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FSTP Perspectives

A publication for financial services industry tax and transfer pricing professionals

June 2007

Foreword

Dear Reader,

It is a pleasure to welcome you to the June Edition of FSTP Perspectives. In our April edition Richard Collier discussed in this forward section the ongoing debate at the OECD regarding attribution of profits. In this edition, I would like to discuss some of the additional general trends we see in transfer pricing around the globe. While the long-run concerns around attribution of profits issues are one key long-term trend, we focus this month on the more immediate impacts of much more aggressive tax audits and FIN48. I look at how taxpayers are responding to the new paradigm and specifically how tax directors can add sustainable value while managing global transfer pricing risks.

The new paradigm

We are seeing a shift in the way companies have to deal with transfer pricing issues. This shift is being driven by several key factors, some tax related, some cost reduction driven and some capital market driven.

First, transfer pricing disputes are becoming more aggressive and integrated across countries/regions. Some of the ominous trends we see evolving are driven by the tax authorities globally in their individual efforts to get "their share" are:

- tax authorities are sharing information across borders to a much greater extent on Transfer Pricing;
- tax authorities are performing Audits on a bilateral or multilateral basis; and
- tax authorities adding enforcement resources.

In addition, tax authorities are tightening their documentation requirements, revising their regulations (such as the Internal Revenue Service's Temporary Regulations for Services), adding penalties, and generally becoming more sophisticated in their audit approaches around the globe. In particular, many developing capital investment centers, such as China and Russia, which previously did not have significant transfer pricing audits or regulations, are developing audit capabilities which will be world class once their new rules are adopted.

Second, the unprecedented volume of global compliance and audit responses needed to manage disputes in the transfer pricing area is driving companies to seek more cost effective ways to manage their global transfer pricing risks.

Finally, we see FIN48 creating a new information regarding uncertain tax positions and new objectives for those SEC registered companies. This is due to the future potential for Tax Authorities to gain access to the work papers dealing with uncertain tax positions and the transparency of these positions and their ultimate outcomes are revealed on financial statements. Given the size of many transfer pricing disputes and the multiple year nature of transfer pricing positions, it is anticipated that it will be one of the major disclosure areas in a FIN48 world.

These factors and the ever increasing volume of multinational business flows has spawned a need for greater global consistency, renewed focus on both the form and substance of transactions, and more efficient management of global compliance/defense costs. The changing landscape will also drive renewed interest in APAs, rulings, and similar "certainty" approaches to manage transfer pricing risks globally around uncertain transfer pricing tax positions.

Because multinationals will be seeking greater certainty in their positions; the avoidance of perceived "earnings surprises" and (or) negative press related to unfavorable (favorable) transfer pricing dispute resolutions will partially drive this behavior. We think this shift in paradigm will create a new objective for many corporate tax departments: the objective to obtain the lowest sustainable effective tax rate.

In anticipation of the new environment you should begin to:

i) Treat local documentation as part of your global solution and "layer one" of a defense file, not minimal local compliance;

ii) Be consistent in your approach to similar transfer pricing issue around the globe (while likely upgrading your analyses; you may also see efficiency gains with this approach);

iii) Evaluate both the appropriateness of both the substance and form of your transactions (can you clearly show that your business model is consistent with the arm's length principle?); and

iv) Consider alternative dispute resolution/certainty: APAs, rulings, and other similar approaches.

In addition, we see a future where the transfer pricing challenges will not always be about correct transfer pricing (while respecting a transaction's characterization), but more often in the future the tax authorities will attempt wholesale re-characterization of transactions to better suit the tax authority's interests. These attacks may manifest themselves in several potential forms:

i) Permanent Establishment;

ii) disrespect for the transaction via looking through the transaction to another level; or

iii) re-characterization of an entity's or transaction's functions, risks and Intellectual Property (eg, 'Key Entrepreneurial Risk Taking' may mean different things to different people).

Therefore, in summary you must now carefully document the business purpose and arm's length nature of any transaction structure and also have proper legal form behind it. We believe that companies can continue to sustain their tax positions when these "arm's length standard" fundamentals are firmly in place. Please enjoy the remainder of this edition of the FSTP Perspectives.

Garry Stone, Ph.D.
Global Leader of Transfer Pricing Services

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.*

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Increased focus on intra-group loans for non-financial corporations

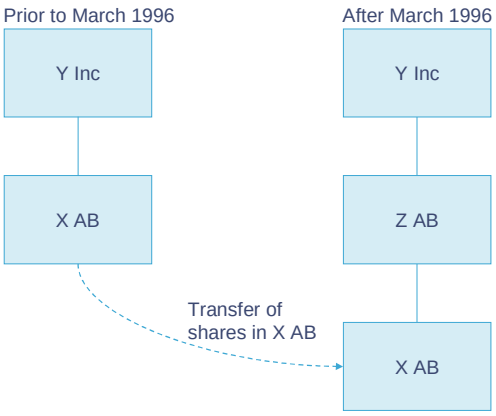
Introduction

Intra-group financing activities are of increasing interest to local tax authorities around the world. The main reason for this is that loans and other types of intra-group financing account for a major portion of the funds transferred across international boarders, and consequently, if priced inappropriately, these transactions can significantly impact a country's local tax base.

In Sweden, the Swedish Tax Authorities have viewed the increased utilisation of debt push down structures with disapproval. In their view, a number of companies abuse the regulations in place by creating holding companies in Sweden which are financed internally through tax havens, in order to achieve an additional tax deduction for amounts which under "normal" circumstances would have been financed on the basis of equity capital. As Sweden currently lacks thin capitalization rules and the level of debt assumed by a company can not be legally tested[1], the tax authority's focus has shifted to other means of attacking what is viewed as inappropriate behaviour. For example, the re-financing of acquisition loans and related financing activities are areas which attract special attention. The recent court case described below illustrates this current trend and the associated tax risks which multinationals are increasingly facing.

Background

Company X AB was acquired by the US-based multinational Y Inc in 1994. In March 1996, Y Inc sold it shares in X AB to a newly established Swedish holding company, Z AB, as illustrated below.



[1] It should be noted that this might change as an official report is being drafted on how to deal with the ongoing re-financing activities of Swedish holding companies. According to our information, it is likely that this official report will at least present the concept of introducing thin capitalization rules, as one alternative approach.

Z AB was established with limited own equity and acquired X AB from Y Inc primarily by issuing a promissory note in the amount of approximately SEK 370 million, with a 10 year term. According to the promissory note, Z AB should pay annual interest of 9.5% until March 2001; thereafter and until March 2006, the interest would be annually adjusted, based on the 5-year Swedish government bond plus 1.5%.

The promissory note was renegotiated already in December 1996 and the interest rate was determined at 6.4% until December 1999; thereafter the interest would be annually adjusted, based on the 5-year Swedish government bond plus 1.5%.

A year later, in December 1997, the terms of the promissory note were, once again, altered and the interest rate was determined at 8.4% for the period until December 1999; thereafter, the interest would be annually adjusted, based on the 5-year Swedish government bond plus 3.5%.

According to the terms of the promissory note, Z AB could make partial instalments of the loan or redeem the total amount of the loan at any point in time. Instalments were first made in 2002 in a total amount of SEK 20 million and then in 2003 in a total amount of SEK 80 million.

The Swedish tax authorities ("STA") opinion

The STA stated that even if the loan and its terms were fixed for 10 years on a legal basis, the fact that (1) the loan had been renegotiated on numerous occasions and thus, de facto, had been changed during the duration of the loan and that 2) the loan could be totally or partially amortized at any given point in time by the borrower, illustrated that the loan was treated, de facto, by both parties as a loan with variable interest rates.

Viewed as a variable loan, STA determined the arm's length interest rate to be STIBOR (Stockholm Interbank Offer Rate) +1%. To support the interest level of STIBOR +1%, the STA presented statistics of the average lending rates for bank loans to non financial companies for the period 1998 to 2003. According to the statistics, the differences in the interest rates against STIBOR varied between 0.62% and 1.49% for the period, with an average for the period of 1.14%. Even if STIBOR +1% varied during the period examined, STIBOR had consistently been a few percentages points lower than the interest rate agreed upon between X AB and Z AB.

The company's point of view

The company objected that the loan could not be viewed as a variable loan and insisted that the loan in its legal form was a fixed interest long-term loan and that the correct interest should be determined on the basis of the general level of long-term interest rates in 1996. In addition, the company stated that the credit rating of Z AB at the time of the loan was BAA.

To defend the applied interest rate, the company presented four indicative pieces of evidence to prove that the applied interest rate was not lower than the applicable market rate at the time of the loan, i.e. that the arm's length interest rate had been applied.

A bank letter stating that the appropriate margin for the bank in 2004 for a loan under similar terms would be a margin of 2-4 % above STIBOR. The letter also stated that in 1996 the bank had used higher margin requirements than it had applied in 2004.

The interest rate had not exceeded the comparable interest rates published by the Federal Reserve for long-term bonds for companies with a BAA-rating.

In 1996, Y Inc's own long-term external financing costs were 10.25%. Swedish case law had previously accepted interest rates of close to 10% when the lender had been a Swedish company.

The conclusion of the Swedish tax authority

The STA dismissed the four indications on the following grounds.

The bank letter was written in a very general manner, contained no credit analysis and did not take a detailed position in this particular case, given the company was part of a multinational group (i.e. the equivalent of an implicit guarantee).

The statistics from Federal Reserve were dismissed on the grounds that the loan was not established in USD, but in SEK. Moreover, the STA noted that in 2004 both Z AB and X AB were AAA-rated but that the possibility for the company to issue bonds in Sweden was probably limited, and the normal procedure for similar external financing would be financing on the basis of a bank loan.

Y Inc's average lending rate of 10.25% in 1996 was also dismissed on the grounds that the loan was made in USD and not in SEK. In addition, the interest reference referred to a long-term loan and not to a variable loan.

The case law was dismissed with the comment that this case referred to (1) a period of time during which the general interest rate levels were higher, and (2) that the case referred to a loan to a company in Belarus, which at the time was considered as a country with a politically unstable situation and, thus, required an additional country risk premium.

Conclusion of the administrative court

The Court deemed that an arm's length interest rate needs to be determined on the basis of a variety of factors, such as type of credit, potential security of the loan, the duration of the loan, the creditworthiness of the borrower, the size of the credit and the applicable currency of the loan. According to the Court, an international loan is to be based on the interest rate level in the currency in which the loan is denominated; in this particular case SEK. Consequently, the starting point should be the interest rate level in Sweden. Furthermore, consideration should be given to the duration of the loan, i.e. 10 years, motivated a higher interest rate. The Court stated that this was generally the case, but in this particular instance the parties had renegotiated the interest level on numerous occasions, and the borrower had the ability to freely amortize the loan at any given point in time and, therefore, the terms of the loan were related more to a variable loan than to a fixed loan. As a consequence, the interest rate level at the time at which the loan agreement was entered into, i.e. 1996, could not serve as an isolated factor in determining the applicable arm's length interest rate. Following upon this, the Court then considered the implication of the creditworthiness of the borrower. The Court concluded that a reasonable degree of collateral was in place for the loan due to the fact that (1) the company controlled the shares of X AB and (2) that Z AB was part of a large multinational group (i.e. had an implicit guarantee for the loan). Consequently, Z AB's specific circumstances could not be deemed to comprise a differentiating factor in comparison with the general terms and conditions viewed to exist in the market. The fact that the bank letter indicated differently was dismissed due to the fact that the letter was written in a very general manner and did not analyse in detail the specific collateral for the loan. The particular purpose of the loan, the financing of the acquisition of the shares in X AB was also not considered to comprise a factor motivating an interest rate higher than market rates.

As a consequence, the Court found no reason for the specific circumstances in this case to motivate a higher than normal interest rate and, therefore, reached the conclusion that an applicable arm's length market rate was STIBOR + 1%, i.e. in agreement with the opinion of the STA. The company appealed the decision of the Administrative Court.

The conclusion of the Court of Appeal

The Court of Appeal largely ruled in favour of the Administrative Court and reached the conclusion that the interest rate applied could not be considered as being at arm's length. However, the Court of Appeal was of the opinion that the STIBOR interest rate was an inter-bank rate used for loans between banks, and, as such, was not appropriate in this particular case. Instead, the Court determined that the average bank borrowing rate for loans to non-financial institutions should be applied as a base.

As a result, Z AB incurred a substantial decrease in the amount of deductible interest it had previously claimed and, as a result, also an increase in its taxable income of close to SEK 65 million for the period. Moreover, the Court ruled that Z AB was to pay a penalty tax of 40% on the additional tax payable. The reason for the penalty tax was that a large international group should be able to demonstrate that it applies an arm's length interest rate on its internal financing activities.

Remarks and comments

This case highlights the fact that it can be difficult for companies to retrospectively verify that their applied interest rates are in accordance with the arm's length principle. Thus, it is important to perform a detailed analysis of intra-group financiering activities, as well as of any sale of products or services when determining the pricing. In particular, financing relating to mergers and acquisitions can - due to the size of the financial transactions - result in substantial amounts of taxable adjustments. The STA has, in a pending case, questioned another intra-company loan amounting to potentially more than SEK 1 billion in additional taxes, and close to SEK 1.5 billion if a tax penalty is to be applied.

As a result of these recent developments and the increased knowledge shared by the local tax authorities in various countries, PricewaterhouseCoopers recommends that companies engaging in intra-group financing activities prepare reasonably thorough comprehensive transfer pricing documentation for loans as a defence in future tax audits. In addition, the above case illustrates the importance not only of the wording of intra-company loan agreements, but also of the fact that the parties must adhere to the wording in the agreements in their day-to-day treatment of these activities.

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OECD invites five countries to membership talks, offers enhanced engagement to other big players

The OECD Council at Ministerial Level which took place on the 15th and 16th of May 2007, focused on the theme 'Innovation: Advancing the OECD Agenda for Growth and Equity'[2]. At the meeting, the OECD Council Resolution on Enlargement and Enhanced Engagement was adopted by the Council in recognition of the OECD's desire to further expand its global reach which has been an integral part of the OECD mission from its beginning. It has become of particular importance recently because as more and more countries embark on integration in the world economy the OECD economies share of world production and trade has diminished. Therefore, in order for the OECD to remain an influential voice in the world economy, the OECD understands the need to strengthen its links with other countries.[3]

Accordingly, Chile, Estonia, Israel, Russia and Slovenia were invited to open discussions for membership of the Organisation and Brazil, China, India, Indonesia and South Africa were offered enhanced engagement, with a view to possible membership.

We set out below a summary of the items addressed in the Council Resolution on Enlargement and Enhanced Engagement (adopted by Council at Ministerial level on 16 May 2007)[4]

1. The Secretary-General was invited to strengthen OECD co-operation with Brazil, China, India, Indonesia and South Africa through enhanced engagement programs with a view to possible eventual membership in the OECD. The decision whether to open discussions on membership with the above countries will be based on the "willingness, preparedness and the ability of these countries to adopt OECD practices, policies and standards".
2. The decision to open discussions with Chile, Estonia, Israel, the Russian Federation and Slovenia was also made with the Secretary-General being invited to set out the terms, conditions and process for the accession of each of these countries to the OECD for subsequent consideration and adoption by Council. Separately, Council can choose to raise issues of a political nature which the Secretary-General will convey to relevant country concerned.
3. The Secretary-General was invited to inform countries that have previously applied for membership that their applications for accession are still being considered on an individual basis by Council as the enlargement process continues with any future applications being similarly considered.
4. The council also invited the Secretary-General to explore and develop recommendations to Council on how to expand the OECD's relations with selected countries and regions that are of interest to the OECD from a strategic perspective. Priority will be given to South East Asia given the growing importance of the region in the world economy, with the aim of identifying particular countries for possible membership.
5. Finally, the Secretary-General was invited to report regularly to the Council on the progress of his discussions and consultations with the countries discussed above and outline the options available in respect of the OECD's further relationship with these countries.

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[2] The Chair's summary of the OECD Council is available at: http://www.oecd.org/document/22/0,2340,en_2649_201185_38604566_1_1_1_1,00.html

[3] http://www.oecd.org/document/42/0,3343,en_2649_201185_38598698_1_1_1_1,00.html

[4] http://www.oecd.org/document/7/0,3343,en_2649_201185_38604487_1_1_1_1,00.html

German tax authorities issue formal guidelines on APAs

On October 5, 2006 the German Federal Ministry of Finance has published a comprehensive circular letter on advanced pricing agreements (APAs), which has been published in the Federal Tax Gazette I, and can also be found on the Ministry's website'.[5]

In the past, the German tax authorities have been reluctant to enter into APAs. They had expressed doubts that APAs would bring further efficiencies in tax audits and no personal resources had been available to administer APAs. By issuing the circular letter, the authorities confirm now, which they had recently stated on other occasions, that they are now willing to issue APAs on a regular basis. This willingness is stressed by the fact that a central team of officials has been installed at the level of the Federal Tax Office (Bundeszentralamt für Steuern) which is fully dedicated to APAs and will act as "competent authority". The circular letter outlines, among other things:

- general principles governing an APA procedure involving Germany;
- preconditions for commencing an APA procedure;
- required content for the application as well as further information and documents to be submitted by the taxpayer with the application;
- regular term of an APA;
- implementation of an APA under national law; and
- further aspects (including rollbacks, extensions, simplifications for small enterprises).

In ongoing legislative procedures, the German parliament intents to enact provisions on fees payable by a taxpayer for an APA. Under the current plan, fees would be €20,000 for an APA, €15,000 for the extension of an existing APA and €10,000 in case an APA application will be amended by the taxpayer after filing. Lower fees apply to small and medium sized business as well as in particular cases.

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[5] http://www.bundesfinanzministerium.de/cln_03/nn_494/DE/Aktuelles/BMF__Schreiben/Veroffentlichungen__zu__Steuerarten/internationales__steuerrecht/011.html

New UK changes to thin cap and treaty clearances regime

Overview

On 27 April 2007, HMRC announced a new withholding tax treaty clearance procedure and the intention to provide, under a separate procedure, binding advance agreements to cover thin capitalisation.

Streamlined treaty clearance procedure

Foreign lenders are required to make an application to HMRC in order to pay interest at the (reduced) treaty rate of withholding tax. Until clearance from HMRC is obtained, the borrower would have to deduct the full 20% rate of withholding tax. HMRC has frequently used the submission of a withholding tax clearance application to test whether the interest is 'excessive' on the basis that the typical interest article in the UK's tax treaties allows the full rate of withholding on interest in excess of an arm's length amount. This often had the effect of delaying the withholding tax clearance.

Going forward, HMRC will issue withholding tax clearances based simply on their assessment of whether the counterparties are entitled to treaty benefits. This should reduce the timescale for obtaining treaty clearance notices and will give certainty on withholding tax issues.

Advance thin capitalisation agreements

HMRC now intends that the routine consideration of the arm's length nature of debt should be made at the time of examining the tax return. However, taxpayers requiring certainty can now apply separately under the APA legislation. It is intended that this procedure will be unilateral and administered separately from the regular (and usually bilateral) APA process that has been in operation since 1999. In order to distinguish the new process from the old, HMRC are referring to agreements under the new route as Advance Thin Capitalisation Agreements (ATCAs).

Draft guidance from HMRC indicates they expect the ATCA process to be faster and less formal to the APA procedure, largely because currently HMRC reserves APAs for the most complex cases only and partly because ATCAs are intended to replace the much less formal process currently in operation for handling thin capitalisation questions. Thus ATCAs will be dealt with by the thin capitalisation specialists at HMRC rather than the existing APA team (although there is in practice some overlap) and ATCA applications will be submitted to a different individual.

ATCAs will be limited to situations where the tax implications for the borrower (or UK group in the case of domestic lending) are "material", which implies that the threshold will vary with the size of the business. HMRC also reserves the right to

refuse applications where they do not consider that agreement is likely.

Conclusions

Overall these changes are welcome as they are expected to provide an improved treaty clearance process and will allow taxpayers more flexibility over when and how they engage HMRC in thin capitalisation discussions.

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Transfer pricing in India – an update

India has completed six years of its Transfer Pricing regime and three years of Audit examination. The journey so far has been characterized by intensive scrutiny by the tax authorities that have led taxpayers to take stock of their India transfer pricing policies and carefully strategize their approaches to minimize tax risks in India. It has also been a learning curve for the Revenue authorities who seem to be reviewing transfer pricing regulations and audit procedures in order to streamline the same.

In this update we shall examine a couple of recent changes in the audit procedures and also discuss developments in areas of transfer pricing for outsourced units. We shall also examine a recent appellate decision in the context of attribution of profits to Dependent Agency Permanent Establishments.

Audit and appeal scenario

Even with a dedicated team of Transfer Pricing Officers (TPO) across the country, it has been strenuous for the Revenue authorities to manage the high number of audit cases. Keeping this in perspective, the Revenue has initiated a couple of welcome changes. The threshold for mandatory selection of audit targets was enhanced last year from INR 50 million (approx USD 1 million) to INR 150 million (approx USD 3 million) or more. The increase in threshold means that fewer cases would be selected, thus reducing the burden for a TPO, and at the same time keep a focus on high value cases.

More recently, another change was enacted through the Indian Union Budget for financial year 2007-2008. In order to provide adequate time to the TPOs to conduct audits, a longer time period has been prescribed for completion of Transfer Pricing audits. The change would give about ten additional months to the TPOs as compared to the existing time frame available for completing Transfer Pricing audits.

These changes indicate the intention of the Indian Revenue to carry out audits in the years ahead in a focused manner.

While these changes have been carried out at the audit level, it is also understood that the Revenue is considering the creation of dedicated Commissioner (Appeals) positions, which is a first level appellate authority. The increasing number of cases reaching the appellate authorities would mean that the Revenue would need to consider such a change sooner rather than later to expedite the process of disposal.

Outsourcing to captive IT / ITES units

India remains a favored outsourcing destination with its vast pool of skilled resources and an obvious cost advantage. While Indian entrepreneurs are key players, there is an increasing number of captive software development (IT) and IT enabled service (ITES) units being established by MNCs. Generally, captive IT/ITES units cater to their group organisations, earn an assured return on cost, and assume less than normal risk than independent entrepreneurs. These units are generally eligible for a tax holiday.

In absence of similar comparables, outsourced captive service units in India have been generally compared to entrepreneurs providing similar outsourcing services. TPOs have expected the limited risk captives to earn margins comparable to the entrepreneurs. Significant adjustments were carried out in two outsourcing hubs in India viz. Bangalore and Hyderabad, where markups on cost were adjusted in the range of 22-25% for IT companies and 32-35% for ITES companies. Adjustments in other locations were on a case by case basis though generally followed the 18% to 20% range. Further, as per the Regulations, tax holiday on such TP adjustments was not allowed.

The high level of mark ups have evoked strong reactions from the industry and have led to continuous representations to policy makers to have a stable TP regime for captive IT/ITES units. The emphasis of the representations has been to drive home the point that these limited risk captive units should earn a steady return on a cost plus basis and should not be compared with full-fledged entrepreneurs. While there may be no immediate changes in regulations, the industry is hopeful that the tax authorities will adopt a practical and consistent approach in the audits for future years.

Growing financial services sector

In the Financials Services sector, the Banking industry recently saw the conclusion of the first level of appeals in a few cases. These have provided some relief in terms of mark-ups on services such as correspondent banking and support on derivative transactions. With sectors such as real estate and private equity booming, there is a case for taxpayers in these sectors to pro-actively structure TP policies against the backdrop of recent experiences.

Dependent agency permanent establishment and attribution of profits

In the foreword of the April 2007 edition of FSTP Perspectives, Richard Collier had written about the OECD's project on the Attribution of Profits to Permanent Establishments (PEs). One of the widely debated issue in relation to that project was the attribution of profits to a Dependent Agency PE (DAPE) in a host country over and above the arm's length remuneration to the Dependent Agent (DA) in the host country. The OECD thinking suggests that such attribution is possible in respect of a DAPE.

The Indian Tax Appellate Tribunal had an opportunity to consider a similar issue in the case of a Singapore based telecasting company operating through a DA in India. The DA, in the instant case, was marketing airtime slots on behalf of the Singapore company and based on facts it was concluded that the activities of the DA led to creation of a DAPE for the Singapore company in India. The Singapore company contended that the arm's length remuneration to the DA would extinguish any further tax liability for the company in India. The Tribunal however held that the DAPE is a hypothetical establishment distinct from the DA and that the arm's length remuneration does not automatically extinguish taxability for the Singapore company which has a DAPE in India. The Tribunal held that in order to compute the taxable income for the DAPE in India, revenues generated on account of Function-Asset-Risk analysis of the DAPE are to be taken into account as hypothetical income of the DAPE, and deduction is to be provided in respect of all the expenses incurred to earn such revenue, including the arm's length remuneration paid to the DA.

Besides being a critical development on the subject of DA PE, this decision indicates that global developments such as that at the OECD level would have a bearing on approaches being adopted by Indian Revenue authorities.

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German tax perspective on intra-group guarantees

The German tax authorities have increased their focus on the financing of subsidiaries through hybrid financing instruments such as interest-free shareholder loans, equity supplementing loans, guarantees or letters of comfort in recent years. Similar to every other inter-company transaction, cross border financing transactions between related parties have to comply with the arm's length principle. Thus, it is essential whether intra-group guarantees are considered as a "financial" service, which has been rendered based on a business connection, or as a shareholder activity.

In general, the German tax authorities comprehensively define the terms of a business connection within the meaning of Sec. 1 (4) Foreign Tax Act; therefore, one can assume that the arm's length principle is applicable to every explicit guarantee. Consequently, a commission charge would be necessary where a guarantee is solely granted out of economical reasons i.e. beyond shareholder activity. Or, when unrelated third parties would have agreed on such a commission and the beneficiary is enabled to lower own financing costs or gain access to a specific capital market (see Tz. 4.4.2. German administrative principles for the examination of income allocation in case of internationally related enterprises 23.02.1983).

The position taken by the German tax authorities is not undisputed, since the Federal Fiscal Court excluded specific intra-group guarantees as a form of equity contribution from the scope of Sec. 1 Foreign Tax Act in 2000 (see BFH v. 29.11.2000 - I R 85/99, BStBl. II 2002, 720). In the case at hand, the court ruled that an unconditional irrevocable guarantee by a mother company to its foreign captive finance subsidiary whose equity was not sufficient to fulfil its function does not qualify as a business relation pursuant to Sec. 1 (4) Foreign Tax Act but rather as a shareholder activity. Such measures are solely performed because of the ownership interest; therefore they do not justify a charge to the recipient company. Despite this ruling, the German Ministry of Finance issued a non-application on September 17th 2002 i.e. the ruling is not applicable to any other cases other than the decided one (see IV B 4 - S 1341 - 14/02, BStBl I 2002, 1025). According to the decree, the granting of a guarantee to a foreign captive finance subsidiary to enhance its creditworthiness constitutes a business relation and thus, has to comply with the arm's length principle. This applies similarly to cases where the finance entity's equity is insufficient.

Unlike the controversy regarding the tax treatment of these explicit guarantees, the treatment of an implicit guarantee e.g. "where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated" (see Sec 7.13 OECD Guidelines) is undisputed in Germany. The German transfer pricing legislations - in

accordance with the OECD Guidelines - do not consider these incidental benefits resulting from the affiliation to a group alone as a rendered "financial" service but rather as ("Rückhalt im Konzern"), which does not justify a commission charge.

This view is supported by the fact that an implicit guarantee does not constitute real collateral for the recipient, since the guarantor has no intention to assume a legally binding liability (see Tz. 4.4. German administrative principles).

In cases where a commission charge for the provision of an explicit intra-group guarantee is applicable, an arm's length commission amount has to be determined. Since the provision of an intra-group guarantee is rather unique, uncontrolled comparable data is rare. Generally, there is a consensus among German scholars that the commission charged by third party banks is not an appropriate arm's length price in the inter company scenario. Among other differences, the provision of financial services (including the provision of guarantees) is part of the bank's main business, which they pursue with a profit motivation. Thus, it is not comparable with an intra-group scenario where the profit motivation is subordinated. There are different approaches to determine an arm's length commission charge:

- Commission charge should equal the difference between the interest rate on a stand alone basis and with the guarantee. This would require a difference in the creditworthiness of the companies under review and the availability of appropriate comparable data concerning credit-rating and applicable interest rate. Regardless of the data availability, this approach is not suitable in PE situations, since according to the new OECD reports on the allocation of profits to permanent establishments, the PE and headquarter have the same creditworthiness. The same applies to situations where the creditworthiness of the beneficiary is higher than the one of the guarantor.
- Commission charge based on the capital cost of the guarantor. The commission charge could be determined based on the estimated capital costs of the guarantor. These costs consist of the remaining debt at any given time and the risk due to the probability of failure by the beneficiary.

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Hungary – interest, thin capitalisation & loan benchmarking

Interest

With Hungary increasingly becoming an integral part of the business community in the European Union, we are seeing international businesses using Hungary as a favoured location in business reorganisations. These include shared service centres, distribution centres for Central and Eastern European countries, contract and fully fledged manufacturing centres, and research and development centres as well as a favourable location for international holding companies. That would not come as much of a surprise to many dealing with European business but the fact that Hungary is also at the heart of Europe in terms of financing companies still does turn heads.

The link between Hungary and financing comes from legislation that encouraged the use of Hungary as a conduit for carrying on European business under what became known as the Hungarian Offshore regime. In addition, to ease of access to the capital markets around the world and a stable banking infrastructure, these entities were also able to operate with an effective tax rate of around 3%. Although that special tax status changed on 1 January 2006 which pushed up the possible effective rate of such companies to between 8% and to 12% it did not mean that Hungary was no longer an attractive location for financing companies.

One of the benefits of using Hungary as a conduit for debt is the favourable tax treatment of interest from related parties. Subject to an election it is possible to reduce the interest income by 50% irrespective of the jurisdiction of the related party.

It is also worth mentioning that Hungary abolished withholding tax on interest (and royalty) payments to all resident and non-resident companies effective from 1 January 2004.

Thin capitalisation

Hungary, not surprisingly has thin capitalisation rules essentially operating a 3:1 ratio.

The ‘thincap’ rule: where the average daily balance of the taxpayer’s interest bearing liabilities exceeds three times the daily average balance of its equity, the interest paid on the excess is not deductible for corporate income tax purposes.

When calculating the 3:1 debt-equity ratio, debts to credit institutions are ignored. Equity includes registered capital, capital reserves, retained earnings and specific tied-up reserves. The financial year’s profit or loss after taxation is ignored when calculating the daily average balance of the equity for thin capitalization purposes.

Loan benchmarking

Loan benchmarking is of course key to documenting loan transactions in accordance with Hungarian transfer pricing regulations which requires documentation to be in place within 5 months of the end of the financial year.

Faced with similar challenges experienced by territories around the world, we face issues around credit risk, country risk, currency risk adjustments, and fixed/variable adjustments as well as difficulties in finding comparables that share characteristics of the terms and conditions agreed between related parties. More recently we have also been faced with determining the practical implications of the different kind of parental guarantees and quantification of the value proposition, if any.

Financial services are one of a number of key areas of development in Hungary. Although experience of tax audits has not shown a great deal of attention in respect of financial transactions it is clear that we have long moved away from the idea that a letter from a friendly bank is sufficient for documentation purposes.

Databases such as Moody's, Standard & Poors and Bloomberg are helpful in terms of providing direction in relation to loan benchmarking however, as with using any database, care needs to be taken in determining search criteria especially when determining adjustments to increase comparability of the sample.

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United States update: tax return preparers to be subject to a "more likely than not" standard

The Small Business and Work Opportunity Act, enacted into law on May 25, 2007, amended Section 6694 of the US Internal Revenue Code to extend the return preparer penalties under this section to preparers of all tax returns prepared after the effective date, including income tax returns, estate and gift tax returns, excise tax returns, and employment tax returns. The new law also increased the amount of penalties and introduced new standards that all federal tax return preparers must follow with respect to tax return positions taken by taxpayers, in order to avoid penalties under Section 6694.

Under this new standard, a federal tax return preparer cannot knowingly prepare a tax return that reports a position that has a 50 percent or less likelihood of success if challenged by the IRS (More Likely Than Not ("MLTN") standard), unless there is a reasonable basis for such position and the position is adequately disclosed (Reasonable Basis Standard).

In addition, the IRS has since provided transitional relief while it considers whether guidance is needed to address questions raised by the law changes. Under Notice 2007-54, the new standards are generally effective for tax returns due (including extensions) after December 31, 2007.

This impacts PwC and clients, as transfer pricing issues impacting tax positions to be taken on federal tax returns have now to meet the MLTN standard or the Reasonable Basis Standard with appropriate affirmative disclosures. It is advisable that any additional analyses or adjustments in transfer pricing policies which might be required with respect to one or more positions to be reported on tax returns are addressed in a timely manner in order to meet the statutory deadline.

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Foreign investment banks in Australia under scrutiny

In a recent speech, the Australian Commissioner of Taxation ("the Commissioner") has raised concerns about the performance of some foreign bank branches in the Australian market. In particular, the Commissioner raised his concern over long term loss patterns that are evident in investment banking and wholesaling financing activities, and where effective tax rates are low relative to their Australian counterparts.

In addition, the Commissioner reiterated the Australian Taxation Office's (ATO's) continued commitment to its review program to ensure that taxpayers are complying with transfer pricing rules, specifically within the areas of thin capitalisation and inter-company financing arrangements (including treasury operations, asset and project financing, repatriation arrangements and cross border arbitrage on debt and equity classifications).

The practical implication of the Commissioner's comments is that increased ATO scrutiny of the financial performance of investment banks can be expected. Accordingly, investment banks should be prepared to provide adequate commercial reasons to support the financial performance of their Australian branches and be in a position to demonstrate the impact or otherwise of transfer prices on the financial results.

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Country Focus: Brazil

This publication's country focus is Brazil and it is presented by Marcos Almeida. Marcos leads the financial services and transfer pricing team in San Paolo which consists of 22 professionals with both transfer pricing and FS industry knowledge

Brazilian financial services transfer pricing environment

Brazil's transfer pricing rules became effective as of 1 January 1997 and from the outset have been very controversial. The intention of the rules has been to enable the Brazilian Government to prevent multinational companies from transferring taxable income abroad through prices on imports and exports of products, services, rights and certain interests charged between related parties.

Contrary to the OECD Guidelines, Brazil's transfer pricing rules do not adopt the internationally accepted arm's length principle. Instead, Brazil's transfer pricing rules define maximum ceilings for deductible expenses on inter-company import transactions and minimum gross income floors for inter-company export transactions.

Brazilian tax authorities approach to transfer pricing

Through the provision of safe harbors and exemptions, the rules were designed to facilitate the monitoring of inter-company transactions by the Brazilian authorities while they develop more profound technical skills and experience in the domain. In this regard, our local tax authorities have created special transfer pricing offices in the Brazilian top economic-developed cities, including special groups with focus on the banking practice and other intangible transactions.

Specifically in the banking & financial segment, transfer pricing authorities are currently developing audit techniques and controlling tools, in co-operation with the income tax banking authorities. In this sense, transfer pricing authorities are under constant training, including technological capacitating and the use of computer-assisted tools in the audit process.

Head office and management fees

Head Office and management fees paid to related companies abroad are often subject to special analysis by the tax authorities. Besides being subject to transfer pricing rules, expenses recognized by a Brazilian entity are deductible for tax computation purposes if: (i) actually incurred; (ii) ordinary and necessary to conduct the business activities of the company; and (iii) properly and adequately documented.

The remittance of head office and management fees abroad is subject to a high tax burden which includes not only withholding tax, but also other Brazilian taxes.

Future developments

Since the Brazilian rules do not adopt the internationally accepted arm's length principle, multinational corporations with Brazilian operations have evaluated their potential tax exposure and developed special transfer pricing plans to defend and optimize their overall international transfer pricing and tax exposures.

In view of the substantial double taxation and documentation burdens, over recent years, a coalition of several international chambers of commerce and multinational companies has been lobbying for a significant overhaul of the current regulatory framework. Mainly as a result of this initiative, in August 2001, legislators presented the Brazilian congress with a draft legal bill to change the current transfer pricing law. In its initial form, the new law would bring transfer pricing rules more in line with international standards, including the adoption of the arm's length principle. Presently several commissions of the Brazilian house of representatives are discussing the bill; however, it is not possible to predict the time and the outcome.

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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:

- 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.

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