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\*connectedthinking

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# Transfer Pricing Update

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# Agenda

## Key Transfer Pricing Issues in Financial Services Industry – 2006

- Group polling questions
- Temporary Services Regs and Other Developments
- Global Trading
- Asset Management
- Investment Banking
- Research
- Sales and Marketing
- Trademark
- Technology
- Loans, Guarantees, Treasury Operations
- Insurance and Reinsurance

## Question #1 for audience

Is your employer headquartered in:

1. U.S.
2. Elsewhere in the Americas
3. Europe
4. Asia

## Question #2 for audience

Your primary job function is within which department:

1. Tax
2. Finance and Accounting
3. Legal / General Counsel
4. Other business unit

## Question #3 for audience

Transfer pricing is viewed by executive management as an important function within your organization:

1. True
2. False

## Question #4 for audience

Transfer pricing is primarily the responsibility of which department within your organization:

1. Tax
2. Finance and Accounting
3. Legal
4. Business Unit
5. Other

## Temp. Services Regs.: Administrative Background

- IRS issued temporary and proposed services regulations (“Temporary Regulations”) on August 4, 2006 (effective for taxable years beginning after December 31, 2006). The Temporary Regulations responded to many comments on the proposed regulations, but questions still remain on several key issues.
- Taxpayers may formally elect to apply the Temporary Regulations to any taxable year beginning after September 10, 2003.
  - Requires that all of the provisions of the Temporary Regulations be applied to such taxable year and all subsequent taxable years of the taxpayer making the election.

## Temp. Services Regs.: Key Changes from Existing, 2003 Proposed and Temporary Regulations

	Existing Regulations	2003 Proposed Regulations	Temporary Regulations
<b>Cost Safe Harbor</b>	Non-integral services	Simplified Cost Based Method (6%)	Services Cost Method
<b>Stewardship</b>	Some guidance, with additional guidance in Treas. Reg. §1.861-8 and case law	Expanded guidance in Prop. Treas. Reg. § 1.482-9	Revised guidance in Treas. Reg. § 1.482-9T(l), cross-referenced in Treas. Reg. §1.861-8T(e)
<b>Profit Split Method</b>	No specified methods; rarely used as “best method”	Best method in cases of “high-value” services	May be best method in cases of “nonroutine” contributions
<b>Shared Services Arrangements</b>	Not addressed	Not addressed	Covered under Services Cost Method
<b>Stock-Based Compensation</b>	Not addressed	Not addressed	Mandatory inclusion in total services costs
<b>Ownership of Intangible Property</b>	Developer- assister rules and cheese examples	Legal ownership the key determinant	Renewed emphasis on economic substance

## Temp. Services Regs.: Overview of Key Topics Addressed in the Temporary Regulations

- A. Specified Methodologies for Services
- B. Services Cost Method and Shared Services Arrangements
- C. Treatment of High Value Services and Embedded Intangibles
- D. Benefit Test
- E. Contractual Relationships
- F. Stock-Based Compensation
- G. Financial Guarantees

## Temp. Services Regs.: Best Method Rule

- Best method rule of Treas. Reg. §1.482-1(c) applies.
- Additional examples provided in Treas. Reg. §1.482-8T(b) illustrate application of the best method rule for services transaction.

## Temp. Services Regs.: PwC Observation

The new regulations essentially create five categories of service transactions:

- Stewardship – Not charged
- IRS “Good List” services – Cost or cost plus markup at taxpayer’s election
- Other low margin services – Cost or cost plus markup at taxpayer’s election
- Services related to global dealing in financial instruments – To be dealt with under the global dealing regulations
- All other services – Addressed under specified methods and the best method rule

## Temp. Services Regs.: Profit Split Method (“PSM”)

- The new regulations modify the operation of the residual profit split method. They require that the division of residual profits be based on “nonroutine contributions” rather than on contributions of intangibles.
- In the IRS’s view, a nonroutine contribution “is one for which the return cannot be determined by reference to market benchmarks” (Treas. Reg. §1.482-6T(c)(3)(i)(B)(1)).
- Examples indicate nonroutine contributions could include customer relationships and a history of success in a territory or business.
- The regulations delete the suggestion that the profit split method may be the best method for highly integrated businesses.

## PSM: PwC Observations

- The revised provisions of the regulations and preamble stating very clearly that contractual arrangements will generally be respected and that transactions involving high value services need not be addressed under a profit split method are welcome changes.
- *“Opinion is like a pendulum and obeys the same law. If it goes past the centre of gravity on one side, it must go a like distance on the other; and it is only after a certain time that it finds the true point at which it can remain at rest.”*

Arthur Schopenhauer

## Other Developments

- US – Proposed Cost Sharing Regulations
- US – Regulation project on definition of “foreign goodwill and going concern value”
- Japan – Changes to Transfer Pricing Guideline
- Australia – Circular on IP Ownership
- OECD – Business Reorganizations Project
- OECD – Project on Attribution of Income to PEs
- OECD – TP project to upgrade status of profits based methods

## Other Developments

### INTANGIBLES

- Includes workforce in place (US cost sharing rules)
- Associated with human resources (such as employee abilities and knowledge) or systems (such as processes or networks (Japan guidelines))
- Transfer of opportunity to conduct business may include a transfer of a business opportunity intangible (US cost sharing regulations) or a transfer of “goodwill” (OECD) for which compensation is required

### ALTERNATIVES

- Reasonably available alternative transactions must be considered in establishing transfer prices (US cost sharing regs)
  - The investor model (US cost sharing regs)
  - The income method (US cost sharing regs)

### MARKETING INTANGIBLES

- Glaxo, Veritas litigation, Australian notice, recent practice in various countries

## Key Topics: Global Trading

- Revenues splits versus profits splits
- Trader remuneration – include bonus? adjust for markets?
- Losses – how are they split? Loss protection?
- Hedge Fund Model?
- PE Issues?

## Temp. Services. Regs.: Global Dealing

- The Temp. Services Regulations state that they do not apply to transactions described in the proposed regulations on global dealing in financial instruments.
- Those regulations are currently being revised and will govern such transactions. In the meantime, taxpayers may rely on the proposed global dealing regulations.

## Key Topics: Asset Management

- TP Analysis: Profit Split? Comparable Transactions? CPM?  
*How do the Temp. Services Regs. impact the best method analysis?*
- Profit Split: The drivers
- Comparable Transactions: Hedge funds? Mutual funds?
- Profitability Benchmarking: Do comparable companies exist?

## Key Topics: Investment Banking

- Usually the deals are very specific and comparables do not exist
- Transaction Comparables
- Profit split – What if the level of integration is not the same for each entity?

*How do the Temp. Services Regs. impact the best method analysis?*

## Key Topics: Research

- Reimbursement at cost may not be allowed under the Temp. Services Regs.
- How to evaluate which legal entities should pay for research and in what proportion?

## Key Topics: Sales and Marketing

- Size of related party transactions
- How important is it compared with other functions of the relevant business
- Remuneration of sales persons
- Is cost plus ever the right answer?
- Availability of relevant CUPs

## Key Topics: Trademark

- Who develops the brand
- Global vs. Local marketing (Vodafone example)
- How well was it known when introduced in the market
- Importance of the brand vs. other characteristics of a specific business
- Customers (e.g., retail vs. institutional)
- Potential Comparables
- Subsidiaries vs. Branches

## Key Topics: Technology Growing Importance

- U.S. banks spent about \$ 20 billion per annum in technology related expenditures in 2003 (survey conducted by ABA and the Tower Group).
- Wire transfer are increasingly used as means of payment for B-to-B transactions across national and international borders. In 2003, the combined value of payments sent over the two major wire transfer systems in the U.S. (Fed-wire and Clearing House Inter-bank Payments System) often exceeded \$ 3 trillion a day.
- Information technology, which is the most important component of overall technology platform in any institution, is becoming a key business process driver and is very important in implementation of any business strategy. North American banks (US and Canada) spent \$ 44.3 billion in information technology in 2005 (Celent study). The estimated spending in US alone is expected to be around \$ 41 billion in 2007. According to a 2003 survey conducted by the Bank Systems and Technology, banks expect to invest almost a quarter of their total IT spending in new technologies alone.

## Key Topics: Examples of Areas affected by Technologies

- Bank enterprise resource planning
- Financial data warehousing and data quality management
- Electronic funds transfer
- Treasury management
- Electronic data interchange
- Accurate voice authentication
- Secured internet messaging between banks
- Electronic lockbox
- Business continuity and disaster management initiatives
- Electronic billing
- Counter phishing initiatives

## Key Topics: Technology Effect on Retail Services

- Electronic payments is fast replacing physical checks as means of payment.
- Securities trading is increasingly moving toward electronic platforms.
- Retail payment product innovations like paper check conversion, contact-less radio frequency ID (RFID) devices, wireless point of sale (POS) terminals, mobile phone payments, magnetic stripe stored value cards, e-purse smart cards, biometrics-based e-wallets, Euro-pay/MasterCard/Visa (EMV) credit smart card, person-to-person (P2P) Internet payments, account-to-account (A2A) funds transfers and kiosk-based payments are becoming more and more popular.
- Electronic methods of payment – automated clearinghouses (ACH), credit cards, debit cards, and wire transfer systems – accounted for only 46.5 percent of total payment transactions in volume and as much as 95.1 percent of all dollar transactions measured in value in 2002.

## Key Topics: Technology Effect on Wholesale Services

- Essential back office and middle office functions like data management, trade reconciliation and account servicing are increasingly being outsourced to countries like India and China. Hence, financial institutions have increased their spending on technology platforms that enable the process/ function outsourcing.
- Technology is playing an important role in a bank's production of traditional wholesale services like account reconciliation, electronic initiation of letters of credit, electronic data interchange, electronic billing, etc.
- Technological improvements in customer management systems are driving a reduction in the time and money spent on overall risk management processes through automated credit underwriting, electronic file retrieval, inter-department electronic data-sharing, electronic documentation, etc.

## Temp. Services Regs.: High Value Services

- The proposed regulations implied that high value services (R&D, engineering, etc.) should generally be evaluated under a residual profit split methodology that would compensate the service provider for any intangible assets or special capabilities utilized in providing the service.
- Where the service provided enhances the value of the recipient's intangible property, this approach would effectively give the service provider a share of the intangible property return.
- The new temporary regulations specifically disclaim an intention to make the profit split method the preferred method for these transactions. They instead treat embedded intangibles and special capabilities as factors to be considered in a comparability analysis.

## Key Topics: Loans and Guarantees, Treasury Operations

### Intercompany Loans and Guarantees

- Stand alone credit rating of each affiliate.
- Implicit guarantees
- Comparable transactions

### Treasury Operations

- Cash pooling or Credit Facility
- Interest Rates
- Spread between placements and loans
- Additional Treasury Functions (e.g., hedging, servicing)
- Frequency of Settlements

## Temp. Services. Regs.: Financial Guarantees

- Temporary Regulations are clear that financial guarantees do not qualify for the SCM
- Preamble language infers that financial transactions, including guarantees, do not necessarily fall under the Temporary Regulations
- However, definition of “Controlled Services Transaction” appears to include financial guarantees
- IRS intends to issue further guidance on the subject

## Key Topics: Insurance and Reinsurance

- OECD Discussion Draft – OECD to rewrite
- Appetite of tax authorities to investigate insurance groups
- Important Facts (e.g., size of related party transactions, location)
- Quota share, Non Proportional Reinsurance: Comparables vs. Actuarial approach

## Question #5 for audience

Over the next 12 months, the amount of time and resources (either internally or through outside consultants) you plan to dedicate in carrying out the transfer pricing function will:

1. Significantly increase
2. Slightly increase
3. Remain about the same
4. Slightly decrease
5. Significantly decrease

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