PRICEWATERHOUSECOOPERS

FSTP Perspectives

A publication for financial services industry tax and transfer pricing professionals

December 2007 - January 2008

Foreword

Dear Reader:

It is a pleasure to welcome you to the December 2007/January 2008 edition of FSTP Perspectives. This is the sixth issue of our bi-monthly publication which was launched last February. This year has been eventful, with respect both to the general economic business climate and developments in the transfer pricing world. There has certainly been no shortage of topics worthy of discussion in FSTP Perspectives.

Perhaps we could take a moment to reflect on 2007, which began with the pre-Christmas 2006 release by the OECD of the *final* Report on the Attribution of Profits to Permanent Establishments, Parts I-III. The Authorized OECD Approach really became "authorized" as far as the OECD member country taxing authorities were concerned. We suddenly moved into the implementation phase for Part I-General Business, Part II-Banking and Part III-Global Trading, which led to the release of draft revised Commentary to Article 7 of the OECD Model Income Tax Treaty. In August, the OECD released a new draft Part IV relating to Insurance which has left open for debate the appropriate value for, and scope in defining, "risk assumption" as a KERT, as acknowledged at the November consultation in Paris. Accordingly, despite things seeming to move forward, the entire package continues to provoke controversy and a number of uncertainties, and sometimes conflicting views on the part of certain taxing authorities.

The legal and regulatory framework in many key countries further advanced in 2007 countries with significant legislative and/or administrative developments in transfer pricing this past year include the US, UK, Canada, China, Germany, India, Ireland (VAT legislation now includes transfer pricing rules) and Japan.

In the US, the Temporary Regulations applicable to controlled services transactions became effective this past year though the IRS announced in December 2006 a one-year delay for most of the provisions of the Services Cost Method, thereby allowing for taxpayers to, in effect, continue to apply the cost safe harbour in the 1968 Treasury Regulations until 2008. While the US Treasury did not issue the awaited new regulations (re-proposed) for Global Dealing transactions, and also for Cost Sharing, these projects continue to remain high priorities and new regulations are expected in 2008.

In the UK, thin capitalisation and financial products have been two key areas of focus for HMRC this year. Further to a recent statement of practice issued by the HMRC, UK based multinational companies are now able to enter into unilateral advance thin capitalisation agreements to provide greater certainty around thin cap. On 6 December, HMRC issued a consultative document on financial products which proposes to challenge any return equivalent to interest which is not taxed and the sale of income streams to create a capital receipt. This raises many questions including what exactly is meant by 'return equivalent to interest'.

The controversy and dispute resolution environment continues to be very active for multinational financial institutions. The management of myriad transfer pricing audits is now a part of virtually every corporate tax department's regular function. The level of cooperation, and sometimes coordination, between countries in accordance with obligations under income tax treaties is unprecedented. A number of taxpayers have opted to take the judicial route as evidenced by the *Morgan Stanley* court decision in India (on the existence of a PE and attribution of profits) and the current *GE* case in Canadian Tax Court, in connection with the appropriate determination of guarantee fees for corporate group member subsidiaries.

The Advance Pricing Agreement process is again thriving as many taxing authorities have added resources and are willing to negotiate up front the pricing for complex financial industry business transactions. We are also seeing a new approach to the Competent Authority process on the treaty negotiation front with several newer treaties and protocols now containing an optional tie-breaker - a "baseball style," winner-take-all arbitration process when the country competent authorities are deadlocked, with the OECD given the key role of appointing the third tie-breaker panel member.

So what might one plan for in 2008? We should expect further developments from the OECD including a draft paper on business restructurings, more new rules and regulations and increasing transfer pricing audits and controversy. An uncertain economic climate, particularly in the financial sector capital area, spawns countercyclical issues such as the allocation of losses and business reorganisations and restructurings. Accordingly, the transfer pricing road ahead is clearly one with many challenges, but those taxpayers which devote adequate resources to the corporate transfer pricing function, work closely with internal financial and business colleagues, should be well-positioned to manage the corporate tax risk.

Finally, as leaders of the PwC Financial Services Transfer Pricing Practice, we wish to thank those who have contributed to the huge success of FSTP Perspectives. This includes many of our global tax leaders who have authored forwards in prior issues -- David Newton and Richard Collier from the UK, Joe Foy and Garry Stone from the US and John Masters from Australia, our editorial team led by Irina Diakonova in Switzerland and Erin Fay in the UK, and those individuals from the PwC global FS TP network who have authored articles and country focus sections.

Wishing each and every reader our best wishes for a happy holiday season and healthy new year!

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December 2007

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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OECD Draft Report on the Attribution of Profits to Permanent Establishments – Part IV (Insurance) developments from consultation meeting

On 26 November representatives from the insurance industry, PricewaterhouseCoopers and other professional firms and the OECD member tax authorities met in Paris to discuss specific issues and concerns around the latest discussion draft of the OECD's Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance), which was released on 22 August 2007.

The OECD's objective is to finalise the report after consideration of the feedback, both written and verbal, with a view to releasing a final version of Part IV in the first quarter of 2008.

Background

The purpose of the OECD report is to promote international consensus and consistency in the taxation of permanent establishments (PEs).

The OECD's approach is based on the premise that it is necessary to determine the profits which the PE might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions.

Purpose of the consultation

Interested parties had been invited to comment on the latest discussion draft, with a deadline for submission of 31 October 2007. Commentators were then invited to the consultation in Paris to discuss specific aspects of the feedback received.

The topics for discussion were:

- Clarity around the definition of insurance risk assumption.
- Whether assumption of insurance risk should be treated as the sole key entrepreneurial risk taking (KERT) function in insurance.
- Whether the scope of the KERT function should be extended to functions performed subsequent to the assumption of risks.
- Recognition of internal reinsurance dealings.
- Allocation of expenses/income resulting from reinsurance transactions with third parties.
- Issues surrounding the attribution of investment income/assets to the PE.

Insurance risk assumption

Many of the written responses had expressed concern that the OECD had limited the insurance industry to only one KERT function, that of insurance risk assumption, and then further restricted risk assumption activities to those falling under the OECD's definition of underwriting.

Participants also considered the OECD's interchangeable use of the terms "risk assumption" and "underwriting" to be confusing and potentially prejudicial against applying a facts and circumstances approach.

At the consultation, participants encouraged the OECD to consider either widening the definition of underwriting or relying less on the term "underwriting" as a proxy for risk assumption.

The OECD expressed reluctance to widen the definition of underwriting but will consider how best to refine the wording to accommodate a more "facts and circumstances" approach to identifying the key components of risk assumption.

Risk assumption as the sole KERT function?

The OECD accepted that, in certain situations, risk management might be sufficiently active to constitute a risk transfer from the original location where the risk was assumed. However, the presumption underpinning Part IV is that functions undertaken post risk assumption, whilst they might be very valuable, should not typically alter the primary ownership of the original risk. This was illustrated by an example where a very poor risk is accepted, with resulting losses. Whilst subsequent risk management might mitigate the losses, the primary responsibility for the consequences should be with the location where the risk was assumed. Subsequent risk management would not transfer the losses to the risk management location.

In view of this presumption, the OECD acknowledged that Part IV is deliberately worded to allow risk management as a KERT only in exceptional circumstances.

All industry delegates considered that risk management could be a very profitable function and that underwriting profits and investment income might still need to be shared, whether or not risk management was considered to be a KERT function.

Industry delegates also had strong views that certain risk management activities, such as capital management, could be sufficiently active to meet the KERT definition.

Life insurance implications

The Canadian Life and Health Insurance Association (CLHIA) had responded in detail in a written response, proposing numerous changes to the wording of Part IV to ensure full relevance to the life sector.

During the consultation, a representative from CLHIA also made clear to the OECD that the life sector wished to consider all annuity types under the principles of Part IV (rather than Parts I or II), regardless of the relative levels of insurance risk, on the basis that the annuities business is liabilities driven and more comparable to insurance than to pure investment products.

Internal reinsurance

A key debate has been whether reinsurance between branch and head office should be accepted for tax purposes. The current wording of Part IV suggests this would be unlikely.

It became apparent during the consultation that, whilst the OECD does not preclude risk transfer within an entity, no realistic examples of internal reinsurance occurring in practice had been put forward by the industry. Similarly, no triggers for recognition of an internal risk transfer had been proposed by the insurance industry.

Delegates from the insurance industry put forward that, if properly priced, the categorisation of a fact pattern as either split KERTs, internal reinsurance or profit sharing risk management might be expected to lead to the same or a very similar attribution of profits.

External reinsurance allocations

Delegates from the insurance industry put forward that, without the recognition of internal reinsurance, external reinsurance premiums/recoveries on, for example, a whole account excess of loss basis, would require potentially sophisticated allocations. The OECD was requested to include this allocation issue more explicitly in the report.

Attributing investment income/assets

A key issue for many insurance companies is how much investment income and gains should be allocated to the branches.

Insurance industry delegates proposed that the term "investment assets", currently used in the report, did not properly reflect the fact that some assets would be non-income generating. The term "financial assets" was proposed as a more accurate representation of a typical insurance company balance sheet. This point was accepted by the OECD.

Delegates requested the elevation of the quasi thin capitalisation attribution method to an approved approach, whereby financial assets would be attributed to each branch based on the minimum regulatory requirement. This was not considered acceptable by the OECD.

In the absence of the option for taxpayers to rely on the quasi thin capitalisation approach, delegates requested an assurance from the OECD that investment income allocated under the OECD authorised approach could not exceed 100% of the entity's total investment income. The OECD was very clear that such a guarantee would not be possible given the option for different tax authorities to select different approved allocation methods.

Some time was spent debating the potential withholding tax consequences of reallocating investment income, with some specific examples used to illustrate the potential issues. The OECD reiterated that the intention was to attribute profit generally, rather than seek to reallocate specific returns on investment assets. However, in view of the examples given, the OECD agreed to consider the matter more closely.

Implementation of the OECD report

The OECD member tax authorities and OECD working party responsible for the report met to discuss the outputs from the consultation process in the days following the consultation meeting.

It is hoped that a final version of Part IV will be released in the first quarter of 2008.

Once finalised**,** the conclusions of Parts I-IV of the report will be implemented in two stages.

The commentary to Article 7 (Business Profits) of the existing OECD model tax treaty is being revised to incorporate the concepts of the PE report, but only to the extent that the concepts do not conflict with the current wording of the treaty or commentary. A first consultation draft of this revised commentary was released in April this year and a finalised version is expected to be released by the end of 2007.

The second stage will be a new text for Article 7 together with accompanying commentary in order to implement the full conclusions of the report. This is expected to be released for consultation by mid 2008.

The OECD states that this two stage approach aims to give maximum legal certainty in the interpretation of both the existing and future treaties. However, tax authorities are still considering the most appropriate way in which to implement the principles of this report.

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US Treasury Report: Global Dealing Excerpt

Treasury Report to US Congress Addresses Income Stripping and Transfer Pricing Regulatory Gaps

Introduction

On November 28, 2007, the Department of Treasury (the "Treasury") issued a report (the "Report") in response to sections 424 and 806 of the American Jobs Creation Act of 2004 (the "AJCA"). In the AJCA, the U.S. Congress directed the Secretary of the Treasury to conduct studies regarding the effectiveness of:

(1) the earnings striping rules;

(2) the transfer pricing rules, and

(3) income tax treaties to which the United States is a party.

This article summarizes some of the key points related to global dealing from the transfer pricing discussion in the Report (the "TP Chapter"). The following sections provide an overview of the TP Chapter and describe the empirical evidence provided on income shifting as well as Treasury's commentary on proposed global dealing regulations.

Overview of the TP Chapter

The TP Chapter comments on shifting income from the United States to other tax jurisdictions and reviews Treasury regulatory guidance under section 482 and the effectiveness of the current transfer pricing rules and compliance efforts.[1] The TP Chapter

[1] Current transfer pricing rules or regulations refer primarily to the existing final regulations under section 482 as of December 31, 2006. These include the 1968 regulations with respect to the intercompany provisions of services under Treas. Reg. §1.482-2(b), the 1994 transfer pricing regulations under Treas. Reg. §1.482, the 1996 cost sharing regulations under Treas. Reg. §1.482-7, and the stock-option regulations under Treas. Reg. §§ 1.482-5 and 1.482-7. For these purposes,

also reviews the administration of section 482 rules and empirical evidence compiled by Treasury on income shifting. The key conclusion is the need for Treasury to complete the process of finalizing and modernizing its transfer pricing regime.

Specifically, Treasury calls upon the need for "finalization and implementation" of three key transfer pricing regulations that address:

(1) cost sharing;

(2) intercompany services; and

(3) global dealing in financial instruments.

These three regulations will address perceived gaps in transfer pricing administration and are expected to alleviate common avenues for income shifting.

Income Shifting (Empirical Evidence)

Through analyzing tax return data for 1996, 2000, and 2002, Treasury seeks to identify empirical evidence on income shifting by analyzing the relationship between local country statutory rates and operating margins. Treasury concedes the data available does not provide sufficient visibility into the various factors that may contribute to this correlation. However, in its conclusion, Treasury states that "while the ability to draw transfer pricing-specific inferences from tax return data is limited to some extent, the analysis of this data does not allay the concerns about potential income shifting from non-arm's length transfer pricing…".

Proposed Global Dealings Regulations

In March of 1998, the IRS released proposed global dealings regulations regarding the arm's length allocation of income and expenses in global dealing operations among related taxpayers and/or branches of a single taxpayer. The 1998 proposed global dealing regulations provide guidance on the execution of customer transactions involving financial products in multiple jurisdictions or through multiple "participants."[2] A participant is either:

(i) a "regular dealer in securities" or

(ii) a member of a controlled group of taxpayers so long as that member conducts one or more activities related to the activities of the regular dealer in securities.

Related activities include marketing, sales, pricing, risk management, and may include brokering.

The Treasury's view is that the existing taxation of financial products is not current with how the industry operates. It is noted that the current transfer pricing regulations for determining the source and effectively connected treatment of securities dealer income were intended to apply in situations where one location participated in the majority of the earnings process. In today's business climate of "global" trading books and electronic and 24-hour trading, there is clear uncertainty in situations where financial institutions operate through one or more entities or trading locations. The Treasury notes that the proposed global dealing regulations provide "insufficient guidelines" for the highly complex intercompany transactions associated with financial service companies. Furthermore, the 1998 proposed global dealing regulations were silent as to whether the provision of capital is a participant function and, thus, how it should be compensated. A key omission since the utilization of capital can impact how global trading manages risk.

Treasury also references the 2006 OECD Report on the Attribution of Profits to Permanent Establishments (the "OECD Report") when discussing the need to have regulations that reflect the current business environment as well as emerging international tax norms.[3] The TP Chapter implies other developed nations have more developed global dealing guidelines in comparison to the U.S.

Conclusion

From a review of the TP Chapter it is the clear intention of Treasury to continue to focus on transfer pricing through the issuance of regulations. The empirical evidence presented seems to indicate that transfer pricing continues to be perceived as an area that taxpayers use to their advantage in shifting income to low tax jurisdictions. PwC also expects this continuing focus will translate into a push to finalize the regulations in the area of global dealing, as well as cost sharing and intercompany services.

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the 1998 proposed global dealing regulations are also considered as part of the current regulatory regime.

2 The Coordinated Issue Paper ("CIP") released on September 27, 2007 the IRS Large and Mid-Size Business Division ("LMSB") on buy-in payments presents many of the theories discussed in the 2005 proposed cost sharing regulations, and further indicates the intent of the IRS to apply such theories to examinations of cost sharing arrangements ("CSA's") under the existing regulations.

3 The Part III of the OECD Report (Global Trading) provides guidelines on attributing economic ownership of assets and the assumption/management risk through "significant people functions" ("SPF"s). This term is consistent with the key entrepreneurial risk taking ("KERT") concept as utilized in Parts I (General Considerations) and II (Banks) of the OECD Report.

IRS official comments on Transfer Pricing Service Audits

IRS: Transfer Pricing Service Audits

Speaking at an American Bar Association tax conference in Philadelphia on November 2nd, John Breen, Chief of Branch 6, Office of Associate Chief Counsel (International), Internal Revenue Service ("IRS"), commented on the IRS' current approach to transfer pricing audits in light of the Temporary and Proposed Regulations on the Treatment of Services under IRC Section 482 ("Services Regulations").

Audit Approach to Intercompany Services

As mentioned at the ABA tax conference, in the context of an audit on service transactions, IRS auditors are being instructed to focus on high-value services rather the more routine, back-office services, in an effort to attain a more effective deployment of IRS resources. In this respect, the IRS will focus, in part, on whether the service transactions in question "contribute significantly to key competitive advantages, core capabilities, or fundamental chances of success or failure in one or more trades or businesses of the renderer, the recipient, or both." (Treas. Reg. §1.482-9T(b)(2)). Large global organizations with significant infrastucture support such as technology and systems could face greater scrutity with respect to the level of charges including a required profit element under the Services Regulations.

The IRS is also instructing its auditors to focus on the proper documentation of service transactions, with particular attention paid to contemporaneous documentation. This statement is consistent with the emphasis conveyed by the Service Regulations on both adopting and following written agreements covering the provision of services among related entities.

Passive Association

With respect to the benefit test and passive association, the IRS' position is that the Temporary Regulations align with OECD Guidelines; however, it was reported in Tax Analysts that the IRS views the new passive association rules as intended to prevent any one parent or subsidiary from taking the benefit of any "economies of scale" that belong to the entire group. From our perspective, the IRS' interpretation represents yet another attempt by the IRS to limit the concept of "location savings," a concept that permits profits arising from operational efficiencies to be located in lower cost and -- potentially-- lower tax geographies. The IRS' view of these rules places a premium on companies identifying and documenting up-front the benefits of a particular service transaction, where that benefit should be captured, and whether such a result is consistent with arm's length behavior. This area of focus for the IRS could have significant implications to many types of service transactions including determinng the level of guarantee fees charged (either explicitly or implicitly) between affiliates.

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Australia - Thin Capitalisation, Interest and Transfer Pricing

On 28 November 2007, the Australian Taxation Office (ATO) released a Draft Taxation Determination, *TD 2007/D20 (*the Draft), which was designed to provide guidance to taxpayers regarding how Australia's thin capitalisation provisions (Division 820 of the *Income Tax Assessment Act 1997*) interact with the transfer pricing provisions of the tax law (Division 13 of the *Income Tax Assessment Act 1936* and the business profits article and associated enterprises article of a relevant double tax treaty).

In brief, the draft states that the ATO may use its powers under the transfer pricing provisions in order to adjust the *interest rate* on a taxpayer's debt, even if its debt falls within a safe harbour debt amount calculated under Division 820. However, it will not use the transfer pricing provisions to completely deny deductions on debt where the debt level is not excessive under Divison 820.

History

In 2002, Australia introduced revised thin capitalisation legislation, which is contained within Division 820. This legislation limits a taxpayer's allowable debt deductions on the taxpayer's debt if the taxpayer's adjusted average debt exceeds its maximum allowable debt. In instances where a taxpayer's adjusted average debt exceeds its maximum allowable debt, the taxpayer will be thinly capitalised under Division 820 and a proportion of the taxpayer's debt deductions will be disallowed.

Australia's thin capitalisation legislation permits taxpayers to establish the maximum allowable debt based upon a safe harbour debt amount, an arm's length debt amount or, for certain taxpayers, a world-wide gearing amount. Broadly speaking, the safe harbour enables taxpayers that are not 'authorised deposit-taking institutions' (ADIs) to obtain debt deductions on debt amounts up to a debt to equity ratio of 3:1. Separate rules exist for ADIs.

Taxpayers may obtain debt deductions beyond the safe harbour through an arm's-length debt test analysis. This requires the taxpayer to demonstrate that the amount and pricing of its debt are both consistent with what a commercial lending institution would provide, (i.e. **an independent lender test**) and result in a level of profitability for the taxpayer that a third-party investor would require (i.e. **an independent investor test**).

Recent transfer pricing disputes have raised the possibility that the ATO might use the transfer pricing provisions to determine the amount of a taxpayer's debt level upon which deductions may be claimed, even if the taxpayer's debt amount is within its safe harbour debt amount. The ATO appears to have partially resolved this potential source of ambiguity in *the Draft*.

Details of Determination

At its outset, *the Draft* affirms that the ATO may use Australia's transfer pricing provisions to adjust the pricing of a taxpayer's 'costs that may become debt deductions', including interest rates and credit guarantee fees if these transactions are not at arm's length, even if the taxpayer is not thinly capitalised. *the Draft* subsequently notes that the 'transfer pricing provisions can not be applied to ***completely*** **deny** deductions for funding costs' on debt

that might be considered to be excessive if the taxpayer was treated as financially independent in respect of its debt funding arrangements (i.e. and not dependent on a related party lender). Such an approach 'would defeat the operation of Division 820 even though the safe harbour debt amount in the particular case is greater than the arm's-length amount of debt amount determined by applying the arm's-length principle in the transfer pricing provisions.'

While this passage appears to leave open the possibility that the ATO may reduce the amount of debt in respect of which a taxpayer can claim debt deductions even if it is within the safe harbour, *the Draft* clarifies the ATO's position. On this point it provides an example where a taxpayer has a related party borrowing with an interest rate which, because the taxpayer is highly geared relative to the industry in which it operates, is higher than that which would have been obtained if the taxpayer was financially independent of the lender. In the example, the ATO concludes that despite the debt level being within the safe harbour debt amount under Division 820, it has the authority to adjust the amount of interest deductions on the debt (i.e. under the transfer pricing provisions), but cannot adjust the amount of debt which gives rise to interest that is otherwise deductible (i.e. because the taxpayer is within its safe harbour debt amount).

The Draft notes that Australia's anti-avoidance provision, Part IVA, 'will not apply to an entity merely because it has taken advantage of the safe harbour debt amount under Division 820', though it will apply in instances when a taxpayer uses contrived arrangements to bring a taxpayer within a safe harbour debt amount.

Consistent with the ATO's position in at least one dispute, *the Draft* also notes that 'all provisions relevant to deductibility must be applied first before Division 820 comes into operation'.

Observations

the Draft is significant to the extent that it provides Australian taxpayers with greater certainty that the ATO will not use transfer pricing principles to adjust the amount of their debt that gives rise to deductible debt deductions, as long as the debt is within the maximum allowable debt level calculated under Division 820, though it may adjust the pricing of this debt (including the interest rate on a related-party loan or a credit guarantee fee) by reference to arm's length levels of debt (and equity) and the resulting interest rate.

Importantly, the Draft Tax Determination indicates that the ATO will use the transfer pricing provisions to establish an arm's-length (but hypothetical) capital structure prior to testing the arm's-length price of the debt. Accordingly, taxpayers need to be cognisant that based on *the Draft*, a hypothetical debt level will need to be determined and documented prior to claiming debt deductions on the taxpayer's actual debt (assuming it is not executive under Division 820) at the interest rate applicable to the hypothetical debt determined in accordance with arm's length principles. The Draft Tax Determination provides no guidance as to how that analysis should be done.

Additional issues exist, including how a taxpayer should evaluate the credit quality of a related-party obligor and appropriate methods for determining arm's-length credit guarantee fees. We understand that the ATO plans to issue draft guidance regarding the arm's-length gearing and associated pricing issues at a later date.

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Country focus: Spain

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

Javier Gonzalez Carcedo presents this publication's country focus on Spain. Javier heads up the Spanish transfer pricing team, together with Michael Walter, also transfer pricing partner, with significant financial services experience. For a long time Javier was a member of the Spanish Tax Administration with a vast experience in international tax matters. For several years Javier has worked for the OECD Centre for Tax Policy and Administration.

Javier and Michael's team is comprised of transfer pricing professionals with background in tax, law, accounting, economics and financial services. When dealing with FSTP issues, the TP team works together with the Financial Services Tax team, led in Spain by Miguel Blasco.

Transfer Pricing Legislation in Spain

Recently introduced changes to the statutory rules have brought Spanish transfer pricing legislation further into line with the OECD Guidelines and also with developments at the European Union level. The changes were contained in Law 36/2006, "Measures to Prevent Fiscal Fraud", which entered into force on 1 December 2006.

The legislation now requires taxpayers to value their intercompany transactions at arm's length. Previously, any adjustment to arm's length prices was only a power of the Spanish tax administration (STA). Additionally, the new legislation applies to both domestic and cross-border transactions.

Documentation will now also be a requirement, with Spanish taxpayers required to produce group-level and taxpayer-specific documentation. However the requirement to produce transfer pricing documentation is postponed until such time as the exact documentation contents are established. A draft Decree setting out the content requirements was published in July 2007 and is expected to be finalised early in 2008.

The draft Decree also establishes certain instances in which there is no documentation requirement for intercompany transactions. These are:

a. Intercompany transactions carried out within a consolidated Spanish fiscal group;

b. Intercompany transactions carried out by economic interest groups and temporary business associations; and

c. Intercompany transactions involving the purchase or sale of publicly traded shares.

At the same time, the draft Decree establishes reduced documentation obligations for (i) intercompany transactions involving small companies (net revenues for the consolidated group of less than €8m in the previous tax year) and (ii) individual persons.

Other important changes are made to align further the Spanish rules with the OECD Guidelines. These include:

- In order to test the arm's length nature of intercompany transactions, the legislation specifically accepts the five OECD methods for valuing intercompany transactions on an arm's length basis (previously, the transaction net margin method was not recognised).
- The regulations regarding the deductibility of the costs of services received and contributions to cost contribution arrangements are revised.
- It is established that the initiation of mutual agreement procedures can suspend the collection of tax if the tax due is adequately guaranteed.

Finally, it is important to note the explicit reference introduced in the law regarding the so called "secondary adjustments". According to the new rules, following a TP adjustment, any difference between the price applied and the determined arm's length principle should be recharacterised and treated for taxable purposes according to the new characterisation. Most of the cases will be treated as deemed dividends or deemed capital contribution, although other constructive transactions could appear. It is too soon to evaluate the actual impact of this new prevision.

Overview of Transfer Pricing Environment

Given the recent revisions to the transfer pricing legislation and the soon to be finalised documentation requirements, transfer pricing is a hot topic in Spain. To date, the STA's expertise in transfer pricing has been limited and generally attention has focussed on less complex transactions, such as management fees.

However transfer pricing audit activity is expected to increase dramatically once the documentation requirements are finalised. Already the STA has launched audits whose scope is limited to an analysis of the arm's length nature of intercompany prices. Resources are being made available to the STA to improve its ability to successfully undertake audits, while the STA has been actively training inspectors in preparation for the new documentation requirements.

Under the new legislation, penalties will be imposed where the required documentation is not provided, where documentation provided is inaccurate or false or where declared prices do not follow from those derived from the documentation. The penalty applied will be dependent on whether the tax administration assesses a transfer pricing adjustment: (i) where there is an adjustment, the penalty will be 15% of the adjusted amount; and (ii) where there is no adjustment, penalties may still apply for missing, inaccurate or false data in the documentation.

Recent Areas of Focus on Financial Services Transfer Pricing

Management Fees

Historically, management fees or head office expenses were a key area of focus for the STA. In particular, attention was paid to the existence of a signed contract – as under previous legislation, head office charges were only deductible in such case as a signed agreement was in place. In addition, STA attention has focussed on the test benefit and allocation keys for such fees – keys must be based on "rational criteria".

Level of Intercompany Interest

The issue of loan pricing is one that is attracting increased attention from the STA. This is in common with a greater awareness amongst tax authorities of intercompany loans but in Spain, it is particularly prescient given the existence of "participative loans". Such loans allow overseas companies to lend money to Spanish companies and receive interest based on some measure of the borrower's performance (e.g. as percentage of net sales or profits). The interest payments are not subject to Spanish withholding tax but are deductible from a Spanish tax perspective.

The issue of thin capitalisation has generally been less important as Spanish thin capitalisation rules do not apply when the lender is an EU-resident company (rules do apply in the case where the lender is resident outside of the EU or in a territory classified as a tax haven – in such case, the deductibility of interest on loans where the debt equity ratio exceeds 3:1 is limited). However, the STA does have the possibility to argue that the indebtedness level of a company is not arm's length and challenge the thin cap position in this way.

Attribution of Profits to a Permanent Establishment (PE)

The situation in Spain is unclear in relation the recent OECD developments on Attribution of Profits to PEs as the STA has not taken a clear line regarding the consequences of the OECD papers.

However, in practice, there has been movement in relation to bank PEs and the claim of a minimal free capital attributed to the PE. Some clients, under tax audit, have been questioned on this issue. In particular, the STA has argued (based on the OECD papers) that the PE should be assigned a minimum non-remunerated equity amount, necessary for the development of the business. This can have consequences through limiting the deducibility of financial expenses or through the attribution of profit to the assigned equity.

Our opinion is that any application of the OECD papers will require a previous change in the domestic law – as while bilateral treaties establish the limits of the Spanish tax system, it has to be the domestic law that establishes the rule of the game inside those limits. At any rate, it is significant that the STA are seriously

considering this issue, with potentially important consequences for the foreign banking sector operating in Spain.

VAT Consolidation Group and Taxable Amount for Related Party Transactions

As a result of recent developments in VAT domestic legislation, TP and VAT issues appear to be closely linked in Spain, especially in the financial sector.

New VAT domestic legislation has imposed the arm's length price as the taxable amount in related party transactions in those cases where acting otherwise could lead to an artificial increase in the VAT deduction (typically because one of the related counterparties does not have a full right of deduction, which is often the case in the financial sector).

On the other hand, and in part to compensate for the change, the law has introduced the concept of a VAT group in Spain. For VAT groups, VAT is levied only on external costs, i.e. the cost of goods or services received from outside the group to be used directly or indirectly, totally or partially, in transactions inside the group.

These VAT developments, in addition to transfer pricing reforms, mean any banking group in Spain should give serious consideration as to its situation regarding the new rules and what appropriate action should be taken.

Tax Authorities' Approach to Transfer Pricing

Historically, transfer pricing has not been a high profile area for STA audits. With the burden of proof falling on the STA, its only means of achieving favourable transfer pricing adjustments was through expensive and time-consuming audits. As a result, the STA has tended to focus more on "straight-forward" transfer pricing audits of manufacturers and distributors.

With the change in the burden of proof and new documentation requirements, the STA has publicly stated that transfer pricing will become a significant area of focus. As such, the STA's awareness and willingness to audit more complex transactions (especially in relation to financial services) is expected to increase significantly.

Firstly, the STA's resources, competence and experience in relation to transfer pricing are expected to grow. This will allow it to more successfully audit and challenge financial service intercompany transactions. Second, the amounts of taxable income at stake in financial service transactions will mean that it will become an area of increased focus for the STA. (One of the prime reasons for the new Spanish transfer pricing legislation was so that the STA could protect the Spanish corporate tax base in light of transfer pricing adjustments being made overseas which affected Spanish companies.)

APA programme

At the same time, the STA has made clear that it will look favourably on both unilateral and bilateral APA applications. Our experience of the APA process has generally been positive and in the financial sector, we would be confident in recommending the process to international groups that aim to increase their certainty regarding their transfer prices in Spain.

Closing Thoughts

The issue of transfer pricing is one that will increasingly rise up the agenda of the STA as new documentation requirements are put in place in 2008. This will impact taxpayers in Spain across all industries. For financial services companies, the STA's improved expertise and experience of transfer pricing will mean that more complicated transactions that have typically been avoided to date by the STA can now expect to be subject to audits.

As such, the current period (before documentation requirements are finalised) offers taxpayers an opportunity to get their transfer pricing affairs in order ahead of the requirement to document their intercompany transactions.

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PwC FSTP Network wishes you a very happy, healthy and successful 2008!

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