

FSTP Perspectives

a publication for financial services industry tax and transfer pricing professionals

April 2007

Foreword

Dear Reader,

It is a pleasure to welcome you to this edition of FSTP Perspectives, our bi-monthly publication focusing solely on transfer pricing and related issues for financial institutions.

Although not strictly a transfer pricing matter, no one who deals with transfer pricing can have failed to observe the progress of the OECD's project on the Attribution of Profits to Permanent Establishment ("PEs"), a project which has been underway for almost 10 years and which has led to the production of a very lengthy paper on this topic. The project was essentially concerned with securing a consistent approach to the interpretation of Article 7(2) of the OECD Model to Double Tax Treaty, namely the task of how one goes about the business of allocating profits as between an existing Head Office and an existing PE.

The current position is that work on the development of the bulk of the project – in relation to the general application of the thinking (Part 1 of the Report); Banks loan business (Part 2); Global Trading (Part 3) has now been concluded, leaving 2007 as the year for the implementation of the project. Work on the final piece of the jigsaw – i.e. in relation to the Insurance Sector (Part 4 of the paper) is understood to be not far behind the other three parts.

Now that the bulk of the work on this project has been done and the task of implementation is in progress, it is perhaps appropriate to reflect on what has gone well and not so well with this very lengthy project.

There are various points that can be claimed to be amongst the positive developments arising from this project. First, the influential guidance on how the business of allocating assets is to be carried on has been updated. That guidance dates back to 1984 and the new material amends that approach in focusing rather more realistically not just on the origination of an asset but in looking at the whole life of financial assets from origination through subsequent risk management. Whatever we think of the "KERT's" analysis (which is used as the primary determinant of the allocation of financial assets: Key Entrepreneurial Risk Taking activities) it does seem to be a clear improvement over the creaking 1984 approach.

Second, there is greater clarity in the process used for the attribution process. The treatment of a number of specific points which previously caused confusion is now much more transparent – e.g. the whole approach to the bearing of risk and if so, whether and where this should be rewarded. A more sensible flexibility has also been introduced to deal with some key points in the analysis – for example, in the way KERTs should be applied from case to case; in the ability of a taxpayer to use its own methodology to compute the underlying risk in the business; and, there is a variety of approaches to the reward for capital. All these points are to be welcomed.

However, on the other side of the balance sheet, there are some points which are clearly less laudable. The sheer scale and ambition of the project might, in retrospect, have been a bridge too far. It is not clear whether the full scale of the undertaking was really appreciated at the outset but the very wide range of fundamental issues raised is not obviously

containable within a single project, even one that lasts about 10 years. Although the project focuses on Article 7 of the OECD Model Tax Treaty, various other articles in the Tax Treaty have been involved in the (sometimes heated) discussions.



Another fundamental concern is the approach. The project kicked off essentially by taking a blank piece of paper and identifying what seemed to be the best approach on the basis of a fresh start. Although one can see the attractions of this approach, it remains essential that whatever thinking is developed must fit into the existing framework of double tax treaties and this process has not proved easy. It is therefore, perhaps, no surprise that there are disputes not just between taxpayer and tax authority but between tax authorities themselves as to how this process of integration of the new thinking is best dealt with. Further, there are various aspects of the new approach that do not – to the taxpayer at least – seem particularly practicable. For example, it seems doubtful if any taxpayer has the systems necessary to deal with split assets where these arise as a consequence of the new approach.

Finally, it is doubtful if the project can be held up as a shining example of a consultation process that worked. Although there were various meetings with representatives of industry, the prevailing view of business seems to be that the process was not a conspicuous success. Indeed, from an industry perspective, the proposals arguably got worse, not better, as the consultative process went along, with multiple approaches to capital attribution being introduced (contrary to the wishes of industry) and what seemed to be a creeping anti-avoidance agenda emerging as the process went on.

Where are we now? We are left with some important issues which will emerge over the next year in the implementation process, (for example in relation to double tax relief), but it is perhaps naïve to think that the formal process now in progress will determine the roll out of the programme by the tax authorities. Those already having suffered from tax authority attack, based on the OECD's work in progress (in some cases with tax authorities citing draft OECD reports as clear support for their views!) may take the view that the formal implementation process is all about a careful and measured shutting of the stable door long after the horse has disappeared over the valley's horizon.

Based on the history to date, it seems highly likely that further twists and turns will emerge with the implementation proposals. Then there is also the tricky matter for taxpayers of dealing in practice with the variety of new measures...watch this space!

Richard Collier, PwC Banking & Capital Markets, Tax Leader

PricewaterhouseCoopers' *FSTP Perspectives* is a bi-monthly publication that offers an insight into trends and developments, tax authorities' approaches, and "hot" topic issues in financial services transfer pricing.*

Index

Introduction	1
Transfer Pricing Key Issues:	
Hedge Funds	2
Trends & Developments:	
• Germany: Approach for the Attribution of Profits to PE	3
• Changes to HMRC Guidance on the UK Thin Capitalisation Rules	4
• Changes in the German Transfer Pricing Legislation in 2008	6
• Update on US Global Trading Regulations	7
• Update: Private Equity in the United Kingdom	7
• Update: Japan Transfer Pricing Guidelines	8
Country Focus: Italy	8
Future Events:	
• 2007 Masters Series	10
• Germany & Switzerland	10

For more information related to this publication please contact any of the editorial team below:

Aamer Rafiq
aamer.rafiq@uk.pwc.com

Adam M. Katz
adam.katz@us.pwc.com

Irina Diakonova
irina.diakonova@ch.pwc.com

Niamh C Millar
niamh.c.millar@uk.pwc.com

Tracy Malyan
tracy.malyan@uk.pwc.com

Transfer Pricing Key Issues: Hedge Funds

Overview

It is hard to imagine that in less than a decade, hedge funds have gone from being considered at the fringe, and more esoteric edge of investment strategies, to being an integral part of (and having a significant influence on) the financial markets. The market has more than quadrupled in size in this period and now has more than over \$1 trillion assets under management. Governments have already taken an interest in the evolution of hedge funds, with significant numbers introducing tax legislation such as the United Kingdom's investment manager exemption ("IME") to facilitate the growth of these markets in their jurisdictions. The IME is essentially a safe harbour that allows investment managers to trade from a particular location without causing a permanent establishment of the fund in that jurisdiction (essentially only the return due to the investment manager is subject to tax rather than the overall gains to the fund).

Hedge fund managers have also become increasingly more international. The United Kingdom (and London in particular) is regarded as the home of the hedge fund market alongside the United States. As managers have sought to identify new opportunities and markets, their presence is now becoming increasingly more international and substantial both in Continental Europe and in the Asia-Pacific regions. As the hedge funds presence has grown and become more prominent in local jurisdictions, so has the taxing authorities' interest in their tax affairs. Hedge funds are traditionally associated with high profits (Long Term Capital Management aside) and a typically aggressive approach to tax management. As such, taxing authorities want to make sure they get their share of the overall profit pie and require a lot of convincing before they will accept that transfer pricing arrangements have been made on an arm's length basis.

Taxing Authorities Approach to Hedge Fund Transfer Pricing

As taxing authorities have become more focused on transfer pricing in the financial sector their specialist skills and experience in these fields has developed. Some now have specialist teams focusing on the financial services sector or its sub-components. For example, in the United Kingdom, Her Majesty's Revenue and Customs ("HMRC") has a dedicated team of specialists focusing on the tax affairs of hedge fund managers. HMRC has been especially vigilant in assessing for incorrect self assessments due to their perception of egregious transfer pricing arrangements. In most countries, the tax adjustment and penalties due to perceived incorrect transfer pricing is simply a consequence of getting it wrong. Another consequence, one potentially more hazardous than the additional tax paid in the United Kingdom at least, is that

transfer pricing failure can lead to a breach in the IME, potentially exposing the fund to a Permanent Establishment ("PE") in the UK.

Despite the growing scrutiny from the tax authorities, hedge fund managers continue to be in a good position to take advantage of transfer pricing to manage their effective tax rate. The key value drivers (or to borrow an OECD phrase, the key entrepreneurial risk taking ("KERT") functions) are the activities of a small number of people performing core portfolio management or distribution functions (in addition to the capital that is put at risk by the fund). As these value drivers are concentrated in a few personnel it is arguably easier to legitimately tax optimise a hedge fund business than businesses in a lot of the other financial sectors. Many hedge funds have already done exactly this by locating a significant portion of their overall functions in more tax efficient locations such as Cayman, Guernsey, Switzerland or Hong Kong while being more parsimonious with their presence in higher tax jurisdictions. Although the benefits are obvious, to be successful, arrangements of this type must be robustly evidenced and documented, and the real value driving functions, assets or risks must be located in the more tax-efficient jurisdictions.

At a very high level the transfer pricing policies in the hedge fund sector often focus on ways of allocating revenues/profits to the key value driver functions of:

- Portfolio Management: covering asset allocation, investment research, investment decisions, position risk management and performance related brand/reputation); and
- Distribution: covering targeting investors and selling the fund.

Whereas the portfolio management is typically done on some form of revenue or profit split and is usually non-contentious (though there are some interesting issues surrounding the actual implementation of revenue/profit splits and the allocation keys used in such a split), rewarding a distribution function can be of critical importance. This is often because it is based in a lower tax jurisdiction as a part of tax efficient planning, or because it is naturally separated from the main activities of the hedge fund manager because it has opened an overseas office with the primary aim of raising new capital. As such, the taxing authorities have increasingly focused on the distribution aspect of hedge fund transfer pricing as a means of successfully securing adjustments and penalties.

Distribution Function Benchmarks

The approach to rewarding the distribution function has typically employed three main methods:

- Characterising the capital raising function as an integrated function of the hedge fund activities and incorporating it within a revenue/profit split method;

- Rewarding the capital raising functions directly with a portion of the management fee (and sometimes the performance fee though practice has been inconsistent). This has typically been based on market “norms” of 20% or 25% of the management fee; or very rarely
- Identifying distribution as a routine business function and rewarding it with a mark-up on costs.

Traditionally, benchmarking the distribution function directly in the hedge fund context has been difficult because of the unavailability of third party benchmarks or a lack on internal comparables. Whilst market practice is to reward distribution with 20% or 25% of the management and performance fee, there has been little direct evidence to support this. Where benchmarking has been done, it has tended to draw evidence from the traditional fund world making comparability a difficult issue. Furthermore, other studies have tended to focus on data used for regulatory purposes such as ADV II data (for SEC filings purposes) which is comparable to the traditional fund model distribution but not comparable to hedge fund distribution.

Given these problems of comparability between industries and recognising that there can be significant tax and/or penalties at stake for most hedge fund managers (or fund managers that have hedge funds), during the course of 2006 PricewaterhouseCoopers LLP undertook research and analyses to develop a benchmark for this function (known as the “The Hedge Fund Distribution Benchmarking Report”). It is worth noting that we are increasingly finding taxing authorities arguing that a Comparable Uncontrolled Price should be used as these can be evidenced in the marketplace (and are also higher in the hierarchy of OECD Methods). This was another primary driver in conducting the Hedge Fund Distribution Benchmarking Report to ensure companies could meet their transfer pricing requirements as per the OECD Guidelines on method selection.

The Hedge Fund Distribution Benchmarking Report

The Hedge Fund Distribution Benchmarking Report that PricewaterhouseCoopers conducted took almost a year to complete and is pulled together from detailed interviews with more than 100 hedge fund managers and independent distribution agents. In addition, the Distribution Benchmarking Report also incorporates reviews of industry publications and publicly available filings of US hedge fund managers. We believe that this benchmark is unique in the marketplace and provides a robust basis upon which to either to support existing arrangements or to plan new structures.

The results illustrate, as is common with transfer pricing comparability analysis, that a range of possible compensation levels could be supported given the functionality of the distribution function centring on the industry standard of 20%. Further, the analysis focuses on the following issues which

have direct commercial and transfer pricing relevance to the hedge fund manager:

- How the distribution fee is calculated;
- Different components of the fee;
- The range of functions that agents perform for hedge fund managers;
- Factors influencing the agents’ fee; and
- Duration of the payment made to agents.

Increasingly, we are finding that these are the very issues that the taxing authorities are focusing on as part of their tax audits.

Closing Thoughts

The results of the Hedge Fund Distribution Benchmarking Report illustrate not only a clear consistency in the benchmark range for hedge fund distribution functions but also provide clear evidence that distribution is a critical and value adding function for a hedge fund manager. As taxing authorities become more sophisticated and as hedge funds focus more on tax efficient structures, the benchmarking of the distribution function is likely to become even more significant and robust documentation, such as the Hedge Fund Survey, will be needed to support any transfer pricing arrangement involving a distribution function.

For more information please contact:

Aamer Rafiq (aamer.rafiq@uk.pwc.com)

David McDonald (david.mcdonald@uk.pwc.com)

Trends and Developments: Germany - "Functionally Separate Entity" approach for the attribution of profits to permanent establishment accepted

The introduction of the Protocol amending the 1989 Income Tax Convention between Germany and the United States, signed on June 1, 2006, changes the German Tax Authorities' general view on how business profits should be attributed to the permanent establishment ("PE"). It is worth noting that the interpretation of this Protocol has not yet been applied in general. This amendment prefers a "functionally separate entity" approach which has been intensively discussed and finalized by the OECD in December 2006. By adopting this approach, the profits to be attributed to the PE are the profits that each entity might be expected to make if they are a distinct and separate entity engaged in the same or similar activities.

Trends and Developments: Changes to HMRC Guidance on the United Kingdom Thin Capitalisation Rules

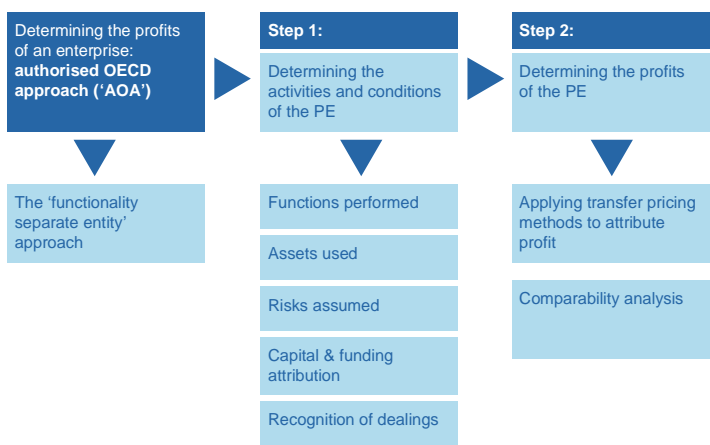
Introduction

Under the United Kingdom (“UK”) thin capitalisation rules (which, on 1 April 2004, were brought wholly within the transfer pricing regime), companies are required to report that their intragroup funding arrangements reflect arm's length conditions for corporation tax purposes. In doing so, companies should be able to demonstrate that both the amount of debt borrowed from related parties (both UK and foreign) and the interest rates attached to that debt reflect the terms at which they could borrow at from third party lenders. To assist local inspectors of tax in dealing with thin capitalisation enquiries, HM Revenue & Customs (“HMRC”) has published a number of chapters in its International Manual which set out the processes that inspectors are expected to follow and provide guidance on how to deal with issues that often arise in the context of intragroup debt. This guidance is publicly available¹ and so provides a useful indicator of HMRC's approach to thin capitalisation. A number of updates have been made to the guidance available from HMRC, effective from 10 January 2007, and a number of areas relevant to companies in the Financial Services (“FS”) sector are summarised in this short article. Whilst none of these changes represent a dramatic change in HMRC's general approach to thin capitalisation, they do highlight certain key implications for companies in the FS sector either seeking to increase debt in their UK operations or defend the thin capitalisation position of UK group companies which already have high levels of debt.

Commerciality of Group Reorganisations

New guidance suggests that HMRC may take a more sceptical view where intragroup debt is introduced into a UK company following a group reorganisation. The reasoning provided is that the normal benefits of an acquisition which are typically used to justify increased gearing, e.g. economies of scale, cost efficiencies and other benefits from the reorganisation likely to result in enhanced cash flows, will be "minimal or absent" since the group entities will already be enjoying these benefits. While this argument may not be wholly convincing, or at the very least not necessarily true in all cases, companies may expect greater challenge in this area. In particular, our experience suggests that restructured groups may be more closely scrutinised by HMRC, who may use this new guidance to challenge the structure on multiple fronts, e.g. by requesting evidence demonstrating that the provisions of the transfer pricing and thin capitalisation rules, loan relationship rules (in respect of the commerciality of new debt) and the new

¹ The HMRC International Manual is available at <http://www.hmrc.gov.uk/manuals/intmanual/index.htm>



A general view on the attribution of profits is illustrated in the German Administrative Principles published in 1999. According to these principles, the approach applied by the German Tax Authorities can either be the "functionally separate entity" or "relevant business activity" approach depending on the type of transactions and the underlying functional profiles. For example, any internal transactions irrelevant to market transactions are expected to incur no mark-up or profit element. However, during the past few years, considerations on the profits to be attributable to the PE have been developed and Germany tends to follow the approaches as suggested in the OECD papers. This was evidenced by the German Ministry of Finance's release of the Administrative Principles for the Attribution of Dotation Capital to Branches of International Banks, which was effective since January 1, 2004. Additionally, the "functionally separate entity" is perceived by most OECD member countries as the approach that is more consistent with the arm's length principle.

An explanation on the application of the "functionally separate entity" approach is illustrated in the following example. A US headquartered bank with head office functions has a German branch that sells various financial products in the local market. This branch is considered a PE in Germany. The PE only sells financial products and, from time to time, receives IT support and training services from the head office. In the past, the services received from the head office would be charged at cost without any profit realization as the head office and the PE are treated as the same legal entity. Hence, no mark-up would be applied. However, in the future, upon the introduction of the new protocol, the profits to be attributed to the PE should be remunerated on an arm's length basis.

For more information please contact:

Jobst Wilmanns (jobst.wilmanns@de.pwc.com)
Christian Jacob (christian.jacob@de.pwc.com)

Avoidance through Arbitrage legislation (or some combination of these rules) are all met.

We are noting a large amount of activity in relation to the introduction of debt as part of such reorganisations taking place within the FS sector. Following the release of the new guidance, it has become more of an imperative that companies considering a restructuring involving new intragroup debt in a UK company should carefully consider both the terms of the financing and the reasons for introducing the new debt.

Referrals to International Corporation Tax

Historically, HMRC has operated on the basis where referrals by local inspectors to HMRC's thin capitalisation specialists would be made where the financing under enquiry amounted to £50 million or more. Guidance on this process has been amended to note that the threshold for automatic referrals will be raised in the near future (although no information has been provided on exactly when this will happen or what the new threshold will be). However, inspectors are now being asked to refer at an early stage any cases involving the following issues to HMRC's thin capitalisation specialists regardless of the amount of the underlying borrowing:

- Increased intragroup debt as a result of a group restructuring;
- Loans from a subsidiary to a parent and other types of "upstream loans";
- Intragroup loans that have been arranged such that lenders and borrowers are in jurisdictions with favourable bilateral tax treaties, i.e. so called 'treaty shopping';
- Intragroup loans where the immediate lender has borrowed the funds on a back-to-back basis that, therefore, may not be the beneficial owner of the interest charged on the loan;
- Private equity transactions;
- The loan relationship unallowable purposes rules;
- Borrowing to repay share capital (e.g. due to rules under American Job Creation Act 2004);
- Excessive dividends / borrowing to pay dividends;
- Tax arbitrage; or
- Cases involving the use of credit ratings.

The point above, indicating increasing HMRC attention to cases where credit scoring is involved, is interesting and indicates the increasing use of analytical tools, such as PricewaterhouseCoopers' *i-rate*², to support both debt capacity and interest rates. The use of such tools in certain areas of the

² *i-rate* is a tool developed by PwC's global transfer pricing group to provide robust support for intragroup loan pricing. The *i-rate* analysis establishes values for the key determinants of loan pricing and then benchmarks this against a wide selection of available market data.

financial services sector; particularly in the case of regulated entities, is often not appropriate. This is because the standard financial ratio analysis (used to derive credit scores) that is applied to non financial services companies bears little relevance to financial services companies whose balance sheet structures are wholly different due to the nature of their business. HMRC intends to issue further guidance on its views of this type of analysis in early 2007. PricewaterhouseCoopers will publish its comments on the new material in a future issue of FS Perspectives once the guidance has been made available.

Timing of an Enquiry

Two significant changes have been made to the guidance on the timings of an enquiry. Firstly, previous versions of the International Manual suggest that, under certain circumstances, it may be correct to assume that HMRC accepted the arm's length nature of the loan if no enquiry was raised and clearance to pay interest gross of withholding tax under a Double Tax Treaty (or under the EU Interest & Royalties Directive) has been provided. The new version of the International Manual categorically rejects this view, stating that Treaty clearances do not prejudice any later enquiries into the interest paid. This revision indicates that such a view has been sustained in the past but will not be accepted going forward. From a practical perspective, this suggests that increasing numbers of Treaty clearances may be granted without any comfort from HMRC as to the deductibility of interest. Despite this change, PricewaterhouseCoopers will continue its policy of requesting HMRC to agree to the thin cap position as part of the clearance process. Secondly, new guidance has been provided on clearance applications made under the EU Interest & Royalties Directive, noting that the 90 day time limit to reach a conclusion does not prevent a thin capitalisation case from being conducted but that the circumstances and procedures would be different. No further guidance has been given as to what these different circumstances or procedures will be, although PricewaterhouseCoopers is currently collecting anecdotal evidence on its experience in this area.

Reviewing Intragroup Loans

On a positive note, new guidance has been added to the International Manual dealing with the factors that inspectors should consider when examining the arm's length nature of intragroup loans. Previously, the three factors given were:

- The period of the loan;
- The capacity of the borrower to make early repayments of loan principal; and
- The interest rate on the new borrowings (particularly in comparison to the third party interest rates paid on the company's other borrowings).

A new, fourth factor has been added noting that companies often have a mixed debt profile containing flexible short term (often revolving) debt and longer term debt (often linked to large items of expenditure). Inspectors are reminded to review the terms of the intercompany debt in the context of its term/purpose.

HMRC tends to review thin capitalisation issues from both the perspective of the lender (could the company have borrowed) and the borrower (would the company have borrowed). As such, this is a helpful development as it suggests that companies may have borrowed several loans from within the group on different terms (e.g. at varying levels of subordination) and that this is not necessarily a non-commercial outcome, i.e. the company would have borrowed in this manner at arm's length. This change may also imply that large, long term intragroup borrowings will be examined in the context of a typical borrowing "profile" for a company acting at arm's length.

For more information please contact:

Daniel Alter (daniel.alter@uk.pwc.com)
Kevin Smith (smith.kevin@uk.pwc.com)
Mohamed Serokh (mohamed.serokh@uk.pwc.com)
Aamer Rafiq (aamer.rafiq@uk.pwc.com)

Trends and Developments: Germany- Expected changes in transfer pricing legislation 2008

Following the transfer pricing documentation rules in 2005 and the new arrangements for advance pricing agreements in 2006, the first official draft version of the corporate tax reform 2008 contains a significant extension in German transfer pricing legislation. Changes affect especially Art. 1 of the German Foreign Tax Law (AStG) and Art. 90 par. 3 of the German Fiscal Code (AO).

The most important changes affect the new Art. 1 AStG which will define its own applicability in relation to the other German income adjustment norms, such as hidden profit distribution and hidden contribution. In future, the "arm's length principle" will apply in addition to the other German income adjustment norms in case the other norms lead to lower income adjustments. Consequentially the terms and conditions of all crossborder intercompany transactions will be principally examined according to their "arm's length nature".

Arm's Length Principle

The new regulations will also contain a defined and detailed description with regard to the practical application of the "arm's length principle". The starting point for the verification of the arm's length nature of crossborder intercompany transactions is the perspective of a respectable and conscientious director

("ordentlicher und gewissenhafter Geschäftsleiter") - a model that originated in German supreme tax court (BFH) rulings. On this basis the new regulations define three successive steps relating to the comparable information actually available in the audited company in order to derive/verify the arm's length nature of its transfer prices.

Arm's Length Range

In cases with no available Comparable Uncontrolled Prices - the first and preferred transfer pricing method - the taxpayer has to draw on limited comparable values (e.g. prices, margins, mark-ups, etc.) to adjust them and to demonstrate the appropriateness of the transfer pricing on the basis of another "suitable" transfer pricing method. Furthermore, in cases where different limited comparable values exist, the resulting range has to be narrowed by the taxpayer (a decree is to be issued which will most likely fix the interquartile-range as obligatory). If the taxpayer's transfer price lies outside this narrowed range, it will be adjusted to the median. This procedure contradicts with the current BFH rulings which grant the taxpayer the whole range of "arm's length prices" as acceptable. In cases where there are no available (limited) comparable values, the taxpayer has to perform a "hypothetical" comparison by taking into account the minimum price acceptable to the providing company and the maximum price acceptable to the receiving company. In this case the resulting mean value shall be relevant for income corrections; with the exception that the taxpayer proves the higher probability of another price within the range. The concepts behind minimum/maximum prices are not detailed in the norm and are, therefore, to some extent vague. However, a formal decree specifying these concepts is expected shortly.

Business Restructuring

Furthermore, the new regulations refer to the transfer/relocation of functions which should primarily be treated as "transfer package" for evaluation purposes. In cases where no (limited) comparable prices exist for the transfer of functions, the minimum/maximum price concept mentioned above shall apply as well. Notwithstanding this, it shall be possible for the taxpayer to evaluate the transferred assets on a stand-alone basis (separate valuation) if he can prove that the separate valuation results in a similar outcome to the "package" approach.

In relation to these new statutory provisions on the transfer of functions, which regularly fall into the definition of "extraordinary business transactions", it can also be seen that the planned tightening of Art. 90 par. 3 regarding the submission deadline of documentation notes for these kinds of transaction moves from 60 days to only 30 days.

For more information please contact:

Jobst Wilmanns (jobst.wilmanns@de.pwc.com)
Christian Jakob (christian.jakob@de.pwc.com)

Update: US Global Dealing Regulations

On February 28, 2007, Steve Musher, Associate Chief Counsel (International) at the Internal Revenue Service ("IRS"), participated on a transfer pricing panel at the International Fiscal Association USA Branch Annual Meeting in New York. The discussion topics included the following:

Global Dealing

The Global Dealing Regulations, replacing the 1998 Proposed Regulations, are expected to be issued in proposed form prior to June 30, 2007. These regulations will also address guarantee fees but it has not been confirmed whether this will only be in a global dealing context or with respect to guarantee transactions more broadly.

Guarantee Fee Measurement

It was noted that some taxpayers had requested that, in setting out rules regarding valuing guarantee fees, the IRS not require taxpayers to divide a passive association benefit from the fee for the guarantee per se. Stated otherwise, when a parent guarantees the debt of a subsidiary, the question is whether the guarantee fee should be the amount an unrelated party would charge to bring the credit from the stand alone rate to the guaranteed rate, or whether the fee should be the amount an unrelated party would charge to bring the rate from the "passive group member" rate to the guaranteed rate. It was noted that the IRS would like to receive input from taxpayers on this issue -- to be consistent with the Temporary Services regulations, the IRS approach is to not require payment for the passive association benefit but the measurement of such benefit may prove difficult.

Applying the Temporary Services Regulations

There is no consistency requirement in connection with the application of the Services Cost Method ("SCM") of Temporary Regulation Sec. 1.482-9T. That is, a taxpayer can rely on SCM with zero mark-up on costs for some services, and rely on another method to support a "plus" with respect to other services.

Regarding which method to use in valuing equity compensation under the Temporary Services Regulations, in applying the SCM, since comparability (unlike the Comparable Profits Method) is not at issue, and because the Temporary Regulations do not state a required, or preferred method, the taxpayer has the choice of which method to use. However, further guidance is likely to be given on this issue.

For more information please contact:

Adam Katz (adam.katz@uk.pwc.com)
Joseph Andrus (joseph.andrus@us.pwc.com)

Update: Private Equity in the United Kingdom

In recent months, there have been significant developments with respect to the private equity industry in the United Kingdom ("UK"). The stimuli for this were the proposed changes to the tax rules designed to bring private equity acquisition debt within the transfer pricing rules and to ensure that private equity investors and investee companies were connected parties for tax purposes, as proposed by the UK Treasury in March 2005. The legislation implementing the changes was enacted on 4 March 2005. These rules apply to debt financing provided after that date but will not be effective for debt financing provided before that date (unless varied) until 1 April 2007. The rules meant that the transfer pricing rules apply where parties who collectively control a business act together to finance that business – as in a typical private equity backed acquisition. The practical effects of the changes are to:

- a) Deny or restrict a corporation tax deduction for the investee company for debt interest to the extent that the loan is not on arm's length terms; and
- b) Deny a corporation tax deduction for unpaid (e.g. rolled up interest) or late paid interest unless and until the interest is actually paid.

Building on the changes made in March 2005, the UK Treasury has recently announced a further review of tax arrangements used by private equity firms. Speaking a few weeks ago, the economic secretary to the Treasury (Ed Balls) said that the review would focus upon whether the tax system should continue to regard interest payments on shareholder debt as a tax-deductible business cost. No terms of reference were released for the review, but it was understood that the aim of the review would be to understand whether the UK tax system gives an unfair advantage to private equity over other forms of ownership - in particular as a result of the tax-deductibility of interest. It was also commented that the review follows concerns raised with the Treasury that 'shareholder debt' is replacing equity in highly leveraged private equity funding arrangements in a few cases.

In view of these recent developments, in the following issue of FSTP Perspectives, we will provide an analysis of the typical types of private equity arrangements that have given rise to the concerns represented to the Treasury. We will also discuss some of the practical considerations private equity investors and investees need to make to overcome obstacles, particularly in the context of a transfer pricing related audit.

For more information please contact:

Mohamed Serokh (mohamed.serokh@uk.pwc.com)
Aamer Rafiq (aamer.rafiq@uk.pwc.com)

Update: Japan – Transfer Pricing Guidelines

Following discussions since October 2006 between the Japanese National Tax Agency (“NTA”) and a study group formed by the Ministry of Economy, Trade and Industry (“METI”) comprised of academics and representatives of the Japanese business community (including the main Japanese business association, Keidanran), the NTA has recently announced that it will provide further transfer pricing guidance to assist Japanese taxpayers to deal with cross border intercompany transactions. The discussions between the NTA and the METI study group arose as a result of growing concerns amongst the local business community about the increasing size and frequency of large transfer pricing assessments; and a perceived lack of transparency in the way that the tax authorities determine arm’s length prices, particularly for transactions involving intangible property.

Technology, Brands and Other Intangible Assets

In its March 15, 2007 morning edition (Japanese and English versions), the Nikkei reported that the NTA’s new guidelines will deal with transactions in relation to technology, brands and other intangible assets, and may be released as early as this summer. For greater clarity, the guidelines will provide examples of particular transactions, and will identify what factors may have an impact on a particular cross border transaction. In the case of a transfer of production expertise for example, the guidelines may demonstrate how if a patent exists, or if a subsidiary has altered the specifications of the relevant technology, this may impact the respective tax obligations. In addition, the guidelines may provide specific industry examples of the value to be placed on a subsidiary’s use of brand intangibles.

Implications for Financial Services Industry

For financial institutions, the question remains whether the guidelines will deal with the peculiar aspects of the financial services industry. For example, how should the transfer of “production expertise” be measured in a proprietary or structured products trading situation? What impact do brand intangibles have in the financial services industry, if any? At this stage it is too early to say, but given the focus of the METI study group, there is some doubt that the new guidance will sufficiently address issues that most directly concern taxpayers in the financial services industry.

More generally, the NTA has also indicated that it is looking at overhauling the APA programme to make it more responsive and timely, by increasing the number of APA examiners and/or by introducing streamlined APA review procedures for smaller size businesses. Interestingly, there has also been consideration given to some form of documentation requirement, which may be introduced in a future law reform

package; however, this issue has yet to be discussed in any detail.

For more information please contact:

Ryann Thomas (ryann.thomas@jp.pwc.com)

Country Focus: Italy

Country focus is a regular feature of this publication which seeks to provide an insight into emerging issues, taxing authority approaches and “hot topic” issues for a country where transfer pricing is becoming increasingly more relevant and important as part of your overall strategy on managing transfer pricing from a risk and planning perspective.



This publication’s country focus is Italy and is presented by Fabrizio Acerbis. Fabrizio leads the financial services transfer pricing team in Italy which consists of professionals with both transfer pricing and FS industry knowledge. The group is regularly involved in PricewaterhouseCoopers FSTP assignments and keeps in regular contact with the Italian major banks and financial institutions on transfer pricing matters.

Transfer Pricing Legislation in Italy



Article 110 of the Presidential Decree n. 917, dated December 22, 1986, contains the statutory rules for transfer pricing adjustments. Under these rules, the Italian tax authorities may adjust the taxable income of an Italian corporation when related party transactions are not

carried out at arm’s length. This adjustment may only be upward. Downward adjustments may only be made as a result of a competent authority decision under an applicable income tax treaty.

The Italian tax authorities have provided some limited guidance in this area and their main commentary is relatively outdated, mainly focusing on the 1979 version of the OECD transfer pricing Guidelines. In a first circular letter issued in September 1980, the Italian tax authorities commented, substantially accepting the general principles stated in the 1979 OECD Guidelines. Today this document is still considered to be the main point of reference for the Italian tax authorities. Aside from the original regulation, integrated and clarified by a second circular letter issued in 1981, the Italian tax authorities have not yet issued any material comments or guidance on transfer pricing matters.

A significant boost in the transfer pricing area is, however, clear from the issuance, in late 2003, of new international tax ruling procedures through which it may be possible to reach an advance pricing agreement with the Italian tax authorities.

The new procedures are still being tested by taxpayers and little actual experience has been made in this area. The extent to which this instrument will be used will mainly depend on the approach of the tax authorities in understanding the issues and accommodating each taxpayer's specific requests with a flexible and business oriented eye.

This type of approach, unknown in a tax audit context, is yet to be proved to the Italian tax and business community.

Overview of the Transfer Pricing Environment

The financial services industry, its international ramifications and particularly the transfer pricing areas have become critical points of interest for the Italian tax authorities in their recent audit activities. Some of the reasons stem from a general increased attention to international tax issues however, other reasons may be sought amongst specific issues of the Italian market.

The first factor resides in the recent financial scandals. In the wake of financial scandals such as Enron, WorldCom and Tyco, the Italian market faced its own billionaire scandal with Parmalat. Use of derivatives, complex financial transactions and the lack of transparency clearly put pressure on anyone having responsibility for monitoring the operations of multinational enterprises and the role of international financial institutions. In response to the market's demand for confidence, the Italian tax authorities feel compelled to increase their monitoring activities towards the capital market and the financial sector.

Secondly, the Italian economic situation is still suffering from a crisis that has knocked down the current public accounts and brought up the level of public debt to peak records. In this environment, taxes collected through audit activities have a critical role in the game, particularly when the business community is calling for a general reduction in the level of taxation, promised at length by the government during the last electoral campaign. The second semester of 2006 has shown a strong increase in revenue collection, going well beyond the initial budget expectations. However, it is likely that pressure on the Italian tax authorities to maintain this trend will continue.

Recent Areas of Focus on Financial Services Transfer Pricing

In the past, the number of tax audits specifically focused on transfer pricing matters was relatively limited. Similarly, the areas of focus have been historically limited to the charge out of management fees or head office expenses. In these instances, existence of legal agreements and evidence of the provision of the service were crucial even before any analysis or discussion on the reasonable amount of the charges could take place.

However, the clear trend is towards a more sophisticated approach touching a number of areas where tax authorities are rapidly gaining business and technical knowledge, such as:

- (i) **Remuneration of advisory service companies.** Many foreign investment operators have often formed Italian entities providing advisory and asset management services. These entities, largely remunerated through cost-plus arrangements, are potentially exposed to transfer pricing adjustments when other additional services such as origination, deal sourcing or more importantly, negotiations are made by people operating for these entities.
- (ii) **Inter-company risk-shifting agreements and derivatives.** The use of these agreements within the group is likely to become a matter of scrutiny to ascertain whether or not these payments were at arm's length.
- (iii) **Level of inter-company interest and adequacy of debt level.** The Italian tax authorities have shown an increased interest in the level of interest charged on intra-group loans, and more particularly, the level of Italian leverage, somewhat independently from capital regulatory requirements. Whether this approach will be maintained in future tax audits is yet to be seen.
- (iv) **Challenge on dependent agent permanent establishments.** In the recent past, more than transfer pricing assessments, the tax authorities have audited major investment banking operators assessing the existence of unwanted Italian permanent establishments. In this very fact oriented area, the tax authorities are generally more focused, probably because under this approach an in-depth understanding of the taxpayer's business is felt less stringent and their role in determining the profit allocation is crucial. It is likely that this approach will be maintained over time and therefore permanent establishment audits will be kept a priority.
- (v) **Attribution of profits to permanent establishments.** The number of audits insisting on the existence of permanent establishments will obviously put significant pressure on the proper profit attribution, which is likely to be based on the arm's length principles and separate entity approach recently recommended by the OECD.

Tax Authorities' Approach to Transfer Pricing

The tax authorities' approach has been significantly changing over the last few years in terms of resources and competence. The formation of dedicated transfer pricing teams, the increased general attention towards international tax matters and the new advanced pricing procedures have strongly contributed to this change.

Despite little activity in providing guidance, the Italian tax authorities have been increasingly active in auditing transfer pricing matters, through the use of dedicated teams. In a typical tax audit, any material intra-group transaction is being put under scrutiny to understand its economic justifications, associated pricing and documentary support. As a consequence of this attitude, the number of tax assessments and litigations in the transfer pricing areas has increased.

One approach has however, been consistent over time: the identification of any documentary support for intra-group

transactions and the analysis of whether these agreements have been properly implemented. The first step of the analysis is generally aimed at identifying whether or not the legal agreements properly reflect the existing facts or, differently, are based on incorrect or outdated assumptions. Once the consistency of the agreements and the existing facts have been determined, the key is to verify whether the pricing methods used in the framework of these arrangements have been properly computed and reflected in the accounts. Any inconsistency arising from this base analysis is likely to result in a tax assessment regardless of the fairness of the adopted methodology or pricing.

Closing Thoughts

The increased attention of the tax authorities towards transfer pricing issues, the market knowledge deriving from the new advanced pricing agreements and the budget pressure is likely to intensify tax audit activities on financial services operators, also focused on transfer pricing issues and allocation of profits to local branches. The creation of legal documents supporting inter-company arrangements, their consistency with the existing factual situation and the proper accounting of their economic formulas and effects will remain critical. Financial services operators should therefore review their existing transfer pricing policies and associated documentary support. Additionally, some operators may also start exploring the feasibility of advanced pricing agreements when appropriate.

For more information please contact:

Fabrizio Acerbis (fabrizio.acerbis@it.pwc.com)

Alessandro Caridi (alessandro.caridi@it.pwc.com)

Future Events:

April 16, 2007, Frankfurt, Germany

International Reflection of the New Versions of the OECD Report on the Attribution of Profits to Permanent Establishment,

For information contact:

Jobst Wilmanns (jobst.wilmanns@de.pwc.com)

May 10, 2007, Geneva, Switzerland

Financial Services Transfer Pricing Lunch Meeting

Topic: Practical Implications of the OECD reports on Attribution of Profits to Permanent Establishments (Part I-IV)

For information contact:

Irina Diakonova, (irina.diakonova@ch.pwc.com)

May 11, 2007, Zurich, Switzerland

Financial Services Transfer Pricing Breakfast Briefing,

Topic: Practical Implications of the OECD reports on Attribution of Profits to Permanent Establishments (Part I-IV)

For information contact:

Irina Diakonova, (irina.diakonova@ch.pwc.com)

Future Events: Transfer Pricing Masters Series



Transfer Pricing Masters Series for Financial Services Professionals

Our 2007 global Masters Series events for financial services professionals will be held in:

- London (April 19),
- Toronto (May 31),
- Sydney (July 24), and
- Hong Kong (July 26).

The Masters Series is an event dedicated to cutting edge, pragmatic and interactive sessions on the current transfer pricing approach taken by the major OECD member country taxing authorities, led by our financial services transfer pricing specialists and guest speakers.

For more information please contact:

Tracy Malyan (tracy.malyan@uk.pwc.com)

Global Financial Services Transfer Pricing Specialist Network

Europe FSTP Country Leaders		Email	Phone number
Austria	Herbert Greinecker	herbert.greinecker@at.pwc.com	+43 1 50 188 3300
Belgium	Patrick Boone	patrick.boone@be.pwc.com	+32 2 710 4366
Denmark	Jorgen Andersen	jorgen.juul.andersen@dk.pwc.com	+45 3 945 9434
Finland	Jukka Karjalainen	jukka.e.karjalainen@fi.pwc.com	+358 9 2280 1792
France	Marie-Laure Hublot	marie-laure.hublot@fr.landwellglobal.com	+33 1 5657 4351
Germany	Jobst Wilmanns	jobst.wilmanns@de.pwc.com	+49 69 9585 5835
Hungary	Zaid Sethi	zaid.sethi@hu.pwc.com	+36 1 461 9289
Ireland	Gavan Ryle	gavan.ryle@ie.pwc.com	+353 1 704 8704
Italy	Fabrizio Acerbis	fabrizio.acerbis@it.pwc.com	+3902 91605 001
Luxembourg	David Roach	david.roach@lu.pwc.com	+352 49 4848 3057
Netherlands	Michel van der Breggen	michel.van.der.breggen@nl.pwc.com	+31 20 568 6160
Norway	Morten Beck	morten.beck@no.pwc.com	+47 9 526 0650
Poland	Piotr Wiewiorka	piotr.wiewiorka@pl.pwc.com	+48 2 2523 4645
Portugal	Carlos Bernarde	carlos.bernardes@pt.pwc.com	+351 2 1791 4202
Russia	Svetlana Stroykova	svetlana.stroykova@ru.pwc.com	+7 49 5967 6024
Spain	Javier Gonzalez Carcedo	javier.gonzalez.carcedo@es.landwellglobal.com	+34 91 568 4542
Sweden	Pär Magnus Wiséen	paer.magnus.wiseen@se.pwc.com	+46 8 5553 3295
Switzerland	Irina Diakonova	irina.diakonova@ch.pwc.com	+41 58 792 4210
South Africa	Jacques van Rhyn	jacques.van-rhyn@za.pwc.com	+27 11 797 5340
United Kingdom	Aamer Rafiq	aamer.rafiq@uk.pwc.com	+44 20 7212 8830
	Annie Devoy	annie.devoy@uk.pwc.com	+44 20 7212 5572
	Lisa Casley	lisa.casley@uk.pwc.com	+44 20 7213 8333
Asia Pacific FSTP Country Leaders		Email	Phone number
Australia	Nick Houseman	nick.p.houseman@au.pwc.com	+61 2 8266 4647
China	Cassie Wong	cassie.wong@hk.pwc.com	+86 10 6561 2233, ext. 7823
Hong Kong	Florence Yip	florence.kf.yip@hk.pwc.com	+85 22 289 1833
India	Dhaivat Anjaria	dhaivat.anjaria@in.pwc.com	+91 22 6669 1471
Japan	Stuart Porter	stuart.porter@jp.pwc.com	+81 3 5251 2944
Korea	Shin-Jong Kang	shin-jong.kang@kr.pwc.com	+82 2 709 0578
Malaysia	Thanneermalai Somasundaram	thanneermalai.somasundaram@my.pwc.com	+60 3 2693 1077, ext. 1852
New Zealand	Michael J Bignell	michael.j.bignell@nz.pwc.com	+64 9 355 8051
Singapore	Paul Lau	paul.st.lau@sg.pwc.com	+65 6236 3733
Taiwan	Richard Watanabe	richard.watanabe@tw.pwc.com	+88 62 2729 6666, ext. 6704
Americas FSTP Country Leaders		Email	Phone number
Argentina	Juan Carlos Ferreiro	juan.carlos.ferreiro@ar.pwc.com	+54 11 4850 6712
Brazil	Marcos Almeida	marcos.almeida@br.pwc.com	+55 11 3674 3350
Canada	Brenda Humphreys	brenda.j.humphreys@ca.pwc.com	+1 416 814 5765
Chile	Roberto Carlos Rivas	roberto.carlos.rivas@cl.pwc.com	+56 2 940 0151
Colombia	Carlos Mario Lafaurie Escorce	carlos_mario.lafaurie@co.pwc.com	+57 1 634 0492
Mexico	Jaime Heredia	jaime.heredia@mx.pwc.com	+52 55 5263 5721
Peru	Rudolf Röder	rudolf.roeder@pe.pwc.com	+51 1 211 6500, ext. 1906
United States	Adam Katz	adam.katz@us.pwc.com	+1 646 471 3215
	Barry Dennis	barry.dennis@us.pwc.com	+1 646 471 3390
	Joseph Andrus	joseph.andrus@us.pwc.com	+1 617 530 5455
	Stan Hales	stan.hales@us.pwc.com	+1 415 498 6086
Venezuela	Fernando Miranda	fernando.miranda@ve.pwc.com	+58 212 700 6123

<http://gweb01.nam.pwcinternal.com/globalfstpnetwork> to access our global network details

www.pwc.com