PRICEWATERHOUSECOOPERS

FSTP Perspectives

A publication for financial services industry tax and transfer pricing professionals

October/November 2007

Foreword

Dear Reader:

It is a pleasure to welcome you to the October/November edition of FSTP Perspectives. In this edition I would like to discuss some of the trends and challenges faced by multinational financial services organisations with operations in Asian countries. Foreign capital has been pouring into the Asian financial centres at an increasingly rapid rate. Regulatory reforms and commercial incentives are being offered in the race to be seen as the leading financial and commercial centre in the region. However, with a few exceptions, taxation laws and practices are struggling to keep up with the pace of change.

As many governments across the region respond to the influx of foreign investment, focus inevitably turns to managing the tax implications and ensuring that the local revenue base is protected. Transfer pricing and permanent establishment issues are naturally becoming a major focus of revenue authorities in the region. When added to the complexity of some of the transactions and business models adopted within the financial services sector more generally, and the level of sophistication and understanding of these markets by some tax authorities, the rate of disputes is on a rapid increase.

In the August edition of FSTP Perspectives, Joseph Foy wrote about the intense pressure on financial institutions to "get it right". In Asia, financial institutions are responding to some of the tax challenges being raised in different ways. There is a general trend towards beefing up the in-house tax capability through setting up regional tax and transfer pricing teams, at least for the larger organisations. However, even the largest organisations with dedicated tax and transfer pricing resource in the region face the challenge of how to best allocate those resources to the many challenges being raised.

In India, tax authorities have carried out detailed audits of the banking and capital markets players, focusing on areas such as correspondent banking, offshore booking of investment banking and treasury deals, broking and management charges. 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 offshore booking, though positions continue to evolve. With sectors such as real estate and private equity booming, there is a need for taxpayers in these sectors to pro-actively structure transfer pricing policies against the backdrop of recent experiences. Recent developments also include expansion in the number of dedicated officers who would audit transfer pricing cases, and extension of time limit to conclude cases. This indicates the intention of the Indian Revenue to carry out transfer pricing audits in a detailed and focused manner.

The recent decision given by the Indian Supreme Court in the case of Morgan Stanley has also attracted the attention of the tax professionals around the globe. The decision deals with creation of service PE on account of deputed employees, payment of arm's length consideration to the Indian BPO arm of the Morgan Stanley and contains certain comments on concepts such as lien on employment and PE exposure from Stewardship activities.

In China, the passing of the new Corporate Income Tax (CIT) Law in March 2007 is changing the tax landscape for foreign investment enterprises. The changes will gradually put foreign investment enterprises on a level playing field with domestic enterprises. As part of the changes new anti-avoidance measures and transfer pricing concepts will be introduced which have a significant impact on foreign investors doing business in China. Many of the details will be released in the Detailed Implementation Rules (DIR) however the signals are clear that the Chinese authorities are becoming more sophisticated and are gearing up their efforts to review inter-company transactions.

Meanwhile Taiwan's, transfer pricing regime is going through its early years of implementation. Taxpayers have had to deal with transfer pricing documentation and disclosure rules for the first time. Recently tax authorities have started requesting taxpayers to provide transfer pricing documentation. The Taiwanese tax authorities (and others in the region for that matter) have been benefiting from formal and informal training from tax authorities with more established transfer pricing regimes. As a result many of the trends seen in other countries in terms transfer pricing risk factors and audit activity are expected to develop in the coming years.

In Australia, the transfer pricing landscape is well established and the tax authorities are currently focusing their attention on the transfer pricing implications of specific issues such as guarantee fees, intangibles and business restructures. Of course, the major change on the Australian tax landscape is the introduction to Australian Parliament of the 3rd and 4th stages of the Taxation of Financial Arrangements ("TOFA") reforms. The legislation provides a menu of optional and default methods for bringing gains and losses on financial arrangements to account. The rules apply on a prospective basis from 1 July 2009 with taxpayers given the election to opt in early on 1 July 2008. Tax payers can also elect to bring pre-existing arrangements into the new rules but balancing adjustments may be required. Elections made under the new rules are irrevocable so careful consideration needs to be given to each of them by taxpayers in transitioning to the new regime.

These are but a few of the examples of the changing transfer pricing and tax landscape in the region. The pace of this change around the region is showing no signs of diminishing. The way in which organizations respond to this change now and address the risks raised will have an impact on their success in the future. As always, those organizations that are proactive and remain ahead of the curve in developing a framework for managing the many tax risks in the region will be best placed when the inevitable disputes with tax authorities arise. I hope you enjoy the reminder of this edition of FSTP Perspectives.

Regards,

John Masters,
PwC Asia Pacific FS Tax Leader

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

Index

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

New VAT rules in Ireland include Transfer Pricing Provisions

The Irish government has enacted new anti-avoidance legislation in relation to transactions between connected persons. The new legislation gives the Irish Revenue authorities the power to impute an open market value to the amount on which value added tax (VAT) is chargeable on a supply of goods or services. Given that Ireland does not have broad based transfer pricing rules, the decision to adopt this piece of legislation is somewhat surprising.

As a result of the new legislation, if a VAT exempt or partially exempt Irish company which is part of a multinational group receives goods or services from other non-Irish group companies but pays less than an arm's length amount, the Irish taxpayer is at risk of a VAT assessment on the amount of the undervaluation in addition to the risk that the counter-party may be subject to a transfer pricing adjustment in its home country. The rules are best explained by reference to the following examples:

Example A

Where a financial services company in Ireland receives an invoice for €10,000 for services from an affiliated Luxembourg company, the affiliated Luxembourg company generally does not charge VAT to its Irish affiliate. The Irish company is obliged to self-account for VAT at 21%, meaning that it recognises input VAT of €2,100 and pays this to the Irish Revenue authorities, however it cannot seek a deduction for this amount due to its VAT exempt status. Were €10,000 to be the open market value of these services, but the affiliated Luxembourg company agrees to charge only €5,000, the VAT payable would fall by €1,050. It is in such circumstances that the Irish Revenue authorities may impute open market value where they consider the amount on which VAT has been accounted is undervalued.

Example B

An Irish financial services company making both exempt and taxable supplies will usually apportion its VAT costs (deductible VAT) attributable to exempt and taxable activities based on the level of turnover derived from each type of supply. The Irish Revenue authorities may impute open market value where in their opinion the value of exempt supplies is understated or the value of taxable supplies is overstated.

Interestingly, the new rules provide a specific definition of open market value. Open market value is defined as the consideration excluding VAT that a customer would reasonably be expected to pay to a supplier at arm's length under conditions of fair competition for a comparable supply of such goods or services. If there is no such comparable supply of goods or services, then open market value can be determined to be the cost of providing the goods or services.

It should be noted that these rules apply solely for the purposes of the VAT Acts. In other words, should the Irish Revenue authorities increase the value of services supplied to a VAT exempt Irish company, the adjustment to the transaction value will only apply for the purposes of calculating the VAT – the amount that is included as an expense in the P&L (and hence as a tax deduction) appears to be unaffected. However, the additional VAT payable is likely to be claimed as a tax deductible expense.

In summary, the Irish Revenue authorities have yet to introduce broad based transfer pricing legislation in Ireland. The specific amendment to the Irish VAT Acts is the first form of transfer pricing law which has been introduced for many years. But as with the existing tax legislation it is very limited in its application and it is unclear how the Irish Revenue authorities will enforce the new provisions given the limited resources which the Irish Revenue authorities have in the area of transfer pricing. It is likely that enforcement of the new provisions will arise from the Revenue's current strategy for audit investigations.

For more information, please contact:
Lynne Rae (lynne.rae@ie.pwc.com)
Gavan Ryle (gavan.ryle@ie.pwc.com)

Re-Proposed U.S. Global Dealing Regulations to be Similar to 1998 Regulations

Almost ten years following the U.S. Treasury's issuance of proposed regulations on transfer pricing and related taxation issues of global dealing transactions, U.S. Government officials recently commented on the pending re-proposed global dealing regulations. Speaking at a tax seminar hosted by the Wall Street Tax Association, in Washington on October 16, Jeff Dorfman, Chief of Branch 5, IRS Office of Associate Chief Counsel (International), stated that the cornerstone principle of these proposed regulations is that capital should be taxed where it is used. Proposed global dealing rules were last issued in March 1998, and the IRS is working on re-proposed rules, which are expected to be broadly similar to the approach contained in the 1998 Proposed Regulations.

As addressed by the OECD Working Party 6 in its December 2006 paper, Attribution of Profits to Permanent Establishments - Part III, Global Trading Businesses, a crucial area is what approach to take in attributing profits among worldwide affiliates in a global dealing operation. Dorfman provided a hypothetical example -- a global dealing operation is set up with a capital provider in the U.K. that does not engage in any trading and a trading affiliate in the U.S. that trades in the name of the capital provider. In deciding how to allocate the profits of the capital provider between the trading affiliate and the capital provider, Dorfman said the first step should be to do a transfer pricing functional analysis. In doing so, depending upon the facts, a profit-split method is most likely the most appropriate method to use and the residual profit-split method is the most common method used.

The next question is to determine whether there is a trade or business in the U.S. It is expected that the approach in the 1998 Proposed Regulations will be that used in the Re-Proposed Regulations. That is, where a U.S. trading affiliate is trading in the name of a capital provider in another country, a qualified business unit ("QBU") is created in the U.S. In other words, there is a trade or business in the U.S. and income attributable to the capital provider is reattributed to the QBU and taxable in the U.S.

The U.S. has rejected the suggested alternative that global dealing profits be attributed using a hedge fund model. Dorfman noted that hedge funds are different from global dealing operations that

engage in narrow trading and capture income from the spread in a transaction.

The re-proposed global dealing regulations are expected to be released in 2008.

For more information, please contact:
Adam M. Katz (adam.katz@us.pwc.com)

Australia: Business restructuring under the microscope

Introduction

With the opportunity to leverage intangible assets and capture operational efficiencies across jurisdictions taking a high priority, the centralisation of key business activities by multinational companies, is continuing unabated.

Australian Taxation Office on the front foot

The growth in tax controversies arising from cross border business restructuring has led to an intensive review by both the OECD Committee on Fiscal Affairs and the Australian Taxation Office (ATO). The ATO has been particularly forthright in this regard by issuing a discussion paper as a platform for further dialogue with companies involved. The ATO paper presents a number of key transfer pricing propositions and other taxation issues proposed as relevant by the ATO for consideration by those companies undertaking business restructuring.

In seeking to ensure that companies consider the broader tax impact business restructuring creates both at transition and going forward, the ATO has raised a number of specific areas of concern. Since ATO representatives have been very active at an OECD level on this topic and in many cases have led key aspects of the discussion on the topic, the views expressed in the ATO paper provide a valuable insight into what other key revenue authorities may be thinking but not yet pronouncing. To provide an insight on what these issues are we describe some of the key factors immediately below.

Commerciality focus

In the discussion paper a key concern in relation to business restructures is the commercial character of the restructure itself with an undertone that the failure to support this may reflect a tax-avoidance motive.

In this regard, the discussion paper outlines the importance to understand the commercial logic and value of business restructures. From a practical perspective, suspicions may result where change programs reflect overriding involvement by the finance team rather than the operational or commercial members of senior management.

Further, in applying the arm's length principle, the ATO is likely to seek an assurance not only that the restructure is in the best commercial interests of the global group as a whole, but of the Australian business specifically. In this regard, broad discussion of local benefits supported by qualitative statements alone appears insufficient for ATO purposes. In many cases quantifiable evidence of commercial benefits and reconciliation of those benefits to the Australian business are sought to support commerciality.

Transition considerations

A particular area of concern that business restructures have raised for the ATO is the potential for a disposal of some form of intangible asset that reflects the migration of business.

It is common for such restructures to involve, at some stage, a transfer of some Intellectual Property ("IP") from the operating units to the "principal" company to ensure the coordination and control of the core assets of the business. More commonly, this includes transfers of identifiable IP such as brands and patents. However, in some cases revenue authorities have queried the potential for transfer of other intangibles, such as business goodwill, in whole or in part as a result of a business restructure.

Ultimately any relocation of an intangible asset will be a question of fact. While the disposal of identifiable IP is dealt with under capital gains tax rules in many territories, there remains a lack of clarity on how these assets should be valued and treated under transitional arrangements.

Convergence issues

The precise nature of any transition and the consequent treatment of businesses restructures are rarely limited to consideration of the transfer pricing implications alone. The establishment of new "non-KERT" structures may generate permanent establishment issues under various double tax treaties. The revised transactional structure may give rise to range of transaction-based taxation issues, and also withholding tax considerations.

Accordingly, it will be necessary to ensure that where a business restructure is being contemplated there is substantial evidence on file to demonstrate that the reorganisation is obviously and conclusively commercial in nature. Importantly, where a business restructure has already been undertaken, quantifying the desired commercial outcomes and compiling supporting information are prudent steps in managing any potential future tax review.

What are the lessons for FS companies involved in business restructuring?

Business restructuring is a real and necessary part of doing the business for multinational enterprises. Boards have the responsibility to ensure that all opportunities associated with business restructures are captured. However, revenue authorities concerned by the impact of business restructuring on the tax base have demonstrated a willingness to rigorously test the substance and outcomes of the business restructuring from a tax perspective, albeit without a consistent local and international policy framework.

The opening of dialogue on the policy issues, both by the OECD and the ATO are welcome, but the debate is still in its early stages. The convergence of taxation issues and the underlying theme of commerciality are likely to sharpen the focus on the arm's length principle and its application to multinational businesses. The development of one single concise view from revenue authorities is necessary to relieve the existing uncertainty on taxation treatment of the key issues relevant to business restructuring.

In the interim, businesses that have completed or envisage a business restructure can take steps to mitigate the potential transfer pricing and other taxation risks that are continuing to emerge. Ensuring that the founding fact pattern underlining the commerciality of the arrangements is supported by clear evidence of operational drivers is a fundamental starting point to supporting a successful position.

For more information please contact:
Nick Houseman (nick.p.houseman@au.pwc.com)
Bill Yohana (bill.yohana@au.pwc.com)
Pete Calleja (pete.calleja@au.pwc.com)
Garrick Robinson (garrick.robinson@au.pwc.com)

Country focus: Canada

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

Brenda Humphreys and Alan Ross jointly present this publication's country focus on Canada. Brenda and Alan are partners in the Canadian Financial Services Transfer Pricing Group. Their team is comprised of transfer pricing professionals with backgrounds in tax, accounting, economics and financial services.

Overview of TP in Canada

Canadian transfer pricing legislation and administrative guidelines are generally consistent with the OECD Guidelines. The Canadian statutory rules on transfer pricing introduced in 1998 as Section 247 of Canada's Income Tax Act ("ITA") embody the arm's length principle. The legislation contains no specific guidelines to measure arm's length; rather, it leaves scope for the application of judgment. Tax audit adjustments to transfer prices in excess of legislated thresholds can be subjected to penalties, regardless of whether the Canadian taxpayer is cash taxable. The best protection against a tax authority adjustment, and penalties, is the maintenance of contemporaneous documentation.

Audit Environment and TP Penalty Regime

Transfer pricing is a hot audit area in Canada and often the subject of great controversy and significant proposed adjustments by the Canada Revenue Agency ("CRA"). Canada's penalties are based on the amount of the transfer pricing adjustment resulting in a net increase in income or a net decrease in a loss. The non-deductible penalty is 10 per cent of the adjustment for taxation years beginning after 1998.

There is a de minimis threshold of $5 million or 10% of gross revenue before a penalty will apply. An adjustment over the threshold amount may also be excepted from the penalty for transactions where reasonable efforts were made to determine and use arm's length transfer prices. In 2006, the CRA issued a transfer pricing memorandum ("TPM-09") which provides additional guidance on what constitutes reasonable efforts to determine and use arm's length transfer prices. Therein, reasonable effort is defined as "the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances."

All transfer pricing adjustments over the de minimis threshold are referred to the CRA Transfer Pricing Review Committee for consistent application of the reasonable efforts assessment. During 2004, the Transfer Pricing Review Committee reviewed and recommended the application of its first transfer pricing penalty under s. 247(3) of the ITA. Since then, the CRA has increased its application of transfer pricing penalties.

Transfer Pricing in the Financial Services Sector

Guarantee Fees

Guarantee fee payments made by Canadian subsidiaries of multinational financial service firms to related non-residents for financial guarantees are under attack by the CRA. Two cases disputing significant disallowed deductions are expected to be heard in the Tax Court of Canada in the coming months.

Management Fees

As in many other industry sectors, the CRA has been active for many years in the audit of management fees or intra-group service charges. In the past decade, the disallowance of intra-group service charges has been a fairly regular source of tax revenue on audit assessment as many taxpayers continue to be lacking in detailed support for charges of this nature.

Foreign-based Information

Often back office and infrastructure type services are centralized. The CRA expects to be able to audit the amount charged for these services. Where the charge is based on an allocation of the cost of providing the service from a location situated outside Canada, a request to audit the underlying accounts is not uncommon.

The CRA may formally request the Canadian taxpayer to provide foreign-based information relevant to the administration or enforcement of the ITA. Supporting documents for inter-company charges and transfer pricing are prime examples of foreign-based information requested under these provisions. The taxpayer must provide the requested information within a reasonable period of not less than 90 days. Failure to do so may lead to possible fines or possible imprisonment.

Requests for access to foreign-based information are not restricted to the audit of management fee type charges.

Advance Pricing Agreement Program ("APA")

Canada launched the APA Program in 1993. Although financial institutions were early entries into the program, the sector's appetite and enthusiasm for APAs quickly dwindled. During the first 10 years, the financial services sector completed 6 APAs representing 11% of the program. Only 1 additional APA was started in the following 4 years representing about 1.5% of all new starts in that period. Generally, outside the financial services sector, the APA Program is clearly gaining momentum in Canada. Perhaps APAs may be an avenue of greater certainty that financial institutions will again consider in future.

New Developments in Canada-US Treaty

Attribution of Profits to a Permanent Establishment (PE)

The Protocol to the Canada-US Treaty signed on September 21, 2007, adopted the methodology of the OECD Guidelines for determining profits attributable to a PE, that being the use of the

functionality separate entity approach. Therefore the profit attributable to a PE will be determined under the same arm's length principle that would be used between legally distinct enterprises.

Further commentary accompanying the Protocol with respect to financial institutions and the attribution of capital, states that equity is to be allocated based on the risk-weighted assets attributable to them. With respect to insurance companies, the commentary states that in addition to allocating premiums earned to a PE, investment income should be allocated based on the reserves and surpluses that support the risks assumed by the PE. These comments are consistent with recent OECD reports in respect of these industries.

Arbitration

With the signing of the Protocols, the two governments also exchanged Diplomatic Notes that paved the way for binding arbitration in mutual agreement procedure (MPA) cases. Briefly, it is the process referred to as "baseball" arbitration where a 3-member arbitration board selects one of the proposed resolutions provided by the competent authorities. The determination will not state a rationale or be considered as a precedent for future cases.

The introduction of arbitration can be perceived as a positive step in respect of quicker resolution of MAP cases. While there is no way of knowing how much use will be made of the process, it will act as an incentive for both sides to reach a settlement within the two-year period before a case becomes eligible for arbitration. With the "baseball" arbitration format, it is anticipated that both competent authorities will now present more reasonable resolutions at earlier stages during the MAP process.

The introduction of binding arbitration should not deter taxpayers from continuing to use the APA program to obtain certainty in their transfer pricing. Certainty for subsequent years can not be assured through the arbitration process, because the determination of the board has no precedential value.

Closing Thoughts

Although the CRA is active in auditing financial institutions, it is early days for transfer pricing audit assessments on complex global transactions in the sector. As the CRA continues to gain experience and gather information in this space, transfer pricing views in the context of the OECD reports and the Protocol changes remain uncertain.

For more information, please contact:
Brenda Humphreys (brenda.j.humphreys@ca.pwc.com)
Alan Ross (alan.r.ross@ca.pwc.com)

Recent FS TP Articles

BPO units in India: Recent Supreme Court Ruling in the Case of Morgan Stanley on PE and Profit Attribution

In a recent article published in BNA International (see attached article at the end of this publication), Rahul Krishna Mitra and Sanjay Tolia analysed the Supreme Court of India's ruling in the case of creation of PE and allocation of income of the business process outsourcing ("BPO") of a global bank. As India is an established outsourcing hub for information technology, research & developments services and back-office functions in the financial services industry, these recent developments help to clarify the grounds and implications for PE and profit attribution issues.

For more information please contact:
Rahul Krishna Mitra (rahul.k.mitra@in.pwc.com)
Sanjay Tolia (sanjay.tolia@in.pwc.com)

BLOG: Pete Brewin's Japan blog September 2007

The background

The idea for this blog came during a meal in Hong Kong's Lan Kwai Fong between Aamer Rafiq, Shyamala Vyravipillai and myself earlier on this year.

Both Shyamala and I had recently left the London FSTP practice to take on new challenges in the Asia Pacific region. Shyamala had recently moved to China where she is helping to develop the FSTP practices in both Shanghai and Hong Kong. I had, within the last month, just started in Tokyo with the aim of assisting our Japan practice with the persistent stream of transfer pricing work that the Japanese National Tax Agency ("NTA") were creating for them with their continuing focus on transfer pricing and the tough audit environment that many international companies face out here, especially now that the financial services industry in this country appears to be finally recovering following on from its long period of sluggish growth.

The idea that we had was to provide informal reports from members of the PwC Global FSTP network that were on secondment or assignment away from the countries in which they were accustomed to working and use this to share their observations about how they have found the change and the things that they have noticed as being significantly different or unique to that location that perhaps the people that have been working there long term either take for granted and no longer notice.

In this respect I hope that you find my initial observations about working in transfer pricing in Japan interesting. I also hope that this blog provides you with some insight into what to expect the next time that you find yourself working here, or involved in a transfer pricing project which has a Japanese angle to it.

Working in Japan

One of the first things that hits you when you first arrive in Japan is that things are done differently here. This applies to many parts of life, from the mobile phone system, to the banking system and credit card systems to the ways in which business meetings are conducted. It also applies to transfer pricing. It has been a steep learning curve these past three months trying to get up to speed with the way in which transfer pricing is practiced and this has meant that I have had to trade in many of the methodologies and techniques that I was used to applying in the UK, which seemed to be generally acceptable in most other locations, for ones which were completely new to me.

Use of comparable data

Because many Japanese financial services businesses, and in some respects whole sectors of the industry, are traditionally structured in a different way to similar businesses in other developed economies, the NTA will not generally accept anything other than Japanese comparable data in justifying a transfer pricing policy. This can cause problems as much of the coverage of the commonly used financial services industry data sources has a US or European bias to it.

Luckily, publicly available data on the financial services companies does exist here, however much of this is not available in the searchable databases that exist in other jurisdictions. This has meant that the team has had to be innovative in how this data has been found and how it is used to support various clients' TP policies from a Japanese perspective. However it also means that it is much more time consuming, in certain cases, to gather the appropriate data.

Local legislation

In terms of understanding the local transfer pricing rules and regulations the difficulty has not so much been getting to know the transfer pricing legislation and guidance, but gaining an understanding as to how a particular transaction would be treated when it is audited. The actual legislation and guidance is relatively short, however as a result of this it can be ambiguous in how it instructs you to treat a transaction. In many cases this is deliberate so as to give both the tax authorities and the tax payer room to negotiate a settlement and compromise without loosing face. This therefore makes practical experiences of how the NTA and the regional tax bureaus view a particular transaction even more important.

Japanese documentation

Because the regional tax bureaus and the NTA are so active from an audit perspective, the preparation of Japanese documentation has to be done with the expectation that the transaction will be audited and the defence strategy has to be planned from day one. There are no TP documentation requirements here and as such there is no point in putting documentation in place with the aim of simply using this to reach a filing position and avoid penalties.

APA's in Japan

This leads to another key difference between working in transfer pricing in Japan and the UK, the number of Advance Pricing Agreements (APAs) that the team here is involved with. In the UK, APAs are relatively rare, that is not to say that they do not occur, however unless a company has a very uncertain tax position, many clients feel that the time and costs involved outweigh the associated benefits of increased certainty. There is also a reluctance by H.M. Revenue and Customs (HMRC) to consider the APA process in all but the most complex and uncertain areas.

In Japan, as companies tend to be subject to more uncertainty about their transfer pricing due to the aggressive positions that are sometimes taken by the NTA during audits, having the opportunity to negotiate a position in advance, appears to be more appealing, as evidenced by the large number of APA applications that are dealt with by PwC Japan each year.

Round up

It has definitely been more challenging adjusting to the change work wise, than I had expected, initially thinking that TP was pretty similar throughout each of the OECD countries. That has however meant that I've learnt much more.

Aside from the transfer pricing differences, the cultural differences are, if anything, even more difficult to adjust to. For example in attending business meetings, it seems to be the case that the more time I spend here, the more I realise how many things I'm doing wrong and how much more there is to understand about how Japanese people interact with each other.

Therefore over the next couple of months I am planning on getting up to speed on my Japanese business etiquette. My Japanese Teacher has also set, as this week's homework, to head down to Shimbashi on my own and get talking to the Salary-Men that congregate there, eating and drinking in the various Izakaya's and stalls that surround the train station, before making their trips home to the suburbs. We will see how that one goes, however as a homework assignment it probably ranks along side the better ones!

I believe that there are blogs due from secondees in other financial centres around the world before it swings back to me in Japan. However I look forward to updating you on how I end up doing on the cultural front in my next instalment. Until then, Sayonara.

For more information, please contact:
Peter Brewin (peter.brewin@jp.pwc.com)

Update on Events

Investment Bank Forum on 26 November in Sydney

This forum is in response to the current state of play in the industry where many financial institutions are under audit or review and the ATO has recently announced its audits focused on losses made by foreign banks. The forum will provide a discussion platform with the ATO and representatives of the financial services industry.

For more information please contact:
Nick Houseman (nick.p.houseman@au.pwc.com)

2007 UK Transfer Pricing Client Conference, Lord's Cricket Ground, London, 15 November 2007

For more information please contact:
Tracy Malyan (tracy.malyan@uk.pwc.com)

TP Circle on November 7 and November 8 in Zurich, Basel, Bern and St.Gallen, Switzerland

For more information please contact:
Irina Diakonova (irina.diakonova@ch.pwc.com)

2nd Treasury Breakfast, Zurich, December 6 2007

For more information please contact:
Irina Diakonova (irina.diakonova@ch.pwc.com)

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
	Junko Yamato	junko.yamato@us.pwc.com	+1 646 471 1432
Venezuela	Fernando Miranda	fernando.miranda@ve.pwc.com	+58 212 700 6123

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Rahul Krishna Mitra *and* ***Sanjay Tolia***
PricewaterhouseCoopers, India

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BPO units in India: Recent Supreme Court ruling in the case of Morgan Stanley on PE & profit attribution

Rahul Krishna Mitra *and* ***Sanjay Tolia***
PricewaterhouseCoopers, India

In the fields of information technology, research and development services and back-office functions India has been the business process outsourcing (BPO) hub of the world for quite some time. With the emergence of foreign BPO units in India, the Indian Government's stand on adopting a proper, fair and reasonable approach in taxing them has, for several years, been the subject matter of discussion and debate. In many cases, this has resulted in unnecessary concerns and complications arising. In several cases, the Indian Revenue has made things complicated by issuing directions which have been interpreted differently by various people. Typically, when a foreign company sets up a BPO unit in India or for that matter in any country, the two primary issues, which arise in the field of taxation are transfer pricing and creation of permanent establishment (PE). The issue of PE has been made the subject matter of too much debate, when the actual focus and attention should go towards adopting a proper transfer pricing policy of the BPO units.

In the midst of this, the Supreme Court of India has recently pronounced a ruling in the case of Morgan Stanley, wherein most of the doubts have been cleared in favour of taxpayers. The ruling comes as a breath of fresh air for multinational companies (MNCs) setting up BPO units in India. Incidentally, Morgan Stanley had earlier filed an application for an advance ruling in the instant case. The Authority for Advance Ruling had pronounced a detailed ruling on various aspects of the case, whereupon both the Indian Revenue and Morgan Stanley filed separate appeals against the same before the Supreme Court, which were disposed vide a common order.

Brief facts of the case

Morgan Stanley US (MSUS) had outsourced certain BPO functions to its Indian subsidiary, Morgan Stanley India (MSI), against payment of fees. MSUS sent, on a regular basis, its employees to the business premises of MSI to carry out stewardship activities. By stewardship activities, it was meant that the stewards supervised the functioning of MSI with a view to ensuring that the deliverables were of the required quality and standard expected by MSUS. The stewards, as such, did not appear to take part in any management functions of MSI. Although not specifically mentioned in the ruling, it appears, and quite logically, that MSI did not pick up the salary costs of the stewards. In other words, MSUS continued to pay and bear the salary costs of the stewards. Incidentally, although the Supreme Court has used the term "stewardship activities", the same should typically be understood as "transition services" under transfer pricing terms. However, for the sake of simplicity, we have retained the term "stewardship activities" in this article. There was another class of employees of MSUS, who visited India. For these employees, MSI made specific requests to MSUS to depute them to its business premises for providing services through training, *etc.* During the stage of such secondment, the technicians or secondees would remain on the payroll of MSUS and MSUS would initially pay their salaries in the United States and thereafter have the same recharged to MS India on the basis of actuals, *i.e.,* without any mark-up.

Issues involved

The basic issues involved in the case were whether MSUS had a PE in India, and if yes, what would be the profits attributable to the PE? Incidentally, the major or raging dispute was whether BPO units of foreign MNCS constituted PEs of such foreign principals, and accordingly whether a percentage of the global profits of the foreign MNCs could be taxed in India as being attributable to the PE, *i.e.,* over and above the arm's length remuneration received by the Indian BPOs from their foreign principals for carrying out the outsourced operations.

Analysis of Supreme Court judgment

The Supreme Court held that MSI did not *per se* constitute a fixed place of business PE of MSUS in India. It is submitted that this had to be an obvious answer, since MSI was a different entity altogether as compared to MSUS, working on a principal-to-principal basis with MSUS, and unless MSI constituted a dependent agent of MSUS through soliciting of orders or concluding contracts on behalf of MSUS, MSI could never create a fixed place of business PE of MSUS. This is also in line with the OECD guidelines.

The Supreme Court held that MSI was not a PE since it carried out back-office functions, being in the nature of preparatory and auxiliary services, which are excluded from the threshold of PEs in tax treaties. Although the Court decided in favour, it is submitted that the better way to address the issue could have been to hold that the premises of MSI did not or could not constitute a fixed place of business of MSUS at all, thus whether MSI carried out back-office functions or high-end

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outsourced work was not relevant, provided that MSI and MSUS were working under a principal-to-principal basis.

The Supreme Court next dealt with the presence of the stewards and secondees, namely whether they led to the creation of any PE of MSUS in India. The Supreme Court held that the stewards did not give rise to any service PE of MSUS in India, overruling the view of the AAR that the stewards did give rise to a service PE. It may be noted that although the concept of service PE is not there in the OECD model, some of the Indian tax treaties contain the concept of service PE. The India-U.S. treaty is one of them. The service PE clause provides that rendering of services (other than services giving rise to fees for technical services (FTS)) by employees or other personnel in India, for a particular period of time, would give rise to a service PE of the U.S. company in India. It is in this context that the Supreme Court was required to examine whether the presence of the stewards and secondees resulted in creation of a service PE or any other PE of MSUS in India. While deciding that the presence of the stewards did not give rise to any service PE in India, the Supreme Court held that since the stewards did not render any services whatsoever in favour of MSI and they merely monitored the workings of MSI with a view to ensuring that the deliverables of MSI met the quality requirements of MSUS, there was no question of a service PE being created by the stewards.

The Supreme Court thereafter held that the presence of the secondees resulted in MSI creating a service PE of MSUS in India. However, in the case where MSI was remunerated at arm's length by MSUS for the BPO functions, *which, under the facts of the case, the Supreme Court noted that the Indian Revenue had accepted the arm's length profits to be a full cost mark-up (FCMU) of 29 percent*, then no other profits could be attributed in the hands of such service PE.

At the outset, it may be noted that the mark-up of 29 percent on full cost, as above, cannot be held to be sacrosanct across all back office operations carried out by captive BPO units in India. The arm's length profit margin for a captive BPO needs to be determined on a case-to-case basis on the strength of a transfer pricing study with reference to an analysis of functions performed, risks assumed and assets owned by the BPO unit.

It is submitted that the issue relating to service PE and profit attribution could have been adjudicated in a different and better way, although there might not be much negative fallout following the way in which the issue has been decided by the Supreme Court. The better way to tackle the issue could have been as follows:

- In the case where the services rendered by the secondees did not qualify as "technical services" for the purposes of the India-U.S. tax treaty, then the secondees would create a service PE if their presence in India crossed the threshold with regard to the creation of a service PE. On the other hand, in the case where the services qualified as "technical services" for the purposes of the tax treaty, then the presence of secondees would not create a service PE. However, if they occupied the premises of MSI for at least six months, which appears to be the fact in this case, then the premises occupied by the secondees could create a fixed place of business PE of MSUS in India.
- Incidentally, an argument was raised by MSUS that the secondees were under the economic employment of MSI and thus did not represent MSUS for the purposes of creating a PE of MSUS in India. However, the Supreme Court negated the argument, holding that the secondees retained lien on their employment with MSUS and thus represented MSUS in India. This particular point merits some discussion:
  - In this case, the employments of the secondees remained with MSUS, although MSI actually picked up their salary costs. MSI could be treated as the economic employer of the secondees, since, it not only picked up the salary costs, but the secondees also worked under the direct control and supervision of MSI (*the discussion draft of OECD commentary on Article 15(2) also expresses the same view)*. Therefore, under the OECD model tax treaties, one could say that the secondees represented MSI and also worked under the economic employment of MSI and thus there was no question of them creating any PE of MSUS in India.
  - However, the Indian model tax treaties (India-U.S. tax treaty is not much of an exception) require slightly more deliberation, as they cover the "source rule" concept of taxation of FTS. Under the India-U.S. tax treaty, the preamble to the definition of fees for technical services contains the words: "consideration for rendering of any technical or consultancy services *including through the provision of services of technical or other personnel*, if such services make available technical knowledge …". However, the definition provides that any payment *inter alia* made to an employee of the payer would fall outside the ambit of FTS.
  - In this case, if one considers the position that MSI became the economic employer of the secondees, then MSUS could be said not to be providing any technical services in accordance with the general connotation of the said term, since providing services generally means doing something in accordance with the request of the service recipient. However, the difficulty arises with the bracketed words contained in the definition of FTS, *i.e.,* "including through the provision of services of technical or other personnel". The question is: what do these words mean? There is not much precedence on the exact meaning of the said term, however, there is a possibility of the same referring to making available of technical personnel by one entity at the disposal of another entity, even in a case where the first entity does not retain control or supervision on the people deputed. In that situation, the secondment of technicians by a U.S. parent to the Indian subsidiary could fall within the category of rendering services by the U.S. parent through the provision of services of technical personnel, so as to attract the provisions of FTS *per se*.
  - In the case where the employment or service contracts of the secondees were transferred to the Indian subsidiary under a similar situation, then a position could be taken that the payments made by the Indian subsidiary for the salary costs of the secondees would represent salaries paid to employees and accordingly the same would fall outside the ambit of FTS. In essence, the same result is achieved even in a situation where the employments or service contracts of the secondees are retained at the level of the foreign parent. However, the secondees virtually become the economic, if not legal, employees of the Indian subsidiary, as they work under the direct supervision and control of the Indian subsidiary and not the foreign parent company. The difficulty is created by the express

provisions of FTS, namely, the bracketed words: "including through the provision of services of technical or other personnel". The OECD is not faced with such a dilemma, since the concept of FTS, in the form referred to above, is quite unique to both the domestic tax laws of India and also the majority of the Indian tax treaties. Thus, there is not much clarity in this regard and one would not have much option but to adhere to the principles laid down by the Supreme Court.

- Now, coming back to the main issue, in either of the two cases referred to in the first bullet point above, the secondees of MSUS could create a PE of MSUS in India, on whether it is a service PE or fixed place of business PE. However, the point to note is that under no circumstances could MSI create a service PE for MSUS in India, as held by the Supreme Court, although, in the end, perhaps there may not be much negative impact of such observations on the part of the Supreme Court, as would be evident from the points raised below.
- Let us say, the salary cost of the secondees is Rs.100. Since, the case in question is not one of transition services, as above, and the services would be rendered by MSUS through the secondees in favour of MSI, in accordance with the specific request of MSI, there is a likelihood that MSUS would need to charge a mark-up on the costs of Rs.100, while invoicing for the service fee on MSI. From general transfer pricing experience on margins of comparable companies, it is likely that the mark-up thereon could be somewhere around 10 percent. *Thus, ideally, MSI should have paid Rs.110 in favour of MSUS for such services, with the result that the service PE of MSUS would have reported profits of Rs.10*.
- When it comes to analysing a situation in the hands of MSI, the said payment of service fees of Rs.110 should not form part of the cost base for calculating the mark-up (in this case, 29 percent on FCMU basis) for rendering BPO functions, being in the nature of a pass-through cost. No doubt, MSUS would reimburse MSI for the said expenditure of Rs.110, however, without any mark-up, since the economic profits relating to the said services would already have been recovered by the service provider, *i.e.*, MSUS.
- Thus, ideally, the salary cost of Rs.100 of the secondees, should have yielded a profit of only Rs.10 in India, taxable in the hands of the service PE of MSUS. On the other hand, as stated by the Supreme Court, MSI reports profits of Rs. 29 on the said sum of Rs.100 based on FCMU of 29 percent. In other words, if one follows the Supreme Court ruling, higher profits are generated and taxed in India, with a corresponding claim for deduction in the hands of MSUS, while on the other hand where a proper analysis of the service PE was undertaken the profits could probably have been calculated at a lower figure. *However, in case the quantum of the salary costs of the secondees is not significant, then the difference of the mark up in absolute terms may not be material*.
- The net result of the Supreme Court ruling is that, in the case where MSI India has included the said sum of Rs.100 as part of its cost base and reported profits at arm's length margin *inter alia* on the said sum, no further profits would be attributed in the hands of the service PE, since, in any event, a higher amount of profits would have already been reported in India, albeit in the hands of MSI.
- To this extent, the ruling of the Supreme Court has the effect of mitigating risks of taxing a portion of the global profits of foreign MNCs in India, by treating their BPO units as PEs.

Conclusion

MNCs have perhaps a good reason to smile, having achieved the primary objective of mitigating risks of captive BPO units in India created through subsidiaries, being held as PEs, even when such BPO units were not soliciting orders or concluding contracts for their foreign principals, and accordingly a percentage of the global profits of the MNCs being taxed in India. However, one would have been happier if the subtle and intricate issues relating to PE and profit attribution would have received better justice from the Supreme Court, although there is not much negative fallout, as such, from the Supreme Court ruling. Further, MNCs could do well to envelop and mitigate exposures for attribution of profits to similar PEs created through secondees, through proper structuring of the business model.

In an attempt to address various views from different quarters, we may conclude with the observations that the Supreme Court ruling has nothing to do whatsoever with the issue of attribution of profits to a dependent agent PE, where the agent, being a separate legal entity as compared to the principal, gives rise to a deemed or hypothesised PE, by wearing two hats: (a) one in the capacity of the agent; and (b) the other in the capacity of a deemed PE of the foreign principal. In that case, *depending upon whether the dependent agent would perform significant people functions for assumption of risks and ownership of assets*, there could be attribution of profits to the PE over and above the arm's length remuneration received by the agent from the principal company, as held by the OECD in the latest discussion paper on attribution of profits to a PE: "The attribution of profits in such case is not automatic and requires an extensive functional & factual analysis of the activities of the agent under a transfer pricing study, *i.e., whether or not the agent performs significant people functions for assumption of risks & ownership of assets".*

However, in this case, there is no "dual hat" being worn by any party for creating the service PE of MSUS. The service PE is a stand alone one, created by the secondees of MSUS, and not by MSI, as held by the Supreme Court, and a reasonable mark-up commensurate to the services rendered by the service PE would need to be attributed to the same, with the corresponding result of lowering the overall impact of the tax liability in India, as discussed above. It just so happens that since MSI reports profits on FCMU basis and, as part of that, *inter alia* includes the cost reimbursement for the salaries of the secondees in the cost base, that the peculiar issue arises that in the case where MSI reports mark-up or profits on the salary reimbursements, the service PE may not be required to pay any further profits, since more than adequate profits would have automatically been paid by MSI thereon, although, it is doubtful whether the Supreme Court had this proposition in mind while pronouncing the ruling. However, this position cannot be generalised for agency PE, for the reasons referred to above.

Rahul Krishna Mitra *and* ***Sanjay Tolia*** *are Partners specialising in transfer pricing at PricewaterhouseCoopers, India. For further information please contact the authors by e-mail at: rahul.k.mitra@in.pwc.com and sanjay.tolia@in.pwc.com.*