

# FSTP Perspectives

A publication for financial services industry  
tax and transfer pricing professionals

April 2009

## Foreword

### Dear Reader:

Welcome to the April 2009 edition of FSTP Perspectives: PwC's market leading financial services transfer pricing publication. This edition focuses on transfer pricing developments in a number of key financial services jurisdictions around the world.

It never ceases to surprise me how often and quickly the transfer pricing environment changes in the financial services sector. Several years ago, the landscape was completely different. Profit splits meant profit splits. Now, profit splits often mean loss splits. A "routine" (and I do use this term with caution!) service provider would not raise an eyebrow if it was to get a cost plus 10% return. Now, the situation has changed. Should a "routine" service provider even get guaranteed a fixed return? Should it be sharing in some of the "pain" and having a reduced return, or even breaking even, or even more controversially – truly sharing in the pain and making a loss?! Money and liquidity was awash in the system. Intra-group funding was found at healthy levels and the spreads on this funding whilst potentially a bone of contention for some jurisdictions were at levels which differ markedly at the levels that the markets are now demanding for lending. Night and day differences effectively.

These were some of the topics that were discussed at our Masters Series events in London (18 March) and in Hong Kong (6 April) where attendance levels were extremely high with over 100 in London and 50 in Hong Kong which contributed to the success of these events.

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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In London, we were fortunate to be joined by Manfred Naumann (Head of International Taxation) from the German Ministry of Finance and by Lee Corrick (Assistant Director Transfer Pricing) and Daniel Servini (Financial Services Transfer Pricing specialist) from Her Majesty's Revenue and Customs (HMRC). What was particularly insightful was to have the taxing authorities' perspectives on issues such as profit and loss splits, business restructurings and financial transactions. We appreciate the candour and insights that the taxing authorities were able to provide on these issues and the direct responses they gave to many of the questions from the audience. Similarly, the Hong Kong Masters Series saw excellent audience participation from industry. What never ceases to amaze is just how diverse and differing are the approaches that are taken by the taxing authorities in Asia. This should come as no surprise however when you consider you have India, Japan, Taiwan, and Australia as some of the key taxing authorities in these jurisdictions!

So, where do we go from here? I am often prone to making predictions as to the hot topics that I feel are going to be relevant in the next two to three years. So here are five (and I could have put down anywhere from ten to twenty) that I think are going to be the key issues (in no particular order):

1. Booking models and how to deal with capital – Given commercial and regulatory imperatives, we are seeing the centralisation of many booking entities. Guidance is limited on how to deal with the capital issue; and the interaction of Article 5 Permanent Establishment threshold issues, Article 7 Attribution and Article 9 Transfer Pricing issues make this a hugely difficult and complicated issue where the technical guidance is quite opaque.
2. Financial Transactions – Encompassing thin capitalisation, interest rates and guarantee fees. Putting aside the debate over passive association, this

I hope you enjoy reading our publication.

Best Regards



Aamer Rafiq  
UK Financial Services Transfer Pricing  
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is already a big issue in many jurisdictions and will only become more of a hot topic as taxing authorities seek to protect their domestic tax base. In countries such as Canada, Austria, Australia and Sweden, there has already been significant activity on this issue.

3. Business Restructuring – Allied again with the protection of the taxation base, there is likely to be a real move by “developed” countries on ensuring businesses do not move profit out of their taxing jurisdictions. Although the impact on the financial sector has not been highlighted, the draft reports on this already marks out significant impact on the way financial organisations will and can conduct business in the future without there being a significant tax impact.
4. Permanent Establishments (PEs) – The OECD has begun a project to look at the threshold issues around Article 5. With the issue of inadvertent PEs already becoming a strong focus in many regions (either through dependent agent, fixed place or services PEs); this will only serve to focus the issue even more.
5. Controversy – Controversy, Controversy, Controversy. As simple as that. Given the extended guidance that the OECD has finalised in recent years and is working on currently, the ambiguity of how to deal with many issues, the lack of technical precision, and the drive for many countries to protect their tax base, and the fact that the impact of the credit crunch will not be audited for several years, I expect controversy to become a huge issue in the next several years.

The key to managing these issues in the forthcoming years will be to have documented contemporaneously and also to have implemented your policies in line with your transfer pricing methods. Although it may sound like an old cliché, documentation may well be the first and most successful line of defence when dealing with these issues in future years.

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### Jobst Wilmanns: 'From my Perspective'



Increasing regulation and explicit scrutiny from tax authorities relating to transfer pricing, combined with unprecedented turbulence in the world's financial markets have resulted in a heightened awareness of transfer pricing amongst multi-national companies.

Even financial institutions which were considered to be well

established are now faced with the daunting tasks of preserving capital and maximising cash flows, potentially exacerbating the transfer pricing challenges already faced.

The following article presents a synopsis of the types of opportunities available and actions required in light of the current economic situation. From my perspective, companies should for example, consider the following:

- In addition to cost reduction initiatives, most companies will review internal processes and pursue plans for optimisation. Such reviews should also be used to optimise transfer pricing arrangements since addressing the value chain does not only concern fixing a price, but also questions the best fiscal environment to drive operations. The current economic situation can present a myriad of opportunities to settle key functions in the most appropriate fiscal environment for companies.
- Under the OECD's new paper on business restructuring, a shift of functions could be remunerated on the basis of the transferred potential profit. Currently, operational functions may not be profitable and viewed only as loss-making activities. Based on this, a transfer of functions may be viewed from both the perspective of the transferor and transferee. If loss-making functions are transferred abroad, it may be argued that a taxable compensation payment is not required.
- Intangible assets and the value of key success factors should be viewed in a different light than compared to a year ago. Planning cycles for intangible assets are often significantly extended and the evaluation of intangible assets - based on future yield - is significantly lower. Long term planning should therefore be considered for intangible assets.
- The internal debt of a company must be carefully examined. What may once have been deemed to be an appropriate interest rate may not stand up to examination under a tax audit when current economic conditions are taken into account. The same applies for credit ratings and the ranking of group companies which are likely to have changed significantly. This also raises the question of the extent and level of intra-group guarantees: How is remuneration determined for guarantees if in the banking rescue plan of the federal government, a guarantee in the amount of 0.5% is to be provided for unsecured borrowings of state bonds between three and twelve months?
- Benchmark analyses used to compare companies performing similar functions are based on historical financial data. The availability of such data means that the taxpayer must base future transfer prices on comparative data from previous years. However, if economic conditions change dramatically, as we are currently experiencing, then the appropriateness of using historical comparable data to determine current or future transfer prices may be questioned. Companies are well advised to examine their benchmarking analyses under to identify opportunities to adapt to the current economic environment.
- Central services are often charged with a mark-up of between 5% and 10%. If an entire company or group achieves a return of say, 2%, then the question may be posed as to why central services in such a situation should achieve a higher return than the collective activities of the entire company or group. In a similar vein, the question may be posed as to whether a guaranteed margin, for example, a stable 2% net margin based on the Transactional Net Margin Method (TNMM) is deemed to be appropriate on the basis that a loss making group guarantees its distributors a profit.

From my perspective, our current economic environment presents a large number of transfer pricing opportunities and challenges. Moreover, as global financial markets continue to enter unprecedented territory and are in a constant state of flux, taxpayers are presented with opportunities to achieve efficiency without bearing high costs and while ensuring its transfer pricing policies are consistent with the arm's length standard.

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# Tax controversy and intra-group financial transactions—an emerging battleground in challenging financial times

Taxation authorities have significantly increased their focus on intra-group financial transactions, including related-party loans, credit guarantees, factoring arrangements, cash pools, and other forms of financing and credit risk transfer arrangements. With the current global financial crisis limiting the availability of once plentiful and relatively inexpensive external funding, many taxpayers in their “hunt for cash” have seen their intra-group financial transactions increase significantly. In this article, we provide an overview of why intra-group financial transactions are receiving so much attention from taxation authorities, key areas of controversy, and potential actions for taxpayers to consider. In addition, although financial transactions can create tax risk, they are also a source of opportunity, notwithstanding recent events. We raise several potential opportunities that may benefit taxpayers.

## Why are financial transactions increasingly a key source of tax controversy?

The transfer pricing aspects of intra-group financial transactions are becoming increasingly contentious. One key reason for this is that the pricing of financial transactions, as with many other areas of transfer pricing, is inherently subjective. At the same time, the value of these transactions can be significant.

For example, to arrive at an arm’s-length interest rate for a loan, one needs a process for evaluating the credit quality of the borrower (i.e. the probability that the borrower will default over a given time period and the amount of loss in the event of a default) and an approach for estimating credit quality and the terms of the transactions to available internal and external comparable transactions. Even when using a structured approach, the credit analysis and the selection of comparables require subjective judgment and expertise. Additionally, even if the parties setting prices possess the knowledge and judgment to accurately estimate an arm’s-length price for a transaction, the reviewer of the prices (such as a taxation authority) might not possess the requisite expertise.

Another important source of controversy for some borrowers is the impact on operating profits of high yield loans provided by private equity firms. This has led in some countries (e.g.

Germany and Italy) to the introduction of specific earnings stripping rules in order to limit the amount of interest that can be deducted from operating profits. In the Netherlands, the Ministry of Finance is investigating the possibility of completely removing group interest from the tax environment. Furthermore, the financial crisis, which has dominated the news over the past year, has demonstrated to taxation authorities that financial markets are a complex area, particularly once the transfer pricing implications of these transactions are considered. As such, it has raised their awareness of and focus on intra-group financial transactions.

Estimating arm’s-length terms for an intra-group financial transaction is further complicated by the fact that taxation authorities have provided little concrete guidance as to how taxpayers should price these transactions. This is compounded by the lack of guidance from the OECD, which increases the possibility that taxation authorities will take significantly different approaches when evaluating intra-group financing. Hence, financial transactions represent yet another area where an approach that may be acceptable to taxation authorities in one jurisdiction may not be acceptable in another. The presence of country-specific safe harbor rules and expectations further increases the potential for cross-border disputes. It should also be noted that substantiating interest rates through the solicitation of non-binding bank quotes is not acceptable to most sophisticated taxation authorities.

Some taxation authorities are also beginning to challenge the pricing of financial transactions using a combination of transfer pricing and tax-related arguments. As an example, in Australia, the Australian Taxation Office (“ATO”) has indicated that multiple provisions of the Tax Act may impact whether a taxpayer receives a deduction on a loan, including the general deductibility provisions, the debt/equity rules, the thin capitalisation legislation, and the transfer pricing rules. The presence of overlapping (and potentially conflicting) rules in a single jurisdiction can complicate the process of pricing and structuring intra-group debt. Furthermore, differences across jurisdictions can also increase the

risk of a challenge, even for relatively simple transactions.

## Some areas of focus by taxation authorities

Most taxation authorities, including those that have expended considerable effort to better understand financial transactions, are grappling with the complex issues that these transactions can raise. Based on our experience in Canada, Australia, New Zealand, the Netherlands, and other jurisdictions, some of the issues that taxation authorities seem to be examining closely include:

- Related-party loans with interest rates or credit margins that might appear high to taxation authorities relative to local benchmarks;
- Credit guarantee fees, particularly where the taxation authority perceives the fee to be “high” or the total amount paid is significant;
- Taxpayers with relatively high debt/equity ratios compared with their peer group;
- Transactions lacking in substance or with terms and conditions that a taxation authority views to be lacking an economic rationale, or that are not documented in a written agreement;
- Not exercising prepayment or call options included in an intra-group loan agreement when market conditions suggest an arm’s length party would;
- Debt pricing and/or debt amounts that result in ongoing low levels of profitability;
- The allocation of the benefit derived from internal cash pooling and other centralised group arrangements among participants; and
- Appropriate rates of return for transactions where a taxpayer serves as a “booking entity” or otherwise acts as an intermediary in a transaction.

As existing guidance for establishing arm’s-length terms for financial transactions is limited in most jurisdictions, it is advisable to have an understanding of the local sensitivities of a given taxation authority (or the examiners that you may deal with), particularly in advance of completing a material transaction that may create significant tax risk.

## Impact of the passive association debate

Traditionally, many taxpayers have established arm’s-length terms for their related-party financing transactions by evaluating the credit quality of a subsidiary on a stand-alone basis (i.e. under the assumption that the borrower is an independent entity that is not related to the lender), which is arguably consistent with OECD guidance. At paragraph 1.6 in its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, the OECD notes that “the authoritative statement of the arm’s-length principle is found in paragraph 1 of Article 9 of the OECD Model Tax

Convention, which forms the basis of bilateral tax treaties involving OECD member countries and an increasing number of nonmember countries.” It further notes that “by seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm’s-length principle follows the approach of treating the members of a multinational enterprise (“MNE”) group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the dealings between those members.”

However, in a recent case in Canada, the Canada Revenue Agency has sought to argue (within the context of the pricing of intra-group credit guarantee fees) that a third-party lender would lend to a subsidiary of a major multinational group (or, more broadly, assume its credit risk) at a lower rate than that implied by a pure “stand-alone” result in light of its affiliation with its parent. Such a “passive association” argument raises several key issues, ranging from the empirical (to what extent do lenders account for group affiliation of subsidiaries that are not formally guaranteed by their parent) to the transfer pricing specific (such as whether a consideration of the potential links between a parent and its subsidiary are consistent with the arm’s-length principle).

From a practical perspective, even if the concept of passive association is inconsistent with the arm’s-length principle, it appears to have been embraced, at least for now, by several sophisticated taxation authorities, including Canada, the Netherlands, and Australia. Hence, until tax courts or taxation authorities provide more definitive guidance, taxpayers may need to consider the possibility that a taxation authority will not consider it appropriate to evaluate the credit quality of a subsidiary of a multinational enterprise on a pure stand-alone basis, and if an adjustment for “group membership” is necessary, how it should adjust the pricing or the documentation of its intra-group financial transactions to proactively address this potentially vexing issue. At the same time, for outbound transactions, taxpayers need to consider the possibility that a taxation authority might question instances where taxpayers have provided credit support but have not applied an appropriate arm’s-length charge that reflects the risk assumed by the guarantor.

## What can you do?

In light of the current focus of taxation authorities on financial transactions, taxpayers might consider a variety of measures, including:

- Establish a comprehensive transfer pricing policy that covers existing and planned intra-group financial transactions;
- Periodically revisit the policy (at least annually);
- Implement legally enforceable, robust loan agreements;
- Evaluate “both sides” of material transactions – does the transaction “make sense” economically for both parties involved?
- Structure and price transactions in a manner consistent with the firm’s tax risk tolerance;
- Monitor global developments – current Canada Revenue Agency or ATO viewpoints may be adopted by other taxation authorities.

## Some potential opportunities

While significant risks may exist in pricing and structuring intra-group financial transactions, current financial market conditions also provide an opportunity for taxpayers to revisit their intra-group financial transactions and ensure they are consistent with the arm’s-length principle, which in many cases will mean higher credit spreads.

### I. Intra-group loans

Opportunities may exist for both existing and new loan transactions. As a starting point, taxpayers should review the terms of existing intra-group loan agreements. For transactions that are about to mature, it may be possible to incorporate revised pricing that reflects current credit market conditions. In addition, taxpayers should carefully review any embedded options incorporated into existing transactions (such as early prepayment provisions granted to borrowers or the ability to demand early prepayment granted to lenders), with a view toward aligning existing agreements with current market conditions where possible. When reviewing the terms of a transaction, it is important to consider the perspective of both the borrower and the lender (and their respective tax jurisdictions) to ensure consistency with arm’s-length behavior. Taxpayers should also evaluate the consistency of any re-pricing with the taxpayer’s broader financial transactions pricing policy.

Furthermore, with the recent dramatic increase in credit margins, the fair value of many intra-group loans has declined and may produce a beneficial tax loss under the right circumstances (or a profit, for instance, by buying one’s own loans or bonds at a discount out of the market, from an “appropriate” group company).

New transactions should be priced under current market conditions. However, taxpayers should account for recent trends in the credit markets. For example, credit to noninvestment grade borrowers (and most borrowers in general) is far more difficult to obtain now than it was a couple of years ago. Borrowers that can obtain funding must

generally do so for shorter time periods, with more stringent covenants. Hence, having proper documentation in place that substantiates not only the interest rate on a loan but also the arm’s length nature of the amount of the loan and its terms and conditions is crucial, especially in the current market.

### II. Credit guarantee fees

Many companies with loans from third parties are facing demands for enhanced security through guarantees on existing and refinanced debt, and some companies are able to effectively redeploy capital from one related party to another with a guarantee from the corporate group.

Charging a guarantee fee can be contentious in some countries, yet it may be expected elsewhere. Hence, a taxpayer should carefully review all of its intra-group guarantees. In particular, the taxpayer should be prepared to demonstrate that the guarantee provides the guaranteed entity with a benefit and that the guarantor is providing a service that is not being provided only by virtue of its being a shareholder. Where the guarantee confers a benefit, the taxpayer should consider charging for this benefit (note that not charging for a service can provide taxation authorities with an additional argument, i.e., that the credit guarantee may have been provided as a shareholder service, which may be disadvantageous if the guarantor needs to perform on the guarantee).

As with loans, market prices for credit guarantees have increased significantly over the past year. Hence, taxpayers should assess whether the guarantee fees charged on existing guarantees are still arm’s length given the change in market conditions, if the pricing of the guarantees are eligible for review.

### III. Factoring of receivables

An intra-group accounts receivable factoring transaction can be beneficial under current market conditions by providing cash to a cash-strapped related party and by potentially producing a tax benefit for taxable related parties.

A factoring transaction involves the sale of accounts receivable at a discount for cash. The sale of a cash-strapped company’s accounts receivable can provide immediate cash to the company in a tax-efficient manner. In addition, an intra-group factoring arrangement provides another benefit that many taxpayers do not consider: intra-group factoring is an off-balance sheet transaction. It involves a sale of assets for a fee, and in many countries may not be affected by withholding tax requirements or interest deductibility rules.

An intra-group factoring arrangement increases the assets of the related party purchasing the accounts receivable. If this related party is also the entity within the corporate group that has third-party borrowings, the increased assets may be accepted as collateral to lower the cost of or increase the amount available through third-party borrowings.

#### IV. Cash pooling

As a result of the financial crisis, companies in need of cash increasingly rely on their internal cash pool(s) for the management of the cash available within the group. Taxpayers need to address certain specific transfer pricing issues that arise from cash pool arrangements, such as how the cash pool operator determines the appropriate interest rate to be applied to intra-group balances, how it prices any underlying (cross) guarantee structure, and how it remunerates the cash pool leader. With the increased use of cash pools and the increase of volumes handled by these cash pools, the attention of taxation authorities to these transfer pricing issues is also increasing.

Recent examples of discussions with taxation authorities in this area relate to the fact that, in practice, positions in a cash pool often end up being long-term loans on which (given the nature of a cash pool) short-term interest is being paid. Furthermore, traditionally the benefit to the group of using a cash pool (i.e. the “cash pool advantage”) ends up being reported by the cash pool leader, which may be a thinly capitalised company that cannot “substantiate” the return on equity that it earns. At the same time, the depositing participants, who may be incurring the credit risk associated with the cash pool, might receive only the rate that they would receive if they had made a deposit at a major commercial bank.

On the other hand, structuring a cash pool properly and taking into consideration the tax position of the participants involved can lead to a tax-optimised situation.

#### Summary

The subjectivity associated with pricing intra-group financial transactions combined with differing taxation authority views on how these transactions should be priced has significantly increased their tax risk in recent years. This is even more prevalent in the current financial markets, in which taxpayers are forced to use their cash in the most optimal way, in many cases resulting in an increase of intra-group financial transactions. However, while intra-group financial transactions can give rise to potential tax risk, if given appropriate attention and with the appropriate documentation in place, they remain a potential source of opportunity, particularly in light of these recent dramatic changes in the financial markets.

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# UK Tax Court Finds for HMRC in UK Transfer Pricing Case

On 22 April 2009 the long awaited decision from the UK's first substantive transfer pricing case was made public.

The case related to the transfer pricing arrangements between the UK's biggest electrical retailer, Dixons, and a captive insurer in the Isle of Man (DISL) in relation to the provision of extended warranty cover to UK customers. Warranty cover was made available to UK customers when they bought electrical goods in the stores of the main UK trading company, DSG Retail Ltd (DSG). Most or all of the risk on the extended warranties was ultimately insured by DISL.

The dispute was principally concerned with whether the arrangements with DISL were supportable as being on arm's length terms and, to the extent they were not, whether DSG could be assessed for corporation tax on imputed income arising from any resulting transfer pricing adjustments.

The Special Commissioners found in favour of HMRC, determining that non-arm's length pricing had resulted in an understatement of UK corporation tax during the period 1996 to 2005.

## Whether the transfer pricing legislation applied

The Special Commissioners found that the transfer pricing legislation applied between DSG and DISL for all of the years under dispute. As DSG had allowed the products to be sold in its stores, DSG was considered to be a party to the overall provision with DISL, regardless of the exclusion of DSG from the formal contractual arrangements for several of the years under dispute and irrespective of the insertion of third party transactions.

## Whether the arrangements were on an arm's length basis

DSG put forward a number of potentially comparable contracts between independent parties as benchmarks of arm's length commissions on similar arrangements (the Comparable Uncontrolled Price (CUP) approach).

In general, the CUP approach is the most direct and reliable way to apply the arm's length principle. However, in order to apply the CUP approach reliably, it is necessary to demonstrate that:

- None of the differences (if any) between the transaction being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or
- reasonably accurate adjustments can be made to eliminate the material effects of such differences.<sup>1</sup>

All of the CUPs which DSG put forward in order to support the overall levels of commission received in the UK were rejected as containing differences which could not reliably be adjusted for.

One contract put forward which related to the sale of extended warranties through Currys stores was rejected on the basis that the contract was negotiated in the early 1980s and the Special Commissioners considered the different market conditions to be too large to adjust for.

Other potentially comparable contracts put forward by DSG were rejected on the basis that the products under warranty were different. The Special Commissioners drew a clear connection between the overall expected profitability of the warranty cover (as indicated by the loss ratio) and the amount an insurer would be prepared to offer in commissions in order to access those profits.

Commission rates cited in an Office of Fair Trading report on extended warranties on an anonymous basis were rejected as there was no evidence of whether the commission rates quoted were between third parties or related parties.

DSG put forward an alternative approach to benchmarking the arrangements with DISL in the shape of Domestic and General Group plc (D&G). D&G is a quoted company providing domestic appliance breakdown insurance to small retailers and manufacturers. The return on capital achieved by D&G

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<sup>1</sup> OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

was offered as an arm's length benchmark for a market return on capital for DISL, applying the Transactional Net Margin Method (TNMM).

The Special Commissioners agreed that the return on capital measure was a widely accepted basis for considering "normal" levels of profitability. However, the Special Commissioners did not consider D&G to be comparable to DISL, citing a number of differences, including:

1. D&G were considered to have a powerful brand in the provision of extensive "off the shelf" warranties, whereas DISL did not;
2. D&G sold its cover through a variety of channels, none of which individually had strong bargaining power. DISL was entirely reliant on DSG for its business, which had a strong brand, a powerful point of sales advantage and detailed claims data and could therefore easily have sourced the basic insurance provided by DISL elsewhere.

The Special Commissioners did not consider there to be a method of adjusting for these differences.

The overall finding on the case was that a profit split approach should be applied so as to distribute the total profits of the extended warranties business between the parties according to the contribution of each party to the business. Under the fact pattern presented, the Special Commissioners considered that DISL possessed only routine actuarial know how and basic adequate capital, both of which DSG could find for itself elsewhere if it chose. Therefore, DISL was only entitled to a routine market return on its economic capital.

All residual profit earned by DISL in excess of this market rate of return was considered to be entirely attributable to assets and advantages belonging to DSG.

## Basis of Calculation of Adjustment

The parties were instructed to adjourn to consider methods to determine an appropriate measure of economic capital as well as a market rate of return on that capital.

## Comments & Conclusions

Transfer pricing analysis requires the selection of an appropriate transfer pricing methodology which, in its turn, almost always involves the requirement to "benchmark" either the transaction price or the profit margins of at least one of the parties to the transaction.

Where one party is clearly more straightforward in its activities, the decision as to which party should be benchmarked often appears clear. However, the

assumption that, after awarding a benchmarked amount to the "tested party", the residual profit unquestionably reverts to the other party, may lead to difficulties, especially if the residual profit is particularly large (or small).

In our view, the DSG decision is important to taxpayers because:

- The case was one of the last to be heard by the Special Commissioners, a body which has been superseded by the First Tier Tax Tribunal. As most of the Special Commissioners are now judges of the Tax Tribunal this case presents useful information on how transfer pricing cases are likely to be considered in the future;
- HMRC have clearly indicated their expectation that the overall contribution of all parties as well as their relative negotiating position should be considered in order to validate the transfer pricing methodology selected and confirm that the benchmarking undertaken fits the facts and circumstances;
- The case demonstrates the high threshold of comparability needed if the intention is to rely on CUPs that appear to give an advantageous result and where there is no secondary supporting methodology to corroborate the outcome;
- This case sets a precedent which will encourage HMRC to challenge arrangements that result in profits outside the UK (particularly those in tax havens) where the transfer pricing is supported from a purely UK perspective; and
- For groups with captive insurers where the captive does not possess significant negotiating power, HMRC are likely to assume that an appropriate measure to determine the arm's length profit of the captive is a routine market return to its economic capital.

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# Recent transfer pricing developments in Singapore

Debt financing forms an integral part of any efficient tax structure. Where debt is extended by a related party to the borrower, consideration should be given to the appropriateness of its pricing. Tax authorities around the world (including Singapore) are increasingly focused on the pricing of related party transactions. To ensure that financing structures withstand such scrutiny, pricing should be comparable to that charged on market terms.

## Achieving optimal outcomes in tax structuring

This article considers the transfer pricing implications of related party financing arrangements from a Singapore perspective. It does not cover other tax implications arising from the use of debt, for example, thin capitalisation, withholding tax or the issue of beneficial ownership in the application of treaties. A robust transfer pricing policy, together with the observance of those other considerations, forms the foundation of achieving an optimal tax structuring outcome.

## Recent developments in Singapore

Like tax authorities in many parts of the world, the Inland Revenue Authority of Singapore (IRAS) has increased its activity around transfer pricing to ensure that cross border transactions undertaken between related parties are conducted at arm's length prices. Following the release of the transfer pricing guidelines in 2006, the IRAS issued a circular in July 2008 entitled *Transfer Pricing Consultation*. This sets out how the IRAS intends to review taxpayers' compliance of the guidelines. This was quickly followed by the first batch of questionnaires, sent to selected taxpayers to request details of their transactions with associated entities. On 23 February 2009, the IRAS issued a circular on related party loans and services, providing further guidance on these two types of transactions commonly undertaken by taxpayers.

## Related party loans – the IRAS circular

The scope of the circular is wider than the title suggests. The IRAS has broadly defined loans to include intercompany trade balances which are left uncollected over a substantial period of time, beyond which a third party creditor would typically allow.

The circular emphasises the need for loan transactions to comply with the arm's length standard, but provides limited safe harbours and transitional provisions to assist taxpayers with implementation. For example, the IRAS does not insist on the charging of arm's length interest provided both the lender and borrower are based in Singapore and the lender is not in the business of borrowing and lending funds. All other loan transactions must be priced on an arm's length basis. What constitutes the borrowing and lending of funds is a question of fact; banks are certainly caught, and so would finance and treasury centres belonging to non banking multinational companies.

Taxpayers who have extended cross border loans on an interest free basis are given a two year period (starting from 1 January 2009) to restructure the loans to reflect commercial, arm's length conditions.<sup>2</sup>

The IRAS prefers the use of the comparable uncontrolled price (CUP) method to determine the arm's length price of related party loans. The IRAS has also noted some of the comparability features which one should observe for pricing purposes:

- The nature and purpose of the loan;
- The market conditions at the time the loan was granted;
- The amount, duration and terms of the loan;
- The currency in which the loan is denominated;
- Exchange risks borne by the lender and borrower;

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<sup>2</sup> During this transitional period, the IRAS will continue to apply interest expense adjustment on the lender, i.e. restrict its claim for interest deductions to that extent that part of the interest is referable to loans that do not generate interest income.

- Security offered by the borrower;
- Guarantees involved in the loan;
- The credit standing of the borrower; and
- The prevailing interest rates for comparable loans (if any).

Nonetheless, the circular is not meant to be prescriptive. The features noted above are not exhaustive and taxpayers should consider how they should be applied in their own circumstances in arriving at (and documenting) the appropriate interest charge.

Finally it should be noted that the draft circular does not touch on other areas typically related to intra-group financing, e.g. guarantees or whether the amount of debt is arm's length, in other words, the question of thin capitalisation. It remains to be seen whether further guidance on these areas will be given in the future.

### Application of the arm's length principle

In relation to inbound transactions (i.e. a Singapore borrower obtaining funding from its offshore related party), the issue from a Singapore perspective is whether the interest charge is excessive, such that the loan transaction is considered to have been entered into with a view to siphoning income sourced within Singapore.<sup>3</sup> Singapore based taxpayers will need to demonstrate that they would have borrowed from an unrelated party on similar terms. Otherwise, a deduction for the interest (in whole or in part) may be denied.

With regards to outbound transactions (i.e. a Singapore lender extending credit to its offshore related party), the issue, from a Singapore perspective would be whether the (actual) interest charge is reflective of what would have been charged to a third party in similar circumstances, such that there is no under reporting of income in Singapore.

However, if interest is not actually charged, it is questionable if the IRAS can impute interest income. It will be difficult to enforce an arm's length interest charge requirement for a Singapore entity that is not in the business of providing finance. This is because in such cases, it may be open to the taxpayer to argue that any interest income earned would have been foreign sourced, which would not be taxable until it is received in Singapore (if the relevant facts support it).

Arguably, any deemed interest under the arm's length principle should similarly be foreign sourced, and since it is merely imputed income, it would not be capable of being remitted into Singapore and hence should not be taxed. The position suggested by the circular, of insisting on an arm's

<sup>3</sup> Interest paid to non-residents would, in general, attract Singapore withholding tax (albeit at a rate lower than the tax rate at which interest deductions are taken). Such interest may also be taxed in the hands of the lender, which may be able to claim a credit for the Singapore tax deducted. It is beyond the scope of this article to consider the ways of mitigating interest withholding tax or the tax treatment of interest income in the hands of the lender.

length interest rate where there is no actual charge introduces an element of uncertainty to such outbound financing arrangements.<sup>4</sup>

The IRAS accepts that the current legislative framework does not support the deeming of an interest charge in certain cases, and will be monitoring the situation to determine if new legislation is needed. However, the IRAS has indicated that it may not be prepared to enter into mutual agreement procedures should a treaty partner make an adjustment resulting in a claim for a corresponding adjustment in Singapore.

### Conclusion

Tax authorities have increasingly applied transfer pricing as a means of protecting their tax base. The use of debt financing, and the resulting interest deductions, could yield material tax savings. It should therefore not be a surprise if tax authorities question the appropriateness of interest charges in the case of related party loans. Taxpayers should therefore ensure that the basis of charging interest on related party debts is properly determined and documented.

The IRAS circular provided very brief guidance on what is regarded as one of the most difficult and controversial subjects in transfer pricing. For example, there is as yet, no guidance on the arm's length amount of debt or the provision of guarantees.<sup>5</sup> It will be useful for the IRAS to provide more clarity on this subject or to widen the safe harbour provisions, so as to enhance Singapore's position as a business and financing hub in Asia.

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<sup>4</sup> While it may be possible to run the foreign source income argument to say any actual interest income is not taxable until it is remitted into Singapore (if the relevant facts would support it), in practice it is usually necessary to bring the income into Singapore in order to benefit from lower source country withholding tax prescribed under Singapore tax treaties with those countries.

<sup>5</sup> Related party guarantee, of itself, poses a number of difficult conceptual issues, e.g. whether adjustments should be made to account for the fact that the borrower is part of a larger group when there is no explicit parental guarantee.

# Update on proposed UK 'debt cap'

Draft legislation relating to the taxation of foreign profits was released by HRMC on 9 December 2008. The purpose of the proposed change in existing legislation is to ensure that the UK tax system remains internationally competitive. It also represents a move towards a more territorial approach to the taxation of foreign profits.

One of the key changes in the proposed foreign profits legislation is a capping of the interest deductions that a UK company can take on intra-group loans both from an overseas affiliate and from a related UK company. On 22 April 2009, it was announced as part of the UK Government's annual budget that the interest capping legislation will be delayed and will only apply to finance expenses payable in accounting periods beginning on or after 1 January 2010.

The exact nature of the interest capping legislation, and specifically its application to companies in the financial services sector, has yet to be agreed. However, a brief summary of the proposed interest capping legislation and current thoughts on its application to companies in the financial services industry is provided below.

## The proposed debt cap

On 7 April 2009, following extensive consultation with business and advisors, the UK Government announced changes to the proposed legislation regarding the calculation of the debt cap. Although the basic principles remain similar to those originally proposed, the mechanics of the calculations have changed substantially.

UK group companies with net finance expense will be required to compare their combined net finance deductions ('tested amount') with the worldwide group's gross external finance expense ('available amount') taken from consolidated accounts prepared either under International Accounting Standards (IAS) or other acceptable standards (including UK and US GAAP). Relevant group companies with net finance income or no finance income or expense are excluded when calculating the tested amount.

Impairment losses, profits or losses on the disposal of a loan (capital gain/loss), foreign exchange, external debt factoring, external hedging arrangements and certain short-term debt

are specifically excluded from the definition of finance expense, whilst all finance leases are included.

To the extent the tested amount exceeds the available amount; the UK group must restrict its finance deductions for tax purposes. Corresponding adjustments may be made to reduce UK group finance income up to the amount of the disallowance.

## Potential exemptions

A gateway test will be introduced and if met, a UK group will not have to take any further action in respect of the debt cap measure. The gateway test will operate by comparing the net debt of UK group companies with the worldwide group's gross debt based on consolidated accounts. If the total net debt of all relevant companies with net debt is less than 75% of gross debt from the worldwide consolidated accounts then the group passes the test. The gateway test is likely to mainly benefit UK inbound groups.

If the group cannot meet the gateway test, it may still avoid the detailed application of the rules if a certifying statement is made confirming that the available amount exceeds the tested amount.

The exemption may also include financial services groups where debt forms an intrinsic part of the way in which the business is conducted. Exemptions may also be available for small and medium sized companies and for de minimis transactions. It is important to note that details of the exact nature of the exemption have not been provided and it is unlikely that all financial services companies will be exempt. Further details will be released prior to 1 January 2010.

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# Recent developments that affect transfer pricing in Korea

## Suspension of tax audits due to global financial crisis

### Past

In October of 2008, the ex-commissioner of the National Tax Service (“NTS”) stated that the NTS would suspend all tax audits on companies with net sales of KRW 500 billion or less until financial markets stabilised. This suspension was put into effect on October 29, 2008. Since this declaration, only a few tax audits have been launched, such as the tax audit of 16 individuals involved in overseas gambling activities.

### Present

The NTS has recently resumed tax audits for some foreign and domestic companies that have not been audited for more than 5 years due to a fear of the lapse of the statute of limitations. This may be an indication that the NTS will end the suspension on tax audits and may conduct fully fledged tax audits in the second half of this year. As such, it is recommended that those companies that have not been audited for more than 5 years should be prepared for a possible tax audit. In general, a notice of a tax audit is sent 10 days prior to the scheduled commencement date. This period may not provide enough time to thoroughly prepare the requested information and documents requested by the NTS, therefore, advanced preparation is beneficial.

In recent tax audits of foreign financial institutions, transfer pricing has been the single most important tax issue for the NTS. Once a tax audit has been scheduled, the following are a few of the issues that should be considered from a Korean transfer pricing perspective.

- Is there a global transfer pricing policy for all intercompany transactions?
- Has the global policy been analyzed and prepared from a local TP perspective?
- Has the policy been updated annually?

Given the NTS' likely resumption of tax audits in the near future, the issues described above are now points that all

companies should review when preparing for a tax audit defense.

## Contemporaneous Transfer Pricing Documentation and Under Reporting Penalty Relief

The following amendment provides tax penalty relief on the under reporting penalty of 10% if the taxpayer maintains contemporaneous transfer pricing documentation when filing corporate income tax returns with the tax office. The amendment is effective for transfer pricing adjustments occurring on or after January 1, 2009. This amendment is included in Article 13 of the Law for the Coordination of International Tax Affairs (“LCITA”) and provides that the underreporting penalty may be waived:

- 1 In cases where the taxpayer prepares and maintains documentation, as stipulated in the relevant regulations of the LCITA, on the transfer pricing method declared on its corporate income tax return; and
- 2 Where the transfer pricing method was reasonably selected and applied.

Prior to this amendment, the underreporting penalty tax could be waived only when a taxpayer demonstrated compliance of their documentation with the arm's length principle through mutual agreement procedures. This amendment now provides a strong incentive to maintain contemporaneous transfer pricing documentation.

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# Country focus: Argentina

## Country Profile

Even though Argentina is not an OECD Member, the 1998 Tax Reform introduced transfer pricing rules into its Income Tax Law ("ITL") following the guidance<sup>6</sup> set forth by the OECD. Two reforms to the ITL took place later, in 1999 and 2003. Nevertheless, principal aspects of the rules remain unchanged.

The most significant differences to OECD Guidelines are:

- A specific non-OECD method exists for the export of commodities when made through an international intermediary who is not the actual receiver of the goods;
- The residual profit split is not a listed method (even though it could be argued that it is a variation of profit split);
- The 'best method' rule is incorporated;
- The tested party must be the Argentine entity (regardless of whether its functions are routine or non routine);
- The use of the interquartile range is mandatory and, in cases of a transfer pricing adjustment, it is prescribed to 0.95 or 1.05 of the median (e.g. in a loan granted by an Argentinean entity to a foreign related party, if the interest rate of the loan is 6% and the arm's length interest range is 8.0% to 12.0% with a median of 10.0%, the adjustment would be to 9.5%); and
- Documentation must be prepared on an annual basis and it must be submitted to the tax authorities verified by a certified public accountant.

## Control

"Control" is defined in a broad sense, including not only shareholder control but also situations of economic, administrative or commercial control, such as situations when the parties grant exclusive rights, have common board members, or provide funds or technology necessary to the development of the business. Transactions with unrelated parties domiciled or located in low or nil tax jurisdictions (specifically listed in the Regulatory Decree) are presumed

<sup>6</sup> OECD Guidelines are not legally binding but as been used by the tax auditors as reference and consultation document to interpret local rules.

not to be at arm's length and subject to transfer pricing analysis.

## Permanent Establishments

Regarding permanent establishments ("PE"), Section 14 of the ITL contains the "functionally separate entity approach" and refers to Section 15 (transfer pricing methods) to evaluate the arm's length nature of the transactions. Nothing is said on how to attribute functions, risks, assets or capital to a PE, other than stating that a PE must have separate accounting records. Since the rules were issued after the OECD report on the attribution of profits to PEs, it is not clear whether the Tax Authorities will reference the OECD report of interpreting local rules or not (as is the case with OECD Guidelines).

## Financial Transactions

With respect to financial institutions, the final paragraph of Section 14 prescribes that

*"In the case of financial entities operating in the country, the dispositions contained in Section 15 for the amounts paid or credited to its headquarters, related company or co branch or other entities or corporations, related, incorporated, domiciled or located abroad, for interests, commissions and any other payment or credit originated in transactions performed with those entities are applicable, when the amounts were not at arm's length".*

The paragraph also states that the Tax Authorities could acquire information from the Central Bank when it is deemed necessary for the analysis.

This paragraph, which is the only specific reference to the financial sector in the Argentine transfer pricing ("TP") regulations, is redundant since financial institutions are already covered by the general rules.

## Most common transactions

After the 2001 crisis, although only a small number of foreign banks left Argentina, the crisis did deeply affect the regulatory environment of the financial sector. Many

transactions that had usually been performed by financial institutions were prohibited. As one of the most important objectives of policy makers has been to control the US Dollar exchange rate, the restrictions on movements of capital has been constantly changing, depending on capital flows.

In Argentina, the most typical transactions with related parties today are those of treasury (the payment of interest for long term financing, the earning of interest for mostly short term finance and investments and foreign exchange transactions), sovereign bond and stock trading and fee earning (custody fees, referral fees, etc).

Another important group of transactions refers to intra-group services. Different charges are received from, and made to headquarters or other group members by the Argentine entities. Regional management, IT, data processing and many other back office services are among the most common.

Capital markets in Argentina are not very developed and presumably, its size will decrease after the nationalisation of the pension funds in 2008. Global trading activity is very limited and those international funds with activity in Argentina mostly perform limited commercial activities and representation services of related entities abroad.

## Transfer pricing environment and audit activity

Based on our experience, we have observed three stages of transfer pricing related audits. The first stage was just before the introduction of the transfer pricing rules in the ITL, after the first due date (in the early 2000s), the tax authorities began transfer pricing audits, principally focusing on manufacturing entities in the automobile and pharmaceutical industries. These audits were undertaken by a specialised group of auditors. Many of these cases are now being litigated in the Tax Courts.

In the second stage, authorities focused on commodity traders (including oil transactions by oil companies), whom they consider a source of tax revenues given their performance after the 2002 devaluation.

Recently, tax authorities in Argentina have started to develop a new aspect of transfer pricing audits of financial transactions undertaken by non financial entities. In this sense, two main groups of transactions can be distinguished: 1) loans received or 2) loans granted or placements within a cash-pooling scheme.

Regarding loans received, the spotlight has been on the arm's length nature of the transaction. The tax authority has focused on characterising loans as equity to disallow the deduction of the foreign exchange loss resulting from the devaluation of the Argentine peso. To this end, tax authorities have taken a very formalistic approach and have

been recharacterising loans arguing that there was no written agreement in place or that it was not notarised. In a recent case (Ericsson SACI), the tax court ruled in favor of a taxpayer, placing more emphasis on the financial conditions of the transaction and the arm's length nature of its behavior.

With respect to loans granted and participation in intercompany cash pools. Tax authorities have recently begun to request very detailed information focusing not only on the formalistic aspects of the transaction but also on the economic substance. Three main topics stand out in the tax authorities' requirements: risk evaluation, opportunity cost and comparable transactions.

The financial sector has not received much attention from the tax authorities because of the complexity of its transactions. Nevertheless, a transfer pricing audit program focusing on this sector would seem like a natural progression following the recent developments on financial transactions, and as tax authorities continue to gain familiarity with complex financial transactions.

Finally, it is important to highlight two other related aspects of the tax audits that have had a major impact in the tax returns of financial entities (although not limited to financial entities). These areas are deductibility and withholding taxes.

Regarding deductibility, the historical leading case in Argentina refers to the allocation of charges to a branch from a multinational bank's headquarters. The case was ruled against the taxpayer.

For a charge of this nature to be fully deductible, the taxpayer has to prove that a service is effectively rendered, that it is necessary to obtain, keep or maintain taxable income in Argentina, and that the charge is determined on an arm's length basis. Among these requirements, the first two are very important since no portion of a charge is deductible if the taxpayer cannot prove with solid evidence that the service is effectively rendered and it is related to the generation of taxable income in Argentina. In order to support the deduction, the taxpayer must gather material evidence to prove the actual rendering of the service and the correlation between the service and the costs incurred in rendering it. The mere allocation of costs generated abroad on a pro rata basis would not be deductible and there are precedents supporting the tax authorities' position on this matter.

Regarding withholding taxes, taxpayers frequently face a dilemma. If the price is not grossed up to consider the withholding tax, the service provider might not be able to support an arm's length return which could result in a transfer pricing adjustment. Such an adjustment would naturally give rise to a corresponding double taxation

risk. However, if the price is grossed up (and not tax credited), double taxation would not be a potential risk, but real. Unless careful planning is undertaken (and this is not always enough), intra-group services could have a major impact in the effective tax rate.

## Conclusions

Argentina has formal transfer pricing documentation requirements that follow in general, the terms set forth by the OECD Guidelines.

Even though the financial sector has not been fully scrutinised, financial transactions are starting to draw the attention of the Argentine tax authorities. Based on recent experience, it is reasonable to expect that a transfer pricing audit program targeting entities in the financial sector could follow.

Other tax issues indirectly related to transfer pricing, such as deductibility and withholding taxes, should also be carefully considered and analyzed.

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