PRICEWATERHOUSECOOPERS

FSTP Perspectives

A publication for financial services industry tax and transfer pricing professionals

August 2007

Foreword

Dear Reader:

It is a pleasure to welcome you to the August edition of FSTP Perspectives. We are halfway through the inaugural year of this publication, and I thought that this would be a good opportunity to take a step back and examine the current environment in the financial services tax world.

In his foreword to the June edition, Garry Stone wrote about the increased global scrutiny on tax issues, particularly in the transfer pricing arena. Local tax authorities, regulatory authorities, and the general public have all expanded their focus on tax related matters. This attention has led to the imposition of new penalty regimes, expanded press coverage, financial accounting restatements, and concerns about reputation in the capital markets. More than ever before, there is intense pressure on tax departments to "get it right." But it isn't easy to get it right. Layer in operations and investments in multiple jurisdictions, and getting it right means mastering a great variety of tax regimes and understanding important differences in applicable legal and regulatory concepts, tax authority practices and procedures, and, of course, local business practices. In a typical centralized tax department that has comparatively weak regional resources, getting it right is understandably difficult.

And there are additional challenges in the financial services sector, where tax executives seem to find themselves constantly operating in a reactive mode to complex new financial products and other transactions raised from the business at the eleventh hour. Needless to say, there are more than a few tax executives in the financial services industry who lie awake at night thinking about all of these challenges.

"Getting it right" in this risk-laden environment is indeed a serious challenge, but many tax departments are successfully meeting that challenge through a clear focus on risk management. There is no "one size fits all" solution to risk management, and in fact each department that has successfully addressed tax risk management has reached different conclusions that fit their business and do not compromise their ability to function in a fast-paced environment.

But a closer examination from a birds' eye view reveals a common approach. First, they took a "global" view of the tax risks faced by their business and discussed both strategic and policy responses to these risks. Next, they identified more regional risks and mapped out the location and magnitude of the risks. Finally, they discussed future exposures and formulated procedural safeguards to assure they will be adequately addressed.

Transfer pricing is global, local, and future exposure for multinational financial services companies, and as such, is in the spotlight at every stage in the development of a tax risk management strategy. And this is a great opportunity to question the soundness of existing policies and procedures in the transfer pricing area. For example, are generic models being used in local jurisdictions? Are they appropriate and acceptable? Could the transfer pricing documentation be better aligned with the corporate business models?

Addressing global tax risk management will be a major focus of many companies this year, and transfer pricing will be one of the most critical areas addressed. This edition of FSTP Perspectives raises several new transfer pricing issues faced by financial services companies. I hope that you find this edition both useful in your practice and as you address global tax risk management.

Regards,

Joseph Foy.
PwC U.S. Financial Services 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.*

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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

Erin Fay
erin.fay@uk.pwc.com

Tracy Malyan
tracy.malyan@uk.pwc.com

Denmark
Financial services transfer pricing audit activity increasing

The Danish Tax Authorities ("DTA") are continuously increasing the transfer pricing audit activity. This is reflected in the significant increase in the number and size of transfer pricing adjustments.

In 2006, the DTA conducted a total of 38 (upward) transfer pricing income adjustments, representing a total adjustment value of DKK 4,496 million (equivalent to approximately € 605 million). This represents an average income adjustment value of DKK 118 million, or € 16 million.

This is a significant increase from 2005 in both the number of adjustments and value of such adjustments. In 2005, there were 25 (upward) transfer pricing adjustments totalling a value of DKK 926 million, or € 125 million.

Group financing activities are one of the main focus areas of the increasing transfer pricing audit activity. This is reflected in the 2007 audit plan, as well as supported by the fact that 27% of all adjustments in 2005 and 2006 related to financial transactions.

The financial services industry is also drawing more attention from the DTA. Still, however, only 13% of the adjustments conducted in 2005 - 2006 are within the financial services industry.

This increase in audit activity was not entirely unexpected given the tightened transfer pricing documentation requirements, applicable as of the 1 January 2006, as well as transfer pricing penalty provisions applicable from the income year 2007.

For more information, please contact:

Jakob Berning (jko@pwc.dk)

India
OECD discuss rationalization of tax mechanism

As part of India's continuing efforts to rationalize its tax system, an International Tax Conference was held in New Delhi on 2 and 3 July, 2007. The conference focused primarily on 'Tax Reforms in India – Achievements and Challenges'. It was co-hosted by the Ministry of Finance – Government of India, Asian Development Bank ("ADB") and Organisation of Economic Cooperation and Development ("OECD").

It was the first such international conference in India which brought together, on a common platform, experts from various countries and India as well as tax officials of the Government of India to discuss tax reforms in different countries. The Conference provided the international participants, a unique opportunity of understanding Indian tax reforms as well as to contribute to the process.

The sessions gave a spectrum of cross-country experiences coming from experts in the fields of Direct and Indirect Taxes. Emphasis upon the need to have a strategic balance between 'Tax Policy' and 'Tax Administration' was also discussed.

The Chairperson stated that by the year 2010 India needs to go on from here towards a regime of an integrated Goods and Services Tax ("GST"). The presentation also highlighted the concept of 'fiscal federalism' in India and emphasized that reforms in taxation were aimed at improving Tax/GDP ratio & reducing Tax Deficit. This was intended to be done through (i) moderating rates of taxes; (ii) minimizing exemptions; (iii) widening of tax base; (iv) simplification of procedures; and (v) removing the discretionary powers of tax officers.

The key deliberations on some technical issues in these sessions are summarized below: -

Strengthening audit capacity: The following important issues emerged with a view to improving the efficiency of audit:

- The need to prescribe a Standard Audit File Format for auditing taxpayers keeping computerized records;
- Continuation of mandatory audit of large taxpayers;
- Close monitoring of compliance behaviour of large taxpayers by assigning a taxpayer to a tax executive; and
- Sharing of data between different tax Departments for better risk management.

Improving taxpayer services: It was unanimously felt that improvement of taxpayers' service minimizes hassles to taxpayers and increases tax compliance. The view was that the use of Information Technology should be maximized, especially in the areas of filing of return, grant of refund and giving tax credit.

Transfer Pricing: Deliberations started with a presentation of the Indian experience of its 5-year old transfer pricing regime. At present, more than 60% of international transactions are between related parties. The need for reorganization of the working of Special Valuation Branches of Custom Houses was discussed. The possible recommendation of the Working Group under ADB-Technical Assistance Programme was put forth before the House. Some of the emerging issues put before the House for discussions were audit triggers, various database related issues, FAR analysis of uncontrolled comparables, Dispute resolution mechanism, and the need for advance pricing agreements ("APA) and Safe-harbour rules. In the concluding remarks by the Chairs, the future challenges before the tax authorities were highlighted. The need for exploring the possibility of better coordination and cooperation between the Customs and Income-Tax departments in valuation matters was also highlighted in view of the recommendations of the Joint Working Group of customs and tax authorities. The participants expressed the views that there

is need to provide extensive training to the Departmental Officers for smooth implementation of law relating to transfer pricing.

International taxation: In the session on International Taxation, issues like attribution of profits to a permanent establishment, ways of preventing treaty misuse, compliance problem relating to withholding tax, taxation of expatriates, problems relating to taxation of outward investments, dispute resolution mechanism, etc. were discussed. The country practices particularly USA, Japan, South Korea, Malaysia, China, UK were deliberated upon by the participants.

In summary, the conference focused on an analysis of tax reforms by international experts in various countries with the objective of formulating the way forward for tax reforms in India.

For more information, please contact:

Dhaivat Anjaria (dhaivat.anjaria@in.pwc.com)
Shefali.Jain (shefali.jain@in.pwc.com)

Russia
Proposed changes to the russian transfer pricing legislation

Introduction

On 1 January 1999, Russia introduced its first transfer pricing ("TP") legislation which is still in force. Although the current TP legislation has some similarities with the OECD's TP Guidelines[1], it differs in many aspects from the OECD TP Guidelines and is quite vague in other areas. As a result, it contains a number of loopholes and with the burden of proof formally resting with the Russian tax authorities, who are lacking sufficient experience in applying the rules, the Russian tax authorities have found it problematic to enforce the TP legislation in the way it was envisaged.

Over the years, a number of attempts have been made to revise the current TP legislation but so far in vain. In February 2007, the Ministry of Finance issued a revised draft Bill attempting to make the definitions contained in the Tax Code more exact, the revised draft Bill still contains a number of significant deviations from the OECD's TP principles. Russia is not a member of OECD, therefore it is not possible to have any reference to the OECD's TP Guidelines in the Russian Tax Code or during court hearings. Currently, the revised draft Bill is under further review and subject to some amendments, and therefore it has not yet been submitted to the Russian parliament.

[1] "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", OECD, 1995.

Although the fate of the revised draft Bill is still unknown, it is expected that it will be enacted relatively soon, perhaps even as early as 1 January 2008 or during 2008 with introduction to force one calendar month after its official publication. It is expected that the draft Bill will be further revised with the main ideas currently reflected in the draft law likely to remain. An overhaul of the current TP legislation has been long overdue and the need for Russia to introduce effective and closely aligned with the OECD principles TP legislation has become ever more important with the view of the expected introduction of Russia into World Trade Organisation and OECD.

Based on the revised draft Bill, we have prepared an overview of the key changes expected to the Russian transfer pricing rules. In addition, we focus below on some of the consequences these will have for the Russian taxpayers.

Controlled Transactions

In line with the current TP legislation, the number of transactions defined as "controlled" will continue to exceed those covered by transfer pricing legislation in majority of countries. The reasons here are partly found in the absence of separate anti-avoidance provisions in the Russian Tax Code. In summary, the controlled transactions are as follows:

- Transactions with related parties (domestic and cross-border);
- Barter transactions (exchange of goods);
- Cross-border transactions involving goods, services (work), property rights, information and intellectual property ("IP");
- Cross-border transactions involving commodities; and
- Transactions between Russian corporate tax residents and counterparties residing in jurisdictions with a preferential tax regime.

However, the revised draft Bill expands the types of "items" covered by the controlled transactions. Currently, the TP legislation refers to goods, work and services only which has left uncertainty with regard to the application of TP rules to financial transaction and licensing of IP. The revised draft Bill attempts to provide certain clarity by specifically referring to items such as IP, (interest) rates and IP rights.

In addition, it is also worth noting that under the current Russian TP provisions the definition of related parties is much wider in Russia than in most OECD jurisdictions. For example, if a taxpayer has a direct or indirect control in excess of 20% in another entity the parties are deemed to be related.

Transfer Pricing Methods and the Market Range

Currently, the TP legislation provides for only three transactional based methods which are set out in a strict hierarchy: first the comparable uncontrolled price ("CUP") Method should be applied, then if the CUP Method can not be applied then the Resale Minus Method should be used and with the Cost Plus Method as the third and final method. The

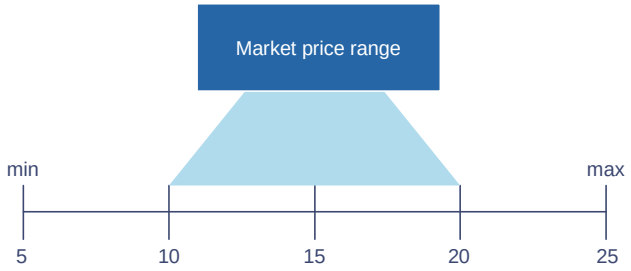
revised Draft Bill expands the number of methods to six by introducing the following methods:

- The Price of Sale of Processed Product (secondary product) Method;
- The Comparable Profitability Method; and
- The Profit Split Method.

As before, the CUP Method will continue to serve as the primary method, but in the absence of any comparable transactions the taxpayer is free to chose between the remaining methods except the Profit Split Method being the method of last resort.

Under the current Russian TP legislation, the three methods were used to identify the market price from which a taxpayer was allowed to deviate by 20%. The revised draft Bill abolishes the 20% safe harbour and introduces a market price range concept instead. However, this market price range will not be defined by reference to an interquartile range. Instead, under the current draft Bill the market price range is calculated as a difference between the minimum and maximum values observed and this difference should be then divided into four equal intervals. The market price range will represent the 2nd and the 3rd intervals. Below is an example of how this is intended to work when the minimum and maximum prices observed are 5 and 25 respectively.

Figure 1. Example of a Market Price Range



Needless to say, this arbitrary approach can cause a lot of controversy as it does not take into account where the majority of market prices are identified but rather it is based on the extreme observations. It is expected that the definition of the range may be revised prior to the current draft Bill is finalised.

On the more positive side, the revised draft Bill expands the number of data sources which can be used to establish the market price range, although it is not quite clear whether these will include pan-European databases / comparables. An issue of more serious concern is that the revised draft Bill also seems to allow the Russian tax authorities to use “secret comparables”.

Documentation Requirements

As for some new provisions, the revised Draft Bill introduces TP documentation requirements which effectively shift the burden of proof to the taxpayer. The documentation requirements apply only to a controlled transaction or a number of controlled transactions concluded with one party (or a number of the same parties) where the income or expenses exceed RUB 1 million (approximately USD 40,000) during one calendar year.

The type of information required to document related party transactions differs from that requested for the other types of controlled transactions listed above, with the former being much more comprehensive. The information can be presented in a free format, and for the related party transactions it includes the following information:

- Description of the controlled transaction, including its terms and conditions;
- Description of the parties involved in the transaction, including the functional analysis of both the taxpayer and the counterparty;
- Information on the TP method and the data sources used to establish the market price range, calculation of the income arising/expenses incurred and the economic gain received from the controlled transaction; and
- Any other factors which influenced the price of the controlled transaction, in particular details of the taxpayer’s marketing strategy and the economic conditions prevailing.

As noted above, the functional analysis is required for both parties to the controlled transaction independent of which entity serves as the tested party. In this regard, the revised Draft Bill specifically points out that irrespective of the method applied all the parties to a controlled transaction should be benchmarked against third party comparables. At present, the Russian tax authorities take a narrow view focusing primarily on the Russian taxpayer only. Hence, one would expect that for the time being the profitability of the Russian party should always be tested.

If a taxpayer receives an official request from the Russian tax authorities, the taxpayer has five working days to present the required TP documentation. However, given that the Russian tax authorities normally do not audit a company accounts until a reporting period is closed, in effect this will mean that the taxpayers should have TP documentation by the time they file their annual accounts. The draft Bill does not currently provide for any transition period, it is however expected that such period may be provided by the law which would introduce these changes to the Russian Tax Code into force.

In contrast to the current TP legislation, the revised draft Bill places a massive administrative burden on the taxpayers with the onus of proof now their responsibility and most likely with limited time for the taxpayers to prepare for these new requirements. Till now, taxpayers have in most cases been

able to sit back and watch the Russian tax authorities fail to establish the market price or take an advantage of the 20% safe harbour.

Going forward, failure to provide sufficient documentation to support the arm's length nature of the price used in a controlled transaction will result in penalties of at a minimum 20% of any additional taxes (profits tax and value added tax) assessed. In addition, it is noted that the revised draft Bill does not address the right of a taxpayer to obtain a corresponding adjustment in the case of a tax adjustment. As in the case now, the Russian taxpayer will be at high risk of double taxation.

Advance Pricing Agreements

From 1 January 2010, taxpayers will have the option to request an APA, which can be concluded for a period of three years and may be extended for another two years. However, given that only the Ministry of Finance of Russia, which is in charge of control and supervision in the area of taxes, will have the authority to conclude APAs, it is expected that only a limited number of APAs will be concluded within the first couple of years after the introduction of the APA provisions the Russian TP rules. It has also been hinted by the Ministry of Finance of Russia that the APA programme primarily is intended for large taxpayers only.

Final Observations

As noted, the revised draft Bill represents a significant move towards international transfer pricing principles, and with the introduction of functional analysis requirements for all parties involved in a controlled transaction the implications are that much more emphasis will be placed on substance over form. In the absence of an effective legislation to deal with Permanent Establishments ("PEs"), the revised draft Bill will give the Russian tax authorities a new and more effective tool to challenge the structures involving, for example, offshore trading companies without any substance. In addition to the administrative burden, it is perhaps no surprise that the revised draft Bill, like its predecessors, has caused some controversy amongst Russian taxpayers. Therefore, as noted above, we expect that some changes to be introduced to the draft Bill before it is finalised.

For more information, please contact:

Christian Ziegler (christian.ziegler@ru.pwc.com)
Evgenia Veter (evgenia.veter@ru.pwc.com)

India
BPO taxation in India- Landmark ruling on PE and attribution

Background

On July 9, 2007, the Supreme (Apex) Court of India delivered a landmark judgement pursuant to a special leave petition filed by Morgan Stanley and Co. (and a similar Petition filed by the Revenue) against the ruling issued by the Authority for Advance Rulings ("AAR"). The AAR ruling dealt with whether Morgan Stanley & Co. (USA) ("MS Co.") has a Permanent Establishment ("PE") in India as a consequence of the back-office operations it had outsourced in India to Morgan Stanley Advantage Services ("MSAS") and the people from USA visiting India. The attendant question was of profits attributable to such PE.

Brief facts

MS Co., a non-resident company incorporated in USA, is an investment bank engaged in the business of providing financial advisory, corporate lending and securities underwriting services. MSAS is a subsidiary of MS Co. in India.

Under an agreement, MS Co. outsourced some of its activities (including back-office research, account reconciliation and IT enabled services) to MSAS, to support the main office functions of MS Co. Further, the US entity also sent certain staff to India for stewardship activities to ensure adherence to high quality standards. MS Co.'s staff was also sent on deputation to India at the request of MSAS, as and when required. From an employment contract perspective, the staff continued to be employed or engaged by MS Co. and their salaries and fees were paid directly by MS Co.

In respect of services rendered by MSAS to MS Co., the Transactional Net Margin Method ("TNMM") was selected for determining the arm's length price.

On these facts, MS Co. applied to the Authority for AAR seeking a ruling on the following main issues:

- Whether MS Co. had a permanent establishment ("PE") in India, under provisions of India-USA Tax Treaty ("the Tax Treaty")?
- If a PE exists, what was the amount of income attributable to such PE in India?

The AAR ruled that MS Co. would not have a fixed place PE or agency PE in India. However, it would have a service PE in India under the provisions of Tax Treaty, as it would send its employees to India on deputation as well as for undertaking stewardship activities. The AAR also ruled that no further income would be attributable to the PE of MS Co in India, if the transaction between MS Co. and MSAS was at arm's length price.

Both, the Revenue Authorities as well as MS Co., appealed to the Supreme Court against the ruling of the AAR. The Supreme Court held as under:

Issues for consideration before Supreme Court

- Whether MS Co. has a PE in India?
- If yes, whether payment of arm's length remuneration by MS Co. to MSAS extinguishes MS Co.'s tax liability in India?

Supreme Court's Ruling

Whether MS Co. has a PE in India?

- MSAS was only engaged in providing back-office support to MS Co. and, therefore, MS Co. could not be said to have a fixed place of business in India under Article 5(1) of the Tax Treaty.
- MS Co. does not have an agency PE in India, as MSAS had no authority to enter into or conclude contracts.
- As regards stewardship functions, the visiting employees of MS Co. were merely protecting MS Co.'s own interest and were not rendering any services to MSAS India. Such employees carrying on stewardship activity would not result in the rendering of services by MS Co. to MSAS within the meaning of Article 5(2)(l) of the Tax Treaty and would not result in the creation of a PE.
- In respect of the personnel deputed to India, the Supreme Court observed that if the activities of an overseas enterprise entail it being responsible for the work of the employees deputed and such employees continue to be on the payroll of the overseas enterprise or they continue to have a lien on their jobs with the overseas enterprise, a Service PE can emerge. Having observed as above, in the facts of the case, it was held that employees who are on long term deputation to MSAS result in MS Co. having a Service PE in India as they continue to be on the payroll of MS Co. and retain a lien on their jobs with MS Co.

Profits attributable to the PE

As regards the income attributable to the PE, it was held that the TNMM was the appropriate method for determination of the arm's length price in respect of transactions between MS Co. and MSAS. The computation of remuneration based on cost plus mark-up, was accepted as correct.

- Regarding attribution of further profits to the PE of MS Co., it was observed that where the transactions between the two entities are at arm's length, the AAR ruling was, in principle correct, provided that an associated enterprise (that also constitutes a PE) was remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise. In such a case, nothing further would be left to be attributed to the PE. It was further observed that the situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a case, there would be a need to attribute profits to the PE for those functions / risks that have not been considered. It was also observed that the entire exercise ultimately is to ascertain whether the service charges payable to MSAS fully represent the value of the profit attributable to its services.

Conclusion

The Ruling is beneficial for taxpayers in so far as it accepts that stewardship activities do not result in the creation of a PE. Further, the acceptance of the principle that once transfer pricing adequately takes into account functions and risks, no further profits are attributable to the PE, is a positive step. It is clear that the Supreme Court is placing significant emphasis on the importance of a transfer pricing analysis to conclude whether there should be any further attribution of profits to a PE. In this regard, it is recommended that taxpayers take a proactive approach in managing their tax risks by maintaining robust transfer pricing documentation that comprehensively captures the functional and risk analysis of the relevant operations. It is important to note that such analysis would need to be undertaken and supported on an annual basis.

For more information, please contact:

Dhaivat Anjaria (dhaivat.anjaria@in.pwc.com)

Country Focus : Australia

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.

Introduction

Nick Houseman leads PwC's Australian Financial Services Transfer Pricing practice. The team is comprised of a diversified team of professionals with backgrounds in accounting, tax, finance, economics, financial services and law. The Australia transfer pricing services team was voted "leading transfer pricing firm 2006/07" by the International Tax Review

Overview of the rules

Australia has a well established transfer pricing regime. The legislation is contained within Division 13 of the Income Tax Assessment Act 1936 ("the Act") and operates without a statute of limitation. Australia is a member of the OECD and has an extensive network of international tax treaties.

Whilst the actual legislation in Division 13 is relatively brief, there is a large body of public rulings on transfer pricing which set out the views of the Australian Taxation Office ("ATO") in relation to a number of topics of relevance. The most important of these rulings are TR 97/202 which sets out the ATO's views on appropriate transfer pricing methods and TR 98/113 which sets out the nature and extent of documentation that the ATO expects taxpayers to prepare in order to demonstrate that all transfer prices are arm's length. Other rulings cover issues such as attribution of profits to permanent establishments (TR 2001/114); pricing loan transactions (TR 92/115) and the process for applying for and concluding an Advance Pricing Arrangement with the ATO (TR 95/236). The transfer pricing methods and approaches set out by the ATO are largely consistent with the OECD Guidelines, however there are some changes in emphasis in certain areas.

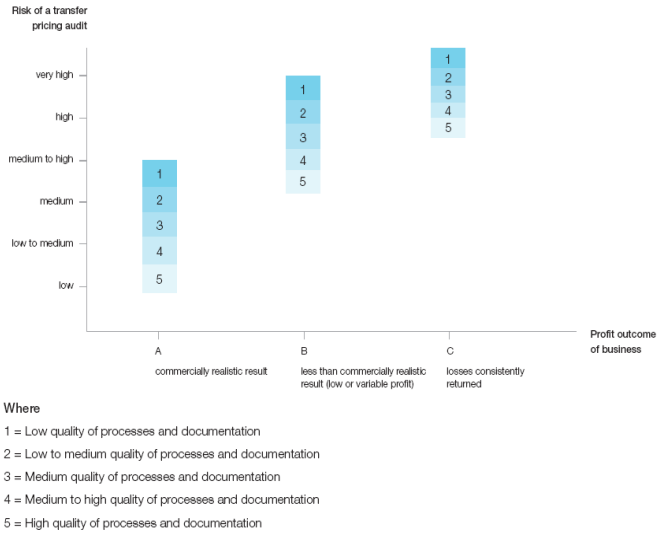
Taxpayers with international related party transactions are required to complete a Schedule 25A which is lodged together with the annual income tax return. The Schedule 25A contains various disclosures about the nature of the transactions and the counterparty countries. It also requires a declaration as to whether the transactions have been documented in accordance with the guidance set out in TR 98/11.

The documentation required to be prepared follows a "four step" process for analysing and documenting that transfer prices are arm's length. This four step process is as follows:

- Step 1: Preparation of a functional and industry analysis relevant to the transactions;
- Step 2: Selection of the most appropriate transfer pricing method including reasons for rejection of alternatives;
- Step 3: Application of the most appropriate method including details of comparable data and analysis; and
- Step 4: Reviewing the outcome and implementing an ongoing process of review.

Enforcement environment

The ATO has vigourously enforced transfer pricing rules over a number of years. In the late 1990's a specific program of targeted risk assessment was undertaken. More than 200 companies were selected for Transfer Pricing Risk Reviews ("TPRRs") and many led to full transfer pricing audits and adjustments. The process that the ATO undertakes for evaluating transfer pricing risk typically takes into account two factors: (1) quality of transfer pricing documentation (measured against the criteria set out in TR98/11); and (2) commerciality of results (as illustrated in the diagram below).



Where

1 = Low quality of processes and documentation

2 = Low to medium quality of processes and documentation

3 = Medium quality of processes and documentation

4 = Medium to high quality of processes and documentation

5 = High quality of processes and documentation

This process of assessing transfer pricing risk remains an integral part of the ATO's compliance approach and selection of cases for transfer pricing audit.

Transfer pricing in the financial services sector

The early days of transfer pricing enforcement focused on the non-financial services sector, with industries such as automotives, brown goods, pharmaceuticals and distribution receiving the most attention. However, in recent years the ATO has turned its focus to the financial services sector. Targeted industry reviews have been undertaken in the banking and insurance sectors.

Specifically, the ATO is currently scrutinising the performance of foreign banks in Australia. The ATO has announced plans to undertake reviews of foreign bank branches in Australia. This approach is consistent with historic approach of undertaking industry based reviews.

Current transfer pricing issues

There are a number of areas of development in the transfer pricing arena that are receiving current attention from the ATO and taxpayers. These are discussed below.

Guarantee fees and financing arrangements

As outlined in its most recent Compliance Program[7], the ATO is focusing on examining where profit shifting may occur in relation to guarantee fees. Although the ATO has not published its views on guarantee fees, it has an internally developed position which it is currently adopting in relation to its cases under review. In short, the key issue is one of how to apply the

[2] Taxation Ruling 97/20 – Income Tax: arm' length transfer pricing methodologies for international dealings.
[3] Taxation Ruling 98/11 – Income Tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings.
[4] Taxation Ruling 2001/11 – Income Tax: international transfer pricing – operation of Australia's permanent establishment attribution rules.
[5] Taxation Ruling 92/11 – Income Tax: application of the Division 13 transfer pricing provisions to loan arrangements and credit balances.
[6] Taxation Ruling 95/23 – Income Tax: transfer pricing – procedures for bilateral and unilateral advance pricing arrangements.

[7] Compliance Program 2006-07, International Tax Issues, page 56

arm's length standard in the case of financing transactions and guarantee fees. In particular, when applying the arm's length standard it is often necessary to consider the rate of interest that an independent lender would have insisted on. In this regard, there is debate around whether it is appropriate to have regard to any 'implicit' guarantees that may be implied by virtue of the fact that the borrower is part of a multinational group. The ATO's informal view is that if the external market were be prepared to provide funding to a subsidiary at an interest rate that reflects the implicit support of the parent, then the fees from any subsequent formal guarantee arrangements between the parent and the subsidiary should reduced by the value of this implicit guarantee. This issue is one of contention and has implications not just for guarantee arrangements but for the pricing of shareholder loans in accordance with the arm's length principle.

Business restructures

Business restructuring refers to arrangements of multinational enterprises by which functions, assets and/or risks of a business are transferred between jurisdictions. The transfer pricing issues associated with business restructures have been under some focus internationally at the OECD level. In May 2007, the ATO released a discussion paper on business restructuring which addresses the following issues:

i) The arm's length principle and business restructuring;

ii) Disregarding a restructuring agreement;

iii) Risk transfers;

iv) Commerciality of a conversion; and

v) Compensation payable upon conversion.

Whilst the paper is an internal discussion paper it does raise some relevant insights into the issues that the ATO will look at in reviewing business restructures, especially those involving the movement of functions and risks out of Australia.

Intangibles

Tax Commissioner, Michael D'Ascenzo, recently announced that that the ATO would turning its attention from transfer pricing issues involving the usual goods and services to intangibles such as the transfer of brand names and mastheads to offshore low-tax jurisdictions; especially where the IP is then licenced back. Specifically, it appears that the ATO is targeting intellectual property rights transferred off-shore and investigating the discrepancies between what companies tell their investors and what they declare to the ATO. We understand that forty listed companies are already under scrutiny.

WR Carpenter Case – burden of proof is on the taxpayer

Whilst there has been no case law in Australia on the substantive transfer pricing provision, there has been a number of cases in the last couple of years with relevance to the way in which transfer pricing rules are applied. In the latest decision in the WR Carpenter Case[8], the Full Court of the Federal Court has upheld an earlier decision by a single judge in the Syngenta Case[9] denying a taxpayer the right to examine and challenge the Commissioner's justification for a transfer pricing determination. The impact for taxpayers is significant. The practical implication is that it increases the burden of proof for taxpayers. In the case of litigation, the taxpayer can only defend its position by proving the positive case that its transfer prices were at arm's length. It cannot rely on proving that the transfer pricing adjustment made by the Commissioner is not arm's length. Clearly this has significant ramifications for the way in which taxpayers will go about both preparing their documentation and managing ATO transfer pricing reviews and audits in the future.

Conclusion

Transfer pricing in Australia is entering a new phase. Whilst the 'easier' targets for the ATO in the manufacturing and distribution sectors will continue to be monitored it is clear that the ATO is turning its attention to more complex arrangements involving financing, business restructures and financial services. With its recent successes in the Courts the ATO will feel an increasing level of confidence in talking these more complex transfer pricing arrangements. Accordingly, it will be important for taxpayers to ensure they stay ahead of the curve in maintaining an appropriate level of documentation to support their transfer prices and ensuring that transfer pricing implications are given due consideration as their businesses evolve.

For more information, please contact:

Nick Houseman (nick.p.houseman@au.pwc.com)

[8] W R Carpenter Holdings Pty Limited v Commissioner of Taxation [2006] FCA 1252

[9] Syngenta Crop Protection Pty Limited v Commissioner of Taxation [2005] FCA 1646

Recent FSTP Publications

As part of a dedicated series written by PwC financial services tax and transfer pricing practitioners for the Transfer Pricing Report the following articles have been published recently:

Hedge Funds - Fringe No More. The Tax Man Cometh...

Authors: Aamer Rafiq, David McDonald, Lirize Loots, Mimi Wang, Adam M. Katz, Frank Douglass, Mac Calva, Irina Diakonova, Ryann Thomas, Florence Yip, Mariana East and Paul Lau

Publication: Tax Management Transfer Pricing Report, Scheduled for Publication: September, 2007

Does Debt Matter? The Transfer Pricing Perspective

Authors: Michel van der Breggen, Barry Dennis,Irina Diakonova, Aamer Rafiq, Jeff Rogers, Mohamed Serokh and Bill Yohana

Publication: Tax Management Transfer Pricing Report, Date of Publication: July 11, 2007

Recent litigation on guarantee fees between Canada and two financial institutions—General Electric and HSBC—and a recent case on interest rates in Sweden highlight that nations are becoming more interested in assessing whether intercompany financial transactions are at arm's-length prices. Practitioners from PricewatershouseCoopers' offices in Amsterdam, Calgary, London, Melbourne, New York, and Zurich provide an overview of the issues arising as companies and governments estimate the pricing of these transactions, with a focus on intercompany debt.

Financial Services and Transfer Pricing in Italy:

Authors: Fabrizio Acerbis, Alessandro Caridi

Publication: Tax Management Transfer Pricing Report, Date of Publication: May 16, 2007

Fabrizio Acerbis and Alessandro Caridi of PricewaterhouseCoopers in Milan review the recent increase in Italian transfer pricing audit activities in the financial services industry—a trend they say is likely to continue as use of derivatives, complex financial transactions, and the lack of transparency compel further monitoring of the capital market and the financial sector.

Financial Institutions - Profit Split's New Frontier

Authors: Lucia Fedina, Adam Katz and Stan Hales

Publication: Tax Management Transfer Pricing Report, Date of Publication: May 2, 2007

Lucia Fedina and Adam Katz of PricewaterhouseCoopers LLP in New York and Stan Hales of the firm's San Francisco office examine tax authorities' increasing use of the profit split method for financial institutions.

Financial Services Transfer Pricing Trends And Developments

Authors: Aamer Rafiq, Annie Devoy, Adam M. Katz,Irina Diakonova, Ryann Thomas and Ana Carolina Albero

Publication: Tax Management Transfer Pricing Report, Date of Publication: April 18, 2007

Practitioners from PricewaterhouseCoopers' offices in New York, London, Zurich, and Tokyo examine draft reports released in December by the Organization for Economic Cooperation and Development on the attribution of profits to permanent establishments, which they say highlight the unique nature of the transfer pricing issues faced by financial services organizations.

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
Iceland	Elin Arnadottir	elin.arnadottir@is.pwc.com	+354 (0) 550-5322
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	Christian Ziegler	christian.ziegler@ru.pwc.com	+7 49 5232 5461
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.e.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

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