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*connectedthinking

PRICEWATERHOUSECOOPERS 

Current economic conditions and impact on cross border tax and transfer pricing policies

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Agenda

- I. Economic Conditions
- II. Global Trading
 1. Overview of Residual Profit Split vs. Hedge Fund Model
 2. Comparative Illustrations
 3. Global Trading Losses – Discussion Points
 4. Governmental Responses to Burgeoning Losses
 5. Increased Emphasis on Effective Use of Losses
- III. Financing Transactions
 1. Overview
 2. Financing Transactions – Discussion Points
 3. Treasury Issues
- IV. Q&A

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Economic Conditions

Conditions

- “Jobless rate bolts to 14-year high of 6.5 percent.” *Associated Press 11/07/08*
- “Ford has \$2.98 billion operating loss, burns \$7.7 billion cash in quarter.”
Bloomberg 11/07/08
- “Libor Dollar Rate Falls to 4-Year Low After Interest-Rate Cuts.”
Bloomberg 11/07/08
- “Treasury puts pressure on bond dealers to fix chronic ‘fails’.” *Bloomberg 11/06/08*
- “EU urges spending boost as data signal recession.” *WSJ 11/04/08*
- “Fannie to write down deferred tax assets.” *WSJ 10/29/08*

Ramifications

- Consolidation of banks
- Accounting for and ramification of losses
- ETR impact
- APB 23

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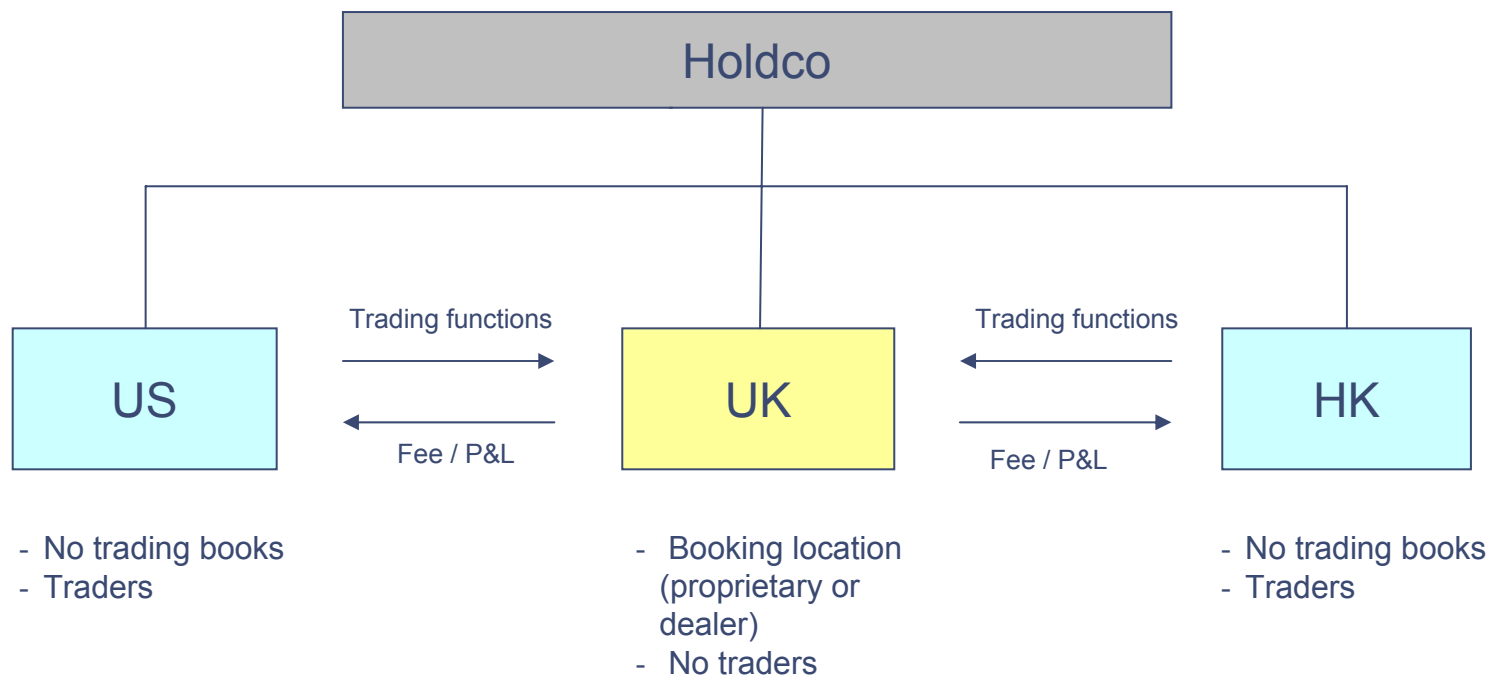
Overview of Residual Profit Split

- Commonly applied in customer driven global trading operations with integrated functions
- All parties considered risk-bearing entrepreneurs in accordance with their relative contributions
 - OECD Report on the Attribution of Profits to PEs (Part III – Global Trading) – Key Entrepreneurial Risk-Taking Functions
 - Proposed Global Dealing Regulations (“GDR”) (Treas. Regs. §1.482-8) – Participants / QBU’s
- Framework:
 - Step 1: Identify the combined global trading profits subject to split
 - Step 2: Compensate routine functions → Residual Profits (Losses)
 - Step 3: Determine allocation drivers for Residual Profits → Allocation Key
 - Step 4: Allocation of Residual Profits to all Participants

Overview of Hedge Fund Model

- Use of hedge funds model
 - OECD: may be a useful analogy for a proprietary trading business whose strategy is comparable to hedge funds, based on facts and circumstances
 - GDR: Not a specified method
- Trading locations serve as “Portfolio Managers” to the Booking Location, which acts as “the Investor”
 - Trading location is service provider
 - Booking location is risk-bearer / “entrepreneur”
- Two-pronged compensation
 - Management Fee
 - Incentive / Performance Fee

Comparative Illustrations – Structure and Assumptions



Comparative Illustration – Profit Scenario – Residual Profit Split

	Total	US	UK	HK
Trading Revenue	450	0	450	0
Operating expenses	200	150	5	45
A. Residual Trading Profits⁽¹⁾	250	(150)	445	(45)
B. 2-Factor Formula				
1) Headcount	15	10	0	5
- relative contribution	100%	67%	0%	33%
2) Compensation	130	100	0	30
- relative contribution	100%	77%	0%	23%
<i>=> 2-Factor relative contribution allocation (simple average)</i>	100%	72%	0%	28%
C. Final Profit Allocation (C=A*B)	250	180	0	70

⁽¹⁾ After compensating for routine functions. In this example these are assumed immaterial

Comparative Illustration – Loss Scenario – Residual Profit Split

	Total	US	UK	HK
Trading Revenue	100	0	100	0
Operating expenses	200	150	5	45
A. Residual Trading Profits⁽¹⁾	(100)	(150)	95	(45)
B. 2-Factor Formula				
1) Headcount	15	10	0	5
- relative contribution	100%	67%	0%	33%
2) Compensation	130	100	0	30
- relative contribution	100%	77%	0%	23%
=> 2-Factor relative contribution allocation (simple average)	100%	72%	0%	28%
C. Final Profit Allocation (C=A*B)	(100)	(72)	0	(28)

⁽¹⁾ After compensating for routine functions. In this example these are assumed immaterial

Comparative Illustration – Loss Scenario – Hedge Fund Model

	Total	US	UK	HK
Residual Trading Profits ⁽¹⁾	(100)			
Management Fee ⁽²⁾	215			
Allocation based on total operating expenses	215	161	0	54
A. Profit element of Management Fee	15	12	0	3
Incentive Fee ⁽³⁾	0			
B. Profit Allocation (by 2-Factor simple average)	0	0	0	0
C. Investor Profits after Management Fee (to booking entity)	(115)	0	(115)	0
D. Final Profit Allocation (D=A+B+C)	(100)	12	(115)	3

(1) After compensating for routine functions. In this example these are assumed immaterial

(2) Based on cost plus, or AuM / NAV

(3) 20 percent of trading profits, assuming no hurdle rate, or clawbacks

Comparative Illustration – Profit Scenario – Hedge Fund Model

	Total	US	UK	HK
Residual Trading Profits ⁽¹⁾	250			
Management Fee ⁽²⁾	215			
Allocation based on total operating expenses	215	161	0	54
A. Profit element of Management Fee	15	12	0	3
Incentive Fee ⁽³⁾	50			
B. Profit Allocation (by 2-Factor simple average)	50	36	0	14
C. Investor Profits after Management Fee (to booking entity)	185	0	185	0
D. Final Profit Allocation (D=A+B+C)	250	48	185	17

- (1) After compensating for routine functions. In this example these are assumed immaterial
- (2) Based on cost plus, or AuM / NAV
- (3) 20 percent of trading profits, assuming no hurdle rate, or clawbacks

Global Trading Losses – Discussion Points

- “... under the authorised OECD approach, the same principles should be applied to attribute losses as to attribute profits.”
Part III of the OECD Paper on Attribution of Profits to PEs in the Financial Industry, Paragraph 5
- Different positions by competent authorities in different countries. *PwC’s TP Global Conference, Vancouver, CA October 2008*

Global Trading Losses – Discussion Points

- Re-evaluate KERTs?
- Return on Capital under the profit split model?
- PSM vs. HF model
 - Functional analysis: facts and circumstances
 - Proprietary vs. customer trading
 - Shift to less risky proprietary trading
 - Shift to centralized vs. desk specific activities
- Regulatory vs. tax vs. transfer pricing
 - Loss reserves/actuals [sourcing (tax & regulatory) vs. 482]
 - Changes in funding- treasury / capital reserve management
 - Accounting for and reporting of losses (i.e., contingency losses, litigation reserves, etc.)

Governmental Responses to Growing Losses

- Search for Revenues
- Tax Relief for Financial Institutions
 - Notice 2008-83 (Relaxation of Section 382 built-in loss rules for banks)
 - Notice 2008-100 (Purchase of shares in banks by US government disregarded; query whether this will be extended to purchases by non-US sovereigns?)
- U.K. Response
 - Preferred stock investments unlikely to implicate ownership change rules

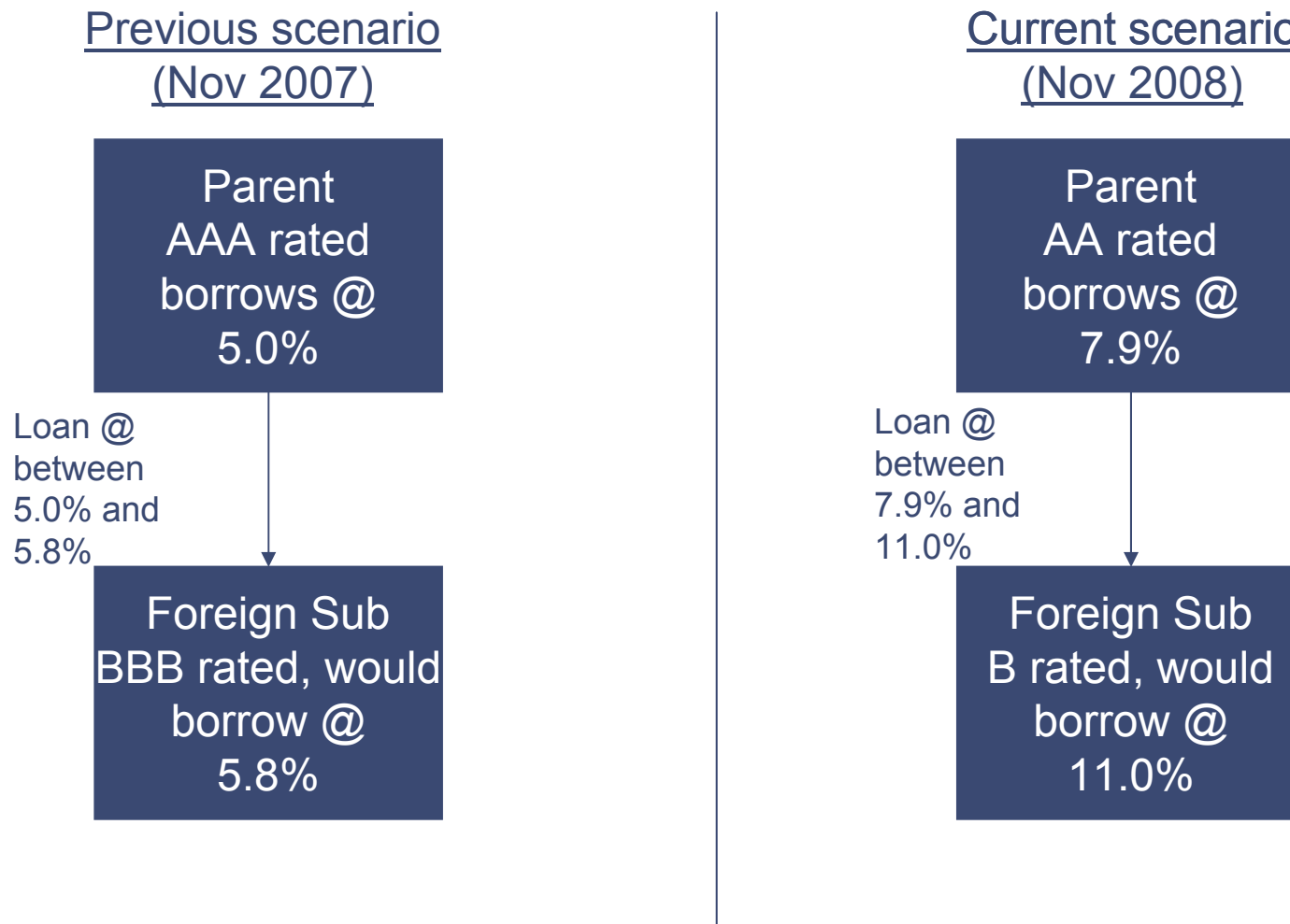
Increased Emphasis on Effective Use of Losses

- Determine at which level or levels the loss can be claimed
 - Loss at corporate level
 - Loss at shareholder level
- Consider the impact of the use of losses on other attributes
 - Source and character Issues
 - Impact on foreign tax credits and shift in attitude towards non-home country taxes
- Evaluate the ability to transfer the benefit of the loss to other companies within the group
 - Transfer pricing
 - Asset transfers
 - M&A transactions
- Carefully navigate Anti-trafficking rules for losses

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Intercompany Financing – Credit Rating Effects

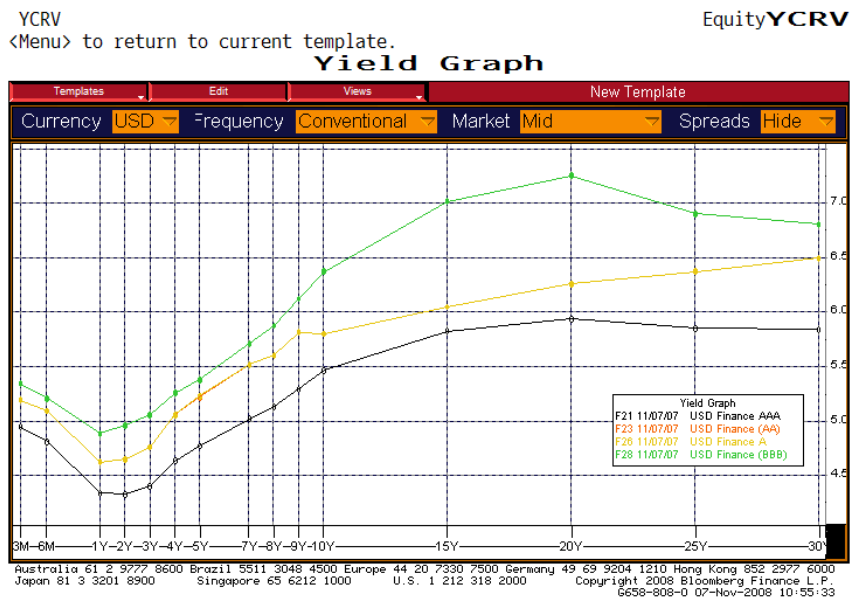


* This example does not consider passive benefit impact in the credit rating of subsidiaries.

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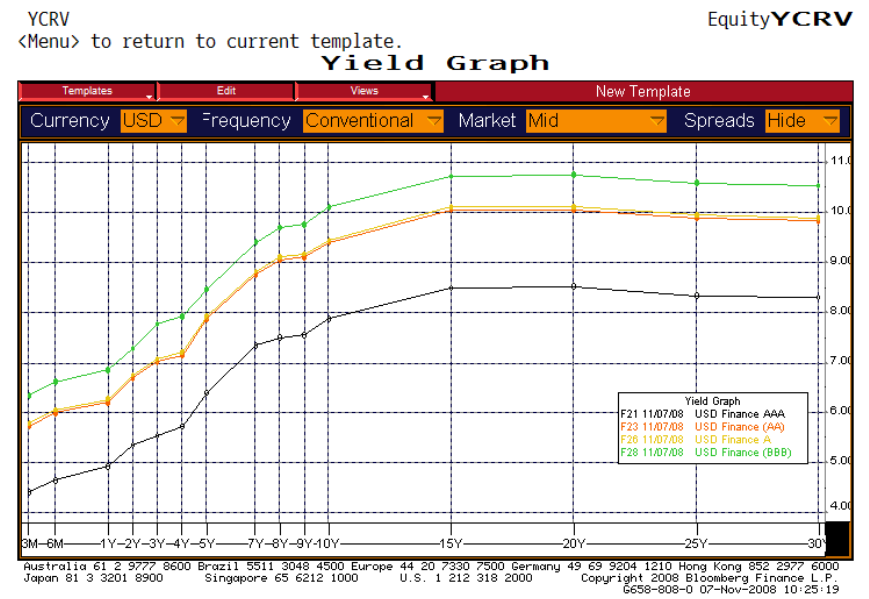
Intercompany Financing – Yield Curves

Previous scenario (Nov 2007)



Source: Bloomberg Terminal

Current scenario (Nov 2008)



Financing Transactions – Discussion Points

- Intercompany financing
 - Thin capitalization- D/E analysis
 - Re-evaluate intercompany cost of debt
 - Evaluate impact on guarantee fees
 - Review credit standing of borrowing and lending entities
 - Consider refinancing transactions to provide liquidity and their tax impact

Treasury Issues

- Tax-efficient Repatriation becomes more challenging
 - Notice 2008-91 gives modest relief on upstream loans
 - TEI response
- CFC Look-through and Active Financing Exception Extended
- Consider Modifying Existing Financing Structures
 - Debtor may be unable to service debt, leading to potential loss of benefit and withholding tax inefficiencies
 - Revisit debt-equity analysis
 - Potential benefit/detriment from higher interest rates
 - Cancellation of indebtedness issues
- New structures must be sensitive to changing environment
- Pressure on APB 23 Assertions

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