

Transfer pricing in the context of a PE: the OECD view

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On December 21, 2006, the Organisation for Economic Co-operation and Development (“OECD”) released its Report on the Attribution of Profits to Permanent Establishments – Parts I (General Considerations), II (Banks) and III (Global Trading) – December 2006 (henceforth referred to as the “Report”).¹ The Report reflects the current views of the OECD’s Committee on Fiscal Affairs with respect to attributing profits to a permanent establishment (“PE”).

Pursuant to the release of the Report, the Committee on Fiscal Affairs directed that the conclusions contained in the Report be implemented in two stages. First, a new Article 7 Commentary is to be adopted reflecting only those elements of the Report that are consistent with the existing language of Article 7 of the current Commentary. This new Commentary would ostensibly provide authoritative interpretation of existing treaties based on the current version of the OECD model treaty language. Subsequently, all elements of the Report are to be reflected in a new version of Article 7 and accompanying Commentary that would be used in the negotiation of future treaties and amendments to existing treaties. On April 10, 2007, the OECD released the first of these documents in draft form (henceforth referred to as the “Revised Commentary”).² The second document is expected to be forthcoming later this year.

The Report and Revised Commentary describe the OECD’s approach with respect to the application of the arm’s length principle set forth in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by the OECD in 1995 and supplemented thereafter (“OECD Guidelines”) in the context of a PE. Under the OECD Guidelines, the allocation of income amongst associated enterprises is predicated on the functions performed, risks incurred and assets employed by each entity.³ For applications in the non-financial services sectors, the authorised OECD approach (“AOA”) introduces the concept of “significant people functions” in relation to the management of risks and assets, respectively.

This article reviews the major conclusions reached by the OECD in developing its authorised approach to the application of the arm’s length standard in the context of a PE. In particular, we focus on the adoption of the “separate entity approach”, which is core to the OECD’s position. In addition, we discuss the application of the “significant people functions” concept before touching on its application to the dependent agent PE scenario. Irrespective of one’s point of view with respect to the degree of success achieved by the OECD in applying the arm’s length standard in the context of a PE, it is clear that taxpayers will need to assemble contemporaneous documentation that also covers those instances where they are operating through a PE. This documentation will need to delineate the respective roles of the relevant parties, including the functions performed, assets used, and risks assumed. Most importantly, the documentation will need to describe in detail the authority each party has with respect to its ability to make operating decisions and the parameters within which those decisions are taken.

“Functionally separate entity” approach

Article 5 of the OECD Model Tax Convention outlines under what conditions a PE might exist. Article 7 then provides guidance on the attribution of profit to the PE once a PE has, in fact, been determined to exist. In developing its current thinking with respect to Article 7, the OECD established a working hypothesis (“WH”). The WH was designed to achieve consensus among members on how the OECD Guidelines, which addresses the application of the arm’s length principle to transactions between associated enterprises under Article 9, might be applied in the context of a PE.

Paragraph 1 of Article 7 states:

The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.⁴

The import of paragraph 1 of Article 7 is the principle of double taxation – namely that an enterprise is only taxable in a state to the extent that it carries on business in that state through a PE.

Once a PE has been established, however, the fundamental perspective on how to allocate income to the PE turns on the application of one of two fundamental approaches. The first is described by the Report as the “functionally separate entity” approach. The other is described as the “relevant business activity” approach. The good news for taxpayers is the Revised Commentary clearly rejects the “force of attraction” approach, which would potentially subject all of the income of the enterprise with a PE to tax.

The “relevant business activity” approach defines “profits of an enterprise” subject to tax as those profits of the business activity in which the PE has some participation.⁵ This view of the world has materially different implications if “relevant business activity” is interpreted as meaning all profit related to a business line, for example, or whether it is defined by reference to a particular function. Because of the lack of clarity and practical problems with its administration, the “relevant business activity” approach to defining income is viewed as inferior by the OECD to the “functionally separate entity” approach.

The “functionally separate entity” approach defines profits attributed to the PE as being those profits that the PE would have earned at arm’s length if it were a “distinct and separate” enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm’s length principle.⁶ This approach is consistent with the language in paragraph 2 of Article 7:

Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it 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 and dealing wholly independently with the enterprise of which it is a permanent establishment.⁷

The Report notes a key distinction between the two competing views on profit attribution that should not be lost on taxpayers – the “functionally separate entity” approach permits profits to be attributed to the PE, even if no profit has been realised by the enterprise as a whole. For example, while an enterprise may lose money overall in a business, a PE properly characterised as a routine distributor may be entitled to a profit. In contrast, the “relevant business activity” approach has generally not regarded profits as being attributable to the PE until profits for the “relevant business activity” on aggregate have been realised.⁸

Consistent with the “functionally separate entity” approach, the Commentary expresses the “generally accepted” view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal

authority of that country should look at the separate sources of profit that the enterprise derives from its country and should apply to each the PE test.⁹

Significant people functions

The Report details a two-step analysis required to attribute profit to a PE under the AOA. The first step is to hypothesise the PE as a distinct and separate enterprise “engaged in the same or similar activities under the same or similar circumstances”.¹⁰ The taxpayer is required to allocate to the PE assets and risks related to its business. It is in this context that the concept of “significant people functions” is introduced. Assets and risks are to be allocated between the PE and the home office by reference to the place of performance of such significant people functions.¹¹ The current Report retains the use of the term key entrepreneurial risk-takers (“KERT”) for the financial enterprise sector. This is distinguished from the use of “significant people functions” outside the financial enterprise sector. The theory is that within the financial enterprise sector, the correlation of asset management and risk management is so intertwined that it is likely that the same individual or individuals are making the key decisions with respect to the management of said assets and associated risks.

Outside the financial enterprise sector, it is theorised that these key functions may be bifurcated. One party may “economically own” an asset, while the risk associated with the use or exploitation of that asset may lie elsewhere. Hence, the AOA requires that the “significant people functions” analysis outside the financial enterprise sector be performed to determine the allocation of intangible assets and risks, respectively.

At first glance, it would seem that the requirements for determining the attribution of profit to the PE require the transfer pricing analyst to develop even greater granularity with respect to the facts uncovered as part of the functional analysis that underlies all properly performed transfer pricing analyses. This follows since in the application of transfer pricing between associated enterprises that operate as distinct legal entities, there is a natural means by which to assign assets, for example. It may be the case that property, plant and equipment is legally owned and hence reported on the balance sheet of Entity A, but not by Entity B. However, just as in the context of a PE, the separate entity analysis still requires one to develop a factual understanding of the terms and conditions that govern the functions being performed by the controlled parties to the transaction.

For example, even in the context of separate but related Entities A and B, Entity A may own the property, plant and equipment, but it operates under a tolling arrangement with Entity B so that the latter party makes decisions related to the utilisation of those assets and hence bears the economic risk. In order to properly allocate income between Entities A and B, the understanding of which entity owns assets and which entity bears the risk of those assets is critical. Moreover, to ensure that the actual conduct of the parties is consistent with the economic substance of the transaction, the transfer pricing analyst is called on to verify that key decisions with respect to the tolling operation are being directed by Entity B.

In the context of a PE, there are typically no contractual arrangements. Rather, the analyst must impute the “contractual terms” by reviewing “accounting records, together with contemporaneous internal documentation, purporting to transfer risks, responsibilities and benefits from part of the enterprise to another part”.¹² The Report acknowledges the added difficulty the analyst has with respect to dealing with risks and assets in the PE setting. Clearly, in the above example, we would expect Entities A and B, operating as distinct legal entities, to memorialise their intended allocation of risk and ownership of any resulting profits via a legal agreement. However, in the context of the PE, it is the enterprise as a whole

that bears the risk.¹³ Nevertheless, under the AOA, the functional analysis sheds light on this and looks to the people functions to sort out the answer. Specifically, “the PE should be considered as assuming risks for which the significant people functions relevant to the assumption of risk are performed by the personnel of the PE at the PE’s location”.¹⁴ Unlike in the separate entity – Article 9 context – it is not possible to separate risk from the people function of managing that risk.

The Report allows for the fact that a risk initially assumed by the PE pursuant to the functional activities of significant people cited at the PE may be passed on to another part of the enterprise so long as the part of the organisation that subsequently assumes the risk is also “managing” that risk. This requirement would seem to comport with economic substance principles. It is unlikely that a third party would assume risks resulting from the independent actions of another party without having some ability either to manage the outcome of the risk or to price the transfer of risk in such a manner that the “seller” of the risk would bear a significant portion of the economic cost related to the risk.¹⁵

With respect to assets, the AOA adopts several different approaches depending upon the type of asset. When allocating tangible assets to the PE, the AOA reflects a broad consensus among OECD member countries for applying “use” as the basis for attributing economic ownership of tangible assets. To the extent that the PE uses the asset in its functional role, that asset would be “economically” owned by the PE. In such a case, it is assumed that the PE would be assigned the cost of depreciation and interest, if the asset is financed. In the case of a lessee, the PE would be entitled to deductions in the nature of rent.¹⁶

For trade intangible assets (i.e., intangibles used in the production of a good or the provision of a service),¹⁷ the AOA allows that economic ownership should reflect the “significant people functions” that reflect the “decision making with regard to the taking on and management of individual risk and portfolios of risks associated with the development of intangible property”.¹⁸ This obviously places a lot of pressure on the exact definition of “significant people functions”. In the OECD’s view, the emphasis should be “on active decision making and management rather than on simply saying yes or no to a proposal”.¹⁹ The following activities are identified in the Report as potentially “significant people functions” with respect to trade intangibles:²⁰

- designing the testing specifications and processes within which research is conducted;
- reviewing and evaluating the data produced by the tests;
- setting stage posts at which decisions are taken; and
- actually making the decisions on whether to commit further resources to the project or to abandon it.

The Report goes on to say that this requirement for active decision making and management

“suggests that, just as for financial assets, economic ownership may often be determined by functions performed below the strategic level of senior management. This is the level at which the active management of a programme toward the development of an intangible would occur, where the ability to actively manage the risks inherent in such a programme lies.”²¹

Such positions seem to reflect a stubborn view that is hard to distinguish from the full-fledged “KERT” era, which supposedly eclipsed after 2004 under sharp attacks by the likes of the U.S., U.K. and Canadian tax authorities.²² Practically speaking, the revised position staked out by the OECD with respect to trade intangibles seems to ignore arm’s length reality – namely, that intangible ownership is ultimately

determined by the assumption of risk in the development, maintenance or acquisition of said intangible. An example emphasising this point is provided in the OECD Guidelines, which states:

“[i]n the latter instance, generally involving frontier research, the additional functions of identifying commercially valuable areas and assessing the risk of unsuccessful research can be a critical factor in the performance of the group as a whole. However, the research company itself is often insulated from financial risk since it is normally arranged that all expenses will be reimbursed whether the research is successful or not. In addition, intangible property deriving from research activities is generally owned by the principal company and so risks relating to the commercial exploitation of that property are not assumed by the research company itself.”²³

The recently published Revised Commentary seems more than a bit confused on the subject. The Report clearly dismisses the position outlined in the 2004 version of the Report, which theorised that intangible costs (and presumably economic ownership) should be allocated within an enterprise, and adopts instead its people function-based approach. Despite the conclusion in the Report that this 2004 approach is “deficient” in a number of respects,²⁴ the Revised Commentary clearly stops short of full implementation of the principles set out in the Report on this matter. The Revised Commentary (preserving old Commentary language) states that “it may be extremely difficult to allocate ‘ownership’ of an intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise.... It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them.... In such circumstances it would be appropriate to allocate between the various parts of the enterprise the actual costs of the creation or acquisition of such intangible rights”.²⁵ The position articulated in the Revised Commentary is inconsistent with the conclusions reached in the Report and is counter to any reasonable interpretation of the arm’s length principle. As such, it simply needs to be revised if the OECD’s intent is to embrace the arm’s length principle in assigning income to a PE. While one would expect that the second instalment of the Commentary will more fully implement the allocation principle in the Report, the half-way interpretation in the current draft is seriously problematic.

The Report’s treatment of marketing intangibles follows along a similar path. The “significant people functions” relevant to the determination of economic ownership are likely to be those associated with the initial assumption and subsequent management of risks of the marketing intangibles. These may include, for example, functions related to:

- the creation of and control over branding strategies;
- trademark and trade name protection; and
- maintenance of established marketing intangibles.

Owing to the fact that marketing intangibles can be long-lived, it is recognised that there can exist a distinction between the party responsible for the creation of the intangible asset and the party that has assumed responsibility for the ongoing maintenance and development of the marketing intangible.

Attribution of assets and costs to the PE

With respect to creditworthiness, the Report reinforces the OECD position that the PE will have the same creditworthiness as the enterprise of which it is a part.²⁶ Hence, the AOA does not recognise the need for guarantee fees between a PE and, say, the home office.

The Report defines “free” capital as “an investment which does not give rise to an investment return in the nature of interest that is deductible for tax purposes under the rules of the host country of the PE”.²⁷ Contributions of shareholder equity and retained earnings are “equity” capital and borrowing is referred to as “debt” capital. In determining the appropriate allocation of “free” capital and interest-bearing debt, the AOA requires that the PE be treated as having an appropriate amount of capital consistent with the functions it performs, the assets it uses and the risks it assumes.²⁸

The AOA involves a two-step process, involving, first, the measurement of risks and assets attributable to the PE and, second, the determination of the “free” capital needed to support those risks and assets consistent with the arm’s length principle. One shortfall of the Commentary to Article 7 highlighted in the Report is its failure to offer clear guidance for determining whether a PE is appropriately capitalised.

In principle, the PE should be attributed sufficient “free” capital to support its functions, risks and assets. The Report presents several approaches for allocating “free” capital to a PE, including the “capital allocation” approach,²⁹ the “economic capital” approach,³⁰ the “thin capitalisation” approach,³¹ and the “safe harbour” approach.³² Although each of these methods attempts to achieve the objective of producing an arm’s length result, it is acknowledged that each has strengths and weaknesses that may result in disagreements amongst tax administrations that may require resolution through Mutual Agreement Procedures.

Similarly, there are multiple approaches for determining funding costs to a PE, including the level of interest-bearing debt and the corresponding rate of interest. For example, under the “tracing” approach, the interest rate for funding provided to the PE is “traced” to its original source and benchmarked to the rate charged by the third party lending institution to the enterprise. By contrast, under the “fungibility” approach, the enterprise’s cost of debt is allocated to the PE based on a pre-determined formula. As with capital attribution, the Report notes that no single method for attributing interest expense to a PE may be applicable in all circumstances.³³

Dependent agent PE

Although the Report does not examine the standards for establishing a dependent agent PE under Article 5, it does discuss the impact on the associated attribution of profit if a PE is found to exist. Article 5 defines a dependent agent PE to exist where a person – other than an agent of an independent status – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State, an authority to conclude contracts in the name of the enterprise.³⁴

Where a dependent agent PE is found to exist, the host country taxing authority may subject both the dependent agent enterprise (in the host country) and the dependent agent PE (abroad) to taxation.

The attribution of income to a dependent agent PE is predicated on the

“nature of the functions carried out by the dependent agent on behalf of the non-resident enterprise and in particular whether it undertakes the significant people functions relevant to the assumption and/or management of risks or to determining the economic ownership of assets.”³⁵

Importantly, under this authorised OECD approach, it is possible that the dependent agent PE may be attributed income after remunerating the dependent agent enterprise at arm’s length.³⁶ This conclusion

follows under a scenario in which it is determined that the “significant people functions” related to the management of risk or assets is at least in part performed by the dependent agent.

Once again we see that this places tremendous pressure on the ability to decide whether a party operating within the context of pre-determined rules or procedures established, for example, by the head office, is in fact doing anything other than providing a routine service function as opposed to a “significant people function” that would, under the AOA, entitle it to additional income that is presumably associated with the risk or asset it is managing.

In developing the AOA with respect to dependent agents, the OECD considered and rejects the “single taxpayer” approach. The “single taxpayer” approach contends that no income is attributable to a dependent agent PE if the dependent agent enterprise is remunerated at arm’s length. Accordingly, under the “single taxpayer” approach, risks that are legally borne by a non-resident enterprise can never be attributed to the dependent agent PE. For example, under a sales agency agreement, customer receivables and the associated credit risk legally belong to the non-resident enterprise, not the dependent agent enterprise. In rejecting the “single taxpayer” view of the world, the AOA argues that those risks may be assigned to the dependent agent PE if the dependent agent performs the significant activities associated with incurring and managing those risks. In doing so, it seems the AOA does not provide for those instances in which the owner of an asset (tangible or intangible) can engage another party to manage that asset on its behalf in return for proper arm’s length remuneration and that the arm’s length remuneration is independent of the income realised from the exploitation of the asset under management.

The combination of half-way implementation of the Report in the Revised Commentary, and the emphasis on dependent agent PEs in both the Report and the Revised Commentary, creates an outcome that is clearly untenable. As noted above, under the provisions of the Revised Commentary applicable to intangible assets, intangible assets are allocated pro-rata to the entire enterprise, not on the basis of “significant people functions” as the Report suggests. Where a local country sales entity constitutes a dependent agent PE, the Revised Commentary would thus appear to permit the allocation of trade intangibles and the income related thereto to an ostensible dependent agent PE, even in situations where the personnel located in the dependent agent play no role in the development, maintenance or protection of the intangible assets. Such an outcome, if intended by the drafters, would allow high tax source countries to lay claim to intangible property related income in situations where they would not be able to do so under the full people function principles of the Report, or under the principles reflected in the current OECD Guidelines. The fact that, as drafted, the Revised Commentary appears to allow source countries to tax intangible property income in situations where local personnel play no role in the development or protection of the intangibles in question is clearly flawed and should be rectified before the Revised Commentary is finalised.

Concluding thoughts

As described above, the “significant people functions” concept introduces a layer of complexity that is at best susceptible to broad interpretation. At worst, application of the “significant people functions” concept ignores the role of the entrepreneur with respect to financial risk taken in the context of asset ownership (tangible or intangible), and hence could lead to a non-arm’s length result in the attribution of income to the PE from the non-resident enterprise which is assuming those risks. The selective application of the “significant people function” principle in the Revised Commentary makes matters worse, creating a taxing

regime that is inconsistent with both well accepted transfer pricing principles and with the principles of the Report.

Be that as it may, the emphasis on “significant people functions” with respect to the assignment of profits related to risks and assets, respectively, will require taxpayers to develop internal documentation that delineates the respective roles of the non-resident enterprise and the PE. This contemporaneous documentation should be clear on the allocation of risks between the respective parties, the benefits that were intended at the onset of the transactions, and, most importantly, the policies and procedures under which each party has authority to exercise decision-making.

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- 1 The Report can be found at <http://www.oecd.org/dataoecd/55/14/37861293.pdf>.
- 2 Revised Commentary on Article 7 of the OECD Model Tax Convention, April 10, 2007, Centre for Tax Policy and Administration, p. 2. The Commentary can be found at <http://www.oecd.org/dataoecd/0/2/38361711.pdf>.
- 3 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD 1995, ¶ 1.20, p. I-9.
- 4 Extracted from OECD Model Tax Convention.
- 5 Report on the Attribution of Profits to Permanent Establishments Parts I (General Considerations), II (Banks) and III (Global Trading), ¶ 61, p. 23.
- 6 Ibid., ¶ 69, p. 25.
- 7 Extracted from OECD Model Tax Convention.
- 8 Report on the Attribution of Profits to Permanent Establishments Parts I (General Considerations), II (Banks) and III (Global Trading), ¶ 70, p. 25.
- 9 Revised Commentary on Article 7 of the OECD Model Tax Convention, April 10, 2007, Centre for Tax Policy and Administration, p. 5.
- 10 Report on the Attribution of Profits to Permanent Establishments Parts I (General Considerations), II (Banks) and III (Global Trading), ¶ 86, p. 28.
- 11 For non-financial service companies, this rule does not apply to tangible assets, which are to be allocated on the basis of use or location. The people function based allocation does apply, however, to risks and to intangible assets.
- 12 Ibid., ¶ 214, p. 55.
- 13 Report on the Attribution of Profits to Permanent Establishments Parts I (General Considerations), II (Banks) and III (Global Trading), ¶ 97, p. 31.
- 14 Ibid.
- 15 It is acknowledged that the pricing of risk can reflect the benefits of commingling uncorrelated risk so as to allow the transaction to occur, for example, as in the case of insurance.
- 16 Report on the Attribution of Profits to Permanent Establishments Parts I (General Considerations), II (Banks) and III (Global Trading), ¶ 104, p. 33.
- 17 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD 1995, ¶ 6.3, p. VI-1.
- 18 Report on the Attribution of Profits to Permanent Establishments Parts I (General Considerations), II (Banks) and III (Global Trading), ¶ 116, p. 36.
- 19 Ibid., ¶ 118, p. 36.
- 20 Ibid., ¶ 119, p. 37.

- 21 Ibid., ¶ 118, p. 36.
- 22 See BNA's Tax Management Transfer Pricing Report, Volume 14, Number 23, March 29, 2006.
- 23 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD 1995, ¶ 7.41, p. VII-14.
- 24 Report on the Attribution of Profits to Permanent Establishments Parts I (General Considerations), II (Banks) and III (Global Trading), ¶ 108, p. 35.
- 25 Revised Commentary on Article 7 of the OECD Model Tax Convention, April 10, 2007, Centre for Tax Policy and Administration, ¶ 30, pp. 10-11.
- 26 Report on the Attribution of Profits to Permanent Establishments Parts I (General Considerations), II (Banks) and III (Global Trading), ¶ 134, p. 40.
- 27 Ibid., ¶ 136, p. 40.
- 28 Ibid., ¶ 141, p. 41.
- 29 Ibid., ¶¶ 155-161, pp. 44-45. The capital allocation approach assigns "free" capital in proportion to the assets and risks attributed to the PE using information obtained in a functional analysis.
- 30 Ibid., ¶ 162, p. 45. The economic capital approach apportions "free" capital based on economic measures of capital and is used primarily in the banking industry.
- 31 Ibid., ¶¶ 163-168, pp. 45-46. The thin-capitalisation approach identifies the functions and risks of the PE, which are used to determine the necessary funding that is allocated into debt and "free" capital based on an analysis of comparables in the host country.
- 32 Ibid., ¶¶ 169-72, pp. 46-47. Although not an AOA, the safe-harbor approach may be used to assign an amount of "free" capital to a PE in the banking industry based on regulatory requirements, assuming this does not result in attributing more income to the PE than would occur if applying an AOA.
- 33 Ibid., ¶ 191, p. 50.
- 34 Article 5, OECD Model Tax Convention.
- 35 Report on the Attribution of Profits to Permanent Establishments Parts I (General Considerations), II (Banks) and III (Global Trading), ¶ 268, p. 67.
- 36 Ibid., ¶ 267, p. 67.

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