action before undertaking major strategic initiatives, investments, and decisions.

## The green future

Investments to create minimal long-term impact on the environment are already taking place across a wide range of areas, including research and development, evolution of products and processes, satisfaction of new regulatory requirements, and implementation of new trading opportunities:

- H. Lee Scott, president and chief executive officer of Wal-Mart, has described sustainability as “the single biggest opportunity of the 21st century” and “the next source of competitive advantage.”<sup>15</sup>
- PricewaterhouseCoopers’ research<sup>16</sup> shows that larger companies anticipate investing a greater proportion of their incomes to address the risks and opportunities associated with climate change. General Electric Co., for example, plans to double its investment in cleaner technologies by 2010 to more than \$1.5 billion and expects its revenues from associated products to be in excess of \$20 billion.<sup>17</sup>

To capture the fast-growing market for sustainable consumption, many businesses are reviewing their brand and product portfolios to develop new green assets with strong appeal. The strategic importance and scale of the investment to capture this market means that development decisions often are made centrally, while the interdependent nature of multinationals means that changes in one location inevitably will impact others: activities in one entity may create costs and benefits for part or all of an organisation.

This impacts the function, asset, and risk profile across a multinational group and thereby alters the flow of intragroup transactions or creates new value transfers that must be considered from a transfer pricing perspective. One of the most powerful macroeconomic impacts is incorporation of environmental costs of doing business that have been avoided or undervalued by some companies. Major costs associated with pollution and waste that have largely been met through public expenditure or ignored are being pushed onto companies to curtail a “free-rider” perception.

<sup>15</sup> Source: PwC, The Sustainability Agenda: Industry Perspectives, 2008, [www.pwc.com/sustainabilityagenda](http://www.pwc.com/sustainabilityagenda).

<sup>16</sup> Source: PwC, 11th Annual Global CEO Survey, 2008, [www.pwc.com/ceosurvey](http://www.pwc.com/ceosurvey).

<sup>17</sup> The Economist Special Report, “The greening of corporate responsibility,” 1/17/08.

The sharing of carbon or emissions credits between affiliated companies will not only require an appropriate pricing mechanism for a group's transfer pricing policy, but will also create challenges and opportunities in identifying an arm's length price because of the impact on cost.

### Cap and trade

The implicit need to both limit and incentivise is driving new mechanisms alongside old-fashioned taxes and tariffs to ensure that the polluter pays. Chief among these are cap-and-trade schemes for carbon and other emissions, which allocate credits up to a cap, then require the purchase of other companies' surplus credits if that cap is exceeded, which creates a cost for emissions.

The creation of active markets in emissions credits places an observable value on them. However, the regional nature of cap-and-trade schemes, as well as market fluctuations, creates differences that mean these values can be both variable and volatile. This can be further complicated by the emergence of futures markets and transactions, such as loans of surplus credits, or the absence of trading because of competitive pressures.

The sharing of carbon or emissions credits between affiliated companies will not only require an appropriate pricing mechanism for a group's transfer pricing policy, but will also create challenges and opportunities in identifying an arm's length price because of the impact on cost. In addition, although the policy must accommodate price fluctuations, differing regional market values and different values in various parts of the business may be optimised for tax purposes.

This new understanding of what now constitutes full cost will require consideration of existing transfer pricing policies, supporting documentation, and benchmarking. "Full-cost plus" charging mechanisms, or benchmarked ranges based on pre-green models, for example, may not appropriately reflect this new cost structure.

### Search for alternatives

The desire to reduce the environmental impact and cost of industrial, transportation, and consumer activities has inspired significant activity, especially in the search for alternative clean energy sources. Governments and international organisations are providing incentives and favourable financial structures to businesses that invest in the development of these new technologies. Though estimates vary, the value of investment in clean energy alone topped \$150 billion in 2007,<sup>18</sup> more than a 60% increase from the previous year.

The search for alternatives is triggering start-up activity from both new independent businesses and new business streams in mature multinational companies. These new endeavours will face traditional issues as they get underway, including initial losses from high expenditure relative to income, potentially exacerbated by increasing fuel and emission costs.

<sup>18</sup> Source: New Energy Finance.

Accordingly, losses or low profits resulting from adoption of green alternatives will need support from the company's transfer pricing policy, which should provide a clear and robust defence of any profit profile changes. The distribution of income and losses must reflect not only a company's strategic value drivers and its assumption of risk, but also its unique market structure in promoting green initiatives.

## Regulation

Aside from market pressures, governments are using regulation to influence and change behaviour. For example, the European Union's Registration, Evaluation and Authorisation of Chemicals (EU REACH) regulation, effective June 1, 2007, requires many European companies to invest heavily in compliance and management of commercial risk. For EU resident companies, the new law has far-reaching obligations that go beyond the European group. This is in large part because of integrated supply chains whereby an impact in one jurisdiction may have a knock-on effect on other jurisdictions in terms of costs and benefits.

For example, the emerging photovoltaic or solar energy production industry is heavily supported by government programs and incentives specific to geographic regions or markets. Different countries use combinations of these incentives to promote the growth of their domestic renewable-energy markets, including photovoltaic. Without the implementation of such programs, the photovoltaic industry would not benefit from the increased demand and the resulting economic rents. Some programs and incentives give solar system installers and solar power producers either a direct reduction in the up-front solar system costs or a payment for solar energy produced.

Companies must consider the effects of these programs and incentives on transfer pricing policy. In particular, international companies should consider how these programs relate to the distribution of income and losses across divisions. In many jurisdictions, these start-up situations need to be documented *ex ante*.<sup>19</sup> This gives companies the opportunity to consider where, if possible, to locate start-up losses as well as the underlying functions, assets, and risks.

Development costs of new technologies, products, and processes may also contribute to start-up losses. Because these cost advances are likely to create intellectual property, they need to be provided (for example, licensed) to group users at an arm's length rate. Asset ownership can be structured with a lower-tax territory, either through correct location of development direction and costs or through the early sale of existing intellectual property.

<sup>19</sup> Regs. §1.482-1(d)(4)(i).

Although many companies operating in Europe need to evaluate the effect of new regulations, it is a safe bet that future regulatory requirements will generate similar scenarios for businesses around the globe.

Business models also are changing through the increased involvement of central offices or the realignment of logistics around local hubs to take millions of miles (and dollars) out of the supply chain. These changes represent the greatest opportunity to integrate transfer pricing planning and commercial opportunities.

The new initiatives require finance. Although arm's length lending rates are a conventional transfer pricing concern, they must still be achieved. Care is required around levels of debt and thin capitalisation defence as finance, profit, and asset levels change, especially where agreements with tax authorities are already in place.

### **Assessing risks, rewards**

How these developments to product, technology, and process intellectual property are initiated, executed and received by the market will be reflected in both company and product brands. Brand protection and enhancement may be one of the main drivers of corporate response to the green agenda.

Green brand owners might be expected to share in the risk and reward through the transfer pricing policy. As for technical intellectual property, this is best addressed as early as possible in the change process to establish both clear ownership and, where the brand is the driving force, the appropriate substance—for example, through meeting cost or taking appropriate development risks.

One company may act, meet requirements, and incur cost on behalf of the European group. The risks and benefits, however, may be broader in that they may also affect the intellectual property assets of a group's product portfolio. How these costs and risks are valued, characterised, met, and shared must be determined and integrated into a group transfer pricing policy.

Key to assessing the impact of governmental regulation is to ask questions such as "Whose obligation is this?" and "For whose benefit is it performed?"

Although many companies operating in Europe need to evaluate the effect of new regulations, it is a safe bet that future regulatory requirements will generate similar scenarios for businesses around the globe. As with emissions credit trading, groups must be able to link the pricing of these disparate costs into an effective transfer pricing policy, as well as determine the effect of these additional costs on benchmarking and other historic arrangements.

Similar evaluation and analysis will be required for costs associated with corporate social responsibility programs. But in the end, companies will see many long-term benefits to having the best possible transfer pricing solution that not only provides robust compliance, but also creates conditions that result in significant tax savings.

To begin integrating such green initiatives into a company's transfer pricing policy requires answering the following questions:

- Which entities benefit from the adoption of green agenda initiatives?
- Who takes the risk?
- Is a new asset created or an existing asset improved?
- Who bears the cost and who reaps the benefit from additional income?
- Do changes in the value chain impact entity characterisation?

To understand and effectively address these questions, those responsible for a group's transfer pricing must gather information on all activities taken across the business in pursuit of the green agenda. They need to engage a wide range of stakeholders to enable the development of transfer pricing policy alongside green initiatives and to uncover the tax benefits of business change relating to intellectual property and the location of functions, assets, and risks in the supply chain.

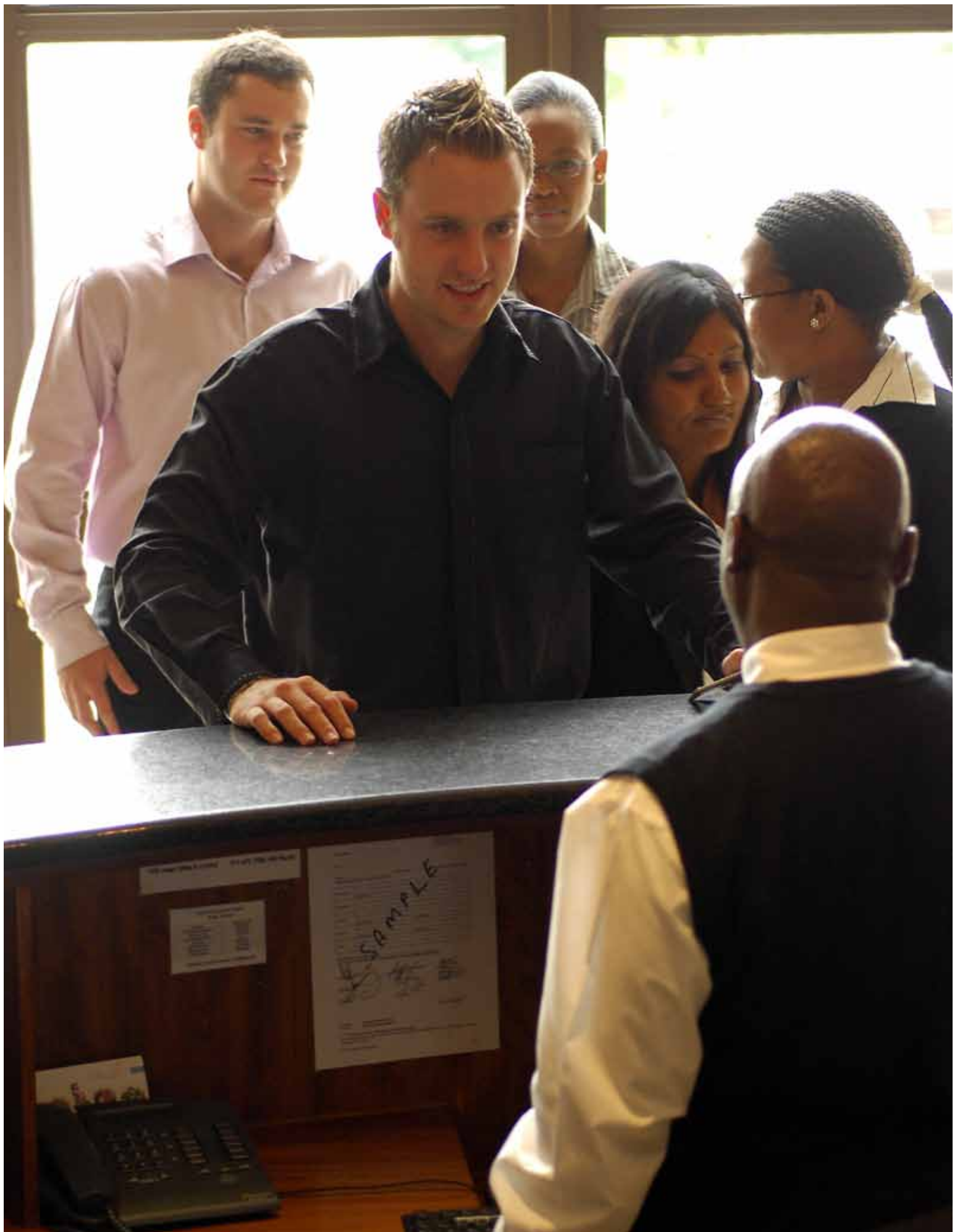
By acting now, forward-thinking companies will realise long-term benefits to having the best possible transfer pricing solution that provides robust compliance and creates conditions that result in significant tax savings.

## Conclusion

As this article describes, environmental goals and successes are triggering many transfer pricing issues. Challenges will arise, but among them will be significant opportunities for effective planning so that businesses can understand the implications of present and planned green strategies.

That agenda is not fixed, but rather in constant flux and development. It changes according to a range of drivers including regulation, innovation, new market conditions, and shocks. Transfer pricing leaders need to stay abreast of these changes as they build a policy that is both robust and stable for new and existing business streams and models and also flexible enough to achieve maximum tax benefits from future developments.

These projects are often complex, with knock-on effects on existing business and transfer pricing models. By acting now, forward-thinking companies will realise long-term benefits to having the best possible transfer pricing solution that provides robust compliance and creates conditions that result in significant tax savings.



# Tax controversy and intragroup financial transactions: An emerging battleground

*By Jeff Rogers (PwC Canada), Michel van der Breggen (PwC The Netherlands) and Bill Yohana (PwC Australia)*

Taxation authorities have significantly increased their focus on intragroup financial transactions, including related-party loans, credit guarantees, factoring arrangements, cash pools, and other forms of financing and credit risk transfer arrangements. With the current global financial crisis limiting the availability of once plentiful and relatively inexpensive external funding, many taxpayers in their “hunt for cash” have seen their intragroup financial transactions increase significantly. In this article, we provide an overview of why intragroup financial transactions are receiving so much attention from taxation authorities, key areas of controversy, and potential actions for taxpayers to consider. In addition, although financial transactions can create tax risk, they are also a source of opportunity, notwithstanding recent events. We raise several potential opportunities that may benefit taxpayers.

## **Why are financial transactions increasingly a key source of tax controversy?**

The transfer pricing aspects of intragroup financial transactions are becoming increasingly contentious. One key reason for this is that the pricing of financial transactions, as with many other areas of transfer pricing, is inherently subjective. At the same time, the value of these transactions can be significant.

For example, to arrive at an arm’s length interest rate for a loan, one needs a process for evaluating the credit quality of the borrower (i.e. the probability that the borrower will default over a given time period and the amount of loss in the event of a default) and an approach for estimating credit quality and the terms of the transactions to available internal and external comparable transactions. Even when using a structured approach, the credit analysis and the selection of comparables require subjective judgment and expertise. Additionally, even if the parties setting prices possess the knowledge and judgment to accurately estimate an arm’s length price for a transaction, the reviewer of the prices (such as a taxation authority) might not possess the requisite expertise.

Another important source of controversy for some borrowers is the impact on operating profits of high yield loans provided by private equity firms. This has led in some countries (e.g. Germany and Italy) to the introduction of specific earnings stripping rules in order to limit the amount of interest that can be deducted from operating profits. In the Netherlands, the Ministry of Finance is investigating the possibility of completely removing group interest from the tax environment.<sup>20</sup> Furthermore, the financial crisis, which has dominated the news over the past year, has demonstrated to taxation authorities that financial markets are a complex area, particularly once the transfer pricing implications of these transactions are considered. As such, it has raised their awareness of and focus on intragroup financial transactions.

<sup>20</sup> On Monday 15 December 2008, the Dutch Secretary of State for Finance sent a letter to the Dutch Second Chamber regarding the division of corporate income taxation costs between taxpayers and the various issues surrounding the treatment of intragroup interest. This letter contains a number of thoughts on possible reforms to the system of corporate income taxation in the Netherlands. It would appear that the primary focus of the Secretary of State for Finance is the (partial or complete) “de-fiscalisation” of intragroup interest.

The presence of country-specific safe harbour rules and expectations further increases the potential for cross-border disputes.

Estimating arm's length terms for an intragroup financial transaction is further complicated by the fact that taxation authorities have provided little concrete guidance as to how taxpayers should price these transactions. This is compounded by the lack of guidance from the OECD, which increases the possibility that taxation authorities will take significantly different approaches when evaluating intragroup financing. Hence, financial transactions represent yet another area where an approach that may be acceptable to taxation authorities in one jurisdiction may not be acceptable in another. The presence of country-specific safe harbour rules and expectations further increases the potential for cross-border disputes. It should also be noted that substantiating interest rates through the solicitation of non-binding bank quotes is not acceptable to most sophisticated taxation authorities.

Some taxation authorities are also beginning to challenge the pricing of financial transactions using a combination of transfer pricing and tax-related arguments. As an example, in Australia, the Australian Taxation Office ("ATO") has indicated that multiple provisions of the Tax Act may impact whether a taxpayer receives a deduction on a loan, including the general deductibility provisions, the debt/equity rules, the thin capitalisation legislation, and the transfer pricing rules. The presence of overlapping (and potentially conflicting) rules in a single jurisdiction can complicate the process of pricing and structuring intragroup debt. Furthermore, differences across jurisdictions can also increase the risk of a challenge, even for relatively simple transactions.

### **Some areas of focus by taxation authorities**

Most taxation authorities, including those that have expended considerable effort to better understand financial transactions, are grappling with the complex issues that these transactions can raise. Based on our experience in Canada, Australia, New Zealand, the Netherlands, and other jurisdictions, some of the issues that taxation authorities seem to be examining closely include:

- Related-party loans with interest rates or credit margins that might appear high to taxation authorities relative to local benchmarks;
- Credit guarantee fees, particularly where the taxation authority perceives the fee to be "high" or the total amount paid is significant;
- Taxpayers with relatively high debt/equity ratios compared with their peer group;
- Transactions lacking in substance or with terms and conditions that a taxation authority views to be lacking an economic rationale, or that are not documented in a written agreement;
- Not exercising prepayment or call options included in an intragroup loan agreement when market conditions suggest an arm's length party would;

- Debt pricing and/or debt amounts that result in ongoing low levels of profitability;
- The allocation of the benefit derived from internal cash pooling and other centralised group arrangements among participants;
- Appropriate rates of return for transactions where a taxpayer serves as a “booking entity” or otherwise acts as an intermediary in a transaction.

As existing guidance for establishing arm’s length terms for financial transactions is limited in most jurisdictions, it is advisable to have an understanding of the local sensitivities of a given taxation authority (or the examiners that you may deal with), particularly in advance of completing a material transaction that may create significant tax risk.

### **Impact of the passive association debate**

Traditionally, many taxpayers have established arm’s length terms for their related-party financing transactions by evaluating the credit quality of a subsidiary on a stand-alone basis (i.e. under the assumption that the borrower is an independent entity that is not related to the lender), which is arguably consistent with OECD guidance. At paragraph 1.6 in its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, the OECD notes that “the authoritative statement of the arm’s length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD member countries and an increasing number of nonmember countries.” It further notes that “by seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm’s length principle follows the approach of treating the members of a multinational enterprise (“MNE”) group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the dealings between those members.”

However, in a recent case in Canada, the Canada Revenue Agency has sought to argue (within the context of the pricing of intragroup credit guarantee fees) that a third-party lender would lend to a subsidiary of a major multinational group (or, more broadly, assume its credit risk) at a lower rate than that implied by a pure “stand-alone” result in light of its affiliation with its parent. Such a “passive association” argument raises several key issues, ranging from the empirical (to what extent do lenders account for group affiliation of subsidiaries that are not formally guaranteed by their parent) to the transfer pricing specific (such as whether a consideration of the potential links between a parent and its subsidiary are consistent with the arm’s length principle).

From a practical perspective, even if the concept of passive association is inconsistent with the arm's length principle, it appears to have been embraced, at least for now, by several sophisticated taxation authorities, including Canada, the Netherlands, and Australia. Hence, until tax courts or taxation authorities provide more definitive guidance, taxpayers may need to consider the possibility that a taxation authority will not consider it appropriate to evaluate the credit quality of a subsidiary of a multinational enterprise on a pure stand-alone basis, and if an adjustment for "group membership" is necessary, how it should adjust the pricing or the documentation of its intragroup financial transactions to proactively address this potentially vexing issue. At the same time, for outbound transactions, taxpayers need to consider the possibility that a taxation authority might question instances where taxpayers have provided credit support but have not applied an appropriate arm's length charge that reflects the risk assumed by the guarantor.

### **What can you do?**

In light of the current focus of taxation authorities on financial transactions, taxpayers might consider a variety of measures, including:

- Establish a comprehensive transfer pricing policy that covers existing and planned intra-group financial transactions;
- Periodically revisit the policy (at least annually);
- Implement legally enforceable, robust loan agreements;
- Evaluate "both sides" of material transactions—does the transaction "make sense" economically for both parties involved?
- Structure and price transactions in a manner consistent with the firm's tax risk tolerance;
- Monitor global developments—current Canada Revenue Agency or ATO viewpoints may be adopted by other taxation authorities.

### **Some potential opportunities**

While significant risks may exist in pricing and structuring intragroup financial transactions, current financial market conditions also provide an opportunity for taxpayers to revisit their intragroup financial transactions and ensure they are consistent with the arm's length principle, which in many cases will mean higher credit spreads.

### **Intragroup loans**

Opportunities may exist for both existing and new loan transactions. As a starting point, taxpayers should review the terms of existing intragroup loan agreements. For transactions that are about to mature, it may be possible to incorporate revised pricing that reflects current credit market conditions. In addition, taxpayers should carefully review any embedded options incorporated into existing transactions (such as early prepayment provisions granted to borrowers or the ability to demand early prepayment granted to lenders), with a view toward aligning existing agreements with current market conditions where possible. When reviewing the terms of a transaction, it is important to consider the perspective of both the borrower and the lender (and their respective tax jurisdictions) to ensure consistency with arm's length behavior. Taxpayers should also evaluate the consistency of any re-pricing with the taxpayer's broader financial transactions pricing policy.

Furthermore, with the recent dramatic increase in credit margins, the fair value of many intragroup loans has declined and may produce a beneficial tax loss under the right circumstances (or a profit, for instance, by buying one's own loans or bonds at a discount out of the market, from an "appropriate" group company).

New transactions should be priced under current market conditions. However, taxpayers should account for recent trends in the credit markets. For example, credit to noninvestment grade borrowers (and most borrowers in general) is far more difficult to obtain now than it was a couple of years ago. Borrowers that can obtain funding must generally do so for shorter time periods, with more stringent covenants. Hence, having proper documentation in place that substantiates not only the interest rate on a loan but also the arm's length nature of the amount of the loan and its terms and conditions is crucial, especially in the current market.

### **Credit guarantee fees**

Many companies with loans from third parties are facing demands for enhanced security through guarantees on existing and refinanced debt, and some companies are able to effectively redeploy capital from one related party to another with a guarantee from the corporate group.

Charging a guarantee fee can be contentious in some countries, yet it may be expected elsewhere. Hence, a taxpayer should carefully review all of its intragroup guarantees. In particular, the taxpayer should be prepared to demonstrate that the guarantee provides the guaranteed entity with a benefit and that the guarantor is providing a service that is not being provided only by virtue of its being a shareholder. Where the guarantee confers a benefit, the taxpayer should consider charging for this benefit (note that not charging for a service can provide taxation authorities with an additional argument, i.e., that the credit guarantee may have been provided as a shareholder service, which may be disadvantageous if the guarantor needs to perform on the guarantee).

As with loans, market prices for credit guarantees have increased significantly over the past year. Hence, taxpayers should assess whether the guarantee fees charged on existing guarantees are still arm's length given the change in market conditions, if the pricing of the guarantees are eligible for review.

### **Factoring of receivables**

An intragroup accounts receivable factoring transaction can be beneficial under current market conditions by providing cash to a cash-strapped related party and by potentially producing a tax benefit for taxable related parties.

A factoring transaction involves the sale of accounts receivable at a discount for cash. The sale of a cash-strapped company's accounts receivable can provide immediate cash to the company in a tax-efficient manner. In addition, an intragroup factoring arrangement provides another benefit that many taxpayers do not consider: intragroup factoring is an off-balance sheet transaction. It involves a sale of assets for a fee, and in many countries may not be affected by withholding tax requirements or interest deductibility rules.

An intragroup factoring arrangement increases the assets of the related party purchasing the accounts receivable. If this related party is also the entity within the corporate group that has third-party borrowings, the increased assets may be accepted as collateral to lower the cost of or increase the amount available through third-party borrowings.

## **Cash pooling**

As a result of the financial crisis, companies in need of cash increasingly rely on their internal cash pool(s) for the management of the cash available within the group. Taxpayers need to address certain specific transfer pricing issues that arise from cash pool arrangements, such as how the cash pool operator determines the appropriate interest rate to be applied to intragroup balances, how it prices any underlying (cross) guarantee structure, and how it remunerates the cash pool leader. With the increased use of cash pools and the increase of volumes handled by these cash pools, the attention of taxation authorities to these transfer pricing issues is also increasing.

Recent examples of discussions with taxation authorities in this area relate to the fact that, in practice, positions in a cash pool often end up being long-term loans on which (given the nature of a cash pool) short-term interest is being paid. Furthermore, traditionally the benefit to the group of using a cash pool (i.e. the “cash pool advantage”) ends up being reported by the cash pool leader, which may be a thinly capitalised company that cannot “substantiate” the return on equity that it earns. At the same time, the depositing participants, who may be incurring the credit risk associated with the cash pool, might receive only the rate that they would receive if they had made a deposit at a major commercial bank.

On the other hand, structuring a cash pool properly and taking into consideration the tax position of the participants involved can lead to a tax-optimised situation.

## **Summary**

The subjectivity associated with pricing intragroup financial transactions combined with differing taxation authority views on how these transactions should be priced has significantly increased their tax risk in recent years. This is even more prevalent in the current financial markets, in which taxpayers are forced to use their cash in the most optimal way, in many cases resulting in an increase of intragroup financial transactions. However, while intragroup financial transactions can give rise to potential tax risk, if given appropriate attention and with the appropriate documentation in place, they remain a potential source of opportunity, particularly in light of these recent dramatic changes in the financial markets.

# The transfer pricing challenge of the future— Managing permanent establishment risk

*By Jorgen Juul Andersen (PwC US)*

In trying to predict the future, it is tempting to look to the past for direction. But what happens when tried and true models and assumptions from the past change so dramatically that they make it impossible to envision what the future will hold? What if all of this happens in the current environment, where the global business community is changing rapidly all while the world endures a major financial crisis?

This is the scenario for stakeholders who are tasked with managing permanent establishment (PE) risk following the recent release of new guidelines from the Organisation for Economic Co-operation and Development (OECD) for allocating profit to a PE.

The OECD released its first discussion draft on allocation of profit to a PE in early 2001. The original release was followed by numerous additional reports and revised versions, which, taken together, reflect the OECD's thought process for developing technical guidance regarding profit allocation for PEs. The length and depth of the process also indicate the complexity of an issue that is not subject to any type of 'quick fix'.

Two documents relevant to this discussion were released in 2008. The first document is the final report on allocation of profit to a permanent establishment. The second is a discussion draft of a revised Article 7 and commentary which, if adopted in final form, would fully implement the changes outlined in the report.

The definition of a PE is defined by Article 5 in the Model Tax Treaty. The amended commentary to Article 7 does not intend to change the definition, but the release of the OECD documents will likely increase the focus on PEs for years to come.

A defined PE is associated with a fixed place of business. For example, is a business address available or does the local representatives work from home? Do they have business cards indicating conclusion of sale? Are their activities of a preparatory or auxiliary character?

The traditional allocation of profit to a PE was based upon an 'all or nothing' approach: either there was a taxable presence and therefore an allocation should be made, or the activities did not meet the threshold for a PE and no allocation was made. The allocation was made arbitrarily based upon revenue or profit.

The new commentary language in Article 7, changes the approach to allocate profit

When a PE did not exist or the activities were deemed to be of a preparatory and auxiliary character, there was no need to start a process of allocating profit.

to a PE by assessing the value chain between the head office and the potential PE in its entirety. As a result of this change, the process for determining a profit allocation has become much more complex, but likely also more accurate. Article 7 reengineers transfer pricing methodology as the tool to identify and qualify the value of the activities undertaken throughout the value chain between the head office and the potential PE and the performance of the proper allocation of profit. This new process may appear to work well in theory, but the reality, it is often much more difficult to describe, especially when it comes to allocation for a PE.

For tax directors, this represents a tremendous challenge. Despite the limited number of examples from case law, some cases in India (Rolls Royce, Morgan Stanley), Italy (Phillip Morris) and France (Zimmer) offer some guidance. The cases are very different in content and nature, but the common denominator was that the PE challenge came as a surprise, that is that documentation to sustain the tax position had to be produced subsequently which always creates a procedural risk to the tax payer.

Obviously, tax directors may have relied on the PE analysis. When a PE did not exist or the activities were deemed to be of a preparatory and auxiliary character, there was no need to start a process of allocating profit.

The Article 7 approach, as reflected in the new commentary and the profit attribution report, looks specifically at the head office and the PE it allocates assets based on where within that single entity functions are performed, and it allocates risks based on the allocation of assets. It then proceeds to allocate income between the home office and the PE based on transfer pricing principles, treating the PE as a notional separate entity.

### **How the new approach differs from traditional TP approach**

As stated earlier, the new approach focuses on the value chain between the head-office and the PE.

The traditional transfer pricing approach is based upon an analysis of the factual and functional arrangement. In addition, the contractual relationship is evaluated to determine the risk and assets deployed. Hence, in ordinary transactions between affiliates, it is possible to segregate functions, risks and ownership to assets by virtue of the contractual relationship. This is the approach deployed by tax authorities and professionals when performing a functional and risk analysis.

The arrangement between a PE and its head office is referred to as a dealing.

### **The first step is to identify whether a dealing could exist**

For multinational companies (MNCs) working cross-border without established legal entities in host countries, the question of whether an arrangement may constitute a dealing can appear. Typical examples are cross-border projects, where people from the head office are on the ground for a longer period of time, or are making decisions that significantly influence the outcome to the project; or if the head office engages in extended maintenance or warranty provisions; or all of the above.

Many progressive companies are introducing virtual management models, where the skill sets and competencies of management rather than the geographic location of a manufacturing site or head office determine how the business is operated. For example, although a company's sales directors are located in US, thought they have responsibility for the sales in Asia. The UK production manager may have a global responsibility, but the head office might be in New York. Management meetings are conducted through virtual technologies (instant messaging, video conferencing, etc.), and may even be conducted from a private residence in order to lower office costs. These types of examples will create a significant challenge, both in identifying whether a dealing is actually taking place between the head office and a potential PE and in allocating the appropriate profit.

When conducting the analysis within this type of model, an organisation's HR department is often a good place to start, since they know where staff is located and usually have determined that they are in compliance with local tax and social laws. Identifying insurance policies taken out on people and projects is another helpful tool.

It should be borne in mind that the accounting records typically will not reflect the transactions corresponding to a dealing until it has actually been identified and treated accordingly.

## **The second step is to identify what is happening**

Under the new process outlined in the commentary on Chapter 7, tax directors should keep in mind that they are properly the only people in the organisation who can speak with authority about PE and PE-related issues. Hence, the tax director needs to have a more sophisticated grasp of the investigation in order to better understand which part of the value chain is undertaken and by whom. The traditional function and risk analysis must be conducted with caution.

If a dealing is found to exist, the allocation of profit is based on a division of function risks and assets between the head office and the PE. But unlike the traditional functional analysis, risk and function cannot be separated by a legal agreement. The analysis further divides assets and liabilities between the head office and the PE using the capital employed for the underlying transactions.

Tax directors will need to build a more intelligent reporting structure to accurately demonstrate whether or not a dealing exists. As always, the devil is in the details. The reporting structure should resemble that of a function and risk analysis, where the tax director seeks to obtain information from both the host and home country of the arrangement in question.

A dealing should be documented similarly to a legal arrangement (i.e. establish the terms and conditions) although, by nature it can not be legally binding on the parties. The documented dealing should also ease the audit process.

In order to complete the analysis, an allocation of capital (PE equity) is made to assert the independence of the PE.

But as in an ordinary transfer pricing study, the price setting will depend on the qualification of the transaction in conjunction with the functional risk analysis and should ultimately be supported by relevant benchmark studies.

### **The third step is the valuation process for establishing an accurate transfer price**

Some may ask, isn't a PE always considered a service provider? As such, it would be appropriate to use the cost plus approach, which would render the economic result insignificant. Why undertake the entire administrative burden of full implementation of the guidance for allocating profit to a PE?

Simply because cost plus may be the right approach. But it will have to be justified based on the actual factual and functional analysis — any TP method must represent a viable solution.

Special care should be observed with respect to the handling of significant people functions. Where undertaken in the PE context, capital follows risk, which follows assets, which follow functions. Hence the execution of significant people functions in the host country may lead to the application of profit split as a more reasonable method for allocation of profit.

But as in an ordinary transfer pricing study, the price setting will depend on the qualification of the transaction in conjunction with the functional risk analysis and should ultimately be supported by relevant benchmark studies.

If a PE is found to exist as part of the exercise, a compliance burden is automatically created and the filing of separate tax returns in the host country may be applicable.

### **The fourth step is documentation**

The allocation of profit to a PE will also be subject to the documentation requirements in Chapter 5 of the OECD guidelines on transfer pricing documentation by analogy.

At the time profit from dealings is determined, taxpayers need to make a reasonable effort to ascertain whether their approach to determining that profit is in accordance with the arm's length principle.

The OECD report highlights elements that can establish the existence of a PE's dealings:

- The documentation is consistent with the economic substance of the activities taking place and supported by the functional and factual analysis.
- The arrangement covered by the dealings does not differ from those adopted between unrelated parties in similar circumstances.
- The arrangement does not seek to separate risks from functions.

However, in addition it will be necessary to produce documentation for the purpose of justifying the application of the arms-length principle for the price setting on the transactions subject to PE's dealings. This documentation may be quite different from the documentation discussed above.

The traditional transfer pricing documentation has not focused on or addressed the PE's dealings, so the requirements presented in the OECD report will add an extra layer to the documentation burden of the taxpayer.

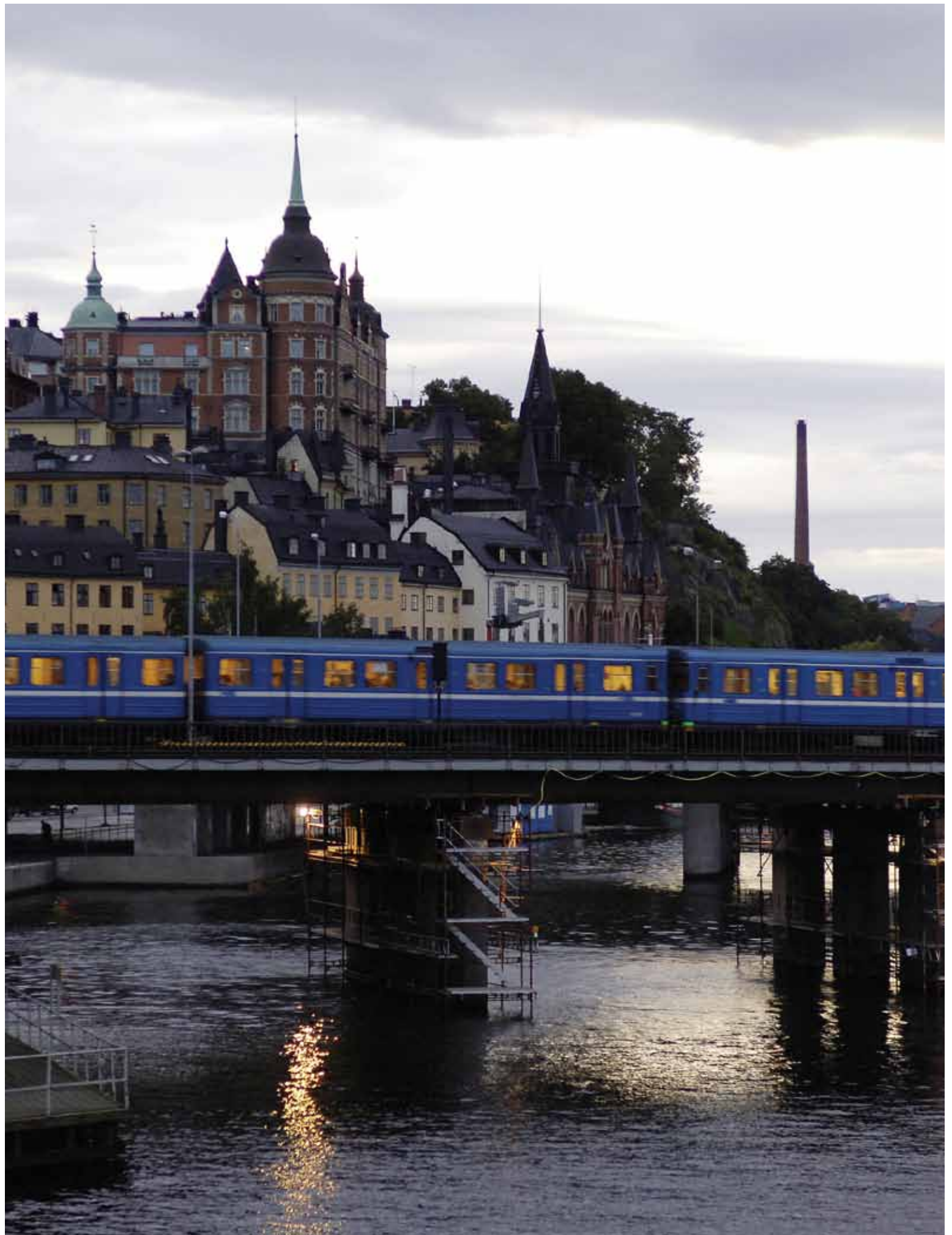
## **Conclusion**

There is no doubt that the updated commentary to Chapter 7 on the allocation of profit to a PE has added additional complexity to a tax director's already busy agenda.

It is possible that tax authorities in local jurisdictions hosting limited-risk distributors or contract manufacturers might be tempted to compensate for declines in sales and idle capacity caused by the current economic downturn by arguing for the presence of a PE in order to maintain a source of revenue, although, if the principal overall is incurring a loss an interesting discussion of loss split may arise.

In fact, there have already been instances where tax authorities have argued for the presence of PE following a challenge to the transfer price or vice versa.

The best way to avoid these types of discussions is by proactively establishing procedures for identifying existing PE dealings and performing the additional detailed analysis and assuring the proper allocation of profit and the presence of proper supporting documentation.



# Tax offices in Central and Eastern Europe: Wind of change?

*By Ionut Simion (PwC Romania), Zaid Sethi (PwC Hungary) and Piotr Wiewiorka (PwC Poland)*

Transfer pricing is rapidly evolving in Central and Eastern Europe and continues to be a major issue for taxpayers and tax authorities. Both Central and Eastern Europe are working to ensure the fair allocation of profits and tax revenues across borders while the Organisation for Economic Co-operation and Development (OECD) develops the concept of what should be regarded as fair by both entities and OECD member states. PricewaterhouseCoopers' network in the CEE region has gathered information on the practices of tax authorities there to consider the transfer pricing environment.<sup>21</sup> This article is intended to summarise the major findings of our research.

## CEE region

The CEE region encompasses 28 countries.<sup>22</sup> This region differs from Western European countries in that it traditionally has shown greater economic growth, thus providing higher rates of return and continually attracting new investments. The region's diversity ranges from countries of the Commonwealth of Independent States (ex-Soviet Union republics) to new European Union members. A number of other factors that should be accounted for when interpreting the results of the search include but are not limited to:

- Stage of the development of tax law;
- General approach by the authorities toward investors;
- Use of various languages (almost all of the 28 countries have an individual language as the official way of communicating with the tax authorities); and
- Industry specifics.

<sup>21</sup> PricewaterhouseCoopers' research covered Azerbaijan, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Macedonia, Poland, Romania, Russia, Slovakia, Slovenia, and Ukraine.

<sup>22</sup> Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

<sup>23</sup> Please note summary table at the end of the article.

## Major observations—legislation

Of the 30 OECD member countries, only four are located in the CEE (the Czech Republic, Hungary, Poland, and the Slovak Republic); further, three CEE countries, Estonia, Russia, and Slovenia, are candidates for accession to the OECD.

Still, the OECD strongly influences transfer pricing regulations across the region. Only Azerbaijan<sup>23</sup> admits that the local regulations do not follow the OECD-style approach, while the remaining countries except for Croatia, Macedonia, Kazakhstan, Russia, and Ukraine fully follow the OECD rules. In particular, the arm's length principle is broadly recognised across the region (Russia and Kazakhstan to an extent, Azerbaijan is the only exception), and documentation rules are now used in eight countries (including Slovakia, which adopted them January 1, 2009).

### **Major observations—practice and tax authorities' approach**

It is often assumed that the tax authorities across the region are not as accomplished as their Western counterparts or that they are aggressive and difficult to approach. The truth lies somewhere in between; CEE tax authorities, at least at the top of the hierarchy, are well-educated now and aware of the economic circumstances of the world. That gives them insight into the drivers of processes taking place at large multinational organisations. At the same time, they have been more willing lately to talk with the taxpayers and take a more open approach.

“In examining the level of sophistication of the tax authorities, it is noted that the traditional stalwarts have experienced tax auditors or specialised/centralised transfer pricing teams. When meeting the tax authorities in the Czech and Slovak republics, Hungary, Poland, and Romania as well as the Baltic States, Slovenia, and Kazakhstan, you can expect that the discussion will be run by an experienced auditor or a member of a centralised, specialised transfer pricing team.”

Even more countries are starting to focus on transfer pricing matters. Croatia, Hungary, Latvia, and Slovakia are recognised as presenting a more aggressive approach toward transfer pricing. That may partially result from the recognition that the taxpayers in such countries as the Czech Republic, Poland, and Romania are already used to detailed transfer pricing audits.

Specific to this region, countries that only a couple of years ago started to learn transfer pricing are now advanced with both their legislation and the level of tax authorities' expertise. In addition to documentation rules first put in place in the region in Poland in 2001 or the general transfer pricing rules being fully aligned to the OECD style in the mid-1990s, there are now the following:

- Advance pricing agreement (APA) regulations have been adopted in five countries (the Czech Republic, Hungary, Kazakhstan, Poland, and Romania), and the Polish Ministry of Finance already has issued more than 10 APAs.
- At least eight countries use sophisticated statistical tools to benchmark related-party transactions, and other countries either use local data or plan to purchase the respective tools.
- Most of the countries are increasingly involved in the exchange of information, and they have used information gathered from their foreign counterparts during tax audits.

All these developments may be seen through the perspective of the training of the tax authorities' officials by their foreign counterparts. This also changes the tax officials' willingness to discuss and negotiate with the taxpayers. Except in Azerbaijan, Croatia, Lithuania, Russia, and Slovenia, the taxpayers may discuss outcomes of a tax audit with the authorities prior to the decision.

That being said, we stress that the tax authorities in the region are often rigorous and formalistic in their approach to documents and audits in general. First, they strongly prefer that all communications be in writing. Also, where they are seeking evidence, written proof is strongly preferred. The correspondence with the tax authorities normally should be in a local language. Only in a couple of countries do the tax authorities recognise the master file concept. In others, either they do not accept it or they require significant local adaptations to follow the country-specific regulations. In addition, global or pan-European benchmarking studies are accepted in only a few countries.

If you are looking for any "regional favourite," it is the central services, or cost sharing, arrangement. The tax authorities present a consistent approach across the region: They attempt to question whether services were rendered at all; whether the local recipient could benefit from these services; or state that the service fee was not commensurate to the benefit for a taxpayer because the taxpayer could purchase comparable services locally at a lower price (because of lower salaries on the local markets).

Foremost, it should be noted that even though the CEE region may seem to be homogenous, it consists of a number of countries with their sovereign jurisdictions. Therefore, each business structure should be examined locally to ensure its feasibility.

### Key theme—restructuring processes

For a number of years, countries in the region have faced a huge inflow of direct foreign investments. Following the integration within the European structures and the economic processes taking place within multinational enterprises, business restructuring is common in most of the countries of the region. The technical aspects of the restructurings are not any different from what is happening across the globe; that is, limited-risk models are being put in place including:

- Commissionaire or agency structures for distribution activity;
- Toll or contract manufacturing; and
- Shared services centres serving the global operations in the areas of support services.

At the same time, companies should consider certain aspects when putting the structures into practice. Foremost, it should be noted that even though the CEE region may seem to be homogenous, it consists of a number of countries with their sovereign jurisdictions. Therefore, each business structure should be examined locally to ensure its feasibility. Additionally, a number of countries report that a taxpayer's changing of its business model can trigger the tax authorities' attention. Similarly, a reduction of the reported income that normally accompanies such business process restructuring may be noticed and analysed in detailed.

Restructuring processes that we observe are principally business-driven. Multinational enterprises are willing to change their modus operandi only if it leads to increasing efficiency, reducing costs, improving client service, etc. Restructuring processes taking place in the period of dynamic economic growth carry optimistic anticipations of further development in the market situation. The underlying assumption of most of the structures tax-wise is that the local entities bear limited business risk, which results in low but relatively stable profit. Such a financial model leads to extraordinary profits realised at the central level under positive market circumstances, but it is also the head office that faces the loss in a downturn. As a result, the limited-risk entities may still be entitled to earn a small profit (or at least break even), while the rest of the group will be in a loss position. Current market circumstances could make a number of entities going through restructuring processes lately reconsider the approaches adopted.

## Summary of the research – legislation

	OECD principles followed	Arm's length principle adopted	Documentation required
Azerbaijan	—	—	—
Bulgaria	✓	✓	—
Croatia	Partially	✓	—
Czech Republic	✓	✓	✓
Estonia	✓	✓	✓
Hungary	✓	✓	✓
Kazakhstan	✓	Partially	From selected taxpayers only
Latvia	✓	✓	—
Lithuania	✓	✓	✓
Macedonia	Partially	✓	—
Poland	✓	✓	✓
Romania	✓	✓	✓
Russia	Partially	Partially	—
Slovakia	✓	✓	✓
Slovenia	✓	✓	✓
Ukraine	Partially	✓	—

## Summary of the research—approach

	Experienced auditors or specialised/centralised teams	Aggressive tax auditors	Advance pricing agreements available	Use of statistical tools to benchmark transactions	Exchange of information	Training for tax auditors lately
Azerbaijan						
Bulgaria		✓			✓	
Croatia		✓				
Czech Republic	✓		✓	✓		
Estonia	✓					✓
Hungary	✓	✓	✓	✓	✓	✓
Kazakhstan	✓		✓	✓	✓	✓
Latvia	✓	✓		✓	✓	
Lithuania	✓			✓		
Macedonia					✓	
Poland	✓		✓		✓	✓
Romania	✓		✓	✓		✓
Russia					✓	
Slovakia	✓	✓		✓	✓	✓
Slovenia	✓			✓		
Ukraine						

## Summary of the research approach

	Dialogue with the tax authorities possible	Master file concept recognised	European benchmarks acceptable	Restructuring triggering the tax authorities' attention	Drop in profitability triggering the tax authorities' attention
Azerbaijan					
Bulgaria	✓			✓	
Croatia		✓			
Czech Republic	✓	✓	✓		
Estonia	✓	✓	Conditionally*		
Hungary	✓		Conditionally	✓	✓
Kazakhstan	✓				
Latvia	✓			✓	
Lithuania		✓			✓
Macedonia	✓				✓
Poland	✓	Conditionally**	Conditionally	✓	✓
Romania	✓		Conditionally	✓	✓
Russia				✓	✓
Slovakia	✓	✓	✓		
Slovenia			✓	✓	✓
Ukraine	✓				

\* If local observations are insufficient

\*\* If supplemented according to local regulations

# India transfer pricing audits— Challenges and emerging trends

*By Shyamal Mukherjee (PwC India) and Tarun Arora (PwC India)*

Globalisation and the inherent advantages enjoyed by India including a large consumer base, low production costs, and a huge skilled work force led numerous multinational enterprises to establish large India operations. Accordingly, India introduced a comprehensive transfer pricing (TP) code into its tax laws in 2001. The code prescribes detailed documentation requirements, stringent penalty provisions, and a procedure for audit of TP cases by specialised revenue officers, known as transfer pricing officers (TPO).

TP audits in India have been characterised by intense scrutiny and aggressive positions by transfer pricing officers. Over the years, the TP challenges faced by multinational enterprises operating in India have undergone a significant change. Controversies arose in the initial years of audit over fundamental issues such as time period (single- vs. multiple-year data) for comparability analysis, choice of TP methodology, application of arm's length range, and other procedural matters. Today, although some of these issues are nearing settlement through rulings of appellate bodies and courts, newer, more complex challenges are emerging.

This article examines major audit issues for taxpayers and emerging areas of focus of Indian TP authorities.

## **Transfer pricing audit issues**

### **Data for comparability analysis**

India's TP rules require the use of "current year" data (data pertaining to the year in which the taxpayer has transactions with group concerns) for transfer pricing analysis.<sup>24</sup> The use of prior data (up to two years) is permitted only in certain circumstances when it reveals facts that could influence the determination of current transfer prices.<sup>25</sup>

Where profit-based methods are used for TP analysis, taxpayers generally compute the margins of functionally comparable companies from publicly available data/databases. Although these databases are updated regularly, the current-year data is usually not available before taxpayers file their tax return and finalise their TP analysis. Taxpayers thus use the past two years' average data to support the transfer prices.

However, by the time the case comes up for a TP audit, current-year data has become available. Then TP officers request that data and test a taxpayer's transfer prices based on the updated results. The practice of conducting fresh searches for comparables and using current-year data causes undue hardship to taxpayers. Even though they may have undertaken a thorough contemporaneous TP analysis while setting transfer prices, the taxpayers face the risk of TP adjustments and harsh penalties from 100 to 300% of the tax on the adjustment amount. Therefore, taxpayers should keep constantly updated about

<sup>24</sup> Rule 10B(4) of the Income Tax Rules, 1962 (Rules)

<sup>25</sup> Proviso to Rule 10B(4) of the Rules

prevailing industry/market trends and undertake comparables selection and economic analysis with utmost care.

### **Use of ‘nonpublic’ comparables**

In some cases, TPOs seek pricing information from competitors of the taxpayers (for computing the arm’s length price of the taxpayer’s transactions) by exercising the powers granted to them under the tax laws of India.<sup>26</sup> The use of competitor data not in the public domain is not only unjust from the taxpayer’s point of view, but may also harm the business interests of the competitor once such strategic pricing information is shared with the taxpayer. Such information is also not enough to undertake a detailed comparability or functional analysis of the enterprises/transactions, thus leading to an inappropriate TP analysis.

The issue requires careful handling and analysis, from a legal/tax as well as an economic viewpoint.

### **Business strategies and comparables selection**

The Indian rules prescribe a comprehensive list of TP documentation that a taxpayer needs to maintain,<sup>27</sup> which includes a broad description of the industry; a record of economic and market analysis; assumptions, policies, price negotiations, etc. In accordance with the requirements, most taxpayers undertake comprehensive TP studies that contain an in-depth industry analysis and set out their business strategies and commercial practices.

However, the tax authorities primarily look at the profit margins of the taxpayer, ignoring the company’s business strategies. For example, some companies voluntarily make losses part of a bigger strategy (entry strategy, loss leaders, cross-subsidisation across products, etc). The general tendency of revenue authorities has been to reject any losses reported by taxpayers and substitute a so-called “arm’s length” profit. It is a commercial reality that even in an arm’s length situation, each and every independent enterprise cannot make profits. In many cases, the authorities tend to ignore the market situation, industry dynamics, business considerations, and strategies of the companies, imposing fictitious profits

Even in the comparable sets prepared by taxpayers, the authorities tend to challenge independent loss-making companies and “cherry-pick” profitable companies for comparison. Companies need to select comparables and do related economic analysis with utmost caution and after a comprehensive functional, assets, and risk analysis of both the taxpayer and the comparables. Since the Indian TP provisions do not evaluate a taxpayer’s transfer prices based on a range of outcomes (unlike international practice), the choice of comparables assumes greater significance. The inclusion of outliers, loss-making companies, etc., is one of the common audit issues taxpayers face during TP audits. Taxpayers should analyse any loss-making comparables in significant detail.

<sup>26</sup> Section 133(6) of the Income Tax Act, 1961

<sup>27</sup> Rule 10D of the Rules

In the Indian context, risk adjustments may be necessary for evaluating the transfer prices of not just captive Indian service set-ups, but also manufacturing or other operations of multinational enterprises having risks significantly different from those of the chosen comparables.

## **Global arrangements determining India transactions**

Under the Indian TP legislation, a taxpayer's transaction with a third party is also covered by the TP code if such transaction is a part of an arrangement that the third party has with a group concern of the taxpayer. Indian TP authorities have started evaluating such transactions in detail to test them from an Indian TP perspective.

## **High-value services—location savings**

India has emerged as the hub for outsourced services such as software development, research and development, engineering design, and business processes. These typically are undertaken on a contract service provider model, which insulates the Indian captive unit against most business risks. However, increasingly, some Indian entities have started taking on higher-end, intangible creating functions.

The evolution and ongoing discussions around the new US regulations, from the concept of “high-value” services to the suggestion of using the profit-split method for “non-routine” contributions, have not escaped the attention of Indian TP authorities. Even though the US regulations as finalised may have moved away from these concepts and suggestions, Indian TP authorities have started nurturing the thought of treating high-end intangible development services as non-routine contributions, and applying the profit-split method for these intangible-generating services. The location savings argument has already been put forward by some officers during TP audits to claim significantly high margins for such services.

Given the widespread extent of outsourced services in India, it becomes imperative to carefully structure and implement clear TP arrangements and contracts for such Indian set-ups, and to undertake and document an in-depth, on-ground functional analysis to counter any such argument put forward by the authorities during TP audits. Comparables selection and adjustments (including risk adjustments) by such entities also require careful attention. Indian entities undertaking entrepreneurial, intangible-creating services and making valuable, non-routine contributions to the crown jewels of the group need to set their transfer prices carefully based on a robust TP analysis.

## **Risk adjustment**

In the Indian context, risk adjustments may be necessary for evaluating the transfer prices of not just captive Indian service set-ups, but also manufacturing or other operations of multinational enterprises having risks significantly different from those of the chosen comparables. The issue of risk adjustment assumes more significance in view of the huge TP adjustments undertaken by transfer pricing officers in the information technology/IT enabled services/business process outsourcing sectors, where captive service units bearing limited risk have been compared with companies having different business and revenue models and bearing full entrepreneurial risks.

The requirement for comparability adjustments (including risk adjustments) is an integral part of the Indian regulations. Recent rulings of appellate authorities have reinforced the need for such adjustments. However, neither the regulations nor the rulings provide any guidance on the methodology to be adopted for computing such adjustment.

Any such risk adjustment needs to be undertaken based on a detailed and well-documented analysis. Companies can use various economic theories/methods as well as statistical tools for making a sound risk adjustment. Globally accepted TP techniques can be utilised for undertaking this adjustment on a rational and scientific basis.

In the absence of a robust technical and well-documented risk adjustment, the revenue/appeal authorities may not permit the adjustment during audit/appeal proceedings or may allow an ad-hoc adjustment that may not be appropriate or adequate. Accordingly, in the absence of specific guidance under law, it is imperative for taxpayers to focus on this issue and make a strong case upfront for computing and claiming the risk adjustment.

### **Royalties/management charges**

The payment of a royalty for the use of intellectual property such as trademarks, know-how, brand names, etc., is a significant focus of the revenue authorities. In many cases, the authorities have rejected the taxpayer's analysis and disallowed payments for use/transfer of intellectual property, on the grounds that the taxpayer has failed to commensurately demonstrate the following:

- Need for sourcing such intellectual property and its actual receipt
- Appropriate documentation evaluating and describing such intellectual property
- Fulfilment of the benefits test by the Indian entity
- Whether the royalty is embedded in the import price of goods, etc.

Similarly, management charges paid by Indian taxpayers invite significant attention from tax authorities. Extensive documentation is sought by the revenue authorities to justify the management charges paid by Indian enterprises. Such documentation includes composition of costs allocated, methodology of cost allocation, benefits derived from each constituent of the costs, need for procuring such services, actual receipt of services, etc.

Taxpayers are required to satisfy the above parameters through extensive documentation, failing which they could face significant adjustments on account of intellectual property or services fee payments made to group concerns.

Indian TP authorities have also started focusing on issues such as disposition of intangibles and consequential exit charges required for implicit or deemed migrations of intellectual property as part of acquisitions, reorganisations, conversions, or business restructurings.

## Emerging areas of focus

In recent years, Indian TP authorities have started examining more subtle and complex issues such as remuneration or cost sharing for marketing intangibles created by Indian taxpayers, migration of intangibles in business restructurings, and profit splits and sharing of “locations savings” resulting from intangible-creating R&D services. Some of these newer challenges are discussed below.

### Business restructuring

TP issues relating to business restructuring have recently started attracting the attention of tax authorities across the globe. The 2008 OECD discussion draft on the subject, the recent rules introduced by Germany on cross-border transfer of functions, and the ruling of the Norwegian Appeal Court in the case of *Cytec Norge KS*, are clear indicators of international thinking on this complex TP issue.

Indian TP authorities have also started focusing on issues such as disposition of intangibles and consequential exit charges required for implicit or deemed migrations of intellectual property as part of acquisitions, reorganisations, conversions, or business restructurings.

Such restructuring could include conversion of an entrepreneurial manufacturer to a contract or toll manufacturer, conversion of a full-fledged product developer to a contract R&D service provider, or conversion of a distributor to a commission agent. The issue requires detailed analysis of intricate matters, such as whether it involves a transfer of valuable, protected or unprotected intellectual property (including identification of it); a loss or migration of profit potential; a required exit charge and, if so, how to quantify such charge, and similar issues. Therefore, the restructuring necessitates a detailed analysis of contracts, financial and functional analyses, and industry/market structure review, followed by preparation of robust, related TP documentation, economic analysis, written agreements, and the like.

### Marketing intangibles

Another issue that has started receiving significant attention during TP audits in India is marketing intangibles. This issue is particularly relevant for Indian group concerns of multinational enterprises that undertake significant local marketing in India.

In recent audits, the TP authorities have examined the marketing activities and spending by Indian subsidiaries developing local market intangibles that are legally owned by overseas parents or other affiliates. For instance, where the Indian entity undertakes significant marketing expenditure above the industry average or comparables levels, transfer pricing authorities have reduced the transfer prices (of goods or other transactions) paid by the Indian subsidiary to its group concerns. In certain cases, the authorities have imputed a cost reimbursement to be received by the Indian entity, and in other cases, they have simply disallowed the “excessive” marketing expenditure incurred by the Indian entity. In all such cases, the intention has been to compensate the Indian subsidiary for its contribution toward development of marketing intangibles.

It needs to be evaluated whether the local marketing efforts contribute to the increase in value of marketing intangibles owned by a group concern or enhance only the value of the contributing entity's own rights under a long-term license or distribution arrangement. Further, it also needs to be evaluated whether the compensation for such contributions is already embedded within another transaction or requires a separate service fee.

In the absence of detailed upfront TP economic analysis as well as robust documentation (including explicit contracts), such Indian operations could be exposed to significant issues during TP audits. Indian TP authorities are closely following international developments including case law and overseas regulations on this matter.

### **Attribution of profits to permanent establishments**

The allocation of profits between a head office and its permanent establishment has been the centre of numerous discussions between taxpayers and Indian revenue authorities. Some countries follow traditional allocation and apportionment techniques for attributing profits to permanent establishments, while others adopt TP principles. Indian TP law has defined a permanent establishment as an "enterprise"<sup>28</sup> and has applied the "functionally separate entity" approach authorised by the OECD for attributing profits to permanent establishments.

Further, the courts in India have upheld the application of TP principles for attributing profits to permanent establishments in India. The Supreme Court of India and other courts have held that where the functions, assets, and risks of the permanent establishment have been appropriately captured while remunerating the enterprise which created the permanent establishment, attribution of profits to the permanent establishment stands subsumed in such remuneration and there can be no further attribution.

In the light of this, a sound TP analysis could be an effective, practical solution for any permanent establishment exposure that multinational enterprises operating in India face.

### **Conclusion**

It is critical for multinational enterprises with operations in India to receive updates about ongoing audit issues and to plan their transfer prices as well as audit/appeal strategy based on such information. In the absence of an advance price agreement mechanism in India, taxpayers need to be well-prepared, from the initial stage of planning transfer prices to maintaining comprehensive documentation and having a robust and holistic strategy for audits as well as dispute resolution.

The dispute resolution strategy should evaluate the mutual agreement procedure under relevant Indian tax treaties. This effective alternative mechanism for dispute resolution can also be used in some cases to avoid upfront deposit of substantial TP-related tax demands raised by Indian revenue authorities.

<sup>28</sup> Section 92F(iii) of the Income Tax Act

# New entrants—Increased enforcement— The Latin American perspective

*By Juan Carlos Ferreiro (PwC Argentina)*

When thinking about transfer pricing in Latin America, companies must take two important factors into consideration:

- Brazil has its own set of rules applicable to transfer pricing matters.
- Even in countries in the region that do not have specific transfer pricing regulations, significant compliance requirements are in force.

Several tax administrations have developed audit processes and made pronouncements that provide useful information about dispute resolution within the region.

## **The Latin American environment**

Formal aspects are important in Latin America. When referring to formalities, we include the transfer pricing forms and reports<sup>29</sup> and the formal documentation of the specific transactions (contracts, certainty about the date of the transaction, adjustments to increase comparability, etc.).

The Organisation for Economic Co-operation and Development's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) are accepted and, in some cases, are specifically quoted in the legislation, with the exception of Brazil. However, they are interpreted with a Latin flavour.

In the countries that have adopted transfer pricing regulations, the audit process begins under the requirement of the tax authority. In countries that do not require companies to submit a transfer pricing report every year, the audit process begins with such a request.

Companies should consider that the tax authority can apply sanctions prior to the audit process. In Venezuela, Peru, and Colombia, fines could result from the lack of compliance with the formal obligations.

Most of the audit processes and discussions are still being developed, some at the administrative level and some in the tax courts. Notable in the court pronouncements so far:

- In countries such as Argentina and Venezuela, the tax authorities have exchanged information with other tax authorities.
- Tax administrations have used secret comparables. Some countries have allowed the use of such comparables in legislation, including Peru and Argentina, while in other countries the comparables have been recognised by the tax courts.

<sup>29</sup> In Argentina and Ecuador, taxpayers are obligated to deliver the transfer pricing report every fiscal year.

## **Main objections given by tax authorities**

Tax authorities have announced their opinions and objections in several transfer pricing matters. Regarding methodology, for example, the authorities have shown a strong preference for the comparable uncontrolled price, or CUP method. In addition, Argentina and Uruguay have a specific method for commodities exports.

For comparables used in the analyses, there is a strong preference for internal comparables. And in most audit cases when tax authorities must use external comparables, they have cross-checked the financial information obtained from databases with the financial statements of the selected comparables.

Likewise, tax authorities have objected regarding specific comparability issues. The main objections include the following:

- The recognition of the inflationary process in local financial statements. Tax authorities have questioned the adjustment of holding results.
- The use of true-up or year-end adjustments.
- An analysis based on average business cycle.
- The adjustment of foreign comparables' financial information to the local environment, including idle capacity, severance payments, bad debts, commercial risks, and country risk adjustments.

One hot issue involves the deductibility of corporate expenses and intercompany services. In these cases, the tax authorities have objected over the effective rendering of the services and whether the expenses were necessary to conduct the business activities of the local company. So far, the formal implementation of the services and the lack of proof that the services and related benefits had actually been received by the local entity have been two important issues for tax administrations.

The Brazilian Tax Authority requests an annual calculation based on contemporaneous information, as well as compliance with the digital tax and accounting systems (SPED) transmission on a regular basis.

### **The Brazilian style**

As noted earlier, Brazilian transfer pricing rules are particularly complex and do not follow the OECD arm's length standard. The Brazilian rules state that no profit-based method is accepted and that all methods must be applied on a product-by-product basis. Moreover, the taxpayer may freely choose the method to be applied because there is no preference for any method.

Several discussions are continuing between the Brazilian Tax Authority and the local taxpayers regarding the local methodology. So far, we highlight the following subjects of those discussions:

- The restrictions on the application of the resale minus method, because the local tax authorities have modified their criteria for use of this method;
- The imposition of a cost definition (discussions looked at what should be considered the cost base and specific adjustments during the revaluation of the Real); and
- The lack of a method to be applied on special transactions.

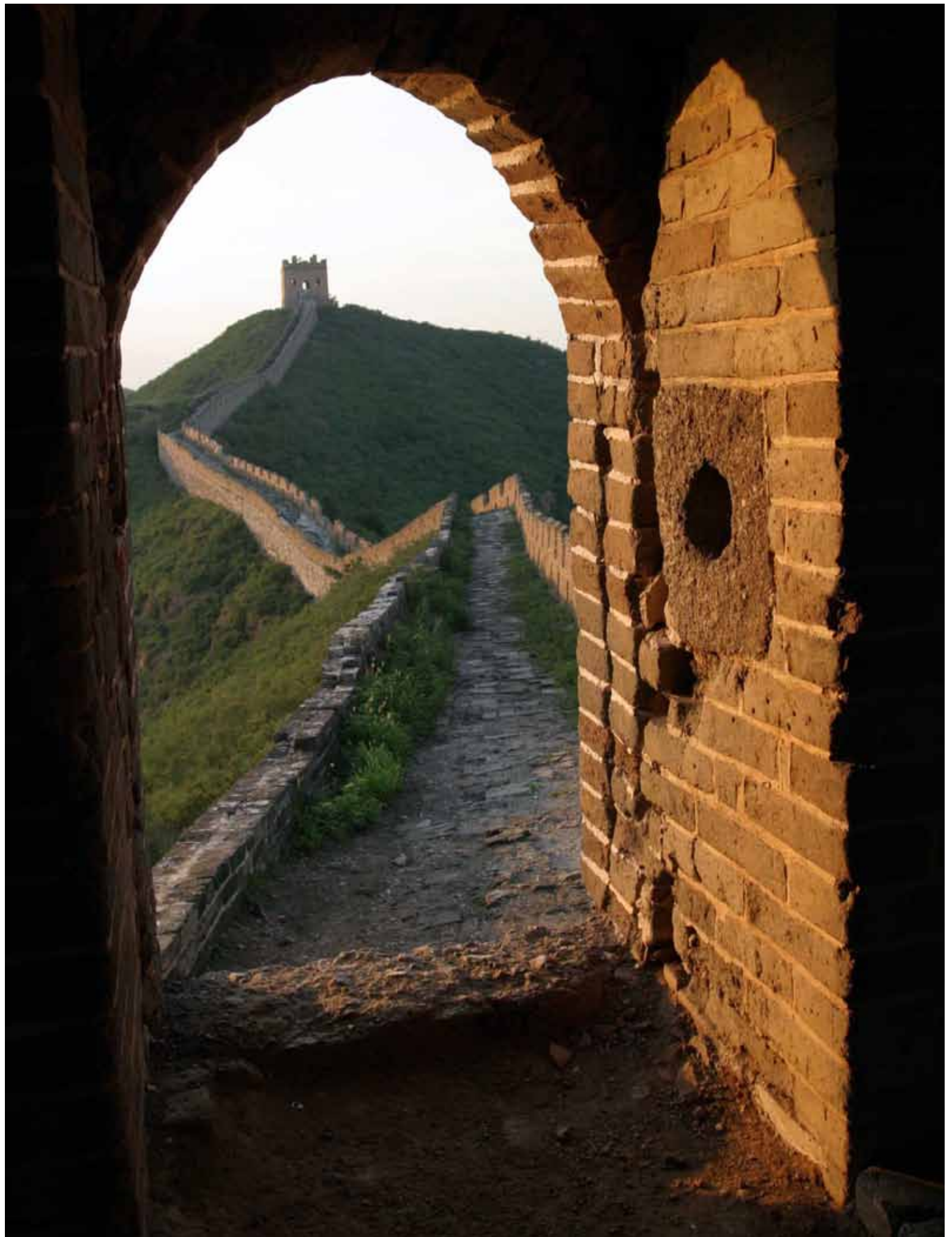
The Brazilian Tax Authority requests an annual calculation based on contemporaneous information, as well as compliance with the digital tax and accounting systems (SPED) transmission on a regular basis. Finally, it put automated procedures for transfer pricing audits in place in January, the beginning of fiscal year 2009. During 2008, the tax authorities were more active, making significant transfer pricing adjustments on multinational companies.

## Perspectives

After reviewing the environment in the region and the actions so far of the tax administrations, we expect to see the following in the coming years:

- Stronger formal requirements related to transfer pricing issues spurred by the increase in audit activity;
- A focus on the substance and purpose of intercompany transactions, as well as on supporting documentation; and
- An increased focus by tax authorities on financial operations, intragroup services, and technical assistance, in addition to the current auditing activity based on tangible goods transactions (including commodities).

The transfer pricing environment in Latin America requires local taxpayers to be prepared, especially if budget constraints cause a local tax administration to increase its efforts to maintain the level of tax collections. Also, the consistency between formal agreements and their economic substance is a key to succeeding in a transfer pricing dispute.



# New entrants—Increased enforcement— The Chinese perspective

*By Spencer Chong (PwC China), Aatika Hayat (PwC China) and Jeff Yuan (PwC China)*

After years granting tax holidays and incentives to many multinational companies operating in China, the erosion of China's tax base has become a top priority for China's State Administration of Taxation (SAT). As tax authorities around the world increase enforcement of tax regimes, China has followed suit and toughened its tax laws, particularly its transfer pricing regulations. China's new corporate income tax (CIT) law, together with its detailed implementation regulations (DIR), introduced a set of anti-avoidance measures under Chapter 6—Special Tax Adjustments. It may well be the most complex chapter of the CIT law, encompassing audit procedures, the introduction of cost sharing agreements, the administration of thin capitalisation, the definition of controlled foreign enterprises and thin capitalisation, and above all, the imposition of mandatory transfer pricing documentation requirements that could demand much greater attention from taxpayers. The new CIT law applies from 1 January 2008.

The new regulations seek to ensure consistency of transfer pricing enforcement and administration throughout China. The SAT has consolidated its past experiences in audit cases into a single document establishing a high-level framework for future transfer pricing policy developments.

With the transfer pricing regulatory framework in China now formalised, companies operating in China will need to review and manage their transfer pricing risks and fulfil their compliance obligations.

This article provides a summary of China's transfer pricing regulatory landscape under the new CIT law. Our interpretation of the regulations and recommendations are based on our recent experiences in applying the law and our ongoing dialogue with the SAT.

## **The measures**

On 9 January 2008, the SAT issued a circular entitled Guo Shui Fa [2009] No. 2, which contains the Implementation Measures of Special Tax Adjustments (Trial) (the measures). The measures detail China's framework for administering special tax adjustments relating to transfer pricing, thin capitalisation, controlled foreign corporations, and general anti-avoidance.

While the measures do not provide all the answers to the uncertainties raised by the new CIT law and the DIR, they do offer valuable insight and additional guidance on the direction of the Chinese tax authorities in their anti-tax avoidance administration efforts.

The taxpayers required to file the RPT forms include not only enterprises residing in China, but also non-tax resident enterprises with an establishment or a place of business in China that file corporate income tax returns with tax authorities and pay income taxes based on their actual accounts.

### **Definition of related party**

The measures define related parties to include a party directly or indirectly owning more than 25% of the shares of another party, or a common third party directly or indirectly owning more than 25% of the shares of both parties. Chinese enterprises should carefully evaluate their own relationships (e.g., major suppliers, customers, financiers) as well as the relationships of their directors and high-level management in light of this definition of related parties.

### **Annual disclosures of related-party transactions**

The final version of China's new related-party transactions disclosure (RPT) forms (required by Article 11 of the measures) were released by the SAT in December 2008 under Guo Shui Fa [2008] No. 114. They place a significantly heavier information disclosure burden on Chinese taxpayers; there are now as many as nine different forms that need to be filed as part of the taxpayer's annual CIT return, due on 31 May 2009. The RPT forms also require companies to indicate whether they have contemporaneous transfer pricing documentation (TPD) in place to substantiate their intercompany arrangements.

The taxpayers required to file the RPT forms include not only enterprises residing in China, but also non-tax resident enterprises with an establishment or a place of business in China that file corporate income tax returns with tax authorities and pay income taxes based on their actual accounts.

The RPT forms require large amounts of information that must be provided precisely in the manner prescribed by the SAT. As a result, they require significant time to comprehend, collate, and complete. In addition, certain sections of the RPT forms can be confusing for those filing for the first time. We recommend taxpayers take a reasonable and commercial approach in interpreting the forms in the absence of specific guidance from the measures.

At an SAT seminar on 31 March 2009, taxpayers were advised that disclosures made in the RPT forms should be supported and closely correlated with the taxpayer's CIT return, its TPD, audited financial statements, and information filed by taxpayers' other related parties in China.

## **Contemporaneous transfer pricing documentation**

The measures require enterprises to prepare and maintain TPD if its related-party transactions exceed RMB200 million (US\$29 million) for purchase and sale of goods transactions or RMB40 million (US\$6 million) for other transactions such as royalties, services, etc. TPD is not required if an advance pricing arrangement (APA) is in place or the foreign shareholding of the enterprise is below 50% and the enterprise has only domestic related-party transactions.

TPD must be submitted to the SAT in Chinese, and the taxpayer has 20 days to provide tax officials with TPD once it has been requested.

For the 2008 year, taxpayers have a one-time extension until 31 December 2009 to prepare TPD; however, after this year, taxpayers will be required to have TPD prepared by the CIT return filing deadline of 31 May.

The measures list as “appropriate methods” for conducting transfer pricing investigations the same six methods provided in the OECD’s transfer pricing guidelines (i.e., the comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method, profit split method and other methods that are consistent with the arm’s length principle). However, there is not any preference or hierarchy of transfer pricing methods.

## **Audits and penalties**

In 2008, the Chinese tax authorities formally initiated transfer pricing audits of 174 companies, and concluded 152 audit cases resulting in total tax adjustments of RMB1.24 billion on total income adjustments of RMB15.55 billion, with the single-largest tax adjustment being RMB423 million.<sup>30</sup>

In 2010, the SAT said audit targets would be selected based on the information disclosed by taxpayers in their RPT forms and TPD.

The measures provide the SAT with the authority to conduct a transfer pricing audit of enterprises if considered necessary. They also detail how the auditors may conduct the investigations, specifically allowing the use of secret comparables.

<sup>30</sup> <http://www.chinatax.gov.cn/n8136506/n8136548/n8136623/8817242.html>

According to the measures, the SAT searches for the following transfer pricing audit flags when identifying enterprises for investigation:

- Significant amounts or numerous types of related-party transactions
- Long-term losses, low profitability, or fluctuating pattern of profits/losses
- Profitability lower than those in the same industry, or with profitability that does not match functions/risks
- Business dealings with related parties in a tax haven
- Lack of preparation of contemporaneous documentation or complete transfer pricing-related tax return disclosures
- Obvious violation of the arm's length standard

If taxpayers fail to provide the tax authorities with TPD when requested, the CIT law allows the tax authority to deem the taxpayer's taxable income and assess a 5% penalty, in addition to the interest levy. Although enterprises with annual related-party transactions below the de minimis thresholds for contemporaneous documentation requirements are not subject to the penalty interest, such protection does not apply for enterprises that originally fell below the threshold, even if the restated amount of related-party transactions as a result of a transfer pricing adjustment exceeds the prescribed threshold.

The measures also give the SAT authority to adjust the income of taxpayers if their results fall below the median, even if they are within an interquartile range, a commonly accepted measure of an arm's length range. How the SAT will use this authority remains to be seen, but it will likely cause difficulties in devising transfer pricing policies or determining the amount of a voluntary taxable income adjustment.

Article 39 of the measures states that enterprises that conduct contract or toll manufacturing activities should not bear risks or suffer operating losses as a result. At the SAT seminar, tax officials generally agreed that despite the economic downturn, all enterprises performing routine functions and bearing routine risks should maintain a certain level of profitability to avoid having their taxable income deemed by the SAT.

The measures do not allow taxpayers to make adjustments on differences in operating profits caused by differences in capital employed without approval from the SAT.

SAT officials have said that the introduction of the concept of cost sharing arrangements to the Chinese income tax regime will be helpful in attracting more advanced intellectual property and sophisticated services from overseas enterprises.

### **Advance pricing arrangements (APA)**

At the SAT seminar, tax officials said that they consider an APA to be a very good tool for the taxpayer to manage their transfer pricing adjustment and double taxation risks. In the eyes of the tax officials, this is also considered a more collaborative approach compared with the adversarial tax audit approach.

The measures provide guidance with respect to the various requirements and procedures associated with applying for, negotiating, implementing, and renewing APAs.

In general, the threshold for APAs is RMB40 million or higher. However, enterprises that were non-compliant with documentation and annual reporting requirements will not be accepted for the APA process. The APA term covers three to five years following the application year and rollbacks are subject to tax authority approval.

For enterprises with more than one entity in China, the measures provide that the SAT will centrally coordinate the joint negotiation and implementation of advance pricing arrangements across the various provincial, municipal, and other “local” tax bureaus.

In 2009, the SAT will engage in bilateral negotiations on advance pricing arrangements with the competent authorities of Japan, Korea, Singapore, the US, and Denmark.

### **Cost sharing arrangements**

SAT officials have said that the introduction of the concept of cost sharing arrangements to the Chinese income tax regime will be helpful in attracting more advanced intellectual property and sophisticated services from overseas enterprises. However, to prevent possible abuses, the SAT will closely scrutinize cost sharing arrangements. The measures state that the costs borne by the participants in a cost sharing agreement should be consistent with what an independent enterprise would bear for obtaining the anticipated benefits under comparable circumstances, and that the anticipated benefits should be reasonable, quantifiable, and based on reasonable commercial assumptions and common business practices. Failure to comply with the benefit testing will be subject to adjustment by tax authorities in the event of an audit assessment.

The measures state that at this stage, service-related cost sharing arrangements should be limited to group procurement or group marketing planning services. At the SAT seminar, tax officials said that once the Chinese tax authorities gain more practical experience with cost sharing arrangements, the SAT will be receptive to other types of service cost sharing arrangements.

### **Controlled foreign corporations**

Article 45 of the CIT law provides for the inclusion in a Chinese enterprise's taxable income the relevant profits of controlled foreign corporations of that Chinese enterprise that are established in countries with effective tax burdens that are substantially lower than China's. However, these controlled foreign corporation rules may not be a concern to most foreign multinational companies, since they are not inclined to use a China-based company to invest outside of China.

### **Thin capitalisation**

China's thin capitalisation rule is designed to disallow the deduction of related-party interest expense pertaining to the portion of related-party debt-to-equity ratio that exceeds a certain prescribed debt-to-equity ratio.

In October 2008, the Ministry of Finance and the SAT jointly issued the circular, Cai Shui [2008] No 121 (Circular 121), which set out the prescribed debt-to-equity ratios as 2:1 for nonfinancial institutions and 5:1 for financial institutions.

Circular 121 suggested that interest expenses for related-party financing in excess of the prescribed ratios may still be deductible if:

- The taxpayer can provide documentation supporting the higher debt to equity ratio complies with the arms' length principle, or
- The effective tax rate of the domestic borrowing enterprise is not higher than that of the domestic lending enterprise

Taxpayers are required to disclose their thin capitalisation ratios as part of the RPT forms.

China is committed to continuously learning and improving its enforcement operations in its bid to catch up with the tax authorities of developed nations.

### Going forward

The themes of pragmatism and gradualism have always been the hallmark of China's economic reform programme which began in the late 70s. Moving forward, the transfer pricing regulations reform is expected to be no different, with the SAT taking a gradual and pragmatic approach in introducing the regulations. Indeed, this is reflected in the title of the measures, which indicates the measures are a "trial" version, implying that an improved version is intended once the results of the "trial" version have been analysed and tested.

At the SAT seminar, the Director of International Taxation delivered the following key messages summarising the SAT's plans for the future:

- Chinese tax authorities will further explore new anti-avoidance measures concerning contemporaneous transfer pricing documentation, cost sharing arrangements, thin capitalisation, and controlled foreign corporations.
- The SAT will intensify efforts to collect information by leveraging their internal and external databases (e.g., databases containing information on corporate income tax returns and export tax refunds) as well as exchanging information with treaty partners.
- The SAT plans to expand its specialised team of tax anti-avoidance to 500 expert officials over the next three years.

The SAT has gained a remarkable level of sophistication in a very short time. The officials have also engaged in dialogue with the OECD.

China is committed to continuously learning and improving its enforcement operations in its bid to catch up with the tax authorities of developed nations.

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